

## LIST OF ABBREVIATIONS

ABLU	Annual Banking Law Update
ALI	American Law Institute
Alta LR	Alberta Law Reports
All ER	All England Law Reports
All ER (D)	All England Direct Law Reports (Digests)
All SA	All South African Law Reports
Bankr	Bankruptcy Court Decisions
BBA	British Bankers' Association
BCLC	Butterworths Company Law Cases
BLR	Building Law Reports
BURR	Burrow's King's Bench Reports Tempore (Mansfield)
CA	Court of Appeal
CFR	Code of Federal Regulations (United States of America)
Ch D	Chancery Division
CLD	Juta's Commercial Law Digest
CLR	Commercial Law Reports (Juta)
CLSB	Committee of London and Scottish Bankers
Com LR	Commercial Law Reports
DLR	Dominion Law Reports
eUCP	Supplement to the Uniform Customs and Practice for Documentary Credits for Electronic Presentation (without referring to a specific version of it)
eUCP (Version 1.0)	Supplement to the Uniform Customs and Practice for Documentary Credits (UCP 500) for Electronic Presentation, Version 1.0 (2002)
eUCP (Version 1.1)	Supplement to the Uniform Customs and Practice for Documentary Credits (UCP 600) for Electronic Presentation, Version 1.1 (2006)
EWCA Civ	England and Wales Court of Appeal (Civil Division) Decisions
EWHC (Comm)	England and Wales High Court (Commercial Court Decisions)
F	Federal Reporter
FIDIC	International Federation of Consulting Engineers
F Supp	Federal Supplement
F 2d	Federal Reporter, Second Series (part of the West's National Reporter Series)
GAAP	General Accepted Accounting Practices

Harv L Rev	Harvard Law Review
HL	House of Lords
ICC	International Chamber of Commerce
IFSA	International Financial Services Association, formerly the United States Council on International Banking Inc ('USCIB')
ISBP	International Standard Banking Practice for the Examination of Documents Under Documentary Credits (published in 2003)
ISBP (2007 Revision)	International Standard Banking Practice for the Examination of Documents Under Documentary Credits (2007 Revision for UCP 600)
ISP98	International Standby Practices
JIBL	Journal of International Banking Law
JIBLR	Journal of International Banking Law and Regulation
KB	King's Bench Division
La App	Louisiana Court of Appeals
Lloyd's L Rep	Lloyd's List Law Reports
Lloyd's Rep	Lloyd's Law Reports
Lloyd's Rep Bank	Lloyd's Law Reports Banking
Minn L Rev	Minnesota Law Review
MLJ	Malayan Law Journal
NCCUSL	National Conference of Commissioners of Uniform State Law (United States of America)
NE	North Eastern Reporter
NCCUSL	National Conference of Commissioners on Uniform State Laws (United States of America)
NW	North Western Reporter
Nw J Int'l L and Bus	Northwestern Journal of International Law and Business
NYS	New York Supplement
NYS 2d	New York Supplement, Second Series
OHADA	French acronym for the Organization for the Harmonization of Business Law in Africa
Prior UCC article 5	Article 5 of the United States Uniform Commercial Code of 1962
QB	Queen's Bench
QB (Com Ct)	Queen's Bench (Commercial Court)
Revised UCC article 5	Article 5 of the United States Uniform Commercial Code of 1995
SA	South African Law Reports
SE	South Eastern Reporter

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SITPRO	Formerly the Simpler Trade Procedure Board; a non-departmental public body for which the United Kingdom Department of Trade and Industry has responsibility
SLR	Singapore Law Reports
So	Southern Reporter
So 2d	Southern Reporter, Second Series
UCC	Uniform Commercial Code of the United States
UCP	Uniform Customs and Practice for Documentary Credits (without referring to any specific version of it)
UCP 400	1983 Version of the Uniform Customs and Practice for Documentary Credits
UCP 500	1993 Version of the Uniform Customs and Practice for Documentary Credits
UCP 600	2007 Version of the Uniform Customs and Practice for Documentary Credits
UNCITRAL	United Nations Commission on International Trade Law
UNCITRAL Convention	United Nations Convention on Independent Guarantees and Stand-by Letters of Credit
URCB	1993 Uniform Rules for Contract Bonds, ICC Publication No 524 (1993)
URCG	1978 Uniform Rules for Contract Guarantees, ICC Publication No 325 (1978)
URDG	1992 Uniform Rules for Demand Guarantees, ICC Publication No 458 (1992)
WLR	Weekly Law Reports



## TABLE OF CONTENTS

PREFACE .....	V
SUMMARY .....	VII
KEY TERMS .....	IX
LIST OF ABBREVIATIONS .....	XI
TABLE OF CONTENTS .....	XV
CHAPTER 1:	
GENERAL INTRODUCTION AND THEME OF THESIS .....	1
1.1    GENERAL INTRODUCTION .....	1
1.1.1    Brief Historical Development, Role and Purpose of Demand Guarantees .....	1
1.1.2    Performance Security Required by the South African Government when Awarding Tenders or Contracts .....	3
1.1.3    Risk of Unfair or Fraudulent Calls of Demand Guarantees .....	4
1.2    TERMINOLOGY USED IN THE THESIS .....	5
1.3    THEME OF THE THESIS .....	7
1.3.1    Issues Dealt With in the Thesis .....	7
1.3.2    Scope of the Thesis.....	10
1.3.3    Structure of the Thesis.....	12
1.3.4    Research Methodology .....	13
1.3.5    Countries Covered in the Thesis .....	14
1.3.6    Period of the Law Covered.....	15
CHAPTER 2:	
AN INTRODUCTION TO DEMAND GUARANTEES AND STANDBY LETTERS OF CREDIT.....	17
2.1    DEFINITION OF A DEMAND GUARANTEE.....	17
2.2    THE PURPOSE AND CLASSIC USES OF THE DEMAND GUARANTEE ...	20
2.3    DEMAND GUARANTEE STRUCTURES: THEIR OPERATION, THE PARTIES INVOLVED AND THE RELATIONSHIPS CREATED.....	20
2.3.1    Parties to a Demand Guarantee and the Terminology.....	20
2.3.1.1    Principal .....	21
2.3.1.2    Guarantor .....	21
2.3.1.3    Beneficiary.....	21
2.3.1.4    Instructing Party.....	21
2.3.2    Demand Guarantee Structures.....	22
2.3.2.1    Direct (Three-Party) Demand Guarantees .....	22
2.3.2.2    Indirect (Four-Party) Demand Guarantees .....	24
2.3.3    Relationships Created by a Demand Guarantee .....	26
2.4    TYPES OF DEMAND GUARANTEE .....	27
2.4.1    Introduction .....	27
2.4.2    Main Types of Demand Guarantee .....	27
2.4.2.1    Tender Guarantee (Tender Bond or Bid Bond) .....	27

2.4.2.2	Performance Guarantee (Performance Bond or Completion Bond)	28
2.4.2.3	The Advance Payment Guarantee (Repayment Guarantee or Interim Payment Guarantee)	28
2.4.2.4	Retention Guarantee	29
2.4.2.5	Maintenance Guarantee (Warranty Guarantee)	29
2.4.3	Other Types of Demand Guarantees not Generated by the Underlying Contract	29
2.5	THE LEGAL NATURE, CHARACTERISTICS AND FUNDAMENTAL PRINCIPLES OF DEMAND GUARANTEES	30
2.5.1	Traditional Guarantees (Suretyship Guarantees), Commercial Letters of Credit and Demand Guarantees	30
2.5.1.1	Traditional Guarantees (Suretyship Guarantees), Surety Bonds and Contract Bonds	31
2.5.1.2	Commercial Letters of Credit	38
2.5.1.3	Demand Guarantees	39
2.5.2	Fundamental Principles of Demand Guarantees	41
2.5.2.1	Abstract Character of the Payment Undertaking	41
2.5.2.2	Independence of the Guarantee from the Underlying Contract: The Principle of Autonomy or Independence	43
2.5.2.3	Independence of the Guarantee from the Principal–Guarantor Relationship	48
2.5.2.4	Documentary Character of the Guarantee	49
2.5.2.4.1	Non-documentary Conditions	50
2.5.2.5	The Requirement of Compliance of the Demand with the Terms of the Guarantee: The Principle of Strict Compliance	55
2.5.2.5.1	Principle Regarding Commercial Letters of Credit	55
2.5.2.5.2	Position in Terms of UCP 500 and UCP 600	59
2.5.2.5.2.1	UCP 500 and ISBP	60
2.5.2.5.2.2	UCP 600 and ISBP (2007 Revision)	63
2.5.2.5.3	Position in Terms of ISP98	65
2.5.2.5.4	Principle Regarding Demand Guarantees	67
2.5.2.5.5	Position in Terms of the UNCITRAL Convention	69
2.5.2.5.6	Conclusion	70
2.5.2.6	Guarantor’s Duty of Examination Limited to Apparent Good Order of the Documents	71
2.5.2.7	Guarantor’s Duty is Limited to the Exercise of Good Faith and Reasonable Care	71
2.5.2.8	Independence of the Counter-Guarantee from the Guarantee	72
2.5.2.9	Independence of the Counter-Guarantee from the Mandate Received from the Instructing Party	72
2.6	KEY ELEMENTS IN A DEMAND GUARANTEE	72
2.7	AMENDMENT TO A DEMAND GUARANTEE	73
2.8	DEMAND GUARANTEES AND COMMERCIAL LETTERS OF CREDIT COMPARED	73
2.8.1	Similarities	73
2.8.2	Critical Differences	74
2.9	STANDBY LETTERS OF CREDIT	76
2.9.1	Introduction	76
2.9.2	The Standby Letter of Credit: An Independent Undertaking	78
2.9.3	Types of Standby Letters of Credit	78
2.9.3.1	Performance Standby Letter of Credit	79
2.9.3.2	Advance Payment Standby Letter of Credit	79

2.9.3.3	Bid Bond or Tender Bond Standby Letter of Credit.....	79
2.9.3.4	Counter Standby Letter of Credit .....	79
2.9.3.5	Financial Standby Letter of Credit .....	80
2.9.3.6	Insurance Standby Letter of Credit.....	80
2.9.3.7	Commercial Standby Letter of Credit.....	80
2.9.3.8	Direct Pay Standby Letter of Credit .....	81
2.9.4	Standby Letters of Credit and Commercial Letters of Credit Compared.....	81
2.9.5	Standby Letters of Credit and Demand Guarantees Compared .....	82
2.10	CALLING OF A DEMAND GUARANTEE.....	84
2.10.1	Introduction .....	84
2.10.2	Grounds for Refusal to Pay: Exceptions to the Autonomy Principle.....	84
2.10.3	Unilaterally Imposed Alterations of the Guarantee Period: ‘Pay or Extend’ Demands .....	86
2.10.4	The Problem of Unfair Calling.....	87
2.11	DEMAND FOR PAYMENT IS DEFECTIVE OR LATE.....	87
2.11.1	Introduction .....	87
2.11.2	South African Law .....	89
2.11.3	Conclusion.....	91
2.12	INSURANCE AS AN ALTERNATIVE TO DEMAND GUARANTEES .....	91
 CHAPTER 3:		
SOURCES OF THE LAW RELATING TO DEMAND GUARANTEES AND STANDBY LETTERS OF CREDIT .....		
		93
3.1	INTRODUCTION .....	93
3.2	RULES OF THE INTERNATIONAL CHAMBER OF COMMERCE.....	94
3.2.1	Introduction .....	94
3.2.2	Uniform Customs and Practice for Documentary Credits.....	96
3.2.2.1	Introduction.....	96
3.2.2.2	Application of the UCP to Standby Letters of Credit and Demand Guarantees .....	102
3.2.3	Supplement to the Uniform Customs and Practice for Documentary Credits for Electronic Presentation .....	105
3.2.4	Uniform Rules for Contract Guarantees.....	107
3.2.4.1	Introduction.....	107
3.2.4.2	Aim and Application.....	107
3.2.5	Uniform Rules for Demand Guarantees .....	110
3.2.5.1	Introduction.....	110
3.2.5.2	Aim and Application.....	111
3.2.5.3	Planned Revision .....	114
3.2.6	International Standby Practices .....	114
3.2.6.1	Introduction.....	114
3.2.6.2	Scope and Application .....	117
3.2.6.2.1	Exclusions from the Scope of the ISP98 .....	119
3.2.7	Uniform Rules for Contract Bonds .....	119
3.2.8	International Standard Banking Practice for the Examination of Documents Under Documentary Credits.....	120
3.2.8.1	The Original International Standard Banking Practice for the Examination of Documents Under Documentary Credits .....	120
3.2.8.2	The Revised International Standard Banking Practice for the Examination of Documents Under Documentary Credits .....	122

3.3	THE UNCITRAL CONVENTION ON INDEPENDENT GUARANTEES AND STAND-BY LETTERS OF CREDIT .....	124
3.3.1	Introduction.....	124
3.3.2	Application and Force of the UNCITRAL Convention.....	125
3.4	NATIONAL LAWS AND PUBLIC POLICY.....	127
3.4.1	The Impact of Mandatory National Laws and Public Policy Requirements .....	127
3.4.2	Special Legislation Governing Standby Letters of Credit and Demand Guarantees.....	128
3.4.2.1	United States Comptroller of the Currency Interpretive Ruling .....	129
3.4.2.2	Article 5 of the American Uniform Commercial Code.....	129
3.5	CASE LAW AND LEGAL WRITINGS .....	132
3.6	SUMMARY AND CONCLUSION.....	132

## CHAPTER 4:

## INTERNATIONAL INITIATIVES TO PREVENT UNFAIR OR FRAUDULENT CALLS ON DEMAND GUARANTEES AND STANDBY LETTERS OF CREDIT .....

4.1	INTRODUCTION.....	135
4.2	EFFORTS MADE BY THE ICC TO TRY AND PREVENT UNFAIR AND FRAUDULENT CALLS.....	136
4.2.1	Uniform Customs and Practice for Documentary Credits .....	136
4.2.2	Uniform Rules for Contract Guarantees .....	138
4.2.3	Uniform Rules for Demand Guarantees.....	142
4.3	EFFORT MADE BY THE INSTITUTE OF INTERNATIONAL BANKING LAW AND PRACTICE AND INTERNATIONAL FINANCIAL SERVICES ASSOCIATION TO TRY AND PREVENT UNFAIR AND FRAUDULENT CALLS.....	146
4.3.1	International Standby Practices.....	146
4.4	EFFORT BY THE UNCITRAL TO TRY AND PREVENT UNFAIR AND FRAUDULENT CALLS.....	149
4.4.1	The UNCITRAL Convention.....	149
4.4.2	Fraud and the UNCITRAL Convention.....	150
4.5	SUMMARY AND CONCLUSION.....	158

## CHAPTER 5:

## THE FRAUD EXCEPTION TO THE AUTONOMY PRINCIPLE .....

5.1	INTRODUCTION.....	161
5.2	MEANING OF AND RATIONALE FOR THE FRAUD EXCEPTION .....	169
5.2.1	Closing a Loophole in the Law Relating to Letters of Credit and Demand Guarantees.....	170
5.2.2	Public Policy for the Control of Fraud.....	170
5.2.3	Maintaining the Utility of Letters of Credit and Demand Guarantees.....	171
5.3	BRIEF HISTORICAL DEVELOPMENT OF THE FRAUD EXCEPTION.....	172
5.3.1	The Earliest Cases .....	173
5.3.2	Fraud Cases in the 1920s .....	175
5.3.3	The First Landmark Case: The <i>Sztejn</i> Case .....	179
5.3.3.1	Facts and Judgment .....	179
5.3.3.2	The Significance and Limits of <i>Sztejn</i> .....	182
5.3.4	Later Fraud Cases.....	183
5.4	ENGLISH LAW .....	183



5.4.1	A General Overview .....	183
5.4.2	The Concept of Fraud: Fraud in the Narrow and Wide Sense .....	196
5.4.3	Standard of Proof of fraud .....	199
5.4.4	The Time at Which Knowledge of Fraud Must be Proved .....	201
5.4.5	Fraud as Basis for Injunctive Relief .....	204
5.4.6	Summary and Conclusion .....	208
5.5	AMERICAN LAW .....	211
5.5.1	Introduction .....	211
5.5.2	Position Under the Uniform Commercial Code .....	211
5.5.2.1	Position Under Prior UCC Article 5 Section 5-114(2) .....	212
5.5.2.2	Position Under the Revised UCC Article 5 Section 5-109 .....	222
5.5.3	The Concept of Fraud: Fraud in the Narrow and Wide Sense .....	228
5.5.4	Standard of Proof of Fraud .....	229
5.5.4.1	Pre-UCC Position .....	229
5.5.4.2	Position Under Prior UCC Article 5 Section 5-114(2) .....	230
5.5.4.3	Iranian Cases .....	231
5.5.4.4	Position Under Revised UCC Article 5 Section 5-109 .....	234
5.5.5	The Bank's Knowledge of Fraud .....	239
5.5.6	Fraud as Basis for Injunctive Relief .....	240
5.5.7	Summary and Conclusion .....	242
5.6	SOUTH AFRICAN LAW .....	244
5.6.1	A General Overview .....	244
5.6.2	Concept of Fraud: Fraud in the Narrow and Wide Sense .....	250
5.6.3	Standard of Fraud .....	252
5.6.4	The Time at Which Knowledge of Fraud Must be Proved .....	253
5.6.5	Fraud and Interdicts .....	253
5.6.6	Summary and Conclusion .....	255
 CHAPTER 6:		
ILLEGALITY AS AN EXCEPTION TO THE AUTONOMY PRINCIPLE .....		257
6.1	INTRODUCTION .....	257
6.2	ENGLISH LAW .....	258
6.2.1	Demand Guarantee Itself is Illegal .....	258
6.2.2	Illegality in the Underlying Contract .....	259
6.2.2.1	Established Illegality, Seriousness of the Illegality and the Time at Which Knowledge of Illegality Must be Proved .....	269
6.2.2.2	Degree of Connectivity .....	272
6.2.3	Illegality in the Underlying Contract and Demand Guarantees .....	272
6.3	AMERICAN LAW .....	272
6.3.1	Introduction .....	272
6.3.2	Illegality in the Underlying Contract .....	273
6.3.2.1	Revised UCC Article 5 .....	273
6.3.2.2	America's View of the <i>Mahonia</i> cases .....	276
6.4	SOUTH AFRICAN LAW .....	277
6.4.1	Demand Guarantee Itself is Illegal .....	277
6.4.2	Illegality in the Underlying Contract .....	278
6.5	ILLEGALITY AND THE UNCITRAL CONVENTION .....	281
6.6	CONCLUSION .....	282

CHAPTER 7:	
INTERIM COURT RELIEF .....	287
7.1 GENERAL INTRODUCTION .....	287
7.2 ENGLISH LAW .....	288
7.2.1 Introduction .....	288
7.2.2 Injunctions Against the Bank: Injunctions to Prevent Payment .....	291
7.2.3 Injunctions Against the Beneficiary: Injunctions to Prevent Demand or Receipt of Payment .....	293
7.2.4 Interim Injunctions and the Balance of Convenience .....	295
7.2.5 Freezing Injunctions ( <i>Mareva</i> Injunctions).....	298
7.2.5.1 Introduction .....	298
7.2.5.2 General Principles of Freezing Injunctions .....	299
7.2.5.3 Freezing Injunctions Granted Against a Bank’s Customer in the Context of a Civil Claim Against that Customer .....	301
7.2.5.4 Protection for the Bank in the Context of Freezing Injunctions Issued Against its Customers.....	304
7.2.5.5 Freezing Injunctions: The Bank as the Defendant .....	304
7.2.5.6 Application of the Freezing Injunction to Demand Guarantees and Letters of Credit.....	305
7.2.6 Conclusion .....	306
7.3 AMERICAN LAW.....	306
7.3.1 Conclusion .....	312
7.4 SOUTH AFRICAN LAW .....	313
7.4.1 Introduction.....	313
7.4.2 Interim Interdicts.....	314
7.4.3 Interdicts Against the Bank Preventing Payment .....	317
7.4.4 Interdicts Against Beneficiaries .....	319
7.4.5 Anti-Dissipation Interdicts.....	321
7.4.6 Conclusion .....	323
7.5 UNCITRAL CONVENTION.....	324
CHAPTER 8:	
SUMMARIES, CONCLUSIONS AND RECOMMENDATIONS .....	327
8.1 BRIEF OVERVIEW .....	327
8.2 DEFENCES THAT ARE NOT CONCERNED WITH THE AUTONOMY PRINCIPLE.....	331
8.2.1 Non-Compliance of Documents/Demands and Late Presentations .....	331
8.2.2 Demand Guarantee Itself is Illegal (and the Underlying Contract Legal) ...	333
8.3 EXCEPTIONS TO THE AUTONOMY PRINCIPLE.....	333
8.3.1 Fraud as an Exception to the Autonomy Principle .....	334
8.3.2 Illegality as an Exception to the Autonomy Principle .....	341
8.3.2.1 Illegality and the UNCITRAL Convention.....	345
8.3.3 Limit the Exceptions to the Autonomy Principle.....	346
8.4 INTERIM INJUNCTIONS AND INTERDICTS .....	349
8.5 INTERNATIONAL RULES AND INITIATIVES TO PREVENT FRAUDULENT OR UNFAIR CALLS .....	357
8.6 USE OF INTERNATIONAL RULES LOCALLY.....	361
8.6.1 Use of the UCP .....	362
8.6.2 Use of the URDG and/or the UNCITRAL Convention.....	362
8.6.3 Use of the ISP98 .....	362

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8.7	CODIFICATION OF THE LAW VERSUS THE ADOPTION OF THE UNCITRAL CONVENTION .....	363
8.7.1	Advantages of Codifying the South African Law .....	363
8.7.2	Disadvantages of Codifying the South African Law.....	364
8.7.3	Adopting the UNCITRAL Convention .....	365
8.8	RECOMMENDATIONS.....	368
8.8.1	Recommendations Regarding the Fraud Exception .....	368
8.8.2	Recommendations Regarding the Illegality Exception.....	370
8.8.3	Illegality and the UNCITRAL Convention .....	371
8.8.4	Limit the Exceptions to the Autonomy Principle .....	371
8.8.5	Interim Injunctions and Interdicts .....	372
8.8.6	Recommendations Addressed Specifically to Banks .....	373
8.8.7	Recommendations Addressed to the Relevant South African Authorities..	374
	BIBLIOGRAPHY .....	377
	LEGISLATION AND OTHER SOURCES OF LAW.....	397
	TABLE OF CASES.....	401
	INDEX.....	417



# CHAPTER 1: GENERAL INTRODUCTION AND THEME OF THESIS

## 1.1 GENERAL INTRODUCTION

### 1.1.1 Brief Historical Development, Role and Purpose of Demand Guarantees

A person (e.g., buyer or employer for construction work) planning to enter into a contract for the purchase of goods or the construction of works by the intended counterparty to the contract (e.g., seller, exporter, supplier or contractor) may wish to have security for the counterparty's performance of his obligations, especially when no previous dealings have taken place between them. In the past it was common practice in international and local transactions to require the furnishing of a cash deposit<sup>1</sup> to serve as form of security that the counterparty would indeed perform the undertaken obligation. Later, when the international trade expanded this practice of furnishing cash deposits, it became prohibitively expensive for the counterparty to do so. It was difficult for sellers, exporters, suppliers and contractors to survive the strain on their cash flow if they had to rely on their own resources to furnish the cash deposits, and therefore the assistance of financial institutions became essential in this regard. In due course this practice was replaced with a safer and more convenient practice, namely the provision of a written undertaking by a bank in favour of the buyer or employer, payable on demand.<sup>2</sup>

Today such payment undertakings are known by various names, such as 'independent undertakings', 'performance bonds/guarantees', 'tender bonds/guarantees', 'independent (bank) guarantees', 'demand guarantees', 'first demand guarantees', 'bank guarantees', and 'default undertakings'.<sup>3</sup> In addition to these common names, these payment undertakings are also commonly known as 'standby letters of credit'.<sup>4</sup> However, although the standby letter of credit is in essence the same type of instrument as the demand guarantee, the standby letter of credit has a very different historical development than the demand guarantee. Standby letters of credit were developed by banks in the United States as an extension of the idea of the traditional (commercial) letter of credit that has been used in international sales contracts.<sup>5</sup> Banks in the United States developed the use of standby

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<sup>1</sup> Post-dated bills of exchange were also sometimes used, but due to the risk of non-payment, this practice was not popular and cash deposits that guaranteed payment were preferred. See R Bertrams *Bank Guarantees in International Trade: The Law and Practice of Independent (First Demand) Guarantees and Standby Letters of Credit in Civil Law and Common Law Jurisdictions* 3 ed (2004) at 2.

<sup>2</sup> See R Goode *Guide to the ICC Uniform Rules for Demand Guarantees* 1992 ICC Publication No 510 (hereinafter the '*Guide to the URDG*') at 8. The use of these undertakings seemed to have begun in international trade transactions as a means of ensuring the performance of a party to the contract (see, M Brindle and R Cox (eds) *Law of Bank Payments* 3 ed (2004) in para 8-026 at 673). For a brief discussion of their history and origin, see R Perrignon 'Performance Bonds and Standby Letters of Credit: The Australian Experience' (1991) *Journal of Banking and Finance Law and Practice* 157; and P O'Brien 'Letters of Intent and Demand Guarantees' *ABLU* 1993 (a paper delivered at the 1993 Annual Banking Law Update held at the Indaba Hotel, Johannesburg) 134 at 157-158.

<sup>3</sup> See M Coleman 'Performance Guarantees' (1990) *Lloyd's Maritime and Commercial Law Quarterly* 223 at 223. The term 'demand guarantee' is the preferred term used in this thesis to refer to this type of payment undertaking. See also para 1.2 below for a full discussion of the terminology used in this thesis.

<sup>4</sup> For a full discussion of standby letters of credit see para 2.9 in Chapter 2.

<sup>5</sup> See Bertrams *op cit* note 1 at 2.

letters of credit as a result of the accepted construction of the United States' National Bank Act of 3 June 1864 (as amended) which precluded the United States banks from giving guarantees as part of their banking business. As the banks were not in general permitted to issue guarantees, they adopted the term 'standby letter of credit' to avoid the language of guarantees.<sup>6</sup> Other countries whose banks were similarly precluded from giving guarantees, for example, Japan, also followed suit and started to employ the use of standby letters of credit in international financing transactions.<sup>7</sup> Although standby letters of credit were initially developed in the United States, they are now used worldwide. As standby letters of credit are essentially the same as demand guarantees (as will be seen in Chapter 2),<sup>8</sup> they will be discussed in conjunction with demand guarantees.

It has now become common practice for many buyers, in particular overseas buyers in the public and major private sectors in strong bargaining positions, to demand that sellers, exporters or suppliers provide demand guarantees as security to ensure that the terms of their tender or contract (depending on the circumstances) are adhered to. Demand guarantees and standby letters of credit issued by banks are still reasonably new bank products. Their use, particularly internationally, has grown dramatically since the 1960s.<sup>9</sup> This type of security has become an established part of international trade, particularly in construction/engineering projects and international sale of goods contracts. They are the legal instruments used to guarantee to a person – for example, a buyer or employer, (commonly referred to as the 'beneficiary' of the guarantee) – that the seller, exporter, supplier or contractor (commonly referred to as the 'principal' of the guarantee) will either not prematurely withdraw from his tender (in the case of a tender guarantee); or will perform his obligations arising under the underlying contract (in the case of a performance guarantee), and is, purportedly, technically and financially capable of performing the underlying contract in line with its provisions.<sup>10</sup>

The beneficiaries (e.g., buyer or employer) of demand guarantees can call (i.e., demand payment) on the guarantee in various instances; for example, if a tenderer fails to enter into a valid contract, or if there is actual or, in some cases likely failure of the principal (e.g., seller, exporter, supplier or contractor) to perform properly in terms of the contract (i.e., underlying contract). As such, these demand guarantees are intended to prevent or penalise bad faith, poor performance and non-performance for whatever reason. They also provide the beneficiary with a ready source of funds that can be used to help meet the costs of remedying the principal's failure to perform in terms of the underlying contract.<sup>11</sup>

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<sup>6</sup> See Bertrams *op cit* note 1 at 5–6. The power of the United States Banks to issue letters of credit and other independent undertakings (i.e., demand guarantees) payable against documents without factual investigation into the underlying relationship was finally recognised in the 1996 Interpretive Ruling of the Comptroller of the Currency (see the United States Comptroller of the Currency Interpretive Ruling of 9 February 1996 at 12 C.F.R section 7.1016 (as revised on 1 January 2000 and 1 July 2008)). See also para 2.9.1 in Chapter 2 and para 3.4.2.1 (particularly note 222) in Chapter 3.

<sup>7</sup> See J Lipton 'Uniform Regulation of Standby Letters of Credit and Other First Demand Security Instruments in International Transactions' (1993) 10 *Journal of International Banking Law* 402 at 403.

<sup>8</sup> See in particular paras 2.9.1–2.9.5 in Chapter 2. See also A N Oelofse *The Law of Documentary Letters of Credit in Comparative Perspective* (1997) (hereinafter '*Oelofse: The Law of Documentary Letters of Credit*') at 62.

<sup>9</sup> See F De Ly 'The UN Convention on Independent Guarantees and Stand-by Letters of Credit' (Fall 1999) 33 *International Lawyer* 831 at 832–833.

<sup>10</sup> See A Pierce *Demand Guarantees in International Trade* (1993) at 1.

<sup>11</sup> See Pierce *op cit* note 10 at 1.

Demand guarantees, being a substitute for cash, are created to provide the beneficiary with a speedy monetary remedy against the principal (counterparty) to the underlying contract, and to that end they are primary in form and documentary in character. This means that the demand guarantee is an abstract payment undertaking, which is expressed to be payable solely on presentation of a written demand and/or any other specified documents conforming to the terms of the undertaking, and is independent of the underlying contract. In view of this, any demand within the maximum amount stipulated in the demand guarantee must, in principle, be paid by the guarantor (often a bank), irrespective of whether the underlying contract has, in fact, been breached and irrespective of the loss actually suffered by the beneficiary. This is in contrast to the suretyship guarantee that is an undertaking to be answerable for another's debt or default, and is triggered only by proof of actual default and is not independent of the underlying contract, and which is limited to the amount of loss suffered from the default within the maximum amount stipulated in the guarantee.<sup>12</sup>

Generally, beneficiaries in foreign countries insist on independent payment undertakings that are payable on demand. In such an instance, a beneficiary may call on the demand guarantee at any time should he feel that the principal has breached the underlying contract. International banks often furnish these types of demand guarantee. Before issuing such a guarantee, a bank would examine the risk involved in terms of the competence and integrity of the principal (i.e., bank's customer) and his ability to repay the bank should the beneficiary make a demand in terms of the demand guarantee. The principal will indemnify his bank who will, in turn, indemnify his correspondent bank in the beneficiary's country. The correspondent bank is usually the last link in the chain furnishing the beneficiary with the international demand guarantee payable on demand.

### **1.1.2 Performance Security Required by the South African Government when Awarding Tenders or Contracts**

There are certain general conditions that are applicable to all the South African government tenders, contracts and orders.<sup>13</sup> These general conditions are also usually supplemented by a special set of conditions (special conditions of contract) that will also be applicable to a specific tender or contract, depending on the circumstances. For example, when a supplier tenders for the supply of goods or services to the South African government, he must comply with the government's general conditions of contract. In particular, he has to comply with the performance security provision<sup>14</sup> that provides:

- (1) Within thirty (30) days of receipt of the notification of contract award, the successful bidder shall furnish to the purchaser the performance security of the amount specified in the SCC [Special Conditions of Contract].

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<sup>12</sup> See the *Guide to the URDG op cit* note 2 at 8; and cf D Dinnie 'A Pound of Flesh' (2007) 15 *Juta's Business Law* 127 at 127.

<sup>13</sup> See, e.g., the *Government Procurement: General Conditions of Contract* (2006) (hereinafter 'the *General Conditions of Contract*') (a copy obtained from the South African National Treasury).

<sup>14</sup> See condition 7 of the *General Conditions of Contract op cit* note 13.

- (2) The proceeds of the performance security shall be payable to the purchaser as compensation for any loss resulting from the supplier's failure to complete his obligations under the contract.
- (3) The performance security shall be denominated in the currency of the contract, or in a freely convertible currency acceptable to the purchaser and shall be in one of the following forms:
  - (a) a bank guarantee or an irrevocable letter of credit issued by a reputable bank located in the purchaser's country or abroad, acceptable to the purchaser, in the form provided in the bidding documents or another form acceptable to the purchaser; or
  - (b) a cashier's or certified cheque.
- (4) The performance security will be discharged by the purchaser and returned to the supplier not later than thirty (30) days following the date of completion of the supplier's performance obligations under the contract, including any warranty obligations, unless otherwise specified in SCC.

It is thus clear that the performance security that should be provided must be like 'cash in hand'. That is evident from the fact that if it is not a bank guarantee or an irrevocable letter of credit that is furnished, it should be a cashier's or certified cheque. Therefore, if a bank guarantee is provided, it should be like cash in hand and it should probably be 'payable on demand without proof of any conditions'.

### **1.1.3 Risk of Unfair or Fraudulent Calls of Demand Guarantees**

If the beneficiary calls on a demand guarantee, he will not have to establish proof of breach of the underlying contract by the principal and the bank will normally be obliged to pay in such circumstances. Therefore, the danger of unfair calling of demand guarantees is always present when these guarantees are used. A case of unfair calling arises if the beneficiary draws the demand guarantee and demands payment, although he knows or can easily ascertain that the risk covered by the guarantee has not materialised. Any seller, exporter, supplier or contractor who wants to conduct business outside his country must always carefully consider the risk of a possible unfair calling of a demand guarantee by the beneficiary, before furnishing the requested demand guarantee.<sup>15</sup>

Where an unfair or fraudulent call has been made on a demand guarantee and the guarantor (e.g., bank) has already made the required payment to the beneficiary, it is the principal providing the demand guarantee that will suffer the loss, for the guarantor will merely collect the money from the principal (e.g., the bank's customer). In an international transaction, there is very often no chance of the principal recovering his monetary loss from the beneficiary who lives in a foreign country under a foreign jurisdiction with a very different political and legal environment. The calling up of a demand guarantee, especially if it is an unfair or fraudulent calling, often has the following severe consequences for the principal:

- irreparable damage to his commercial reputation;
- cash liquidity problems; and

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<sup>15</sup> See J J C Smit 'Performance Bonds' (1979) *Moderne Besigheidsreg* 148 at 148–149.



- the risk that the cash will be misappropriated by the beneficiary and no longer recoverable.<sup>16</sup>

Therefore, as soon as a principal of a demand guarantee learns of the danger that an unfair or fraudulent calling of the guarantee might be made by the beneficiary, he must promptly take emergency measures to prevent it from being paid. Owing to the severe consequences mentioned above that an unfair or fraudulent calling might have, there have been several attempts by principals worldwide over the past couple of years to obtain injunctions (i.e., interdicts in South African law) to prevent *mala fide* beneficiaries from converting the demand guarantees into cash.<sup>17</sup> These principals have tried to involve courts with regard to the prevention of the unfair and fraudulent calling of demand guarantees. Not all court decisions have been completely consistent, and a general view has developed which mostly favours the beneficiary and generally fails to protect the contractually compliant principal who is required to provide such guarantees against unfair and fraudulent demands for payment.<sup>18</sup> However, in more recent years, several principals have been successful in obtaining interlocutory injunctions (i.e., interim interdicts) preventing unfair and fraudulent calls.<sup>19</sup>

## 1.2 TERMINOLOGY USED IN THE THESIS

The terminology surrounding these types of independent payment undertaking referred to above is rather confusing. Such independent payment undertakings are known by various names, such as ‘performance bonds/guarantees’, ‘tender bonds/guarantees’, ‘independent (bank) guarantees’, ‘independent undertakings’, ‘demand guarantees’, ‘bank guarantees’, ‘first demand guarantees’, ‘default undertakings’ and ‘standby letters of credit’. It is important to note that these terms have no unique legal content.<sup>20</sup> The fact that exporters, bankers and insurers rather than lawyers developed them has contributed to the confusion in this area of the law. Another reason for the confusion in terminology is the fact that different instruments are used internationally. Often the form of the instrument is determined by a potential contracting party in another country who insists upon the use of that form in order for the contract to be made. As a result, some of the terms used are often inaccurate from a legal point of view, but well understood by the businessperson.<sup>21</sup> From a legal viewpoint these various terms are all legally synonymous in their essential character.<sup>22</sup> The most important point to remember here is the fact that the nature and contents of the obligations created by such independent payment undertakings are not established by their label (title or heading), but by the substance and construction of the

<sup>16</sup> See B Zillmann ‘A Further Erosion Into the Autonomy of Bank Guarantees?’ (December 1997) 13 *Building and Construction Law* 354 at 355; and J C Phillips ‘Unconditional Performance Bonds – Or are They?’ (June 1991) 7 *Building and Construction Law* 81 at 82.

<sup>17</sup> For a full discussion, see Chapters 5–7.

<sup>18</sup> See Pierce *op cit* note 10 at 1. For a full discussion of fraudulent calls on demand guarantees, see Chapter 5 and for other unfair calls made on demand guarantees, see Chapter 6.

<sup>19</sup> See Zillmann *op cit* note 16 at 355; and N Horn *German Banking Law and Practice in International Perspective* (1999) in Chapter 11 ‘The UN Convention on Independent Guarantees and the *Lex Mercatoria*’ 189 at 201. See also Chapters 5–7.

<sup>20</sup> See Coleman *op cit* note 3 at 223; and O’Brien *op cit* note 2 at 135.

<sup>21</sup> See Pierce *op cit* note 10 at 4.

<sup>22</sup> See *Guide to the URDG op cit* note 2 at 8.

undertaking.<sup>23</sup> Therefore, as there is no real consistency in terminology used in relation to these types of independent undertaking, it will always be necessary to analyse the substance of the particular instrument in order to see into which legal category it falls.<sup>24</sup> Furthermore, the use of the word ‘bank’ in conjunction with these terms is merely indicative that the bank issued the undertaking and will act as the guarantor of it.

The terms mentioned above are generally used to describe a primary undertaking given by a guarantor (often a bank) to a third party (beneficiary) in respect of obligations of its customer (principal) to that third party (beneficiary). The guarantor of these types of undertaking promises or gives a primary or direct undertaking to perform the customer’s (principal’s) obligation, irrespective of whether or not the customer’s (principal’s) obligation is enforceable. For purposes of this thesis, the term ‘demand guarantee’ is used to describe these types of primary undertaking.<sup>25</sup> However, although the standby letter of credit and the demand guarantee are essentially the same (as seen below and in Chapter 2),<sup>26</sup> I will refer to the term ‘standby letter of credit’ where reference is specifically made to a standby letter of credit. This thesis is concerned only with those undertakings that are primary in form and that are not accessory to the underlying contract, such as suretyship guarantees or suretyship bonds. Although banks issue most demand guarantees, in recent years other types of financial institutions have also become involved in the issuing of guarantees. This thesis is, however, concerned only with demand guarantees issued by banks (i.e., bank demand guarantees). Therefore, when reference is made to demand guarantees, it refers to those that are issued by banks.

When dealing with these types of independent payment undertakings, the words ‘guarantee’ and ‘bond’ are often used interchangeably, for example, in relation to the expressions ‘performance bond’ and ‘performance guarantee’. The generic term ‘guarantee’ can comprise two very different devices: (1) the primary guarantee (i.e., demand guarantee) and (2) the secondary (accessory) guarantee (i.e., suretyship guarantee). In this thesis the word ‘guarantee’ will be used to refer to the first device, unless specifically indicated otherwise. In this thesis a distinction will not be made between the words ‘bonds’ and ‘guarantees’. For the sake of style, each is given equal meaning unless specifically indicated otherwise.

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<sup>23</sup> See also O’Brien *op cit* note 2 at 135. In *List v Jungers* 1979 (3) SA 106 (A) at 118C–E, the court mentioned:

It is, in my view, an unrewarding and misleading exercise to seize on one word in a document, determine its more usual or ordinary meaning, and then, having done so, to seek to interpret the document in the light of the meaning so ascribed to that word. Apart from the fact that to decide on the more usual or ordinary meaning of a word may be a delicate task . . . it is clear that the context in which the word is used is of prime importance.

In *Gold Coast Ltd v Caja de Ahorros del Mediterraneo and Others* [2002] 1 Lloyd’s Rep 617 (CA) ([2002] 1 All ER (Comm) 142 (CA)), the English Court of Appeal still found that an instrument was a demand guarantee and not a contract of suretyship, despite the fact that it contained a pertinent reference to the underlying contract (for a discussion of this case, see A N Oelofse ‘Developments in the Law of Letters of Credit’ *ABLU* 2002 (a paper delivered at the 2002 Annual Banking Law Update held at the Indaba Hotel, Johannesburg on 24 April 2002) (unpaginated) at 21 of his article).

<sup>24</sup> See D Warne and N Elliott *Banking Litigation* 2 ed (2005) at 273–274.

<sup>25</sup> This term is used, as it is the term that is used by the ICC in the URDG. For a full discussion of these rules, see para 3.2.5 in Chapter 3 and para 4.2.3 in Chapter 4.

<sup>26</sup> See paras 2.9.1–2.9.5 in Chapter 2.

The traditional commercial letter of credit will be referred to as ‘commercial letter of credit’ or ‘documentary credit’ interchangeably. Where reference is made specifically to a standby letter of credit, it will be so indicated. However, when the phrase ‘letter of credit’ is used, it sometimes refers to both a commercial and standby letter of credit, while at other times, it may only refer to one of them. The exact meaning will depend on the context in which it is used.

In this thesis words in the singular also mean in the plural and *vice versa*, and words in the masculine also mean in the feminine and neuter.

### 1.3 THEME OF THE THESIS

#### 1.3.1 Issues Dealt With in the Thesis

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

Demand guarantees and standby letters of credit imply the danger that they may be abused. In fact, in the past few decades many cases in various countries have been brought before the courts where a party to, for example, an export transaction has complained that the other party (beneficiary) has used the demand guarantee or standby letter of credit contrary to its purpose; in other words, tried to collect money under the guarantee or standby letter of credit in an unjustified or fraudulent way.<sup>27</sup> An abuse of a demand guarantee/standby letter of credit can be described as a case where the risk covered by that guarantee/standby letter of credit has not materialised and payment is demanded without justification. It is not the bank but the customer (principal of a demand guarantee or applicant of a standby letter of credit) who instructed his bank to issue the demand guarantee/standby letter of credit who, in the end, is hit by the damage caused by an unfair or fraudulent call on the guarantee/standby letter of credit, because the customer has to reimburse the sum paid by his bank as guarantor/issuer to the beneficiary on the basis of the contractual relationship between the bank and the customer.<sup>28</sup>

Most courts treat demand guarantees, standby letters of credit and commercial letters of credit as autonomous contracts with whose operation they will not be interfere on grounds immaterial to the guarantee/credit itself. However, over the years a limited number of exceptions to the autonomy principle have come to be acknowledged and accepted in practice. In certain circumstances the autonomy of demand guarantees and letters of credit may be ignored by the bank, and regard may be had to the terms and conditions of the underlying contract. The main exceptions concern fraud<sup>29</sup> and illegality.<sup>30</sup> Today it is a

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<sup>27</sup> See Chapter 5.

<sup>28</sup> See Horn *op cit* note 19 at 194.

<sup>29</sup> For a full discussion, see Chapter 5.

<sup>30</sup> For a full discussion, see Chapter 6. See also J P van Niekerk and W G Schulze *The South African Law of International Trade: Selected Topics* 2 ed (2006) at 311–312.

well-established exception to the principle of autonomy that the courts will intervene where they conclude that payment should be refused on the ground of fraud on the part of the beneficiary.<sup>31</sup> Fraud as an acknowledged exception, as well as illegality (illegality of the underlying contract) as a possible exception in the chosen jurisdictions, will be looked at in more detail.<sup>32</sup> However, over the past few years a number of other possible grounds have also been acknowledged in the different jurisdictions.<sup>33</sup> Further discussion of these possible exceptions falls beyond the scope of this thesis, and attention will only be given to the main exceptions, namely fraud and illegality.

The courts progressively take the view that it is for the guarantor of the demand guarantee/the issuer of the standby letter of credit to make up his own mind on whether he should refuse payment on the grounds of fraud or forgery. If the evidence of fraud is unconvincing, the guarantor/issuer will pay.<sup>34</sup> However, independent of the right of the guarantor/issuer to refuse payment, a performing party (principal/applicant) may apply for an injunction (interdict in South African law) to restrain enforcement of a demand guarantee or standby letter of credit by the beneficiary if he can prove fraud on the part of the beneficiary of which the guarantor/issuer has knowledge.<sup>35</sup> That is not simple to do, and it has accordingly been extremely difficult to prevent fraudulent, and in some cases even illegal, demands for payment being made by beneficiaries on guarantors/issuers.<sup>36</sup>

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<sup>31</sup> See A Pugh-Thomas 'Letters of Credit – Injunctions – The Purist and the Pragmatist: Can a Buyer Bypass the Guarantor and Stop the Seller from Demanding Payment from the Guarantor?' (1996) 5 *Journal of International Banking Law* 210 at 210. See also *Hamzeh Malas and Sons v British Imex Industries Ltd* [1958] 2 QB 127 (CA); *Howe Richardson Scale Co Ltd v Polimex-Cekop and National Westminster Bank Ltd* [1978] 1 Lloyd's Rep 161 (CA); *R D Harbottle (Mercantile) Ltd v National Westminster Bank Ltd* [1978] QB 146 (QB); and *United City Merchants (Investments) Ltd and Glass Fibres and Equipments Ltd v Royal Bank Of Canada, Vitrorefuerzos SA and Banco Continental SA (incorporated in Canada)* [1983] AC 168 (HL). For a full discussion of fraud as a basis upon which payment of a demand guarantee may be restrained, see Chapter 5.

<sup>32</sup> See Chapters 5–6.

<sup>33</sup> For a further discussion of these possible exceptions, see N Enonchong 'The Problem of Abusive Calls on Demand Guarantees' (2007) *Lloyd's Maritime and Commercial Law Quarterly* 83; J Bailey 'Unconditional Bank Guarantees' (2003) 20 *International Construction Law Review* 240; and Q Loh and T H Wu 'Injunctions Restraining Calls on Performance Bonds – Is Fraud the Only Ground in Singapore?' (2000) *Lloyd's Maritime and Commercial Law Quarterly* 348. In these articles the possibility of other exceptions to the autonomy principle, for example, unconscionable conduct, no underlying contract, breach of a negative stipulation in the underlying contract, or lack of good faith/absence of reasonableness as constituting valid grounds are discussed and they also contain limited references to court cases in Australia, Singapore and Malaysia where these grounds have been considered as possibilities. See also notes 162 and 357 in Chapter 2 and note 8 in Chapter 5.

<sup>34</sup> For a recent example of evidence being too flimsy, see *Banque Saudi Fransi v Lear Siegler Services Inc* [2006] 1 Lloyd's Rep 273 (for a full discussion, see C Hugo 'Documentary Credits and Independent Guarantees' *ABLU* 2006 (a paper delivered at the 2006 Annual Banking Law Update held at the Indaba Hotel, Johannesburg during April 2006) 160 at 168–170).

<sup>35</sup> See also C Hugo 'Discounting Practices and Documentary Credits' (2002) 119 *South African Law Journal* 101 at 105–106. For a discussion of the interlocutory relief that courts can give, see Chapter 7.

<sup>36</sup> See Pugh-Thomas *op cit* note 31 at 210. See also *Edward Owen Engineering Ltd v Barclays Bank International Ltd* [1978] QB 159 (CA); *Bolivinter Oil SA v Chase Manhattan Bank NA* [1984] 1 Lloyd's Rep 251 (CA); and *United Trading Corporation SA and Murray Clayton Ltd v Allied Arab Bank Ltd and Others* [1985] 2 Lloyd's Rep 554 (CA). For a full discussion of fraud, see Chapter 5 and for a discussion of illegality, see Chapter 6.

The unfair and fraudulent demand for payment made by beneficiaries on demand guarantees is an indisputable problem. In practice, it has proved difficult to persuade guarantors (banks) that the beneficiaries' demands are fraudulent or otherwise unfair, and guarantors have been reluctant in the exercise of their own discretion to refuse payment. Where principals have felt strongly that the demand is unjustified or fraudulent and have applied for an injunction (interdict) preventing the guarantor from paying, the courts have increasingly been reluctant to substitute their own discretion for that of the guarantor (i.e., the bank).<sup>37</sup> Principals have also tried applying for injunctions against the beneficiaries in such circumstances to prevent them (the beneficiaries) from making a demand at all.<sup>38</sup>

From the case law discussed in this thesis, it will become clear that the calling of a demand guarantee does not preclude the principal from going to court if compelling merits exist.<sup>39</sup> In this thesis a great deal of consideration has been given to fraud<sup>40</sup> and illegality<sup>41</sup> as possible grounds on which payment under demand guarantees and standby letters of credit have been attacked (and sometimes even prevented) in the English, American and South African case law. This study will show that the prospect of success depends on the law applicable to the demand guarantee/standby letter of credit and the approach a court in a specific jurisdiction takes. It will also become obvious that such success is, unfortunately, often somewhat limited.<sup>42</sup> At present, South Africa has limited literature on demand guarantees and standby letters of credit, and its case law regarding the grounds upon which payment under a guarantee or standby letter of credit might be prevented is scarce and often non-existent. In South Africa one finds guidance by looking at similar cases dealing with commercial letters of credit and applying those similar principles to demand guarantees. The South African courts also further find guidance by looking at how other jurisdictions, in particular the English courts, deal with these issues.<sup>43</sup> Therefore, how the South African courts currently deal/should be dealing/probably will be dealing with the unfair and fraudulent calling of demand guarantees or standby letters of credit is discussed in subsequent chapters.<sup>44</sup>

This thesis makes it clear that principals should be given greater protection against unfair and fraudulent calls. However, this should be done without preventing the beneficiaries from making legitimate use of demand guarantees as incentives towards performance. An attempt has been made to ascertain how far local and certain foreign courts, and international organisations have moved towards countering the misuse of demand

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<sup>37</sup> See Chapters 5 and 7.

<sup>38</sup> See Pugh-Thomas *op cit* note 31 at 213. See also *Themehelp Ltd v West* [1996] QB 84 (CA); and Chapters 5–7.

<sup>39</sup> See Chapters 5–7.

<sup>40</sup> See Chapter 5.

<sup>41</sup> See Chapter 6.

<sup>42</sup> See Chapters 5–7.

<sup>43</sup> See e.g., *Phillips and Another v Standard Bank of South Africa Ltd and Others* 1985 (3) SA 301 (W); *Ex parte Sapan Trading (Pty) Ltd* 1995 (1) SA 218 (W); *Loomcraft Fabrics CC v Nedbank Ltd and Another* 1996 (1) SA 812 (A); *Union Carriage and Wagon Company Ltd v Nedcor Bank Ltd* 1996 CLR 724 (W); and *Koumantarakis Group CC v Mystic River Investments 45 (Pty) Ltd and Another* [2007] JOL 19699 (D).

<sup>44</sup> See Chapters 5–8.

guarantees and standby letters of credit in international commerce, while maintaining the efficiency of irrevocable obligations.<sup>45</sup>

The International Chamber of Commerce ('ICC') and the United Nations Commission on International Trade Law ('UNCITRAL') have both been active in seeking a solution to the problems caused by unfair and fraudulent calls on demand guarantees and standby letters of credit. Attempts made by the ICC and the UNCITRAL to prevent unfair and fraudulent calling of demand guarantees are discussed to see whether or not these attempts have assisted in preventing unfair and fraudulent calls.<sup>46</sup>

### 1.3.2 Scope of the Thesis

Although surety companies, insurance companies, banks or other financial institutions may all issue demand guarantees, this thesis is concerned only with demand guarantees that are issued by banks. One can also distinguish between irrevocable<sup>47</sup> and revocable<sup>48</sup> demand guarantees, but because in the international trade bank demand guarantees are invariably irrevocable,<sup>49</sup> the aim here is to deal only with irrevocable demand guarantees. Therefore, no further attention will be given to this distinction.<sup>50</sup>

The independence of the demand guarantee from the underlying contract has the effect that, in principle, the guarantor must pay a demand presented in compliance with the terms of the guarantee, irrespective of whether or not the principal has, in fact, committed a breach of the underlying contract with the beneficiary. However, all legal systems acknowledge that there are a few exceptions to this independence principle.<sup>51</sup> The most common of these take place when there is fraud on the part of the beneficiary,<sup>52</sup> a concept that varies slightly from jurisdiction to jurisdiction, but is characterised by the beneficiary

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<sup>45</sup> See Chapters 4–7.

<sup>46</sup> See Chapter 4, and para 6.5 in Chapter 6 and the conclusions reached and set out in paras 8.3.2.1, 8.4, and 8.5 in Chapter 8.

<sup>47</sup> An irrevocable demand guarantee constitutes a definite undertaking of the bank to pay the beneficiary (or another bank, depending on the circumstances), provided that the stipulated documents in the instrument (if any) are presented to the bank and that the terms and conditions of the instrument are complied with. It gives the beneficiary a high degree of assurance that he will be paid, provided he complies with the terms of the guarantee. An irrevocable demand guarantee cannot be amended or cancelled without the consent of the beneficiary (or other bank).

<sup>48</sup> When a bank has issued a revocable demand guarantee, the bank gives notice to the beneficiary (or another bank) that it can be amended or cancelled at any moment and even without any prior notice to the beneficiary until the demand (and other documents) has been honoured by the bank.

<sup>49</sup> See, e.g., *Koumantarakis Group CC v Mystic River Investments 45 (Pty) Ltd and Another* [2007] JOL 19699 (D) in para [43]; and also A van Wyk 'Letters of Credit and Attachment Proceedings' (September 1995) *De Rebus* 575 at 575. Virtually all commercial letters of credit that are issued are also irrevocable (see E Eitelberg 'Autonomy of Documentary Credit Undertakings in South African Law' (2002) 119 *South African Law Journal* 120 at 121–122).

<sup>50</sup> For a full discussion of the distinction of revocable and irrevocable letters of credit and how they influence the issuing bank's liability, see C F Hugo *The Law Relating to Documentary Credits from a South African Perspective with Special Reference to the Legal Position of the Issuing and Confirming Banks* (published LLD, University of Stellenbosch (1996)) (1997) (hereinafter '*Hugo: The Law Relating to Documentary Credits*') at 36–37; and *Oelofse: The Law of Documentary Letters of Credit* *op cit* note 8 at 29–52.

<sup>51</sup> See Chapters 5–6.

<sup>52</sup> See Eitelberg *op cit* note 49 at 126. For a full discussion, see Chapter 5.

making a dishonest demand, knowing full well that the principal is not in breach. In practice this is difficult to prove, because it does not merely need to be proved that the principal has fully complied with all the terms of the underlying contract, but also that the beneficiary knew this at the time of the demand.<sup>53</sup>

Although fraud is the most common ground upon which payment under a demand guarantee may be restrained, it is certainly not the only one. So far only a few established exceptions exist to the autonomy principle and the absolute detachment of demand guarantees from their underlying contracts.<sup>54</sup> The main focus of this thesis is to discuss only fraud and illegality as possible grounds on which payment under a demand guarantee may be restrained under the English, American and South African law.<sup>55</sup> Although no such case regarding demand guarantees specifically has ever been brought before the South African courts, the intention is to discuss the possible attitudes that these courts might adopt if they were to be presented with cases dealing with these issues. In so doing, reference will be made specifically to the English experience and its relevance will be appraised by taking into consideration the concurring legal principles as applied in the South African law.

For purposes of this thesis, a comprehensive discussion of the history and development of demand guarantees is not required. However, a general discussion of the basics and legal nature of demand guarantees is essential for a proper understanding of the topic of the thesis.<sup>56</sup> The main focus is on demand guarantees that are payable on demand. As the United States prefer to make use of the standby letter of credit (which is similar to the demand guarantee) rather than the demand guarantee that is used by other jurisdictions, such as England and South Africa, special attention will also briefly be given to the standby letter of credit. Accordingly, a concise discussion of the history and development of the standby letter of credit and a general discussion of its basics and legal nature are also essential for a proper understanding of the topic of the thesis.<sup>57</sup> As the commercial letter of credit and the standby letter of credit in their essential legal character are also legally synonymous with the demand guarantee, it is essential that they be compared to one another. The intention is not to provide a comprehensive discussion of all the issues pertinent to demand guarantees. The thesis is concerned with the obligation created by the demand guarantee. It is concerned with the relationship created by the demand guarantee; in other words, the relationship between the guarantor and the beneficiary. It is not concerned with the relationship between the principal and his bank (i.e., the guarantor bank or instructing party bank depending on the circumstances) or the one between the instructing party bank (i.e., the principal's bank) and the guarantor bank (i.e., local bank of the beneficiary). Therefore, special attention is not given to the counter-guarantees (or counter-indemnities) that are issued in relation to demand guarantees. Issues relating to

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<sup>53</sup> See the *Guide to the URDG op cit* note 2 at 22–23.

<sup>54</sup> It has been said that the independence principle and its boundaries is one of the most complex issues in the law of documentary credits and demand guarantees (see Hugo *op cit* note 35 in note 21 at 105). Therefore, this thesis merely attempts to deal with fraud and illegality as possible exceptions to the independence principle. It therefore, should by no means be seen as a comprehensive discussion of this topic, but should merely be viewed as a basis for further exploration of this interesting and often complex topic.

<sup>55</sup> See Chapters 5–7.

<sup>56</sup> See Chapter 2.

<sup>57</sup> See Chapter 2.

private international law, in other words, establishing which law applies to a demand guarantee, also falls outside the scope of this thesis.<sup>58</sup>

A concise discussion of the sources of law applicable to demand guarantees and standby letters of credit is also imperative.<sup>59</sup>

The ICC has made various attempts in its uniform rules and UNCITRAL in its convention to prevent unfair, and especially fraudulent calls, of demand guarantees and standby letters of credit, and therefore a discussion as to whether or not their attempts have assisted in the prevention is essential for purposes of this thesis.<sup>60</sup>

Also inside the scope of this thesis is a brief discussion of issues relevant to the availability of South African interdicts and anti-dissipation interdicts; injunctions and *Mareva* injunctions in the English law; and injunctions in the American law in relation to demand guarantees and standby letters of credit.<sup>61</sup>

This thesis only deals with selective legal aspects of demand guarantees and it is not intended to be a comprehensive study of the South African law of bank demand guarantees.<sup>62</sup> To have attempted such a work, would have fallen well beyond the scope of this thesis.

### 1.3.3 Structure of the Thesis

Chapter 1 provides a general introduction to the thesis. The theme and scope of the thesis are also set out in Chapter 1.

The purpose of Chapter 2 is to explain the nature and role of the different types of demand guarantee in relation to international construction/engineering contracts and international sale of goods contracts. Chapter 2 is structured to enable the reader to understand in broad terms the general legal nature and fundamental principles of demand guarantees. The development and legal nature of the standby letter of credit, an instrument similar to the demand guarantees, is also discussed. This chapter also explains the scope of the problem of unfair and fraudulent callings often experienced when demand guarantees are used.

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<sup>58</sup> For a full discussion of this topic, see *Oelofse: The Law of Documentary Letters of Credit op cit* note 8 at 507–537; and E A Fredericks and J L Neels ‘The Proper Law of a Documentary Letter of Credit’ (Part 1) (2003) 15 *South African Mercantile Law Journal* 63 and ‘The Proper Law of a Documentary Letter of Credit’ (Part 2) (2003) 15 *South African Mercantile Law Journal* 207.

<sup>59</sup> See Chapter 3.

<sup>60</sup> See Chapter 4, and para 6.5 in Chapter 6 and the conclusions reached and set out in paras 8.3.2.1, 8.4, and 8.5 in Chapter 8.

<sup>61</sup> See Chapter 7.

<sup>62</sup> At present there is no comprehensive work dealing specifically with demand guarantees in South Africa. So far there are only a few articles that deal specifically with demand guarantees, for example, Smit *op cit* note 15; O’Brien *op cit* note 2; and Dinnie *op cit* note 12. As regards letters of credit, there are many articles (too many to list here) and two comprehensive books dealing specifically with letters of credit: *Hugo: The Law Relating to Documentary Credits op cit* note 50; and *Oelofse: The Law of Documentary Letters of Credit op cit* note 8. There is also a comprehensive discussion of letters of credit in Chapter 5 found in Van Niekerk and Schulze *op cit* note 30. However, internationally there has been a vast number of articles and books or chapters of books dealing comprehensively with demand guarantees. A particularly comprehensive international book dealing with demand guarantees is Bertrams *op cit* note 1.



Chapter 3 sets out the sources of law that govern demand guarantees and standby letters of credit.

The ICC and the UNCITRAL have both been active in seeking solutions to the problems caused by unfair calls on demand guarantees and standby letters of credit. Uniform rules have been created by them to prevent unfair calling of demand guarantees and standby letters of credit. These international initiatives to prevent unfair calls on demand guarantees and standby letters of credit are discussed in Chapter 4.

Generally, only a few established exceptions exist to the autonomy principle and the absolute detachment of demand guarantees from their underlying contracts; for example, the infringement of international obligations, fraud<sup>63</sup> and the express contractual derogation from the principle of autonomy.<sup>64</sup> These exceptions are also referred to as the grounds upon which payment of demand guarantees may be restrained. In Chapters 5 to 6 only the exceptions of fraud and illegality (of the underlying contract) as possible grounds on which the payment of a demand guarantee may be restrained are discussed in some detail. These chapters also contain various English, American and South African court cases that have contributed to the development of these grounds and from which the legal attitudes of these jurisdictions may be inferred.

Court relief in the form of interlocutory (provisional or preliminary) interdicts (injunctions) and anti-dissipation interdicts (i.e., freezing injunction (*Mareva* injunction) in the English law) that are available in the English, American and South African law are also briefly considered in Chapter 7.

Lastly, Chapter 8 contains conclusions reached based on the issues dealt with in this thesis and it also contains a few recommendations.

#### **1.3.4 Research Methodology**

Firstly, an analysis of the main problems experienced with using demand guarantees and standby letters of credit locally and internationally was done. A wide search was conducted to find the possible relevant legislation, articles, court cases and books in various jurisdictions, including the United States, England, Australia, Hong Kong, Canada, Singapore, Germany, Belgium and France.

An in-depth examination of the relevant individual cases and articles of the chosen jurisdictions was done in an attempt to extract the legal principles relevant to this study. The issues commonly in dispute between the chosen jurisdictions were compared in an attempt to find solutions to the main problems explored in this thesis. The issues most commonly raised in litigation seemed to relate to the unfair and often fraudulent demands made by beneficiaries of demand guarantees and standby letters of credit on the guarantors/issuers and the reluctance of courts to prevent such calls.

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<sup>63</sup> See Chapter 5.

<sup>64</sup> See H N Bennett 'Performance Bonds and the Principle of Autonomy' (1994) *Journal of Business Law* 574 at 581.

The traditional practice in writing a South African thesis is to undertake comparative legal research in countries that represent different legal families, often one from the Anglo-American family (e.g., England and the United States) and one from the Romance and the Germanic legal families (e.g., France and Germany).<sup>65</sup> This traditional approach was not followed here, because the vast majority of published articles and reported case law specifically falling within the scope of the thesis was from England and the United States, which is indicative of the fact that these countries are the leaders in this field of law. Therefore, it was decided that these two countries, in conjunction with South Africa, would form the main sources of law for purposes of this thesis.<sup>66</sup>

Another reason why the traditional approach was not followed here was because of the highly international nature of demand guarantees. It was decided that this thesis would add more value if it rather contained a discussion of all the relevant international rules and conventions. Therefore, attention was also paid to international conventions governing demand guarantees, such as the UNCITRAL Convention; and international rules issued by the ICC, such as their Uniform Rules for Contract Guarantees ('URCG'), Uniform Rules for Demand Guarantees ('URDG'), and the Uniform Customs and Practice for Documentary Credits ('UCP'). Other international rules, such as the International Standby Practices ('ISP98') that deal with standby letters were also looked at and analysed closely.

In relation to the United States, attention was also given to their extensive legislation, namely article 5 of their Uniform Commercial Code ('UCC'), dealing with commercial letters of credit and standby letters of credit. This was done in order to see if the South African law needs to be supplemented or harmonised in any way.

### 1.3.5 Countries Covered in the Thesis

The vast majority of published books, articles and reported case law specifically falling within the ambit of the thesis was from England and the United States, which is indicative of the fact that these countries are the leaders in this field of law.

As already mentioned, South Africa has limited literature available on demand guarantees, standby letters of credit and even commercial letters of credit. The country also does not have specific legislation dealing with these instruments. One has to take cognisance of English law, as that system has had a significant influence on the development of South African banking law in general, and particularly its letters of credit law.<sup>67</sup> Therefore, the South African courts often look at the English courts for guidance when dealing with these instruments. It makes sense therefore that this thesis should entail an in-depth discussion of how the English courts deal with these various instruments.

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<sup>65</sup> On the general approach, research methods, and objectives to comparative legal studies, see D H van Zyl *Beginsels van Regsvergelyking* (1981); and F Venter *et al Regsnavoring Metode en Publikasie* (1990).

<sup>66</sup> The main aim with the comparative research that was undertaken was to ascertain whether the two comparative systems would enable a better understanding of the position in South Africa, and whether the English and American systems offered possible solutions to situations that were currently unclear in the South African system (for a full discussion of all the possible aims and functions there are of doing comparative research, see Van Zyl *op cit* note 65 at 17–34).

<sup>67</sup> See Van Niekerk and Schulze *op cit* note 30 at 273; and C Hugo 'Documentary Credits and Independent Guarantees' *ABLU* 2005 (a paper delivered at the 2005 Annual Banking Law Update held at the Indaba Hotel, Johannesburg on 20 April 2005) (unpaginated) at 1 of his article.

England, just like South Africa, has no legislation specifically governing demand guarantees and letters of credit. This is in contrast with the United States that has extensive legislation, in the form of article 5 of the UCC, dealing specifically with commercial letters of credit and standby letters of credit. It was thus thought to be useful to include a country that has specific governing legislation and that clearly seems to be a leader in this field of law. The well-used standby letter of credit also originated in the United States and no thesis relating to demand guarantees would be complete without a discussion of standby letters of credit.

Accordingly, it was decided that England and the United States, in conjunction with South Africa, would form the main sources of law for purposes of this thesis. However, where relevant and interesting, the thesis also contains limited references to case law and legal writing from other jurisdictions, such as Malaysia and Singapore.

### **1.3.6 Period of the Law Covered**

Case law, legislation and legal writings up to 1 July 2008 were taken into consideration for purposes of writing this thesis.



## CHAPTER 2: AN INTRODUCTION TO DEMAND GUARANTEES AND STANDBY LETTERS OF CREDIT

### 2.1 DEFINITION OF A DEMAND GUARANTEE

A ‘demand guarantee’ is generally a short and simple instrument issued by a bank (or other financial institution) under which the obligation to pay a stated or maximum sum of money arises merely upon the making of a demand for payment in the prescribed form and sometimes also the presentation of documents as stipulated in the guarantee within the period of validity of the guarantee.<sup>1</sup> Many demand guarantees are payable on first demand without any additional documents, which reflects their origin in replacing cash deposits,<sup>2</sup> although increasingly guarantees require at least a statement indicating that the principal is in breach.<sup>3</sup> Therefore, a demand guarantee is like a substitute for cash<sup>4</sup> and must be honoured on presentation of a written demand that complies with the provisions of the guarantee.<sup>5</sup> Demand guarantees are particularly common in construction and project contracts, and are frequently required by Middle Eastern customers.<sup>6</sup>

The International Chamber of Commerce (‘ICC’)<sup>7</sup> defines a demand guarantee in article 2(a) of its Uniform Rules for Demand Guarantees (‘URDG’)<sup>8</sup> as follows:

For the purpose of these Rules, a demand guarantee (hereinafter referred to as “Guarantee”) means any guarantee, bond or other payment undertaking, however named or described, by a bank, insurance company or other body or person (hereinafter called the “Guarantor”) given in writing for the payment of money on presentation in conformity with the terms of the undertaking of a written demand for payment and such other document(s) (for example, a certificate by an architect or engineer, a judgment or an arbitral award) as may be specified in the Guarantee, such undertaking being given

- (i) at the request or on the instructions and under the liability of a party (hereinafter called the “the Principal”); or

<sup>1</sup> See D Warne and N Elliott *Banking Litigation* 2 ed (2005) at 277; M S Kurkela *Letters of Credit and Bank Guarantees Under International Trade Law* 2 ed (2008); and J O’Donovan and J Phillips *The Modern Contract of Guarantee* English Edition (2003) at 525.

<sup>2</sup> See para 1.1.1 in Chapter 1.

<sup>3</sup> See also P O’Brien ‘Letters of Intent and Demand Guarantees’ *ABLU* 1993 (a paper delivered at the 1993 Annual Banking Law Update held at the Indaba Hotel, Johannesburg) 134 at 159.

<sup>4</sup> See *Intraco Ltd v Notis Shipping Corporation (The ‘Bhoja Trader’)* [1981] 2 Lloyd’s Rep 256 (CA) at 257.

<sup>5</sup> See SITPRO’s *Financial Guide: Demand Guarantees* (2007) (hereinafter ‘*SITPRO’s Financial Guide*’) at 2 (www.sitpro.org.uk accessed 3 June 2008). (SITPRO was formerly the Simpler Trade Procedure Board; a non-departmental public body for which the United Kingdom Department of Trade and Industry has responsibility.)

<sup>6</sup> See SITPRO’s *Report on the Use of Demand Guarantees in the UK* (July 2003) (hereinafter ‘*SITPRO’s Report*’) at 5 (www.sitpro.org.uk accessed 3 June 2008).

<sup>7</sup> For a full discussion of the International Chamber of Commerce (hereinafter the ‘ICC’) see para 3.2.1 in Chapter 3.

<sup>8</sup> ICC Publication No 458, Paris (April 1992) (hereinafter the ‘URDG’). For a full discussion of these rules see para 3.2.5 in Chapter 3 and para 4.2.3 in Chapter 4.

- (ii) at the request or on the instructions and under the liability of a bank, insurance company or any other body or person (hereinafter “the Instructing Party”) acting on the instructions of a Principal to another party (hereinafter the “Beneficiary”).<sup>9</sup>

Goode<sup>10</sup> provides a somewhat broader definition than the more detailed definition found in article 2(a) of the URDG. He states that a demand guarantee may be defined as an undertaking given for payment of a fixed or maximum sum of money on presentation to the party giving the undertaking of a demand for payment (nearly always required to be in writing) and such other documents (if any) as may be specified in the guarantee within the period and in conformance with the other conditions of the guarantee.

Goode’s definition is somewhat broader than the more detailed definition found in article 2(a) of the URDG, the scope of which is limited to guarantees in writing given for the account of a third party (as opposed to the issuer’s own account), and providing for payment against a written demand and other specified documents. In reality, most demand guarantees are payable on ‘first written demand’ or ‘simple demand’ without any additional documents. In its truly simplest form, the simple demand guarantee authorises the beneficiary to make demand for payment in any form, including oral, and at any time within the period of effectiveness of the guarantee without justifying the legitimacy of the demand.<sup>11</sup> This mirrors the cash deposit origin as well as the traditionally superior negotiating power of most buyers and employers. However, there are some countries in which the requirement for additional documents is more common than in others. For instance, the demand guarantee may stipulate that the beneficiary must support his written demand by a statement of breach; a requirement that is also embodied in article 20 of the URDG.<sup>12</sup>

A ‘bank demand guarantee’ can be described as a personal security (undertaking) in terms of which a bank promises payment to a beneficiary if a principal (often the bank’s client) defaults in the performance of his obligation in terms of the underlying contract. The bank has to pay if the documents presented with the demand for payment comply with the documents that are mentioned in the text of the demand guarantee. For this reason, the bank’s obligations are autonomous from the underlying contract between the beneficiary and the principal; which means that, in principle, the bank must pay if proper complying documents are presented, even if the beneficiary and the principal have not stipulated that

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<sup>9</sup> Standby letters of credit (see the full discussion in para 2.9 below) undoubtedly fall within the definition of ‘demand guarantee’ as set out in article 2(a) of the URDG.

<sup>10</sup> See R Goode *Guide to the ICC Uniform Rules for Demand Guarantees* (1992) ICC Publication No 510 (hereinafter the ‘*Guide to the URDG*’) at 8–9.

<sup>11</sup> See E E Bergsten ‘A New Regime for International Independent Guarantees and Stand-by Letters of Credit: The UNCITRAL Draft Convention on Guaranty Letters’ (1993) *27 International Lawyer* 859 at 868.

<sup>12</sup> See the *Guide to the URDG op cit* note 10 at 9. Article 20 of the URDG provides as follow:

Any demand for payment under the Guarantee shall be in writing and shall (in addition to such other documents as may be specified in the Guarantee) be supported by a written statement (whether in the demand itself or in a separate document or documents accompanying the demand and referred to in it) stating:

- (i) that the Principal is in breach of his obligation(s) under the underlying contract(s) or, in the case of a tender guarantee, the tender conditions; and
- (ii) the respect in which the Principal is in breach.

there is a default under the original underlying contract.<sup>13</sup> In this regard, demand guarantees differ from surety guarantees or bonds, in which the security lender (i.e., surety) is only involved if the principal party defaults in the performance of an obligation.<sup>14</sup>

The above definitions of a demand guarantee also embrace instruments known as ‘performance bonds’<sup>15</sup> or ‘performance guarantees’.<sup>16</sup> These instruments are merely forms of demand guarantees. It is normal practice for construction contracts to require the contractor to provide some form of security to guarantee the performance of his obligations under the contract. In practice, performance guarantees tend to be used where the underlying obligation is not the payment of money, but the performance of other obligations such as those arising under a construction or engineering contract.<sup>17</sup>

In *Edward Owen Engineering Ltd v Barclays Bank International Ltd and Another*<sup>18</sup> Lord Denning MR held that performance guarantees were virtually promissory notes payable on demand.<sup>19</sup> He also stated that<sup>20</sup>

[a]ll this leads to the conclusion that the performance guarantee stands on a similar footing to a letter of credit. A bank which gives a performance guarantee must honour that guarantee according to its terms. It is not concerned in the least with the relations between the supplier and the customer; nor with the question whether the supplier has performed his contracted obligation or not; nor with the question whether the supplier is in default or not. The bank must pay according to its guarantee, on demand, if so stipulated, without proof or conditions. The only exception is when there is clear fraud of which the bank has notice.

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<sup>13</sup> See F De Ly ‘The UN Convention on Independent Guarantees and Stand-by Letters of Credit’ (Fall 1999) 33 *International Lawyer* 831 at 832; and cf M Brindle and R Cox (eds) *Law of Bank Payments* 3 ed (2004) in para 8-026 at 672–673; and D Dinnie ‘A Pound of Flesh’ (2007) 15 *Juta’s Business Law* 127 at 127.

<sup>14</sup> See De Ly *op cit* note 13 in note 5 at 832. See also para 2.5.1.1 below.

<sup>15</sup> However, in the United States the term ‘performance bond’ is used to refer to a type of surety bond. In most US States and under Federal law, these types of performance bond are required of the prime or general contractor for the construction of public improvements. (For a full discussion of this, see E G Gallagher (ed) *The Law of Suretyship* 2 ed (2000) American Bar Association (Tort and Insurance Practice); R C Lewis *Contract Suretyship: From Principle to Practice* (2000); L R Moelmann and J T Harris (eds) *The Law of Performance Bonds* (1999), American Bar Association (Tort and Insurance Practice); and S J Strawbridge and L Lerner (eds) *The Most Important Questions a Surety Can Ask About Performance Bonds* (1997) American Bar Association (Fidelity and Surety Law Committee: Tort and Insurance Practice Section)). For a case involving such a performance bond/surety bond in the South African law (i.e., South West Africa Division), see *Administrator General South West Africa v Trust Bank of Africa Ltd* 1982 (1) 635 (SWA).

<sup>16</sup> See Brindle and Cox *op cit* note 13 in para 8-026 at 673.

<sup>17</sup> See M Hapgood (with contributions from N Levy, M Phillips and R Hooley) *Paget’s Law of Banking* 12 ed (2003) (hereinafter ‘*Paget’s Law of Banking*’) at 729.

<sup>18</sup> [1978] 1 QB 159 (CA) ([1978] 1 Lloyd’s Rep 166 (CA); and [1978] 1 All ER 976 (CA)).

<sup>19</sup> [1978] 1 QB 159 (CA) at 170H.

<sup>20</sup> At 171A–B.

## 2.2 THE PURPOSE AND CLASSIC USES OF THE DEMAND GUARANTEE

Buyers of goods or services, whether in their own domestic or international sector, often insist on demand guarantees. The provision of such a guarantee gives the buyer security for the due performance of the seller's obligation in terms of the underlying commercial contract. In order to be effective, a bank will give its personal undertaking to pay in certain circumstances; for example, when a demand for payment is made by the buyer. If the demand is made in accordance with the strict terms of the guarantee, then the bank is obliged to make payment and to look to its customer (i.e., the principal) for an indemnity.<sup>21</sup>

The purpose of the demand guarantee is to allow the beneficiary to have immediate access to funds necessary to remedy an alleged default under the underlying contract by the principal. The idea behind this structure is 'pay now and litigate later'. It prevents the performance of the project in question from being held up due to lack of funds while the parties in question litigate or arbitrate over the merits of a particular call by the beneficiary under the demand guarantee. This consideration is particularly significant in international transactions where conflicts of law issues may well cause litigation or arbitration to be even more expensive and time-consuming than they would be in a purely domestic transaction. In this regard, demand guarantees are different from true (traditional) guarantees under the terms of which payment to the beneficiary is usually conditional on proof of a default by the principal.<sup>22</sup>

Demand guarantees are typically used in construction contracts, engineering contracts and contracts for the international sale of goods. However, they could also be used for any other type of contract. Whereas commercial letters of credit are used to ensure that the seller, exporter or supplier is paid, demand guarantees are intended to safeguard the other party (e.g., buyer) against non-performance or late or defective performance by the seller, exporter or supplier to the underlying contract.<sup>23</sup>

## 2.3 DEMAND GUARANTEE STRUCTURES: THEIR OPERATION, THE PARTIES INVOLVED AND THE RELATIONSHIPS CREATED

### 2.3.1 Parties to a Demand Guarantee and the Terminology

Generally, there is a minimum of three parties involved in the provision of a demand guarantee.<sup>24</sup> However, sometimes a fourth party may also be involved.<sup>25</sup> The different parties<sup>26</sup> that are involved are discussed below.

<sup>21</sup> See Warne and Elliott *op cit* note 1 at 236–237.

<sup>22</sup> See J Lipton 'Uniform Regulation of Standby Letters of Credit and Other First Demand Security Instruments in International Transactions' (1993) 10 *Journal of International Banking Law* 402 at 402.

<sup>23</sup> See the *Guide to the URDG op cit* note 10 at 9.

<sup>24</sup> See O'Brien *op cit* note 3 at 158. The commercial letter of credit usually arises in connection with the international sale of goods. In this transaction, the buyer of the goods causes its bank (i.e., the issuer) to issue the letter of credit in favour of the seller. The buyer thus 'applies' for the credit and is the 'applicant'. The seller is the party to whom the credit runs, that is, the 'beneficiary' of the letter of credit. Commonly, the issuer causes a bank in the seller's market, the nominated bank, to advise the credit. Often the adviser will also confirm the credit or at least pay it under the issuer's mandate (for a discussion of all the parties to a commercial letter of credit, see J P van Niekerk and W G Schulze *The South African Law of International Trade: Selected Topics* 2 ed (2006) at 271–272; and E Eitelberg 'Autonomy of Documentary Credit Undertakings in South African Law' (2002) 119 *South African Law Journal* 120 at 122–123). Standby letters



### 2.3.1.1 *Principal*

The principal, as he is termed in the URDG,<sup>27</sup> is typically the party to the underlying contract; for example, a seller, exporter, supplier or contractor whose performance is required to be covered by the demand guarantee and who gives instructions for its issue. He is also commonly referred to as the ‘account party’. However, for purposes of this thesis, the term ‘principal’ will be used to describe this party.

### 2.3.1.2 *Guarantor*

The guarantor<sup>28</sup> (usually a bank) is the party issuing the demand guarantee on behalf of the principal (normally its customer).

### 2.3.1.3 *Beneficiary*

The beneficiary, as he is named in the URDG,<sup>29</sup> is the other party to the underlying contract; for example, the buyer, importer or employer in whose favour the demand guarantee is issued. For purposes of this thesis, the term ‘beneficiary’ will be used to describe this party.

### 2.3.1.4 *Instructing Party*

Where the beneficiary requires the demand guarantee to be issued by a bank in his own country and the principal does not bank with such a bank, the principal requests his bank to arrange for the issuance of the guarantee by a bank in the country (local bank) of the beneficiary. Instructions are then given by the principal’s bank (which, in this situation, is designated by the URDG as the ‘instructing party’) to a bank in the beneficiary’s country to issue the guarantee against a counter-guarantee (or counter-indemnity) by the instructing party who, in turn, is entitled to an indemnity from its customer (the principal). In such a situation it is the beneficiary’s bank that issues the demand guarantee and it is thus the guarantor of the demand guarantee.

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of credit can secure any executory obligation. In the standby transaction, there is commonly only one bank, the issuer of the standby. The person obligated in the underlying executory obligation is the person who applies for the standby letter of credit to be issued (i.e., the applicant). The beneficiary is the party to whom the applicant owes the executory obligation and in whose favour the standby letter of credit is issued. See also J F Dolan ‘Analysing Bank Drafted Standby Letter of Credit Rules, the International Standby Practice (ISP98)’ (2000) 14 *Wayne Law Review* 1865 in notes 5 and 6 at 1866–1867.

<sup>25</sup> See also O’Brien *op cit* note 3 at 159–161.

<sup>26</sup> See the *Guide to the URDG op cit* note 10 at 9 and 11; and F Schwank ‘Electronic International Bank Guarantees and Letters of Credit’ (1991) *Comparative Law Yearbook of International Business* 317 at 319.

<sup>27</sup> See article 2(a)(i).

<sup>28</sup> See, e.g., article 2(a) of the URDG.

<sup>29</sup> See article 2(a)(ii).

## 2.3.2 Demand Guarantee Structures

### 2.3.2.1 Direct (Three-Party) Demand Guarantees<sup>30</sup>

A demand guarantee, as defined by the URDG, involves a minimum of three parties: (1) the principal, (2) the guarantor and (3) the beneficiary. Normally, the guarantor in the three-party structure is the principal's bank and conducts business in the same country as the principal, while the beneficiary conducts business in a foreign country. Such three-party demand guarantees are known as 'direct guarantees', because the guarantee is issued directly by the principal's bank and not by a local bank in the beneficiary's country.

A direct (or three-party) demand guarantee may be explained by way of the following scenario:<sup>31</sup> P in South Africa has negotiated a contract with B in Australia for the construction of a gold mine in Australia and it is a requirement of the contract that P provide a bank demand guarantee covering this contract. P banks with a South African Bank, G Bank. P, the principal, then instructs his bank, G Bank, to issue the guarantee in favour of B, the beneficiary. G Bank is not obliged to comply with P's instruction, unless it has agreed to do so and it will in any event require P to indemnify it for any potential liability it might incur under the guarantee.

In this scenario, when G Bank issues the demand guarantee, it becomes the guarantor and B becomes the beneficiary. Normally, the demand guarantee will state, *inter alia*, the following: the parties, the underlying contract, the duration of the guarantee, the amount or the maximum amount for which a demand (call) may be made under it and the documents to be presented by the beneficiary when making a demand. G Bank may transmit the guarantee directly to B or through G's correspondent bank in Australia. In such an instance G's correspondent bank will be acting purely as advising and transmitting bank without incurring any responsibility other than to check that the signatures on the guarantee appear to be legitimate.

Where B honestly believes that P has breached (defaulted on) the underlying contract (and it is improper to make a claim without such belief), B then presents a written demand for payment to G Bank, together with any documents required by the guarantee (e.g., a statement of P's default issued by B). As long as the demand and other documents conform to the guarantee and are presented before its expiry or cancellation, G Bank must pay in the absence of established fraud or another ground upon which payment of the guarantee may be restrained. G Bank then claims reimbursement from P under its counter-indemnity. In the case of breach of the underlying contract, P and B also have the right to claim damages against each other.

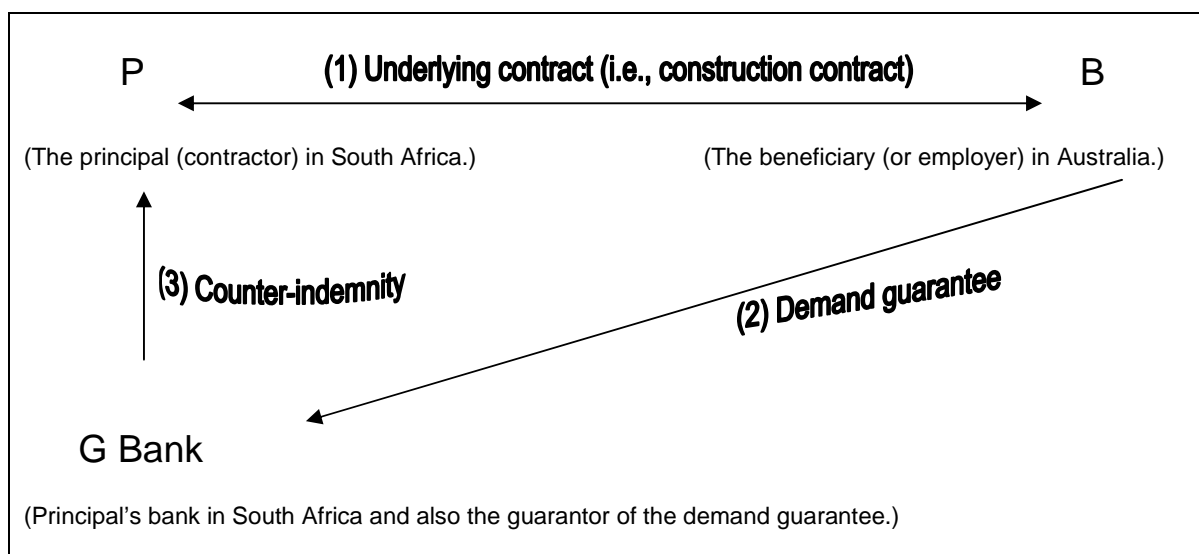
The tripartite structure explained above can be indicated diagrammatically as follows (the arrows indicate the direction of the claims):<sup>32</sup>

<sup>30</sup> See, in general, the *Guide to the URDG op cit* note 10 at 9–11; *SITPRO's Financial Guide op cit* note 5 at 3; and O'Brien *op cit* note 3 at 159–160.

<sup>31</sup> Based on the example given in the *Guide to the URDG op cit* note 10 at 10.

<sup>32</sup> Figure 1 has been adopted from the one set out in the *Guide to the URDG op cit* note 10 at 11 and has been slightly amended.

Figure 1: Structure of a direct (three-party) demand guarantee



When a demand is made under the demand guarantee, the claims flow in the direction indicated in Figure 1. B claims on G Bank and G Bank then claims on P under the counter-indemnity. In the case of breach of the underlying contract, P and B also have the right to claim damages against each other, depending on the circumstances.

In this structure of a direct demand guarantee there are three separate contracts:

1. The underlying contract (i.e., construction contract) between P and B (contract no (1) in Figure 1);
2. The counter-indemnity contract (or reimbursement contract) between P and G Bank (contract no (3) in Figure 1); and
3. The contract established by the demand guarantee issued by G Bank in favour of B (contract no (2) in Figure 1).

These three contracts are completely separate from one another. This principle is also confirmed in the URDG.

As mentioned, G Bank may transmit the demand guarantee directly to B or it may decide to have the guarantee advised and transmitted to B by a local bank, say L Bank, in Australia. This action does not alter the contractual structure. The demand guarantee will remain a direct (three-party) guarantee, because L Bank's function is limited to checking that the signatures on the guarantee appear to be valid. If L Bank merely advises and transmits the demand guarantee issued by G Bank, it will not incur liability under the guarantee itself, unless it is requested and agrees to confirm the guarantee; a practice that is common in the case of commercial letters of credit or standby letters of credit, but is unusual in the case of demand guarantees.<sup>33</sup>

<sup>33</sup> See the *Guide to the URDG op cit* note 10 at 11.

### 2.3.2.2 *Indirect (Four-Party) Demand Guarantees*<sup>34</sup>

Where the beneficiary wants the demand guarantee to be issued by a bank in his own country and the principal does not bank with this bank, the principal requests his bank to arrange for the issue of the guarantee by a local bank in the country of the beneficiary. Instructions are then given by the principal's bank (now termed the 'instructing party') to a bank in the beneficiary's country to issue the guarantee against a counter-guarantee (or counter-indemnity) by the instructing party who, in turn, is entitled to an indemnity (reimbursement) from its customer (the principal). In such a situation it is the beneficiary's bank (i.e., a local bank in the country of the beneficiary) that issues the demand guarantee and is therefore the guarantor of the demand guarantee.

Therefore, in indirect (four-party) demand guarantees there is an additional contract, that is, the contract between the instructing party (principal's bank) and the guarantor (local bank in the country of the beneficiary). This contract has two aspects: (1) the mandate from the instructing party to the guarantor regarding the instruction to issue the demand guarantee, which the guarantor as mandatory must comply with if he accepts the instruction; and (2) the counter-guarantee (or counter-indemnity) that the guarantor requires from the instructing party as a pre-condition for issuing the guarantee and that is distinct from the mandate. In indirect transactions the principal's contract (mandate) is with the instructing party, not with the guarantor.<sup>35</sup>

If the previous scenario<sup>36</sup> is adapted, an indirect demand guarantee structure will be as follows: P, the principal, arranges for his bank, IP Bank (now referred to as the 'instructing party') based in South Africa, to request the intended guarantor, G Bank, based in Australia (the country of the beneficiary, B), to issue the demand guarantee to B against a counter-guarantee (or counter-indemnity) from IP Bank. IP Bank is not obliged to comply with P's instruction, unless it has agreed to do so and it will in any event require P to indemnify it for any potential liability it might incur under the counter-guarantee. This four-party guarantee is known as an indirect guarantee structure, because it is not P's own bank issuing the demand guarantee directly to B, as in the direct guarantee structure described above, but P's bank, as instructing party, who arranges for its issue by the beneficiary's (B's) bank against a counter-indemnity.

This indirect (four-party) guarantee structure explained above can be indicated diagrammatically as follows (the arrows indicate the direction of the claims):<sup>37</sup>

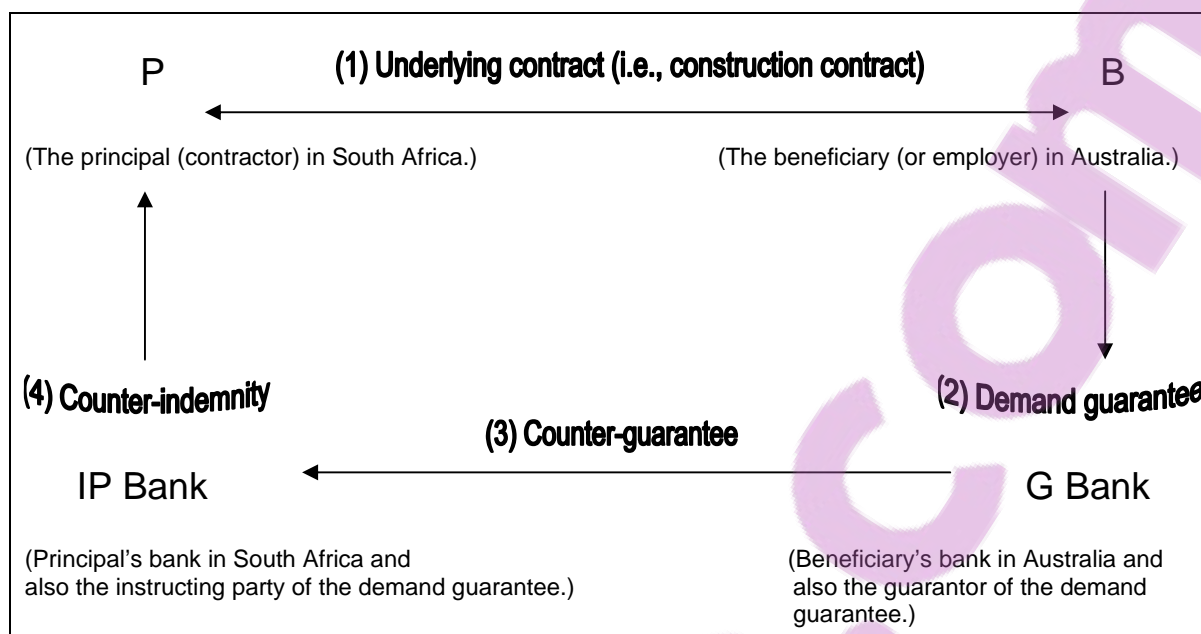
<sup>34</sup> See in general, the *Guide to the URDG op cit* note 10 at 11–12; *SITPRO's Financial Guide op cit* note 5 at 3; and O'Brien *op cit* note 3 at 160–161.

<sup>35</sup> See the *Guide to the URDG op cit* note 10 at 18.

<sup>36</sup> Based on the example given in the *Guide to the URDG op cit* note 10 at 12.

<sup>37</sup> Figure 2 has been adopted from the one set out in the *Guide to the URDG op cit* note 10 at 12 and has been slightly amended.

Figure 2: Structure of an indirect (four-party) demand guarantee



In this structure of an indirect demand guarantee there are four separate contracts:

1. The underlying contract (i.e., construction contract) between P and B (contract no (1) in Figure 2);
2. The counter-indemnity contract (or reimbursement contract) between P and IP Bank (contract no (4) in Figure 2);
3. The counter-guarantee contract issued by IP Bank to G Bank (contract no (3) in Figure 2); and
4. The contract established by the demand guarantee issued by G Bank to B (contract no (2) in Figure 2).

These four contracts are each completely separate from one another. Each contract does not concern any participant who is not a party to that particular contract. After P and B have concluded the construction contract, P instructs IP Bank to arrange for the issue of the demand guarantee by G Bank. P then gives IP Bank a counter-guarantee (or counter-indemnity) against its liability. Thereafter, IP Bank instructs G Bank to issue the demand guarantee and gives G Bank a counter-guarantee against its liability, and G Bank issues the guarantee to B.

When a demand is made under the demand guarantee, the claims flow in the direction indicated in Figure 2. If B makes a demand in terms of the demand guarantee, he presents it to G Bank, which is responsible for paying it (the demand) if it is in order; G Bank then makes a demand on IP Bank under the counter-guarantee, and if this (the demand) is in order, IP Bank must pay; and IP Bank, in turn, collects reimbursement from P, its customer, under the counter-indemnity.<sup>38</sup> In the case of breach of the underlying contract, P and B also have the right to claim damages from each other, depending on the circumstances.

<sup>38</sup> See the *Guide to the URDG op cit* note 10 at 12.

### 2.3.3 Relationships Created by a Demand Guarantee

From the above it is clear that depending on whether or not it is a direct (three-party) or indirect (four-party) demand guarantee there will either be three or four separate contracts:<sup>39</sup>

1. The underlying contract (i.e., construction contract) between the principal and the beneficiary;
2. The counter-indemnity contract (or reimbursement contract) between the principal and his bank (the guarantor in the case of a direct guarantee, or an instructing party in the case of an indirect guarantee);
3. The counter-guarantee contract (in the case of an indirect guarantee) issued by the instructing bank (principal's bank) to the beneficiary's bank (the guarantor); and
4. The contract established by the demand guarantee issued by either the principal's bank or the beneficiary's bank (depending on whether or not it is a direct or an indirect guarantee).

Each of the contractual relationships established by a demand guarantee is separate from the others.<sup>40</sup> The guarantor's undertaking (commitment) to the beneficiary arises once he issues the demand guarantee, and his obligation to pay is conditioned only on presentation of a demand and other specified documents in compliance with the terms and within the duration of the guarantee. The guarantor is not a party to the underlying contract and is not concerned with its performance or non-performance.<sup>41</sup>

The relationship between the principal and guarantor embodies an internal mandate. The guarantor must act in conformity with the terms of his customer's (principal's) mandate (the strictness of this obligation differs from one jurisdiction to another). If he fails to do so, he may forfeit his right to reimbursement, but those terms are of no concern to the beneficiary, whose right to payment depends solely on his acting in accordance with the terms of the demand guarantee.<sup>42</sup>

The principal is also not concerned with the contract between the guarantor and the beneficiary. Similarly, the beneficiary has no interest in the contract between the guarantor and the principal. Therefore, if the principal fails to put the guarantor in funds (i.e., complies with the indemnity) to cover the guarantee liability, the beneficiary's rights are not affected.<sup>43</sup>

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<sup>39</sup> For a discussion of the relationships on a commercial letter of credit, see Van Niekerk and Schulze *op cit* note 24 at 292–305; C Hugo 'Discounting Practices and Documentary Credits' (2002) 119 *South African Law Journal* 101 at 103–105; G Penn 'On-demand Bonds – Primary or Secondary Obligations?' [1986] 4 *Journal of International Banking Law* 224 at 226–227; J A Rondenberg 'Letters of Credit in Bankruptcy: Can the Independence Doctrine Survive Preference Attacks?' (1991) *Commercial Law Journal* 431 at 433; R Perrignon 'Performance Bonds and Standby Letters of Credit: The Australian Experience' (1991) *Journal of Banking and Finance Law and Practice* 157 at 159–160; and Eitelberg *op cit* note 24 at 123–125.

<sup>40</sup> Each of the relationships established by a commercial letter of credit is also separate from the others (see Van Niekerk and Schulze *op cit* note 24 at 292).

<sup>41</sup> See the *Guide to the URDG op cit* note 10 at 17; and cf Dinnie *op cit* note 13 at 128; and H N Bennett 'Performance Bonds and the Principle of Autonomy' (1994) *Journal of Business Law* 574 at 575.

<sup>42</sup> See the *Guide to the URDG op cit* note 10 at 17.

<sup>43</sup> See the *Guide to the URDG op cit* note 10 at 18.

## 2.4 TYPES OF DEMAND GUARANTEE

### 2.4.1 Introduction

Reference was made above to the difference between direct (three-party) and indirect (four-party) demand guarantees. Demand guarantees may also be classified by reference to the phase or part of performance they are designed to secure. It is possible for the parties to the underlying contract to have a single demand guarantee covering all phases or parts of performance, but parties often find it to be more convenient to have separate guarantees for specific phases of performance. Viewed from the principal's position, this has the advantage of limiting his liability in respect of a specific phase to the amount of the guarantee covering that phase, instead of having a much larger single guarantee where the entire amount of the guarantee could be demanded in the event of non-performance of any part of the contract.<sup>44</sup>

### 2.4.2 Main Types of Demand Guarantee

When construction or engineering companies or suppliers of goods conduct business in a foreign country, or even locally in their own countries, they are often required to provide certain types of demand guarantee at particular phases of the transaction (contract). The main types of guarantee they usually have to provide include the following:<sup>45</sup>

#### 2.4.2.1 Tender Guarantee (*Tender Bond or Bid Bond*)

The first type of guarantee that a construction or engineering company or supplier of goods often needs to furnish with its tender for a contract is the tender guarantee, tender bond or the bid bond. The tender guarantee often amounts to between 0.5 and 5 per cent of the contract price that is tendered.<sup>46</sup> Where tenders are invited, it is commonly a condition of consideration of the tender that the tenderer undertakes to sign the contract if it is awarded to him, to procure the issue of any performance or other guarantee required by the contract and not to alter or withdraw his tender in the meantime.<sup>47</sup>

The purpose of the tender guarantee, given for a specified percentage of the project value (contract price), is to safeguard the tender-inviting party (beneficiary) against breach of such an undertaking and to prevent frivolous bidders from submitting a tender. Should the tender then be awarded to the tenderer (contractor or supplier) and he decides not to execute the contract, the amount of the tender guarantee is forfeited in favour of the beneficiary (the party inviting tenders). The tender guarantee provides the beneficiary with a source of funds to help cover his additional unexpected costs should the successful tenderer not proceed with the contract when awarded to him; for example, by refusing to sign it or by failing to submit the required guarantee. It is also common practice for

<sup>44</sup> See the *Guide to the URDG* *op cit* note 10 at 13.

<sup>45</sup> See also *SITPRO's Financial Guide* *op cit* note 5 at 4; Schwank *op cit* note 26 at 319; and Perrignon *op cit* note 39 at 159.

<sup>46</sup> See A Pierce *Demand Guarantees in International Trade* (1993) at 5.

<sup>47</sup> See the *Guide to the URDG* *op cit* note 10 at 13; and P R Wood *Law and Practice of International Finance: International Loans, Bonds, Guarantees, Legal Opinion* 2 ed (2007) in para 22-004 at 389.

contractors or suppliers to protect their own interests by requiring their subcontractors or sub-suppliers to furnish similar tender guarantees.<sup>48</sup>

#### **2.4.2.2 Performance Guarantee (Performance Bond or Completion Bond)**

Another important guarantee that must often be furnished by a contractor, supplier or exporter of goods at the beginning of a construction or engineering project or an international sale of goods contract is the performance guarantee, performance bond or completion bond.<sup>49</sup> Used in its narrow sense, the performance guarantee is the guarantee of the central performance of the contract from commencement to completion (i.e., the phrase ‘performance guarantee’ is often used to cover a single guarantee covering all stages of the contract). The value of the performance guarantee in favour of a beneficiary is usually between 5 and 10 per cent of the contract value, and it is designed to safeguard the beneficiary against breach of contract by the contractor, supplier or exporter. However, there are phases in the relationship between the parties to the underlying contract that both precede and follow the central performance, and there may be distinct parts of liability to be covered within that performance as shown below.<sup>50</sup>

The function of a performance guarantee is to replace cash retained by way of security. The essence of a performance guarantee is that it should be like ‘cash in hand’. Performance guarantees are a means of ensuring completion of the contract or of extracting a financial penalty from the contractor, supplier or exporter if he fails to fulfil his obligations in terms of the contract.<sup>51</sup> In practice, performance guarantees tend to be used where the underlying obligation is not the payment of money, but the performance of other obligations such as those arising from a building contract.<sup>52</sup>

#### **2.4.2.3 The Advance Payment Guarantee (Repayment Guarantee or Interim Payment Guarantee)**

In instances where the underlying contract entitles a contractor to payment of stated sums in advance of performance, the counterparty to the contract could also require a guarantee for the repayment of the advanced money in the event of default by the contractor.<sup>53</sup> The advance payment guarantee, repayment guarantee or interim payment guarantee often amounts to between 10 and 20 per cent of the contract value. The advance payment guarantee is designed to secure the beneficiary’s right to repayment of the advance if the performance to which it relates is not provided.<sup>54</sup>

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<sup>48</sup> See the *Guide to the URDG op cit* note 10 at 13; *Pierce op cit* note 46 at 5–6; and J J C Smit ‘Performance Bonds’ (1979) *Moderne Besigheidsreg* 148.

<sup>49</sup> A performance guarantee is only one of a number of guarantees that might have to be furnished during the course of a contract, or even before signature. See *Wood op cit* note 47 in para 22–004 at 389.

<sup>50</sup> See the *Guide to the URDG op cit* note 10 at 13 and *Pierce op cit* note 46 at 6.

<sup>51</sup> See Bennett *op cit* note 41 at 574 and 579; C Debattista ‘Performance Bonds and Letters of Credit: A Cracked Mirror Image’ (1997) *Journal of Business Law* 289 at 289; and Smit *op cit* note 48 at 148.

<sup>52</sup> See *Paget’s Law of Banking op cit* note 17 at 729.

<sup>53</sup> See *Wood op cit* note 47 in para 22–004 at 389.

<sup>54</sup> See the *Guide to the URDG op cit* note 10 at 13–14; and *Pierce op cit* note 46 at 6–7.



#### 2.4.2.4 *Retention Guarantee*

In local and international construction contracts it is also common practice to provide for phased payments against architects' or engineers' certificates and for a particular percentage of the amount certified in each certificate to be retained (retention moneys) by the employer of the contract for a specified period as a safeguard against defects. This permits the employer to retain a specified percentage of the total contract price pending satisfactory performance by the contractor. In the case of default by the contractor, the party containing the retention money is spared the need to resort to a legal process to secure final redress in so far as he may simply keep the retention money or a part thereof. However, the employer may be willing to release such retention moneys against a retention guarantee securing repayment of the released retention moneys if defects are later found or if the contractor fails to complete the contract. This enables the contractor to receive a large portion of the contract price (thereby improving his cashflow) while the retention guarantee remains outstanding for a certain period (the maintenance or defects liability period), often up to one year, to safeguard the employer against latent defects. At the end of the maintenance period the employer issues the final job completion certificate and the guarantee expires.<sup>55</sup>

#### 2.4.2.5 *Maintenance Guarantee (Warranty Guarantee)*

Usually, construction contracts provide that on completion of the contract, the retention moneys are to be retained for a certain period (the maintenance or defects liability period) to cover the costs of any defects or malfunction that becomes apparent during that period. However, the employer may be willing to release this remaining part of the retention moneys against a maintenance guarantee or warranty guarantee for a certain percentage of the contract value. The purpose of this guarantee is to ensure that, once the contract has been completed, the contractor, having been paid the full contractual price, will continue to fulfil his obligations during the maintenance or warranty period.<sup>56</sup>

### 2.4.3 **Other Types of Demand Guarantees not Generated by the Underlying Contract**

There are also other types of demand guarantees that are not in favour of a party to the underlying contract and therefore fall outside the scope of this thesis. For example, customs guarantees or bonds are issued to the customs to cover any duty that may become payable when imported goods that would be exempt from duty if re-exported within an exact time are not in fact re-exported within that time. They give the customs department in the buyer's country assurance that import duty will be paid if re-export does not take place by a set date. Another example is the freight guarantee or bond, often associated with the international construction industry where special freight rates are quoted for the two-way transportation of the construction plant. This serves to assure the shipping company that if the construction plant is sold off locally and not reshipped, then the unearned discount on the freight will be repaid.<sup>57</sup>

<sup>55</sup> See Smit *op cit* note 48 at 148; the *Guide to the URDG op cit* note 10 at 14; Pierce *op cit* note 46 at 7; and Wood *op cit* note 47 in para 22–004 at 389.

<sup>56</sup> See the *Guide to the URDG op cit* note 10 at 14; Pierce *op cit* note 46 at 7; and Wood *op cit* note 47 in para 22–004 at 389.

<sup>57</sup> See Pierce *op cit* note 46 at 7–8; and the *Guide to the URDG op cit* note 10 at 14.

## 2.5 THE LEGAL NATURE, CHARACTERISTICS AND FUNDAMENTAL PRINCIPLES OF DEMAND GUARANTEES

A demand guarantee is an abstract payment undertaking (a promise of payment) which, though intended to protect the beneficiary from loss in relation to the underlying contract, is separated from the underlying contract between principal and beneficiary, and is in form a primary undertaking between guarantor and beneficiary that becomes binding solely by way of its issue and the beneficiary's acceptance of it. Therefore, once the terms and conditions of the guarantee are met, the beneficiary is entitled to claim payment and he need not show default in any other way than that stipulated in the terms of the guarantee.<sup>58</sup>

### 2.5.1 Traditional Guarantees (Suretyship Guarantees), Commercial Letters of Credit and Demand Guarantees

'Guarantees are usually taken to provide a second pocket to pay if the first should be empty.'<sup>59</sup> Guarantees and indemnities, which are also described as 'securities', are distinct arrangements in terms of which a third party – the surety (guarantor) – agrees to assume liability if the debtor defaults or causes loss to the creditor. The former arrangement is a guarantee (suretyship) and the latter involves an indemnity.<sup>60</sup> Therefore, a guarantee is usually issued to cover a credit transaction; in other words, the guarantee is issued as financial security by a third party in favour of the creditor.<sup>61</sup>

In South African law the words 'guarantee' and 'suretyship' have often been referred to as synonymous and have been referred to interchangeably by legal writers and courts alike. For example, sometimes the word 'guarantee' or variants of the word are used when suretyship is meant. Other times the word 'guarantee' is meant to be used as a verb and the meaning is then more straightforward. In recent years this practice of using the words 'guarantee' and 'suretyship' synonymously and interchangeably has been criticised. However, this practice is ingrained in the South African law reports and will be difficult to eradicate.<sup>62</sup> It is not my intention to distinguish between the exact differences between the words 'guarantee' and 'suretyship', nor is it my intention to distinguish between the

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<sup>58</sup> See the *Guide to the URDG op cit* note 10 at 14; *Pierce op cit* note 46 at 15; R Bertrams *Bank Guarantees in International Trade: The Law and Practice of Independent (First Demand) Guarantees and Standby Letters of Credit in Civil Law and Common Law Jurisdictions* 3 ed (2004) at 11; *Paget's Law of Banking op cit* note 17 at 730; and *Dinnie op cit* note 13 at 127. See also further, article 2(b) of the URDG; rules 1.06 and 2.01(a) of the International Standby Practices (hereinafter the 'ISP98') (for a full discussion of these rules, see para 3.2.6 in Chapter 3 and para 4.3.1 in Chapter 4); and articles 2 and 3 of the United Nation's Convention on Independent Guarantees and Stand-by Letters of Credit (1996) (hereinafter the 'UNCITRAL Convention' or the 'Convention' interchangeably) (for a full discussion of this Convention, see para 3.3 in Chapter 3 and para 4.4 in Chapter 4).

<sup>59</sup> See P R Wood *Law and Practice of International Law: Comparative Law of Security and Guarantees* (1995) in Chapter 24 at 313.

<sup>60</sup> See E P Ellinger *Modern Banking Law* (1987) at 259.

<sup>61</sup> See L Gorton 'Draft UNCITRAL Convention on Independent Guarantees' (May 1997) *Journal of Business Law* 240 at 240.

<sup>62</sup> See C F Forsyth and J T Pretorius *Caney's Law of Suretyship in South Africa* 5 ed (2002) in note 7 at 27; and *Mouton v Die Mynwerkersunie* 1977 (1) SA 119 (A). In the English law the word 'guarantee' is used loosely to describe a contract that is actually an indemnity and *vice versa* (see G M Andrews and R Millett *Law of Guarantees* 3 ed (2000) in para 1-003 at 2).

‘suretyship’ and the ‘indemnity contract’.<sup>63</sup> The generic term ‘guarantee’ can comprise two very different devices: (1) the primary guarantee (i.e., demand guarantee) and (2) the secondary (accessory) guarantee (i.e., suretyship guarantee). In this thesis, the word ‘guarantee’ will be used to refer to the first device, unless specifically indicated otherwise.<sup>64</sup> However, as demand guarantees and letters of credit (including standby letters of credit) are also sometimes regarded as either forms of guarantees, particularly contracts of suretyship,<sup>65</sup> or closely related to them, but with distinct characteristics,<sup>66</sup> it is important for current purposes to distinguish the demand guarantee, the commercial letter of credit and the suretyship guarantee (i.e., a true or traditional guarantee) from one another.<sup>67</sup> From the discussion below, it will be seen that the demand guarantee is unique in character and actually stands between the suretyship guarantee (where the undertaking to pay is secondary both in intent and in form (i.e., it is accessory to the principal debt)) and the commercial letter of credit (where the undertaking to pay is primary both in form and intent), in the sense that, it is secondary in intent but primary in form (i.e., the guarantor has a secondary intent to pay, but the payment obligation is primary in form).

It is a question of construction whether a particular contract is a true guarantee or a demand guarantee.<sup>68</sup>

### **2.5.1.1 Traditional Guarantees (Suretyship Guarantees), Surety Bonds and Contract Bonds**

The Roman law and the Roman-Dutch common law required no formalities regarding contracts of suretyship.<sup>69</sup> Initially, it was not necessary for a contract of suretyship to be

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<sup>63</sup> For a discussion of the difference between suretyship and contract of guarantee, see Forsyth and Pretorius *op cit* note 62 at 30–32 and the authorities cited; and for a discussion of the differences between a contract of suretyship and indemnity contract, see also J T Pretorius ‘Borgkontrak of Vrywaringskontrak?’ (1982) 45 *Tydskrif vir Hedendaagse Romeins-Hollandse Reg* 7; G F Lubbe ‘Die Onderskeid tussen Borgtog en Ander Vorme van Persoonlike Sekerheidstellings (1984) 47 *Tydskrif vir Hedendaagse Romeins-Hollandse Reg* 383; J C de Wet and A H van Wyk *Die Suid-Afrikaanse Kontraktereg en Handelsreg* (Vol No 1) 5 ed (1992) at 391; J T Pretorius ‘Surety and Indemnity’ (2001) 13 *South African Mercantile Law Journal* 95; and A P M de Villiers *The Suretyship and the Indemnity Contract Differentiated* (unpublished LLM dissertation, University of South Africa) (undated) and the authorities cited there (see also note 81 below for a brief discussion of the indemnity contract).

<sup>64</sup> See also para 1.2 in Chapter 1.

<sup>65</sup> See Van Niekerk and Schulze *op cit* note 24 at 302. It has also been said that a demand guarantee is comparable to an indemnity rather than a suretyship (for a full discussion of this, see Penn *op cit* note 39 at 225–226). However, for a view that a demand guarantee is distinguished from a true indemnity, see Perrignon *op cit* note 39 at 161.

<sup>66</sup> See, e.g., J F Dolan *The Law of Letters of Credit: Commercial and Standby Credits* Revised Edition (loose-leaf) (1996) (hereinafter ‘Dolan: *The Law of Letters of Credit*’) in para 2.10[1]; and Andrews and Millett *op cit* note 62 at 1; and O’Brien *op cit* note 3 at 158.

<sup>67</sup> *Marubeni Hong Kong and South China Ltd v Government of Mongolia* [2005] 2 Lloyd’s Rep 231 (CA) serves as a good example of the importance of distinguishing clearly between independent undertakings and secondary guarantees (for a full discussion of this case, see C Hugo ‘Documentary Credits and Independent Guarantees’ *ABLU* 2006 (a paper delivered at the 2006 Annual Banking Law Update held at the Indaba Hotel, Johannesburg during April 2006) 160 (hereinafter ‘*ABLU 2006*’) at 171–175).

<sup>68</sup> See, e.g., *Marubeni Hong Kong and South China Ltd v The Mongolian Government* [2004] 2 Lloyd’s Rep 198 (QB (Com Ct)).

valid to take a specific form or to be embodied in writing.<sup>70</sup> This position was later changed by legislation. Today, section 6 of the General Law Amendment Act<sup>71</sup> requires that the terms of a contract of suretyship must be embodied in a written document signed by, or on behalf of, the surety, in order to be valid and enforceable in the South African law.<sup>72</sup>

Unfortunately, section 6 neglected to define what a contract of suretyship was.<sup>73</sup> The early and classical jurists also did not clearly define the contract of suretyship.<sup>74</sup> Although some Roman-Dutch jurists tried to offer a definition, none of them could offer an exact definition of the suretyship.<sup>75</sup> The lack of a legislative definition or any other proper definition of the suretyship led to disagreements among South African jurists.<sup>76</sup> The courts also tried to formulate definitions.<sup>77</sup> For instance, in *Corrans and Another v Transvaal Government and Coull's Trustee*<sup>78</sup> Innes CJ said that the definitions of the old authorities came to this, namely

that the undertaking of the surety is accessory to the main contract, the liability under which he does not disturb, but it is an undertaking that the obligation of the principal debtor will be discharged, and, if not, that the creditor will be indemnified.

Eventually, Forsyth and Pretorius provided a well-drafted definition of the suretyship. They define the suretyship as an

accessory contract by which a person (the surety) undertakes to the creditor of another (the principal debtor), primarily that the principal debtor, who remains bound, will perform his obligation to the creditor and, secondarily, that if and so far as the principal debtor fails to do so, the surety will perform it or, failing that, indemnify the creditor.<sup>79</sup>

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<sup>69</sup> See J A C Thomas *Textbook of Roman Law* 2 ed (1981) at 335; H R Hahlo and E Khan *The Union of South Africa: The Development of Its Laws and Constitution* (1960) at 705; Forsyth and Pretorius *op cit* note 62 at 25; and De Villiers *op cit* note 63 at 3.

<sup>70</sup> See De Villiers *op cit* note 63 at 3.

<sup>71</sup> Act 50 of 1956.

<sup>72</sup> For a full discussion of the law of suretyship, see Forsyth and Pretorius *op cit* note 62; and J G Lotz (revised by J J Henning) 'Suretyship' in WA Joubert (ed) *The Law of South Africa* (Vol No 26) (first reissue, 1997) at paras 189–217 at 191–222.

<sup>73</sup> See Forsyth and Pretorius *op cit* note 62 in note 2 at 24.

<sup>74</sup> See A A Roberts *Wessels, Sir JW: The Law of Contract in South Africa* (Vol 2 No 2) 2 ed (1951) at § 3785 at 969.

<sup>75</sup> See N J Grové *Die Formaliteitsvereiste by Borgstelling* (unpublished LLM dissertation, University of Pretoria) (1984) at 65; and De Villiers *op cit* note 63 at 4.

<sup>76</sup> See Grové *op cit* note 75 at 65, who refers to Roberts *op cit* note 74 as authority.

<sup>77</sup> See *Corrans and another v Transvaal Government and Coull's Trustee* 1909 TS 605 at 612; and *Gerber v Wolson* 1955 (1) SA 158 (A) at 166.

<sup>78</sup> 1909 TS 605 at 612. This definition was approved in *Hutchinson v Hylton Holdings and Another* 1993 (2) SA 405 (T).

<sup>79</sup> See Forsyth and Pretorius *op cit* note 62 at 27–28.

Their definition of suretyship has since been supported by the Appellate Division (as it was known then).<sup>80</sup> According to them, the fact that the surety's obligation is an accessory obligation, simply means that in order to constitute a valid suretyship between surety and creditor, there has to be a valid principal obligation between the debtor and the creditor. The suretyship is said to be accessory to the transaction that creates the obligation of the principal debtor. In other words, every suretyship is conditional upon the existence of a principal obligation. Therefore, in the absence of a valid principal obligation, the surety is generally not bound and the surety can raise any defence that the principal debtor can raise.<sup>81</sup>

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<sup>80</sup> See e.g., *Trust Bank of Africa Ltd v Frysch* 1977 (3) SA 562 (A) at 584F; *Sapirstein and Others v Anglo African Shipping Co (SA) Ltd* 1978 (4) SA 1 (A) at 11H; and *Nedbank Ltd v Van Zyl* 1990 (2) SA 469 (A) at 473I. It was also referred to with approval in *Basil Read (Pty) Ltd v Beta Hotels (Pty) Ltd and Others* 2001 (2) SA 760 (C) at 766F. See in this regard, Forsyth and Pretorius *op cit* note 62 at 27. However, in *Carrim v Omar* 2001 (3) All SA 71 (W) Stegmann J (in para 57 at 93) disagreed with the definition given by Forsyth and Pretorius and stated:

In light of these considerations, I am respectfully, but firmly, of the view that Caney's definition of the contract of suretyship as comprising a primary undertaking by the surety that the principal debtor will perform his obligation, and only a secondary obligation that if the principal debtor defaults, the surety will indemnify the creditor, cannot be supported. The authorities establish clearly enough that by the contract of suretyship, the surety accedes to the obligation of the principal debtor in the sense that, without disturbing the primary liability of the principal debtor, the surety gives a conditional undertaking that if the principal debtor should fail to perform his obligation, the surety will perform it in his place, if appropriate, or will otherwise indemnify the creditor. Such other indemnification will generally take the form of the payment of such damages as the creditor may have suffered in consequence of the principal debtor's breach of contract. It is not a prerequisite of a contract of suretyship that the intending surety should primarily undertake that the principal debtor will perform his obligation to the creditor.

However, not all jurists agree with the definition provided by Forsyth and Pretorius. For instance, Lotz (*op cit* note 72 in para 190 at 192) states that although there is no universally accepted definition of suretyship, that the following definition correctly reflects the normal incidents of a suretyship:

Suretyship is a contract in terms of which one person (the surety) binds himself as debtor to the creditor of another person (the principal debtor) to render the whole or part of the performance due to the creditor by the principal debtor if and to the extent that the principal debtor fails, without lawful excuse, to render the performance himself.

Lotz, in criticising the definition provided by Forsyth and Pretorius, states that while it can be accepted that it will, at the time of contracting, be in the mind of both the creditor and the surety that the principal debtor will perform, it seems futile to say that the surety's primary undertaking is that the principal debtor will perform as that 'primary undertaking' clearly does not create a primary (or any) obligation between the creditor and the surety. Furthermore, if such a primary obligation were indeed created, a creditor would probably have to call on a surety to perform in terms of the primary obligation (i.e., call on the surety to persuade the principal debtor to perform) before enforcing the secondary obligation and that is not the law (see in para 191 at 193).

<sup>81</sup> See Forsyth and Pretorius *op cit* note 62 at 28. In our law the contract of suretyship is also a contract of indemnity, because it is entered into for the better security of the creditor. However, the same cannot be said of indemnity contracts, because not all contracts of indemnity are contracts of suretyship. The absolute and independent nature of the contract of indemnity distinguishes itself from the subsidiary and accessory nature of the contract of suretyship (see Roberts *op cit* note 74 at § 3795; and De Villiers *op cit* note 63 at 6)). There is no statutory definition or acceptable definition of contract of indemnity in modern South African literature or case law. The latest definition offered, which took all previous definitions provided by jurists as well as courts into consideration, defines a contract of indemnity (see De Villiers *op cit* note 63 at 8–9 and the authorities cited) as:

an agreement in terms whereof a person (the indemnifier), binds himself as principal debtor to another (the indemnified), to protect, secure and hold the indemnified

Today, another Act also needs to be taken into consideration when dealing with a contract of suretyship. The National Credit Act<sup>82</sup> provides that, subject to certain exemptions, the Act generally applies to every credit agreement (e.g., money-lending transactions irrespective of the amount) between parties dealing at arm's length and made or having an effect in South Africa.<sup>83</sup> The National Credit Act defines the word 'credit' when used as a noun as: 'a deferral of payment of money owed to a person, or a promise to defer such a payment; or a promise to advance or pay money to or at the direction of another person'.<sup>84</sup> The Act also defines a 'credit agreement' in section 8 and states that it includes a 'credit facility';<sup>85</sup> or a 'credit transaction';<sup>86</sup> or a 'credit guarantee';<sup>87</sup> or any combination of the aforementioned.

Furthermore, section 8(5) of the Act provides that an agreement will be a credit guarantee if 'in terms of that agreement, a person undertakes or promises to satisfy upon demand any obligation of another consumer in terms of a credit facility or a credit transaction' to which the National Credit Act applies. A general contract of suretyship in terms whereof the surety provides personal security for the debts of another person will meet the definition of a 'credit guarantee' if the principal debt (i.e., the credit agreement) is a debt (an agreement) that falls within the scope of the National Credit Act.<sup>88</sup> Such a surety would thus be entitled to rely on the various protection mechanisms of the National Credit Act by raising, for example, the defence that the credit guarantee (principal debt) itself amounted to 'reckless credit lending',<sup>89</sup> or that the entire credit agreement is unlawful<sup>90</sup> or a specific provision in the agreement is unlawful.<sup>91</sup> The National Credit Act does not stipulate that there are any formalities that need to be complied with for such a contract of suretyship to be valid. However, the Act does deal with all the issues relating specifically to the credit agreement (i.e., principal debt) in order for it to be valid. For example, the Act stipulates certain disclosures that need to be made by the creditor before a credit agreement may be

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harmless against any hurt, harm or loss sustained, or legal responsibility incurred by the indemnified as a result of past or future events, whatever the nature of such events, and which form the subject matter of the indemnity.

In practice, it is often difficult to distinguish between a suretyship and a contract of an indemnity, particularly because they share many similarities, but also have important differences. A discussion of the differences and similarities of a suretyship and a contract of indemnity falls outside the scope of this thesis, but a full discussion thereof can be found in the following sources: J T Pretorius 'Borgkontrak of Vrywaringskontrak?' (1982) 45 *Tydskrif vir Hedendaagse Romeins-Hollandse Reg* 7; Lubbe *op cit* note 63; De Wet and Van Wyk *op cit* note 63 at 391; J T Pretorius 'Surety and Indemnity' (2001) 13 *South African Mercantile Law Journal* 95; and De Villiers *op cit* note 63.

<sup>82</sup> Act 34 of 2005. Hereinafter 'the National Credit Act' or 'the Act'.

<sup>83</sup> See section 4 of the National Credit Act.

<sup>84</sup> See section 1.

<sup>85</sup> See section 8(3).

<sup>86</sup> See section 8(4).

<sup>87</sup> See section 8(5).

<sup>88</sup> See J M Otto *The National Credit Act Explained* (2006) at 21.

<sup>89</sup> See section 80 of the National Credit Act.

<sup>90</sup> See section 89.

<sup>91</sup> See section 90.

concluded, and the form or format in which the credit agreement must be. Furthermore, the Act also prohibits a number of terms that were often found in the standard terms and conditions of many credit agreements in the past. For instance, terms waiving certain common law rights, such as the liability for latent defects; and terms exempting or limiting the credit provider's liability for pre-contractual misrepresentation or its vicarious liability for employees may not be included in credit agreements. The Regulations to the Act<sup>92</sup> also specifically provide that the following common law rights or remedies that are available to a debtor may not be waived in a credit agreement: *exceptio errore calculi*, *exceptio non numerate pecuniae* and *exceptio non causa debiti*. However, where the principal debt is not a 'credit agreement' that falls under the provisions of the Act, the suretyship will fall under the common law and the surety will not be entitled to raise any of the defences or provisions of the National Credit Act.

In the English law a 'guarantee' is defined as a promise to be liable for the debt, or failure to perform some other legal obligation, of another person.<sup>93</sup> The person to whom the promise is made, for example a bank, may be called the 'creditor', the person who makes the promise is the surety or guarantor, and the other whose obligation is guaranteed, for example, the bank's customer, is the principal debtor.<sup>94</sup> A true guarantee obligation (e.g., suretyship) is secondary and accessory to the obligation, the performance of which is guaranteed; and the surety (or guarantor) undertakes that the principal debtor (bank's customer) will perform his (the principal debtor's) obligation to the creditor (bank) and that he (the guarantor or surety) will be liable to the creditor if the principal debtor does not perform. The guarantor's (surety's) liability for the non-performance of the principal debtor's obligation is therefore co-extensive with that obligation. This means that if it turns out that the principal debtor's obligation does not exist, is void, discharged or diminished, the guarantor's (surety's) obligation in respect thereof is also. This is contrary to the situation where a primary or direct undertaking has been given to perform the customer's obligation. If the undertaking is of this nature, then the promise will be enforceable whether or not that of the principal debtor is enforceable.<sup>95</sup>

When a bank advances money to its customer, it often requires security from a third party by way of a contract of guarantee (i.e., contract of suretyship) to secure the money

<sup>92</sup> See Regulation Gazette No 8477, R489 in GG 28864 of 31 May 2006.

<sup>93</sup> See section 4 of the Statute of Frauds 1677 (England); and see also the authorities cited in *Paget's Law of Banking op cit* note 17 at 701 and in endnote 1 at 702. For a full discussion of the law of guarantee (including any formal requirements a contract of guarantee must comply with), see *Paget's Law of Banking op cit* note 17 in Chapter 33 at 701–726; Andrews and Millett *op cit* note 62; and O'Donovan and Phillips *op cit* note 1. Section 4 of the Statute of Frauds 1677, which apparently does not apply to contracts of indemnity, (see Andrews and Millett *op cit* note 62 at 2) provides that (for a full discussion of section 4, see Andrews and Millett *op cit* note 62 in Chapter 3):

no action shall be brought . . . whereby to charge the defendant upon any special promise to answer for the debt default or miscarriage of another person . . . unless the agreement upon which such action shall be brought or some memorandum or note thereof shall be in writing and signed by the party to be charged therewith or some other person thereunto by him lawfully authorised.

<sup>94</sup> See *Paget's Law of Banking op cit* note 17 at 701. For a discussion of the differences between a true guarantee, an indemnity, a demand guarantee, and a standby letter of credit in the English law, see R Bethell-Jones 'Guarantees and Indemnities: Some Important Differences' (2006) 21 *Journal of International Banking Law and Regulation* 156.

<sup>95</sup> See *Paget's Law of Banking op cit* note 17 at 701–702. See also Bennett *op cit* note 41 at 575.

advanced to the customer.<sup>96</sup> It has been stated that a ‘suretyship’ is the generic term given to contracts in terms of which one person (the surety) agrees to answer for some existing or future liability of another (the principal) to a third person (the creditor), and by which the surety’s liability is in addition to, and not in substitution for, that of the principal’s.<sup>97</sup> A suretyship guarantee is *secondary both in intent and in form*. The intention of the parties is that the surety (guarantor) will be called upon to pay (or, instead, to perform the principal debtor’s obligations under the underlying contract) only if the principal debtor defaults in performance, and then only to the extent of the principal debtor’s liability and subject to any defences available to the principal debtor. This intention is reflected in the form of the suretyship guarantee, which is expressed to become payable only upon the principal debtor’s default.<sup>98</sup>

In the United States suretyship is defined as a contractual relationship, synonymous with guarantee, in which one party promises to be answerable for the debt, default or miscarriage of another.<sup>99</sup> Dolan writes that, traditionally, a guarantee (guaranty) or surety contract is an undertaking by one party to assure a second party of payment or performance by a third party. The liability of the guarantor is secondary and arises upon non-performance by the third party, that is, the ‘principal obligor’.<sup>100</sup> In contrast, the liability of an issuer of a letter of credit (which includes a standby letter of credit) is primary, not secondary, and it arises on the presentation of documents, not on the

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<sup>96</sup> See the *Guide to the URDG op cit* note 10 at 15.

<sup>97</sup> See Andrews and Millett *op cit* note 62 in para 1-001 at 1. According to Andrews and Millett, the contracts of suretyship fall into two main categories: (1) contracts of guarantee and (2) contracts of indemnity. These contracts share many similar characteristics, and similar rights and duties arise between the parties. Often the word ‘guarantee’ is used loosely to describe a contract that is actually an indemnity and *vice versa* (see Andrews and Millett *op cit* note 62 in para 1-003 at 2). A contract of guarantee, in the true sense, is defined as a contract whereby the surety (or guarantor) promises the creditor to be responsible, in addition to the principal, for the due performance by the principal of his existing or future obligations to the creditor, if the principal fails to perform those obligations (see Andrews and Millett *op cit* note 62 in para 1-004 at 3). In *Wardens and Commonalty of the Mystery of Mercers of the City of London v New Hampshire Insurance Company* (1991) 3 *Journal of International Banking Law and Financial Law* 144 in para 101, the following definition of a guarantee was cited which is given in *Halsbury Laws of England* 4 ed (2004 reissue): ‘A guarantee is an accessory contract by which the promisor undertakes to be answerable to the promisee for the debt, default or miscarriage of another person, whose primary liability to the promisee must exist or be contemplated’.

A contract of indemnity, in its broadest sense, comprises an obligation imposed by operation of law or by contract on one person to make good a loss suffered by another. Therefore, most contracts of insurance and all contracts of guarantee fall within the broad definition. However, it seems that the term ‘contract of indemnity’ is more often used in the English law to denote a contract where the person giving the indemnity does so by way of security for the performance of an obligation by another (see Andrews and Millett *op cit* note 62 in para 1-012 at 10). In a contract of indemnity, contrary to a contract of guarantee, a primary liability falls upon the indemnifier, and that liability is wholly independent of any liability that may arise as between the principal and the creditor (unless the indemnifier undertakes a joint liability with the principal) (see Andrews and Millett *op cit* note 62 in para 1-013 at 10). This thesis is not concerned with a discussion of the differences between contracts of guarantee and contracts of indemnity. However, for a full discussion, see Andrews and Millett *op cit* note 62 at 1–13.

<sup>98</sup> See the *Guide to the URDG op cit* note 10 at 15.

<sup>99</sup> See Restatement Third, Suretyship and Guaranty, section 1 (1996); CA. Civ. Code section 2787; *Madison County Farmers’ Association v American Employers’ Ins Co* 209 F 2d 581, 585 (8th Cir 1954); and Gallagher *op cit* note 15 at 81.

<sup>100</sup> See Dolan: *The Law of Letters of Credit op cit* note 66 in para 2.10[1] at 2-61.



non-performance of a principal obligor.<sup>101</sup> As a surety or guarantee contract is secondary in nature, it depends on the non-performance of the principal obligor, whose performance the surety contract guarantees. The determination of guarantee liability requires an examination of the principal obligor's conduct. That determination is generally lengthy, complicated and costly. This differs inherently from the letter of credit's prompt payment feature that rests on the practice of examining documents at a desk in a bank.<sup>102</sup>

Kurkela<sup>103</sup> provides that in traditional guarantees the guarantor, generally a bank or an insurance company, guarantees, that is, assumes an undertaking to pay (up to) a certain amount of money for, and on behalf of, the account party to the beneficiary should the account party, that is, the obligor under the transaction, fail to meet its obligations under it. Such a guarantee may cover one or specific duties of the account party or one or several generic duties of the primary obligor or his performance as a whole under the transaction. The so-called sureties seem to function in similar ways. Therefore, a traditional guarantee is secondary (and accessory) in the sense that it requires a breach or alleged breach or failure under the transaction as a condition before it will become payable. In Kurkela's view, the word 'secondary' describes this substantive dependence (requiring a proved default under the underlying transaction) better than the word 'accessory' does, because all of these instruments are in one way or another accessory. Secondary guarantees are normally subject to the same substantive law and the same jurisdiction or arbitration clause to which the transaction itself is subject.<sup>104</sup>

In contrast to this, the demand guarantees and letters of credit create another kind of duty that is a primary duty which is not materially, that is, substantively conditional on bringing proof of the breach or failure of the primary obligor under the transaction. These instruments are in this regard materially independent, and they may become due and payable before any such duty arises under the transaction or even entirely regardless of whether or not any such duty matures now or later on.<sup>105</sup>

Insurance companies can also act as sureties by issuing 'performance guarantees or bonds'. In this regard, performance guarantees or bonds may either be formulated: positively, in which case the insurer becomes an immediate surety *in solidum* for, and co-principal debtor jointly and severally with, the contractor or supplier for the due and punctual performance and due discharge by the contractor or supplier of all his obligations under the contract; or negatively, in which case the contract of guarantee comes into existence once (actual) proof of default by the contractor has been established. When these types of guarantee are issued, they are known as a 'surety bond' or 'contract bond' and the normal principles of suretyship apply.<sup>106</sup> The essence of suretyship is the existence of the principal

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<sup>101</sup> *Idem.*

<sup>102</sup> See Dolan: *The Law of Letters of Credit op cit* note 66 in para 2.10[1] at 2-63–2-64.

<sup>103</sup> See Kurkela *op cit* note 1 at 11–12.

<sup>104</sup> See Kurkela *op cit* note 1 at 13.

<sup>105</sup> See Kurkela *op cit* note 1 at 12–13.

<sup>106</sup> The ICC has even drafted uniform rules for these types of guarantee (see Uniform Rules for Contract Bonds, ICC Publication No 524, Paris (1993) (hereinafter the 'URCB'). For a full discussion of the URCB, see para 3.2.7 in Chapter 3. The URCB uses the word 'accessory' in the meaning of substantive dependence as opposed to substantive independence (see Kurkela *op cit* note 1 in note 20 at 12). Article 3(b) of the URCB provides:

obligation of the debtor to which that surety becomes accessory.<sup>107</sup> This type of guarantee is issued conditionally and is depended upon (accessory to) the underlying contract.<sup>108</sup> Demand guarantees differ specifically from ‘contract bonds’ or ‘surety bonds’ in that the security lender (i.e., surety/guarantor) of the surety or contract bond is only involved if the principal party actually defaults in the performance of an obligation.<sup>109</sup> Because of the different nature of this type of surety bond or contract bond, these bonds fall outside the scope of this thesis.

A bank demand guarantee in contrast can be described as a personal security under which a bank promises payment to a beneficiary if a principal (the bank’s customer) defaults in the performance of his obligation. The bank pays if the documents presented with the demand for payment (where applicable) comply with the documents that are mentioned in the text of the demand guarantee. The bank’s obligations are independent (autonomous) of the underlying contract between the beneficiary and the principal, which means that, in principle, the bank must pay if proper complying documents are presented, even if the beneficiary and the principal have not stipulated that there is a default under the original underlying contract.<sup>110</sup>

### 2.5.1.2 Commercial Letters of Credit

Contrary to the traditional guarantee (i.e., suretyship guarantee), the commercial letter of credit is a credit in which the bank’s *undertaking to pay is primary both in form and intent*. The classic case is a commercial letter of credit covering the price of a shipment of goods under a documentary sale transaction (particularly international sale transactions).<sup>111</sup> The agreed method of payment of the price is not payment by the buyer, but payment by the bank pursuant to its independent undertaking. The bank is the first port of call for payment, and the buyer’s direct payment obligation under the contract of sale is suspended pending presentation of the documents and payment by the bank. Only if the documents are properly presented and the bank declines to pay, does the buyer’s own duty of payment revive.<sup>112</sup> If the credit is honoured, that duty is extinguished; while if the bank refuses to pay because of the seller’s failure to tender conforming documents, the buyer is entitled to

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The liability of the Guarantor to the Beneficiary under the Bond is accessory to the liability of the Principal to the Beneficiary under the Contract and shall arise upon Default. The Contract is deemed to be incorporated into and form part of the Bond. The liability of the Guarantor shall not exceed the Bond Amount.

<sup>107</sup> For a full discussion, see Forsyth and Pretorius *op cit* note 62; and cf Smit *op cit* note 48 at 148 and the authority cited in note 2 at 149.

<sup>108</sup> In the United States the term ‘performance bond’ is used to refer to these types of surety bonds. In this regard, see also note 15 above.

<sup>109</sup> See De Ly *op cit* note 13 in note 5 at 832. For a full discussion of the distinction between surety bonds and demand guarantees, see R M Goode ‘Surety and On-Demand Performance Bonds’ (1988) *Journal of Business Law* 87.

<sup>110</sup> See De Ly *op cit* note 13 at 832; and para 2.1 above.

<sup>111</sup> A commercial letter of credit is also used in other international transactions, see, e.g., *Deutsche Rückversicherung AG v Walbrook Insurance Co Ltd and Others; Group Josi Re (formerly known as Group Josi Reassurance SA) v Walbrook Insurance Co Ltd and Others* [1994] 4 All ER 181 (QBD).

<sup>112</sup> See Eitelberg *op cit* note 24 at 121.

withhold payment and, indeed, to treat the contract of sale as repudiated in the absence of a fresh and conforming tender within the period of the credit.<sup>113</sup>

In this scenario, the intention of the parties to the underlying contract (i.e., contract of sale) is that the bank issuing the commercial letter of credit is to be the first port of call for payment and this is the effect of the agreement between them. Whereas in the case of a traditional guarantee (i.e., suretyship guarantee) the beneficiary cannot make a call for payment on the guarantor without establishing default by the principal debtor, the opposite is true of the commercial letter of credit where the parties have elected payment by the bank as the primary method of payment. Only if this fails without fault on the part of the beneficiary is he (the beneficiary) entitled to resort to the buyer (principal) under the underlying contract of sale.<sup>114</sup>

### 2.5.1.3 Demand Guarantees

The demand guarantee<sup>115</sup> stands between the traditional guarantee (i.e., suretyship guarantee) and the commercial letter of credit in the sense that it is *secondary in intent but primary in form*. Performance in terms of the underlying contract is due, in the first instance, from the principal and the demand guarantee is intended to be resorted to only if the principal has failed to perform. Although this is the intention of the parties, the demand guarantee is not in form linked to default under the underlying contract, nor is there any question of performance of that contract by the guarantor. The only purpose of the demand guarantee is to hold the beneficiary risk-free up to the agreed maximum amount; and the only condition of the guarantor's payment liability is the presentation of a demand and all the other documents (if any) specified in the guarantee in the prescribed manner and within the period of the guarantee.<sup>116</sup>

The demand guarantee is unique in its character. The guarantor is not concerned with the underlying contract, and if the demand is duly presented, payment must be made – in spite of allegations by the principal that he (the principal) has fully performed in terms of that contract – in the absence of established fraud or other event constituting grounds for non-payment under the applicable law.<sup>117</sup> The guarantor (bank) of a demand guarantee therefore promises or gives a primary or direct undertaking to perform the principal's obligation, irrespective of whether or not the principal's (principal debtor's) obligation is enforceable.<sup>118</sup>

<sup>113</sup> See R Goode 'Abstract Payment Undertakings and the Rules of the International Chamber of Commerce' (1995) 39 *Saint Louis University Law Journal* 725 at 729; and Schwank *op cit* note 26 at 318.

<sup>114</sup> See the *Guide to the URDG op cit* 10 at 15.

<sup>115</sup> It was pointed out by Barwick CJ in *Wood Hall Ltd v The Pipeline Authority and Another* (1979) 141 CLR 443 at 445, an Australian case, that the use of the word 'guarantee' in this context was inappropriate, because in such an instance the bank has a primary obligation to pay the beneficiary upon demand. It is not a relationship of surety and creditor, where the bank's obligation is a secondary obligation to pay upon default occurring under the underlying contract (see also B Zillmann 'A Further Erosion Into the Autonomy of Bank Guarantees?' (December 1997) 13(6) *Building and Construction Law* 354 at 354).

<sup>116</sup> See the *Guide to the URDG op cit* 10 at 15.

<sup>117</sup> See the *Guide to the URDG op cit* 10 at 15.

<sup>118</sup> See *Paget's Law of Banking op cit* note 17 at 701–702. Note also that the Statute of Frauds 1677 does not apply to an original or primary obligation (see *Paget's Law of Banking op cit* note 17 at 703).

The fundamental difference between a true guarantee (suretyship guarantee) and a demand guarantee is that the liability of a surety of a true guarantee is secondary, whereas the liability of the guarantor (issuer) of a demand guarantee is primary. A surety's liability is co-extensive with that of the principal debtor and, if the surety disputes default by the principal debtor, the creditor must prove such default. Neither statement applies to a demand guarantee. The principle that underlies demand guarantees is that each contract is autonomous. More specifically, the obligations of the guarantor of a demand guarantee are not affected by disputes under the underlying contract between the beneficiary and the principal. If the beneficiary makes an honest demand, it does not matter whether between himself and the principal, he is entitled to payment.<sup>119</sup> The guarantor must honour such a demand, the principal must reimburse the guarantor or counter-guarantor (instructing party), and any disputes between the principal and the beneficiary, for example, any claim by the principal that the drawing was a breach of the contract between them, must be resolved in separate proceedings to which the guarantor will not be a party.<sup>120</sup> Therefore, if actual proof of breach or non-performance is required under the guarantee, the facility is not a demand guarantee, but a true guarantee in the strict sense.

The guarantor of the demand guarantee undertakes an absolute obligation to pay the beneficiary according to the tenor of the guarantee. The purpose of a demand guarantee is to guarantee performance of the underlying contract, whereas liability under a true guarantee is secondary in nature, dependent upon breach of the underlying contract. Furthermore, a demand guarantee generates a primary liability on its issuer, dependent

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<sup>119</sup> See *Paget's Law of Banking* op cit note 17 at 730; M Coleman 'Performance Guarantees' (1990) *Lloyd's Maritime and Commercial Law Quarterly* 223 at 224; and *State Trading Corp'n of India Ltd v ED and F Man (Sugar) Ltd and ANR* [1981] Com LR 235 (CA).

<sup>120</sup> See *Paget's Law of Banking* op cit note 17 at 730. In *Comdel Commodities Ltd v Siporex Trade SA* [1997] 1 Lloyd's Rep 424 (CA) at 431 Potter LJ explained:

Those authorities are to the effect that it is implicit in the nature of a performance bond that, in the absence of some clear words to a different effect, when the bond is called, there will at some stage in the future be an "accounting" between the parties to the contract of sale in the sense that their rights and obligations will finally be determined at some future date. The bond is a guarantee of due performance; it is not to be treated as representing a pre-estimate of the amount of damages to which the beneficiary may be entitled in respect of the breach of contract giving rise to the right to call for payment under the bond. If the amount of the bond is not enough to satisfy the seller's claim for damages, the buyer is liable to the seller for damages in excess of the amount of the bond. On the other hand, if the amount of the bond is more than enough to satisfy the seller's claim for damages, the buyer can recover from the seller the amount of the bond which exceeds the seller's damages.

In this case, the Court of Appeal clearly held that a performance guarantee was 'a guarantee of due performance' and not a 'pre-estimate of damages' which could be endured as a result of a breach of the underlying contract. This meant that if the performance guarantee exceeded the damages payable, the principal might be able to recover the excess on the restitutionary grounds (i.e., based on the underlying relationship) (see J C T Chuah *Law of International Trade* 2 ed (2001) in note 22 at 438). This view was also followed in *Cargill International SA v Bangladesh Sugar and Food Industries Corporation* [1998] 2 All ER 406 (CA) (for a full discussion of this case, see A N Oelofse 'Developments in the Law of Documentary Letters of Credit' *ABLU* 1997 (a paper delivered at the 1997 Annual Banking Law Update held at the Indaba Hotel, Johannesburg) (unpaginated) at 5–6 of his article). See also *TTI Team Telecom International Ltd and Another v Hutchison 3G UK Ltd* [2003] 1 All ER (Comm) 914 ([2003] All ER (D) 83 (Apr); and [2003] EWHC 762); and *Tradigrain SA v State Trading Corporation of India* [2006] 1 Lloyd's Rep 216 (for a full discussion, see R Fayers 'Developments Concerning the "Accounting Principle"' (October–December 2006) 12 *ICC's DCInsight* 18).

merely upon the beneficiary calling on the guarantee in conformity with any requirements stipulated therein. This independence of the demand guarantee from the underlying contract is enshrined in the cardinal principle of autonomy of the guarantee.<sup>121</sup>

## 2.5.2 Fundamental Principles of Demand Guarantees

From the discussion that follows it will become clear that, in essence, the demand guarantee shares many of the characteristics of the commercial letter of credit.<sup>122</sup>

### 2.5.2.1 Abstract Character of the Payment Undertaking

This thesis deals with abstract payment undertakings by banks: undertakings that are given to support a commercial contract between the bank's customer (principal) and the customer's counterparty (beneficiary), but that are considered in law distinct from, and largely independent of, that contract.<sup>123</sup> Three such payment instruments are: (1) the commercial letter of credit, (2) the standby letter of credit and (3) the demand guarantee.<sup>124</sup>

Goode<sup>125</sup> has said that these types of abstract payment undertakings do not fall within the ordinary contract principles. For example, 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.<sup>126</sup> The demand guarantee, for instance, comprises an abstract payment undertaking, which becomes binding solely by way of issue of the guarantee, subject to the beneficiary not rejecting it.<sup>127</sup> These payment undertakings are best regarded as mercantile specialties; undertakings which, through the usage of merchants, have effect by virtue of their issue without any additional requirements.<sup>128</sup> Prominent American writers treat such undertakings as engagements rather than as contractual promises in the strict sense.<sup>129</sup> English writers tend to regard them as

<sup>121</sup> See Bennett *op cit* note 41 at 575.

<sup>122</sup> See Bertrams *op cit* note 58 at 2–3; and Schwank *op cit* note 26 at 317.

<sup>123</sup> Goode has given the generic term 'abstract payment undertaking' to commercial letters of credit, standby letters of credit and to demand guarantees (see R Goode 'Abstract Payment Undertakings and the Rules of the International Chamber of Commerce' (1995) 39 *Saint Louis University Law Journal* 725; R Goode 'Abstract Payment Undertakings in International Transactions' (1996) XXII *Brooklyn Journal of International Law* 1; and Dolan *op cit* note 24 in note 1 at 1866). See also A N Oelofse *The Law of Documentary Letters of Credit in Comparative Perspective* (1997) (hereinafter '*Oelofse: The Law of Documentary Letters of Credit*') in para 9.1 at 354.

<sup>124</sup> See the *Guide to the URDG op cit* note 10 at 18; and R Goode 'Abstract Payment Undertakings in International Transactions' (1996) XXII *Brooklyn Journal of International Law* 1 at 3.

<sup>125</sup> *Idem*.

<sup>126</sup> See the *Guide to the URDG op cit* note 10 at 18; and R Goode 'Abstract Payment Undertakings in International Transactions' (1996) XXII *Brooklyn Journal of International Law* 1 at 3.

<sup>127</sup> See the *Guide to the URDG op cit* note 10 at 18.

<sup>128</sup> See R Goode 'Abstract Payment Undertakings in International Transactions' (1996) XXII *Brooklyn Journal of International Law* 1 at 3.

<sup>129</sup> See Dolan: *The Law of Letters of Credit op cit* note 66 in para 3.03; and cf R Goode 'Abstract Payment Undertakings in International Transactions' (1996) XXII *Brooklyn Journal of International Law* 1 at 3. Letters of credit (which include standby letters of credit) in the United States is governed by article 5 of the

contractual in character, since the grounds for avoiding them and the remedies for their breach are determined by ordinary contract principles.<sup>130</sup>

South African writers<sup>131</sup> state that the rights and obligations of the parties are construed and applied on the basis of the express and tacit terms of the letter of undertaking, as well as with reference to the general principals of the law of contract. In addition to this, the rules of customary law or trade usage also play an important role in explaining many of the aspects of the relationship between the issuing or guarantor bank.<sup>132</sup> They also confirm that it is settled law that a contractual obligation comes into existence by way of an offer and an acceptance. However, when it comes to the relationship between the bank that issued a letter of credit/demand guarantee and the beneficiary it is evident that there was no prior negotiation between them. Consequently, the bank's undertaking of, for example, a revocable letter of credit can only be regarded as an offer to the beneficiary. When the beneficiary presents the documents to the bank and claims payment or acceptance of his bill of exchange, this may be regarded as his acceptance of the bank's offer. It would therefore seem that such a contract between the issuing bank and the beneficiary comes into existence only at the time when the beneficiary presents the documents to the issuing bank.<sup>133</sup> However, in the case of an irrevocable letter of credit (and by implication also a demand guarantee) it would seem that South African courts will probably accept that an irrevocable letter of credit creates an obligation on the issuing bank without any formal acceptance of the issuing bank's offer. But the bank's obligation will become legally binding only when the beneficiary receives and takes notice of the document of the letter of credit. This construction is in line with the information theory regarding the moment of formation of a contract. This theory rests on the principle that the primary basis for contractual liability is actual and conscious agreement between the parties to the contract. Generally, an agreement is concluded only when the acceptance is communicated to the offeror (e.g., the issuing bank/guarantor). However, the general principles of the law of contract provide for exceptions to the information theory where the offeror expressly or tacitly waives or abandons its right to notification of the other party's acceptance of its offer. It has also been submitted that it is a customary rule that beneficiaries do not expressly notify the issuing or guarantor bank of their acceptance of the latter's offer. For example, by receiving a commercial letter of credit and proceeding to ship the goods, the beneficiary accepts the offer by his conduct.<sup>134</sup>

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Uniform Commercial Code and therefore the theoretical basis of credits is obviously not contractual (see also Hugo *op cit* note 39 in note 18 at 104).

<sup>130</sup> See Goode *op cit* note 128 at 3; and Hugo *op cit* note 39 at 104.

<sup>131</sup> In South Africa the exact nature of such instruments is a matter of some conjecture. Some of the solutions that have been suggested to explain the basis of the relationship between the bank (i.e., the issuer/guarantor) and the beneficiary include cession, suretyship (see also para 2.5.1.1 above), agency, and the stipulation in favour of a third party. However, none of these legal concepts provides a satisfactory explanation. The difficulty in categorising this relationship lies in identifying any recognised form of acceptance of the instrument on the part of the beneficiary (see Van Niekerk and Schulze *op cit* note 24 at 302). Apparently a more acceptable explanation for this contractual relationship is that of delegation, more specifically a non-novatory delegation (for a full discussion of how a non-novatory delegation works, see Van Niekerk and Schulze *op cit* note 24 at 302–303).

<sup>132</sup> See Van Niekerk and Schulze *op cit* note 24 at 303.

<sup>133</sup> See Van Niekerk and Schulze *op cit* note 24 at 303–304.

<sup>134</sup> See Van Niekerk and Schulze *op cit* note 24 at 304.

Therefore, it would seem that South African writers appear to be in favour of the view that these instruments are contractual in nature and that the relationships between the parties to such instruments are governed by the general principals of the law of contract.<sup>135</sup> This also seems to be the view of the South African courts.<sup>136</sup> The view has also been expressed that such a payment undertaking (e.g., letter of credit/demand guarantee) by a bank is not legally binding because it lacks just cause (i.e., *iusta causa* or ‘consideration’ as it is known in common law jurisdictions). In this regard, Van Niekerk and Schulze have stated that one should not rely on the requirement of a just or reasonable cause, but should rather employ the concept of *animus contrahendi* that involves the notions of seriousness, deliberation and the intention that a lawful obligation should be created.<sup>137</sup> Furthermore, the binding nature of such payment undertakings issued by banks has been established globally as a rule of customary law.<sup>138</sup>

Goode, however, correctly indicates that one needs not be overly concerned about the difference in approach, because once one accepts the binding force of such undertakings, it will in most cases be of little practical consequence.<sup>139</sup>

### 2.5.2.2 *Independence of the Guarantee from the Underlying Contract: The Principle of Autonomy or Independence*

A fundamental characteristic of documentary credit law is the autonomy of the credit.<sup>140</sup> This means that the payment undertaking embodied in the letter of credit is independent of

<sup>135</sup> See Van Niekerk and Schulze *op cit* note 24 at 273 and 302–304; and C Hugo ‘Documentary Credits: The Basis of the Bank’s Obligation’ (2000) 117 *South African Law Journal* 224. However, for a different view, see Eitelberg *op cit* note 24 at 127–137.

<sup>136</sup> See, e.g., *Phillips and Another v Standard Bank of South Africa Ltd and Others* 1985 (3) SA 301 (W) at 304A–B; and *Loomcraft Fabrics CC v Nedbank Ltd and Another* 1996 (1) SA 812 (A) at 815F–G.

<sup>137</sup> See *Saambou-Nasionale Bouvereniging v Friedman* 1979 (3) SA 978 (A).

<sup>138</sup> See Van Niekerk and Schulze *op cit* note 24 at 305.

<sup>139</sup> See R Goode ‘Abstract Payment Undertakings in International Transactions’ (1996) XXII *Brooklyn Journal of International Law* 1 at 3.

<sup>140</sup> See *Phillips v Standard Bank of South Africa supra* note 136 at 304A–B and 304E–F; *Ex parte Sapan Trading (Pty) Ltd* 1995 (1) SA 218 (W) at 223I–225G; *Z Z Enterprises v Standard Bank of South Africa Ltd* 1995 CLD 769 (W) (during the course of the judgment the court referred to the autonomy principle as it applied to commercial letters of credit); *Loomcraft Fabrics v Nedbank supra* note 136 at 815F–816C; *Union Carriage and Wagon Company Ltd v Nedcor Bank Ltd* 1996 CLR 724 (W) at 732; *Total South Africa (Pty) Limited v Nedcor Bank Limited* [1997] All SA 562 (W) at 567A (for a discussion of this case, see A N Oelofse ‘Developments in the Law of Documentary Letters of Credit’ *ABLU* 1998 (a paper delivered at the 1998 Annual Banking Law Update held at the Indaba Hotel, Johannesburg) (unpaginated) (hereinafter ‘*ABLU 1998*’) at 3–7 of his article); A N Oelofse ‘Developments in the Law of Letters of Credit’ *ABLU* 2002 (a paper delivered at the 2002 Annual Banking Law Update held at the Indaba Hotel, Johannesburg on 24 April 2002) (unpaginated) (hereinafter ‘*ABLU 2002*’) at 15 of his article; *Sztejn v J Henry Schroder Banking Corporation* 31 NYS 2d 631 (1941) at 633–634; *United City Merchants (Investments) Ltd and Glass Fibres and Equipments Ltd v Royal Bank of Canada (incorporated in Canada), Vitrorefuerzos SA and Banco Continental SA* [1983] AC 168 (HL) ([1982] 2 Lloyd’s Rep 1 (HL)); *Decor by Nikkei International Inc v Federal Republic of Nigeria* 497 F Supp 893 (1980) at 907; *Wood v RR Donnelley and Sons Company* 888 F 2d 313 (1989) at 318; *Pastor v National Republic Bank of Chicago* 390 NE 2d 894 (1979) at 899; *Dulien Steel Products Inc of Washington v Bankers Trust Company* 298 F 2d 836 (1962) at 841; *United States of America v Foster Wheeler Corporation* 639 F Supp 1266 (1986) at 1269; *Northwestern Bank v NCF Financial Corporation* 365 SE 2d 14 (1988) at 18; *Murphy v Federal Deposit Insurance Corporation* 38 F 3d 1490 (1994) at 1501–1502; *McReynolds v Cherokee Insurance Company* 896 SW 2 137 (1994) at 140–141; and *Newport Industries North America Inc v Berliner Handels und Frankfurter Bank* 923 F Supp 31 (1996).

both the performance of the underlying contract between the applicant of the credit and the beneficiary, and of the relationship between the applicant and the issuing bank.<sup>141</sup>

Generally, it is thus not a defence to a claim on the commercial letter of credit that the beneficiary appears to have committed a breach of the underlying contract, that the contract is unenforceable or that the applicant for the credit has failed to put funds in the issuing bank. The issuing bank is simply not concerned with any dispute arising out of the possible breach of the underlying contract.<sup>142</sup> This is hardly surprising, for the traditional letter of credit transaction sets up a string of commitments involving different parties, and it would be strange if a breach of contract between, for instance, the beneficiary and the applicant for the credit were to constitute a defence to a claim under a totally separate commitment between the issuing bank and beneficiary; a commitment to which the applicant for the credit is not a party.<sup>143</sup>

The autonomy principle is also fundamental to demand guarantees.<sup>144</sup> Although the issuing of the demand guarantee follows from the underlying contract between the principal and the beneficiary, the demand guarantee is separate from that underlying contract, and the rights and obligations created by the guarantee are independent of those arising from the

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See also W G Schulze 'Attachment *Ad Fundandam Jurisdictionem* of the Rights Under a Documentary Letter of Credit – Some Questions Answered, Some Questions Raised' (2000) 63 *Tydskrif vir Hedendaagse Romeins-Hollandse Reg* 672 at 673–375; R Goode 'Abstract Payment Undertakings in International Transactions' (1996) XXII *Brooklyn Journal of International Law* 1 at 12; R Jack, A Malek and D Quest *Documentary Credits: The Law and Practice of Documentary Credits Including Standby Credits and Demand Guarantees* 3 ed (2001) (hereinafter 'Jack') in paras 1.41 and 8.11; B Wunnicke, D B Wunnicke and P S Turner *Standby and Commercial Letters of Credit* 2 ed (1996) in paras 2.6 and 2.7; Van Niekerk and Schulze *op cit* note 24 at 306–309; and C F Hugo *The Law Relating to Documentary Credits from a South African Perspective with Special Reference to the Legal Position of the Issuing and Confirming Banks* (published LLD, University of Stellenbosch (1996)) (1997) (hereinafter 'Hugo: The Law Relating to Documentary Credits') at 174; and Hugo *op cit* note 39 at 105.

<sup>141</sup> See R Goode 'Abstract Payment Undertakings in International Transactions' (1996) XXII *Brooklyn Journal of International Law* 1 at 12; Dolan: *The Law of Letters of Credit op cit* note 66 in para 2.01; J C T Chuah *Law of International Trade* 3 ed (2005) in para 10-36 at 487; E McKendrick (gen ed) *et al Sale of Goods* 2000 in para 14-068; F R Malan 'Letters of Credit and Attachment *ad Fundandam Jurisdictionem*' 1994 *Tydskrif vir die Suid-Afrikaanse Reg* 150 at 150–151; W G Schulze 'Attachment *Ad Fundandam Jurisdictionem* of the Rights Under a Documentary Letter of Credit – Some Questions Answered, Some Questions Raised' (2000) 63 *Tydskrif vir Hedendaagse Romeins-Hollandse Reg* 672 at 674; and Oelofse: *The Law of Documentary Letters op cit* note 123 in para 9.1 at 354–357. See also *Urquhart Lindsay and Co Ltd v Eastern Bank Ltd* [1922] 1 KB 318 (KB) ([1921] All ER 340 (KB)).

<sup>142</sup> See Schulze *op cit* note 141 at 674; Van Niekerk and Schulze *op cit* note 24 at 307; and J P Geraghty 'Many a slip . . . Acceptance by a Bank of Documents under an International Documentary Credit' (1999) 11 *South African Mercantile Law Journal* 331 at 332.

<sup>143</sup> See R Goode 'Abstract Payment Undertakings in International Transactions' (1996) XXII *Brooklyn Journal of International Law* 1 at 12.

<sup>144</sup> See Bennett *op cit* note 41; I Ndekugri 'Performance Bonds and Guarantees: Construction Owners and Professionals Beware' (November/December 1999) 125 *Journal of Construction Engineering and Management* 428 at 432; A Ganotaki 'Unconscionability and Bank Guarantees' (2004) *Lloyd's Maritime and Commercial Law Quarterly* 148 at 148; I Ndekugri 'Performance Bonds and Guarantees in Construction Contracts: A Review of Some Recurring Problems' (1999) 16 *International Construction Law Review* 294 at 304–305; Jack *op cit* note 140 in para 1.41 at 21; *SITPRO's Report op cit* note 6 at 5; *ABLU 1998 op cit* note 140 at 7 of the article; and *ABLU 2002 op cit* note 140 at 15 of the article. In *Union Carriage and Wagon Company Ltd v Nedcor Bank Ltd supra* note 140 at 731–732 it was confirmed that the autonomy principle also applies to standby letters of credit and advance payment guarantees (i.e., demand guarantees) (see also Van Niekerk and Schulze *op cit* note 24 at 307).



underlying contract, with which the guarantor is generally not concerned.<sup>145</sup> Most demand guarantees issued in practice are payable ‘on demand’ or ‘on first demand’, which clearly implies that such guarantees create a binding obligation to pay against the simplest of demands by the beneficiary without any proof of any default by the principal on the underlying contract.<sup>146</sup> Therefore, a bank that gives a demand guarantee must honour that guarantee according to its terms. The bank is not concerned in the least with relationships between the principal and the beneficiary; nor with the question of whether or not the principal has performed in terms of the underlying contract; and nor with the question of whether or not the principal is in default.<sup>147</sup> The guarantor of the demand guarantee undertakes an absolute obligation to pay the beneficiary according to the direction of the guarantee.<sup>148</sup>

In the United States revised article 5 of the Uniform Commercial Code (‘UCC’)<sup>149</sup> (i.e., the 1995 version) deals with letters of credit (both commercial and standby letters of credit). The principle of autonomy is codified in article 5-103(d) of the UCC.<sup>150</sup> Article 5 section 5-103 specifically provides that an issuer’s rights and obligations in relation to a nominated person or beneficiary are independent of the underlying transaction.

The principle of autonomy is also codified in articles 3 and 4 of the 1993 version of the Uniform Customs and Practice for Documentary Credits (‘UCP 500’),<sup>151</sup> and articles 4 and

<sup>145</sup> See the *Guide to the URDG* *op cit* note 10 at 17–18; cf *Dinnie op cit* note 13 at 128; *Bennett op cit* note 41 at 575; N Enonchong ‘The Problem of Abusive Calls on Demand Guarantees’ (2007) *Lloyd’s Maritime and Commercial Law Quarterly* 83 at 84; J Bailey ‘Unconditional Bank Guarantees’ (2003) 20 *International Construction Law Review* 240 at 252; and *SITPRO’s Financial Guide op cit* note 5 at 4.

<sup>146</sup> See *Penn op cit* note 39 at 224.

<sup>147</sup> See *Edward Owen Engineering Ltd v Barclays Bank International Ltd* [1978] 1 QB 159 (CA) ([1978] 1 Lloyd’s Rep 166 (CA); and [1978] 1 All ER 976 (CA)) at 171A–B. See also *Coleman op cit* note 119 at 223.

<sup>148</sup> See the *Guide to the URDG op cit* note 10 at 17–18; cf *D Dinnie op cit* note 13 at 128; and *Bennett op cit* note 41 at 575.

<sup>149</sup> Hereinafter the ‘UCC’.

<sup>150</sup> For a further discussion of article 5 of the UCC, see para 3.4.2 (particularly in para 3.4.2.2) in Chapter 3.

<sup>151</sup> In the context of documentary credits, which include standby letters of credit (and by implication also demand guarantees) the autonomy principle was confirmed and expressed in article 3, in particular article 3(a), and article 4 of the 1993 version of the Uniform Customs and Practice for Documentary Credits (see *ICC Publication No 500*, Paris (1993) (hereinafter the ‘UCP 500’)). For a full discussion of UCP 500, see para 3.2.2 in Chapter 3. The UCP 500 had been in force since 1 January 1994 until it was replaced on 1 July 2007 by the 2007 version of the Uniform Customs and Practice for Documentary Credits (see *ICC Publication No 600*, Paris (2006) (hereinafter the ‘UCP 600’) (see also note 152 below)). The first part of article 3(a) of UCP 500 provided that

[c]redits, by their nature, are separate transactions from the sales or other contract(s) on which they may be based and banks are in no way concerned with or bound by such contract(s), even if any reference whatsoever to such contract(s) is included in the Credit. Consequently, the undertaking of a bank to pay, accept and pay Draft(s) or negotiate and/or to fulfil any other obligation under the Credit, is not subject to claims or defences by the Applicant resulting from his relationships with the Issuing Bank or the Beneficiary.

In addition to this, article 4 of the UCP 500 provided that when dealing with documentary credits, all the parties involved (which included the banks) were concerned with documents, and not with goods, services, and/or other performances to which the documents might have related. Article 4 aimed to complement article 3 of the UCP, which dealt with the principle of autonomy, by making it very clear that in determining

5 of the 2007 version of the Uniform Customs and Practice for Documentary Credits ('UCP 600').<sup>152</sup>

The autonomy principle of demand guarantees and standby letters of credit is also expressly incorporated into article 2(b) of the URDG<sup>153</sup> and rule 1.06(a) and (c) of the ISP98.<sup>154</sup>

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whether the beneficiary was entitled to be paid, banks were concerned with one question only: whether the documents presented to them conformed to the credit. This concept of autonomy, enshrined in articles 3 and 4, was widely recognised and applied by courts worldwide.

<sup>152</sup> On 1 July 2007 the UCP 500 was replaced with the UCP 600. For a full discussion of UCP 600, see para 3.2.2 in Chapter 3. In the UCP 600 the principle of autonomy is again clearly confirmed. Article 4(b) of the UCP 600 even goes as far as specifically stating that an issuing bank should discourage any attempt by the applicant to include, as an integral part of the credit, copies of the underlying contract. However, in the UCP 600, the principle of autonomy is set out in articles 4, in particular article 4(a), and then confirmed in article 5. The first part of article 4(a) provides as follows:

A credit by its nature is a separate transaction from the sale or other contract on which it may be based. Banks are in no way concerned with or bound by such contract, even if any reference whatsoever to it is included in the credit. Consequently, the undertaking of a bank to honour, to negotiate or to fulfil any other obligation under the credit is not subject to claim or defences by the applicant resulting from its relationship with the issuing bank or the beneficiary.

Article 5 provides that '[b]anks deal with documents and not with goods, services or performance to which the documents may relate'. These articles (i.e., articles 4(a) and 5 of the UCP 600) are basically the same as their counterparts that were found in articles 3 and 4 of UCP 500 (see note 151 above). The only basic difference between the two versions in this regard, seems to be found in the fact that the latest version sets out the autonomy principle in a more user-friendly way.

<sup>153</sup> For a full discussion of the URDG, see para 3.2.5 in Chapter 3 and para 4.2.3 in Chapter 4. Article 2(b) of the URDG provides as follows:

Guarantees by their nature are separate transactions from the contract(s) or tender conditions on which they may be based, and Guarantors are in no way concerned with or bound by such contract(s), or tender conditions, despite the inclusion of a reference to them in the Guarantee. The duty of a 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.

<sup>154</sup> Rule 1.06(a) of the ISP98, which applies to standby letters of credit (including to other independent undertakings, like demand guarantees), provides that a standby letter of credit or undertaking, to which the ISP98 applies, is an irrevocable, independent, documentary, and binding undertaking when issued irrespective of whether or not it states so. (These rules have been published in booklet form as *ICC Publication No 590*, Paris (1998) under licence from the Institute of International Banking Law and Practice, Inc which holds the copyright). For a full discussion of the ISP98, see para 3.2.6 in Chapter 3. Furthermore, rule 1.06(c) provides that

[b]ecause a standby is independent, the enforceability of an issuer's obligations under a standby does not depend on:

- i. the issuer's right or ability to obtain reimbursement from the applicant;
- ii. the beneficiary's right to obtain payment from the applicant;
- iii. a reference in the standby to any reimbursement agreement or underlying transaction; or
- iv. the issuer's knowledge of performance or breach of any reimbursement agreement or underlying transaction.

Rule 1.06(a) read with subrule (c) provides that the obligation under a standby does not depend upon any relationship or undertaking except the undertaking of the issuer to the beneficiary. This principle applies even if the standby contains a reference to the underlying agreement, reimbursement agreement or any similar agreement as indicated in subrule (c)(iii) (See J E Byrne (edited by J G Barnes) *The Official Commentary on*

The UNCITRAL Convention,<sup>155</sup> which applies to an international undertaking such as a demand guarantee (in the Convention the term ‘independent guarantee’ is used) or a standby letter of credit, also mentions the autonomy principle of these credits and guarantees in articles 2 and 3.<sup>156</sup>

The applicability of the principle of autonomy to demand guarantees may well put the principal at the mercy of an unscrupulous beneficiary. The total detachment of the demand guarantee from the underlying contract generally denies any right to prevent performance in the event of an unjustified call upon the guarantee.<sup>157</sup> However, the independence of the demand guarantee, standby letter of credit and commercial letter of credit have boundaries and are not absolute, all jurisdictions (including South Africa) acknowledge certain exceptions to the autonomy principle.<sup>158</sup> For instance, established fraud on the part of the beneficiary or his agent (e.g., where the beneficiary or his agent makes a demand knowing that the principal has fully performed his obligations under the underlying contract) disentitles him to payment and the bank is entitled to refuse payment (i.e., the beneficiary’s fraud is a valid defence to an action brought on the demand guarantee).<sup>159</sup> Furthermore, in the event of the bank contemplating payment, nearly all jurisdictions allow an interdict or injunction, either against the bank to prohibit payment, and/or against the beneficiary to prohibit him from making a demand or receiving payment.<sup>160</sup>

Fraud and forgery are certainly the most proclaimed exceptions to the autonomy principle with respect to both demand guarantees and documentary credits (including standby letters of credit).<sup>161</sup> However, there are also other accepted grounds besides fraud on which

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*the International Standby Practices* (1998) (hereinafter ‘*The Official Commentary on the ISP98*’) Official Comment 5 to rule 1.06 at 26.).

<sup>155</sup> For a full discussion of the UNCITRAL Convention, see para 3.3 in Chapter 3 and para 4.4 in Chapter 4.

<sup>156</sup> Article 2 of the UNCITRAL Convention declares that the Convention is concerned with an undertaking that ‘is an independent commitment’, whereas article 3 of the UNCITRAL Convention describes the independence of the undertaking as follows:

For the purposes of this Convention, an undertaking is independent where the guarantor/issuer’s obligation to the beneficiary is not:

- (a) Dependent upon the existence or validity of any underlying transaction, or upon any other undertaking (including stand-by letters of credit or independent guarantees to which confirmations or counter-guarantees relate); or
- (b) Subject to any term or condition not appearing in the undertaking, or to any future, uncertain act or event except presentation of documents or another such act or event within a guarantor/issuer’s sphere of operations.

<sup>157</sup> See Bennett *op cit* note 41 at 575.

<sup>158</sup> See Hugo: *The Law Relating to Documentary Credits op cit* note 140 at 174 and 251–339; Hugo *op cit* note 39 at 105; Oelofse: *The Law of Documentary Letters of Credit op cit* note 123 at 357–481; Van Niekerk and Schulze *op cit* note 24 at 307; Bennett *op cit* note 41 at 581–586; Enonchong *op cit* note 145; and N Enonchong ‘The Autonomy Principle of Letters of Credit: An Illegality Exception? (2006) *Lloyd’s Maritime and Commercial Law Quarterly* 404.

<sup>159</sup> See the *Guide to the URDG op cit* note 10 at 18–19; Jack *op cit* note 140 in paras 1.42 and 8.11; and cf *Phillips v Standard Bank of South Africa* 1985 (3) SA 301 (W) at 304A; and *Loomcraft Fabrics CC v Nedbank* 1996 (1) SA 812 (A). For a full discussion of fraud, see Chapter 5.

<sup>160</sup> See also Hugo *op cit* note 39 at 105–106. For a full discussion of injunctions/interdicts, see Chapter 7.

<sup>161</sup> See J C T Chuah *Law of International Trade* 2 ed (2001) in para 10-36 at 423.

payment under a demand guarantee may be restrained,<sup>162</sup> for example, illegality<sup>163</sup> or the infringement of international obligations.<sup>164</sup> The grounds for non-payment under a commercial letter of credit also often constitute a similar ground for non-payment under a demand guarantee. In many jurisdictions the ambit of the exceptions (especially regarding the fraud exception) to the autonomy principle has been a matter of considerable debate and controversy (see discussions in subsequent chapters).<sup>165</sup> For instance, in the United States it is not necessary that the fraud should relate to the documents, as fraud in the underlying transaction suffices.<sup>166</sup> These exceptions to the autonomy principle are not necessarily derived from uniform international rules. They are often rules of law applied by courts in relation to the law applicable to the guarantee (e.g., domestic law). Only the exceptions of fraud and illegality will be discussed in more detail in the following chapters.<sup>167</sup>

The position regarding the principle of autonomy can thus be summed up as follows: in the absence of established fraud by the beneficiary or some other accepted grounds for non-payment under the applicable law, the guarantor is not entitled to refuse payment, and the principal is not entitled to have payment restrained merely because of a dispute between the principal and the beneficiary as to whether or not the principal has, in fact, defaulted on the underlying contract.

### 2.5.2.3 Independence of the Guarantee from the Principal–Guarantor Relationship

In the same way, the demand guarantee is separate from the contract between the principal and the guarantor, and the guarantor is not entitled to invoke a breach of that contract (e.g., failure of the principal to put him in funds (indemnify him)) as a ground for refusing payment of a demand.<sup>168</sup>

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<sup>162</sup> For instance, in Australia there have been suggestions that unconscionable conduct of a gross nature might suffice (see J Ulph ‘The UCP600: Documentary Credits in the Twenty-first Century’ (2007) *Journal of Business Law* 355 at 371; *Hortico (Australia) Pty Ltd v Energy Equipment Co (Australia) Pty Ltd* (1985) 1 NSWLR 545 ((1986) 2 BCL 366 (Sup Ct)); *Inflatable Toy Co v State Bank of NSW* (1994) 34 NSWLR 243; contrast *Olex Focas Pty Ltd and Another v Skodaexport Co Ltd* (1996) 134 FLR 331 ((1996) 70 ALJR 983; (1997) ATPR (Digest) [46-163]; and [1998] 3 VR 380 (Sup Ct Vic)); and Xiang Gao *The Fraud Rule in the Law of Letters of Credit: A Comparative Study* (2002) at 94–96). For a further discussion of these possible exceptions and others, see Enonchong *op cit* note 145; Bailey *op cit* note 145; and Q Loh and T H Wu ‘Injunctions Restraining Calls on Performance Bonds – Is Fraud the Only Ground in Singapore?’ (2000) *Lloyd’s Maritime and Commercial Law Quarterly* 348. In these articles the possibility of other exceptions to the autonomy principle, for example, unconscionable conduct, no underlying contract, breach of a negative stipulation in the underlying contract, or lack of good faith/absence of reasonableness as constituting valid grounds are discussed and they also contain limited references to court cases in Australia, Singapore and Malaysia where these grounds have been considered as possibilities. See also note 33 in Chapter 1, note 357 below, and note 8 in Chapter 5.

<sup>163</sup> See Chapter 6.

<sup>164</sup> See Bennett *op cit* note 41 at 581.

<sup>165</sup> See Chapters 5–6.

<sup>166</sup> See R Goode ‘Abstract Payment Undertakings in International Transactions’ (1996) XXII *Brooklyn Journal of International Law* 1 at 12–13. See also para 5.5 in Chapter 5.

<sup>167</sup> See Chapters 5–6.

<sup>168</sup> See the *Guide to the URDG op cit* note 10 at 19; Eitelberg *op cit* note 24 at 123; and cf *Ex parte Sapan Trading (Pty) Ltd supra* note 140 at 223I–224B. In the context of documentary credits, which includes standby letters of credit (and by implication also demand guarantees), the second part of article 4(a) of the UCP 600 confirms this principle and provides that ‘a beneficiary can in no case avail itself of the contractual

### 2.5.2.4 Documentary Character of the Guarantee

The other aspect of the autonomy principle is the documentary character of the demand guarantee, standby letter of credit and the commercial letter of credit.<sup>169</sup> The demand guarantee is documentary in character, in the sense that the amount and duration of the duty to pay, the conditions of payment and termination of the payment obligation depend exclusively on the terms of the guarantee itself (e.g., the expiry date), and the presentation of a demand and such other documents, if any, as may be stipulated in the guarantee. The guarantor's duty is to pay against specified documents that are presented within the period and in accordance with the other conditions of the guarantee.<sup>170</sup> The guarantor is also under no obligation to authenticate the documents submitted.<sup>171</sup> The guarantor is therefore not interested in the investigation of external facts, such as the principal's default in performance of the underlying contract or the amount of loss actually suffered by the beneficiary as a result of that default.<sup>172</sup>

The documentary character of the documentary credit, which includes standby letters of credit (and by implication also demand guarantees), is also confirmed in article 5 of the UCP 600 (a similar provision was found in article 4 of the UCP 500, the predecessor of UCP 600).<sup>173</sup> The ISP98 also affirm the documentary character of the standby letter of credit (including other independent undertakings, such as demand guarantees).<sup>174</sup>

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relationships existing between banks or between the applicant and the issuing Bank.' A similar provision was found in article 3(b) of the UCP 500. Furthermore, rule 1.07 of the ISP98 which applies to standby letters of credit (and other independent undertakings, such as demand guarantees) provides:

**1.07 Independence of the Issuer-Beneficiary Relationship**

An issuer's obligations toward the beneficiary are not affected by the issuer's rights and obligations toward the applicant under any applicable agreement, practice, or law.

Rule 1.07 is clearly a formulation of the independence principle. It applies the general principles set out in ISP98 rule 1.06 (see note 154 above). The issuer's obligation to the beneficiary is independent of and separate from its obligation to the applicant. No defense or claim, whether based on the lack of or failure of consideration running from the applicant to the issuer, applicant insolvency, non-reimbursement, misrepresentation, absence of *causa*, or fraudulent inducement by the applicant can excuse the issuer's obligation under the standby letter of credit. As indicated in note 154 above, rule 1.06(c)(iii) provides that a reference in the standby to the reimbursement agreement has no effect on the issuer's obligation (see Official Comment 1 and 2 to rule 1.07 in *The Official Commentary on the ISP98 op cit* note 154 at 29).

<sup>169</sup> See Van Niekerk and Schulze *op cit* note 24 at 309; and the *Guide to the URDG op cit* note 10 at 19.

<sup>170</sup> For a discussion of what the role of the bank is in evaluating whether a document conforms with the terms of a letter of credit, see Geraghty *op cit* note 142.

<sup>171</sup> For example, article 15 of UCP 500 provided that banks assumed no liability or responsibility for

- the form, sufficiency, accuracy, genuineness, falsification or legal effect of any document;
- the description, quantity, weight, quality, condition, packing, delivery, value or existence of the goods represented by any document; or
- the good faith, acts or omissions, solvency or performance of any other party associated with the transaction.

<sup>172</sup> See the *Guide to the URDG op cit* note 10 at 19; R Goode 'Abstract Payment Undertakings and the Rules of the International Chamber of Commerce' (1995) 39 *Saint Louis University Law Journal* 725 at 735; Malan *op cit* note 141 at 151; and Eitelberg *op cit* note 24 at 122.

<sup>173</sup> Article 5 of the UCP 600 provides that 'banks deal with documents and not with goods, services, or performance to which the documents may relate.' The purpose of article 5 of the UCP 600 is to complement article 4 of the UCP (just as the purpose of article 4 of UCP 500 was to complement article 3 (which confirmed the autonomy principle) of UCP 500), which deals with the principle of autonomy, by making it clear that in determining whether the beneficiary is entitled to be paid, banks are concerned with one question

#### 2.5.2.4.1 Non-documentary Conditions

It often happens that a non-documentary condition is included in a commercial letter of credit, standby letter of credit and demand guarantee. A non-documentary condition is a condition (requirement) under the credit/guarantee that cannot be satisfied by presenting a document.<sup>175</sup> A condition that requires the issuer/guarantor to pay the beneficiary when, for instance, the applicant is in breach of a lease is a non-documentary condition. Satisfaction of the condition is dependent on an extrinsic fact – whether the applicant is in breach of the lease – not on the presentation of a document. In contrast, a condition in the credit/guarantee that requires the beneficiary to present a document stating that the applicant is in breach of the lease would be a documentary condition that may be satisfied by the presentation of the document.<sup>176</sup>

Conceptually, non-documentary conditions are alien to commercial letters of credit, standby letters of credit and demand guarantees. However, many applicants of letters of credit and standby letters of credit or principals of demand guarantees do not understand the importance of adhering to the rule that banks only deal with documents, not with goods, services or other performances, and instruct their banks to incorporate into credits or

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only: whether the documents presented to them conform to the credit. The same idea is expressed, though in different language in article 2(b) of the URDG: ‘The duty of a Guarantor . . . is to pay the sum . . . on the presentation of a written demand for payment and other documents’ (see Goode *op cit* note 172 at 735). The documentary nature of a letter of credit is also further confirmed by article 14(a) of the UCP 600 that provides that banks must examine a presentation to determine, on the basis of the documents alone, whether or not the documents appear on their face to constitute a complying presentation. The documentary nature of letters of credit was also confirmed by article 13(a) of the UCP 500 that provided that banks had to examine all documents stipulated in the credit with reasonable care, to determine whether or not they appeared, on their face to be in compliance with the terms and conditions of the credit. It follows that it is a fundamental rule of the UCP 600, just as it was with their predecessor, that banks deal only 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 (see R Goode ‘Abstract Payment Undertakings in International Transactions’ (1996) XXII *Brooklyn Journal of International Law* 1 at 11).

<sup>174</sup> Rule 1.06(a) of the ISP98 provides that a standby letter of credit, to which the ISP98 applies, is an irrevocable, independent, documentary, and binding undertaking when issued irrespective of whether or not it states so. Furthermore, rule 1.06(d) of the ISP98 provides that because a standby letter of credit is documentary in character, an issuer’s obligations depend on the presentation of documents and an examination of required documents on their face. This rule emphasises the principle that an issuer’s obligation turns upon the presentation of documents. The documentary character of a standby letter of credit is closely linked to its independence (see *The Official Commentary on the ISP98 op cit* note 154 Official Comment 7 to rule 1.06 at 26). Furthermore, rule 4.08 of the ISP98 even goes as far as to provide that even if a standby letter of credit does not specify any required document, it will still be deemed to require a documentary demand for payment. (For a discussion of rule 4.08 see *The Official Commentary on the ISP98 op cit* note 154 Official Comments 1 to 2 to rule 4.08 at 160. For a discussion of what the effect of rule 4.08 is where the only requirement of a standby letter of credit is a non-documentary condition, see P S Turner ‘New Rules for Standby Letters of Credit: The International Standby Practices’ (1999) 14 *Banking and Finance Law Review* 457 at 482–484.) In addition to rule 1.06 that reinforces the documentary character of standby letters of credit, rule 2.01 of the ISP98 also emphasises the documentary character. Rule 2.01 provides that an issuer of a standby letter of credit merely undertakes to the beneficiary to honour a presentation that appears on its face to comply with the terms and conditions of the standby letter of credit in accordance with these rules supplemented by standard standby practice. In other words, the undertaking is to honour a document ‘that appears on its face to comply’ and not to consider the facts which it represents (see *The Official Commentary on the ISP98 op cit* note 154 Official Comment 2 to rule 2.01 at 63).

<sup>175</sup> See Hugo: *The Law Relating to Documentary Credits op cit* note 140 at 122.

<sup>176</sup> See Turner *op cit* note 174 at 482.

guarantees conditions that are non-documentary in character. Often banks, despite their better judgement, act on these instructions, whereas they should have explained to their customers that non-documentary conditions are unacceptable. Such conditions were outside the scope of the UCP 500 altogether and, if literally construed, compelled the banks to satisfy themselves that the specified conditions had been satisfied; a task for which banks were ill-equipped and which they were reluctant to undertake. Non-documentary conditions are also outside the scope of the current UCP 600. In the past banks often found practical solutions by converting these apparent non-documentary conditions into documentary conditions by construing them as requiring the production of a document reasonably evidencing fulfilment of the stated condition and in so doing they were generally supported by the courts, at least in England.<sup>177</sup>

Many banks dislike the inclusion of non-documentary conditions in letters of credit and demand guarantees. Banks' aversion to non-documentary conditions are based on an appreciation of the fundamental character of the letter of credit/demand guarantee as an undertaking independent of factual determinations apart from those within the control of the examiner. Therefore, if it is admitted that a bank could avoid its undertaking due to non-documentary conditions not being fulfilled, the independent character of the letter of credit/guarantee is threatened. The bank's determination of facts outside its domain is not reliable. In fact, most such facts are subject to differing interpretations and can ultimately be decided with finality only by a court or arbitral tribunal that has the power to compel the production of evidence and to command testimony under penalty of perjury. If banks had to make such judgements subject to being second-guessed by tiers of fact, it is inevitable that they would choose the most conservative approach, namely refusal to pay until ordered to do so. As a result, on both a practical and theoretical level, the distinction between accessory guarantee and the letter of credit would disappear. Therefore, the documentary character of the letter of credit (or guarantee) undertaking is the practical manifestation of the principle of autonomy.<sup>178</sup>

It was a controversial issue, especially for banks, to decide what to do about non-documentary conditions that were inserted in undertakings that were intended to be either letters of credit/demand guarantees. There were various courses of action available: (1) to treat the undertaking as accessory, giving effect to the non-documentary condition;<sup>179</sup> (2) to disregard the non-documentary condition; or (3) to require that a document embodying its fulfilment be submitted.<sup>180</sup> For instance, if the letter of credit required that

<sup>177</sup> See *Banque de L'Indochine et de Suez SA v JH Rayner Ltd (Mincing Lane) Ltd* [1982] 2 Lloyd's Rep 476 (QB) ([1983] 1 QB 711 (QB)) at 480 asserting that a bank was entitled to require documentary proof of the satisfaction of a stipulation in the credit when the credit had not itself called for presentation of a document. See also *Esal (Commodities) Ltd and Reltor Ltd v Oriental Credit Ltd and Wells Fargo Bank NA; Banque du Caire SAE v Wells Fargo Bank NA* [1985] 2 Lloyd's Rep 546 (CA); R Goode 'Abstract Payment Undertakings and the Rules of the International Chamber of Commerce' (1995) 39 *Saint Louis University Law Journal* 725 at 735–736; and R P Buckley 'The 1993 Revision of the Uniform Customs and Practice for Documentary Credits' (1995) 28 *George Washington Journal of International Law and Economics* 265 at 289.

<sup>178</sup> See J E Byrne 'The International Standby Practices (ISP98): New Rules for Standby Letters of Credit' (Fall 1999) 32 *Uniform Commercial Code Law Journal* 149 at 164–165. See also *Hugo: The Law Relating to Documentary Credits op cit* note 140 at 122–123.

<sup>179</sup> See, e.g., *Wichita Eagle and Beacon Publishing Co Inc v Pacific National Bank of San Francisco* 493 F 2d 1285 (9th Cir 1974), where the instrument that was called a 'letter of credit' was deemed a (traditional) guarantee by the court due to its non-documentary conditions.

<sup>180</sup> See, e.g., *Banque de L'Indochine et de Suez SA v JH Rayner Ltd (Mincing Lane) Ltd supra* note 177.

goods be delivered at the harbour of City Y, but did not specify a document to that effect, the option would be to require that a document representing delivery be produced or that the condition be disregarded.

However, it later became evident that banks were not able to determine what type of document would be appropriate to satisfy such a non-documentary condition in all circumstances and they were reluctant to impose a documentary requirement not stipulated in the letter of credit. While the ICC was revising the 1983 version of the UCP,<sup>181</sup> the letter of credit community reached consensus on the issue of non-documentary conditions and decided that where such conditions were inserted in a letter of credit, they had to be disregarded.<sup>182</sup> Accordingly, a provision was specifically incorporated, firstly, into the amended 1993 version of the UCP, (i.e., the UCP 500)<sup>183</sup> and, secondly, also into the 2007 version of the UCP (i.e., the UCP 600)<sup>184</sup> to address the problem of non-documentary conditions.

Therefore, the bank practice of converting non-documentary conditions into documentary ones was no longer as easy, since banks had to take cognisance of article 13 of the UCP 500 – in particular of article 13(c), which provided that '[i]f a credit contains conditions without stating the document(s) to be presented in compliance therewith, banks will deem such conditions as not stated and will disregard them'.<sup>185</sup> Article 13(c) was incorporated into the UCP in an attempt to eradicate the totally wrong practice of incorporating non-documentary condition(s) into documentary credits and standby letters of credit (and by implication also demand guarantees). This provision required banks to ignore conditions in which the issuer sought to embody in the documentary credit some of the terms of the contract between the beneficiary and the applicant without setting out the documents to be tendered to establish compliance therewith.<sup>186</sup> The practice of incorporating non-documentary conditions into documentary credits defeated the underlying principle of the documentary credit itself and directly contradicted the wording of various articles of the UCP 500,<sup>187</sup> all of which clearly indicated that payment, acceptance or negotiation under a documentary credit was to be effected against documents stipulated in the documentary credit. The ICC Banking Commission therefore expressed its strong disapproval of the fact that notwithstanding the provision of article 13(c), certain banks continued to issue documentary credits and

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<sup>181</sup> ICC Publication No 400, Paris (1983) (hereinafter the 'UCP 400'). For a full discussion of UCP 400, see para 3.2.2 in Chapter 3.

<sup>182</sup> See Byrne *op cit* note 178 at 165.

<sup>183</sup> See article 13(c) of UCP 500. It was one of the major aims of the UCP 500 to address the problem of non-documentary conditions (see *Hugo: The Law Relating to Documentary Credits op cit* note 140 in note 319 at 123 and the authorities cited).

<sup>184</sup> See article 14(h) of the UCP 600.

<sup>185</sup> The approach was also echoed in the URDG in article 20(a) which provides that a demand for payment under a guarantee 'shall be in writing and shall (in addition to such other documents as may be specified in the Guarantee) be supported by a written statement (whether in the demand itself or in a separate document or documents accompanying the demand and referred to in it)'. Furthermore, the approach was also repeated in the Revised UCC section 5-108(g) which provides that '[i]f an undertaking constituting a letter of credit under Section 5-102(a)(10) contains nondocumentary conditions, an issuer shall disregard the nondocumentary conditions and treat them as if they were not stated'.

<sup>186</sup> See E P Ellinger 'The Uniform Customs and Practice for Documentary Credits – The 1993 Revision' (1994) *Lloyd's Maritime and Commercial Law Quarterly* 377 at 391.

<sup>187</sup> See articles 2, 4, 5(b) and 13(a) of the UCP 500.



amendments thereto which contained non-documentary conditions. The commission therefore reminded banks that where a documentary credit or amendment thereto contained one or more conditions and did not state the document(s) to be presented to evidence compliance therewith, article 13(c) clearly provided that banks had to deem such a condition(s) as not stated and had to disregard it (them). Accordingly, it suggested that banks should have included any appropriate ‘condition(s)’ in the detail of the document(s) stipulated, or stated expressly the document which was to evidence compliance with a specific ‘condition(s)’. A condition was not deemed to be a non-documentary condition, if it could be clearly linked to a document stipulated in the credit.<sup>188</sup>

Today, article 14(h) of the UCP 600 also sets out how banks should deal with non-documentary conditions in letters of credit. Article 14(h) provides that ‘if a credit contains a condition without stipulating the document to indicate compliance with the condition, banks will deem such condition as not stated and will disregard it’.<sup>189</sup> Furthermore, article 14(g) provides that if a document is presented that is not required by the credit, the bank will disregard it and may then return such a document to the presenter.<sup>190</sup>

The ISP98 also formulated a rule regarding non-documentary conditions included in standby letters of credit. Rule 4.11 of the ISP98 deals specifically with the inclusion of non-documentary terms and conditions in standby letters of credit (and by implication also demand guarantees).<sup>191</sup> Rule 4.11(a) provides that a standby term or condition that is non-documentary must be disregarded whether or not it affects the issuer’s obligations to treat a presentation as complying or to treat the standby as issued, amended or terminated. Rule 4.11(b) continues, and states that terms and conditions are non-documentary if the standby letter of credit does not require presentation of a document in which they are to be evidenced and if their fulfilment cannot be determined by the issuer from its own records or its normal operations. Furthermore, rule 4.11(c) provides that determinations from the issuer’s own records or within its normal operations include determinations of:

- i. when, where, and how documents are presented or otherwise delivered to the issuer;
- ii. when, where, and how communications affecting the standby are sent or received by the issuer, beneficiary, or any nominated person;
- iii. amounts transferred into or out of accounts with the issuer; and

<sup>188</sup> For a full discussion, see the ICC Banking Commission’s ‘Position Paper No 3: UCP 500 sub-Article 13(c)’ in G Collyer (ed) *More Queries and Responses on UCP 500 (1997): Opinions of the ICC Banking Commission 1997* (ICC Publication No 596, Paris (1998)) at 85–86; and see also the Opinions published by the ICC Banking Commission in G Collyer and R Katz (eds) *ICC Banking Commission Collected Opinions 1995–2001 on UCP 500, UCP 400, URC 522 and URDG 458* (ICC Publication No 632, Paris (2002)) Query Ref Number 388(4) at 48–53 and Query Ref Number R 212 (1) at 125–126. For a full discussion of the problems experienced with including non-documentary conditions into letters of credit and demand guarantees, see R Goode ‘Abstract Payment Undertakings and the Rules of the International Chamber of Commerce’ (1995) 39 *Saint Louis University Law Journal* 725 at 735–737.

<sup>189</sup> This is similar to article 13(c) of the UCP 500.

<sup>190</sup> Under article 13(a) of the UCP 500 documents that were presented, but not required under the credit, were to be returned to the presenter or passed on without responsibility.

<sup>191</sup> For a full discussion of non-documentary conditions under the ISP98, see Turner *op cit* note 174 at 482–485; and see *The Official Commentary on the ISP98 op cit* note 154 Official Comments 1 to 6 to rule 4.11 at 16–170.

- iv. amounts determinable from a published index (e.g., if a standby provides for determining amounts of interest accruing according to published interest rates.)

Rule 4.11(d) merely addresses the situation where a document contains a calculation or computation and provides that the issuer need not verify the accuracy of the calculation.

The approach that was taken in article 13(c) in the UCP 500 raised a series of questions with respect to conditions that were not mentioned in a document, but that were within the operational purview of the bank to confirm. For example, some standby letters of credit require that a deposit be made to an account maintained at the issuer as a condition to the availability of the standby. It was therefore asked whether or not such a provision was non-documentary and had to be disregarded.<sup>192</sup> Therefore, the ISP98 attempted to address these issues and, accordingly, rules 4.11(b) and (c) were inserted.

Therefore, rules 1.06(d)<sup>193</sup> and 4.11 (discussed above) of the ISP98 can be understood both to formulate the non-documentary condition principle and to address the question that has been raised regarding its application. For instance, it is common for standby letters of credit to refer to external sources, such as published indices for interest rates. Such a provision is often not declared in a document. It is, however, within the operational purview of a financial institution acting as an issuer of a standby to be aware of, and have access to, major financial publications and the rates published in them. Such a provision does not require a factual determination other than the examination of information to which the examiner has ready access in the normal course of its business. The same principle would apply to a deposit in an account maintained with the examiner. Therefore, rules 4.11(c)(iii) and (iv) provide that such matters are not non-documentary and are not to be disregarded.<sup>194</sup>

In the United States' Revised UCC article 5 there is a section that relates to non-documentary conditions. Section 5-108(g) states that '[i]f an undertaking constituting a letter of credit under section 5-102(a)(10) contains nondocumentary conditions, an issuer shall disregard the nondocumentary conditions and treat them as if they were not stated.'

In Official Comment 9 to section 5-108 of the UCC it is stated that it is the responsibility of the issuer of a letter of credit to examine documents and to make a prompt decision to honour or dishonour this letter of credit based on that examination. Non-documentary conditions have no place in the letter of credit regime, and are better accommodated under contract or suretyship law and practice. Therefore, non-documentary conditions in letters of credit should be ignored.<sup>195</sup>

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<sup>192</sup> See Byrne *op cit* note 178 at 166.

<sup>193</sup> See note 174 above.

<sup>194</sup> See Byrne *op cit* note 178 at 166.

<sup>195</sup> In addition to this, Official Comment 6 to UCC article 5 section 5-102 also states that

[w]hen a document labelled a letter of credit requires the issuer to pay not upon the presentation of documents, but upon the determination of an extrinsic fact such as applicant's failure to perform a construction contract, and where that condition appears on its face to be fundamental and would, if ignored, leave no obligation to the issuer under the document labelled a letter of credit, the issuer's undertaking is not a letter of credit. It is probably some form of suretyship or other contractual arrangement and may be enforceable as such.

It follows that including non-documentary conditions into commercial letters of credit, standby letters of credit and demand guarantees is undesirable, and it is suggested that banks should rather explain the dangers of including non-documentary conditions into their credits and guarantees than to try to convert these conditions into documentary conditions.

#### **2.5.2.5 *The Requirement of Compliance of the Demand with the Terms of the Guarantee: The Principle of Strict Compliance***

A question that troubles bankers and lawyers is how strictly the documents must conform to the terms of the letter of credit/demand guarantee. 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/principal of the credit/guarantee? Or is it a substantial compliance standard in terms of which deviations that the bank has no reason to believe are of commercial significance are ignored? Or does the law adopt another standard – a bifurcated standard (i.e., a strict compliance in suits by the beneficiary against the issuing bank, but only substantial compliance in suits by the applicant against the issuing bank) in terms of which the bank is free to invoke a strict standard of compliance against the beneficiary, but is entitled to the benefit of a more relaxed standard *vis-à-vis* its customer in choosing to pay despite minor deviations?<sup>196</sup>

##### **2.5.2.5.1 *Principle Regarding Commercial Letters of Credit***

The doctrine of strict compliance is well established for commercial letters of credit. The doctrine entails that the documents presented in terms of a letter of credit must be precisely those for which the letter of credit calls.<sup>197</sup> This doctrine can basically be traced back to Viscount Sumner's statement in *Equitable Trust Company of New York v Dawson Partners Ltd.*<sup>198</sup>

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 authorised 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.* Business could not proceed securely on any other lines. The bank's branch abroad, which knows nothing officially of the details of the transaction thus financed, cannot take it upon itself to decide what will do well enough and what will not. If it does as it is told, it is safe; if it declines to do anything else, it is safe; if it departs from the conditions laid down, it acts at its own risk.<sup>199</sup> (Emphasis added.)

<sup>196</sup> See R Goode 'Abstract Payment Undertakings in International Transactions' (1996) XXII *Brooklyn Journal of International Law* 1 at 6.

<sup>197</sup> See *Jack op cit* note 140 in para 8.21; J C T Chuah *Law of International Trade* 2 ed (2001) at 427–434; McKendrick *op cit* note 141 in para 14-060; C F Hugo 'Letters of Credit: Reflections on Recent Developments' *ABLU* 1994 (a paper delivered at the 1994 Annual Banking Law Update held at the Indaba Hotel, Johannesburg) (unpaginated) (hereinafter '*ABLU 1994*') at 8–11 of his article; Van Niekerk and Schulze *op cit* note 24 at 299–300, 306 and 309–311; and *Oelofse: The Law of Documentary Letters of Credit op cit* note 123 at 271. See also *I E Contractors Ltd v Lloyds Bank plc and Rafidain Bank* [1990] 2 Lloyd's Rep 496 (CA) at 500.

<sup>198</sup> (1927) 27 Lloyd's L Rep 49 (HL) at 52.

<sup>199</sup> This *dictum* has been cited with approval and applied in various cases, see, for instance, *JH Rayner and Company Ltd v Hambro's Bank Ltd* [1943] KB 37 (CA) at 40–41; *Bank Melli Iran v Barclays Bank*

The English courts<sup>200</sup> apply a doctrine of strict compliance to documents provided in conformance with a letter of credit.<sup>201</sup> This doctrine, however, is not the same as exact compliance.<sup>202</sup> For instance, this doctrine of strict compliance does not mean that a document will be treated as non-conforming if every ‘i’ is not dotted or every ‘t’ is not crossed or contains obvious typographical errors. Rigid and meticulous fulfilment of precise wording is not required in all cases.<sup>203</sup> Gutteridge and Megrah have clearly stated that it is impossible to define exhaustively the nature and extent of the bank’s duty with regard to the exactness of compliance of documents presented to it under a credit, and each case must be considered on its own merits in the light of the language of the credit and the circumstances in which it has been established. A dogmatic generalised approach must be rejected.<sup>204</sup> Therefore, a measure of common sense is used when the standard, which is in principle strict, is applied.<sup>205</sup>

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(*Dominion, Colonial and Overseas*) [1951] 2 Lloyd’s L Rep 367 (KB) at 375; and *Moralice (London) Ltd v E D & F Man* [1954] 2 Lloyd’s Rep 526 (QB) at 532. See also *Gian Singh & Co Ltd v Banque de L’Indochine* [1974] 2 Lloyd’s Rep 1 at 12: ‘this oft-cited passage has never been questioned or improved upon’.

<sup>200</sup> See *Equitable Trust Company of New York v Dawson Partners Ltd supra* note 198 at 52; *JH Rayner and Company Ltd v Hambro’s Bank Ltd supra* note 199 at 40–41; *Bank Melli Iran v Barclays Bank supra* note 199 at 375; and *Moralice (London) Ltd v E D & F Man supra* note 199 at 532.

<sup>201</sup> See also *Jack op cit* note 140 in para 8.21 at 183; J C T Chuah *Law of International Trade* 2 ed (2001) at 427–434; McKendrick *op cit* note 141 in para 14-060; R King *Gutteridge & Megrah’s Law of Bankers’ Commercial Credits* 8 ed (2001) at 181–187; *Hugo: The Law Relating to Documentary Credits op cit* note 140 at 296–298 and the authorities cited there; and *Oelofse: The Law of Documentary Letters of Credit op cit* note 123 at 282–288.

<sup>202</sup> In *Banque de L’Indochine et de Suez SA v JH Rayner (Mincing Lane) Ltd* [1983] 1 QB 711 (CA) ([1983] 1 Lloyd’s Rep 228 (CA)), Parker J (at 721E–F) commented on Viscount Sumner’s statement made in *Equitable Trust Company of New York v Dawson Partners Ltd supra* note 198:

I also accept . . . that Lord Sumner’s statement cannot be taken as requiring rigid meticulous fulfilment of precise wording in all cases. Some margin must and can be allowed, but it is slight, and banks will be at risk in most cases where there is less than strict compliance. They may pay on a reasonable interpretation . . . where instructions are ambiguous, but where the instructions from the issuing bank are clear they are obliged to see to it that the instructions are complied with and entitled to refuse payment to the beneficiary unless they are.

In *Kredietbank Antwerp v Midland Bank Plc* [1999] Lloyd’s Rep Bank 219 (CA) the requirement was expressed as follows: ‘The requirement of strict compliance is not equivalent to the test of exact literal compliance in all circumstances and as regards all documents. To some extent, therefore, the banker must exercise his own judgement whether the requirement is satisfied by the documents presented to him’.

<sup>203</sup> See *King op cit* note 201 in para 7-13 at 186 and authorities cited.

<sup>204</sup> See *King op cit* note 201 in para 7-16 at 187.

<sup>205</sup> See R Goode ‘Abstract Payment Undertakings in International Transactions’ (1996) XXII *Brooklyn Journal of International Law* 1 at 6; J C T Chuah *Law of International Trade* 2 ed (2001) at 427–434 and the authorities cited; *Jack op cit* note 140 at 182–183 and the authorities cited; and *Banque de L’Indochine et de Suez SA v JH Rayner (Mincing Lane) Ltd* [1983] 1 QB 711 (CA) ([1983] 1 Lloyd’s Rep 228 (CA)) at 721E–G. However, for an example of how strict the English courts sometimes apply the compliance principle, see *Seaconsar Far East Ltd v Bank Markazi Jomhouri Islami Iran* [1993] 1 Lloyd’s Rep 236 (CA) (for a discussion of this case, and its appeal in *Seaconsar Far East Ltd v Bank Markazi Jomhouri Islami Iran* [1994] 1 Lloyd’s Rep 1 (HL) see A N Oelofse ‘Developments in the Law of Documentary Letters of Credit’ (1996) 8 *South African Mercantile Law Journal* 56 at 61–62). In the *Seaconsar* case the letter of credit required that the number of the letter of credit and the buyer’s name were to appear on all documents. However, they did not appear on a certain document and the court refused to regard the discrepancy as trivial.

Initially in the United States there was uncertainty regarding what standard of compliance was required. In terms of the previous 1962 version of article 5 of the UCC,<sup>206</sup> provision was made in section 5-114(1) for an issuer had to honour a draft or demand for payment that complied with the terms of the relevant credit. However, both the Code and its Official Commentary were silent on the standard to be applied for determining whether a document ‘complied’. The courts’ interpretations differed widely in this regard in the United States. The majority of courts applied a doctrine of strict compliance to documents tendered in conformity with a letter of credit,<sup>207</sup> whereas the minority applied a lower standard, namely that of ‘substantial compliance’.<sup>208</sup> This standard allows greater freedom for discrepant documents, but at the expense of raising problems for the paying bank as to whether or not it should pay. A few other courts in the United States have even applied a bifurcated standard, that is, strict compliance in suits by the beneficiary against the issuing bank, but only substantial compliance in suits by the applicant against the issuing bank.<sup>209</sup>

However, the preponderant view in the United States supported a principle of strict compliance sensibly applied. According to this approach, strict compliance did not mean a blind adherence. It was expected of a banker, where he was able to do so, to determine the relevance of a particular discrepancy. Generally, this meant that if the requirements related to the underlying transaction, then they had to be complied with meticulously because a banker could not be expected to determine the relevance of such a discrepancy. In contrast, a banker ought to have been able to determine the relevance of a discrepancy relating to the banker’s own business. Obvious typographical errors were also disregarded.<sup>210</sup> Thus it appeared that the American approach to strict compliance was less strict than that of the English courts.<sup>211</sup>

<sup>206</sup> For a brief discussion of the background to the 1962 version of article 5 of the UCC, see para 3.4.2, in particular para 3.4.2.2, in Chapter 3.

<sup>207</sup> See, e.g., *Corporacion De Mercadeo Agricola v Mellon Bank Int’l* 608 F 2d 43 (2nd Cir 1979); *AMF Head Sports Wear Inc v Ray Scott’s All-Am Sports Club Inc* 448 F Supp 222 (D Ariz 1978); *North Woods Paper Mills Ltd v National City Bank* 121 NYS 2d 543 (Sup Ct 1953), aff’d 283 AD 731, 127 NYS 2d 663 (1954); and cf G McLaughlin ‘The Standard of Strict Documentary Compliance in Letter of Credit Law: An American Perspective’ (1993) 1 *Journal of Banking and Finance Law and Practice* 81 at 81. For a full discussion of the cases that applied a strict compliance standard, see *Dolan: The Law of Letters of Credit op cit* note 66 in paras 6.03–6.04.

<sup>208</sup> For the application of a substantial compliance standard, see, e.g., *Tosco Corporation v Federal Deposit Insurance Corporation* 723 F 2d 1242 (6th Cir 1983) at 1248; *Flagship Cruises Ltd v New England Merchants National Bank of Boston* 569 F 2d 699 (1st Cir 1978) at 702–705; *Banco Espanol de Credito v State Street Bank and Trust Company* 385 F 2d 230 (1st Cir 1967) at 233–234; and *First National Bank of Atlanta v Wynne* 256 SE 2d 383 (Ga App 1979) at 386. For a full review of these and other cases supporting or influenced by the substantial compliance standard, see *Dolan: The Law of Letters of Credit op cit* note 66 in para 6.05; and cf G T McLaughlin ‘On the Periphery of Letter-of-Credit Law: Softening the Rigors of Strict Compliance’ (1989) 106 *Banking Law Journal* 4.

<sup>209</sup> For the application of a bifurcated standard, see *Transamerica Delaval Inc v Citibank NA* 545 F Supp 200 (SDNY 1982) at 203–204; and *Far Eastern Textile Ltd v City National Bank and Trust Company* 430 F Supp 193 (SD Ohio 1977) at 196. See also Buckley *op cit* note 177 at 278, in particular in note 84; and J F Dolan ‘Letter-of-Credit Disputes Between the Issuer and its Customer: The Issuer’s Rights Under the Misnamed “Bifurcated Standard”’ (1988) 105 *Banking Law Journal* 380.

<sup>210</sup> Examples of such ‘irrelevant’ mere typographical errors are to be found in the cases of *Beyene v Irving Trust Company* 762 F 2d 4 (1985); and *Voest-Alpine Trading USA Corp v Bank of China* 167 F Supp 2d 940 (SD Tex 2000).

<sup>211</sup> See R Goode ‘Abstract Payment Undertakings in International Transactions’ (1996) XXII *Brooklyn Journal of International Law* 1 at 6; and see also *Hugo: The Law Relating to Documentary Credits op cit* note 140 at 300–301.

In 1995 article 5 of the UCC<sup>212</sup> was revised (the revision currently in force) and it brought more clarity regarding documentary compliance. At present section 5-108(a) states that an issuer must 'honor a presentation that, as determined by the standard practice referred to in subsection (e), appears on its face strictly to comply with the terms and conditions of the letter of credit'. If it appears that such a presentation does not so comply, the issuer must dishonour such a presentation. In the Official Comment<sup>213</sup> it is confirmed that section 5-108(a) adopts strict compliance rather than 'substantial compliance'. By implication, the new revision also rejects the bifurcated standard. However, it is also pointed out in the Official Comment that it is possible for an issuer to restrict contractually its liability to the applicant. For instance, an applicant might agree that the issuer would have no duty whatsoever to examine documents on certain presentations (e.g., those below a certain dollar amount). In such a case, 'the beneficiary would have to meet a more stringent standard of compliance as to the issuer than the issuer will have to meet as to the applicant'.<sup>214</sup>

Furthermore, section 5-108(e) of the revised article 5 provides that an issuer must observe the standard practice of financial institutions that regularly issue letters of credit. Subsection (e) also provides that the determination of the issuer's observance of the standard practice is a matter of interpretation for the court; and parties before the court will be given an opportunity to present evidence of the standard practice. The Official Comment<sup>215</sup> points out that the standard practice referred to in subsection (e) includes (1) international practice set forth in, or referenced by, the UCP;<sup>216</sup> (2) other practice rules published by associations of financial institutions; and (3) local and regional practice. The principle of strict compliance is clearly accepted, but what amounts to 'strict compliance' must be determined with reference to 'standard practice'. Therefore, it is possible that standard practice will vary from one place to another. Where there are conflicting practices, the parties should indicate which practice governs their rights. However, it is also pointed out that a practice may be overridden by agreement or course of dealing.<sup>217</sup> It was stressed in the Official Comment that the effect of using standard practice as a way of measuring strict compliance is that 'strict compliance does not mean slavish conformity to the terms of the credit'.<sup>218</sup>

It follows that it is clear that the United States currently applies a principle of strict compliance and determines what amounts to 'strict compliance' by looking at the standard of practice as set out in the UCP, other rules issued by associations of financial institutions, and how they are applied locally and regionally.

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<sup>212</sup> For a brief discussion of the background to the 1995 version of article 5 of the UCC see para 3.4.2, in particular para 3.4.2.2, in Chapter 3.

<sup>213</sup> See Official Comment 1 to section 5-108.

<sup>214</sup> See *Hugo: The Law Relating to Documentary Credits op cit* note 140 at 301.

<sup>215</sup> See Official Comment 8 to section 5-108.

<sup>216</sup> See also the discussion under para 2.5.2.5.2 below.

<sup>217</sup> See *Hugo: The Law Relating to Documentary Credits op cit* note 140 at 301–302. See also Official Comment 8 to section 5-108.

<sup>218</sup> See Official Comment 1 to section 5-108.

In South Africa it is still uncertain what the required standard of compliance is regarding documents that are presented in terms of a commercial letter of credit. It has been implied indirectly (and by implication) that the principle of strict compliance is applicable.<sup>219</sup> However, there is no direct authority in the South African case law that directly sheds light on the matter.<sup>220</sup> In the past the courts were basically guided exclusively by English judgments in cases related to documentary credits, and it is therefore also likely that the English approach of a strict documentary compliance will be followed here.<sup>221</sup>

#### 2.5.2.5.2 Position in Terms of UCP 500 and UCP 600

The UCP 600, as well as their predecessor, UCP 500, contain a number of provisions that aim to relax the requirements of strict conformity.<sup>222</sup> Therefore, by incorporating one of these versions of the UCP into their contract, either expressly or tacitly, the applicant (or the principal in case of a demand guarantee) and the beneficiary agree to a certain relaxation of the required degree of compliance regarding the documents.<sup>223</sup>

Although the UCP 500 were replaced with the UCP 600 on 1 July 2007, there are still letters of credit in operation that are subject to UCP 500 and some banks are also still

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<sup>219</sup> See, e.g., *Delfs v Kuehne and Nagel (Pty) Ltd* 1990 (1) SA 822 (A); and *Nedcor Bank Ltd v Hartzler* 1993 CLD 278 (W) (for a discussion of this case, see *ABLU* 1994 *op cit* note 197 at 11–12 of the article). These two cases do not discuss the actual content of the principle of strict compliance, but they do illustrate the principle that a waiver of discrepancies by the applicant only does not mean that the issuing bank will be obliged to pay. Generally, the bank will pay if its customer is prepared to waive the discrepancies, but it is not obliged to do so, unless it has undertaken to do so. The bank's obligation to pay is determined purely by the letter of credit (see *Oelofse: The Law of Documentary Letters of Credit op cit* note 123 at 288–290). In *Standard Bank of South Africa Ltd v OK Bazaars (1929) Ltd* 2000 (4) SA 382 (W) ('the court *a quo*') the letter of credit stipulated that certain, specified documentation had to be provided in order to trigger payment by the issuing bank to the beneficiary. The letter also provided for partial shipments to be made. When the documentation for the first partial shipment arrived, there were various discrepancies. The court *a quo* emphasised that under these circumstances the issuing bank was allowed, but not obliged, to approach the applicant to waive those discrepancies (which the applicant had done in this case) On appeal, in *OK Bazaars (1929) Ltd v Standard Bank of South Africa Ltd* 2002 (3) SA 688 (SCA), the Supreme Court of Appeal confirmed the judgment of the court *a quo* and held (at 697G- 698A):

A bank ("the issuing bank") that establishes a letter of credit at the request and on the instructions of a customer thereby undertakes to pay a sum of money to the beneficiary against the presentation to the issuing bank of stipulated documents . . . The documents that are to be presented . . . are stipulated by the customer and the issuing bank generally has no interest in their nature or in their terms . . . Its interest is confined to ensuring that the documents that are presented conform with its client's instructions (as reflected in the letter of credit) in which event the issuing bank is obliged to pay the beneficiary. If the presented documents do not conform with the terms of the letter of credit the issuing bank is neither obliged nor entitled to pay the beneficiary without its customer's consent.

See also the convincing reasons given by Geraghty as to why South African courts should not take a 'substantial compliance' approach (see Geraghty *op cit* note 142 at 336–337).

<sup>220</sup> See *Hugo: The Law Relating to Documentary Credits op cit* note 140 at 300.

<sup>221</sup> See *Hugo: The Law Relating to Documentary Credits op cit* note 140 at 314; and *Oelofse: The Law of Documentary Letters of Credit op cit* note 123 at 288.

<sup>222</sup> See, e.g., article 13 of UCP 500 and article 14 of the UCP 600.

<sup>223</sup> See Van Niekerk and Schulze *op cit* note *op cit* note 24 at 300.

issuing letters of credit subject to UCP 500.<sup>224</sup> Therefore, a discussion of the positions under both the UCP 500 and the UCP 600 is necessary.

#### 2.5.2.5.2.1 UCP 500 and ISBP

The advantage of a strict rule is that it is reasonably clear and absolves the bank from making judgemental decisions. However, if one looks at international uniform rules, such as the UCP 500, it becomes clear that this strict rule has come under some pressure.<sup>225</sup> Although the UCP 500 retained certain built-in tolerances that make allowances for differences in the credit amount, quantity and unit price set out in the stipulated documents,<sup>226</sup> they also prescribe a standard of compliance with which the stipulated documents presented under a documentary credit or a standby letter of credit (and by implication also a demand guarantee) must comply. However, the UCP 500 do not directly address the problem of how to measure the compliance of the presented documents with the requirements of the credit.<sup>227</sup> In this regard, article 13(a) merely provides as follows:

Banks must examine all documents stipulated in the Credit with reasonable care, to ascertain whether or not they appear, on their face, to be in compliance with the terms and conditions of the Credit. 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 reflected in these Articles. Documents which appear on their face to be inconsistent with one another will be considered as not appearing on their face to be in compliance with the terms and conditions of the Credit.

Therefore, article 13(a) of the UCP requires banks to examine documents with reasonable care and provides that compliance of the stipulated documents on their face with the terms and conditions of the credit is to be determined by *international standard banking practice* as reflected in the UCP 500.<sup>228</sup> Article 13(a) is worded in this way, because in the past the doctrine of strict compliance was construed as prescribing a rigid proofreading exercise devoid of mercantile reality. This article was in line with a later trend that manifested in a few decisions that suggested that not every minor mistake in a document, such as a misprint or typographical error, constituted a discrepancy.<sup>229</sup> Therefore, one of the aims of article 13(a) of the UCP 500 is to deter the courts from being too ritualistic in treating documents as non-conforming where the defects are trivial and obvious. The other is to discourage courts from being too liberal by invoking considerations, such as good faith or the lack of commercial importance of the discrepancy.

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<sup>224</sup> See R Dobáš 'Issues and Question Marks' (January–March 2008) 14 *ICC's DCInsight* 3 at 3; and see also DCI Interview: D Smith 'The Insight Interview: Donald Smith' (July-September 2007) 13 *ICC's DCInsight* 5 at 7.

<sup>225</sup> See R Goode 'Abstract Payment Undertakings in International Transactions' (1996) XXII *Brooklyn Journal of International Law* 1 at 7.

<sup>226</sup> See article 39 of UCP 500.

<sup>227</sup> See Turner *op cit* note 174 at 473.

<sup>228</sup> See, e.g., *Blonder and Co Inc v Citi Bank NA* 23 AD 3d 180 (NY App Div 2006).

<sup>229</sup> See E P Ellinger 'The Uniform Customs and Practice for Documentary Credits – The 1993 Revision' (1994) *Lloyd's Maritime and Commercial Law Quarterly* 377 at 391.



In terms of the wording of article 13(a), if the international standard banking practices are not embedded in the UCP 500, they are not relevant. The international standard banking practices to which reference is to be made are only those practices ‘as reflected in these Articles’. Therefore, the words of the article do not permit expert testimony on what is standard banking practice beyond the extent to which other articles of the UCP 500 reflect it. The difficulty with this article was not only where to draw the line, but also where international standard banking practice was to be found, as such a practice was not reflected in the UCP 500.<sup>230</sup> Real doubt has been expressed that ‘international standard banking practices’ even exist.<sup>231</sup> The lack of such a published practice resulted in a situation where various banks had different rules on acceptability and checking of documents presented under documentary credits and standby letters of credit. The words ‘as reflected in these Articles’ tie in with the standard for compliance, the other provisions of the UCP 500 and only the international banking practice that those other provisions reflect. For instance, this includes provisions such as article 37(c) in terms of which the description of the goods on the invoice must correspond with the description in the credit, whereas in all other documents the goods may be described in general terms not inconsistent with the description of the credit. For this purpose, the UCP 500 should be read as a whole. The banking practice that is embodied or reflected in those other provisions may be considered to be determinative. However, there is no other provision that deals directly with the standard for compliance.<sup>232</sup> Therefore, it is not clear from article 13(a) whether strict compliance is necessary or whether substantial compliance is enough. The other provisions of the UCP 500 are silent on this issue, and under the wording of article 13(a), the practice of bankers with regard to the standard remains inadmissible.<sup>233</sup>

Under ‘international standard banking practice’, the great majority of courts, as stated above, have held that documents must ‘strictly comply’ with the terms and conditions of the credit. Strict compliance, however, as measured by ‘standard banking practice’, is not the equivalent of ‘mirror image’ compliance. The courts have experienced common sense in applying the strict compliance standard. Typographical and spelling errors, and other obviously trivial differences between the wording in the credit and the wording in the presented documents have been held not to render the presentation non-compliant under the strict compliance standard measured by standard practice.<sup>234</sup>

However, the ICC attempted to address this problem caused by article 13(a) of the UCP 500 by the publication of the International Standard Banking Practice for the Examination of Documents Under Documentary Credits (‘ISBP’) in 2003.<sup>235</sup> The ISBP

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<sup>230</sup> See R Goode ‘Abstract Payment Undertakings and the Rules of the International Chamber of Commerce’ (1995) 39 *Saint Louis University Law Journal* 725 at 740–741; and See R Goode ‘Abstract Payment Undertakings in International Transactions’ (1996) XXII *Brooklyn Journal of International Law* 1 at 9.

<sup>231</sup> See Buckley *op cit* note 177 in note 92 at 279.

<sup>232</sup> However, there are provisions that allow for irrelevant or immaterial irregularities, see, e.g., article 39. Therefore, mere technical or irrelevant discrepancies, as opposed to discrepancies that go to the substance of the documents, may not be relied upon to reject tendered documents (see Van Niekerk and Schulze *op cit* note 24 at 310).

<sup>233</sup> See Buckley *op cit* note 177 at 279–280 and in particular note 94 at 280.

<sup>234</sup> See *Tosco Corporation v Federal Deposit Insurance Corporation* 723 F 2d 1242 (6th Cir Tenn 1983); and Turner *op cit* note 174 at 473.

<sup>235</sup> ICC Publication No 645, Paris (2003) (hereinafter the ‘ISBP’). For a full discussion of the ISBP, see para 3.2.8.1 in Chapter 3.

was created with a view merely to define the international banking practice regarding the examination of the different documents tendered under documentary credits.<sup>236</sup> For instance, paragraph 24 of the ISBP provides that '[d]ocuments presented under a credit must not appear to be inconsistent with each other. The requirement is not that the data content be identical, merely that the documents not be inconsistent.'

The ISBP cannot be incorporated into a documentary credit and therefore the ISBP cannot be regarded as comprising standard terms governing the contractual relationships created in documentary credit transactions. The ISBP's effect is bound to depend on it being accepted as a declaration – or an authoritative statement – of the international practice developed by banks and referred to in article 13(a) of the UCP 500. The drafting of the ISBP was not based on an extensive study of existing banking practice. Its purpose was merely to explain how practices set out in the UCP 500 were to be applied by documentary practitioners. It cannot be stated with confidence that courts have, in fact, accepted that the ISBP declares or states the nature of international standard banking practice. In fact, the drafters of the ISBP recognised that the law in certain countries may compel a practice different from that stated in the ISBP. After all, the UCP was created to harmonise banking practice and to prescribe a uniform set of rules. Therefore, the adoption of different compliance standards in different jurisdictions tends to undermine the very uniformity the rules are designed to promote. It therefore follows that the UCP 500, read with the ISBP, provides no more than a very generalised statement as to the compliance standard applicable to documentary credits and standby letters of credit, still leaving it to be dealt with by the courts in the different jurisdictions.<sup>237</sup>

Article 13(a) of the UCP 500 (the third sentence) states: 'Documents which appear on their face to be inconsistent with one another will be considered as not appearing on their face to be in compliance with the terms and conditions of the Credit.' Therefore, article 13(a) provides that the data content of documents presented must be consistent not only with the terms and conditions of the credit, but with that of the other documents presented as well. In the context of a commercial letter of credit, inconsistencies in the documents may indicate that the goods are non-conforming. Commercial letters of credit normally deal with integrated transactions in which it is to be expected that all the documents presented relate to payment of the purchase price against documents evidencing the same transaction. The purpose of the consistency rule contained in article 13(a) is to allow the issuer to assure itself that the documents relate to one and the same transaction. That assumption cannot be made with respect to the typical standby.<sup>238</sup> In the context of a standby letter of credit, however, no useful purpose is normally served by requiring that the issuer search

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<sup>236</sup> For instance, the ISBP has a provision dealing specifically with the issue where there are misspellings or typing errors in a document. Paragraph 28 of the ISBP provides that

[m]isspellings or typing errors that do not affect the meaning of a word or the sentence in which it occurs, do not make a document discrepant. For example, a description of the merchandise as "mashine" instead of "machine", "fountan pen" instead of "fountain pen" or "modle" instead of "model" would not make the document discrepant. However, a description as "model 123" instead of "model 321" would not be regarded as a typing error and would constitute a discrepancy.

<sup>237</sup> See R Goode 'Abstract Payment Undertakings in International Transactions' (1996) XXII *Brooklyn Journal of International Law* 1 at 6.

<sup>238</sup> See *The Official Commentary on the ISP98 op cit* note 154 Official Comment 2 to rule 4.03 at 146.

for – or take note of – inconsistencies among the documents.<sup>239</sup> Therefore, it has been said that this requirement is not illogical in a commercial letter of credit, since the transaction is typically a holistic exercise in which internal consistency can be expected. However, this expectation does not necessarily follow for standby letters of credit. While there may be consistency as to some data, the very reason for the drawing may require an inconsistency between two documents, thereby evidencing the default. The problem is even more distinct in commercial standbys where the goods are usually in the possession of the applicant before the drawing. For instance, to dishonour commercial documents for inconsistencies between themselves where the documents comply with the terms and conditions in the letter of credit is normally without justification in a standby situation. Even more importantly, the examiner is never in a position to know whether an apparent inconsistency in a standby presentation is intended to reflect a default and often lacks the data to determine the context of how the entire transaction was structured so as to give isolated figures some contextual meaning, as would be the case in a commercial letter of credit.

#### 2.5.2.5.2.2 UCP 600 and ISBP (2007 Revision)

Since the UCP 500 were replaced with the UCP 600, it also became necessary to update the ISBP to bring it in line with the new UCP rules. Accordingly, the new International Standard Banking Practice for the Examination of Documents Under Documentary Credits, 2007 Revision for UCP 600 ('ISBP (2007 revision)')<sup>240</sup> came about. The ISBP (2007 revision) is an updated version of ISBP and its aims are similar to those of the ISBP (i.e., to provide document checkers (and other participants) with the interpretation of what international standard banking practice represents in relation to the UCP, a credit and the examination of documents).

The most common basis on which documents presented under documentary credits are rejected by banks worldwide is the inconsistency of the data in the different documents presented. A vote by the national committees prevented the Drafting Group of the UCP 600 from addressing this problem by a provision in the UCP to the effect that the data in a document should only be considered against the requirements in the credit for that document and the UCP rules.<sup>241</sup> Therefore, the drafters included article 14(d), which provides that '[d]ata in a document, when read in context with the credit, the document itself and international standard banking practice, *need not be identical to, but must not conflict with*, data in that document, any other stipulated document or the credit'<sup>242</sup> (emphasis added).

<sup>239</sup> See Turner *op cit* note 174 at 472–473.

<sup>240</sup> ICC Publication No 681 (E), Paris (2007) (hereinafter 'the ISBP (2007 revision)'). For a full discussion of the ISBP (2007 revision), see para 3.2.8.2 in Chapter 3.

<sup>241</sup> See C Hugo and O Lambertyn 'Documentary Credits and Independent Guarantees' *ABLU 2007* (a paper delivered at the 2007 Annual Banking Law Update held at the Indaba Hotel, Johannesburg on 18 April 2007) 177 (hereinafter '*ABLU 2007*') at 186.

<sup>242</sup> Paragraph 24 of ISBP (discussed in para 2.5.2.5.2.1 above) dealing with inconsistency in documents has been removed from the ISBP (2007 revision) and its contents now appear in article 14(d) of the UCP 600. The expression 'inconsistent' used in the ISBP was therefore changed to 'not conflict with'. This substitution has also been made in other paragraphs of ISBP (2007 revision). See H Erdemol H 'A Summary of the Updated ISBP' (July-September 2007) 13 *ICC's DCInsight* 3.

The wording used in article 14(d) of the UCP 600 does away with the less-precise and difficult-to-interpret requirements in article 13(a) of the UCP (discussed above) that the documents must ‘appear, on their face, to be in compliance with the terms and conditions of the Credit’ and must not ‘appear on their face to be inconsistent with one another’. This is believed to be a major improvement.<sup>243</sup>

There are also two other important articles of the UCP 600, namely article 14(a) and article 2. Article 14(a) provides that ‘[a] nominated bank acting on its nomination, a confirming bank, if any, and the issuing bank must examine a presentation to determine, on the basis of the documents alone, whether or not the documents appear *on their face* to constitute a complying presentation’<sup>244</sup> (emphasis added). Article 2 of the UCP 600 introduces the definition of ‘complying presentation’ and states that ‘a complying presentation means a presentation that is in accordance with the terms and conditions of the credit, the applicable provisions of these rules and international standard banking practice’. This definition lays the foundation for the test applied in article 14(a) relating to the bank’s duty to examine the documents.<sup>245</sup>

From the above, it follows that article 14 does in the UCP 600 what the old article 13 did in the UCP 500: it establishes the basic responsibility of banks to examine documents presented under letters of credit.<sup>246</sup>

The reference to ‘international standard banking practice’ in this context, as in the case of the UCP 500 (discussed above), does not mean the ISBP (2007 revision) or even the ISBP.<sup>247</sup> It means international standard banking practice in the wider sense, which definitely includes the ISBP (2007 revision) and the ISBP, but is not limited to them.<sup>248</sup> As

<sup>243</sup> See *ABLU 2007 op cit* note 241 at 187.

<sup>244</sup> The expression ‘with reasonable care’, which was used in article 13(a) of the UCP 500, has been omitted from article 14(a) of the UCP 600. Debattista indicated that it was not expected that this omission would lead to any substantive difference in the way this duty would be construed by the banks in the exercise of their duty to examine the documents. He further states that given that the duty always was – and remains – to ascertain whether documents appear to conform, it must follow that the banks are under a duty to exercise reasonable care rather than any stricter duty of examination (see C Debattista ‘The New UCP600 – Changes to the Tender of the Seller’s Shipping Documents under Letters of Credit’ (2007) *Journal of Business Law* 329 at 337 and the authority cited; and cf M Isaacs and M Barnett ‘International Trade Finance – Letters of Credit, UCP 600 and Examination of Documents’ [2007] 22 *Journal of International Banking Law and Regulation* 660). Concern has also been expressed for the use of the word ‘on their face’ in article 14(a). This expression has caused concern, because of its vague meaning in various languages (see M Ford ‘Issues and Challenges under UCP 600’ (October–December 2007) 13 *ICC’s DCInsight* 1 at 23 (where Ford refers to a statement made by Roberto Bergami, a senior lecturer at the Victoria University’s Practice of International Trade School of Applied Economics)). However, Debattista states that one should not be overly concerned with this. He says that the important thing for users to remember is that the banks are still bound – and entitled – to accept or reject documents on the basis of whether they comply with the letter of credit rather than on whether what they say is accurate (see C Debattista ‘The New UCP600 – Changes to the Tender of the Seller’s Shipping Documents under Letters of Credit’ (2007) *Journal of Business Law* 329 at 338).

<sup>245</sup> See E P Ellinger ‘The Uniform Customs and Practice for Documentary Credits (UCP): Their Development and the Current Revisions’ (2007) *Lloyd’s Maritime and Commercial Law Quarterly* 152 at 160.

<sup>246</sup> See Debattista *op cit* note 244 at 337.

<sup>247</sup> See Note ‘ISBP 681 Approved Unanimously’ (July–September 2007) 13 *ICC’s DCInsight* 2. Furthermore, the UCP 600 contains no express reference to the ISBP (2007 revision).

<sup>248</sup> See P Andriele ‘Ambiguities in the New UCP’ (July–September 2007) 13 *ICC’s DCInsight* 17 at 18.

mentioned above, it appears that under ‘international standard banking practice’, the great majority of courts have held that the doctrine of strict compliance is applicable. However, strict compliance as measured by ‘standard banking practice’ is not the equivalent of ‘mirror image’ compliance. Therefore, it would appear that international standard banking practice favours fairly strict compliance, ignoring trivial discrepancies, and obvious typographical and spelling errors.

The UCP 600 have not watered down the principle of strict compliance. They have, however, eliminated the possibility of rejecting documents for inconsequential discrepancies.<sup>249</sup> For example, in *Seaconsar Far East Limited v Bank Markazi Jomhuri Islami Iran*<sup>250</sup> a letter of credit required that the buyer’s name had to appear on all documents. One of the documents did not contain this and the English Court of Appeal refused to ignore the discrepancy. With the new UCP 600, the possibility of documents being rejected for inconsequential discrepancies, such as that in the *Seaconsar* case, will be dramatically reduced. This change has also been regarded as a major improvement. It also appears that it will be less problematic for banks and courts to determine compliance in future.<sup>251</sup>

#### 2.5.2.5.3 Position in Terms of ISP98

However, this problem has been addressed in ISP98 by way of rule 4.03 (Examination of Inconsistency) which establishes the opposite rule.<sup>252</sup> Rule 4.03 of the ISP98 deals with the examination of inconsistency between documents. It provides that the issuer (or nominated person) is required to examine documents for inconsistency with one another only to the extent provided in the standby letter of credit. This rule affirms that the only consistency at issue in the examination of documents under a standby (even documents regarding a transaction for the sale of goods) is with respect to the terms and conditions of the standby itself. Under this rule the test is whether each document relates to the standby. Each document under a standby must comply with the terms and conditions of the standby.

<sup>249</sup> There are provisions in the UCP 600, just like there was in the UCP 500, that allows for certain irrelevant or immaterial irregularities. For example, article 14(j) of the UCP 600 provides that

[w]hen the addresses of the beneficiary and the applicant appear in any stipulated document, they need not be the same as those stated in the credit or in any other stipulated document, but must be within the same country as the respective addresses mentioned in the credit. Contact details (telefax, telephone, email and the like) stated as part of the beneficiary’s and the applicant’s address will be disregarded. However, when the address and contact details of the applicant appear as part of the consignee or notify party details on a transport document subject to articles, 19, 20, 21, 22, 23, 24 or 25, they must be stated in the credit.

Further examples are also found in articles 14(e) and (f).

<sup>250</sup> [1993] 1 Lloyd’s Rep 236 (CA).

<sup>251</sup> See *ABLU 2007 op cit* note 241 at 187–188. However, not all agree. Bergami is of the view that the cause of many discrepancies in letters of credit has not been alleviated, because the requirement of consistency of data among documents has been kept, regardless of whether these data are actually called for in the credit or not. He states that ‘the doctrine of materiality does not appear to have been considered in UCP600; rather the doctrine of strict compliance is still being followed’. He argues that this still enables a bank to reject the documents and jeopardize the payment, regardless of how minor or irrelevant a small error may be (see *Ford op cit* note 244 at 23 (where Ford refers to statements made by Roberto Bergami, a senior lecturer at Victoria University’s Practice of International Trade School of Applied Economics)).

<sup>252</sup> See *Byrne op cit* note 178 at 156.

Examination and comparison of the documents with one another is not required, because there is not necessarily any one underlying obligation from which the examiner can determine what constitutes consistency. It is said that the documents may well be related to different obligations under the same or different transactions and, indeed, in the case of a default, may well be expected to be inconsistent with one another (e.g., the presentation of documents requiring performance, together with those indicating default).<sup>253</sup>

The ISP98, like the UCP, refer to the ‘standard’ practice when the documents presented under the standby letter of credit (including to other independent undertakings, such demand guarantees) are examined. Rule 2.01 of the ISP98 provides that an issuer of a standby letter of credit merely undertakes to the beneficiary to honour a presentation that appears on its face to comply with the terms and conditions of the standby in accordance with these rules supplemented by standard standby practice. Furthermore, rule 4.01 of the ISP98 in this regard, also provides as follows:

**4.01 Examination for Compliance**

- a. Demands for honour of a standby must comply with the terms and conditions of the standby.
- b. Whether a presentation appears to comply is determined by examining the presentation on its face against the terms and conditions stated in the standby as interpreted and supplemented by these Rules which are to be read in the context of standard standby practice.<sup>254</sup>

Rules 4.01 and 2.01 restate the fundamental undertaking of letter of credit practice: that the issuer undertakes to honour complying demands.<sup>255</sup> Therefore, both the presentation and the documents must be examined in the light of the terms and conditions of the standby. Rule 4.01 avoids the term ‘strict compliance’, which is a crude and abstract formulation in terms of which the standard of examination is described and one which is used primarily because it is less inaccurate than the notion of ‘substantial compliance’ with which it is normally contrasted. The test of compliance turns on the role of the particular document in standby practice. The text of some documents must correspond with the text of the standby, others must be identical or exact, while still others need merely be not inconsistent with the standby. Rule 4.01 affirms the principle of letter of credit practice that the issuer is responsible for examining documents on their face and has no duty to investigate or inquire into matters beyond the face of the documents.<sup>256</sup>

Rule 4.02 deals with the non-examination of extraneous documents, and provides that documents presented that are not required by the standby need not be examined and, in any

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<sup>253</sup> See *The Official Commentary on the ISP98 op cit* note 154 Official Comment 3 to rule 4.03 at 146.

<sup>254</sup> For a discussion of the problems experienced with rule 4.01(b), which provides that examiners read documentary compliance rules ‘in context of standard standby practice’, see Dolan *op cit* note 24 at 1887–1889.

<sup>255</sup> See article 13(a) of the UCP 500 and article 14(a) of the UCP 600. However, the organisation of ISP98 differs from that of article 13 of the UCP 500 and that of article 14 of the UCP 600 in that extraneous documents, consistency, the mirror image of the documents, and non-documentary conditions are treated separately in rules 4.02 (Non-Examination of Extraneous Documents), 4.03 (Examinations for Inconsistency), 4.09 (Identical Wording and Quotation Marks), and 4.11 (Non-Documentary Terms and Conditions (see discussion in para 2.5.2.4.1 above)) respectively (see *The Official Commentary on the ISP98 op cit* note 154 Official Comment 6 to rule 4.01 at 141).

<sup>256</sup> See *The Official Commentary on the ISP98 op cit* note 154 Official Comment 1 and 2 to rule 4.01 at 140.

event, will be disregarded for purposes of determining compliance of the presentation. These documents may then, without responsibility, be returned to the presenter or passed on with the other documents presented.<sup>257</sup>

While rule 4.01 helpfully states that the ISP98 are to be read in the context of standard practice, the ISP98 drafters were not content to let the standard practice dictate how documentary compliance is to be measured. Instead, they attempted in rule 4.09 to formulate new rules to apply when the documents presented to the examining bank do not reflect the mirror image of the documents described in the credit. Rule 4.09 was also inserted because the counterparties to the underlying contract often specify the wording (terms) to be used by inserting it in the standby accompanied by some indication that the required document(s) that must be presented is to contain these terms. The indication also typically appears in the form of quotation marks surrounding the desired phrase, an indented and blocked portion of the text of the standby, or an entire document, which is attached as an exhibit.<sup>258</sup> In order to cater for this practice and the situation where the documents presented do not reflect the mirror image of the documents described in the credit, rule 4.09 was inserted into the ISP98.<sup>259</sup> Rule 4.09 provides the following:

If a standby requires:

- a. a statement without specifying precise wording, then the wording in the document presented must appear to convey the same meaning as that required by the standby;
- b. specified wording by the use of quotation marks, blocked wording, or an attached exhibit or form, then typographical errors in spelling, punctuation, spacing, or the like that are apparent when read in context are not required to be duplicated and blank lines or spaces for data may be completed in any manner not inconsistent with the standby; or
- c. specified wording by the use of quotation marks, blocked wording, or an attached exhibit or form, and also provides that the specified wording be “exact” or “identical”, then the wording in the documents presented must duplicate the specified wording, including typographical errors in spelling, punctuation, spacing and the like, as well as blank lines and spaces for data must be exactly reproduced.

#### 2.5.2.5.4 Principle Regarding Demand Guarantees

It also needs to be established whether the doctrine of strict appliance applies with equal force to demand guarantees. If the demand guarantee is governed by the URDG, article 9 will apply. Article 9 provides that

<sup>257</sup> For a full understanding of rule 4.02 see *The Official Commentary on the ISP98 op cit* note 154 Official Comments 1–5 to rule 4.02 at 143–44.

<sup>258</sup> For a full discussion of the advantages and disadvantages of making use of this method, as well as why the ISP98 included rules dealing with this practice, see Byrne *op cit* note 178 at 171–172.

<sup>259</sup> For a full discussion of rule 4.09 see *The Official Commentary on the ISP98 op cit* note 154 Official Comments 1–7 to rule 4.09 at 162–164. However, the insertion of rule 4.09, in particular rules 4.09(b) and (c), has been severely criticised. It has been said that these rules should have been omitted from the ISP98 and the issue of documentary compliance be determined by ‘the standard standby practice’. For a full discussion of this criticism and the many problems experienced with rule 4.09, see Turner *op cit* note 174 at 474–482; and Dolan *op cit* note 24 at 1890–1891.

[a]ll documents specified and presented under a Guarantee, including the demand, shall be examined by the Guarantor with reasonable care to ascertain whether or not they appear on their face to conform with the terms of the Guarantee. Where such documents do not appear so to conform or appear on their face to be inconsistent with one another, they shall be refused.

Therefore, article 9 requires the guarantor to examine documents with reasonable care to ascertain whether they appear on their face to conform with the terms of the guarantee. The wording of article 9 of the URDG is very similar to that of the corresponding provision, namely article 15, of the UCP 400 (i.e., the 1983 version),<sup>260</sup> which was in operation when the URDG were published in 1992. Article 15 of the UCP 400 provided that

[b]anks must examine all documents with reasonable care to ascertain that they appear on their face to be in accordance with the terms and conditions of the credit. Documents which appear on their face to be inconsistent with one another will be considered as not appearing on their face to be in accordance with the terms and conditions of the credit.

The language of article 9 of the URDG is also similar to other prior-UCP rules<sup>261</sup> and to article 5 of the 1962 version (previous version) of the UCC of the United States. Section 5-109(2) of the 1962 version of the UCC provided that '[a]n issuer must examine documents with care so as to ascertain that on their face they appear to comply with the terms of the credit'.

From the above it follows that the obvious intention is that the standard of compliance regarding a demand guarantee, which is governed by the URDG, should be the same as for a documentary letter of credit.<sup>262</sup>

However, where the demand guarantee is not governed by the URDG, the position under the English law is not so clear. For instance, in *Siporex Trade SA v Banque Indosuez*<sup>263</sup> the application of the doctrine of strict compliance was questioned. There is also some authority in this case that this doctrine does not apply with the same rigour in relation to demand guarantees. This was also considered in *I E Contractors Ltd v Lloyds Bank plc and Rafidain Bank*,<sup>264</sup> where Staughton LJ indicated that the reasoning behind the doctrine of strict compliance regarding letters of credit did apply and that the degree of documentary compliance required by a demand guarantee (the court referred to the expression 'performance bond') might be strict or less strict, depending on the construction of the guarantee bond.<sup>265</sup> However, legal writers<sup>266</sup> have said that such an approach was a risky approach for individuals whose duty it was to examine documents, because it added an additional process of having to make an initial judgement about the required degree of

<sup>260</sup> The UCP 400 were effective from 1 October 1984 until 31 December 1993.

<sup>261</sup> See article 7 of the 1974 version of the UCP (*ICC Publication* No 290, Paris (1974)) with the same language, but different punctuation; and see also article 7 of the 1962 version of the UCP (*ICC Publication* No 222, Paris (1962)) with the same language.

<sup>262</sup> See *Paget's Law of Banking* *op cit* note 17 at 733.

<sup>263</sup> [1986] 2 Lloyd's Rep 146 (QB (Com Ct)).

<sup>264</sup> [1990] 2 Lloyd's Rep 496 (CA) at 501.

<sup>265</sup> See Warne and Elliott *op cit* note 1 at 281.

<sup>266</sup> See *Paget's Law of Banking* *op cit* note 17 at 733.



strictness of compliance. The better approach, according to them, was to adopt the same standard of strict documentary compliance as is applied to letters of credit because

- this was a standard with which all document checkers ought to be familiar;
- the adoption of a high standard was not unfair on beneficiaries given that a demand guarantee was similar to a promissory note payable on demand; and
- if a discrepancy in the documents was capable of being remedied, the beneficiary would usually be in a position to make a new demand.

It would appear that courts in England have now started to apply the same degree of strict compliance to demand guarantees as they do to commercial letters of credit. For instance, in *Frans Maas (UK) Ltd v Habib Bank AG Zurich*<sup>267</sup> the demand guarantee required presentation of a written statement which read: '[T]he Principals have failed to pay you under their contractual obligation'. The demand that was made, however, read: '[W]e claim the sum of £500,00, [the Principals] having failed to meet their contractual obligations to us'. The court held that the demand did not comply with the guarantee, because it did not allege breach of a payment obligation.<sup>268</sup>

In terms of section 5-108(a) and (e) of the UCC, discussed above,<sup>269</sup> the United States also applies a principle of strict compliance to commercial as well as standby letters of credit, and determines what amounts to 'strict compliance' by looking at the standard of practice as set out in the UCP, other rules issued by associations of financial institutions, and how they are applied locally and regionally.

As already mentioned,<sup>270</sup> the doctrine of strict compliance has not been fully established in South Africa for commercial letters of credit. The standard of compliance applicable to demand guarantees in South Africa has also not been settled yet, mainly due to a lack of case law and legal writings dealing with this issue. Based on the fact that South Africa presumably already follows a standard of strict documentary compliance in relation to commercial letters of credit and that its courts often follow the English judgments in this area of law, the assumption is made that the South African courts will also apply the same standard of strict documentary compliance to demand guarantees.

#### 2.5.2.5.5 *Position in Terms of the UNCITRAL Convention*

However, if the UNCITRAL Convention<sup>271</sup> were to apply to the demand guarantee or standby letter of credit, regard should be had for the articles in the Convention that establish what the standard of documentary compliance is that is required for guarantees/credits governed by the Convention. The standard of compliance is found in

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<sup>267</sup> [2001] Lloyd's Rep Bank 14.

<sup>268</sup> See [2001] Lloyd's Rep Bank 14 in paras 59 and 60; and the discussion of the case in *Paget's Law of Banking op cit* note 17 at 733.

<sup>269</sup> See para 2.5.2.5.1 above.

<sup>270</sup> See para 2.5.2.5.1 above.

<sup>271</sup> For a full discussion of this Convention, see para 3.3 in Chapter 3 and para 4.4 in Chapter 4.

article 16, but articles 13(2) and 14 of the Convention are also relevant to establish the standard required.<sup>272</sup> Article 13(2) provides that

[i]n interpreting terms and conditions of the undertaking and in settling questions that are not addressed by the terms and conditions of the undertaking or by the provisions of this Convention, regard shall be had to *generally accepted international rules and usages* of independent guarantee or stand-by letter of credit practice. (Emphasis added.)

Article 14(1) spells out that ‘the guarantor/issuer shall act in good faith and exercise reasonable care having due regard to generally accepted standards of international practice of independent guarantees or stand-by letters of credit’. Furthermore, paragraph (2) of article 14 also states that the guarantor/issuer ‘may not be exempted from liability for its [the guarantor’s/issuer’s] failure to act in good faith or for any grossly negligent conduct’. Article 16 lays down the principles for the care to be used by the guarantor/issuer in its examination of the demand and the accompanying documents. Article 16(1) provides that

[t]he guarantor/issuer shall examine the demand and any accompanying documents in accordance with the standard of conduct referred to in paragraph (1) of article 14. In determining whether documents are in facial conformity with the terms and conditions of the undertaking, and are consistent with one another, the guarantor/issuer shall have due regard to the *applicable international standard* of independent guarantee or stand-by letter of credit practice. (Emphasis added.)

By incorporating into the document the examination article, article 16, the notion that the guarantor/issuer must examine documents with ‘due regard to the applicable international standard of independent guarantee or stand-by letter of credit practice’, it is clear that the Convention adopts the strict standard of compliance over the minority substantial compliance standard. Therefore, it is clear that the UNCITRAL Convention adopts the rule that in order to obtain payment, the beneficiary must present documents to the guarantor/issuer that comply strictly with the terms of the demand guarantee or standby letter of credit.<sup>273</sup>

#### 2.5.2.5.6 Conclusion

From the above, it appears that it is an international rule that the beneficiary becomes entitled to payment only by conforming strictly to the terms of the demand guarantee. If the beneficiary neglects to present a document specified by the guarantee or presents a document that does not meet all the requirements of the guarantee or if the demand is not made in the manner and within the prescribed period of the guarantee, the beneficiary is not entitled to payment.<sup>274</sup>

However, the standard of compliance required varies from jurisdiction to jurisdiction. In some jurisdictions, such as England, South Africa and the United States, there must be

<sup>272</sup> For a discussion of article 14 and 16 of the UNCITRAL Convention, see J F Dolan ‘The UN Convention on International Independent Undertakings: Do States with Mature Letter-of-Credit Regimes Need It?’ (1998) 13 *Banking and Finance Law Review* 1 at 11–16.

<sup>273</sup> See Dolan *op cit* note 272 at 11.

<sup>274</sup> See also the *Guide to the URDG op cit* 10 at 19.

strict compliance, so that even very slight deviations might disentitle the beneficiary to receive payment. Then again, in other jurisdictions the requirement is less stringent and only substantial compliance is required.<sup>275</sup>

#### **2.5.2.6 Guarantor's Duty of Examination Limited to Apparent Good Order of the Documents**

The guarantor is not responsible for the adequacy, correctness or genuineness of the documents presented under a demand guarantee,<sup>276</sup> merely for ascertaining with reasonable care<sup>277</sup> whether they appear on their face to conform to the requirements of the guarantee. Therefore, the guarantor is not obliged to do more than conduct a reasonable visual examination.<sup>278</sup>

#### **2.5.2.7 Guarantor's Duty is Limited to the Exercise of Good Faith and Reasonable Care**

The duty of the guarantor is restricted to the exercise of good faith and reasonable care in the performance of his duties.<sup>279</sup> A guarantor is also not liable for acts outside his control.<sup>280</sup>

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<sup>275</sup> See the *Guide to the URDG op cit* 10 at 19.

<sup>276</sup> Article 11 of the URDG provides that the guarantor (or instructing party) assumes no liability or responsibility for the form, sufficiency, accuracy, genuineness, falsification, or legal effect of any document presented to him or for the general and/or particular statements made therein. The ISP98 that apply to standbys (standby letters of credit and other independent undertakings, like demand guarantees) also provide that an issuer is not responsible for the accuracy, genuineness, or effect of any document presented under the standby (see rule 1.08(b)). Similar provisions are also found in the UCP 500 (see article 15) and the UCP 600 (see article 34).

<sup>277</sup> As already mentioned, this duty of reasonable care of the guarantor is also confirmed by article 9 of the URDG. See also article 14(1) read with article 16(1) of the UNCITRAL Convention imposing a similar duty.

<sup>278</sup> See the *Guide to the URDG op cit* note 10 at 19 and see also articles 9 and 11 of the URDG. Rule 2.01 of the ISP98 provides that an issuer of a standby letter of credit merely undertakes to the beneficiary to honour a presentation that appears on its face to comply with the terms and conditions of the standby in accordance with these rules supplemented by standard standby practice. See also article 5-108(a) and (e) of the American UCC.

<sup>279</sup> See the *Guide to the URDG op cit* note 10 at 20 and also article 9 of the URDG. The duty of reasonable care and good faith of the guarantor is also confirmed by articles 14(1) and 16(1) of the UNCITRAL Convention. Article 13(a) of the UCP 500 required banks to exercise 'reasonable care' in examining the presented documents. However, the reference to 'reasonable care' disappeared in articles 14(a) and (d) of the UCP 600. The present duty of banks subject to the rule is to 'examine the presentation to determine, on the basis of the documents alone, whether or not the documents appear on their face to constitute a complying presentation.' Apparently, the code provides for a strict duty rather than a duty to exercise reasonable care. It has been stated that courts may, however, decide that, on the basis of the general contract of banker and customer, such an examination must be conducted with reasonable care (see E P Ellinger 'The Uniform Customs and Practice for Documentary Credits (UCP): Their Development and the Current Revisions' (2007) *Lloyd's Maritime and Commercial Law Quarterly* 152 at 166). Others again, have said that the commonly held view is that it is unlikely that this will affect what was in any event a restatement of the common law position (see Isaacs and Barnett *op cit* note 244 at 662). No such requirement of 'reasonable care' exists in the ISP98. However, the 'standard practice' that would apply to examination under the UCP 500 (article 13(a)), the UCP 600 (articles 2 (i.e., definition of complying presentation), 14(a), and (d)), as well as, the ISP98 (rule 4.01(b)) is to honour a presentation that appears strictly to comply with the requirements of the credit and to dishonour a presentation that does not appear strictly to comply with those requirements. Therefore, the bank that honours a compliant presentation carelessly does so rightfully nevertheless. A bank that honours a noncompliant presentation does so wrongfully, even when the bank has

### 2.5.2.8 *Independence of the Counter-Guarantee from the Guarantee*

When a counter-guarantee (or counter-indemnity) is issued – that is, in an indirect (four-party) guarantee structure – the counter-guarantee possesses the same independence from the demand guarantee as the latter from the underlying contract between the principal and the beneficiary.<sup>281</sup> Accordingly, as long as the guarantor's demand under the counter-guarantee complies with the requirements of the counter-guarantee, the guarantor is entitled to payment (in the absence of established fraud or another ground for non-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.<sup>282</sup>

### 2.5.2.9 *Independence of the Counter-Guarantee from the Mandate Received from the Instructing Party*

As the counter-guarantee, like the demand guarantee, is documentary in character and comprises an abstract payment undertaking, it is in principle independent of the distinct contractual relationship created by the mandate given by the instructing party (principal's bank) to the guarantor (local bank of beneficiary).<sup>283</sup> For that reason, a breach of that mandate by the guarantor (e.g., in respect of the terms on which the guarantee was to be issued) is a matter internal to the dealings between the guarantor and instructing party, and is not in itself grounds for refusal to pay the guarantor's demand, except in so far as the terms of the mandate are incorporated into the counter-guarantee.<sup>284</sup>

## 2.6 KEY ELEMENTS IN A DEMAND GUARANTEE

Although the form and content of demand guarantees differ significantly, there are certain key elements that every properly drawn guarantee must contain: in particular, the parties involved; a reference to the underlying contract; the amount or maximum amount of the guarantee and any agreement for reduction or increase; the currency of payment; the documents (if any) to be presented for the purpose of a demand or of reduction or expiry; and the expiry date or expiry provisions; and any agreement for extension. It is also extremely important to state the date of issue.<sup>285</sup> If it is the intention that the demand guarantee should not commence until presentation of a specific document, this fact should be stipulated.

In the event of a direct (three-party) demand guarantee, the parties to be identified are the principal, the guarantor and the beneficiary. In the event of an indirect (four-party) demand

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been exceedingly careful. Therefore, the absence of the requirement in the ISP98 and the UCP 600 is not adverse to the users of standby and commercial letters of credit (see Turner *op cit* note 174 at 487).

<sup>280</sup> See the *Guide to the URDG op cit* note 10 at 20 and also articles 9 to 16 of the URDG. Rule 1.08(c) of the ISP98 also provides that the issuer of a standby letter of credit is not responsible for actions or omissions of others. The UCP 600 (as did the UCP 500) also contains similar provisions, see e.g., articles 34–37.

<sup>281</sup> See *SITPRO's Report op cit* note 6 at 5.

<sup>282</sup> See article 2(c) of the URDG and also the *Guide to the URDG op cit* note 10 at 20 and 45. Furthermore, see also para 2.5.2.9 below.

<sup>283</sup> See *SITPRO's Report op cit* note 6 at 5.

<sup>284</sup> See the *Guide to the URDG op cit* note 10 at 20.

<sup>285</sup> See the *Guide to the URDG op cit* note 10 at 16–17. See also article 3 of the URDG.

guarantee, the guarantee must identify the principal, the guarantor and the beneficiary, while the counter-guarantee must identify the principal, the instructing party and the guarantor, and may also identify the beneficiary. The demand guarantee may be advised and transmitted directly or through an advising bank, but the bank, although concerned with checking that the signatures on the guarantee appear to be genuine, assumes no responsibility under the guarantee itself and has no contractual status except in its dealings with the guarantor. The guarantor party may consist of a sole guarantor or joint guarantors, and the responsibilities of the guarantor may be distributed by virtue of syndication or participation.<sup>286</sup>

## 2.7 AMENDMENT TO A DEMAND GUARANTEE

An amendment to a demand guarantee, as the guarantee itself, takes effect upon issue and the beneficiary's acceptance of it. If the beneficiary rejects the amendment, the effect of this is that the demand guarantee continues in force in its unamended form.<sup>287</sup>

## 2.8 DEMAND GUARANTEES AND COMMERCIAL LETTERS OF CREDIT COMPARED

### 2.8.1 Similarities

It is said that the demand guarantee (performance guarantee) is on a similar footing to a commercial letter of credit.<sup>288</sup> In *Edward Owen Engineering Ltd v Barclays Bank International Ltd*<sup>289</sup> Lord Denning MR stated the following:<sup>290</sup>

A performance bond is a new creature so far as we are concerned. It has many similarities to a letter of credit, with which of course we are very familiar. It has been long established that when a letter of credit is issued and confirmed by a bank, the bank must pay it if the documents are in order and the terms of the credit are satisfied. Any dispute between buyer and seller must be settled between themselves. The bank must honour the credit.

He continued:<sup>291</sup>

All this leads to the conclusion that the performance guarantee stands on a similar footing to a letter of credit. A bank which gives a performance guarantee must honour that guarantee according to its terms. It is not concerned in the least with the relations between the supplier and the customer; nor with the question whether the supplier has performed his contracted obligation or not; nor with the question whether the supplier is in default or not. The bank must

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<sup>286</sup> See the *Guide to the URDG op cit* note 10 at 17.

<sup>287</sup> See the *Guide to the URDG op cit* note 10 at 20.

<sup>288</sup> See Bennett *op cit* note 41 at 575; Debattista *op cit* note 51 at 289; *Edward Owen Engineering Ltd v Barclays Bank International Ltd* [1978] 1 QB 159 (CA) ([1978] 1 Lloyd's Rep 166 (CA); and [1978] 1 All ER 976 (CA)); and *Howe Richardson Scale Co Ltd v Polimex-Cekop and National Westminster Bank Ltd* [1978] 1 Lloyd's Rep 161 (CA) at 165.

<sup>289</sup> [1978] QB 159 (CA).

<sup>290</sup> At 169A–B.

<sup>291</sup> At 171A–B.

pay according to its guarantee, on demand, if so stipulated, without proof or conditions. The only exception is when there is clear fraud of which the bank has notice.

Commercial letters of credit and demand guarantees have many characteristics in common, namely both are<sup>292</sup>

- abstract payment undertakings, so that they are not required to conform to the ordinary conditions for a valid and binding contract;<sup>293</sup>
- 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 commercial letters of credit, 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;<sup>294</sup> and
- documentary in character, so that the obligation is triggered simply 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 fulfils its duty by paying against documents that appear, on reasonable examination, to conform to the credit/guarantee. This occurs even if it becomes apparent that without the bank's knowledge one (or more) of the documents have been forged or fraudulently altered or contain false data.<sup>295</sup>

Owing to the nature of a demand guarantee, its equation with a commercial letter of credit is therefore valid. This similarity between the two therefore brings the demand guarantee within the ambit of the law relating to commercial letters of credit (documentary credits). However, in other respects there are vital differences between commercial letters of credit and demand guarantees, which will be discussed below.

## 2.8.2 Critical Differences

In international trade, commercial letters of credit have long been commonly used instruments to secure payment. The letter of credit secures the claim of the seller to obtain payment of the price.<sup>296</sup> The essence of every letter of credit is an independent promise by a bank or other issuer of such letter to pay the purchase price to the exporter against the presentation of precisely described documents, such as a bill of lading or another document representing the goods sold.<sup>297</sup>

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<sup>292</sup> See R Goode 'Abstract Payment Undertakings in International Transactions' (1996) XXII *Brooklyn Journal of International Law* 1 at 4.

<sup>293</sup> See para 2.5.2.1 above.

<sup>294</sup> See para 2.5.2.2 above.

<sup>295</sup> See para 2.5.2.4 above.

<sup>296</sup> In *Rosen v Ekon* 2001 (1) SA 199 (W) ([2000] 3 All SA 19 (W)) at 206–208 Wunsh J compared the function of a letter of an undertaking with that of a commercial letter of credit. Wunsh J clearly indicated that the commercial letter of credit has a security function, whereas the letter of undertaking has a payment function (for a full discussion of this case, see A N Oelofse 'Developments in the Law of Letters of Credit' *ABLU* 2001 (a paper delivered at the 2001 Annual Banking Law Update held at the Indaba Hotel, Johannesburg on 25 April 2001) (unpaginated) at 23–25 of his article.

<sup>297</sup> See N Horn *German Banking Law and Practice in International Perspective* (1999) in Chapter 11 'The UN Convention on Independent Guarantees and the *Lex Mercatoria*' 189 at 191; and Hugo *op cit* note 135

A vital difference between commercial letters of credit and bank demand guarantees can be found in their payment function. The letter of credit constitutes a normal mode of payment; the bank demand guarantee does not. For instance, when parties to an export contract agree on a letter of credit, their common intention is that the exporter (supplier) receives its money through the use of that letter of credit. The bank demand guarantee, in contrast, will only be used if a risk occurs that is to be covered by that guarantee, for instance, if the goods are not delivered in time; or if they are not delivered in conformity with the contract; or if an advance payment is to be repaid for lack of performance. The parties do not expect that such a risk will materialise and the party that furnishes the guarantee hopes that it will never be used. Thus, payment on a guarantee is the exception, while payment on a letter of credit is the normal course in the execution of the contract.<sup>298</sup>

In a nutshell, the commercial letter of credit is designed to ensure the discharge of a payment obligation.<sup>299</sup> By contrast, the demand guarantee is used almost exclusively to secure the performance of a non-monetary obligation – classically, the execution of construction works or the delivery of conforming goods under a contract of sale<sup>300</sup> – and is conceived as a default mechanism. It is the principal (the equivalent of the applicant for the commercial letter of credit in a documentary credit transaction) who is primarily responsible for the performance to which the demand guarantee refers, and the agreement between the principal and the beneficiary requires, expressly or by implication, that the beneficiary resorts to the bank only if the principal defaults. Thus, while a bank pays a commercial letter of 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. However, 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 it is to pay against a written demand and such other documents, if any, as the guarantee may stipulate. Demand guarantees are different from commercial letters of credit in that they are properly invoked only if the principal has defaulted. Then again, the guarantor of a demand guarantee, like the issuer of a commercial letter of credit, is not concerned with the fact of default, but only with documents.<sup>301</sup> Therefore, the demand guarantee shares with the commercial letter of credit the characteristic that it is an abstract payment undertaking, separate from the underlying contract, but differs from the letter of 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. In view of that, the problem of unfair or abusive calls is peculiar to demand guarantees and cannot be raised in relation to commercial letters of credit, where it is agreed from the beginning that the bank, not the principal, is to be the first port of call for payment.<sup>302</sup>

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at 224 (Hugo discusses the position under English, American, German and South African law; as well as the position under the UCP and the UNCITRAL Convention).

<sup>298</sup> See Horn *op cit* note 297 at 192.

<sup>299</sup> See also Hugo *op cit* note 135 at 224.

<sup>300</sup> This is only one of the many respects in which the demand guarantee is different from the standby letter of credit, which is commonly used to secure payment obligations (for a full discussion of the differences between the standby credit and the demand guarantee, see para 2.9.5 below).

<sup>301</sup> See the ‘Introduction’ of the URDG at 4.

<sup>302</sup> See R Goode ‘Abstract Payment Undertakings in International Transactions’ (1996) XXII *Brooklyn Journal of International Law* 1 at 15.

There are also further differences between commercial letters of credit and demand guarantees.<sup>303</sup> Firstly, commercial letters of credit normally involve the presentation of a substantial volume of documents, whereas the documentation required for a claim on a demand guarantee is skeletal in the extreme, entailing in most instances presentation of no more than the written demand itself. Secondly, the making of ‘extend or pay’ demands is a particular feature of demand guarantee practice for which the URDG made special provision.<sup>304</sup>

## 2.9 STANDBY LETTERS OF CREDIT

### 2.9.1 Introduction

The development of the standby letter of credit or standby is a consequence of restrictions in the United States banking legislation on American banks to issue bank guarantees.<sup>305</sup> The United States’ National Bank Act of 3 June 1864 (as amended) precluded American banks from giving guarantees as part of their banking business. As these banks were not in general permitted to issue guarantees, they adopted the term ‘standby letter of credit’ to avoid the language of guarantees.<sup>306</sup>

The standby letter of credit is an adaptation of the commercial letter of credit to serve as a form of guarantee. Instead of requiring documents that, for example, evidence the shipment of goods under a contract of sale, the standby letter of credit is payable against documents that evidence (or, at least, imply) that the applicant is in breach of an obligation owed to the beneficiary.<sup>307</sup> The underlying contract may also be one of performance, for instance, under a supply or a construction contract or one of payment, such as the repayment of a loan.<sup>308</sup> The standby letter of credit was created in the United States as a payment undertaking primary in form but intended to be used only as a fall-back (‘standby’) (i.e., a secondary or fallback payment mechanism) in the event of default by the principal in terms of the underlying contract.<sup>309</sup> For example, in the oil trade, the difficulty of obtaining a set of documents that correspond with the stipulations of the commercial letter of credit has led to the use of standby letters of credit that can be

<sup>303</sup> See R Goode ‘Abstract Payment Undertakings in International Transactions’ (1996) XXII *Brooklyn Journal of International Law* 1 at 15–16.

<sup>304</sup> See the discussion in para 2.10.3 below.

<sup>305</sup> In the past it was held that the giving of guarantees by American Banks did not constitute legitimate banking business in terms of The United States National Bank Act of 3 June 1864 (as amended), and that such guarantees were *ultra vires* and void (see, e.g., *Border National Bank of Eagle Pass Tex v American National Bank of San Francisco Cal* 282 F 73 (5th Cir 1922); *Barclays Bank DCO v Mercantile National Bank* 339 F Supp 457 (1972); *National Surety Corporation v Midland Bank and Trust Company* 408 F Supp 684 (1976); *Hugo: The Law Relating to Documentary Credits op cit* note 140 at 41 and the authorities cited; and for a full discussion of this, see *Dolan: The Law of Letters of Credit op cit* note 66 in para 12.03 and the authorities cited). However, overseas branches of American Banks were not subject to this restriction (see *Perrignon op cit* note 39 at 158). See also *Coleman op cit* note 119 at 225.

<sup>306</sup> See *Bertrams op cit* note 58 at 5–6; and also *Perrignon op cit* note 39 at 158.

<sup>307</sup> See *Rondenberg op cit* note 39 at 435; and *Perrignon op cit* note 39 at 158.

<sup>308</sup> See A Ward and G McCormack ‘Subrogation and Banker’s Autonomous Undertakings’ (2000) 116 *Law Quarterly Review* 121 at 123.

<sup>309</sup> See the *Guide to the URDG op cit* note 10 at 16.



satisfied by the submission of less-rigorous documentation if, following an agreed period after the oil has been delivered, the supplier has not been able to obtain payment otherwise.<sup>310</sup> Therefore, unlike the commercial letters of credit, they are not a general means of payment of goods or services, but are a method of providing for default by the seller or buyer (i.e., they secure the performance of the applicant),<sup>311</sup> depending on the situation. American banks, which were prohibited from giving guarantees on behalf of customers until a couple of years ago, adapted standby letters of credit to have the same function.<sup>312</sup> These banks normally issue standby letters of credit subject to article 5 of the UCC.<sup>313</sup>

Although United States banks have since been freed from the prohibition on giving guarantees,<sup>314</sup> they still use standby letters of credit because of their familiarity with these instruments.<sup>315</sup> In other countries, for instance in England, standby letters of credit are used mainly in relation to international trade.<sup>316</sup>

In the United States standby letters of credit are used in a huge range of transactions, such as lease agreements, stock purchases, financial security, commercial paper, trade investments and many other such contracts.<sup>317</sup> There appears to be no limit to the number and variety of transactions out of which the standby letter of credit can arise.<sup>318</sup> Standby letters of credit can secure any executory obligation. Illustrative transactions also include the obligation of a promisor under a promissory note,<sup>319</sup> the duty of a contractor to complete subdivision improvements,<sup>320</sup> or the obligation of a parent to return children to a divorced spouse in terms of a child custody agreement.<sup>321</sup>

From the modest beginnings of standby letters of credit in the 1950s as a mere addition (appendage) of commercial letters of credit, standbys have evolved into a workhorse of corporate finance. The most recently available reports from the United States for the end of the second quarter of 2005 indicate that reported bank standby obligations increased to 3.6 per cent from the same period in 2004 to a total outstanding of US\$339.7 billion, while commercial letter of credit obligations dropped by 5.8 per cent from 2004. For non-American banks with offices in the United States, these trends were more pronounced

<sup>310</sup> See Ward and McCormack *op cit* note 308 at 123.

<sup>311</sup> See Rondenberg *op cit* note 39 at 435.

<sup>312</sup> See paras 3.4.2 and 3.4.2.1 (particularly note 222) in Chapter 3.

<sup>313</sup> For background information regarding article 5 of the UCC, see paras 3.4.2 and 3.4.2.2 in Chapter 3; and for a discussion of how article 5 deals with fraud, see para 5.5 in Chapter 5.

<sup>314</sup> For more on this, see paras 3.4.2 and 3.4.2.1 (particularly note 222) in Chapter 3.

<sup>315</sup> See Bertrams *op cit* note 58 at 5–6.

<sup>316</sup> See Warne and Elliott *op cit* note 1 at 275.

<sup>317</sup> See Warne and Elliott *op cit* note 1 at 274–275. For a discussion of the main uses of standby letters of credit in the United States, see C Del Busto ‘Are Standby Letters of Credit a Viable Alternative to Documentary Credits?’ (1991) *Journal of International Banking Law* 72 at 73; and G W Jones ‘Letters of Credit in the United States Construction Industry’ (Feb 1986) *International Business Lawyer* 17–22.

<sup>318</sup> See Rondenberg *op cit* note 39 at 435.

<sup>319</sup> See *Republic National Bank v Northwest National Bank* 578 SW 2d 109 (Tex 1978).

<sup>320</sup> See *McGee Constr Co v Neshobe Dev Inc* 594 A 2d 415 (Vt 1991).

<sup>321</sup> See *In re Tischendorf* 321 NW 2d 405 (Minn 1982). See also Dolan *op cit* note 24 in note 6 at 1867.

for the second quarter of 2005. Standby issuance soared by 16.8 per cent to a total of US\$194.2 billion, while commercial letters of credit plummeted to 15.8 per cent to a total of US\$9.45 billion over the same quarter in 2004.<sup>322</sup> During 1998/99, the worldwide total outstanding for standby letters of credit was estimated at well in excess of US\$750 billion. It appears that for more than a decade standbys have overshadowed commercial letters of credit, with the outstanding amount of standbys exceeding commercial credits 5 to 1. Although banks in the United States developed standby letters of credit, they are now used worldwide. It is conservatively estimated that the standby volume by non-American banks in the United States equals and possibly exceeds that of the American banks. Outside the United States, the use of standbys has increased dramatically. For instance, even in Europe, the bastion of the first demand guarantee, banks have reported significant increases in the use of standby letters of credit.<sup>323</sup>

### 2.9.2 The Standby Letter of Credit: An Independent Undertaking

The standby letter of credit is a member of the family of independent undertakings that include commercial letters of credit and demand guarantees. What these undertakings have in common – and what distinguishes them from dependent undertakings – is that the person making the undertaking (i.e., the guarantor/issuer) cannot avoid paying because he has not been reimbursed or because of some defence based on the underlying transaction. What characterises them is that they are undertakings to pay against required documents.<sup>324</sup>

A standby letter of credit is generally used to describe a letter of credit, however named or described, recognised under applicable law as a letter of credit or other independent undertaking supporting an obligation of the applicant that is not based on payment of goods or services by way of a commercial letter of credit. A demand guarantee could be defined in the same manner as a standby letter of credit. A commercial letter of credit is generally used to describe a letter of credit, however named or described, that is intended to serve as the means of payment for the provision of goods or services, usually against presentation of documents representing delivery.<sup>325</sup>

### 2.9.3 Types of Standby Letters of Credit

Standby letters of credit are generally classified by type, depending on their function in the underlying contract and other factors not necessarily related to the terms and conditions of the standby itself. There are basically no limits to the variety of transactions that the

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<sup>322</sup> See J E Byrne ‘Overview of Letter of Credit Law and Practice in 2005’ in J E Byrne and C S Byrnes (eds) *2006 Annual Survey of Letter of Credit Law and Practice* (2006) (hereinafter ‘2006 Annual Survey’) 6 at 6, in particular notes 3 and 4.

<sup>323</sup> See J E Byrne ‘ISP98: New Rules for Standby Letters of Credit’ (September-October 1999) 19 *Treasury Management Association’s (TMA’s) Journal* 66 at 66; and J E Byrne ‘New Rules for Standby Letters of Credit: The International Standby Practices/ISP98’ (May 1998) 100 *Business Credit* 32 at 32.

<sup>324</sup> See Ward and McCormack *op cit* note 308 at 122; and J E Byrne ‘New Rules for Standby Letters of Credit: The International Standby Practices/ISP98’ (May 1998) 100 *Business Credit* 32 at 32; J E Byrne ‘ISP98: New Rules for Standby Letters of Credit’ (September-October 1999) 19 *Treasury Management Association’s (TMA’s) Journal* 66 at 66; and Perrignon *op cit* note 39 at 158.

<sup>325</sup> See J E Byrne ‘New Rules for Standby Letters of Credit: The International Standby Practices/ISP98’ (May 1998) 100 *Business Credit* 32 at 32; and J E Byrne ‘ISP98: New Rules for Standby Letters of Credit’ (September-October 1999) 19 *Treasury Management Association’s (TMA’s) Journal* 66 at 66.

standby credit can serve. Generally, standby credits can be used in any contract where the performance of one party is executory. Therefore, only a few types are listed below. The different classifications of standby letters of credit are descriptive and have no impact on standby law or practice.<sup>326</sup>

### ***2.9.3.1 Performance Standby Letter of Credit***

A performance standby supports an obligation to perform other than to pay money (i.e., non-monetary obligation) and includes an obligation to pay for losses arising from a default of the applicant (e.g., a construction or engineering company) in completion of the underlying contract (e.g., construction/building contract).

### ***2.9.3.2 Advance Payment Standby Letter of Credit***

An advance payment standby supports an obligation to account for an advance payment made by the beneficiary (e.g., employer for construction work) to the applicant (e.g., a construction or engineering company) before the contract has been completed.

### ***2.9.3.3 Bid Bond or Tender Bond Standby Letter of Credit***

A bid bond/tender bond standby supports an obligation of the applicant (e.g., a construction or engineering company or supplier of goods) to execute a contract (e.g., construction/building contract or a contract of sale) if the applicant is awarded a bid/tender. Where tenders are invited, it is commonly a prerequisite of consideration of the tender that the tenderer undertakes to sign the contract if it is awarded to him, to procure the issue of any performance standby or other standby required by the contract and not to alter or withdraw his tender in the meantime. The purpose of the tender bond standby is to safeguard the tender-inviting party (beneficiary) against breach of such an undertaking and to prevent frivolous bidders from submitting a tender. Should the tender then be awarded to the tenderer (contractor or supplier) and he decides not to execute the contract, the amount of the tender guarantee is forfeited in favour of the beneficiary (the party inviting tenders). The tender bond standby provides the beneficiary with a source of funds to help cover his additional unexpected costs should the successful tenderer not proceed with the contract when it is awarded to him.<sup>327</sup>

### ***2.9.3.4 Counter Standby Letter of Credit***

A counter standby supports the issuance of a separate standby or other undertaking by the beneficiary of the counter standby. This will, for example, be found in the case where there are different banks involved in a standby-letter-of-credit transaction. Where an issuing bank has instructed a paying bank to pay on its behalf under a standby letter of credit that it has issued, the issuing bank will often issue a counter standby as part of the reimbursement contract between the issuing bank and the paying bank of the standby letter of credit.

<sup>326</sup> See J E Byrne 'ISP98: New Rules for Standby Letters of Credit' (September-October 1999) 19 *Treasury Management Association's (TMA's) Journal* 66 at 66. For a full discussion of the types of standby letters of credit see J E Byrne 'New Rules for Standby Letters of Credit: The International Standby Practices/ISP98' (May 1998) 100 *Business Credit* 32; *Dolan: The Law of Letters of Credit op cit* note 66 in para 1.06; Wunnicke, Wunnicke and Turner *op cit* note 140 in Chapter 14; and the 'Preface' to the ISP98.

<sup>327</sup> See also Wunnicke, Wunnicke and Turner *op cit* note 140 at 372–373. See also the discussion of the tender guarantee in para 2.4.2.1 above.

### 2.9.3.5 *Financial Standby Letter of Credit*

A financial standby supports an obligation to pay money, including any instrument evidencing an obligation to repay borrowed money. For instance, where a performance standby (see discussion above)<sup>328</sup> becomes payable where an applicant fails to perform a non-monetary obligation (e.g., fails to complete a building), a financial standby, in contrast, becomes payable, where an applicant (e.g., debtor) fails to perform a monetary obligation (i.e., to repay a certain amount of money (the principal debt or interest)) in relation to a loan agreement that the applicant has concluded with a financial institution or bank). The financial standby is normally paid upon presentation of documents evidencing or alleging the applicant's default on the underlying contract (e.g., loan agreement).<sup>329</sup>

### 2.9.3.6 *Insurance Standby Letter of Credit*

An insurance standby supports an insurance or reinsurance obligation of the applicant (insurance company). Ever since the 1960s, the reinsurance business has increasingly used letters of credit to secure the credit of reinsurers. Reinsurance enables an insurance company, the reinsured, to share the risk of one or more contracts with another insurance company, the reinsurer. This allows for the risks to be spread. Most American states allow an insurance company to effect a credit for reinsured liabilities and therefore it can write more insurance: the reinsurer obtains a profit opportunity without the overhead expenses associated with creating and servicing the business. In the past American state regulators required out-of-state reinsurers to deposit funds toward their obligations. The concept of using letters of credit to replace cash deposits was introduced in the 1950s by Lloyd's of London and Citibank. The American states normally have different regulations governing letters of credit issued in these circumstances and also sometimes the reinsurance agreement.<sup>330</sup>

### 2.9.3.7 *Commercial Standby Letter of Credit*

A commercial standby supports the obligations of an applicant (e.g., purchaser) to pay for goods or services in the event of non-payment by other methods. For example, some sellers and purchasers, in order to avoid the paper problems of commercial letters of credit, sometimes use a standby arrangement to support their sales. In terms of this use, the seller will invoice the purchaser directly and will draw under the standby credit only if the buyer fails to honour the invoice.<sup>331</sup>

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<sup>328</sup> See para 2.9.3.1 above.

<sup>329</sup> See *The Official Commentary on the ISP98 op cit* note 154 at 2–3. For a full discussion of financial standby letters of credit, see B Kozolchyk 'The Financial Standby Letter of Credit' (1995) 235 *International Business Law Journal* 405; and B Kozolchyk 'The Financial Standby: A Summary Description of Practice and Related Legal Problems' (1996) 28 *Uniform Commercial Code Law Journal* 327.

<sup>330</sup> See Wunnicke, Wunnicke and Turner *op cit* note 140 at 385. For examples, where insurance standby letters of credit were issued, see *Insurance Corporation of Hannover v Latino Americana de Reaseguros SA* 868 F Supp 520 (SDNY 1994); and *Pine Top Insurance Co v Century Indemnity Co* 716 F Supp 311 (ND Ill 1989).

<sup>331</sup> See Dolan: *The Law of Letters of Credit op cit* note 66 in para 1.06.

### 2.9.3.8 Direct Pay Standby Letter of Credit

A direct pay standby is intended to be the primary means of payment and may or may not be linked to default in performance or payment. It supports payment, when due, of an underlying payment obligation typically in connection with a financial standby without regard to a default. As a direct pay standby letter of credit is intended as the primary means of payment of a financial obligation, and not as a secondary or alternative method to be used in the event of a default, it is closer in nature to the commercial letter of credit.<sup>332</sup>

### 2.9.4 Standby Letters of Credit and Commercial Letters of Credit Compared

The ICC has included the standby letter of credit in its universally known and accepted Uniform Customs and Practices for Documentary Credits ('UCP') since its 1983 version.<sup>333</sup> In the UCP, the standby letter of credit appears to be only one sub-species or special type of letter of credit. However, there are important differences between the commercial letter of credit and the standby letter of credit:<sup>334</sup>

- As already mentioned, the commercial letter of credit is a credit in which the bank's undertaking to pay is primary both in form and intent. Contrary to this, the standby letter of credit is primary in form, but secondary in intent and it cannot properly be invoked by the beneficiary unless there has been actual default by the principal or, at the very least, an honest belief that such default has occurred. It is true that the standby credit has certain significant features in common with the commercial letter of credit. In particular, it is independent of the underlying contract and is documentary in character in that the payment obligation is triggered solely by a written demand and any other specified documents presented in conformity with the credit.<sup>335</sup> However, this is where the similarity ends. In the case of a commercial letter of credit, the beneficiary is the party who has the duty to perform the underlying contract and he receives payment on tendering the prescribed documentary evidence of performance. By contrast, the beneficiary of the standby credit is not a performing party to the underlying contract, but the party entitled to receive performance and his entitlement to make a demand for payment arises not because of his own performance, but because of the other party's (principal's) failure to perform.<sup>336</sup> Therefore, the distinction between commercial and standby letters of credit lies in the fact that a commercial credit typically supports the applicant's obligation as a purchaser in a sale of goods, while a standby credit commonly supports the applicant's obligation to pay a loan or similar monetary obligation or to perform services. The commercial credit is a payment mechanism in which the issuer is expected to pay the beneficiary for the goods purchased by the applicant. In the

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<sup>332</sup> See B Kozolchyk 'The Financial Standby Letter of Credit' (1995) 235 *International Business Law Journal* 405 at 407.

<sup>333</sup> For a full discussion of this see para 3.2.2 in Chapter 3.

<sup>334</sup> See Horn *op cit* note 297 at 196; and Coleman *op cit* note 119 at 225.

<sup>335</sup> See Hugo: *The Law Relating to Documentary Credits op cit* note 140 at 42.

<sup>336</sup> See R Goode 'Abstract Payment Undertakings and the Rules of the International Chamber of Commerce' (1995) 39 *Saint Louis University Law Journal* 725 at 730.

standby credit, by contrast, the issuer is not expected to pay the beneficiary unless the applicant defaults in the underlying obligation to the beneficiary.<sup>337</sup>

- Furthermore, in the commercial letter of credit the documents are evidence of the fact that certain goods sold have been shipped.<sup>338</sup> These documents are issued by a third person, for example the shipper, as is the case with the bill of lading. Furthermore, a bill of lading or a similar document represents an economic value. The promise contained in that document by the issuer to deliver the goods to the holder of the bill of lading constitutes such an economic value. The bank that opened the letter of credit accepts these documents and gives them to its client who is the purchaser of the goods. The documents enable the purchaser to have the goods at his disposal and to transfer them to a third party to whom he has sold the goods in turn. In a standby letter of credit the beneficiary is not obliged to furnish bills of lading or similar documents evidencing the supply and shipping of goods sold, but simply to make a unilateral written declaration that a certain risk covered by the standby letter of credit has materialised. This declaration has no economic value as such. In the worst case of an unfair calling of the standby letter of credit, the written demand is nothing more than a written lie by the beneficiary.<sup>339</sup>

### 2.9.5 Standby Letters of Credit and Demand Guarantees Compared

As already mentioned,<sup>340</sup> the banks in the United States have long used standby letters of credit as a substitute for demand guarantees, in other words, in transactions outside the traditional scope of the application of commercial letters of credit. There is a general misconception that standby letters of credit are legally distinct from demand guarantees. That is not true.

As banks in the United States were not in general permitted to issue guarantees, the term ‘standby credit’ was adopted to avoid the language of guarantees. From a legal viewpoint the standby credit is simply another term for demand guarantee.<sup>341</sup> In fact, standby letters of credit undoubtedly fall within the definition of ‘demand guarantee’ in article 2(a) of the URDG.<sup>342</sup> Both are undertakings for the payment of money that are independent of the underlying contract; both are documentary in character; and both are primary in form but secondary in intent.<sup>343</sup> The difference between them is not one of legal characterisation, but of practice and business use. From a commercial viewpoint, the standby letter of credit is a different product, for it is used to support not only non-money performance (e.g., sale of goods or construction), but also an extremely diverse range of financial performances and is governed by banking practices that are in many respects more akin to commercial letters of credit than to demand guarantees. The standby letter of credit has developed into an all-purpose financial support instrument comprising a much broader range of uses than the

<sup>337</sup> See Turner *op cit* note 174 at 459; and Van Niekerk and Schulze *op cit* note 24 at 266–267.

<sup>338</sup> See Van Niekerk and Schulze *op cit* note 24 at 266.

<sup>339</sup> See Horn *op cit* note 297 at 196.

<sup>340</sup> See para 2.9.1 above.

<sup>341</sup> See R Goode ‘The New ICC Uniform Rules for Demand Guarantees’ (1992) *Lloyd’s Maritime and Commercial Law Quarterly* 190 at 193.

<sup>342</sup> See the definition of demand guarantee in article 2(a) of the URDG in para 2.1 above. See also Goode *op cit* note 341 at 196.

<sup>343</sup> See also Ward and McCormack *op cit* note 308 at 124.

normal demand guarantee. Therefore, standby letters of credit are used to support financial as well as non-financial obligations of the principal and to provide credit enhancement for the primary financial undertaking. However, in the United States, unlike other countries, standby letters of credit are used more to guarantee money obligations (as opposed to performance obligations) incurred in transactions on the capital market. The major difference between demand guarantees and standby letters of credit is that standby letters of credit are usually drafted in the form of a letter of credit. Banks have tended to apply to standby letters of credit many of the practices in current use for commercial letters of credit, for instance, banks may issue standby letters of credit for their own account as well as for that of their customers; arrange for confirmation of the standby credit by a second bank; and they may even arrange for payment by a third party rather than their own.<sup>344</sup> Standby letters of credit are extremely similar to demand guarantees in respect of their function and legal regime, although they differ regarding their form. However, as a matter of law, there is no distinction between these instruments.<sup>345</sup>

Although there are both historical differences in the development of the demand guarantee<sup>346</sup> and the standby letter of credit,<sup>347</sup> and some technical differences in the procedures followed, these two instruments still serve the same economic function and should therefore be treated as equivalent instruments. The guarantor/issuer of the standby letter of credit/demand guarantee undertakes to pay the beneficiary a certain sum of money because of the failure on the part of the principal to pay or to perform some other obligation. Demand guarantees and standby letters of credit are distinguished from the true (traditional) guarantee (i.e., the suretyship guarantee) in that the beneficiary of the demand guarantee or standby credit has the right to payment, either upon simple demand without justification or upon demand accompanied by one or more specified documents. Such a specified document may be a statement of the beneficiary himself that the principal has failed in his obligation or it may be a statement of a third party as to such failure. In both cases the guarantor/issuer of the undertaking is not interested in the performance or failure to perform as it merely acts upon receipt of the simple demand or of the demand and the specified documents, as the case may be.<sup>348</sup> Even though the processing of a demand guarantee or a standby credit is identical to that of a commercial letter of credit, the economic function is quite different. The commercial letter of credit serves as a means of payment to the beneficiary when the underlying contract is properly performed, whereas the demand guarantee and the standby letter of credit serve as means of payment to the beneficiary when the underlying contract is not properly performed.<sup>349</sup>

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<sup>344</sup> See De Ly *op cit* note 13 at 833.

<sup>345</sup> See the *Guide to the URDG op cit* 10 at 16; and R Goode 'Abstract Payment Undertakings and the Rules of the International Chamber of Commerce' (1995) 39 *Saint Louis University Law Journal* 725 at 730.

<sup>346</sup> See para 1.1.1 in Chapter 1.

<sup>347</sup> See para 2.9.1 above.

<sup>348</sup> See also Bailey *op cit* note 145 at 248.

<sup>349</sup> See Bergsten *op cit* note 11 at 860.

## 2.10 CALLING OF A DEMAND GUARANTEE

### 2.10.1 Introduction

The minimum prerequisite of the guarantor's obligation to pay the demand guarantee is that the beneficiary presents a demand for payment, which is almost invariably required to be in writing.<sup>350</sup> The applicable law determines what constitutes 'writing'. Article 2(d) of the URDG specifically provides that writing includes any authenticated teletransmission or tested electronic data interchange messages equivalent to it. However, sometimes other documents are specified, for example, the demand guarantee may also stipulate that the beneficiary must support his written demand by a statement of breach of the underlying contract. This requirement is also embodied in article 20 of the URDG. If a party incorporates the URDG into his demand guarantee, article 20(a) will apply which provides that any demand for payment must be in writing and must (in addition to such other documents as may be specified in the guarantee) be supported by a written statement (whether in the demand itself or in a separate document or documents accompanying the demand and referred to in it) stating: that the principal is in breach of his obligations under the underlying contract or, in the case of a tender guarantee, the tender conditions; and the respect in which the principal is in breach. However, article 20(c) grants parties the option of having article 20 specifically excluded. The purpose of this article is to discourage unfair calling, while preserving the speed and simplicity of remedy that the needs and practice of the market require. Whether this article succeeds in its aim is discussed in subsequent chapters.<sup>351</sup> The demand guarantee may, of course, also stipulate other documents, for example, the production of a judgment or an arbitral award.

Obviously the demand and any other specified documents must relate to the underlying contract covered by the guarantee, and must be presented within the specified time and in the manner prescribed by the guarantee.<sup>352</sup>

### 2.10.2 Grounds for Refusal to Pay: Exceptions to the Autonomy Principle

The independence of the demand guarantee from the underlying contract has the effect that, in principle, the guarantor must pay a demand presented in compliance with the terms of the guarantee, irrespective of whether or not the principal has, in fact, committed a breach of the underlying contract with the beneficiary. However, all legal systems acknowledge that there are exceptions to this principle. The most common of these take place when there is fraud on the part of the beneficiary;<sup>353</sup> a concept that varies slightly from jurisdiction to jurisdiction, but that is characterised by the beneficiary making a dishonest demand, knowing full well that the principal is not in breach. Practically, this is difficult to prove, because it does not merely need to be proved that the principal has complied fully with all the terms of the underlying contract, but also that the beneficiary knew this at the time of the demand.<sup>354</sup>

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<sup>350</sup> For instance, rule 4.08 of the ISP98 provides that even if a standby letter of credit does not specify any required document, it will still be deemed to require a documentary demand for payment.

<sup>351</sup> See paras 4.2.3 and 4.5 in Chapter 4 and para 8.5 in Chapter 8.

<sup>352</sup> See the *Guide to the URDG op cit* note 10 at 21.

<sup>353</sup> See Eitelberg *op cit* note 24 at 126.

<sup>354</sup> See the *Guide to the URDG op cit* note 10 at 22–23; and Ulph *op cit* note 162 at 371–372. For a full discussion of fraud, see Chapter 5.



Fraud is certainly the most proclaimed exception to the autonomy principle with respect to both demand guarantees and commercial letters of credit. It is dutifully acknowledged as an exception, but yet it remains elusive to the point of being illusory in practice save in the most exceptional circumstances.<sup>355</sup> The difficulty is even more acute in the case of indirect (four-party) guarantees, because what the principal then needs to show is not fraud on the part of the beneficiary, but fraud by the guarantor. However, the concept of fraud has not been fully developed by the courts. In various jurisdictions, fraud is not limited to dishonesty or fraudulent intent, but extends, for instance, to an absence of objective good faith, as where no reasonable person would have considered the demand to be justified.<sup>356</sup>

Although fraud is the most declared exception to the duty to pay a conforming demand, it is not the only one. There are also a few other established exceptions to the autonomy principle and the absolute detachment of demand guarantees from their underlying contracts,<sup>357</sup> for example, illegality in the demand guarantee contract or underlying contract,<sup>358</sup> or the infringement of international obligations and express contractual derogation from the principle of autonomy.<sup>359</sup> Another possibility is, for example, the total failure of the basis of the contract (i.e., the reason for its existence).<sup>360</sup> However, the main exceptions concern fraud and illegality.<sup>361</sup> Therefore, based on the limited scope of this thesis, attention will only be given to these two exceptions to the autonomy principle. These exceptions, particularly illegality, are controversial and their scope is often uncertain.<sup>362</sup> The exceptions to the autonomy of a commercial letter of credit also often constitute a similar exception to the autonomy principle of a demand guarantee.<sup>363</sup>

<sup>355</sup> See Bennett *op cit* note 41 at 581.

<sup>356</sup> See the *Guide to the URDG op cit* note 10 at 23; and see Ulph *op cit* note 162 at 371. For a full discussion of the fraud exception, see Chapter 5; and see also Xiang Gao *op cit* note 162.

<sup>357</sup> For instance, in Australia, there have been suggestions that unconscionable conduct of a gross nature might suffice (see Ulph *op cit* note 162 at 371; *Hortico (Australia) Pty Ltd v Energy Equipment Co (Australia) Pty Ltd* (1985) 1 NSWLR 545 ((1986) 2 BCL 366 (Sup Ct)); *Inflatable Toy Co v State Bank of NSW* (1994) 34 NSWLR 243; contrast *Olex Focas Pty Ltd and Another v Skodaexport Co Ltd* (1996) 134 FLR 331 ((1996) 70 ALJR 983; (1997) ATPR (Digest) [46-163]; and [1998] 3 VR 380 (Sup Ct Vic)); and Xiang Gao *op cit* note 162 at 94–96). For a further discussion of these possible exceptions and others, see Enonchong *op cit* note 145; Bailey *op cit* note 145; and Loh and Wu *op cit* note 162. In these articles the possibility of other exceptions to the autonomy principle, for example, unconscionable conduct, no underlying contract, breach of a negative stipulation in the underlying contract, or lack of good faith/absence of reasonableness as constituting valid grounds are discussed and they also contain limited references to court cases in Australia, Singapore and Malaysia where these grounds have been considered as possibilities. See also note 162 above, note 33 in Chapter 1, and note 8 in Chapter 5.

<sup>358</sup> See, e.g., *Mahonia Ltd v West LB AG* [2004] EWHC 1938 (Commercial Court England (Comm)) at [427]–[428] (violation of US security law); and Enonchong *op cit* note 145. For a full discussion of illegality, see Chapter 6.

<sup>359</sup> See Bennett *op cit* note 41 at 581; and Gorton *op cit* note 61 at 248. See also note 33 in Chapter 1, notes 162 and 357 above, and note 8 in Chapter 5.

<sup>360</sup> See *Eliau and Rabbath (trading as Eliau & Rabbath) v Matsas and Matsas; JD McLaren and Co Ltd; and Midland Bank Ltd* [1966] 2 Lloyd's Rep 495 (CA); contrast *Howe Richardson Scale Co Ltd v Polimex-Cekop and National Westminster Bank Ltd* [1978] 1 Lloyd's Rep 161 (CA).

<sup>361</sup> See Chapters 5–6.

<sup>362</sup> See Ulph *op cit* note 162 at 371–372; and J F Dolan 'Letters of Credit: A Comparison of UCP500 and the New U.S. Article 5' (1999) *Journal of Business Law* 521 at 533–534. See also Chapters 5 and 6.

<sup>363</sup> See the *Guide to the URDG op cit* note 10 at 23.

Subsequent chapters<sup>364</sup> will investigate whether or not these are indeed exceptions to the principle of autonomy and how courts in the chosen jurisdictions deal with them.

Should the principal hear that the beneficiary intends to make an unjustified call on the demand guarantee, an interlocutory injunction (i.e., an interdict in the South African law) may be sought, either against the guarantor (bank) preventing payment, and/or against the beneficiary, preventing him from making a demand on the guarantor.<sup>365</sup>

### 2.10.3 Unilaterally Imposed Alterations of the Guarantee Period: ‘Pay or Extend’ Demands

In some countries it has become common practice for beneficiaries to present ‘pay or extend’ or ‘extend or pay’ demands.<sup>366</sup> Although the two differ according to the primary action demanded of the guarantor, the message is the same, namely that payment is required immediately, unless the guarantor complies with the beneficiary’s demand to extend the guarantee beyond the expiry date. Consecutive pay or extend demands are fairly common and if complied with, they may result in a significant prolongation of the guarantee period.<sup>367</sup>

These types of demands are not necessarily unfair or inappropriate; the beneficiary may honestly believe that there has been non-performance by the principal that entitles the beneficiary to demand payment and may offer the alternative of an extension that allows the guarantor to avoid having to make immediate payment. However, not all such demands are always made in good faith and may be presented in order to force an extension of the guarantee when the principal has not defaulted in performance of the underlying contract.<sup>368</sup>

Upon receiving the extend or pay demand, the guarantor must, without delay, inform the party who gave him his instructions and must suspend payment for as long as is reasonable to enable the principal to arrange for such an extension to be issued. Therefore, irrespective of whether or not the pay or extend demand is made in good faith, the guarantor has to have regard to his mandate from the principal (in the case of a direct guarantee) or instructing party (in the case of an indirect guarantee), to whom he may incur a liability if he grants an extension without authorisation. Likewise, before agreeing to an extension, the instructing party must consider his own mandate from the principal. However, these respective mandates are of no concern to the beneficiary, whose contract is with the guarantor and who is entitled to rely on any extension, irrespective of whether or not the guarantor was authorised to grant it. However, not all extensions are unilaterally imposed

<sup>364</sup> See Chapters 5 and 6 for a full discussion.

<sup>365</sup> See Bennett *op cit* note 41 at 581–582. For a full discussion, see Chapter 7.

<sup>366</sup> See also article 26 of the URDG and rule 3.09 of ISP98 dealing with these types of demands (for a full discussion of rule 3.09 of the ISP98 see *The Official Commentary on the ISP98 op cit* note 154 Official Comments to rule 3.09 at 119–120). The UNCITRAL Convention, however, does not contain any specific provisions dealing with the ‘extend or pay’ demands. For a discussion of the ‘extend or pay’ phenomenon, see Bertrams *op cit* note 58 at 236–243; and see also De Ly *op cit* note 13 at 841. These types of pay or extend demands normally provide no real difficulty in practice and for purposes of this thesis a further discussion of these conventions is therefore not required.

<sup>367</sup> See the *Guide to the URDG op cit* note 10 at 22.

<sup>368</sup> *Idem*.

in this way. For instance, they may be provided for in the guarantee itself or subsequently agreed without any demand being made. However, if the demand is triggered automatically because of non-extension of the guarantee, it must be a demand that conforms to the rules that are applicable, for instance, to the requirements of article 20 of the URDG, if applicable.<sup>369</sup>

If it can be proved that the demand is fraudulent, the guarantor will be entitled to refuse payment. The applicable law may also give the guarantor other grounds for such refusal. However, in the absence of established fraud or other grounds for non-payment,<sup>370</sup> the guarantor must pay if the extension is not granted, provided, obviously, that all the other terms and conditions of the guarantee have been complied with.<sup>371</sup>

#### 2.10.4 The Problem of Unfair Calling

The most controversial problem related to demand guarantees is the problem of unfair or abusive callings.<sup>372</sup> The problem of fraudulent documents in relation to commercial letter of credit transactions was demonstrated in various cases already during the 1920s.<sup>373</sup> The similarity between such situations and corresponding problems in connection with demand guarantees appears in case law from the 1970s and 1980s.<sup>374</sup> Such unfair callings are, to a large extent, due to the independent nature of demand guarantees. Whereas the payment obligation of a surety of a true guarantee is linked to the underlying transaction, the beneficiary's right to payment in a commercial letter of credit is independent of the underlying transaction and said to be absolute or almost absolute. This is also the idea in relation to a demand guarantee, where the beneficiary is entitled to payment, irrespective of the underlying transaction, immediately upon the calling for payment under the guarantee or upon the presentation of some document(s).

The possibilities of an unfair or fraudulent demand do not decline by requiring the demand to be made in writing, as will be seen in subsequent chapters.<sup>375</sup>

### 2.11 DEMAND FOR PAYMENT IS DEFECTIVE OR LATE

#### 2.11.1 Introduction

The UCP 600<sup>376</sup> (as did the UCP 500)<sup>377</sup> recognise that the presentation of non-conforming documents is a valid defence available to a bank against the

<sup>369</sup> See the *Guide to the URDG op cit* note 10 at 22; and R Goode 'Abstract Payment Undertakings in International Transactions' (1996) XXII *Brooklyn Journal of International Law* 1 at 18.

<sup>370</sup> See also Chapters 5–7.

<sup>371</sup> See the *Guide to the URDG op cit* note 10 at 22; and R Goode 'Abstract Payment Undertakings in International Transactions' (1996) XXII *Brooklyn Journal of International Law* 1 at 18.

<sup>372</sup> See also, Enonchong *op cit* note 145 at 84; and Penn *op cit* note 39 at 228.

<sup>373</sup> See para 5.3.2 in Chapter 5.

<sup>374</sup> See Gorton *op cit* note 61 at 243–244. See also paras 5.3.4, and 5.4–5.6 in Chapter 5.

<sup>375</sup> See Chapters 4–7.

<sup>376</sup> See e.g., articles 2 (definition of 'complying presentation'), 5, 7, 8, 14(a), 15 and 16 of the UCP 600. Of particular importance is article 16(a) that provides that '[w]hen a nominated bank acting on its nomination, a

beneficiary.<sup>378</sup> Rules 1.06(d), 2.01 and 4.01 of the ISP98 also confirm that an issuer of a standby is under an obligation to honour only complying demands.<sup>379</sup> Furthermore, articles 9(a) and (b) of the UCP 500 also provide that the liability of the bank (i.e., guarantor) to the beneficiary is dependent on presentation of the stipulated documents, and compliance with the terms and conditions of the credit.<sup>380</sup>

The question of whether or not the documents conform is mostly determined with reference to what type of standard for compliance (i.e., strict compliance or substantial compliance) is used and how it is applied in the different jurisdictions.<sup>381</sup> In the United States, England and South Africa it appears that the relevant standard is that of strict compliance.<sup>382</sup> Furthermore, the UCP 600 (as did the UCP 500), URDG, ISP98 and the UNCITRAL Convention all set out what standard of documentary compliance is required for letters of credit and demand guarantees.<sup>383</sup>

In principle, a bank must refuse payment if the documents and/or demand tendered under a letter of credit/demand guarantee presented does not comply strictly (exactly) with the requirements stipulated in the credit/guarantee.<sup>384</sup> Where a demand is not in conformity with the demand guarantee, because incorrect documentation is presented, the payment may be refused, in keeping with the principle of strict compliance.<sup>385</sup> A bank must also refuse payment if the documents are presented after the expiry date or where the demand is made after the expiry date of the guarantee.<sup>386</sup> Therefore, the bank's liability under a letter

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confirming bank, if any, or the issuing bank determines that a presentation does not comply, it may refuse to honour or negotiate'.

<sup>377</sup> See article 13(a) and 14(b) of the UCP 500. Particularly important is article 14(b) that provides as follows:

Upon receipt of the documents the Issuing Bank and/or Confirming Bank, if any, or a Nominated Bank acting on their behalf, must determine on the basis of the documents alone whether or not they appear on their face to be in compliance with the terms and conditions of the Credit. If the documents appear on their face not to be in compliance with the terms and conditions of the Credit, such banks may refuse to take up the documents.

<sup>378</sup> See *Hugo: The Law Relating to Documentary Credits op cit* note 140 at 295. See also para 2.5.2.5.2 above.

<sup>379</sup> See also para 2.5.2.5.3 above.

<sup>380</sup> See also articles 2(b), 19 and 20 of the URDG. See also para 2.5.2.5.4 above. Furthermore, see also article 15(1) read with article 17 of the UNCITRAL Convention.

<sup>381</sup> See para 2.5.2.5 above.

<sup>382</sup> For a full discussion of the doctrine of strict compliance, see para 2.5.2.5 above.

<sup>383</sup> For a full discussion of this, see para 2.5.2.5.2–2.5.2.5.5 above.

<sup>384</sup> See *Hugo: The Law Relating to Documentary Credits op cit* note 140 at 114.

<sup>385</sup> See *Edward Owen Engineering Ltd v Barclays Bank International Ltd and Another* [1978] 1 QB 159 (CA) ([1978] 1 Lloyd's Rep 166 (CA); and [1978] 1 All ER 976 (CA)) at 169A; and *Lorne Stewart Plc v Hermes Kreditversicherungs AG* [2001] All ER (D) 286.

<sup>386</sup> Article 19 of the URDG specifically provides as follows:

A demand shall be made in accordance with the terms of the Guarantee before its expiry, that is, on or before its Expiry Date and before any Expiry Event . . . In particular, all documents specified in the Guarantee for the purpose of the demand, and any statement required by Article 20, shall be presented to the Guarantor before its expiry at its place of issue; otherwise the demand shall be refused by the Guarantor.

of credit and demand guarantee is conditional. Its liability depends on the presentation and the presentation of conforming documents within the stipulated period.<sup>387</sup> Therefore, late presentation and the presentation of non-conforming documents and/or defective demands are clearly valid defences against non-payment.<sup>388</sup> However, although they are valid defences, they are in no way concerned with the autonomy principle.<sup>389</sup>

The presentation of non-conforming documents and/or demands has been raised successfully as a defence in England and the United States.<sup>390</sup> However, for a defence of non-compliance to be raised successfully in English law, good faith is not a requirement.<sup>391</sup> In this regard Ellinger said:<sup>392</sup>

One result of the doctrine of strict compliance is that the person to whom the documents are tendered may raise any lawful objections against the documents, even if in fact his objection is purely technical and the true motive for his rejection of the tender is to be found in a falling market or in some other extraneous circumstances.

### 2.11.2 South African Law

In South Africa there has been no case dealing directly with the matter where the bank has refused to pay under a demand guarantee, because the demand was defective or where the documents presented under a demand guarantee were not compliant.<sup>393</sup> Neither has there been any such case dealing with this matter in relation to commercial or standby letters of credit.<sup>394</sup> However, in this regard, the Appellate Division (as it was then known) in

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Furthermore, article 6(e) of the UCP 600 also clearly states that, subject to certain exemptions, a presentation must be made on or before the expiry date. See also, section 5-108(a) and (d) of the UCC, and article 15 read with article 17 of the UNCITRAL Convention.

<sup>387</sup> See also *Koumantarakis Group CC v Mystic River Investments 45 (Pty) Ltd and Another* [2007] JOL 19699 (D) in para 51.

<sup>388</sup> Section 5-108 of the UCC does not only require that the documents presented under a letter of credit themselves appear on their face to strictly apply, but also that the other terms of the credit such as those dealing with the time and place of presentment are strictly complied with (see Official Comment 1 to section 5-108). See also *Loomcraft Fabrics CC v Nedbank Ltd and Another* 1996 (1) SA 812 (A) at 815I–J; and *Hugo: The Law Relating to Documentary Credits op cit* note 140 at 255–258.

<sup>389</sup> See *Hugo: The Law Relating to Documentary Credits op cit* note 140 at 314.

<sup>390</sup> *Idem*.

<sup>391</sup> See *Hugo: The Law Relating to Documentary Credits op cit* note 140 at 298.

<sup>392</sup> See E P Ellinger ‘Documentary Credits and Finance by Mercantile Houses’ in A G Guest (gen ed) *Benjamin’s Sale of Goods* 3 ed (1987) in para 2272 at 1443.

<sup>393</sup> In *Koumantarakis Group CC v Mystic River Investments 45 (Pty) Ltd* [2007] JOL 19699 (D) in para 51 Madondo AJ said (while referring to *Loomcraft Fabrics CC v Nedbank Ltd and Another* 1996 (1) SA 812 (A) at 815G–J) that ‘[t]he liability of the bank to the beneficiary to honour the credit arises upon presentation to the bank of the document specified in the credit, The bank will escape liability only upon proof of fraud on the part of beneficiary.’

For a discussion of what the role of the bank is in evaluating whether a document conforms with the terms of a letter of credit, see Geraghty *op cit* note 142.

<sup>394</sup> See *Hugo: The Law Relating to Documentary Credits op cit* note 140 at 314. In *Loomcraft Fabrics CC v Nedbank Ltd* 1996 (1) SA 812 (A) the Appeal Court (as it was then) remarked (at 823H–I) that if the documents presented under a letter of credit are, on their face, actually non-conforming, the bank cannot be restrained from paying if it despite this chooses to do so. The reason for that is evident. The applicant would

*Loomcraft Fabrics CC v Nedbank Ltd and Another*<sup>395</sup> made an important observation. It said that if the documents did not conform as stipulated, but the bank, nevertheless, decided to pay, there was nothing that the applicant (i.e., the customer of the bank) could do to prevent the bank from paying. However, the bank would then not be able to reimburse itself from the funds of the applicant. In those circumstances the bank would in effect be paying from its own funds.

In *OK Bazaars (1929) Ltd v Standard Bank of South Africa Ltd*<sup>396</sup> the Supreme Court of Appeal (as per Nugent JA), reiterated some of the principles relating to letters of credit and said:<sup>397</sup>

A bank (“the issuing bank”) that establishes a letter of credit at the request and on the instructions of a customer thereby undertakes to pay a sum of money to the beneficiary against the presentation to the issuing bank of stipulated documents . . . The documents that are to be presented (which invariably include documents of title to the goods in question) are stipulated by the customer and the issuing bank generally has no interest in their nature or in their terms . . . Its interest is confined to ensuring that the documents that are presented conform with its client’s instructions (as reflected in the letter of credit) in which event the issuing bank is obliged to pay the beneficiary. *If the presented documents do not conform with the terms of the letter of credit the issuing bank is neither obliged nor entitled to pay the beneficiary without its customer’s consent . . .*

Nevertheless, an issuing bank that is presented with non-conforming documents may refer the documents to its customer, who might be willing to accept them notwithstanding the discrepancies. If they are accepted by the customer, and the beneficiary or his agent is so advised, then naturally the issuing bank becomes entitled and obliged to pay the beneficiary. (Emphasis added.)

From the *OK Bazaars* and *Loomcraft* cases it is clear that banks are not obliged to pay in terms of letters of credit (and by implication also demand guarantees), unless the documents presented conform with the terms of the credit. However, from the statements made in *OK Bazaars* (quoted above) the deduction can be made that the presentation of non-conforming documents and/or demands under a letter of credit/demand guarantee will most likely also be viewed by the South African courts as a successful defence. This assumption is also strengthened by the fact that the South African courts have in the past been guided basically exclusively by English judgments in documentary credit issues and

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have no interest in preventing such action by the bank. The bank would merely pay away its own money, and would not be entitled to recover that amount from the applicant (i.e., its customer). It is thus clear that such a payment would not cause the applicant any harm (see also A N Oelofse ‘Developments in the Law of Documentary Letters of Credit’ *ABLU* 1996 (a paper delivered at the 1996 Annual Banking Law Update held at the Indaba Hotel, Johannesburg) (unpaginated) at 14 of his article).

<sup>395</sup> 1996 (1) SA 812 (A).

<sup>396</sup> 2002 (3) SA 688 (SCA). For a full discussion of this case, see C Hugo ‘Documentary Credits and Independent Guarantees’ *ABLU* 2004 (a paper delivered at the 2004 Annual Banking Law Update held at the Indaba Hotel, Johannesburg on 21 April 2004) (unpaginated) at 1–5 of his article; and H Schulze ‘Letters of Credit’ (July 2002) *De Rebus* 40–41. For a discussion of the decision of the court *a quo* (*Standard Bank of South Africa Ltd v OK Bazaars (1929) Ltd* 2000 (4) SA 382 (W)), see D J Lötze and C J Nagel ‘*Standard Bank of South Africa Ltd v OK Bazaars (1929) Ltd* 2000 (4) SA 382 (W)’ (2001) 34 *De Jure* 414.

<sup>397</sup> 2002 (3) SA 688 (SCA) in paras 25–26 at 697G–698D.

therefore the English approach is also likely to prevail here.<sup>398</sup> As South Africa apparently also follows a strict standard of compliance,<sup>399</sup> it is also quite possible that it will follow suit in holding that non-compliance is a proper defence that can be invoked. Of course, the success of such a defence will also depend on how strictly the South African courts will apply the doctrine of strict compliance in respect of demand guarantees.

### 2.11.3 Conclusion

The late presentation and the presentation of non-conforming documents and/or defective demands are clearly valid defences against non-payment under English and American law. In the South African tradition of following the English law when it comes to documentary credit issues, it appears that the defence of non-compliance is also likely to succeed in South Africa. Whether or not documents comply will clearly depend on the standard of compliance that is required and how it is interpreted in the different jurisdictions. Whether or not the demand guarantee is subject to any specific rules (such as the UCP, URDG, or ISP98) or is subject to the UNCITRAL Convention, will also be important in establishing whether or not the documents and/or demand complies with the standard of compliance set out in the rules or the Convention. It should also be remembered that these defences are in no way concerned with the autonomy principle of demand guarantees.

## 2.12 INSURANCE AS AN ALTERNATIVE TO DEMAND GUARANTEES

It would be safer for a principal if he could insure himself against the ‘unfair’ calling of a demand guarantee. Insurance can also be obtained against ‘fair’ calling of the demand guarantee where the contract could not be performed, for example, for ‘political reasons’ such as non-renewal of import or export licences, the imposition of embargoes or the inability to complete a contract due to war or civil unrest.<sup>400</sup> These types of insurance are available in most jurisdictions.<sup>401</sup> However, it should be remembered that if a principal decides to insure himself against this risk, he will have to inflate his contract price to make provision for the high premiums required in this specialised field of insurance. An analysis of this type of available insurance cover is beyond the scope of this thesis.<sup>402</sup>

An alternative to the furnishing of a demand guarantee payable on demand is, for example, the use of supplier default insurance that is offered to contractors in the United Kingdom. This type of cover indemnifies the client against consequential loss, should the contractor default and commit breach of contract. Here provision is usually made for arbitration in the

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<sup>398</sup> See *Hugo: The Law Relating to Documentary Credits op cit* note 140 at 314.

<sup>399</sup> As mentioned earlier (see paras 2.5.2.5.1, 2.5.2.5.4 and 2.5.2.5.6 above), the South African law regarding the doctrine of strict compliance has not been authoritatively settled yet (see *Hugo: The Law Relating to Documentary Credits op cit* note 140 at 314).

<sup>400</sup> See *SITPRO's Financial Guide op cit* note 5 at 5.

<sup>401</sup> In a survey conducted by SITPRO in 2003 regarding the use of demand guarantees in the United Kingdom, it was shown that about two-thirds of the respondents (i.e., exporters) making use of demand guarantees were also taking out insurance to cover unfair calling (see *SITPRO's Report op cit* note 6 at 3, 5, 8 and 11).

<sup>402</sup> For more information regarding this type of insurance, see *Pierce op cit* note 46 at 144, 185, 195–196, 203–211; and 283.

event of a dispute. An analysis of this type of insurance is beyond the scope of this thesis.<sup>403</sup>

Time will tell whether insurance as an alternative to demand guarantees will be generally accepted. It seems unlikely, however, that the insistence on demand guarantees will cease as long as contractors or suppliers, in their eagerness to do business, are willing to accept the various consequences stemming from conducting business abroad.<sup>404</sup>

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<sup>403</sup> See, e.g., also Van Niekerk and Schulze *op cit* note 24 in para 2.2.3.4 at 42–44.

<sup>404</sup> See Smit *op cit* note 48 at 151.



## CHAPTER 3: SOURCES OF THE LAW RELATING TO DEMAND GUARANTEES AND STANDBY LETTERS OF CREDIT

### 3.1 INTRODUCTION

The commercial letter of credit was first employed by merchants to effect payment and to finance their transactions in the early part of the nineteenth century.<sup>1</sup> Since then, the law of documentary credits has developed mainly through practice and customary usage.<sup>2</sup> Many of its operative rules, irrespective of geography or legal system, have emerged from the customs of bankers dealing with importers and exporters, and with shipping and insurance companies. Since 1933,<sup>3</sup> the International Chamber of Commerce ('ICC')<sup>4</sup> has drafted and issued Uniform Customs and Practice for Documentary Credits ('UCP').<sup>5</sup> The UCP<sup>6</sup> are a set of rules issued and regularly revised by the ICC (last revised in 2007).<sup>7</sup>

Besides this, the ICC has also introduced other uniform rules that can apply to demand guarantees and standby letters of credit, namely the Uniform Rules for Contract Guarantees ('URCG'), the Uniform Rules for Demand Guarantees ('URDG') and the International Standby Practices ('ISP98'). In addition to these rules, the United Nations Commission on International Trade Law ('UNCITRAL') adopted a universal legal framework for demand guarantees and standby letters of credit called the 'United Nations Convention on Independent Guarantees and Stand-by Letters of Credit' ('UNCITRAL Convention').<sup>8</sup>

<sup>1</sup> For a discussion of the history of documentary credits, see C F Hugo *The Law Relating to Documentary Credits from a South African Perspective with Special Reference to the Legal Position of the Issuing and Confirming Banks* (published LLD, University of Stellenbosch (1996)) (1997) (hereinafter '*Hugo: The Law Relating to Documentary Credits*') in Chapter 2 at 51–75.

<sup>2</sup> See J P van Niekerk and W G Schulze *The South African Law of International Trade: Selected Topics 2 ed* (2006) at 306.

<sup>3</sup> *ICC Publication No 82*, Paris (1933).

<sup>4</sup> Hereinafter the 'ICC'. See also para 3.2.1 below.

<sup>5</sup> Hereinafter the 'UCP'. In the 1980s, the ICC promulgated the first version of the UCP (1983 version) to provide that the UCP would also apply to standby letters of credit, to the extent to which they may be applicable to standby letters of credit. In 1993, the ICC revised the 1983 version and promulgated the 1993 version with a similar scope provision (see J F Dolan 'The UN Convention on International Independent Undertakings: Do States with Mature Letter-of-Credit Regimes Need It?' (1998) 13 *Banking and Finance Law Review* 1 at 2). The 1993 version was similarly revised and promulgated in 2007.

<sup>6</sup> This is the term used if reference is not made to a specific version of the UCP. For a full discussion of the UCP, see para 3.2.2 below.

<sup>7</sup> See L Gorton 'Draft UNCITRAL Convention on Independent Guarantees' (May 1997) *Journal of Business Law* 240 at 242; and Van Niekerk and Schulze *op cit* note 2 at 306.

<sup>8</sup> See Xiang Gao *The Fraud Rule in the Law of Letters of Credit: A Comparative Study* (2002) at 15. Hereinafter the United Nations Commission on International Trade Law will be referred to as the 'UNCITRAL'. In the Uniform Act on Securities, issued by the Organization for the Harmonization of Business Law in Africa ('OHADA', the French acronym), the rules on demand guarantees are set out in part 1, Chapter II. This uniform Act of the OHADA is applicable in all 16 Member States (i.e., Benin, Burkina Faso, Cameroon, Central African Republic, Comoros, Congo, Côte d'Ivoire, Gabon, Guinea, Guinea Bissau, Equatorial Guinea, Mali, Niger, Senegal, Tchad and Togo) (see N Enonchong 'The Problem of Abusive Calls on Demand Guarantees' (2007) *Lloyd's Maritime and Commercial Law Quarterly* 83 at 84 and 84n7–8). A further discussion of this OHADA Act falls beyond the scope of this thesis.

Therefore, general sources of the law of commercial and standby letters of credit and demand guarantees, due to their highly international nature are also often international banking practice and the usages in international trade.<sup>9</sup> These are often set out in the rules issued by the ICC.

In most countries, both of common and civil law origins, there are no explicit statutory rules for demand guarantees and standby letters of credit.<sup>10</sup> Therefore, disputes must primarily be addressed under explicit contractual provisions, unwritten rules, principles of contract and commercial law, and case law.<sup>11</sup> However, owing to their highly international nature, demand guarantees, standby letters of credit and commercial letters of credit certain individual countries have introduced special legislation governing these instruments. Usually where there is any legislation in this regard in a country, with the exception of article 5 of the Uniform Commercial Code ('UCC') in the United States, 'it tends to consist of only a few provisions often of a general nature'.<sup>12</sup> In the United States article 5 of their UCC specifically governs commercial letters of credit. Disputes relating to the United States' standby letters of credit, which were developed for bank regulatory reasons,<sup>13</sup> are also decided under article 5 of the UCC.<sup>14</sup>

Another important source of law of demand guarantees and standby letters of credit in certain jurisdictions is case law. Also often supplementary to the law in this area are legal writings.<sup>15</sup>

This chapter will introduce the sources of the law of demand guarantees and standby letters of credit generally. More specifically, the relevant uniform rules of the ICC, the UNCITRAL Convention, and article 5 of the UCC of the United States will be introduced briefly and the provisions relevant for purposes of this thesis will be highlighted.

## **3.2 RULES OF THE INTERNATIONAL CHAMBER OF COMMERCE**

### **3.2.1 Introduction**

In view of the highly international character of the market for demand guarantees and standby letters of credit, and the possibility of regulatory competition between various countries, there have only been a few initiatives at the national (domestic) level to create regulations. Therefore, initiatives have mainly been developed at the international level

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<sup>9</sup> See E P Ellinger 'The Uniform Customs and Practice for Documentary Credits (UCP): Their Development and the Current Revisions' (2007) *Lloyd's Maritime and Commercial Law Quarterly* 152 at 152.

<sup>10</sup> See F Schwank 'Electronic International Bank Guarantees and Letters of Credit' (1991) *Comparative Law Yearbook of International Business* 317 at 320.

<sup>11</sup> See F De Ly 'The UN Convention on Independent Guarantees and Stand-by Letters of Credit' (Fall 1999) 33 *International Lawyer* 831 at 833.

<sup>12</sup> See Xiang Gao *op cit* note 8 at 15; and Schwank *op cit* note 10 at 320. The American Uniform Commercial Code will hereinafter be referred to as the 'UCC'.

<sup>13</sup> See para 2.9.1 in Chapter 2.

<sup>14</sup> See Xiang Gao *op cit* note 8 at 15.

<sup>15</sup> *Idem*.

where a distinction should be made between self-regulation and official regulation. As regards the former, one should concentrate on the uniform rules promulgated by the ICC.<sup>16</sup>

In 1919 a few business leaders founded the ICC. The ICC is an international, non-governmental organisation consisting of thousands of member companies and associations from over 130 countries. It operates through its numerous specialist commissions based in Paris and its national committees<sup>17</sup> in all major capitals, and coordinates with their membership to address the concerns of the business community and to put across to their government the business views formulated by the ICC. The ICC's aim is to promote an open international trade and investment system, and the market economy worldwide. One of its most vital functions is to harmonise international trade practices through uniform rules and trade terms incorporated into contracts, and through the publication of guides devoted to specific fields of activity or specific problems areas. In other words, it represents the diverse interests of the world business community and makes rules that govern the conduct of business globally. The ICC is the international business organisation and it is the only representative body that speaks with authority on behalf of enterprises from all sectors in every part of the world. It also provides essential services, the most important among them being the International Court of Arbitration. Within a year of the creation of the United Nations, the ICC was granted consultative status at the highest level with the United Nations and its specialised agencies. To date, the ICC is the preferred partner of international and regional organisations whenever decisions have to be made on international issues of importance to business.<sup>18</sup>

A few of the universal rules (standard guidelines) promulgated by the ICC have become cornerstones of international commercial law and, as such, even indispensable. One such set, discussed below, is the UCP (1993 revision) ('UCP 500').<sup>19</sup> It is also expected that the same success will be achieved with the latest 2007 version. However, as will be seen from this discussion, not all the ICC's projects have been successful. A few have been only slightly significant.<sup>20</sup>

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<sup>16</sup> See De Ly *op cit* note 11 at 834.

<sup>17</sup> For details on the ICC's national committee in South Africa, see the official website of the South African Chamber of Business ('SACOB') (<http://www.sacob.co.za> accessed 1 January 2008).

<sup>18</sup> See ICC Publication No 645, Paris (2003) 'ICC at a glance' at 101; R Goode 'Abstract Payment Undertakings and the Rules of the International Chamber of Commerce' (1995) 39 *Saint Louis University Law Journal* 725; and Van Niekerk and Schulze *op cit* note 2 at 274. See also the official website of the ICC (<http://www.iccwbo.org> accessed 1 January 2008).

<sup>19</sup> While the 1993 version of the UCP (hereinafter the 'UCP 500') was in operation, it was incorporated into a vast majority of letters of credit issued worldwide (see Van Niekerk and Schulze *op cit* note 2 at 274).

<sup>20</sup> See E P Ellinger 'British Business Law: Banking Law' (November 2005) *Journal of Business Law* 704 at 704.

## 3.2.2 Uniform Customs and Practice for Documentary Credits<sup>21</sup>

### 3.2.2.1 Introduction

Owing to the international characteristics of documentary credits, there have been various attempts in the past to create uniform rules governing documentary credits. Pioneering efforts were made on a national basis, from as early as the 1920s, in the United States, Germany, France, Norway, Czechoslovakia, Italy, Sweden, Argentina, Denmark and in the Netherlands.<sup>22</sup>

The 1929 Congress of the ICC held in Amsterdam initiated the first real international attempt at standardising letters of credit. This attempt proved to be unsuccessful as the ensuing regulations were adopted only in Belgium and in France. Later, in 1933, the ICC in Vienna made another attempt and issued the first version of the UCP.<sup>23</sup> This was considered to be the first important step towards achieving uniformity in the field of international letters of credit. The 1933 version of the UCP, which formed the basis for subsequent revisions, was adopted by bankers in some European countries and, on an individual basis, by some banks in the United States. However, banks in the United Kingdom and most Commonwealth countries refused to adopt it.<sup>24</sup>

For the next few years there were no significant developments, until the 1933 version of the UCP was revised and a new version adopted in 1951.<sup>25</sup> This version was adopted by bankers of various countries in Europe, Asia, Africa and the United States. However, bankers in the United Kingdom again rejected this version, although ‘many Commonwealth banking communities toed the line’.<sup>26</sup>

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<sup>21</sup> For a comprehensive discussion of the development of the UCP (since the beginning until the 1993 version), see C Hugo ‘The Development of Documentary Letters of Credit as Reflected in the Uniform Customs and Practice of Documentary Credits’ (1993) 5 *South African Mercantile Law Journal* 44; and Hugo: *The Law Relating to Documentary Credits op cit* note 1 at 77–128; and for a brief discussion, see Van Niekerk and Schulze *op cit* note 2 at 274–275. On its legal nature, see J C Stassen ‘The Legal Nature of the Uniform Customs and Practice for Documentary Credits (UCP)’ (1982) 4 *Modern Business Law* 125–138; C Hugo ‘The Legal Nature of the Uniform Customs and Practice for Documentary Credits: Lex Mercatoria, Custom, or Contracts?’ (1994) 6 *South African Mercantile Law Journal* 143; and Van Niekerk and Schulze *op cit* note 2 at 275–277. For a publication that contains all the rules of the UCP from the earliest rules to the current 2007 revision (‘UCP 600’) and which provides a brief history of the development of the rules, see D Tayler (ed) *The Complete UCP: Texts, Rules and History 1920-2007* (2008) ICC Publication No 683, Paris.

<sup>22</sup> See E P Ellinger ‘The Uniform Customs – Their Nature and the 1983 Revision’ (1984) *Lloyd’s Maritime and Commercial Law Quarterly* 578 at 578; and E P Ellinger ‘The Uniform Customs and Practice for Documentary Credits – The 1993 Revision’ (1994) *Lloyd’s Maritime and Commercial Law Quarterly* 377 at 377–378.

<sup>23</sup> ICC Publication No 82, Paris (1933).

<sup>24</sup> See E P Ellinger ‘The Uniform Customs – Their Nature and the 1983 Revision’ (1984) *Lloyd’s Maritime and Commercial Law Quarterly* 578 at 579; E P Ellinger ‘The Uniform Customs and Practice for Documentary Credits – The 1993 Revision’ (1994) *Lloyd’s Maritime and Commercial Law Quarterly* 377 at 378; and Van Niekerk and Schulze *op cit* note 2 at 274.

<sup>25</sup> ICC Publication No 151, Paris (1951). For a critical analysis of this version see S Mentschikoff ‘Letters of Credit: The Need for Uniform Legislation’ (1956) 23 *University of Chicago Law Review* 571.

<sup>26</sup> See E P Ellinger ‘The Uniform Customs – Their Nature and the 1983 Revision’ (1984) *Lloyd’s Maritime and Commercial Law Quarterly* 578 at 579. See also in particular Ellinger’s discussion of the objections raised by the banks in the United Kingdom against the 1951 version of the UCP at 579–580; and E P Ellinger

In 1962 the UCP were revised again.<sup>27</sup> One of the main purposes of this revision was to evolve a system that could be applied universally. To this end, it was necessary to adapt the UCP to the needs of Britain and Commonwealth countries. The 1962 revision accomplished this breakthrough. This version solved most of the specific problems that had been the cause for the rejection of the 1951 version by banks in the United Kingdom. The 1962 version was adopted by all the previous participants, as well as by the banks in the United Kingdom and the Commonwealth of Nations.<sup>28</sup>

Technological advances, in particular the far-reaching container revolution, and the entry of new banks into the market led to a further revision of the UCP in 1974.<sup>29</sup> The UNCITRAL assisted the ICC with this version. Banking organisations in socialist countries, which were not members of the ICC, made contributions through an *ad hoc* Working Party.<sup>30</sup> The 1974 draft was a considerable improvement on that of the earlier versions. The 1974 version was adopted by banking organisations and individual banks in nearly 170 countries. This version attained world-wide acclaim and undoubtedly became the cornerstone of the law pertaining to letters of credit.<sup>31</sup>

In order to keep up with the changes in the law in the field of letters of credit and further developments in technology, it was necessary to revise the UCP again in 1983 ('UCP 400').<sup>32</sup> The UCP 400 widened the scope of their application and introduced

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'The Uniform Customs and Practice for Documentary Credits – The 1993 Revision' (1994) *Lloyd's Maritime and Commercial Law Quarterly* 377 at 378–379.

<sup>27</sup> *ICC Publication* No 222, Paris (1962), which was effective from 1 July 1963.

<sup>28</sup> See Xiang Gao *op cit* note 8 at 16; E P Ellinger 'The Uniform Customs – Their Nature and the 1983 Revision' (1984) *Lloyd's Maritime and Commercial Law Quarterly* 578 at 580; E P Ellinger 'The Uniform Customs and Practice for Documentary Credits – The 1993 Revision' (1994) *Lloyd's Maritime and Commercial Law Quarterly* 377 at 379; and Van Niekerk and Schulze *op cit* note 2 at 274.

<sup>29</sup> *ICC Publication* No 290, Paris (1974), which was effective from 1 October 1975.

<sup>30</sup> See the introduction to the 1974 version of the UCP (*ICC Publication* No 290, Paris (1974)).

<sup>31</sup> See E P Ellinger 'The Uniform Customs – Their Nature and the 1983 Revision' (1984) *Lloyd's Maritime and Commercial Law Quarterly* 578 at 578 and 580; Xiang Gao *op cit* note 8 at 16; E P Ellinger 'The Uniform Customs and Practice for Documentary Credits – The 1993 Revision' (1994) *Lloyd's Maritime and Commercial Law Quarterly* 377 at 379–380; and Van Niekerk and Schulze *op cit* note 2 at 274. For a further discussion of the 1974 version of the UCP, see E J Jhirad 'Uniform Customs and Practice for Documentary Credits, 1974 Revision: The Principle Emendations of the 1962 Text' (1976) 9 *Uniform Commercial Code Law Journal* 109; and B S Wheble 'Uniform Customs and Practice for Documentary Credits (1974 Revision)' (1975) *Journal of Business Law* 281.

<sup>32</sup> *ICC Publication* No 400, Paris (1983) (hereinafter the 'UCP 400'), which was effective from 1 October 1984. For a comparison with the 1974 Revision, see the B S Wheble (prepared by) *ICC's Documentary Credits: UCP 1974/1983 Revisions Compared and Explained ICC Publication* No 411. However, for a full discussion of the 1983 version of the UCP ('UCP 400') see E P Ellinger 'The Uniform Customs – Their Nature and the 1983 Revision' (1984) *Lloyd's Maritime and Commercial Law Quarterly* 578; C M Schmitthoff 'The New Uniform Customs for Letters of Credit' (1983) *Journal of Business Law* 193; D J Cannon 'The Uniform Customs and Practice for Documentary Credits: The 1983 Revision' (1984) 17 *Uniform Commercial Code Law Journal* 42; J E Byrne 'The 1983 Revision of the Uniform Customs and Practice for Documentary Credits' (1985) 102 *Banking Law Journal* 151; C Del Busto 'Operational Rules for Letters of Credit: Effect of New Uniform Customs and Practice Rules' (1985) 17 *Uniform Commercial Code Law Journal* 298; B Kozolchyk 'The 1983 UCP Revision, Trade Practices and Court Decisions: A Plea for a Closer Relationship' (1984) 9 *Canadian Business Law Journal* 214; M A Wayne 'The Uniform Customs and Practice as a Source of Documentary Credit Law in the United States, Canada, and Great Britain: A Comparison of Application and Interpretation' (1989) 7 *Arizona Journal of International and Comparative*

changes necessitated by technological developments. The 1983 version specifically extended the scope of the UCP to cover standby letters of credit. Article 1 of the UCP 400 provided that their articles would ‘apply to all documentary credits, including, to the extent to which they may be applicable [to] standby letters of credit’. The 1983 version of the UCP was the first to indicate expressly that it applied to both commercial letters of credit and standby letters of credit. The UCP 400 were adopted by banking associations and individual banks in more than 160 countries.<sup>33</sup>

A few years later (in 1993) the ICC again revised UCP 400 in an attempt to address new developments in the transport industry and new technological applications. This revision was also intended to improve the functioning of the UCP. In the past the UCP were a product of bankers, but with the 1993 revision it was the first time that law professors and lawyers had also participated in the revision process.<sup>34</sup> The ICC promulgated the revised version as UCP 500.<sup>35</sup> The UCP 500 came into effect on 1 January 1994. The UCP 500 apply to all documentary credits, including to the extent to which they may also be applicable to standby letters of credit, where they are incorporated into the text of the credit. If UCP 500 are incorporated into the text of the credit, they are binding on all parties thereto, unless otherwise expressly stipulated in the credit.<sup>36</sup> Therefore, like their

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*Law 147*; C J Chapman ‘The 1983 Revisions to the Uniform Customs and Practice for Documentary Credits’ (January 1985) 90 *Commercial Law Journal* 13; H Harfield ‘An Agnostic View’ (1990) *Brooklyn Law Review* 1; P Šarčević and P Volken (eds) *International Contracts and Payments* (1991) (contribution No 4) L Rosenberg ‘The Law of International Documentary Credits: Principles, Liabilities and Responsibilities’ 51; and J Lipton ‘Uniform Regulation of Standby Letters of Credit and Other First Demand Security Instruments in International Transactions’ (1993) 10 *Journal of International Banking Law* 402.

<sup>33</sup> See Xiang Gao *op cit* note 8 at 16–17; and E P Ellinger ‘The Uniform Customs and Practice for Documentary Credits – The 1993 Revision’ (1994) *Lloyd’s Maritime and Commercial Law Quarterly* 377 at 381.

<sup>34</sup> See Xiang Gao *op cit* note 8 at 17; and R P Buckley ‘The 1993 Revision of the Uniform Customs and Practice for Documentary Credits’ (June 1995) 6 *Journal of Banking and Finance Law and Practice* 77 at 77.

<sup>35</sup> *ICC Publication No 500*, Paris (1993) (hereinafter the ‘UCP 500’). The use of UCP 500 was – just as for the previous revisions of 1962, 1974 and 1983 – recommended by the UNCITRAL (see UNCITRAL Doc A/CN.9/395 of 29 April 1994 and XXV UNCITRAL Y.B, 1994, 28). For more discussion about the UCP 500 see, Buckley *op cit* note 34; R P Buckley ‘The 1993 Revision of the Uniform Customs and Practice for Documentary Credits’ (1995) 28 *George Washington Journal of International Law and Economics* 265; R Goode ‘Abstract Payment Undertakings and the Rules of the International Chamber of Commerce’ (1995) 39 *Saint Louis University Law Journal* 725; R Goode ‘Abstract Payment Undertakings in International Transactions’ (1996) XXII *Brooklyn Journal of International Law* 1; E P Ellinger ‘The Uniform Customs and Practice for Documentary Credits – The 1993 Revision’ (1994) *Lloyd’s Maritime and Commercial Law Quarterly* 377; J F Dolan ‘Weakening the Letter of Credit Product: The New Uniform Customs and Practice for Documentary Credits’ (1994) *International Business Law Journal* 149; B Kozolchyk ‘Towards New Customs and Practices for Documentary Credits: The Methodology of the Proposed Revision’ (1993) *Commercial Law Annual* 371; C Hugo ‘The 1993 Revision of the Uniform Customs and Practice for Documentary Credits’ (1996) 8 *South African Mercantile Law Journal* 151; A N Oelofse ‘Developments in the Law of Documentary Letters of Credit’ (1996) 8 *South African Mercantile Law Journal* 56; A N Oelofse ‘Developments in the Law of Documentary Letters of Credit’ *ABLU* 1995 (a paper delivered at the 1995 Annual Banking Law Update held at the Indaba Hotel, Johannesburg) (unpaginated) (hereinafter ‘*ABLU 1995*’); and Van Niekerk and Schulze *op cit* note 2 at 274–277. For a detailed comparison of the UCP 500 and the UCP 400 see C Del Busto *Documentary Credits: UCP 500 and UCP 400 Compared* (ICC Publication No 511, Paris (1993)).

<sup>36</sup> See article 1 of the UCP 500.

predecessor from 1983,<sup>37</sup> UCP 500 also apply to standby letters of credit, provided that the UCP are at all applicable (usually incorporated by reference). Until 30 June 2007, the UCP 500 was the latest version that was in operation.

In May 2003, the ICC authorised the ICC Commission on Banking Technique and Practice ('the Banking Commission') to begin revising UCP 500. The general objective was to address developments in the banking, transport and insurance industries. The Banking Commission appointed a Drafting Group to do the revision. A second group, known as the 'Consulting Group', was also established that reviewed and advised on earlier drafts submitted by the Drafting Group. A draft version was sent out to all the national committees of the ICC during 2005 and their comments had to be submitted before 5 November 2005. A full draft was again sent out to the national committees during March 2006. A meeting was scheduled in Vienna during May 2006 to discuss the revised UCP. Final comments on the draft revision were due in June 2006 whereafter a final draft was compiled during July/August 2006.<sup>38</sup> On 25 October 2006 the Banking Commission by a unanimous vote (this included the South African National Committee's vote) approved a final version of the UCP.<sup>39</sup> This latest revision (the 2007 version), which came into effect on 1 July 2007, is commonly referred to as the 'UCP 600'.<sup>40</sup> It is understood that this revision was the work of bankers rather than of lawyers. The new rules are the result of more than three years of intensive work by the Banking Commission.<sup>41</sup> The

<sup>37</sup> For a comparison of the 1983 version ('UCP 400') with the 1993 version ('UCP 500') see E P Ellinger 'The Uniform Customs and Practice for Documentary Credits – The 1993 Revision' (1994) *Lloyd's Maritime and Commercial Law Quarterly* 377.

<sup>38</sup> Oral presentation made by D R Smith 'UCP 600 Topics' at the Institute of International Banking Law and Practice Inc's 2006 Annual Survey of Letter of Credit Law and Practice held in Miami, Florida on 1 March 2006. Smith was also a member of the Consulting Group which worked on the revision of the UCP 500. See also the Electronic Newsletter *Letter of Credit Update* (LCU) (21 March 2006) Issue 4 issued by Institute of International Banking Law and Practice Inc at 1.

<sup>39</sup> See Note, 'Reflections Prior to the UCP Vote' (January–March 2007) 13 *ICC's DCInsight* 2.

<sup>40</sup> See *ICC Publication* No 600, Paris (2006) (hereinafter the 'UCP 600'). For a discussion of UCP 600, see C Hugo and O Lambertyn 'Documentary Credits and Independent Guarantees' *ABLU* 2007 (a paper delivered at the 2007 Annual Banking Law Update held at the Indaba Hotel, Johannesburg on 18 April 2007) 177; Drafting Group of the UCP 600, *Commentary on UCP, ICC Publication* No 680, Paris (2007) (in this book the Drafting Group of the UCP 600 fully explain the reasons behind the provisions contained in the UCP 600); S Heiskanen 'Should B/Ls Have Been Excluded from UCP 600 Article 17?' (July–September 2007) 13 *ICC's DCInsight* 16; P Andrieu 'Ambiguities in the New UCP' (July–September 2007) 13 *ICC's DCInsight* 17; P Ellinger 'The Uniform Customs and Practice for Documentary Credits (UCP): Their Development and the Current Revisions' (2007) *Lloyd's Maritime and Commercial Law Quarterly* 152; C Debattista 'The New UCP600 – Changes to the Tender of the Seller's Shipping Documents under Letters of Credit' (2007) *Journal of Business Law* 329; J Ulph 'The UCP600: Documentary Credits in the Twenty-first Century' (2007) *Journal of Business Law* 355; M Isaacs and M Barnett 'International Trade Finance – Letters of Credit, UCP 600 and Examination of Documents' (2007) 22 *Journal of International Banking Law and Regulation* 660; M Ford 'Issues and Challenges under UCP 600' (October–December 2007) 13 *ICC's DCInsight* 1; N D George 'Loss of Documents and UCP 600 Article 35' (October–December 2007) 13 *ICC's DCInsight* 3; R Katz (ed) *Insights Into UCP 600: Collected Articles from DCI 2003 to 2008* (2008) *ICC Publication* No 682; and J F Dolan and W Baker *Users' Handbook for Documentary Credits Under UCP 600* (2008) *ICC Publication* No 694. See also the different articles discussing UCP 600 and issues related to it by different authors that have been reprinted in J G Barnes and J E Byrne 'Letters of Credit' (2007) 62 *Business Lawyer* 1607 (as reprinted in J E Byrne and C S Byrnes (eds) 2008 *Annual Survey of Letter of Credit Law and Practice* (2008) (hereinafter '2008 Annual Survey') at 29–53, 118–120; 121–171. For a detailed discussion of a comparison of the UCP 500 and UCP 600, see J E Byrne *The Comparison of UCP600 & UCP500* (2007).

<sup>41</sup> See the 'introduction' to the UCP 600 (see *ICC Publication* No 600, Paris (2006) at 11).



2006 revision incorporates a number of changes from UCP 500, for example, new sections on ‘definitions’ and ‘interpretations’ have been added to clarify the meaning of ambiguous terms.<sup>42</sup>

As the UCP 500 were still in operation until 30 June 2007, it is possible that many letters of credit and standby letters of credit might still be in operation that were issued subject to UCP 500,<sup>43</sup> and therefore this thesis will refer to, or deal with, both UCP 500 and the UCP 600. Furthermore, it also appears that some banks are still issuing letters of credit subject to UCP 500, despite the fact that UCP 600 have come into operation.<sup>44</sup> However, when reference is made merely to ‘the UCP’, it does not refer to a specific version.

The UCP are a set of rules issued by the ICC in an attempt to create a uniform and standard set of conditions under which banks may issue documentary credits. The UCP further attempt to standardise the interpretation of documentary credit practice and govern most aspects of documentary credits, except for the relationship between the applicant of a documentary credit and the issuing bank. More accurately, they are a compilation of internationally accepted banking customs and practice regarding documentary credits.<sup>45</sup> To the extent that the UCP apply to documentary credits themselves, they are also applicable to standby letters of credit.<sup>46</sup> The UCP apply only to documentary credits, including standby letters of credit, that are specifically issued by banks.<sup>47</sup> The UCP are the most successful harmonising measure in the history of international commerce so far, and they have removed a vast number of technical problems that could have undermined the smooth operation of letters of credit. The UCP 500 have been a remarkable success and most banks have incorporated them into their documentary credits.<sup>48</sup> It remains to be seen whether the same success will be achieved with the UCP 600.<sup>49</sup>

<sup>42</sup> See <http://www.iccwbo.org/iccjcd/index.html> (accessed 1 January 2008).

<sup>43</sup> See DCI Interview: D Smith ‘The Insight Interview: Donald Smith’ (July–September 2007) 13 *ICC’s DCInsight* (hereinafter ‘DCI Interview: D Smith’) 5 at 7.

<sup>44</sup> See R Dobáš ‘Issues and Question Marks’ (January–March 2008) 14 *ICC’s DCInsight* 3 at 3; and see also DCI Interview: D Smith *op cit* note 43 at 7.

<sup>45</sup> See Van Niekerk and Schulze *op cit* note 2 at 275.

<sup>46</sup> Articles 1 and 2 of the UCP 500 express the ICC’s intention that the rules should apply to standby letters of credit issued by banks to the extent that they may be so applicable. Article 1 of the UCP 600 also provides that it applies to any documentary credit (including, to the extent to which they may be applicable, any standby letter of credit) when the text of the credit expressly indicates that it is subject to the rules of the UCP 600.

<sup>47</sup> See article 2 of the UCP 600 and article 2 of the UCP 500.

<sup>48</sup> See Xiang Gao *op cit* note 8 at 18; and Lipton *op cit* note 32 at 402. South African commercial banks have also accepted the UCP 500 through their banker’s organisation, and almost invariably incorporates it into the text of the letters of credit they issue (see Van Niekerk and Schulze *op cit* note 2 at 275–276).

<sup>49</sup> There are indications that the UCP 600 will be widely used and the general feeling among bankers regarding the latest version has been positive so far (see e.g., B Wunnicke ‘A Lawyer’s Personal Welcome to the New UCP’ (April–June 2007) 13 *ICC’s DCInsight* at 3–4; K Christensen ‘A Practical Approach to the New UCP’ (April–June 2007) 13 *ICC’s DCInsight* at 9–10; K Iftikhar ‘Correspondents’ Views from Three Countries: United Arab Emirates’ (July–September 2007) 13 *ICC’s DCInsight* 15 at 15; and Andrie *op cit* note 40 at 17). For example, it has been stated that there are strong indications that the UCP 600 will be used widely by the Chinese Banks (see D A Laprès and J Mo ‘L/Cs, Collections, Guarantees and Other Instruments in the PRC’ (October–December 2007) 13 *ICC’s DCInsight* 21). However, although the UCP 600 were adopted unanimously, it appears that not all banks are in favour of the new rules. There seems to be a trend among some banks to exclude the operation of certain provisions of the UCP 600 (particularly, articles 7(c), 12(b), 14(d), (e), (j), (k) and (l), parts of 16(c)(iii), 28(h) and (i); and 35) in the letters of credit



The UCP, like any other rules promulgated by the ICC, are primarily intended to guide banking practice relating to documentary credits, and not to provide a comprehensive treatment of legal rights and duties. In accordance 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 autonomy of the credit, leaving these and related issues to be dealt with by the courts in the various jurisdictions.<sup>50</sup>

Although UCP are widely accepted and used, due to the international good standing of the ICC, they are technically not law. The UCP are neither a statute nor a code.<sup>51</sup> Rather, they are the work of the world banking community, under the auspices of the ICC, to unify banking customs in letter of credit law.<sup>52</sup> Therefore, the UCP will apply only if the operating banks, in particular the issuing banks, make the credit subject to the UCP.<sup>53</sup> However, practically all evidence indicates that the UCP rules constitute a defined and reliable supranational code that is commonly given the force of law. Although the UCP are technically only a set of standard terms, they have evolved to fulfil the function of law.<sup>54</sup> The UCP contain definitions, the treatment of party liability and responsibility, and set norms normally expected of law. The UCP are considered to be ‘*de facto* law’ or ‘*quasi-law*’ and the cornerstone of the law pertaining to letters of credit.<sup>55</sup> In fact, over time the UCP have gained universal acceptance in international trade. Many domestic courts and legislatures recognise the UCP because they reflect existing industry practice.<sup>56</sup> So pervasive is their use that the revised article 5 of the UCC of the United States specifically refers to them, providing that article 5 is not to apply to the extent that the

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that they have issued thus far (see Iftikhar *op cit* note 49 at 15; Dobáš *op cit* note 44; P Andrie ‘Excluding Articles: A Troublesome Trend’ (January–March 2008) 14 *ICC’s DCInsight* 4; F Reynolds and D Smith ‘Reports from the UCP Seminars (Part 2)’ (January–March 2008) 14 *ICC’s DCInsight* 6; and N Keller ‘More on Those Troublesome Exclusion Clauses’ (April–June 2008) 14 *ICC’s DCInsight* 6). In this regard, Hugo and Lambertyn have said: ‘The UCP is one of the most successful instruments of harmonization of international trade law. It would be a pity if the harmonizing effect of the UCP 600 is diminished by banks excluding or modifying certain provisions allowed under article 1’ (see Hugo and Lambertyn *op cit* note 40 at 192). It should also be borne in mind that the implementation of the UCP 600 is still in its transition phase and it is to be expected that there will be some teething problems initially. Therefore, only time will reveal whether the UCP 600 will be just as successful as what their predecessor was.

<sup>50</sup> See R Goode ‘Abstract Payment Undertakings in International Transactions’ (1996) XXII *Brooklyn Journal of International Law* 1 at 6.

<sup>51</sup> See Van Niekerk and Schulze *op cit* note 2 at 275.

<sup>52</sup> See M A Wayne ‘The Uniform Customs and Practice as a Source of Documentary Credit Law in the United States, Canada, and Great Britain: A Comparison of Application and Interpretation’ (1989) 7(1) *Arizona Journal of International and Comparative Law* 147 at 148.

<sup>53</sup> See article 1 of the UCP 500 and article 1 of the UCP 600.

<sup>54</sup> See, R P Buckley ‘The 1993 Revision of the Uniform Customs and Practice for Documentary Credits’ (June 1995) 6 *Journal of Banking and Finance Law and Practice* 77 at 78.

<sup>55</sup> See E P Ellinger ‘The Uniform Customs – Their Nature and the 1983 Revision’ (1984) *Lloyd’s Maritime and Commercial Law Quarterly* 578 at 578; J G Barnes ‘Internationalisation of Revised UCC Article 5 (Letters of Credit)’ (1995) 16 *Northwestern Journal of International Law and Business* 215 at 216; and R P Buckley ‘The 1993 Revision of the Uniform Customs and Practice for Documentary Credits’ (1995) 28 *George Washington Journal of International Law and Economics* 265 at 267–268.

<sup>56</sup> For a discussion of whether or not the UCP could be considered to be part of a South African rule of custom or trade usage, see Van Niekerk and Schulze *op cit* note 2 at 275–277.

parties expressly adopt the UCP.<sup>57</sup> It appears that the UCP are in every sense the centrepiece of law and practice in the area of letters of credit.<sup>58</sup>

In order to deal with the various concerns being raised regarding the wording and certain provisions of the UCP, the Banking Commission of the ICC often publishes their (i.e., the ICC's) opinions and Position Papers in an attempt to address these issues without having to amend the UCP.<sup>59</sup> In the Banking Commission's published opinions they record particular problems that were put to them, the points made in the discussion of the problem and conclusions as to whether or not the problem does, in fact, lie within the ambit of the UCP and if so, the meaning and effect of the relevant UCP provision. Over the years the opinions of the Commission have been very helpful in clarifying points on which the UCP provisions have been unclear. Furthermore, these opinions have an independent value in helping to ensure that the UCP are applied in a consistent manner from one country to another. However, although these opinions are influential, they do not, of course, bind courts or arbitrators, and merely provide a useful tool in the application and interpretation of the UCP.<sup>60</sup>

### 3.2.2.2 *Application of the UCP to Standby Letters of Credit and Demand Guarantees*

As already mentioned, UCP 400 introduced an innovation by extending the UCP to standby letters of credit. Subsequently, the UCP 500 and the UCP 600 retained this. This extension was motivated by a concern on the part of banks in the United States that their courts might confuse a standby letter of credit with a suretyship guarantee, which most banks in America were legally prohibited from issuing. American banks, therefore, naturally pressed for standby letters of credit to be included in the UCP, so that standby

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<sup>57</sup> South Africa has no specific legislation dealing with commercial and standby letters of credit or demand guarantees. It also has not enacted legislation to incorporate the UCP as part of their domestic law. However, it has also become standard practice in South Africa, just like in the rest of the world, to incorporate the UCP expressly in contracts relating to documentary letters of credit (see Van Niekerk and Schulze *op cit* note 2 at 276; and *Transcontinental Procurement Services CC v ZVL and ZKL International AS* 2000 CLR 67 (W) at 87).

<sup>58</sup> See Xiang Gao *op cit* note 8 at 18; and R Goode 'Abstract Payment Undertakings in International Transactions' (1996) XXII *Brooklyn Journal of International Law* 1 at 5.

<sup>59</sup> For interpretative opinions on issues arising under the UCP 400, see ICC, *Opinions of the Banking Commission (1984–1986)* (ICC Publication No 434, Paris (1987)); ICC, *Opinions of the Banking Commission (1987–1988)* (ICC Publication No 469, Paris (1989)); and ICC, *Opinions of the Banking Commission (1989–1991)* (ICC Publication No 494, Paris (1992)). Under the leadership of Gary Collyer, the ICC Banking Commission also issued a series of interpretive opinions arising under the UCP 500. In this regard, see G Collyer (ed) *Opinions of the ICC Banking Commission (1995–1996): Responses to queries on UCP 400, UCP 500 and URC 522* (ICC Publication No 565, Paris (1997)); G Collyer *More Queries and Responses on UCP 500 (1997): Opinions of the ICC Banking Commission 1997* (ICC Publication No 596, Paris (1998)); A N Oelofse 'Developments in the Law of Documentary Letters of Credit' *ABLU* 2000 (a paper delivered at the 2000 Annual Banking Law Update held at the Indaba Hotel, Johannesburg) (unpaginated) at 1–3 of his article; G Collyer and R Katz (eds) *ICC Banking Commission Collected Opinions 1995–2001 on UCP 500, UCP 400, URC 522 and URDG 458* (ICC Publication No 632, Paris (2002)); ICC 'Three Opinions from the Singapore Commission Meeting' (July–September 2007) 13 *ICC's DCInsight* at 10–13; and ICC 'More Queries from the Singapore Banking Commission Meeting' (October–December 2007) 13 *ICC's DCInsight* at 8–10. For the first opinions under the UCP 600, see, e.g., ICC 'First Banking Commission Opinions Under UCP 600' (January–March 2008) 14 *ICC's DCInsight* 7–10; and ICC 'Two More Recent Opinions on UCP' (April–June 2008) 14 *ICC's DCInsight* at 9–12.

<sup>60</sup> See R Goode 'Abstract Payment Undertakings and the Rules of the International Chamber of Commerce' (1995) 39 *Saint Louis University Law Journal* 725 at 742.

letter of credit would be visibly equated with autonomous documentary credits (and not with suretyship guarantees) to which the prohibition did not apply.<sup>61</sup>

However, despite the fact that the UCP did not address standby letters of credit until the 1983 version (i.e., UCP 400), standby letters of credit had frequently been issued subject to both the 1962 and 1974 versions of the UCP. Banks in the United States and other countries that were influenced by the United States banking practices often referred to the UCP when issuing standby letters of credit long before standby letters of credit were incorporated into the UCP. One of the reasons for this was that since the UCP were a set of practice rules, their provisions relating to their scope could be varied and the rules incorporated into any undertaking. Another was that as most standby users regarded standby letters of credit as a derivative of the commercial letter of credit, they saw no difficulty in issuing standby letters of credit subject to the UCP.<sup>62</sup> This could also be explained by the fact that they had the desire to dismiss any doubt as to the independent and documentary nature of the standby letter of credit, and possibly by the fact that a suitable uniform set of rules other than the UCP did not exist until the International Standby Practices ('ISP98') came into operation on 1 January 1999.<sup>63</sup>

The incorporation of standby letters of credit into the UCP did not result in specific rules for this form of letter of credit being included into the UCP. In fact, a large part of the UCP does not even apply to standby letters of credit or is inappropriate, while other issues that are vital in a standby letter of credit context are not addressed at all in the UCP.<sup>64</sup> The UCP were drafted with traditional form documentary credits in mind. They were drafted to apply primarily to international sale transactions, which included documentary credits as a method of payment under a contract of sale. There are thus a number of shortcomings in the application of the UCP to standby letters of credit, which are not a payment method under a contract of sale, but a standby payment method in case of default under some underlying transaction.<sup>65</sup> Therefore, the application of the UCP to standby letters of credit merely implies that the UCP's general letters of credit principles are expressly made applicable to standby letters of credit.<sup>66</sup> It is also often necessary for the standby letter of credit to exclude large parts of the UCP expressly, if the provisions of the UCP are not

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<sup>61</sup> See R Goode 'Abstract Payment Undertakings and the Rules of the International Chamber of Commerce' (1995) 39 *Saint Louis University Law Journal* 725 at 729; and R Goode 'Abstract Payment Undertakings in International Transactions' (1996) XXII *Brooklyn Journal of International Law* 1 at 16.

<sup>62</sup> See J E Byrne 'The International Standby Practices (ISP98): New Rules for Standby Letters of Credit' (1999) 32 *Uniform Commercial Code Law Journal* 149 in note 8 at 153.

<sup>63</sup> Hereinafter the 'ISP98'. See R Bertrams *Bank Guarantees in International Trade: The Law and Practice of Independent (First Demand) Guarantees and Standby Letters of Credit in Civil Law and Common Law Jurisdictions* 3 ed (2004) at 33–34; and for a full discussion of the ISP98 see para 3.2.6 below.

<sup>64</sup> See Bertrams *op cit* note 63 at 33–34. The assimilation of standby letters of credit to documentary credits in the UCP has been severely criticised; for the reasons why, see R Goode 'Abstract Payment Undertakings and the Rules of the International Chamber of Commerce' (1995) 39 *Saint Louis University Law Journal* 725 at 730.

<sup>65</sup> See Lipton *op cit* note 32 at 403. For a full discussion of which of the UCP 500 provisions are unsuitable or problematic for standby letters of credit and important issues relating to standbys that are not addressed in the UCP 500 see Byrne *op cit* note 62 at 155–162.

<sup>66</sup> See De Ly *op cit* note 11 at 835.

applicable to a specific kind of transaction. There are also many standby letters of credit that exclude the UCP in their entirety.<sup>67</sup>

Although the UCP apply to documentary credits and standby letters of credit, by implication they also apply to demand guarantees, since demand guarantees, though not mentioned in the UCP, are the same from a legal viewpoint as standby letters of credit.<sup>68</sup> Most English demand guarantees are not subject to the UCP at all because their terms are not necessary, or sometimes even inappropriate, to the particular transaction.<sup>69</sup>

For many years the UCP were the only set of rules that could govern standby letters of credit. However, that was only until 1992 when the ICC published their Uniform Rules for Demand Guarantees ('URDG'),<sup>70</sup> which applied to demand guarantees specifically and also to standby letters of credit. So, in the past, from a legal viewpoint, standby credits and demand guarantees were capable of falling within two sets of rules – the UCP and the URDG – and could be governed by whichever set of rules was incorporated into the documents. However, the banking sector, in particular in the United States, was inclined to apply to standby letters of credit many of the practices in current use for documentary credits, including issuance for the guarantor's own account, confirmation of the standby credit by a second bank and payment otherwise than at the counters of the issuing bank. For this reason, the UCP were used for many years in preference to the URDG and this was even signalled by the Introduction to the URDG.<sup>71</sup> Later, a separate set of rules, the ISP98, came into operation on 1 January 1999. The ISP98 were created for the sole application to standby letters of credit. Today, standby letters of credit can be governed by the UCP, URDG or the ISP98. In addition to these rules, it is also possible that the United Nation's Convention on Independent Guarantees and Stand-by Letters of Credit can apply to standby letters of credit.<sup>72</sup> However, since the coming into effect of the ISP98 in 1999, many standby letters of credit are no longer issued subject to the UCP.<sup>73</sup>

In my view, the UCP 600 should not again have incorporated standby letters of credit, because the ISP98 were published specifically for standby letters of credit<sup>74</sup> and today it would appear that most standby letters of credit are issued subject to the ISP98, rather than to the UCP.

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<sup>67</sup> See Warne and N Elliott *Banking Litigation 2* ed (2005) at 275.

<sup>68</sup> For a full discussion of this, see para 2.9.5 in Chapter 2. See also R Goode 'Abstract Payment Undertakings and the Rules of the International Chamber of Commerce' (1995) 39 *Saint Louis University Law Journal* 725 in note 20 at 729; and R Goode *Guide to the ICC Uniform Rules for Demand Guarantees* (1992) ICC Publication No 510 (hereinafter the '*Guide to the URDG*') at 8.

<sup>69</sup> See Warne and Elliott *op cit* note 67 at 275.

<sup>70</sup> Hereinafter the '*URDG*'.

<sup>71</sup> See the *Guide to the URDG op cit* note 68 at 16; and Byrne *op cit* note 62 in note 16 at 153. For a further discussion on why the UCP was preferred to the URDG, see R Goode 'Abstract Payment Undertakings in International Transactions' (1996) XXII *Brooklyn Journal of International Law* 1 at 16–17.

<sup>72</sup> Hereinafter 'the Convention' or 'the UNCITRAL Convention'. See the *Guide to the URDG op cit* note 68 at 16. See also para 3.3 below in this regard for a full discussion.

<sup>73</sup> See DCW Feature 'LC Practice Trends: International Standby Practices (ISP98) and Uniform Rules for Demand Guarantees (URDG)' (September 2004) 8 *Documentary Credit World* at 17–23.

<sup>74</sup> For a similar view, see DCW Interview with V Maulella 'Should Reference to Standbys Remain in UCP?' (September 2004) 8 *Documentary Credit World* at 23–26.

### 3.2.3 Supplement to the Uniform Customs and Practice for Documentary Credits for Electronic Presentation

At its meeting in May 2000, the Task Force of the ICC's Banking Commission indicated that it was going to focus more on the electronic trade. Later the need was identified to develop a bridge between the UCP 500 and the processing of the electronic equivalent of paper-based credits. The UCP 500 were unclear as to whether or not they allowed electronic presentations of credits and some of their provisions were incompatible with electronic presentations.<sup>75</sup> Therefore, with the current evolution from paper to electronic credits, it was established that the market was looking at the ICC to provide guidance in this transition. The ICC's Banking Commission established a Working Group consisting of the necessary experts to prepare the appropriate set of rules as a supplement to the UCP 500.<sup>76</sup> In 2002 this resulted in the ICC publishing an electronic supplement to the UCP 500 called the 'Supplement to the Uniform Customs and Practice for Documentary Credits for Electronic Presentation, version 1.0' ('eUCP version 1.0')<sup>77</sup> to be used for part-electronic or all-electronic presentations of documents tendered under letters of credit.<sup>78</sup> The eUCP version 1.0 came into effect on 1 April 2002, but was later replaced with the Supplement to the Uniform Customs and Practice for Documentary Credits for Electronic Presentation, version 1.1 ('eUCP version 1.1')<sup>79</sup> when the UCP 600 came into operation on 1 July 2007.

The eUCP versions 1.0 and 1.1 deal with the electronic presentation of documents under documentary credits. They do not address any issues regarding the issuance or advice of credits electronically, because market practices and the UCP have allowed for electronic issuance and advice of documentary credits for a number of years and no specific problems have arisen in this regard.<sup>80</sup> The eUCP versions 1.0 and 1.1 are meant to deal with cases in which electronic records are presented, as well as cases in which electronic records are presented in combination with paper documents.<sup>81</sup> The eUCP version 1.0 was not an amendment of the UCP 500, but was merely a supplement to the UCP 500 which would have, when used together with the UCP 500, provided the necessary rules for the presentation of the electronic equivalents of paper documents under letters of credit.<sup>82</sup> Similarly, the eUCP version 1.1 is a supplement to the UCP 600.<sup>83</sup>

<sup>75</sup> See C Cauffman 'The eUCP, an E-supplement to the Uniform Customs and Practice for Documentary Credits (UCP 500)' (2002) *European Transport Law* 737 at 737.

<sup>76</sup> For background information see J G Barnes and J E Byrne 'E-Commerce and Letter of Credit Law and Practice' (Spring 2001) 35(1) *International Lawyer* 23 at 26–28.

<sup>77</sup> *ICC Publication* No 500/2, Paris (2002) (hereinafter the 'eUCP version 1.0'). For a full discussion of this, see C Hugo 'The eUCP' (a paper delivered on at the Law and E-commerce Conference held at the University of Stellenbosch on 30 April 2004) (unpublished).

<sup>78</sup> See also the 'Introduction' to the eUCP version 1.0 (see *ICC Publication* No 500/2, Paris (2002)) in paras 1–2 at 53.

<sup>79</sup> *ICC Publication* No 600, Paris (2006) (hereinafter the 'eUCP version 1.1').

<sup>80</sup> See the 'Introduction' to the eUCP version 1.0 (see *ICC Publication* No 500/2, Paris (2002)) and the 'Introduction' to the eUCP version 1.1 (see *ICC Publication* No 600, Paris (2006)). See also Cauffman *op cit* note 75 at 738; and Barnes and Byrne *op cit* note 76.

<sup>81</sup> See article e1(a) of the eUCP version 1.0 and Article e1(a) of the eUCP version 1.1.

<sup>82</sup> See the 'Introduction' to the eUCP version 1.0 (see *ICC Publication* No 500/2, Paris (2002)) in para 3 at 53.

<sup>83</sup> See the 'Introduction' to the eUCP version 1.1 (see *ICC Publication* No 600, Paris (2006)) in para 2 at 53.

The eUCP version 1.0 applied as a supplement to the UCP 500 where the credit indicated that it was subject to the eUCP version 1.0.<sup>84</sup> Therefore, the eUCP version 1.0 did not automatically apply to a credit subject to the UCP 500. The eUCP version 1.1 will also not automatically apply as a supplement to the UCP 600, unless the credit indicates that it is subject to the eUCP version 1.1.<sup>85</sup> However, a credit subject to either the eUCP version 1.0 or version 1.1, would automatically be subject to either the UCP 500 or UCP 600 (whichever version of the eUCP was referred to) without express incorporation of the UCP 500 or UCP 600. A credit subject to either the eUCP version 1.0 or version 1.1 is called an ‘eUCP credit’.<sup>86</sup>

Although the eUCP version 1.0 had the approval of the ICC, it appeared that in practice it had not been generally accepted.<sup>87</sup> Despite various workshops, conferences and professional literature attempting to explain and promote their use, these guidelines have remained of theoretical value only. It is not clear what the reasons for this failure were, but writers have speculated on what they might have been.<sup>88</sup> At the end of 2005, it had been said that the eUCP version 1.0 remained a futuristic voyage without any discernable practical landing whatsoever.<sup>89</sup>

However, while the UCP 500 were still being revised, the opinion was expressed that, if the eUCP version 1.0 were to be constituted as a new part of the latest version of the UCP (i.e., UCP 600), many banks would include in their standard forms a clause excluding the operation of the respective provisions (as they were allowed to do by virtue of article 1 of the UCP 500).<sup>90</sup> In the end, however, the drafting team of the UCP 600 decided not to incorporate the eUCP’s treatment of electronic presentations in the UCP 600, but rather to keep the eUCP as a supplement to the UCP 600. The eUCP version 1.0 was therefore solely updated to reflect the changes made in the UCP 600 with regard to terminology and style of presentation.<sup>91</sup> In terms of article 1 of UCP 600, parties are still allowed to exclude the operation of certain provision of the UCP, including the provisions of the eUCP version 1.1. However, whether banks will, in fact, exclude the operation of the latest version of the eUCP (as they have threatened to do), remains to be seen. Only time will tell whether the new eUCP version 1.1 will be used more widely.

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<sup>84</sup> See article e1(b) of the eUCP version 1.0.

<sup>85</sup> See article e1(b) of the eUCP version 1.1.

<sup>86</sup> See article e2(a) of the eUCP version 1.0 and eUCP version 1.1. See also Cauffman *op cit* note 75 at 738. The eUCP is issued in version numbers. The current version is version 1.1. A credit must indicate the applicable version. If it does not do so, it will be subject to the version in operation on the date on which the credit is issued or, if made subject to eUCP by an amendment accepted by the beneficiary, on the date of that amendment. (See article e1(c) of the eUCP version 1.0 and article e1(c) of the eUCP version 1.1.)

<sup>87</sup> See the ‘Introduction’ to the eUCP version 1.1 (see *ICC Publication No 600*, Paris (2006)) in para 2 at 53.

<sup>88</sup> For a full discussion of possible reasons for the failure of the eUCP, see Ellinger *op cit* note 20 at 706–707; and Cauffman *op cit* note 75 at 739–741.

<sup>89</sup> See J E Byrne ‘Overview of Letter of Credit Law and Practice in 2005’ as published in J E Byrne and C S Byrnes (eds) *2006 Annual Survey of Letter of Credit Law and Practice* (2006) 6 at 9.

<sup>90</sup> See Ellinger *op cit* note 20 at 707.

<sup>91</sup> See the ‘Introduction’ to the eUCP version 1.1 (see *ICC Publication No 600*, Paris (2006)) in para 2 at 53.

The eUCP is a source of law of the commercial letter of credit as well as the standby letter of credit (and by implication also the demand guarantee). However, as the eUCP merely provide the necessary rules for the presentation of the electronic equivalents of paper documents under letters of credit and standby letter of credit, a further detailed discussion of the eUCP is not required for purposes of this thesis.

### 3.2.4 Uniform Rules for Contract Guarantees

#### 3.2.4.1 Introduction

Over the years, tender, performance and repayment guarantees for international projects became an important feature of world trade practice. This caused the ICC's Commissions on Banking and on Commercial Practice to start working on creating uniform rules governing the issuing of such guarantees. On the one hand, the Banking Commission is concerned with bringing together world bankers for the purpose of harmonising and defining practices and terminology used in international banking and, on the other hand, the Commission on Commercial Practice is generally concerned with standardising commercial usage.<sup>92</sup> In an attempt to draft a set of uniform rules for these guarantees, the two Commissions of the ICC convened a Working Party whose members represented different interest groups in both industrialised and developing countries. In close co-operation with the intergovernmental and international commercial organisations concerned, in particular the UNCITRAL, the Working Party drafted the uniform rules. It took the ICC about 12 years to complete a set of standardised rules, and in 1978 the ICC approved and published the Uniform Rules for Contract Guarantees ('URCG').<sup>93</sup> This was followed in 1982 by another publication namely the 'Model Forms for Issuing Contract Guarantees'.<sup>94</sup>

#### 3.2.4.2 Aim and Application

The application of the URCG is voluntary and will only apply if parties incorporate them into a guarantee. Therefore, if a party desires that these rules should be applicable, the guarantee itself must contain a specific statement that it is subject to the URCG. In such a case, the URCG are binding on all parties to the guarantee, unless otherwise expressly stated in the guarantee or any amendment thereto.<sup>95</sup> Therefore, it follows that the parties to the guarantee may agree on partial application of the URCG. Hence, article 1 provides that

<sup>92</sup> See P J Parsons 'Commercial Law Note: ICC (International Chamber of Commerce) Uniform Rules for Contract Guarantees' (April 1979) 53 *Australian Law Journal* 224 at 226.

<sup>93</sup> *ICC Publication* No 325, Paris (1978) (hereinafter the 'URCG'). See also the 'Foreword' to the URCG at 6. For a full discussion of the URCG see Parsons *op cit* note 92; and P Šarčević and P Volken (editors) *International Contracts and Payments* (1991) (contribution No 5) L A E Hjerner 'Contract Guarantees' (hereinafter 'Šarčević and Volken') at 69. Only those articles of the URCG relevant for purposes of this thesis will be discussed in more detail. Two articles that are especially important for purposes of this thesis are articles 8 and 9, and they will therefore be discussed in more detail in para 4.2.2 in Chapter 4. Article 8 deals with the submission of claims under a contract guarantee and article 9 is concerned with the documentation required to support a claim.

<sup>94</sup> *ICC Publication* No 406, Paris (1982) (a further discussion of these model forms are irrelevant for purposes of this thesis.) See also Šarčević and Volken *op cit* note 93 at 71.

<sup>95</sup> See para 1 of article 1 of the URCG.

[t]hese Rules apply to any guarantee, bond, indemnity, surety or similar undertaking, however named or described (“guarantee”), which states that it is subject to the Uniform Rules for Tender, Performance and Repayment Guarantees (“Contract Guarantees”) of the International Chamber of Commerce (Publication No 325) and are binding upon all parties thereto unless otherwise expressly stated in the guarantee or any amendment thereto.

The term ‘contract guarantees’ as used in the URCG refers to three types of contract guarantees: First, *tender guarantees*, whereby a party inviting tenders (the beneficiary) is assured of a specific sum if a party submitting a tender (the principal) fails to sign a contract if his tender is accepted, or fails to meet some other specified obligation arising from the submission of a tender. A second type is the *performance guarantee* which gives the beneficiary recourse against the guarantor (i.e., payment of a specified amount or, if guarantee so provides, at the guarantor’s option, to arrange for performance of the contract) if the principal fails to perform a relevant contract between him and the beneficiary. The URCG therefore apply to a performance bond as a type of demand guarantee, as well as to a performance guarantee as a type of surety bond. A third type of contract guarantee is the *repayment guarantee* which assures the beneficiary of the repayment of advances, or payments if the principal fails to fulfil a relevant contract.<sup>96</sup>

Although party autonomy is the main principle in the URCG, it may happen that in some countries there are mandatory regulations in the field of guarantees. For instance, mandatory rules of national law may require that claims under the guarantee be made within the limitation period prescribed by national law, irrespective of other limitation periods set out in the URCG or in the guarantee itself. In this regard, article 1(2) of the URCG provides that the mandatory rules must prevail.<sup>97</sup>

The aim of the URCG was to create uniformity and to achieve a fair balance between the legitimate interests of three parties concerned – the beneficiary, principal and the guarantor – and of defining the rights and obligations of the three parties with precision to avoid disputes, while observing the commercial purpose of the tender, performance and repayment guarantees (contract guarantees), that is, to ensure the availability of funds with an independent third party in the event of the beneficiary having a justified claim against the principal.<sup>98</sup>

Article 2 of the URCG defines various terms already mentioned above: ‘tender guarantee’, ‘performance guarantee’, ‘repayment guarantee’, ‘principal’, ‘beneficiary’, ‘instructing party’ and the ‘guarantor under the guarantee’. The URCG do not deal with the issue of the nature of a contract guarantee nor do they attempt to define its nature. In this regard, it does not stipulate whether the guarantee is a primary and independent obligation or whether it is a secondary and accessory one; nor does it indicate the legal consequences of such characterisation. However, the link between performance of the guarantor’s undertaking and default by the principal is established in the definitions.<sup>99</sup> Instead, attention has been given to the prerequisites for payment under a contract guarantee (which

<sup>96</sup> See Parsons *op cit* note 92 at 224. See also paras (a)–(c) of article 2 of the URCG; and see also Šarčević and Volken *op cit* note 93 at 69–70.

<sup>97</sup> See Šarčević and Volken *op cit* note 93 at 71–72.

<sup>98</sup> See the ‘Introduction’ of the URCG at 8.

<sup>99</sup> See Šarčević and Volken *op cit* note 93 at 72.



goes to the beneficiary–guarantor relationship) and the objections and defences available to the guarantor. Furthermore, save for a few exceptions,<sup>100</sup> the URCG do not specifically deal with the relationship between the principal and the guarantor.<sup>101</sup>

The URCG also aimed at encouraging more equitable practices in the area of contract guarantees (demand guarantees), especially by limiting the problem of unfair calling of these guarantees. The URCG attempted to protect the principal from unjustified calls on the guarantor by the beneficiary by stipulating the need for appropriate documentation to support a claim in article 9. Therefore, it was considered desirable that the URCG should not provide for on-demand guarantees, that is, guarantees payable on simple or first demand without any (independent) evidence of default.<sup>102</sup> It is true that all guarantees are payable only on demand; however, the term ‘on-demand guarantee’ normally signifies that the only condition stipulated for payment is simple demand on the part of the beneficiary. Therefore, guarantees of this type are sometimes referred to as ‘unconditional guarantees’. However, this term is sometimes inadequate because there may be some restrictive conditions. For instance, payment may be effected only if the claim is submitted before the expiry date of the guarantee.<sup>103</sup> As mentioned above, the parties may agree on partial application of the URCG and therefore these rules may be applied also to simple or first demand guarantees, but this would require exclusion of those articles relating to documentation necessary to perfect a claim under a guarantee (in particular article 9 of the URCG, discussed later).<sup>104</sup>

The URCG therefore sought to deal with the problem of unfair calling of contract guarantees (demand guarantees) by requiring in article 9, as a condition of the beneficiary’s right to payment, the production of a judgment or arbitral award or the principal’s written approval of the claim and its amount. Although the object of this requirement was commendable, it did have the effect of limiting the acceptability of the URCG, for it resulted in the exclusion from their scope the simple on-demand guarantee that accounted for the great majority of documentary guarantees issued by banks.<sup>105</sup> Furthermore, although the requirement to produce a judgment or arbitral award was theoretically a documentary requirement, practically it meant that beneficiaries had to prove default by the principal by way of litigation or arbitration, and this tended to defeat the objective of the demand guarantee in providing the beneficiary with a speedy monetary remedy.<sup>106</sup> This requirement was unacceptable to importers and because of their strong bargaining position, it resulted in the URCG seldomly being incorporated. This requirement also did not gain general acceptance, because it proved to be too far removed from the current banking and commercial practice. It has been contended that another

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<sup>100</sup> See articles 7(3), 8(2) and 11(2) of the URCG.

<sup>101</sup> See the ‘Introduction’ of the URCG at 9.

<sup>102</sup> See the ‘Introduction’ of the URCG at 8–9.

<sup>103</sup> See Šarčević and Volken *op cit* note 93 at 71.

<sup>104</sup> See Parsons *op cit* note 92 at 225. See also para 4.2.2 in Chapter 4.

<sup>105</sup> See G Penn ‘On-demand Bonds – Primary or Secondary Obligations?’ [1986] 4 *Journal of International Banking Law* 224 at 230; and R Perrignon ‘Performance Bonds and Standby Letters of Credit: The Australian Experience’ (1991) *Journal of Banking and Finance Law and Practice* 157 at 160; and P O’Brien ‘Letters of Intent and Demand Guarantees’ *ABLU* 1993 (a paper delivered at the 1993 Annual Banking Law Update held at the Indaba Hotel, Johannesburg) 134 at 161–162.

<sup>106</sup> See *Guide to the URDG op cit* note 68 at 6.

reason why the URCG failed to gain general acceptance in the market is because the rules are rather general, vague, fragmentary and conceptually fragile.<sup>107</sup>

Therefore, in summary, the ill-fated URCG were in theory intended to cover tender, performance and repayment guarantees (demand guarantees). However, their requirements for a judgment or arbitral award as a condition of entitlement to pay were too far removed from international practice to be acceptable, coming close to crossing the line between a documentary guarantee and a suretyship guarantee.<sup>108</sup>

### 3.2.5 Uniform Rules for Demand Guarantees

#### 3.2.5.1 Introduction

In the light of the dissatisfaction with the 1978 URCG, the Committee of London and Scottish Bankers ('CLSB') (subsequently merged into the British Bankers' Association ('BBA')) submitted a draft Code of Practice for Contract Guarantees or Bonds to the ICC for consideration in 1985. This was followed in 1987 by a new edition of the draft.<sup>109</sup> The ICC was therefore prompted to work on a new set of uniform rules due to the limited acceptance of the 1978 URCG. The idea was that the inclusion of first demand guarantees, in addition to a more comprehensive and detailed set of rules, would encourage wider adoption in practice.

The ICC's Commission on Banking Technique and Practice (the creators of the successful UCP) joined forces with the Commission on International Commercial Practice to create a Joint Working Party to draft the new uniform rules. The Working Party carried out extensive work in this regard and a smaller Drafting Group eventually completed the rules. The UNCITRAL Working Group on International Contract Practices also contributed by reviewing the draft rules and making numerous recommendations for changes and improvements. A major difficulty experienced in formulating the uniform rules was the balancing of the interests of banks, exporters and industrialised countries – which tended to be at the account party's (principal's) end of guarantee deals – with the rights of importers and developing countries – which were usually at the beneficiary's end. This was one of the reasons why the project took longer than was initially anticipated.<sup>110</sup> The uniform rules were eventually approved by the two commissions and endorsed by the ICC in

<sup>107</sup> See Bertrams *op cit* note 63 at 28; and De Ly *op cit* note 11 at 833–834.

<sup>108</sup> See R Goode 'Abstract Payment Undertakings and the Rules of the International Chamber of Commerce' (1995) 39 *Saint Louis University Law Journal* 725 at 726.

<sup>109</sup> See Šarčević and Volken *op cit* note 93 at 78.

<sup>110</sup> For details of the preliminary work and the key issues that had to be resolved, see R Goode 'The New ICC Uniform Rules for Demand Guarantees' (1992) *Lloyd's Maritime and Commercial Law Quarterly* 190. For instance, one of the most serious controversies related to article 20, which provided at some stage that the beneficiary had to submit a statement relating to the principal's default in support of his demand for payment. This article caused a great deal of distress, because a major number of guarantees, namely simple demand guarantees, do not require the submission of such a statement. The continued difficulties experienced with article 20 resulted in the Joint Working Party deleting the article. However, the two commissions of the ICC requested them to reconsider their decision, and eventually it resulted in a reinstatement of article 20, but with granting parties the option of having it specifically excluded. In this regard, see Bertrams *op cit* note 63 in note 22 at 29; and also R Goode 'Abstract Payment Undertakings and the Rules of the International Chamber of Commerce' (1995) 39 *Saint Louis University Law Journal* 725 at 740. For a full discussion of article 20, see para 4.2.3 in Chapter 4.

December 1991. In the end the rules embodied the collective knowledge and experience of the ICC's two commissions, professional and commercial associations and individual specialists across the world. In April 1992 the URDG were officially published.<sup>111</sup> This was followed in 1994 by another publication namely the 'Model Forms for Issuing Demand Guarantees'.<sup>112</sup>

The URDG were created to be more in line with established international bank guarantee practice, under which the great majority of documentary guarantees are payable on first written demand, with or without supporting documents. The URDG also aim to provide some safeguards against unfair calling of the demand guarantees.<sup>113</sup>

The URDG appear effectively to have superseded the 1978 URCG. Initially, it was the intention to repeal the 1978 URCG, but since they are still being used in certain sectors, in particular those outside banking, the decision was therefore made to leave them in force for the time being. For that reason, the 1978 URCG are still available for incorporation should parties choose to do so.<sup>114</sup>

### 3.2.5.2 *Aim and Application*

The URDG are intended to apply worldwide to the use of demand guarantees,<sup>115</sup> specifically guarantees, bonds or other payment undertakings, however named or described, under which the duty of the guarantor/issuer (i.e., a bank, insurance company or other body or person)<sup>116</sup> to make payment arises on the presentation of a written demand and any other documents specified in the guarantee (e.g., a certificate by an engineer) and is not conditional on actual default by the principal in the underlying transaction.<sup>117</sup> Although the URDG apply to demand guarantees rather than to standby letters of credit, standby letters of credit may also be governed by the URDG. However, it was felt that the UCP were a more suitable set of rules for standby letters of credit than the URDG.<sup>118</sup> That was, of course, until the ISP98 came into operation in 1999, which specifically deals with standby letters of credit.<sup>119</sup>

<sup>111</sup> ICC Publication No 458, Paris (April 1992). The URDG were provided with an ICC commentary prepared by R Goode (see *Guide to the URDG op cit* note 68). See also Bertrams *op cit* note 63 at 28–29. The Banking Commission has also adopted more than twenty opinions on the URDG, but they are not widely known outside the Banking Commission (see DCI Interview: G Affaki 'On Revising the Uniform Rules for Demand Guarantees (URDG)' (January–March 2007) 13 *ICC's DCInsight* 18 at 19).

<sup>112</sup> ICC Publication No 503(E), Paris (1994). A further discussion of these model forms are irrelevant for purposes of this thesis.

<sup>113</sup> See the *Guide to the URDG op cit* note 68 at 6–7.

<sup>114</sup> See the *Guide to the URDG op cit* note 68 at 7. See also the 'Introduction' to the URDG at 5.

<sup>115</sup> Standby letters of credit unquestionably fall within the definition of 'demand guarantee' as set out in article 2(a) of the URDG. Therefore, parties to standby letters of credit may elect to incorporate the URDG into these instruments.

<sup>116</sup> Unlike the UCP that apply only to documentary credits and standby letters of credit that are issued by banks, the URDG apply to demand guarantees and standby letters of credit that are issued by banks, insurance companies or other body or persons.

<sup>117</sup> See article 2(a) of the URDG.

<sup>118</sup> A point also stressed in the Introduction to the URDG at 4. See also the *Guide to the URDG op cit* note 68 at 7.

<sup>119</sup> See discussion of the ISP98 in para 3.2.6.

Article 2(b) of the URDG confirms the independence of the guarantees to which the URDG apply: ‘guarantees by their nature are separate transactions from the contract(s) or tender conditions on which they may be based’. However, the URDG do not apply to suretyship or conditional bonds or guarantees or other accessory undertakings under which the guarantor’s duty to pay arises only on actual default by the principal. Although these instruments are widely used, they fall outside the scope and purpose of the URDG, because they are different in character from demand guarantees.<sup>120</sup>

The URDG apply to a demand guarantee solely by way of their explicit incorporation into the guarantee by the parties to the guarantee.<sup>121</sup> As the URDG operate solely by way of contract, the parties are free to exclude or alter any of these rules to the extent permissible by the law applicable to their agreement. The main purpose of the URDG is to codify rules of good practice to which parties subscribe by expressly incorporating these rules into their contracts.

The URDG therefore provide a contractual framework for dealings between guarantor and beneficiary, between instructing party and guarantor, and (in a few respects only) between principal and guarantor or instructing party. Therefore, the URDG do not only cover the relations between guarantor and beneficiary, but also those arising under counter-guarantees. However, the URDG do not deal with the rights and duties of the parties to the underlying contract (namely the principal and the beneficiary), nor do they regulate the internal mandate given by the principal to the guarantor or to the instructing party.

The URDG also do not deal with issues that are the proper preserve of national laws and national courts, such as the circumstances in which the principal may obtain injunctive relief against payment of a demand suspected to be fraudulent or otherwise abusive. These are issues of positive law, not of contract, and the URDG, like other ICC rules, deal only with issues that can properly be regulated by agreement between the parties.<sup>122</sup>

In the end, the success of the URDG depends on the extent to which the international business society is willing to adopt them in practice. During the first couple of years of their existence, it seemed that the URDG were not widely accepted.<sup>123</sup> At the end of 2005 the URDG still had not gained wide acceptance and were not frequently used in practice. The exact reason for this limited acceptance is not clear.<sup>124</sup> However, one reason appears to be the fear that the URDG might conflict with the standard guarantee texts that banks employ or the particular provisions that banks and beneficiaries wish to include or exclude. It has been said that this fear is unfounded, since the URDG themselves do not contain

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<sup>120</sup> See the ‘Introduction’ to the URDG at 4–5. See also the discussion under para 2.5.1 in Chapter 2.

<sup>121</sup> See article 1.

<sup>122</sup> See Bertrams *op cit* note 63 at 24–25.

<sup>123</sup> See P S Turner ‘New Rules for Standby Letters of Credit: The International Standby Practices’ (1999) 14 *Banking and Finance Law Review* 457 in note 3 at 458.

<sup>124</sup> *Idem*. For a discussion of possible reasons see Ellinger *op cit* note 20 at 705.

guarantee texts or specific provisions.<sup>125</sup> Furthermore, any of these rules can be excluded or altered by contractual clauses in the guarantee as agreed by the parties. Another reason appears to be that certain banks in a number of countries raise the objection that article 20(a) of the URDG, which provides that the payment condition be a written demand for payment supported by a specific statement of default, is contrary to the ‘simple demand’ guarantees that do not require such a statement. In this regard it has also been said that such an objection was unfounded, because the difference between these two types of demand guarantees was small and that demand guarantees requiring a statement of default were increasingly becoming common practice. Furthermore, article 20(c) also allowed parties to exclude the requirement of a statement of default. A third reason for the limited acceptance of the URDG, according to banks, is that the market – the principals and in particular the beneficiaries – does not request the incorporation of these rules. Nonetheless, banks have indicated that they are prepared to comply with parties’ requests for the incorporation of the URDG.<sup>126</sup>

During recent years, however, it seems that the URDG have grown in popularity and are currently being used by banks worldwide.<sup>127</sup> They were adopted in 1999 by the International Federation of Consulting Engineers (‘FIDIC’) in their model guarantee forms and later in 2002 also by the World Bank.<sup>128</sup> A few national lawmakers have even taken the URDG as a model for independent guarantee statutes.<sup>129</sup> Seminars worldwide on the rules have also started to attract enthusiastic audiences.<sup>130</sup> It has taken more than a decade for the URDG to achieve its objective of being accepted internationally (it is not nearly as widely used as the UCP).

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<sup>125</sup> However, the ICC has prepared standard texts (see in general, the ICC’s Model Forms for Issuing Demand Guarantees *ICC Publication* No 503(E), Paris (1994)). In this regard, see also Ellinger *op cit* note 20 at 705.

<sup>126</sup> See Bertrams *op cit* note 63 at 29–30 and notes 25–27 also at 29–30.

<sup>127</sup> For example, Chinese Banks generally issue their demand guarantees subject to the URDG (see Laprès and Mo *op cit* note 49 at 21), and in 2004, the Central Bank of Iran (Bank Markazi Jomhuri Islami Iran) issued a circular indicating that Iranian banks could use the URDG (see DCI Interview: F Tazhibi, ‘The URDG and Demand Guarantees in Iran’ (January–March 2008) 14 *ICC’s DCInsight* 11 (hereinafter ‘Tazhibi’) at 11). See also, DCI Interview: A Hauptmann ‘Insights on the URDG Revision’ (October–December 2007) 13 *ICC’s DCInsight* 5 (hereinafter ‘Hauptmann’) at 5. However, in a fairly recent survey conducted by SITPRO (formerly the Simpler Trade Procedure Board; a non-departmental public body for which the United Kingdom’s Department of Trade and Industry has responsibility) it was shown that in the United Kingdom the URDG were not often used and the respondents (i.e., exporters and banks) to the survey indicated that they preferred to issue demand guarantees that were subject to UCP 500. Banks that took part in the survey indicated that the URDG did not reflect United Kingdom or international banking practice (see SITPRO’s *Report on the Use of Demand Guarantees in the UK* (July 2003) at 8 and 10 ([www.sitpro.org.uk](http://www.sitpro.org.uk) accessed 3 June 2008)).

<sup>128</sup> See DCI Interview: G Affaki ‘On Revising the Uniform Rules for Demand Guarantees (URDG)’ 13(1) (January–March 2007) *ICC’s DCInsight* 18 at 18.

<sup>129</sup> See, e.g., the Uniform Act Organizing Securities (adopted on 17 April 1997 and enforced by derogation on 1 January 1998) as adopted by the 16 African states belonging to OHADA (see note 8 above) provides that the demand for payment under a demand guarantee must not only state that the principal has defaulted, but also in what respect the principal has defaulted on his contractual obligations towards the beneficiary, a provision based on article 20 of the URDG (see P Taneja ‘The URDG Revision and Islamic Banking’ (April–June 2008) 14 *ICC’s DCInsight* 14 at 14).

<sup>130</sup> See ‘ICC to Revise its Uniform Rules for Demand Guarantees’ (24 May 2007) on the official website of the ICC (<http://www.iccwbo.org> accessed 24 May 2007).

### 3.2.5.3 *Planned Revision*

In 2007, the ICC Banking Commission gave the go-ahead to begin a revision of the URDG. The chair of the ICC Task Force on Guarantees (established in 2003), Georges Affaki, stated that the time was right for a revision of the rules. He said: '[T]he rules were drafted two decades ago and need to keep up with current practice.' He also indicated that many of the provisions of the URDG would benefit from a rejuvenation that would make them clearer and more precise. The revision has been entrusted to a Drafting Group consisting of guarantee experts from a wide range of countries. The revision process is being fast-tracked and it is expected that the revised rules will be ready within two years.<sup>131</sup> The Drafting Group submitted a first draft to the ICC Task Force on Guarantees in October 2007 and is awaiting their comments.<sup>132</sup>

I am not sure that this decision comes at the right time. As already mentioned above, the URDG have only recently been accepted internationally and it does not make sense to me to amend them at this point. I agree that some of the rules are in need of a re-drafting to make them clearer, but I think a better option would be rather to wait a few years, so that all the problematic and ambiguous provisions can be identified. This could obviously not have been done before, because they were not being widely used in the past. However, in the end, we will have to wait and see whether the end product will be an improvement on its predecessor and more acceptable internationally.

## 3.2.6 *International Standby Practices*

### 3.2.6.1 *Introduction*

As mentioned above, standby letters of credit were brought within the scope of the 1983, 1993 and 2007 versions of the UCP. Approximately half of all standby letters of credit were initially governed by the UCP, but could also later be governed by the URDG. However, it was felt that the UCP were a more suitable set of rules for standby letters of credit than the URDG; a point also stressed in the Introduction to the URDG. Therefore, in the past, standby letters of credit were capable of falling within two sets of rules, either the UCP or the URDG, and could be governed by whichever set of rules was incorporated into the credit.<sup>133</sup>

Later during 1996, the UNCITRAL published their 'Convention on Independent Guarantees and Stand-by Letters of Credit' applicable to international standby letters of credit and demand guarantees.<sup>134</sup> During negotiations regarding the Convention the United States expressed its concerns<sup>135</sup> about the application of the Convention to the American

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<sup>131</sup> See 'ICC to Revise its Uniform Rules for Demand Guarantees' (24 May 2007) on the official website of the ICC (<http://www.iccwbo.org> accessed 24 May 2007). For a brief discussion on which issues are being looked at during the drafting process, see the DCI interview with A Hauptmann, a member of the URDG Drafting Group (see Hauptmann *op cit* note 127 at 5–6); and also the DCI interview with F Tazhibi, another member of the Drafting Group, (see Tazhibi *op cit* note 127 at 11–12).

<sup>132</sup> See Tazhibi *op cit* note 127 at 12.

<sup>133</sup> See the *Guide to the URDG op cit* note 68 at 7.

<sup>134</sup> For a full discussion of the UNCITRAL Convention see para 3.3 below.

<sup>135</sup> These concerns were already mentioned in 1992 by the United States delegation to the UNCITRAL working session (see UNCITRAL Doc A/CN.9/WG.II/WP.77 (1992)).

standby letter of credit<sup>136</sup> and suggested that specific rules on standby letters of credit should be included. This proposal was, however, rejected. These developments, in addition to the fact that there was no effort under way to formulate standby rules and the decision of the ICC Banking Commission not to make any of the adjustments for standbys requested by the United States letter of credit community in the UCP 500 revisions, the United States Department of State requested that the letter of credit community take the lead in formulating standby rules in consultation with letter of credit communities throughout the world. This effort was coordinated by the International Financial Services Association ('IFSA') (formerly the United States Council on International Banking, Incorporated ('USCIB')),<sup>137</sup> the trade association representing the major banks in the United States in this field, and the Institute of International Banking Law and Practice, Incorporated. This eventually resulted in the Institute of International Banking Law and Practice Incorporated, based in the United States, with the support of the IFSA, embarking on a project to formulate self-regulatory rules for the American standby letter of credit market. This International Standby Practices Project ('ISP Project') was started in the United States and was aimed at providing self-regulatory rules that were more appropriate than the UCP to address standby letter of credit problems. The Institute of International Banking Law and Practice Incorporated interacted with hundreds of people over a five-year period, and looked at various comments received from individuals, banks, and national and international associations. The ICC's Commission on Banking Technique and Practice also formed an *ad hoc* Working Group chaired by Gary Collyer (which led to the ICC's endorsement of the ISP98) who also provided their assistance with the ISP Project. Various sponsorships and support were received from banks, a firm of attorneys and the National Law Centre for Inter-American Free Trade. The Secretariat of the UNCITRAL also played an active role in this project.<sup>138</sup>

Eventually, it resulted in the creation of a separate set of rules, namely the 'ISP98'.<sup>139</sup> The IFSA adopted the ISP98, after which they were also submitted to the ICC for approval. Although the ICC Banking Commission did not initiate this ISP Project, it did endorse the rules on 6 April 1998 and they came into operation on 1 January 1999. The ISP98 have gained considerable acceptance as they have been adopted by major banks in the United States.<sup>140</sup>

<sup>136</sup> For a discussion on what the position under the standby letter of credit law will be in the United States if the Convention is adopted by the United States, see P S Turner 'The United Nations Convention on International Standby Letters of Credit: How Would It Change Existing Letter of Credit Law in the United States?' (1997) 114 *Banking Law Journal* 790.

<sup>137</sup> See the website of IFSA (<http://www.ifsaonline.org> accessed 1 July 2007).

<sup>138</sup> See J E Byrne 'New Rules for Standby Letters of Credit: The International Standby Practices/ISP98' (May 1998) 100 *Business Credit* 32; J E Byrne 'ISP98: New Rules for Standby Letters of Credit' (September-October 1999) 19 *Treasury Management Association's (TMA's) Journal* 66 at 67-68; and Byrne *op cit* note 62 at 162-163.

<sup>139</sup> These rules have been published in booklet form as *ICC Publication No 590*, Paris (1998) under licence from the Institute of International Banking Law and Practice, Incorporated which holds the copyright. See also the 'Preface' to the ISP98. For a detailed commentary on these rules, see J E Byrne (edited by J G Barnes) *The Official Commentary on the International Standby Practices* (1998) (hereinafter '*The Official Commentary on the ISP98*'); Byrne *op cit* note 62; Turner *op cit* note 123; and J F Dolan 'Analysing Bank Drafted Standby Letter of Credit Rules, the International Standby Practice (ISP98)' (2000) 14 *Wayne Law Review* 1865. Furthermore, see also the ISP98 website (<http://www.ISP98.com> accessed 1 January 2008). Only those rules of the ISP98 relevant for purposes of this thesis are discussed in this thesis.

<sup>140</sup> See Ellinger *op cit* note 20 at 704; De Ly *op cit* note 11 at 836; and Xiang Gao *op cit* note 8 at 20.

To address inevitable questions, to provide for official interpretation of the rules of the ISP98 and to assure their proper evolution, the Institute of International Banking Law and Practice Incorporated created a Council on International Standby Practices, which is representative of the various constituencies that have contributed to the ISP98, and has charged it with the task of maintaining the integrity of the ISP98 in co-operation with the Institute, the ICC Banking Commission, the IFSA and various supporting organisations.<sup>141</sup> The council is charged with the duty of explaining the intentions of the drafters and providing official interpretations of the ISP98. It also has to monitor the ISP98 and assure its application, interpretation and revision in a manner consistent with sound standby practice.<sup>142</sup>

As there were no specific rules for standby letters of credit in the past, most standby credits were issued subject to various versions of the UCP. However, it was commonly accepted that the UCP were not appropriate for standby letters of credit, because the UCP were originally written for use only in commercial letters of credit and therefore did not contain any specific provisions relating to standby letters of credit. Furthermore, many of the provisions were either not applicable or inappropriate in a standby letter of credit context.<sup>143</sup> Contrary to this, the ISP98 were specifically and exclusively drafted for standby letters of credit and were intended to be complementary to the UNCITRAL Convention in order to address the above-mentioned concerns on the part of the United States. The ISP98 are intended as a replacement for the UCP for standby letters of credit. Seen from this perspective, the ISP98 are welcomed, because they were written explicitly for standby letters of credit and are generally better suited to govern standby letters of credit than are the UCP.<sup>144</sup> Notwithstanding the coming into effect of the ISP98, the UCP 500 were still available for incorporation into a standby letter of credit (and now the UCP 600 are too).<sup>145</sup> It was expected that with the publication of the ISP98, standby letters of credit would no longer be made subject to the UCP 500 or other further versions of the UCP. It was stated that, if the ISP98 turned out to be successful, which they already appeared to be, one might even consider excluding standby letters of credit from future revisions of the UCP all together. If that were done, the UCP could then solely apply to commercial letters of credit and the ISP98 to standby letters of credit. However, if by some chance the ISP98 turned out to be unsuccessful, parties might then still have the option of issuing standby letters of credit subject to the UCP. It was hoped that some novel provision in ISP98 might have influenced the revision of the UCP 500 in this regard,<sup>146</sup> but unfortunately, it has not and

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<sup>141</sup> See the 'Preface' to the ISP98.

<sup>142</sup> See Byrne *op cit* note 62 at 180.

<sup>143</sup> For instance, articles 23–37 of the UCP, relating to transport and insurance documents, would normally not be applicable to a standby letter of credit, while the rules relating to instalment obligations (article 41), 'stale' shipping documents (article 43), and *force majeure* (article 17) would typically be not only inappropriate, but potentially harmful to the beneficiary in a standby context (see Turner *op cit* note 123 at 459–460). See also J E Byrne 'New Rules for Standby Letters of Credit: The International Standby Practices/ISP98' (May 1998) 100 *Business Credit* 32; J E Byrne 'ISP98: New Rules for Standby Letters of Credit' (September-October 1999) 19 *Treasury Management Association's (TMA's) Journal* 66 at 66–67; and J F Dolan 'Analysing Bank Drafted Standby Letter of Credit Rules, the International Standby Practice (ISP98)' (2000) 14 *Wayne Law Review* 1865 at 1874.

<sup>144</sup> See Bertrams *op cit* note 63 at 31 and also the 'Preface' to the ISP98.

<sup>145</sup> For a discussion of the significant differences between the rules of ISP98 and the rules of the UCP, see Turner *op cit* note 123.

<sup>146</sup> See De Ly *op cit* note 11 in note 25 at 837.



the UCP 600, just like UCP 500, were also made available for incorporation into a standby letter of credit.<sup>147</sup>

As discussed above, standby letters of credit may also still be issued subject to the URDG that govern the demand guarantees. Although standby letters of credit and demand guarantees are different in form, they are functionally equivalent. In fact, courts have applied standby letter of credit law to the bank demand guarantee<sup>148</sup> and scholars are in general agreement that the same law should apply to them.<sup>149</sup> However, it has been stressed that the application of the UCP to standby letters of credit is preferred to the application of the URDG to standby letters of credit.

It follows that at present the UCP 600, ISP98 and the URDG are all available for incorporation into a standby letter of credit. However, it would appear that widespread use of ISP98 continues in sophisticated financial standbys and independent undertakings.<sup>150</sup>

### 3.2.6.2 *Scope and Application*

The ISP98 reflect generally accepted practice, custom and usage of standby letters of credit that can either be accepted or modified. To the extent that the rules may be unclear, incomplete or become outdated, they should be interpreted and supplemented by reference to standard standby practice, because they do not perfectly and completely state all practices for all times.<sup>151</sup> The ISP98 are intended to apply to domestic and international standby letters of credit and not to commercial letters of credit. The ISP98 provide separate rules for standby letters of credit in the same sense that the UCP do for commercial letters of credit and the URDG do for demand guarantees.<sup>152</sup>

Rule 1.01 outlines the scope and application of the ISP98, and indicates the types of undertaking for which the rules are intended. Rule 1.01 provides:

- a. These Rules are intended to be applied to standby letters of credit (including performance, financial, and direct pay standby letters of credit).
- b. A standby letter of credit or other similar undertaking, however named or described, whether for domestic or international use, may be made subject to these Rules by express reference to them.
- c. An undertaking subject to these Rules may expressly modify or exclude their application.

<sup>147</sup> For a view on this, see DCW Interview: V Maulella 'Should Reference to Standbys Remain in UCP?' (September 2004) 8 *Documentary Credit World* at 23–26.

<sup>148</sup> See J F Dolan 'Analysing Bank Drafted Standby Letter of Credit Rules, the International Standby Practice (ISP98)' (2000) 14 *Wayne Law Review* 1865, in particular the case law cited in note 40, at 1873.

<sup>149</sup> See Dolan *op cit* note 148 in particular the authorities cited in note 41 at 1873.

<sup>150</sup> See J E Byrne 'Overview of Letter of Credit Law and Practice in 2005' as printed in J E Byrne and C S Byrnes (eds) *2006 Annual Survey of Letter of Credit Law and Practice* (2006) (hereinafter '2006 Annual Survey') at 9. However, in survey conducted by SITPRO in 2003 it was shown that in the United Kingdom standby letters of credit were more often issued subject to the UCP 500 than to the ISP98 (see SITPRO's *Report on the Use of Demand Guarantees in the UK* (July 2003) at 8 and 10 (www.sitpro.org.uk accessed 3 June 2008)).

<sup>151</sup> See *The Official Commentary on the ISP98 op cit* note 139 Official Comment 3 to rule 2.01 at 63; and the 'Preface' to the ISP98; and see also J E Byrne 'The International Standby Practices (ISP98): New Rules for Standby Letters of Credit' (Fall 1999) 32 *Uniform Commercial Code Law Journal* 149 at 163.

<sup>152</sup> See the 'Preface' to the ISP98.

- d. An undertaking subject to these Rules is hereinafter referred to as a “standby”.

Although the intended use of the ISP98 is for international and domestic standby letters of credit, it is not limited to standby letters of credit. Theoretically, any international or domestic undertaking,<sup>153</sup> however far removed from a standby letter of credit, can be issued subject to ISP98. The use of ISP98 for dependent undertakings (such as suretyship guarantees) and *quasi*-independent undertakings (such as commercial paper or negotiable instruments) is not intended or suitable and will lead to confusion. However, it may be used for independent undertakings, such as demand guarantees, although the URDG, have been specifically drafted for this type of undertaking.<sup>154</sup> By their terms, the ISP98 rules apply to a letter of credit or independent undertaking that incorporates them by express reference, such as ‘this letter of credit is subject to ISP98’ or ‘subject to ISP98’.<sup>155</sup> Therefore, like the UCP and the URDG, the ISP98 also apply to any independent undertaking, such as demand guarantee, issued subject to it.<sup>156</sup> So therefore parties themselves are allowed to choose the applicable set of rules. In other words, a party may choose to use the ISP98 for certain types of standbys, the UCP for others and the URDG for still others.<sup>157</sup>

The ISP98 use the term ‘standby’ in two distinct senses. Subrules (a) and (b) of rule 1.01, refer to a ‘standby letter of credit’. No definition of standby letter of credit is provided in the ISP98. It has been said that this approach avoids the impractical and often impossible task of identifying and distinguishing standby letters of credit from commercial letters of credit. Therefore, it was decided not to provide a technical definition, and to leave it to the market to decide which undertakings should be governed by the ISP98. Subrule (d) indicates that an undertaking is a ‘standby’ for purposes of ISP98 if it is issued subject to it.<sup>158</sup> Rule 1.11(b) (Interpretation of these Rules) recognises that the terms ‘standby letter of credit’ and ‘standby’ have different meanings in the rules. A ‘standby letter of credit’ is the type of letter of credit that is understood to be a letter of credit. A ‘standby’ is any undertaking subject to the ISP98. If the issuer of a standby credit incorporates ISP98, the credit is a ‘standby’ credit for purposes of the rules. Hence, a demand guarantee issued subject to ISP98 would be a ‘standby’ for purposes of these rules.<sup>159</sup>

Unlike the UCP that apply only to documentary credits, including standby letters of credit, which are specifically issued by banks, the ISP98 will also apply to standbys that are issued by other institutions or persons.<sup>160</sup>

The ISP98 were designed to be compatible with the UNCITRAL Convention and also with local law, whether statutory or judicial, and to embody standby letter of credit practice

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<sup>153</sup> See rule 1.01(b).

<sup>154</sup> See *The Official Commentary on the ISP98 op cit* note 139 Official Comment 2 to rule 1.01 at 1–2.

<sup>155</sup> See Turner *op cit* note 123 at 458; and *The Official Commentary on the ISP98 op cit* note 139 Official Comment 10 to rule 1.01 at 4–5.

<sup>156</sup> See rule 101(b) of the ISP98.

<sup>157</sup> See Xiang Gao *op cit* note 8 at 20–21; and see also the ‘Preface’ to the ISP98.

<sup>158</sup> See rule 1.01(d).

<sup>159</sup> See *The Official Commentary on the ISP98 op cit* note 139 Official Comment 3 to rule 1.01 at 2.

<sup>160</sup> See Turner *op cit* note 123 at 462.

under that law. If the rules of the ISP98 conflict with the mandatory law on an issue, the applicable law will prevail.<sup>161</sup>

### 3.2.6.2.1 Exclusions from the Scope of the ISP98

Rule 1.05 of ISP98 provides that questions of capacity (e.g., who may issue a standby credit), formal requirements (e.g., whether the issuer's undertaking must be contained in a written document) and the issue of fraud<sup>162</sup> are left to the applicable jurisdictional law. In other words, these questions are therefore beyond the scope of the ISP98. In addition to these issues, many other issues regarding standby credits, for example, choice of law, legal remedies and recovery of damages, are also excluded from the scope of the ISP98 and are left to the applicable jurisdictional law.<sup>163</sup>

## 3.2.7 Uniform Rules for Contract Bonds

While the URDG were being drafted, a few representatives – especially those of Scandinavian countries and Japan – voiced their concern about the desirability of simple first demand guarantees requiring no evidence of the principal debtor's default and the associated risk of abuse by the beneficiary. The insurance industry and the construction industry shared this concern. It was felt that there was some need for a security device in terms of which the guarantor's liability was accessory to that of the principal debtor, based upon established fraud. The ICC Commission on Insurance, in co-operation with representatives of the construction industry, was requested to draft rules in this regard. In April 1993 the Uniform Rules for Contract Bonds ('URCB') was adopted and they came into operation on 1 January 1994.<sup>164</sup>

The URCB only apply to bonds (guarantees) to which they are stated as applying. The URCB deal with suretyship guarantees (bonds),<sup>165</sup> to be precise, guarantees that are secondary both in intent and in form, and are thus triggered only by established default, as opposed to the presentation of documents. The main provisions are articles 3(b) and (d), which stipulate that the guarantor's liability under the bond is accessory and arises upon default, and that all defences of the principal debtor against the beneficiary under the underlying contract are also available to the guarantor. In the event of a dispute, article 7(j) provides that default is deemed to be established upon a certificate issued by the guarantor, or, if the bond so provides, upon a certificate of default being issued by a third party, which could, for instance, be an independent engineer or a pre-arbitral referee of the ICC, or upon final judgment or arbitral award. Contrary to the URDG, the URCB allow the guarantor of the bond to elect to make good the principal's default by performing the obligations under the underlying contract instead of paying the demand (i.e., the bond amount).<sup>166</sup> Owing to

<sup>161</sup> See 'Preface' to the ISP98 and rule 1.02(a).

<sup>162</sup> For more on this, see para 4.3.1 in Chapter 4.

<sup>163</sup> See Turner *op cit* note 123 at 462–463.

<sup>164</sup> ICC Publication No 524, Paris (1993) (hereinafter the 'URCB'). See also Bertrams *op cit* note 63 at 34.

<sup>165</sup> A suretyship guarantee (bond) is the traditional guarantee (a true guarantee): a payment (alternatively payment or performance) obligation triggered only by actual default on the part of the principal (see R Goode 'Abstract Payment Undertakings and the Rules of the International Chamber of Commerce' (1995) 39 *Saint Louis University Law Journal* 725 at 726). See also paras 2.5.1 and 2.5.1.1 in Chapter 2.

<sup>166</sup> See the *Guide to the URDG op cit* note 68 at 7; and Bertrams *op cit* note 63 at 34.

the different nature of this type of security, the URCEB are not a source of law for the demand guarantee or the standby letter of credit. Therefore, a further discussion of the URCEB is beyond the scope of this thesis.

### **3.2.8 International Standard Banking Practice for the Examination of Documents Under Documentary Credits**

#### ***3.2.8.1 The Original International Standard Banking Practice for the Examination of Documents Under Documentary Credits***

Another ICC publication relating to documentary credits is the ‘International Standard Banking Practice for the Examination of Documents Under Documentary Credits’ (‘ISBP’), which was drafted by a Task Force of the Banking Commission and approved on 30 October 2002.<sup>167</sup> The detailed provisions of ISBP aimed to stipulate the requirements of the documents normally called for in documentary credit transactions. It was originally created to help reduce the large percentage of documents refused for discrepancies on first presentation.<sup>168</sup> It was aimed at all parties involved in a documentary credit transaction. Furthermore, it also aimed to fill in many voids and uncertainties left unanswered by the UCP 500.<sup>169</sup> The ISBP provided an insightful checklist of items that document checkers could refer to in determining how the UCP 500 applied in daily practice.<sup>170</sup>

Since the publication of the UCP 500 in 1993, it has been said that various articles (in the UCP 500) were open to ambiguity and the high level of rejections of documentary presentations had done little to comfort exporters concerned about the likelihood of prompt payment when this age-old method (i.e., letters of credit) was used. One of the main problems voiced was that banks did not have a common standard covering the checking of the various documents that could be presented under a letter of credit. Article 13(a) of the UCP 500 provided that ‘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 reflected in’ the UCP 500. The lack of such a published international practice has resulted in a situation where various banks have different rules on acceptability, or otherwise, of documents.<sup>171</sup>

The ICC then attempted to address this problem by publishing the ISBP. Contrary to the UCP 500 and the eUCP version 1.0, the ISBP was not designed to be incorporated into a documentary credit. Instead, it was created in an attempt to define the international banking practice regarding the examination of documents tendered under documentary credits. In view of that, the ISBP could not be regarded as comprising standard terms governing the contractual relationships created in documentary credit transactions. The ISBP’s effect was bound to depend on its being accepted as a declaration – or an

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<sup>167</sup> ICC Publication No 645, Paris (2003) (hereinafter the ‘ISBP’).

<sup>168</sup> Anecdotal evidence suggests that this objective has been partially achieved (see the ‘foreword’ of the International Standard Banking Practice for the Examination of Documents Under Documentary Credits, 2007 Revision for UCP 600, ICC Publication No 681 (E), Paris (2007) at 3).

<sup>169</sup> See Ellinger *op cit* note 20 at 707–708.

<sup>170</sup> See the ‘Foreword’ of the International Standard Banking Practice for the Examination of Documents Under Documentary Credits, 2007 Revision for UCP 600, ICC Publication No 681 (E), Paris (2007) at 3.

<sup>171</sup> See J Walden ‘Letters of Credit – International Standard Banking Practice (ISBP)’ (September 2003) *Credit Management* 23.

authoritative statement – of the international practice developed by banks and referred to in article 13(a) of the UCP 500.<sup>172</sup>

It cannot be stated with confidence whether the courts have, in fact, accepted that the ISBP has declared, or stated the nature of international standard banking practice. The drafting of the ISBP was not based on an extensive study of the existing practice. Its purpose was, rather, to explain how practices set out in the UCP 500 were to be applied by documentary practitioners. In fact, the drafters of the ISBP even recognised that the law in certain countries might compel a practice different from that stated in the ISBP.<sup>173</sup> Moreover, the ISBP even recognised that it was impossible to deal with all the documents that might be called for in documentary credits. However, it did attempt to cover terms commonly seen on a daily basis and the documents most often presented under documentary credits.<sup>174</sup>

The ISBP recognised that it did not provide a complete guide to the banking practice concerned and also accepted the existence of local variants of international banking practice. Up to a certain point, these are dictated by the prevailing local laws with which the ISBP might have been inconsistent. Therefore, if a certain practice described by the ISBP was in conflict with the local laws, the latter would have prevailed.<sup>175</sup>

It has been said that a weakness in the ISBP was the express reference to determinations of the Banking Commission. Although the influence of these decisions was acknowledged, it should have been remembered that banking practice changes itself to, and develops in accordance with, the changes seen in international business. It is a common fact that banking practice is not static and therefore determinations of the Banking Commission will serve only as a guideline as long as the point of practice remains the same.<sup>176</sup>

This also applies to the ISBP generally. If the ISBP were not amended regularly, in future courts may be inclined to wonder if the ISBP's specific statements are current. (Fortunately, this is happening, as is clearly seen from its current 2007 revision.<sup>177</sup>) Therefore, it is to be expected that expert evidence, which has always played such a major role in commercial credit cases, will continue to be crucial in future cases. Since banking practice is generally an issue of fact, it has to be determined by appropriate evidence on the current precepts. Furthermore, courts may be convinced that particular practices, outlined or defined in the ISBP, do not apply in the local practice relevant in a case before them.<sup>178</sup>

As a result, the ISBP could not be viewed as an ultimate statement of banking practice universally applicable to documentary credits. The publication of the ISBP has understandably attracted conflicting opinions on the effectiveness of the publication. Some commentators have proclaimed that it was a solution to all the problems experienced with the presentation of purportedly discrepant documents, while others have stated that this publication could only intensify and enhance the confusion surrounding the UCP 500 and

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<sup>172</sup> See Ellinger *op cit* note 20 at 708.

<sup>173</sup> See the 'Introduction' to the ISBP para 2 at 8.

<sup>174</sup> See the 'Introduction' to the ISBP para 3 at 8. See also Ellinger *op cit* note 20 at 708.

<sup>175</sup> See Ellinger *op cit* note 20 at 708.

<sup>176</sup> See Ellinger *op cit* note 20 at 708–709.

<sup>177</sup> See para 3.2.8.2 below.

<sup>178</sup> See Ellinger *op cit* note 20 at 709.

the ICC's subsequent policy statements, position papers and decision papers.<sup>179</sup> However, it did appear that the majority of countries and banks appeared to have been encompassing the ISBP.<sup>180</sup> A concern was even expressed that the ISBP might possibly also have turned out to be yet another unsuccessful effort on the part of the ICC.<sup>181</sup> Fortunately, it does not seem to have been a failure. The ISBP has apparently evolved into an essential companion to the UCP 500 for determining compliance of documents presented with the terms of letters of credit.<sup>182</sup>

### **3.2.8.2 *The Revised International Standard Banking Practice for the Examination of Documents Under Documentary Credits***

As the UCP 500 were replaced with the UCP 600, it also became necessary to update the ISBP to bring it in line with the new UCP rules.<sup>183</sup> The same Drafting Group that created the final version of UCP 600 was tasked with the development of the new update, after the UCP 600 had been approved in October 2006. The Drafting Group entertained comments from various countries of the ICC Banking Commission during the drafting process. During the ICC Banking Commission's April 2007 meeting held in Singapore, the International Standard Banking Practice for the Examination of Documents Under Documentary Credits, 2007 Revision for UCP 600 ('ISBP (2007 revision)')<sup>184</sup> was adopted by a vote of 71 to 0.<sup>185</sup>

The ISBP (2007 revision) is viewed merely as being an updated version of the original ISBP published in 2002, rather than a revision thereof.<sup>186</sup> However, although much of the ISBP (2007 revision) remains unchanged from the first version, certain alterations (some technical or merely cosmetic) had to be made to bring the wording in line with UCP 600.

<sup>179</sup> For example, some of the commentators stated that the ISBP's application had no clear relationship with the UCP 500 (see the 'Introduction' of the International Standard Banking Practice for the Examination of Documents Under Documentary Credits, 2007 Revision for UCP 600, *ICC Publication No 681 (E)*, Paris (2007) at 11).

<sup>180</sup> See Walden *op cit* note 171; and see also DCI Interview: D Smith *op cit* note 43 at 5–7.

<sup>181</sup> See Ellinger *op cit* note 20 at 704 and 709.

<sup>182</sup> See the 'Introduction' of the International Standard Banking Practice for the Examination of Documents Under Documentary Credits, 2007 Revision for UCP 600, *ICC Publication No 681 (E)*, Paris (2007) at 11; and see also DCI Interview: D Smith *op cit* note 43 at 5–7).

<sup>183</sup> For a speculation on what effect UCP 600 will have on the ISBP, see J E Byrne 'Overview of Letter of Credit Law and Practice in 2005' in *2006 Annual Survey* *op cit* note 150 at 9.

<sup>184</sup> *ICC Publication No 681 (E)*, Paris (2007) (hereinafter 'the ISBP (2007 revision)'). See also the 'Foreword' to the ISBP (2007) Revision at 3. For a discussion of the ISBP (2007 revision), see H Erdemol 'A Summary of the Updated ISBP' (July-September 2007) 13 *ICC's DCInsight* 3; and see also DCI Interview: D Smith *op cit* note 43 (a member of the Drafting Group) at 5–7). As already mentioned in para 3.2.2.1, there are still letters of credit in operation that are subject to UCP 500, and some banks are also still issuing letters of credit subject to UCP 500, despite the coming into operation of the UCP 600. It is also possible that some countries will rather choose to continue to use the original version of ISBP (with which they are familiar) than the updated 2007 version (see Dobáš *op cit* note 44 at 3; and see also DCI Interview: D Smith *op cit* note 43 at 7). Therefore, this thesis will refer to/deal with the UCP 500, UCP 600, ISBP, and ISBP (2007 revision) respectively.

<sup>185</sup> For a full discussion of the approval of the ISBP (2007 revision), see Note 'ISBP 681 Approved Unanimously' (July-September 2007) 13 *ICC's DCInsight* 2. It is interesting to note that South Africa was neither present at the Meeting, nor was it one of the countries that had voted on the acceptance of the text.

<sup>186</sup> See the 'Introduction' to the ISBP (2007 revision) in *ICC Publication No 681 (E)*, Paris (2007) at 11.

Furthermore, certain paragraphs also had to be removed from the original version, where they had been incorporated into UCP 600.<sup>187</sup>

In the introduction to the ISBP (2007 revision) it is mentioned that the international standard banking practices that are documented in this publication are consistent with the UCP 600 and the Opinions and Decisions of the ICC Banking Commission. It also clearly stated that the ISBP (2007 revision) does not amend UCP 600. It is merely explained how the practices articulated in the UCP 600 are applied by documentary practitioners. Therefore, it is suggested that the ISBP (2007 revision) and the UCP 600 should be read in their entirety and not in isolation. The ISBP (2007 revision), just like its predecessor, also recognises that the law in some countries may compel results different from those set out in this publication.<sup>188</sup>

It should be remembered that the term ‘standard banking practice’ as incorporated in the UCP 600 encompasses more than can be found in the ISBP and ISBP (2007 revision).<sup>189</sup> This is also made clear by the introduction to the ISBP (2007 revision). In the introduction it was stated that no single publication can anticipate all the terms or the documents that may be used in connection with documentary credits or their interpretation under UCP 600, and the standard practice they reflect. However, the Task Force that had prepared the original version of the ISBP, endeavoured to cover terms commonly seen on a daily basis and the documents most often presented under documentary credits.<sup>190</sup>

As already stated, the ISBP was originally created to help reduce the large percentage of documents refused for discrepancies on first presentation. Anecdotal evidence suggested that this objective had partially been achieved.<sup>191</sup> Participants in ICC seminars and workshops have also indicated that rejection rates have dropped due to the application of the practices that were detailed in ISBP.<sup>192</sup> The ISBP apparently evolved into an essential companion to the UCP 500 for determining compliance of documents generally presented with the terms of letters of credit. It is also hoped that the ISBP (2007 revision), and subsequent revisions thereof, would also be such a companion to the UCP 600 while they (the UCP 600) are in operation.<sup>193</sup> However, only time will tell to what extent a universal application of the ISBP (2007 revision) will be realised.

It follows that the ISBP and the ISBP (2007 revision) are both sources of law of the commercial letter of credit and, to the extent to which they may be applicable, the standby letter of credit (and also by implication the demand guarantee).<sup>194</sup>

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<sup>187</sup> See ‘Foreword’ and the ‘Introduction’ to the ISBP (2007 revision) in *ICC Publication* No 681 (E), Paris (2007) at 3 and 11.

<sup>188</sup> See the ‘Introduction’ to the ISBP (2007 revision) in *ICC Publication* No 681 (E), Paris (2007) at 12.

<sup>189</sup> See Note ‘ISBP 681 Approved Unanimously’ (July–September 2007) 13 *ICC’s DCInsight* 2.

<sup>190</sup> See the ‘Introduction’ to the ISBP (2007 revision) in *ICC Publication* No 681 (E), Paris (2007) at 12.

<sup>191</sup> See the ‘Foreword’ to the ISBP (2007 revision) in *ICC Publication* No 681 (E), Paris (2007) at 3.

<sup>192</sup> See the ‘Introduction’ to the ISBP (2007 revision) in *ICC Publication* No 681 (E), Paris (2007) at 11. See also DCI Interview: D Smith *op cit* note 43 at 5).

<sup>193</sup> See the ‘Introduction’ to the ISBP (2007 revision) in *ICC Publication* No 681 (E), Paris (2007) at 11.

<sup>194</sup> However, based on the content of the ISBP and the ISBP (2007 revision), a further detailed discussion of them is not required for purposes of this thesis.

### 3.3 THE UNCITRAL CONVENTION ON INDEPENDENT GUARANTEES AND STAND-BY LETTERS OF CREDIT

#### 3.3.1 Introduction

From 1988 to 1995 the UNCITRAL<sup>195</sup> worked on a Uniform Law on International Guaranty. This eventually resulted in the drafting of the UNCITRAL Convention.<sup>196</sup> The UNCITRAL adopted this Convention and opened it for signature by the General Assembly by its resolution 50/48 of 11 December 1995.<sup>197</sup> States were given a two-year period to sign the Convention, whereafter they had to accede to it. The Convention could only come into effect after it had been ratified by five states. Furthermore, in terms of article 28 of the Convention, it could also only enter into force on the first day of the month following the expiration of one year from the deposit of the fifth instrument of ratification. As a result of this, the Convention only came into effect on 1 January 2000.<sup>198</sup>

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<sup>195</sup> In 1966, the United Nations created the UNCITRAL because it desired to play a more active role in reducing and removing legal obstacles to the flow of international trade. UNCITRAL's aim is to further the progressive harmonisation and unification of the law of international trade and its mandate is to be the main legal body in the field of international trade law within the United Nations system. UNCITRAL was initially composed of 29 states, but was expanded in 1973 to 36 states by a General Assembly resolution. Membership is structured so that a specified number of seats are allocated to each of the various geographic regions. Therefore, UNCITRAL is an intergovernmental body of the General Assembly that prepares international commercial law instruments designed to assist the international community in modernising and harmonising laws dealing with international trade. Various legal instruments have since been prepared by UNCITRAL. See the Explanatory Note by the UNCITRAL Secretariat on the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit, UN Doc A/CN9/431 (4 July 1996) which accompanies the text on the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit (1996) (hereinafter the 'UNCITRAL Explanatory Note') note 2 at 13; and cf M E Trager 'Towards a Predictable Law on International Receivables Financing: The UNCITRAL Convention' (1999) 31 *Journal of International Law and Politics* (University of New York) 611 at 614–615.

<sup>196</sup> See the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit (1996). For a discussion of the background to this UNCITRAL convention and a discussion of a previous draft of this Convention see E E Bergsten 'A New Regime for International Independent Guarantees and Stand-by Letters of Credit: The UNCITRAL Draft Convention on Guaranty Letters' (1993) 27 *International Lawyer* 859. For a further legislative history of the UNCITRAL Convention, see J E Byrne 'The International Standby Practices (ISP98): New Rules for Standby Letters of Credit' (Fall 1999) 32 *Uniform Commercial Code Law Journal* 149 in particular the authorities cited in note 2 at 150–151; The Draft Convention on Independent Guarantees and Stand-by Letters of Credit, *Report of the United Nations Commission on International Trade Law on the Work of its Twenty-Eighth Session, 2–26 May 1995*, General Assembly, Official Records, 50th Session, Supplement No 17 (A/50/17), as reprinted in J F Dolan *The Law of Letters of Credit: Commercial and Standby Credits* Revised Edition (loose-leaf edition) (1996) (hereinafter 'Dolan: The Law of Letters of Credit') at SAPP F-1; and N Horn *German Banking Law and Practice in International Perspective* (1999) in Chapter 11 'The UN Convention on independent guarantees and the *Lex Mercatoria*', in particular the authorities cited in note 2 at 189. Only those articles of the UNCITRAL Convention important for purposes of this thesis will be discussed here.

<sup>197</sup> See the UNCITRAL Explanatory Note *op cit* note 195 in note 1 at 13. For a full discussion of the UNCITRAL Convention see L Gorton 'Draft UNCITRAL Convention on Independent Guarantees' (February 1996) *Lloyd's Maritime and Commercial Law Quarterly* 42; Gorton *op cit* note 7; J F Dolan 'The UN Convention on International Independent Undertakings: Do States with Mature Letter-of-Credit Regimes Need It?' (1998) 13 *Banking and Finance Law Review* 1; De Ly *op cit* note 11; and Horn *op cit* note 196 at 189.

<sup>198</sup> As of 1 July 2006, the Convention was ratified (acceded to) by Ecuador, El Salvador, Kuwait, Panama, Belarus, Tunisia, Gabon and most recently (on 16 September 2005) by Liberia. Although the United States had already signed the Convention on 11 December 1997, they have not yet acceded to it. In this regard, see [http://www.uncitral.org/uncitral/en/uncitral\\_texts/payments/1995Convention\\_guarantees\\_status.html](http://www.uncitral.org/uncitral/en/uncitral_texts/payments/1995Convention_guarantees_status.html) (accessed 1 July 2008). In order for the US to ratify the Convention, it will require the advice and consent of



In view of the URDG, it may at first sight appear to be strange that the UNCITRAL has invested such time and effort in producing its own Convention dealing with demand guarantees and standby letters of credit. The reason for this is historical. Soon after the UNCITRAL first began to look at demand guarantees, the ICC embarked on its project to formulate a set of demand rules, the URDG, intended to be more accommodating of prevailing practice than the URDG. Thereupon, UNCITRAL agreed to stop further work and to abide by the ICC project. Unfortunately, this proceeded slower than had been anticipated and when, after the lapse of a number of years, it showed no signs of reaching finality, the UNCITRAL justifiably decided to proceed with its own proposals for a convention or uniform law. By the time the ICC got back on track with the URDG, the UNCITRAL project was considered too far advanced to be abandoned. Furthermore, being a work designed to lead either to a convention or to a uniform law capable of adoption in national legislation, it was able to deal with matters that could not properly be the subject of contractually incorporated rules, particularly the effect of fraud and the granting of interim injunctive relief.<sup>199</sup>

### 3.3.2 Application and Force of the UNCITRAL Convention

The UNCITRAL Convention applies to an international undertaking such as a demand guarantee or a standby letter of credit, (1) where the place of business of the guarantor/issuer at which the undertaking is issued is in a contracting state<sup>200</sup> or (2) the rules of private law lead to the application of the law of a contracting state,<sup>201</sup> unless the undertaking excludes its application. The Convention can also apply to commercial letters of credit if the parties expressly state that their credit is subject to it.<sup>202</sup>

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

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the US Senate. After many years of inaction, there are now signs that the US might possibly ratify the Convention soon. Recently a delegation from the Uniform Law Conference of Canada met with a delegation from Mexico and delegates invited by the National Conference of Commissioners on Uniform State Laws ('NCCUSL'), the organisation which oversaw the drafting of the article 5 of the American UCC, to discuss the implementation of the Convention in North America. NCCUSL, Mexico and Canada all expressed interest in adopting the Convention (see *2008 Annual Survey op cit* note 40 at 13). For a discussion on what the position under the letter of credit law will be in the United States if the Convention is adopted by the United States, see Turner *op cit* note 136. The Secretariat for UNCITRAL has explained the main objectives of the Convention in the UNCITRAL Explanatory Note *op cit* note 195. The UNCITRAL has announced that it will maintain on its website a record of court rulings applying the Convention (see <http://www.un.or.at/uncitral/clout/index.htm> accessed 1 July 2007).

<sup>199</sup> See R Goode 'Abstract Payment Undertakings in International Transactions' (1996) XXII *Brooklyn Journal of International Law* 1 at 19.

<sup>200</sup> See article 1(1)(a) of the UNCITRAL Convention. The Convention will apply to international undertakings (demand guarantees or standby letters of credit) issued by banks in Ecuador, El Salvador, Kuwait, Panama, Belarus, Tunisia, Gabon and also in Liberia (from 1 October 2006).

<sup>201</sup> See article 1(1)(b) of the UNCITRAL Convention. For instance, the Convention will apply to international undertakings (demand guarantees or standby letters of credit) if the courts in Ecuador, El Salvador, Kuwait, Panama, Belarus, Tunisia, Gabon and Liberia (from 1 October 2006) under conflict rules determine that the law of any of these countries is applicable.

<sup>202</sup> See article 1(2) of the UNCITRAL Convention.

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

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

For the purposes of this Convention, an undertaking is independent where the guarantor/issuer’s obligation to the beneficiary is not:

- (a) Dependent upon the existence or validity of any underlying transaction, or upon any other undertaking (including stand-by letters of credit or independent guarantees to which confirmations or counter-guarantees relate); or
- (b) Subject to any term or condition not appearing in the undertaking, or to any future, uncertain act or event except presentation of documents or another such act or event within a guarantor/issuer’s sphere of operations.

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

It was decided that the application of the UNCITRAL Convention should be limited to international undertakings (demand guarantees or standby letters of credit), in particular, since it was felt that the inclusion of domestic instruments would adversely affect the global acceptability of the Convention.<sup>203</sup> Article 4 defines what is meant by ‘international character of the undertaking’. According to article 4(1), an undertaking is international if the places of business (or residence) specified in the undertaking of any two of the following persons are in different states (countries): guarantor/issuer, beneficiary, principal/applicant, instructing party or confirmer.

Therefore, the UNCITRAL Convention extends only to independent undertakings that are international in origin.<sup>204</sup>

The Convention is shaped round both the UCP and the URDG, but it is distinctive in that both the UCP and the URDG are drafted by the ICC, a private organisation, as voluntary rules or self-regulation, whereas the Convention is drafted by the UNCITRAL, as a uniform law or official regulation for those countries who adopt it. Therefore, a state’s adoption of the Convention has the effect of making it law in that state, in contrast to the URDG and other ICC rules, which take their force from incorporation into the contract of

<sup>203</sup> See Bergsten *op cit* note 196 at 863; and see also De Ly *op cit* note 11 at 838.

<sup>204</sup> J F Dolan ‘The UN Convention on International Independent Undertakings: Do States with Mature Letter-of-Credit Regimes Need It?’ (1998) 13 *Banking and Finance Law Review* 1 at 9.

the parties.<sup>205</sup> The Convention, in addition to being essentially consistent with the solutions found in the rules of practice, supplements their operation by dealing with issues beyond the scope of such rules. It does so especially regarding the question of fraudulent or unfair demands for payment and judicial remedies available in such instances.<sup>206</sup> In other words, because the legal status of the Convention is distinctive from the ICC rules, the Convention includes provisions relating to the fraud rule.<sup>207</sup> In its treatment of contractual relations between the parties, the Convention follows the URDG rather closely in scope and effect, although its drafting is fairly different and the Convention does not contain any equivalent of article 20 of the URDG.<sup>208</sup>

Since the adoption of the UNCITRAL Convention no major trading nation<sup>209</sup> has acceded, although the ICC<sup>210</sup> and World Bank have indicated their approval. To date, South Africa has neither signed nor acceded to the UNCITRAL Convention. It also seems that South Africa has no immediate plans to do so.<sup>211</sup>

### 3.4 NATIONAL LAWS AND PUBLIC POLICY

#### 3.4.1 The Impact of Mandatory National Laws and Public Policy Requirements

Although most jurisdictions accord a high degree of autonomy to the parties of a demand guarantee in making their own bargain, demand guarantees, like other contracts, are subject to any mandatory rules imposed by the law applicable to the guarantee and are also subject to the mandatory law of the country before whose court the dispute is being heard (*lex fori*), even if those rules apply to contracts governed by foreign law. Whether the mandatory rules of the *lex fori* are overriding in their effect or can be displaced by the selection of a foreign law to govern the contract is a matter to be determined by the *lex fori*. Likewise, the terms agreed between the parties give way to rules of public policy denying or limiting the effect of demand guarantees when such rules are imposed by the applicable law or the *lex fori*. In the latter case, they are given overriding effect.<sup>212</sup>

When the overriding mandatory rules of a country provide that a guarantee is to remain in force for a particular period, or until return of the guarantee document, notwithstanding any provisions of the guarantee to the contrary, those rules will prevail over the guarantee where it is governed by the law of the country concerned. This is also the case where proceedings to enforce the guarantee are brought in that country; its overriding mandatory rules have effect although the guarantee is governed by foreign law.<sup>213</sup>

<sup>205</sup> See the *Guide to the URDG op cit* note 68 at 7.

<sup>206</sup> See the UNCITRAL Explanatory Note *op cit* note 195 in note 5 at 15.

<sup>207</sup> See Xiang Gao *op cit* note 8 at 21. For a full discussion of these provisions, see Chapter 4.

<sup>208</sup> See R Goode 'Abstract Payment Undertakings in International Transactions' (1996) XXII *Brooklyn Journal of International Law* 1 at 19.

<sup>209</sup> See note 198 above.

<sup>210</sup> The ICC endorsed the UNCITRAL Convention on 21 June 1999. In this regard, see *ICC Publication* No 500/2, Paris (2002) at 69.

<sup>211</sup> Information received from the South African Department of Foreign Affairs: Multi-Lateral Division based in Pretoria on 24 May 2006.

<sup>212</sup> See the *Guide to the URDG op cit* note 68 at 20–21.

<sup>213</sup> See the *Guide to the URDG op cit* note 68 at 20–21.

### 3.4.2 Special Legislation Governing Standby Letters of Credit and Demand Guarantees

Owing to the highly international character of demand guarantees, standby letters of credit and commercial letters of credit, only a few individual countries in the world have introduced special legislation governing these instruments.<sup>214</sup> For instance, neither South Africa<sup>215</sup> nor England has specific national legislation governing commercial letters of credit, standby letters of credit or demand guarantees.

Normally where a country has any legislation governing demand guarantees, commercial letters of credit or standby letters of credit, it often tends to consist of only a few provisions, often of a general nature.<sup>216</sup> However, one such an exception is article 5 of the American UCC. Article 5 of the UCC deals with letters of credit and it encompasses both the commercial letter of credit and the standby letter of credit. Therefore, disputes relating to an American standby letter of credit are decided under article 5 of the UCC.<sup>217</sup> The text of article 5 was revised in 1995<sup>218</sup> and all 50 states of the United States, the District of Columbia, Puerto Rico and the United States Virgin Islands adopted revised article 5 of the UCC in some version.<sup>219</sup> Therefore, article 5 of the UCC is an important source of law for commercial letters of credit and standby letters of credit in America. As the United States is one of the chosen jurisdictions of this thesis, article 5 of the UCC is discussed in more detail here. However, only those sections of article 5 of the UCC that are relevant for purposes of this thesis are discussed. What follows below is merely a brief introduction to article 5.

In addition to this, the United States Comptroller of the Currency, the main regulator of United States banks, regularly issues Interpretive Rulings<sup>220</sup> dealing with independent undertakings. These rulings extensively expand the authority of the United States banks to issue demand guarantees (independent undertakings) and create standards of good banking practice for them.

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<sup>214</sup> For a discussion of a few countries that have statutory provisions regarding documentary credits, see R A Schütze and G Fontane *Documentary Credit Law Throughout the World: Annotated Legislation from More than 35 Countries* (2001) ICC Publication No 633 at 43–140. For a discussion of a few countries that have statutory provisions regarding demand guarantees, see Bertrams *op cit* note 63 at 35–36 and also notes 41–42 at 35.

<sup>215</sup> In the absence of legislation, the legal relationships between the parties to a commercial letter of credit, demand guarantee and standby letter of credit are generally governed by the law of contract (see Van Niekerk and Schulze *op cit* note 2 at 273).

<sup>216</sup> See Xiang Gao *op cit* note 8 at 15.

<sup>217</sup> For a discussion of how article 5 deals with fraud in relation to letters of credit, see par 5.5 in Chapter 5.

<sup>218</sup> See Bertrams *op cit* note 63 at 34.

<sup>219</sup> On 27 March 2006, Wisconsin became the latest and last US state to enact Revised article 5 of the UCC. After the enactment of Revised article 5 of the UCC, Wisconsin published Revised article 5 on 10 April 2006 and it became effective on 1 July 2006 (see Electronic Newsletter *Letter of Credit Update* (LCU) (2006) Issue 6 issued by the Institute of International Banking Law and Practice).

<sup>220</sup> See the United States Comptroller of the Currency's Interpretive Ruling of 1 July 2008 at 12 CFR section 7.1016. See also Bertrams *op cit* note 63 at 6. See also para 3.4.2.1 below and note 222 below.

### 3.4.2.1 *United States Comptroller of the Currency Interpretive Ruling*

The development of the standby letter of credit or standby is a consequence of previous restrictions in United States banking legislation on American banks to issue bank guarantees. The United States' National Bank Act of 3 June 1864 (as amended) precluded American banks from giving guarantees as part of their banking business. As the banks in the United States were not in general permitted to issue guarantees, they adopted the term 'standby letter of credit' to avoid the language of guarantees.<sup>221</sup>

The power of the American banks to issue letters of credit and other independent undertakings (i.e., demand guarantees) to pay against documents without factual investigation into the underlying relationship was finally recognised in the revised Interpretive Ruling of the Comptroller of the Currency of 9 February 1996.<sup>222</sup> Although banks in the United States have been freed from the prohibition on giving guarantees, they still use standby letters of credit because of their familiarity with those instruments.<sup>223</sup>

### 3.4.2.2 *Article 5 of the American Uniform Commercial Code*

The UCC<sup>224</sup> is a compilation of model statutes drafted and recommended by the National Conference of Commissioners of Uniform State Law (the 'NCCUSL') and the American

<sup>221</sup> See Bertrams *op cit* note 63 at 5–6. See also para 1.1.1 in Chapter 1 and para 2.9.1 in Chapter 2.

<sup>222</sup> See the United States Comptroller of the Currency Interpretive Ruling at 12 CFR section 7.1016 (as revised on 1 July 2008). The initial regulatory pronouncements of the Office of the Comptroller of the Currency focused on the liability of national banks to issue standby letters of credit and related safety and soundness issues (see 12 CFR section 7.7016 (1976); and 42 Fed Reg 24206 (1977)). The later ruling, promulgated in 1996 (see 61 Fed Reg 4865 (9 February 1996)) spoke of 'independent undertakings to pay against documents', whereas the prior Interpretive Ruling (Letter) spoke of 'letters of credit'. This revision covered not only letters of credit, but all independent undertakings and provided guidelines for issuers of independent guarantees (see Comptroller of the Currency, Interpretive Ruling, 12 CFR section 7.1016 (1996)). Recently, on 1 July 2008, a revised Interpretive Ruling was made specifically recognising that the US banks may issue and commit to issue letters of credit and other independent undertakings within the scope of the applicable laws or rules of practice recognized by law (e.g., article 5 of the UCC, the UCP, ISP98, URDG or the UNCITRAL Convention). It stresses that under such letters of credit and other independent undertakings, the bank's obligation to honour depends upon the presentation of specified documents and not upon non-documentary conditions or resolution of questions of fact or law at issue between the applicant and the beneficiary. A national bank may also confirm or otherwise undertake to honour or purchase specified documents upon their presentation under another person's independent undertaking within the scope of such laws or rules. There are also specific minimum requirements that an American bank must comply with before it is allowed to issue independent guarantees (e.g., the independent character of the undertaking should be apparent from its terms; the undertaking should be limited in amount and duration; permit the bank to terminate the undertaking either on a periodic basis (consistent with the bank's ability to make any necessary credit assessments) or at will upon either notice or payment to the beneficiary; and strict provisions arranging the manner in which the bank should be reimbursed by the applicant). The aim of such minimum requirements is to prevent that a bank is exposed to an undue risk. See also J F Dolan 'The UN Convention on International Independent Undertakings: Do States with Mature Letter-of-Credit Regimes Need It?' (1998) 13 *Banking and Finance Law Review* 1 at 3, in particular notes 8 and 9; De Ly *op cit* note 11 at 833–834; and J E Byrne 'The International Standby Practices (ISP98): New Rules for Standby Letters of Credit' (Fall 1999) 32 *Uniform Commercial Code Law Journal* 149 in note 4 at 152. For a detailed discussion of the early developments, see Dolan: *The Law of Letters of Credit op cit* note 196 in para 12.03.

<sup>223</sup> See Bertrams *op cit* note 63 at 5.

<sup>224</sup> For a full historical discussion of the UCC, see Hugo: *The Law Relating to Documentary Credits op cit* note 1 at 129–130.

Law Institute (the ‘ALI’) for enactment by the legislatures of the states of the United States. The UCC consists of 11 different articles, each covering a different aspect of commercial law. Article 5 is a uniform statutory scheme governing letters of credit, and it encompasses both the commercial letter of credit and the standby letter of credit.<sup>225</sup>

When article 5 of the UCC was initially drafted in the 1950s (this was the 1962 version of article 5) (‘Prior UCC article 5’),<sup>226</sup> it was not a complete ‘code’ like some of the other articles. Instead, it was intended to set up an ‘independent theoretical framework for the further development of letters of credit’.<sup>227</sup> The drafters were of the view that no statute could effectively or wisely codify the law of letters of credit without hampering development of the device.<sup>228</sup> According to Official Comment 2 on Prior UCC article 5 section 5-102, article 5 was to be applied in accordance with ‘the canon of liberal interpretation’ of UCC section 1-102(1), so as to promote the underlying purposes and policies of the article.<sup>229</sup>

After nearly 40 years of hard use, article 5 of the UCC was revised in 1995 (‘Revised UCC article 5’)<sup>230</sup> to cure the ‘weaknesses, gaps and errors in the original statute which compromise its relevance’,<sup>231</sup> and to meet the challenges of the development of letters of credit. Before the appointment of the drafting committee of Revised UCC article 5, a special Task Force, consisting of eminent letter of credit specialists, was appointed to study the relevant case law, evolving technologies, and changes in customs and practices.<sup>232</sup> The Task Force identified a large number of issues, discussed them and made recommendations for the revision of article 5. The revision of article 5 was completed in October 1995. The revised article 5 is a substantial improvement over original article 5.<sup>233</sup> By 1 July 2006, Revised UCC article 5 had been adopted by almost all the American states, except Wisconsin.<sup>234</sup> Today, all 50 American states, the District of Columbia, Puerto Rico and the United States Virgin Islands have adopted revised article 5 of the UCC in some version.

<sup>225</sup> See Xiang Gao *op cit* note 8 at 21–22.

<sup>226</sup> Hereinafter ‘Prior UCC Article 5’. For a discussion of Prior UCC article 5, see B V McCullough *Banking Law* (Vol No 12: International Banking – Letters of Credit) (loose-leaf edition) (1981–) in para 230.06[a].

<sup>227</sup> See Official Comment on Prior UCC article 5 section 5-101.

<sup>228</sup> Anon ‘Letters of Credit: Injunction as a Remedy for Fraud in UCC Section 5-114’ (1979) 63 *Minnesota Law Review* 487 in note 27 at 493.

<sup>229</sup> See Xiang Gao *op cit* note 8 at 22. For a full historical discussion of Prior UCC article 5, see *Hugo: The Law Relating to Documentary Credits op cit* note 1 at 130–133.

<sup>230</sup> Hereinafter the ‘Revised UCC Article 5’. For a discussion of Revised UCC article 5, see B V McCullough *Banking Law* (Vol No 12: International Banking – Letters of Credit) (loose-leaf edition) (1981–) in para 230.06[b]. For a full historical discussion of Revised UCC article 5, see *Hugo: The Law Relating to Documentary Credits op cit* note 1 at 133–135.

<sup>231</sup> See the Report of the Task Force on the Study of UCC article 5 ‘An Examination of UCC Article 5 (Letters of Credit)’ (1990) 45 *The Business Lawyer* 1521 (hereinafter the ‘Task Force Report’) at 1532.

<sup>232</sup> See the ‘Prefatory Note’ to Revised UCC article 5.

<sup>233</sup> See the ‘Legislation Report’ by Senator Lack of Senate Judicial Committee of New York on 10 May 1999 (<http://www.nysba.org/legis/99report> accessed 1 July 2007).

<sup>234</sup> For details see [http://www.nccusl.org/nccusl/uniformact\\_factsheets/uniformactfs-ucca5.asp](http://www.nccusl.org/nccusl/uniformact_factsheets/uniformactfs-ucca5.asp) (accessed 1 July 2007). See also 2006 *Annual Survey op cit* note 150 at 12; and Xiang Gao *op cit* note 8 at 22.

Although there are some non-conforming amendments in some states, the statute is remarkably uniform.<sup>235</sup>

Regardless of the existence of article 5 of the UCC, the UCP also has great influence in the United States. Section 5-116(c) specifically provides as follows:

Except as otherwise provided in this subsection, the liability of an issuer, nominated person, or adviser is governed by any rules of custom or practice, such as the Uniform Customs and Practice for Documentary Credits, to which the letter of credit, confirmation, or other undertaking is expressly made subject.

Section 5-116(c) continues by expressly stating that in the event of a conflict between article 5 and the provisions of UCP, the UCP shall ‘govern except to the extent of any conflict with the nonvariable provisions specified in Section 5-103(c)’. There are three situations that can be distinguished: (1) where a provision of article 5 and the UCP do not conflict, both apply; (2) where a non-variable provision of article 5 conflicts with the UCP, the relevant provision of article 5 will apply; and (3) where any other provision of article 5 conflicts with the UCP, the UCP will apply.<sup>236</sup> In the whole of the universal letter of credit transactions, article 5 governs only a limited part. Revised UCC article 5 section 5-103 states that article 5 ‘applies to letters of credit and to certain rights and obligations arising out of transactions involving letters of credit’. A large share of all letter of credit transactions are international transactions and most of those are governed by the UCP. Therefore, for many, the UCP will be a more significant source of law than the UCC.<sup>237</sup>

The UCP (i.e., UCP 500, the version that was in force at the time) had a larger influence on the drafting of Revised UCC article 5 than Prior UCC article 5,<sup>238</sup> which was specifically demonstrated by the fact that

- the revision of the UCC article 5 was part of the global effect of internationalising the letter of credit law and practice; and
- a number of participants in the revision of the UCC article 5 also participated in the revision or drafting of the UCP (i.e., UCP 500), the URDG or the UNCITRAL Convention, and as strong proponents for harmonising the international law and

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<sup>235</sup> On 27 March 2006, Wisconsin became the latest and last American state to enact Revised article 5 of the UCC. After the enactment of Revised article 5 of the UCC, Wisconsin published Revised article 5 on 10 April 2006 and it became effective on 1 July 2006 (see Electronic Newsletter *Letter of Credit Update* (LCU) (2006) Issue 6 issued by the Institute of International Banking Law and Practice Inc; and *2008 Annual Survey op cit* note 40 at 14).

<sup>236</sup> See also *Hugo: The Law Relating to Documentary Credits op cit* note 1 at 135.

<sup>237</sup> See Xiang Gao *op cit* note 8 at 22. For the application of the UCC and the UCP in the United States, see, e.g., K A Barski ‘Letters of Credit: A Comparison of Article 5 of the Uniform Commercial Code and the Uniform Customs and Practice for Documentary Credits’ (1996) 41 *Loyola Law Review* 735; and M R Schroeder ‘The 1995 Revisions to UCC Article 5, Letters of Credit’ (1997) 29 *Uniform Commercial Code Law Journal* 331. For statutory provisions of how the UCP is applied in the United States, see Revised UCC article 5 section 5-116(c), and Official Comment 3 therein.

<sup>238</sup> White J ‘The Influence of International Practice on the Revision of Article 5 of the UCC’ (1995) *Northwestern Journal of International Law and Business* 189 at 211.

practice of letters of credit, they sought to exchange information and insights with colleagues throughout the world during the revision process.<sup>239</sup>

Therefore, Revised UCC article 5 is in many regards consistent with, and complementary to, the UCP. Where article 5 of the UCC is mainly concerned with issues of liabilities and responsibilities, the UCP provide a vehicle through which international banking lawyers can familiarise themselves with the mechanics of letter of credit practice. However, because article 5 of the UCC is drafted as a statute or real law, there is one major difference between article 5 of the UCC and the UCP (and other ICC rules); that is, that article 5 of the UCC, like the UNCITRAL Convention, contains provisions regarding the fraud rule, which the UCP do not. The fraud rule, which was provided in Prior UCC article 5 section 5-114(2), is now embodied in Revised UCC article 5 section 5-109.<sup>240</sup>

### 3.5 CASE LAW AND LEGAL WRITINGS

In certain jurisdictions, particularly those discussed in this thesis, court decisions have constituted an important part of the law of demand guarantees, standby letters of credit and documentary credits. In common law countries the law on demand guarantees has developed, especially in case law. Owing to the international nature of most commercial and standby letters of credit and demand guarantees, the decisions of courts from other jurisdictions, especially English courts, have played, and will continue to play, an important role in the judicial interpretation of these instruments issued by South African banks.<sup>241</sup> Legal writings are also regarded as supplementary to the law of demand guarantees, standby and commercial letters of credit.<sup>242</sup>

### 3.6 SUMMARY AND CONCLUSION

The first version of the UCP was published in 1933, and since then there have been a few revisions, that is, in 1951, 1962, 1974, 1983 ('UCP 400'), 1993 ('UCP 500') and the latest in 2006 ('UCP 600'). In essence, the UCP are a set of rules issued by the ICC governing all aspects of documentary credits, except for the relationship between the applicant of a documentary credit and the issuing bank. Initially, the UCP only applied to letters of credit, but from 1 January 1984 it also applies to standby letters of credit. However, the incorporation of standby letters of credit into the UCP did not result in specific rules for this form of letters of credit being included; in fact, the larger part of the UCP does not apply to standby letters of credit or is inappropriate, while other issues that are vital in a standby letter of credit context are not addressed at all in the UCP. In fact, the application of the UCP merely implied that the UCP's general letters of credit principles were expressly made applicable to standby letters of credit. Initially, banks in the United States and other countries that were influenced by the United States banking practices, issued standby letters of credit subject to the UCP. However, since the ISP98 came into operation

<sup>239</sup> See Xiang Gao *op cit* note 8 at 23; and J E Byrne 'Critical Issues in the International and Domestic Harmonisation of Letter of Credit Law and Practice' (1995) *Commercial Law Annual* 389 at 392.

<sup>240</sup> See Xiang Gao *op cit* note 8 at 23. Both these sections will be discussed in more detail in para 5.5 in Chapter 5.

<sup>241</sup> See Van Niekerk and Schulze *op cit* note 2 at 273.

<sup>242</sup> Therefore, court decisions and legal writings that are relevant for purposes of this thesis have been dealt with throughout this thesis.



on 1 January 1999, the majority of standby letters of credit is no longer issued subject to the UCP.

Today it appears that in relation to demand guarantees and standby letters of credit, four ICC instruments (uniform rules) for self-regulation are available: (1) the UCP (UCP 600, the version currently in force) for standby letters of credit (and by implication also for demand guarantees); (2) the ISP98 for standby letters of credit (and by implication also for demand guarantees); (3) the URCG for demand guarantees; and (4) the URDG for demand guarantees and also for standby letters of credit. None of these uniform rules has the force of law in any jurisdiction. The ICC is a private commercial organisation, not a law-making body, and its uniform rules have no independent force of their own and they take effect by incorporation into contracts. Each set of rules provides that parties to the relevant transaction may elect to incorporate the relevant set of rules into the relevant transaction in whole or in part. To the extent that such incorporation is not inconsistent with domestic legislation applicable to the demand guarantee, courts will normally uphold provisions of the UCP, URDG, URCG or the ISP98, where specifically incorporated into the guarantee.

In addition to the above-mentioned instruments of self-regulation, it is also possible that the UNCITRAL Convention may apply to demand guarantees and standby letters of credit. If the UNCITRAL Convention is adopted by a state, it will acquire the force of law in that contracting state.

In most jurisdictions, such as South Africa and England, there are no explicit statutory rules for documentary credits, demand guarantees and standby letters of credit, and therefore disputes must be primarily addressed under explicit contractual provisions, unwritten rules, domestic principles of contract and commercial law. Then again in other countries, such as the United States, there are statutory provisions for documentary credits, standby letters of credit and demand guarantees. The United States has statutory provisions – in the form of article 5 of the UCC – regulating commercial letters of credit and standby letters of credit. Owing to the importance of the United States to this thesis, article 5 of the UCC needed to be discussed in more detail in subsequent chapters.

Other important sources of the law of demand guarantees and standby letters of credit in certain jurisdictions – such as South Africa, England and the United States – are case law and legal writings.



## CHAPTER 4: INTERNATIONAL INITIATIVES TO PREVENT UNFAIR OR FRAUDULENT CALLS ON DEMAND GUARANTEES AND STANDBY LETTERS OF CREDIT

### 4.1 INTRODUCTION

The International Chamber of Commerce ('ICC')<sup>1</sup> and the United Nations Commission on International Trade Law ('UNCITRAL')<sup>2</sup> have both been active in seeking a solution to the problems caused by unfair calls on demand guarantees and standby letters of credit. Four instruments that are particularly relevant are (1) the ICC Uniform Rules for Contract Guarantees ('URCG');<sup>3</sup> (2) the ICC Uniform Rules for Demand Guarantees ('URDG');<sup>4</sup> (3) the International Standby Practices ('ISP98');<sup>5</sup> and (4) the United Nations Convention on Independent Guarantees and the Stand-by Letters of Credit (the 'UNCITRAL Convention').<sup>6</sup> The first three instruments are, in effect, standard-term contract rules available for incorporation into demand guarantees by the parties; and the adoption of the UNCITRAL Convention by a state has the effect of making it law in that state.<sup>7</sup>

In this chapter particular attention will be paid to the international attempts made by the ICC and UNCITRAL to prevent unfair or fraudulent calls on demand guarantees and standby letters of credit. The chapter also examines which of the ICC instruments and the UNCITRAL Convention departs the furthest from the principle of autonomy in the context of demand guarantees and standby letters of credit. Broadly speaking, the URCG and UNCITRAL Convention have both attempted to protect the principal against unfair calls in a manner that severely weakens the principle of autonomy, whereas the URDG have attempted to effect a compromise between the parties by effectively subjecting all calls on demand guarantees to documentary conditions.<sup>8</sup>

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<sup>1</sup> Hereinafter the 'ICC'. For a discussion of who the ICC is, see para 3.2.1 in Chapter 3.

<sup>2</sup> Hereinafter the 'UNCITRAL'.

<sup>3</sup> Hereinafter the 'URCG'. For a full discussion, see para 3.2.4 in Chapter 3.

<sup>4</sup> Hereinafter the 'URDG'. For a full discussion, see para 3.2.5 in Chapter 3.

<sup>5</sup> Hereinafter the 'ISP98'. For a full discussion, see para 3.2.6 in Chapter 3.

<sup>6</sup> Hereinafter 'the Convention' or 'the UNCITRAL Convention' interchangeably. For a full discussion, see para 3.3 in Chapter 3.

<sup>7</sup> See C Debattista 'Performance Bonds and Letters of Credit: A Cracked Mirror Image' (1997) *Journal of Business Law* 289 at 295.

<sup>8</sup> See Debattista *op cit* note 7 at 295.

## 4.2 EFFORTS MADE BY THE ICC TO TRY AND PREVENT UNFAIR AND FRAUDULENT CALLS

### 4.2.1 Uniform Customs and Practice for Documentary Credits

The Uniform Customs and Practice for Documentary Credits (2007 version) ('UCP 600')<sup>9</sup> contain no provisions that attempt to prevent unfair or fraudulent calls on commercial or standby letters of credit. Neither did their predecessor, Uniform Customs and Practice for Documentary Credits (1993 version) ('UCP 500').<sup>10</sup> The UCP do not deal with the problems that arise where documents presented under a credit are forged or otherwise fraudulent. Article 34 of the UCP 600 goes as far as stating that a 'bank assumes no liability or responsibility for the form, sufficiency, accuracy, genuineness, falsification or legal effect of any document'.<sup>11</sup> In fact, the UCP is completely silent on the issue of fraud and the fraud rule. The reason for this, as already mentioned in the previous chapter, is that the UCP were primarily devised to provide a contractual framework for dealings between issuers and beneficiaries, and issuers and correspondent banks. The UCP do not deal with the rights and duties of parties to the underlying contract, nor is it the function of the UCP to regulate issues that are the proper province of national law and national courts. The content and the interpretation of the ICC uniform rules are equally influenced by the fact that their function is to serve as rules of best banking practice, not rules of law; and the fraud rule issue is commonly considered as the province of the applicable national law and of the courts of the forum.<sup>12</sup> Therefore, national laws should deal with any injunctive relief on the grounds of fraud by the beneficiary. The drafters of the UCP 500 and UCP 600 respectively deliberately decided to leave out the fraud issue. Accordingly, the lack of a provision for fraud in the UCP clearly indicates that the intention of the drafters was that the issue of fraud should be determined by the applicable national law.<sup>13</sup> The difficulty with leaving these issues to national law is that, except in the United States, such cases come so rarely before the courts that there are very limited opportunities to develop a coherent body of rules.<sup>14</sup>

The view has been expressed that the decision of the drafters of the UCP 500 not to address the issue of fraud reflected either an unwillingness to tackle a difficult but necessary issue or an outdated view of the limited scope of the UCP as merely a

<sup>9</sup> See *ICC Publication* No 600, Paris (2006) (hereinafter the 'UCP 600'). See also the full discussion of UCP 600 in para 3.2.2 in Chapter 3.

<sup>10</sup> See *ICC Publication* No 500, Paris (1993) (hereinafter the 'UCP 500'). See also the full discussion of UCP 500 in para 3.2.2 in Chapter 3.

<sup>11</sup> The UCP 500 contained a similar provision (section 15).

<sup>12</sup> See R Goode 'Abstract Payment Undertakings and the Rules of the International Chamber of Commerce' (1995) 39 *Saint Louis University Law Journal* 725 at 727.

<sup>13</sup> For instance, in England, South Africa and Australia, the common law applies, but in the United States Revised article 5 section 5-109 of the Uniform Commercial Code (hereinafter the 'UCC') applies. Furthermore, see also J F Dolan 'Commentary on Legislative Developments in Letter of Credit Law: An Interim Report' (1992) 8 *Banking and Finance Law Review* 53 at 63; K A Barski 'Letters of Credit: A Comparison of Article 5 of the Uniform Commercial Code and the Uniform Customs and Practice for Documentary Credits' (1996) 41 *Loyola Law Review* 735 at 751; and Xiang Gao *The Fraud Rule in the Law of Letters of Credit: A Comparative Study* (2002) at 56.

<sup>14</sup> See R P Buckley 'The 1993 Revision of the Uniform Customs and Practice for Documentary Credits' (1995) 28 *George Washington Journal of International Law and Economics* 265 at 303.

codification of bankers' practices rather than a dispositive regime of rules.<sup>15</sup> It has been said that one of the main weaknesses of the UCP 500 was that it did not address the rights of an applicant of a documentary credit against a bank that proposes to pay on documents that are forged or otherwise fraudulent.<sup>16</sup>

Then again, several commentators have welcomed this inactive approach of the UCP as a remarkable success. It is their view that any attempt by the ICC to formulate a uniform fraud rule is unnecessary and bound to fail, since the fraud rule is rather sensitive to national laws and these rules vary among jurisdictions.<sup>17</sup> They contend that the current position of the UCP may generate an incentive for the different jurisdictions to fashion fraud rules that do not interfere with the marketability of credits issued by the jurisdiction's banks.<sup>18</sup>

Xiang Gao disagrees. He is of the view that although it is correct that the UCP are technically not law, but a collection of accepted commercial practices, the truth is that the UCP are currently incorporated into substantially all cross-border documentary credits (and also to a lesser extent into standby letters of credit), studied and observed by letter of credit bankers and users globally, and accordingly, treated as *quasi-law* of credit. Therefore, the UCP have basically become *de facto* law.<sup>19</sup> He also says that a good commercial law is one that serves commerce best. A law that serves commerce best maximises certainty and predictability for the commercial world. To have such an effect, a law should provide the best answer it can give to problems that can be predicted. Furthermore, it is debatable whether the UCP satisfy this standard without dealing with the fraud issue. Although the drafters of the UCP knew of this problem and that it caused problems in documentary credit transactions, they still chose not to address it, leaving users of commercial and standby letters of credit without any guidance on how to deal with the fraud they might encounter. Accordingly, this has left both the commercial and standby letter of credit community with a degree of uncertainty and unpredictability.<sup>20</sup>

What makes matters worse is the fact that national fraud rules are diverse and lacking in clarity.<sup>21</sup> In such a situation, when a fraud case goes to court and a decision is made, the decision will most likely not be criticised by the letter of credit experts for non-conformity with the practice of the letter of credit community and for being detrimental to the commercial utility of letters of credit. It is therefore ironic that in drafting the UCP, those same letter of credit specialists say that it is for the courts to make the relevant rules. According to Xiang Gao, this is neither logical nor fair to the courts.<sup>22</sup>

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<sup>15</sup> See Buckley *op cit* note 14 at 302.

<sup>16</sup> See Buckley *op cit* note 14 at 312–313.

<sup>17</sup> See J Ulph 'The UCP600: Documentary Credits in the Twenty-first Century' (2007) *Journal of Business Law* 355 at 371.

<sup>18</sup> See Dolan *op cit* note 13 at 63; Barski *op cit* note 13 at 751; and Xiang Gao *op cit* note 13 at 56.

<sup>19</sup> See Xiang Gao *op cit* note 13 at 56–57; and also J G Barnes 'Internationalisation of Revised UCC Article 5 (Letters of Credit)' (1995) 16 *Northwestern Journal of International Law and Business* 215 at 216.

<sup>20</sup> See Xiang Gao *op cit* note 13 at 57.

<sup>21</sup> See also Chapter 5.

<sup>22</sup> See Xiang Gao *op cit* note 13 at 57.

It is true that the letter of credit is a specialised commercial creature and that the law governing it is complex. Even letter of credit specialists are at times perplexed by its complicated structure and the relationships between the parties. Although judges should be legal experts, it is not practical to expect each judge to be an expert in the law of letter of credit or to make good law within the short period of time that a case is before a court. In reality, most trial judges have hardly had any experience with letter of credit matters.<sup>23</sup>

I agree with Xiang Gao's opinion that it is desirable for the drafters of the UCP, who are well-known letter of credit experts, to provide guidance for issues commonly raised during practice, such as the issue of fraud. I also concur with his view that even if a detailed rule is not practical, guidance is better than nothing.<sup>24</sup> Schmitthoff had already submitted in 1982 that it would have been desirable for the 1983 version of the UCP<sup>25</sup> to have dealt with the problem of fraud.<sup>26</sup> It is regretted that the 2007 version of the UCP has again remained silent on the issue of fraud.

#### 4.2.2 Uniform Rules for Contract Guarantees

The URCG<sup>27</sup> are aimed at encouraging more equitable practices in the area of contract guarantees (i.e., tender, performance, or repayment guarantees (demand guarantees)), particularly by limiting the problem of unfair calling of these guarantees. Therefore, unlike the UCP, the URCG have attempted to deal with the unfair calling of demand guarantees.<sup>28</sup> Of the instruments examined in this chapter the URCG went furthest in protecting the principal against unfair calls.<sup>29</sup> It was considered desirable that the URCG should not provide for first demand guarantees payable without any evidence of default. To prevent abuse by unscrupulous beneficiaries, the URCG therefore provide that 'evidence' of default by the principal is required to justify the honouring of a claim under a contract guarantee. It can be expected that in most cases the parties to such a guarantee will specify in it what form of evidence is required. Guarantors have been advised to require documentation prepared independently of the beneficiary and in a form capable of verification by the guarantor. For example, a claim under a performance guarantee could be required to be supported by a certificate from specific engineers indicating the defect in the construction or performance of a particular structure.<sup>30</sup>

Later the ICC created the URDG with the objective that they would replace the URCG. However, since the URDG came into effect in 1992, the ICC have not yet withdrawn the URCG and they are therefore still available for incorporation into demand guarantees should parties choose to do so. One of the main reason why the URCG are not in general

<sup>23</sup> *Idem*; and see also the Report of the Task Force on the study of the United States' Uniform Commercial Code Article 5 'An Examination of UCC Article 5 (Letters of Credit)' (1990) 45 *Business Lawyer* 1521 (hereinafter 'the Task Force Report') at 1611.

<sup>24</sup> See Xiang Gao *op cit* note 13 at 57.

<sup>25</sup> ICC Publication No 400, Paris (1983).

<sup>26</sup> See C M Schmitthoff 'Export Trade' (1982) *Journal of Business Law* 319 at 321.

<sup>27</sup> ICC Publication No 325, Paris (1978).

<sup>28</sup> See Xiang Gao *op cit* note 13 at 57.

<sup>29</sup> See Debattista *op cit* note 7 at 296.

<sup>30</sup> See P J Parsons 'Commercial Law Note: ICC (International Chamber of Commerce) Uniform Rules for Contract Guarantees' (April 1979) 53 *Australian Law Journal* 224 at 225.

use – and the reason why a new set of rules was required in 1992 – lies mainly in the two most important articles of the UR CG, namely articles 8 and 9.<sup>31</sup>

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

- 8(1) A claim under a guarantee shall be made in writing or by cable or telegram or telex to be received by the guarantor not later than on the expiry date specified in the guarantee or provided for by these Rules.
- (2) On receipt of a claim the guarantor shall notify the principal or the instructing party, as the case may be, without delay, of such claim and of any documentation received.
- (3) A claim shall not be honoured unless:
  - (a) it has been made and received as required by para. 1 of this Article; and
  - (b) it is supported by such documentation as is specified in the guarantee or in these Rules; and
  - (c) such documentation is presented within the period of time after the receipt of a claim specified in the guarantee, or, failing such a specification, as soon as practicable, or, in the case of documentation of the beneficiary himself, at the latest within six months from the receipt of a claim.

In any event, a claim shall not be honoured if the guarantee has ceased to be valid in accordance with its own terms or with these Rules.

In terms of paragraph (1) of article 8, the claim should be made in writing and received by the guarantor no later than the day of expiry. Once the guarantor receives a claim, he should notify the principal or the instructing party, as the case may be, not only of the claim itself, but also of any documentation received. However, problems may arise in relation to the requirement that documentation – preferably a court decision, arbitral award or approval of the principal – be presented by the beneficiary if he makes a claim. Since it may be difficult for the beneficiary to provide adequate documentation at the time of the claim or even before the expiry date of the guarantee, article 8(3)(c) provides that such documentation may be presented after receipt of the claim within the time limit specified in the guarantee, or failing such specification, as soon as is practical. If a court decision or an arbitral award is required, this can clearly take a long time. However, if the claim has been made, this apparently excludes the guarantee from expiring before the required documentation can be presented. In cases where the beneficiary must provide the necessary documentation himself, for instance, an expert affidavit, a fixed time limit of six months is stipulated.<sup>32</sup>

It has been indicated that the wording of article 8(3) is ambiguous in that it provides that in any event a claim shall not be honoured if the guarantee ‘has ceased to be valid in accordance with its own terms or with these Rules’. It has been suggested that this implies that a claim would not be honoured if the necessary documentation, for example, a court decision or an arbitral award, cannot be presented before the expiry date of the guarantee. Moreover, it appears that the UR CG intended to make a distinction between *the last day for a claim* and *the date on which the guarantee ceases to be valid* but failed to do so. In

<sup>31</sup> See Debattista *op cit* note 7 at 296.

<sup>32</sup> See Parsons *op cit* note 30 at 224. See also paras (a)–(c) of article 2 of the UR CG; and see also P Šarčević and P Volken (editors) *International Contracts and Payments* (1991) Contribution No 5: L A E Hjermer ‘Contract Guarantees’ at 75–76.

practice, if the claim is made in time, the guarantee does not cease to be valid because the case has not been settled before the expiry date.<sup>33</sup>

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

If a guarantee does not specify the documentation to be produced in support of a claim or merely specifies only a statement of claim by the beneficiary, the beneficiary must submit:

- (a) in the case of a tender guarantee, his declaration that the principal's tender has been accepted and that the principal has then either failed to sign the contract or has failed to submit a performance guarantee as provided for in the tender, and his declaration of agreement, addressed to the principal, to have any dispute on any claim by the principal for payment to him by the beneficiary of all or part of the amount paid under the guarantee settled by a judicial or arbitral tribunal as specified in the tender documents or, if not so specified or otherwise agreed upon, by arbitration in accordance with the Rules of the ICC Court of Arbitration or with the UNCITRAL Arbitration Rules, at the option of the principal;
- (b) in the case of a performance guarantee or of a repayment guarantee, either a court decision or an arbitral award justifying the claim, or the approval of the principal in writing to the claim and the amount to be paid.

Referring to party autonomy, the first part of article 9 leaves it to the parties to decide which type of documentation will be required. If the parties fail to include such a specification, the beneficiary is required to submit the documents stipulated in subparagraphs (a) and (b) of article 9. In a rather confusing way, article 9 also refers to 'on-demand guarantees' (those requiring 'only a statement of claim by the beneficiary'). This follows that, if the URCG apply to an on-demand guarantee, in order to be effective 'on-demand' the guarantee must clearly exclude article 9 or provide that the requirements for documentation under subparagraph (a) and (b) do not apply. It will not suffice to state that, although subject to the URCG, the guarantee is payable on first and simple demand. By including on-demand guarantees in this article, the drafters of the URCG deliberately attempted to discourage their use. In this regard, it has been said that they may have gone too far.<sup>34</sup>

The effect of article 8(3)(b) and article 9 was to make all demand guarantees conditional and, furthermore, to make the conditions to which calls were subject particularly onerous on the beneficiary. If payment under the demand guarantee was subject to justification under the underlying contract or the agreement of the principal, then the guarantee was not truly independent of the underlying contract: for payment to be justified, the veil of the guarantee had to be lifted and justification found in the underlying contract.<sup>35</sup>

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<sup>33</sup> See Šarčević and Volken *op cit* note 32 at 76.

<sup>34</sup> See Šarčević and Volken *op cit* note 32 at 76.

<sup>35</sup> See Debattista *op cit* note 7 at 295.



In relation to tender guarantees, no court decision or arbitral award is necessary in support of a claim. This is not surprising, since at that stage no contract would have been concluded between the principal and the beneficiary. Therefore, a bona fide statement by the beneficiary is adequate in which he acknowledges that the principal's tender was accepted, but thereafter the principal neglected to sign the contract or to provide the performance guarantee as indicated in the tender. In addition to such statement, the beneficiary must offer to have any dispute arising between himself and the principal in connection with the repayment of the amount paid under the tender guarantee settled by arbitration.<sup>36</sup>

Proceeding to performance and repayment guarantees, subparagraph (b) of article 9 stipulates that a claim must be supported by a court decision or an arbitral award justifying the claim, or the approval of the principal in writing to the claim and the sum to be paid. Even though this rule is less complicated than the one in subparagraph (a), it may nevertheless lead to complications. There is no suggestion as to whether the court decision should be final (i.e., no longer subject to appeal). Furthermore, even to obtain a decision in the first place may take considerable time. In the interim, the guarantee is of no use to the beneficiary, although he had probably thought that by using a demand guarantee he would quickly receive the money as compensation for the loss he had incurred due to the alleged breach of the underlying contract with the principal. The situation may even be worse for the beneficiary if disputes between him and the principal have to be settled by arbitration. This is so, because it is well known that even 'speedy' arbitration procedures last longer than one year; often two or more years. Such a solution is evidently unsatisfactory if the purpose of the guarantee was to make the money available to the beneficiary simply and speedily. However, it has been said that it has to be balanced against the risk that money had been paid and that in the end the claim could not be justified.<sup>37</sup>

The question has been raised whether article 9(b) was too severe, and it was even said that it was not clear what the URCG would achieve in this situation. If the beneficiary had to justify his claim by arbitration or litigation, it would cause a delay in him receiving payment in terms of the guarantee. He would also have to incur unnecessary expenses in justifying his claim. However, if the beneficiary met the requirements of article 9(b), he would be armed with documentation of its own force and effect requiring the honouring of the relevant guarantee.<sup>38</sup>

Goode states<sup>39</sup> that the URCG sought to deal with the problem of unfair calling of demand guarantees (performance guarantees or repayment guarantees) by requiring, as a condition of the beneficiary's right to payment, the production of a judgment or arbitral award or the principal's written approval of the claim and the amount. Although the object of this requirement was laudable, it did have the effect of limiting the acceptability of the URCG, for it resulted in the exclusion from their scope the simple on-demand guarantee that accounted for the great majority of documentary guarantees issued by banks. Furthermore, although the requirement to produce a judgment or arbitral award was theoretically a

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<sup>36</sup> See Šarčević and Volken *op cit* note 32 at 76–77.

<sup>37</sup> See Šarčević and Volken *op cit* note 32 at 76.

<sup>38</sup> See Parsons *op cit* note 30 at 226.

<sup>39</sup> See R Goode *Guide to the ICC Uniform Rules for Demand Guarantees* (1992) ICC Publication No 510 (hereinafter the '*Guide to the URDG*') at 6.

documentary requirement, practically it meant that beneficiaries had to prove default by the principal by way of litigation or arbitration, and this tended to defeat the objective of the demand guarantee in providing the beneficiary with a speedy monetary remedy. This requirement was unacceptable to importers (buyers) and because of their strong negotiating position, it resulted in the URCG seldom being incorporated. This requirement also did not gain general acceptance, because it proved to be too far removed from current banking and commercial practice.<sup>40</sup>

The URCG, since their incorporation in 1978, have been used by parties with varying success. The major criticism voiced has been in relation to article 9 and the fact that the URCG cannot be easily applied to on-demand guarantees. On-demand guarantees are probably the most common form of guarantees requested by certain groups of beneficiaries. However, by requiring documentation to support the claim, article 9 directly contradicts the very character of on-demand guarantees, which are intended to assure the availability of the money on demand. It appears that the most severe criticism comes from the continental banking sectors. Conversely, other business sectors have confirmed that the URCG have been accepted in guarantees even with developing countries where government agencies often require submission to local rules and the use of on-demand guarantees. Even with their limited success, it appears that discontent still exists.<sup>41</sup>

Although the purpose of the above-mentioned provisions of the URCG is to prevent fraud, they are strictly speaking not the same as the fraud exception discussed in Chapter 5. The fraud rule is concerned with the circumstances under which payment under a demand guarantee may be disrupted, whereas article 9 provides the conditions that trigger the payment of demand guarantees.<sup>42</sup>

### 4.2.3 Uniform Rules for Demand Guarantees

Owing to the problems experienced as a result of using the URCG, the drafters of the URDG<sup>43</sup> decided to adopt an approach similar to the one taken in the UCP on the issue of fraud in relation to demand guarantees, by simply remaining silent and leaving it to the courts of the various jurisdictions to deal with.<sup>44</sup>

During the formulation of the URDG, conflicting views reflecting the competing interests of the parties involved were expressed. At one end of the spectrum banks required a simple instrument whereby the issuer (guarantor) would have to pay without having to make difficult investigations or take complicated decisions based on doubtful evidence. At another end, beneficiaries were claiming that they needed a device that would enable them to get paid against a simple demand or document without risking obscure objections. Then

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<sup>40</sup> See R Bertrams *Bank Guarantees in International Trade: The Law and Practice of Independent (First Demand) Guarantees and Standby Letters of Credit in Civil Law and Common Law Jurisdictions* 3 ed (2004) at 28.

<sup>41</sup> See Šarčević and Volken *op cit* note 32 at 77–78.

<sup>42</sup> See Xiang Gao *op cit* note 13 at 58.

<sup>43</sup> ICC Publication No 458, Paris (April 1992).

<sup>44</sup> See Xiang Gao *op cit* note 13 at 58.

at a totally different end, principals were interested in having some kind of safety mechanism in the system so as to prevent unfair callings.<sup>45</sup>

Therefore, the URDG attempted to effect a compromise between the interests of the beneficiaries to obtain speedy payment and that of the principals to avoid the risk of unfair calling by the beneficiaries.<sup>46</sup> From all this, in order to prevent the beneficiary's outright unfair calling, a few fundamental articles, in particular articles 9, 17, 20 and 21, were incorporated into the URDG. However, as will be seen below, article 20 implicitly goes a small way towards restricting the beneficiary's right of payment.<sup>47</sup>

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

- (a) Any demand for payment under the Guarantee shall be in writing and shall (in addition to such other documents as may be specified in the Guarantee) be supported by a written statement (whether in the demand itself or in a separate document or documents accompanying the demand and referred to in it) stating:
  - (i) that the Principal is in breach of his obligation(s) under the underlying contract(s) or, in the case of a tender guarantee, the tender conditions; and
  - (ii) the respect in which the Principal is in breach . . .
- (c) Paragraph (a) of this Article applies except to the extent that it is expressly excluded by the terms of the Guarantee . . .'

Furthermore, article 9 provides that

[a]ll documents specified and presented under a Guarantee, including the demand, shall be examined by the Guarantor with reasonable care to ascertain whether or not they appear on their face to conform with the terms of the Guarantee. Where such documents do not appear so to conform or appear on their face to be inconsistent with one another, they shall be refused.

The compromise between the interests of the beneficiary and the principal is based on three features. First, although the URDG clearly state in article 2(b) that the demand guarantee is independent, they still seek to justify the call in terms of the underlying contract. Second, that connection is weakened in the sense that the requirement in the URDG of a court decision or arbitral award, or the agreement of the principal, is substituted by a detailed allegation – itself contained in a document and at times accompanied by other specific documents – by the beneficiary of a breach by the principal. Third, the allegation and any accompanying documents are subjected to the scrutiny of strict compliance by the paying bank (guarantor), very much as if a call on a demand guarantee were the same as a demand for payment under a letter of credit.<sup>48</sup> Therefore, the URDG have retained the principle of autonomy, but have counter-balanced it by the doctrine of strict compliance.<sup>49</sup>

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<sup>45</sup> *Idem.*

<sup>46</sup> See Debattista *op cit* note 7 at 296.

<sup>47</sup> See Xiang Gao *op cit* note 13 at 58–59.

<sup>48</sup> For a discussion of the application of the principle of strict compliance to demand guarantees and letters of credit, see para 2.5.2.5 in Chapter 2.

<sup>49</sup> See Debattista *op cit* note 7 at 297.

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. The expression ‘the respect in which’ as apposed to ‘respects’ is intended to require only a general statement of the nature of the breach, for example, that the principal has been guilty of delay or defective workmanship, not a detailed specification.<sup>50</sup> Therefore, article 20 requires the beneficiary, when demanding payment, to stipulate in writing both that there is some kind of breach of the underlying contract and what type of breach is involved, therefore giving the other party or parties some form of protection by providing a ground for a claim of fraud.<sup>51</sup> This places a certain obligation on the beneficiary to show his hand. The aim of this provision is to give some measure of protection against the unfair calling of the guarantee without interfering with the documentary character of the guarantee and the need of the beneficiary to have speedy recourse in the event of a perceived breach. It has been said that although the protection is rather limited in that it is the beneficiary himself, rather than an independent third party, who has to issue the statement of breach, the effect of this should not be too lightly dismissed. Beneficiaries who may be quite ready to make an unjustified demand, if this is all that is required, may be more reluctant to commit themselves to a false statement of breach, particularly where the general nature of this has to be identified. This article does not affect the documentary character of the demand guarantee. The guarantor is not required to investigate the truth of the beneficiary’s statement that the principal is in breach.<sup>52</sup> In its nature, article 20 of the URDG is similar to that of article 9 of the URCG, in that it provides a kind of safety device against the triggering of the payment of the demand guarantee to prevent fraud. Article 20 (just as article 9 of the URCG does) differs from the fraud exception discussed in Chapter 5. The fraud exception discussed in Chapter 5, unlike article 20 of the URDG, specifically addresses what to do when fraud is found to have been committed.<sup>53</sup>

Although the word ‘fraud’ is not used in the URDG, the prevention of fraud is central to the URDG. The demand for payment must stipulate the reasons for calling on the guarantee in order to meet the URDG’s clear preference for reasoned demand guarantees. It is hoped that the requirement of providing reasons will prevent fraud. However, commentators have doubted the effectiveness of reasoned demand guarantees. It has been said that in order to prevent fraud, it is imperative that the principal is informed about the demand for payment. Article 17 of the URDG obliges banks to do so, but does not require a bank to hold payment until the principal has been made aware of the demand and its reasons. Therefore, banks may use their discretion to decide whether or not to wait with payment, or to proceed with payment as long as the principal is informed. In the event of fraud, the principal will then have the opportunity of requesting provisional and/or conservatory measures from a competent court. However, as no requirement for

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<sup>50</sup> See the *Guide to the URDG op cit* note 39 at 93–94; and Goode *op cit* note 12 in note 47.

<sup>51</sup> There is a similar provision relating to counter-guarantees. In terms of article 20(b) of the URDG any demand under the counter-guarantee is to be supported by a written statement that the guarantor has received a demand for payment under the guarantee in accordance with its terms and with article 20 itself. In other words, the guarantor, when claiming under the counter-guarantee, is, in effect, required to certify that the beneficiary’s demand was accompanied by the statement of breach required by article 20. See Goode *op cit* note 12 at 739–740.

<sup>52</sup> See Goode *op cit* note 12 at 739–740.

<sup>53</sup> See Xiang Gao *op cit* note 13 at 59.

withholding payment is imposed, the fraud prevention provided in article 17 is without much force if a bank decides to pay before the principal has been able to obtain interim relief. The URDG's purpose, however incomplete, is to achieve a more even distribution of risk between principal parties and beneficiary parties than was previously the case. It would appear that from the side of principals, the rules have been welcomed. However, it seems that beneficiaries will not frequently accept the URDG, since these rules worsen their position.<sup>54</sup>

Furthermore, the ICC also incorporated article 21 into the URDG in an attempt to prevent unfair calls. Article 21 provides that '[t]he Guarantor shall without delay transmit the Beneficiary's demand and any related documents to the Principal or, where applicable, to the Instructing Party for transmission to the Principal'.

The purpose of article 21 is to give the principal the chance to challenge an unfair call before payment is made under it. Article 21 obliges the bank to send the beneficiary's demand and any prescribed documents to the principal, but it does not require a bank to hold payment until the principal has received the demand and the documents. Therefore, as with article 17 (discussed above), guarantors (banks) may again use their discretion to decide whether or not to wait with payment, or to proceed with payment as long as the demand and relevant documents have been transmitted to the principal. Article 21 also does not contain a provision that payment will be withheld until the principal has obtained interim court relief. Therefore, the fraud prevention provided in article 21 is also without much force if a bank decides to pay before the principal has been able to obtain interim relief.

It was intended that the URDG would replace the URDG, which had proved a failure in consequence of the complex payment procedure that they introduced. In contrast, the URDG provide a simple mechanism, based on the guarantor's unconditional duty to meet a demand or call on the facility as set out in article 20. However, in spite of this, the URDG initially did not gain wide acceptance and were, until recently,<sup>55</sup> rarely incorporated in first-demand guarantees or in performance guarantees.<sup>56</sup> One of the reasons for this limited acceptance was apparently due to certain banks' objection that article 20(a) of the URDG, which provides that the payment condition is a written demand for payment supported by a specific statement of default, is contrary to the on-demand guarantees (i.e., guarantees payable on simple or first demand) which do not require such a statement. Banks objected to this payment condition, despite the fact that article 20(c) allows parties to exclude the requirement of a statement of default.

The Drafting Group appointed to revise and redraft the existing URDG<sup>57</sup> indicated that special attention was given to article 20 during the drafting process. At this point, it seems that the crux of the contentious article 20 will be kept, but that some of the

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<sup>54</sup> See F De Ly 'The UN Convention on Independent Guarantees and Stand-by Letters of Credit' (Fall 1999) 33 *International Lawyer* 831 at 835–836.

<sup>55</sup> See para 3.2.5.2 in Chapter 3 for a discussion of the recent increased usage of the URDG.

<sup>56</sup> See E P Ellinger 'British Business Law: Banking Law' (November 2005) *Journal of Business Law* 704 at 704–705.

<sup>57</sup> See para 3.2.5.3 in Chapter 3.

misunderstanding surrounding it will be clarified in the revised version.<sup>58</sup> Whether better success will be achieved by taking a new approach in a revised article remains to be seen.

### **4.3 EFFORT MADE BY THE INSTITUTE OF INTERNATIONAL BANKING LAW AND PRACTICE AND INTERNATIONAL FINANCIAL SERVICES ASSOCIATION TO TRY AND PREVENT UNFAIR AND FRAUDULENT CALLS**

#### **4.3.1 International Standby Practices**

The ISP98<sup>59</sup> do not attempt to regulate fraud or abusive drawing. The ISP98 take a similar approach to the UCP and in rule 1.05(c) expressly leave the issue of fraudulent or abusive demands for payment (drawings) or ‘defenses to honour based on fraud, abuse or similar matters’ to be determined by the applicable jurisdictional law, for instance Revised UCC article 5 section 5-109<sup>60</sup> (in the case of the United States) or articles 19 and 20 of the UNCITRAL Convention (where a state/country has adopted the Convention).<sup>61</sup>

Byrne states<sup>62</sup> that although the ISP98 provides no systematic rule with regard to fraud or abuse, it does contain rules based on principles that would provide important guidance in determining whether and what remedy might be appropriate in the event of fraud. These principles include the documentary character of the undertaking; the absence of any duty to investigate the transaction beyond the face of the complying document; the right to reimbursement for payments made in good faith, notwithstanding the fraudulent or forged character of the documents; the independence of transferee beneficiaries from the consequences of any fraudulent or abusive conduct on the part of the first beneficiary; and the right of nominated persons who have acted within the scope of their nomination to obtain reimbursement, notwithstanding the presence of fraudulent or abusive drawings. The ISP98 are also based on the assumption that an exception to the obligation to pay and the independence principle arise only in the case of material fraud or clear, manifest abuse.

The omission of the fraud rule from the ISP98 has, nonetheless, been commended by some commentators as an act that is ‘especially welcome’, because fraud has been addressed in different ways in different countries. It has been said that if provisions on fraud were to be included in the ISP98, it would probably have created needless complications in countries such as the United States, where the issue of fraud has been dealt with by the courts and

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<sup>58</sup> See the interviews with members of the Drafting Group: Interview: A Hauptmann ‘Insights on the URDG Revision’ (October–December 2007) 13 *ICC’s DCInsight* 5 at 6; and Interview: F Tazhibi ‘The URDG and Demand Guarantees in Iran’ (January–March 2008) 14 *ICC’s DCInsight* 11 at 12.

<sup>59</sup> *ICC Publication* No 590, Paris (October 1998). As already mentioned in para 3.2.6.1 in Chapter 3, the Institute of International Banking Law and Practice created the ISP98 with the support of the United States Council on International Banking, Incorporated (‘USCIB’, now the International Financial Services Association or ‘IFSA’). The IFSA adopted the ISP98, after which it was also submitted to the ICC for approval. During 1998, the ICC Banking Commission endorsed the rules, where after they came into operation on 1 January 1999.

<sup>60</sup> For a full discussion of Revised article 5 section 5-109 of the United States UCC see para 3.4.2 in Chapter 3 and paras 5.5.2.2, 5.5.3, and 5.5.4.4 in Chapter 5.

<sup>61</sup> See Xiang Gao *op cit* note 13 at 59. For a full discussion of articles 19 and 20 of the UNCITRAL Convention see para 4.4 below.

<sup>62</sup> See J E Byrne (edited by J G Barnes) *The Official Commentary on the International Standby Practices* (1998) (hereinafter ‘*The Official Commentary on the ISP98*’) Official Comment 5(c) to rule 1.05(c) at 20–21.

legislators in detail over a long period of time.<sup>63</sup> Dolan states that it was a wise decision of the drafters of the ISP98 to leave questions regarding the troublesome subject of fraud in the transaction to local law.<sup>64</sup> He further indicates that a major failing of the UNCITRAL Convention lies in the Convention's attempt to codify rules dealing with that subject. According to him, fraud rules are best left to local law, because questions of fraud are inextricably entwined with matters of local procedural law and because the notion of fraud itself varies from jurisdiction to jurisdiction. It is the market that will sort out the problem. Jurisdictions that do not fashion efficient rules, procedurally and otherwise, for resolving questions of fraud, will find credits issued by their banks unacceptable in world markets. Dolan is of the view that the ISP98, like the UCP, correctly eschew the question of fraud.<sup>65</sup> However, Xiang Gao rightly disagrees with this, and states that avoiding problems might not be the best way to resolve them.<sup>66</sup>

Although there is no rule dealing with fraudulent or abusive demands, there are a few rules that are relevant for purposes of this thesis and should therefore be considered in more detail. For instance, rule 4.08 of the ISP98 provides that even if a standby letter of credit does not specify any required document, it will still be deemed to require a documentary demand for payment.<sup>67</sup> Therefore, when a standby letter of credit does not call for a demand explicitly, the standby is not properly called on by the beneficiary, unless it includes a demand in the package of documents presented to the issuer. The effect of this rule is that if the issuer leaves out the requirement for the demand, the beneficiary who does not present one will have made a non-complying presentation and may lose the entire benefit of the standby.

The ISP98 have created certain rules setting out certain data that have to be included in a demand made under a standby letter of credit. For instance, rule 3.03 stipulates that the demand identifies the standby. Such a requirement is important to a bank issuer that may have thousands of outstanding standby credits in favour of the beneficiary that is making the demand. This rule renders any draft or demand that does not identify the credit non-compliant, even when the credit does not contain that requirement, although the issuer may, on its own motion, waive this requirement under rule 3.11(a)(ii).<sup>68</sup> Furthermore, rule 14.6 of the ISP98,<sup>69</sup> under the heading 'Demand for Payment', provides as follows:

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<sup>63</sup> See P S Turner 'New Rules for Standby Letters of Credit: The International Standby Practices' (1999) 14 *Banking and Finance Law Review* 457 at 463. See also Chapter 5 for a full discussion of fraud.

<sup>64</sup> See J F Dolan 'Analysing Bank Drafted Standby Letter of Credit Rules, the International Standby Practice (ISP98)' (2000) 14 *Wayne Law Review* 1865 in note 129 at 1901. For criticism of the UNCITRAL's attempt to legislate fraud, see J F Dolan 'The UN Convention on International Independent Undertakings: Do States with Mature Letter-of-Credit Regimes Need It?' (1998) 13 *Banking and Finance Law Review* 1; and see also the discussion of this subject in para 4.4 below.

<sup>65</sup> See J F Dolan 'Analysing Bank Drafted Standby Letter of Credit Rules, the International Standby Practice (ISP98)' (2000) 14 *Wayne Law Review* 1865 in note 129 at 1901.

<sup>66</sup> See Xiang Gao *op cit* note 13 at 60.

<sup>67</sup> For criticism of rule 4.08, see J F Dolan 'Analysing Bank Drafted Standby Letter of Credit Rules, the International Standby Practice (ISP98)' (2000) 14 *Wayne Law Review* 1865 at 1893.

<sup>68</sup> See J F Dolan 'Analysing Bank Drafted Standby Letter of Credit Rules, the International Standby Practice (ISP98)' (2000) 14 *Wayne Law Review* 1865 at 1892–1893.

<sup>69</sup> For a discussion of rule 4.16 see *The Official Commentary on the ISP98 op cit* note 62 Official Comments 1–7 to rule 4.16 at 183–185.

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

In addition to this, the ISP98 also stipulate the content of a certificate of default. Most standby letters of credit call for two documents: (1) a demand or draft and (2) a certificate indicating that the drawing event (e.g., default) has occurred or that payment is due; commonly a certificate of default.<sup>70</sup> In this regard, rule 14.7,<sup>71</sup> under the heading 'Statement of Default or Other Drawing Event', provides as follows:

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

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

It follows that under rules 3.03, 4.08, 4.16 and 4.17 of the ISP98, a demand for payment under a standby letter of credit is not required to indicate a default or other event in the underlying contract, if that is not required under the terms and conditions of the standby letter of credit. This is a step back from the position of the URDG, where the beneficiary is required to state that there is a breach of the underlying contract and what type of breach is involved.<sup>72</sup>

Furthermore, the issuer under rule 3.10 of the ISP98, unlike article 17 of the URDG, is not required to notify the applicant (the principal in the case of a demand guarantee) of receipt of a demand for payment under the standby letter of credit.<sup>73</sup> Article 17 of the URDG requires 'in the event of a demand' that the guarantor 'shall without delay' notify the principal or his instructing party. Rule 3.10 is consistent with the standby letter of credit practice that rejects the notion embodied in article 17 that the issuer has a duty to notify the applicant upon receipt of a demand under a standby.

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<sup>70</sup> See J F Dolan 'Analysing Bank Drafted Standby Letter of Credit Rules, the International Standby Practice (ISP98)' (2000) 14 *Wayne Law Review* 1865 at 1893.

<sup>71</sup> For a discussion of rule 4.17 see *The Official Commentary on the ISP98 op cit* note 62 Official Comments 1–3 to rule 4.17 at 187–189. However, for criticism on rule 4.17, see J F Dolan 'Analysing Bank Drafted Standby Letter of Credit Rules, the International Standby Practice (ISP98)' (2000) 14 *Wayne Law Review* 1865 at 1894.

<sup>72</sup> See article 20(a) of the URDG. See also Xiang Gao *op cit* note 13 at 60.

<sup>73</sup> See De Ly *op cit* note 54 at 836.



Byrne has explained the rationale behind rule 3.10.<sup>74</sup> Apparently, the concern raised is that by giving notice to the applicant before payment is made might have the effect that the applicant might seek to prevent payment by trying to obtain a judicial order restraining payment. While it is agreed that such relief may be appropriate in the case of an abusive or fraudulent drawing, it is not appropriate in the event of a contractual dispute between the applicant and beneficiary. It is stated that, in fact, many standbys are meant to be drawn upon in just such a situation. It has been said that to propose a duty to give notice calls into question the neutrality of the issuer; a concept that is at the heart of the standby's commercial value. It is agreed that there may, of course, be valid commercial reasons for contacting the applicant prior to honour, for example, in order to notify the applicant that he is being called upon to fund the drawing. The abuse of such notice, however, may not only compromise the reputation of the issuer, but may expose it to legal liability as well.

This rationale behind rule 3.10 of the ISP98 is not convincing and the approach taken in article 17 of the URDG is to be preferred. Merely informing the applicant that a presentation has been made does not prevent the issuer from paying the standby. Placing such a duty on the issuer will merely allow the applicant to approach a court for the appropriate relief (i.e., application for an injunction or interdict) sooner, thereby enabling the applicant, for instance, to attach (by way of a *Mareva*-type injunction or anti-dissipation interdict) the money before it is used by the beneficiary.<sup>75</sup> Including such a duty in the ISP98 will go a small way in preventing fraudulent or abusive calls on standbys.

#### **4.4 EFFORT BY THE UNCITRAL TO TRY AND PREVENT UNFAIR AND FRAUDULENT CALLS**

##### **4.4.1 The UNCITRAL Convention**

As already mentioned in Chapter 3, the UNCITRAL Convention<sup>76</sup> is specifically designed to regulate demand guarantees and standby letters of credit, although commercial letter of credit users may also choose to use it if they so wish.<sup>77</sup> The most important articles of the Convention are found in Chapters IV and V, which concern the bank's payment obligation and the exceptions to this obligation. Contrary to the ICC Rules, the UNCITRAL Convention made an attempt to address the issue of fraud, and to prevent fraudulent or unfair calling of standby letters of credit and demand guarantees.<sup>78</sup> However, the terms 'fraud' and 'abuse of right' have not been used in the Convention in order to avoid possible confusion resulting from different (and inconsistent) interpretations already developed in various jurisdictions about the meaning of these terms. This was done especially since criminal law notions often influence the concept of fraud.<sup>79</sup>

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<sup>74</sup> See *The Official Commentary on the ISP98 op cit* note 62 Official Comments to rule 3.10 at 122.

<sup>75</sup> For a full discussion of the appropriate relief that courts may give, see Chapter 7.

<sup>76</sup> See also para 3.3 in Chapter 3.

<sup>77</sup> See article 1(2) of the UNCITRAL Convention.

<sup>78</sup> See Xiang Gao *op cit* note 13 at 60.

<sup>79</sup> See Xiang Gao *op cit* note 13 in note 105 at 60–61; E E Bergsten 'A New Regime for International Independent Guarantees and Stand-by Letters of Credit: The UNCITRAL Draft Convention on Guaranty Letters' (1993) 27 *International Lawyer* 859 at 872, in particular note 61; and Bertrams *op cit* note 40 at 356.

In relation to the payment obligation, articles 13 to 17 of the Convention determine that the bank must honour a payment demand if it meets the requirements in the demand guarantee or standby letter of credit. The bank is given a reasonable amount of time to examine the demand (a maximum of seven working days).<sup>80</sup>

In article 15, the Convention first puts up a general requirement for the beneficiary demanding payment under a demand guarantee or standby letter of credit. Article 15(3) of the Convention provides that '[t]he beneficiary, when demanding payment, is deemed to certify that the demand is not in bad faith and that none of the elements referred to in subparagraphs (a), (b) and (c) of paragraph (1) of article 19 are present'.

In other words, article 15(3) states that a beneficiary 'is deemed to certify that the demand is not in bad faith' and that the demand is not fraudulent.

In terms of article 17 of the Convention, the guarantor/issuer must, subject to article 19, pay against a demand made in accordance with the provisions of article 15. Article 18 spells out an exception due to the right of set-off<sup>81</sup> and article 19 contains certain exceptions in which cases the bank does not have to pay. In other words, payment under a demand guarantee or standby letter of credit has the potential to be disrupted if the elements listed in article 19 exist in the demand/credit.<sup>82</sup>

From the viewpoint of unfair calls and the principle of autonomy, the vital articles of the UNCITRAL Convention are articles 15(3), 19 and 20. These articles work together to make it more difficult for an unfair call to succeed and they do so by seeking a justification for the call in the underlying contract.<sup>83</sup>

#### 4.4.2 Fraud and the UNCITRAL Convention

The UNCITRAL Convention also recognises exceptions to the absolute and independent nature of demand guarantees and standby letters of credit. Article 19, under the heading 'Exception to Payment Obligation' stipulates the circumstances under which the issuer/guarantor may dishonour the beneficiary's demand for payment. Article 19(1) reads as follows:

If it is manifest and clear that:

(a) Any document is not genuine or has been falsified;

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<sup>80</sup> See article 16(2).

<sup>81</sup> A problem that has already been raised regarding letters of credit concerns the right of set-off against the beneficiary. The UCP and URDG contain no provisions relating to set-off, since this is regarded as part of domestic law with which the rules should not interfere. Then again, the general idea of the letter of credit is that the beneficiary should be paid without risking set-off and case law has developed in that direction. The common understanding has then become almost settled that no such right of set-off exists with regard to the principal's (buyer's) claim against the beneficiary. However, there may be a right of set-off for the bank. The UNCITRAL Convention contains a provision on the right of set-off in article 18 that appears to follow up generally established practice, and unless otherwise agreed, the guarantor may discharge the payment obligation under the undertaking 'by availing itself of a right of set-off, except with any claim assigned to it by the principal/applicant or the instructing party'. See L Gorton 'Draft UNCITRAL Convention on Independent Guarantees' (May 1997) *Journal of Business Law* 240 at 249.

<sup>82</sup> See Xiang Gao *op cit* note 13 at 61.

<sup>83</sup> See Debattista *op cit* note 7 at 297.

- (b) No payment is due on the basis asserted in the demand and the supporting documents; or
- (c) Judging by the type and purpose of the undertaking, the demand has no conceivable basis, the guarantor/issuer, acting in good faith,<sup>84</sup> has a right, as against the beneficiary, to withhold payment.

Paragraph (2) of article 19 explains what the term ‘no conceivable basis’ referred to in subparagraph (c) of paragraph (1) means. It provides that the following are types of situations in which a demand has no conceivable basis:

- (a) The contingency or risk against which the undertaking was designed to secure the beneficiary has undoubtedly not materialized;
- (b) The underlying obligation of the principal/applicant has been declared invalid by a court or arbitral tribunal, unless the undertaking indicates that such contingency falls within the risk to be covered by the undertaking;
- (c) The underlying obligation has undoubtedly been fulfilled to the satisfaction of the beneficiary;
- (d) Fulfilment of the underlying obligation has clearly been prevented by wilful misconduct of the beneficiary;
- (e) In the case of a demand under a counter-guarantee, the beneficiary of the counter-guarantee has made payment in bad faith as guarantor/issuer of the undertaking to which the counter-guarantee relates.

For the first time the Convention contains a codification of the different situations where fraud is present and it too requires strong evidence of this. This list may not be exhaustive, but it is a remarkable and encouraging way in which to define the kind of misconduct that may provoke the fraud exception. It unquestionably stands as the most detailed provision so far to clarify the misconduct that may bring the fraud exception into operation.<sup>85</sup> This definition of unfair calling and the acknowledgment of a legal defence are embedded in a more general codification of exceptions to the payment obligation in article 19 of the Convention. This situation of unfair calling is generally described in article 19(1)(c) as ‘judging by the type and purpose of the undertaking, the demand has no conceivable basis’. Accordingly, this is then more specifically described by five cases set out in article 19(2).<sup>86</sup>

Article 19 deliberately avoids the terms ‘bad faith’ ‘abuse’ and ‘fraud’,<sup>87</sup> since they have confusing and inconsistent meanings in the different legal systems and are often influenced by criminal law notions of malicious intent, which are not suitable in relation to guarantees. Therefore, article 19(1) of the Convention has instead employed the general formula of a demand for payment that ‘has no conceivable basis’, while paragraph (2) of article 19 also shows that the impropriety of the demand may relate, or could be determined by reference to, the underlying transaction. As far as the degree of proof is

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<sup>84</sup> See also article 14(1) that expressly imposes on the guarantor/issuer a duty to act in good faith and exercise reasonable care having due regard to generally accepted standards of international practice of standby letters of credit/demand guarantees in discharging its obligations under the undertaking and under the Convention.

<sup>85</sup> See Xiang Gao *op cit* note 13 at 97.

<sup>86</sup> See N Horn *German Banking Law and Practice in International Perspective* (1999) in Chapter 11 ‘The UN Convention on Independent Guarantees and the *Lex Mercatoria*’ 189 at 200–201.

<sup>87</sup> See Bergsten *op cit* note 79 at 872.

concerned, fraud must be ‘manifest and clear’ and ‘immediately available’.<sup>88</sup> The Convention is mainly concerned with the nature of the documents presented. It does not mention, and is not concerned with, the identity of the fraudulent party. Therefore, the fraud exception applies under the Convention, if ‘any document is not genuine or has been falsified’, regardless of the identity of the fraudster.<sup>89</sup> Furthermore, although the Convention requires ‘manifest and clear’ evidence to invoke the fraud exception, it does not mention that the wrongdoer’s intention should be proven. From reading the provisions of the Convention, it seems that the Convention, like United States Revised UCC article 5 section 5-109,<sup>90</sup> focuses rather on the nature of misconduct than the fraudster’s state of mind or the identity of the fraudster.<sup>91</sup>

Article 19 does not place an express duty on the guarantor to refuse payment under certain circumstances, but only a right to do so. The article seems to allow the guarantor/issuer certain discretion when payment is demanded, but it also implies a certain duty on him to make a judgement whether the requirements are met or not. The article therefore allows for certain objections of payment under certain circumstances and they seem to go further than the limits that have developed in case law. The most significant part is perhaps that there now appears to be a certain duty on the guarantor to make a judgement call as to whether payment should be made. Whether the enumerated causes giving right to a refusal to pay are precise and clear enough is something that will have to be resolved in future case law, but the ground is certainly laid for a narrowing down of the independence of the demand guarantee.<sup>92</sup>

The exception set out in article 19(1)(b) includes the so-called literal defences – the defences available that stem from the text of the guarantee or standby letter of credit and that the bank can use against the beneficiary. With the exception stipulated in article 19(1)(c), the Convention has formulated a general definition of the fraud exception. In view of the fact that in different countries various descriptions are given of the circumstances under which it is possible to reject payment under a demand guarantee or standby letter of credit (i.e., fraud, abuse of rights, and manifestly unreasonable demand), the decision was made to use a general formulation of the fraud exception.<sup>93</sup> The downside of this open formulation is that judges from various contracting states could interpret this provision in different ways. However, the risk has been reduced to some degree by the examples of the grounds for denying payment given in article 19(2).<sup>94</sup>

However, two aspects of article 19 depart quite clearly from the principle of autonomy. First, in determining whether a call is justified, articles 19(1)(b) and (c) and 19(2)(a), (b), (c) and (d) all require the guarantor/issuer of the demand guarantee or standby letter of credit to look to the underlying contract for good cause to pay. Second, by constantly insisting on the exercise of good faith, article 15(3), the tailpiece of article 19(1) and article

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<sup>88</sup> See articles 19 and 20 of the Convention. See also Bertrams *op cit* note 40 at 356.

<sup>89</sup> See also Xiang Gao *op cit* note 13 at 117.

<sup>90</sup> See para 5.5.3 in Chapter 5.

<sup>91</sup> See Xiang Gao *op cit* note 13 at 97 and 117. See also notes 323 and 401 in Chapter 5.

<sup>92</sup> See Gorton *op cit* note 81 at 249.

<sup>93</sup> For a full discussion of how the fraud exception is dealt with in England, the United States and South Africa, see Chapter 5.

<sup>94</sup> See De Ly *op cit* note 54 at 842–843.

19(2)(e) put both the beneficiary and the issuer of the guarantee on notice that payment needs to be justifiable by good cause.<sup>95</sup>

From the above, it is clear that the UNCITRAL Convention represents a step back from the URDG and towards the URCG. Under the Convention, a demand is not in itself sufficient to trigger payment. A simple declaration that payment is due under the underlying contract is also not sufficient: the demand needs to be justified in good faith within the context of the underlying contract. Despite the declaration of the principle of independence in article 3 of the Convention,<sup>96</sup> when it comes to examining the validity of a claim (call), the veil separating the guarantee (or standby letter of credit) from the underlying contract is well and truly discarded.<sup>97</sup>

Article 19 not only provides the guarantor/issuer with some basis for refusing payment, but also enables the principal to take court measures against a fraudulent beneficiary. Paragraph (3) of article 19 states that ‘in the circumstances set out in subparagraphs (a), (b) and (c) of paragraph (1) of this article, the principal/applicant is entitled to provisional court measures in accordance with Article 20’.<sup>98</sup> Article 20 of the Convention, under the heading ‘Provisional Court Measures’, then stipulates the measures a court can take by providing:

- (1) Where, on an application by the principal/applicant or the instructing party, it is shown that there is a high probability that, with regard to a demand made, or expected to be made, by the beneficiary, one of the circumstances referred to in subparagraphs (a), (b) and (c) of paragraph (1) of article 19 is present, the court, on the basis of immediately available strong evidence, may:
  - (a) Issue a provisional order to the effect that the beneficiary does not receive payment, including an order that the guarantor/issuer hold the amount of the undertaking, or
  - (b) Issue a provisional order to the effect that the proceeds of the undertaking paid to the beneficiary are blocked,
 taking into account whether in the absence of such an order the principal/applicant would be likely to suffer serious harm.
- (2) The court, when issuing a provisional order referred to in paragraph (1) of this article, may require the person applying therefore to furnish such form of security as the court deems appropriate.
- (3) The court may not issue a provisional order of the kind referred to in paragraph (1) of this article based on any objection to payment other than those referred to in subparagraphs (a), (b) and (c) of paragraph (1) of article 19, or use of the undertaking for a criminal purpose.

<sup>95</sup> See Debattista *op cit* note 7 at 298.

<sup>96</sup> Article 3 describes an independent guarantee (demand guarantee) to which the Convention applies as one that is not dependent on the underlying contract or subject to any term not appearing in the undertaking itself. However, it has been said that the effect of this article is to describe the demand guarantees or standby letters of credit (undertakings) to which the Convention is to apply, not to establish the principle of autonomy in the context of demand guarantees. See Debattista *op cit* note 7 in note 32 at 298

<sup>97</sup> Debattista *op cit* note 7 at 298

<sup>98</sup> See Xiang Gao *op cit* note 13 at 61.

Article 20 of the Convention makes provision both for measures similar to an injunction (i.e., an interdict under the South African law) preventing payment<sup>99</sup> and for attachment or *Mareva*-type injunctions (freezing orders)<sup>100</sup> to be available to the court where there is a ‘high probability’ shown by ‘immediately available strong evidence’;<sup>101</sup> the court ‘may issue a provisional order’ or similar.<sup>102</sup> Although the exact meaning of the two crucial phrases, namely, ‘high probability’ and ‘immediately available strong evidence’ will have to be determined by the courts in the different jurisdictions, Hugo has indicated that it appears that one may conclude that the position of the bank’s customer would in most jurisdictions be significantly better under the Convention than under the prevailing law.<sup>103</sup>

However, neither the UCP nor the URDG contain any provisions on court procedure. This is rather obvious taking into consideration the contractual/custom status of the UCP and the URDG. In recent years various national courts and/or legislators have established provisional court measures (such as injunctions in Anglo-American law), allowing the applicant to request provisional court interference to prevent the payment to the beneficiary under a letter of credit/demand guarantee under certain circumstances.<sup>104</sup>

Article 19 of the Convention codifies the exception of fraud, in particular the cases in which the bank does not have to pay (however, payment is permitted). This article is immediately attached to the right of the principal to petition the court in the case of fraud and to invoke his rights, which are set out in article 20.<sup>105</sup> Accordingly, articles 19 and 20 provide respectively for the definition and description of the fraud exception, and the measures available to the principal in such case.<sup>106</sup>

Xiang Gao indicates that these provisions of the Convention are clear and narrow in scope, and provide an exceptional international standard. He points out that these provisions will undoubtedly provide good guidance for courts to enhance their application of the fraud

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<sup>99</sup> For a full discussion of injunctions (i.e., interdicts), see Chapter 7.

<sup>100</sup> See the discussion of *Mareva*-type injunctions (freezing orders) and the South African anti-dissipation orders in paras 7.2.5 and 7.4.5 in Chapter 7.

<sup>101</sup> See C F Hugo *The Law Relating to Documentary Credits from a South African Perspective with Special Reference to the Legal Position of the Issuing and Confirming Banks* (published LLD, University of Stellenbosch (1996)) 1997 (hereinafter ‘*Hugo: The Law Relating to Documentary Credits*’) at 309.

<sup>102</sup> In *BC Ltd v KPMG Inc* [2004] 238 DLR (4th) 13 (BC Ct App) a Canadian court concluded that a drawing on a letter of credit where there was no breach of the underlying contract would be abusive and within the concept of fraud (see the case summary in J E Byrne and C S Byrnes (eds) 2005 *Annual Survey of Letter of Credit Law and Practice* (2005) at 260–262). The view has been expressed that this case is on the edge of what is fraud and it was decided correctly. (This view was expressed by one of the a panellist (it is uncertain from which jurisdiction he or she was) during the 2005 Annual Survey of Letter of Credit Law & Practice, held by the Institute of International Banking Law and Practice Inc in Miami, Florida on 17–18 March 2005). B Kozolchyk, adding to this, indicated that that case clearly demonstrated the value of the UNCITRAL Convention in helping to protect against abusive drawings (see Note ‘2005 Annual Survey of Letter of Credit Law & Practice’ *Institute of International Banking Law and Practice Inc’s 2006 Annual Survey of Letter of Credit Law & Practice* (Miami Florida, March 2006) Supplemental Materials at 50).

<sup>103</sup> See *Hugo: The Law Relating to Documentary Credits op cit* note 101 at 309.

<sup>104</sup> See Gorton *op cit* note 81 at 251.

<sup>105</sup> See article 19(3).

<sup>106</sup> See De Ly *op cit* note 54 at 842.

exception.<sup>107</sup> He is also of the view that these provisions are generally in accordance with the current practice. They include most of the elements of the fraud rule that have been developed over the years by national courts and/or legislators, and provide a detailed and helpful guide to users of demand guarantees and the courts.<sup>108</sup> Furthermore, he states that like the United States Revised UCC article 5 section 5-109(b),<sup>109</sup> the Convention<sup>110</sup>

- has clearly indicated what kind of actions victims of fraud may take when fraud is ‘manifest and clear’ in a transaction of demand guarantees or standby letters of credit, namely the guarantor’s/issuer’s dishonour of a presentation or withholding payment,<sup>111</sup> and the principal’s/applicant’s entitlement to a court injunction preventing the honouring of a presentation by the guarantor/issuer;
- has listed what kind of misconduct may invoke the fraud rule;<sup>112</sup>
- has specified that either fraud in the documents or fraud in the underlying contract may invoke the fraud rule;<sup>113</sup> and
- has provided necessary guidelines for courts considering the application of the fraud rule.<sup>114</sup>

It has been said that the regulation of the fraud exception in article 19 is a success both politically and technically. Politically, a uniform and mandatory concept of fraud avoids regulatory competition between different legal systems and therefore between the banking industries of various countries, concentrating competition on the terms and prices of the banking products and not on regulatory issues.<sup>115</sup> Technically, the somewhat open-ended formulation of the fraud exception has avoided the exercise of reaching an agreement on the concept of fraud in various national legal systems. Moreover, the description of fraud is strong enough so that payment as a rule remains, while refusal to pay is an exception. Apparently, the examples in article 19(2) make the rule sufficiently clear. However, an open and uniform description has the disadvantage that judges in contracting states will interpret this concept differently. This often happens when one is dealing with a uniformed text (e.g., a convention) that does not provide for an international court to decide in a binding way how uniform law is to be interpreted. It is possible though to control this risk, if there is sufficient information available in other countries regarding the interpretation of the unifying text. As mentioned in Chapter 3, the UNCITRAL has developed a databank

<sup>107</sup> See Xiang Gao *op cit* note 13 at 97 and the authority cited.

<sup>108</sup> For a full discussion of how the fraud exception is dealt with in England, the United States and South Africa, see Chapter 5.

<sup>109</sup> For a full discussion of this section, see paras 5.5 in Chapter 5 and para 7.3 in Chapter 7.

<sup>110</sup> See Xiang Gao *op cit* note 13 at 62–63.

<sup>111</sup> See article 19(1)(c).

<sup>112</sup> See article 19.

<sup>113</sup> See articles 19(1)(a) and (c).

<sup>114</sup> See article 20.

<sup>115</sup> For a contrary view see J F Dolan ‘The UN Convention on International Independent Undertakings: Do States With Mature Letter-of-Credit Regimes Need It?’ (1998) 13 *Banking and Finance Law Review* 1 at 16–21 and 23, who prefers that fraud be left to be governed by the domestic law of mature letter of credit and bank demand guarantee jurisdictions.

that contains court decisions on unifying texts. It also publishes summaries of recent decisions.<sup>116</sup>

Many countries – including South Africa, England and the United States – authorise the courts to grant an order (i.e., an interdict or injunction) enjoining the guarantor/issuer from paying or enjoining the beneficiary from receiving payment under a demand guarantee or standby letter of credit.<sup>117</sup> In article 20 of the UNCITRAL Convention the legal remedies are provided which principals can make use of to prevent payment under a demand guarantee or a standby letter of credit. It seems that the text of article 20 suggests that provisional rather than final measures are intended. In various countries summary proceedings (such as injunctive relief) are interpreted as provisional measures and therefore it is doubtful that (conserving) attachment orders would fall under article 20. In this regard it has been said that the text of article 20, the requirements of provisional measures and the cases in which provisional measures can be employed are arguments for keeping ‘attachment orders’ and similar (final) measures outside of the Convention.<sup>118</sup> In terms of the Convention, the principal can request provisional measures under which the beneficiary will not receive payment (including the bank putting the funds into an escrow account) or in which the beneficiary’s funds are blocked. This is only possible under the exceptions listed in article 19 and if the demand guarantee or standby letter of credit is used for a criminal purpose. In terms of procedural law, provisional measures have been given extra guarantees to prevent them from being accepted too often. Most of all, the principal must present the circumstances set out in article 19 in a manner in which *prima facie* evidence is insufficient, as ‘immediately available strong evidence’ is required. The judge may only allow provisional measures if there is a ‘high probability’ that the circumstances set out in article 19 exist and it may be taken into account that the account party is ‘likely to suffer serious harm’ if no provisional measure is taken. Therefore, it appears that article 20 is not an open invitation for the judge to interfere. The view has been expressed that with regard to provisional measures, the Convention is strict enough with principals while still being flexible enough to permit the application of provisional measures in exceptional cases.<sup>119</sup>

However, the Convention does not provide the principal with the highest degree of protection from fraud. In the URDG the principal is protected by the requirement, set out in article 9, that a document is provided that proves default, while article 20 of the URDG requires that a demand for payment states the reasons. Under article 15(3) of the UNCITRAL Convention none of this is required, and the Convention limits itself to the statement that the beneficiary is considered to have judged whether or not the demand is made in good faith and whether the exceptions set out in article 19(1) apply. It has been said that the weakness contained in the article regarding the beneficiary’s examination of his own conscience will in practice in cases of fraud prove to be meaningless and ineffective in countering fraud. Furthermore, the practical difference between the URDG and the Convention in this perspective is not to be exaggerated; also the reasoned demand of payment by the beneficiary in many cases will not prevent fraud.<sup>120</sup>

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<sup>116</sup> See De Ly *op cit* note 54 at 843.

<sup>117</sup> For a full discussion, see Chapter 7.

<sup>118</sup> See De Ly *op cit* note 54 in note 37 at 843.

<sup>119</sup> See De Ly *op cit* note 54 at 843–844.

<sup>120</sup> See De Ly *op cit* note 54 at 844–845.



It has also been stated that the Convention fraud rules are defensible from the viewpoint of banks and beneficiaries. However, the principal is left out in the cold if a demand for payment is made and the bank makes payment without notifying the principal. The Convention does not place a duty on the bank to provide information and to wait a few days before payment is made so that in cases of fraud the principal is not in a legal position to take immediate action. Furthermore, the Convention would have achieved a better balance by including an obligation to provide information and to delay payment. Only then would market participants have been able to choose between strong protection against fraud under the URCG, moderate protection under the Convention and minimal protection under the URDG. Moreover, in this regard the Convention is not inventive, is too closely aligned with the self-regulation of the URDG and UCP, and an important chance to correct the current situation was missed.<sup>121</sup>

It is true that the provisions relating to the fraud rule contained in the Convention signal a significant and encouraging development in this area of the law.<sup>122</sup> Furthermore, the Convention is the first document to provide details of the fraud rule at an international level. Another important issue is that, unlike the ICC rules, which have to be incorporated into the demand guarantee as contractual terms to be effective, the Convention becomes law in a country that signs and/or ratifies it.<sup>123</sup>

However, although the Convention already came into effect on 1 January 2000, it has so far been ratified (acceded to) by only a few countries, including Ecuador, El Salvador, Kuwait, Panama, Belarus, Tunisia, Gabon and Liberia. The United States signed the Convention on 11 December 1997, but has yet to accede to it. Therefore, no major trading country has thus far ratified it.<sup>124</sup> It would also appear that South Africa has no immediate future plans to adopt it either. From this it appears that the success of the Convention has been rather limited. The reasons for this could be numerous. However, from a critical point of view, it is possible that the codified fraud rule might be one of the reasons for countries being hesitant to adopt it. Therefore, the fraud exception may possibly need further improvement. However, viewed politically, it seems to be rather impossible to do. Banks, in general, apparently also oppose the adoption of the Convention. They understandably want to keep their involvement as far as demand guarantees, commercial and standby letters of credit are concerned to a minimum, and it is their opinion that the Convention, particularly articles 15(3) and 19, would bring about their greater involvement.<sup>125</sup>

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<sup>121</sup> See De Ly *op cit* note 54 at 845–846.

<sup>122</sup> However, Dolan has criticised the inclusion of the provision of the Convention aimed at the prevention of fraudulent calls. He suggests that like the UCP, the UNCITRAL Convention should have left the question of fraud out of the Convention and should rather have left it to the domestic law of the different jurisdictions. In fact, according to him it would have been better if the Convention were never created. See J F Dolan ‘The UN Convention on International Independent Undertakings: Do States With Mature Letter-of-Credit Regimes Need It?’ (1998) 13 *Banking and Finance Law Review* 1 at 19–21 and 23.

<sup>123</sup> See Xiang Gao *op cit* note 13 at 61.

<sup>124</sup> See para 3.3.1 and note 198 in Chapter 3.

<sup>125</sup> See R Fayers ‘Developments Concerning the “Accounting Principle”’ (October–December 2006) 12 *ICC’s DCInsight* 18 at 20.

## 4.5 SUMMARY AND CONCLUSION

It is regrettable that the UCP, which have become such an important universal set of rules (source of law) are silent on the issue of unfair or fraudulent calling of letters of credit and standby letters of credit. What is even more regrettable is the fact that the UCP do not contain any provision on the guarantor's right to refuse payment.

One of the objectives of the URCG was to limit the possibilities of unfair demands of guarantees issued under it. In terms of article 9 of the URCG, if the guarantee did not specify the documentation to be produced in support of a claim or merely specified the submission of a statement of claim, the beneficiary was required to submit (1) in the case of a tender guarantee, the beneficiary's declaration that the guarantee was due and an agreement to have any dispute with the principal submitted to litigation or arbitration, and (2) in the case of a performance guarantee or of a repayment guarantee, either a court decision or an arbitral award justifying the claim, or the approval of the principal in writing to the claim and to the amount to be paid. However, in addition to limiting the possibility of improper demand, the requirements of article 8(3)(b) read with article 9 effectively eliminate the simple demand guarantee. Therefore, one of the major problems with respect to the URCG is that they did not take into consideration the increasing use and importance of on-demand (simple or first demand) guarantees.

Article 20 of the URDG does not go so far. The article has gone some small way in placing restrictions on the beneficiary's right of payment. This article only requires that the demand be in writing and supported by a written statement that the principal is in breach of the underlying contract and in what respect the principal is in breach. The simple demand guarantee is thereby transformed into a documentary guarantee, with a required minimum content of the document. However, the wording used here is not a very effective safety device, but at least it places on the beneficiary a certain obligation to show his hand. The requirement that the beneficiary has to state in writing both that there is some kind of breach of the underlying contract and the type of breach that is involved gives the principal limited protection. However, the URDG do not contain any provision on the guarantor's right to refuse payment.

Therefore, although the URCG and the URDG have both attempted to prevent unfair calls on demand guarantees, in conclusion, it can be said that neither the URCG nor the URDG seem quite sufficient. In fact, the URDG have not only failed to win the support of all groups but have also been strongly opposed by some.

In the UNCITRAL Convention, neither the approach of the URCG nor that of the URDG was taken. However, the attempts made by the UNCITRAL Convention by way of articles 19 and 20 are commendable, especially since it is the first real international attempt to prevent unfair calls and to codify the fraud rule. However, the effectiveness of the UNCITRAL Convention is seriously doubted.

The ISP98 take a similar approach to the UCP and expressly leave the issue of fraudulent or unfair calling of standby letters of credit to be determined by the applicable jurisdictional law. As with the UCP, it is also regretted that the ISP98 is silent on this issue.

It follows that if market participants want strong protection against fraud, they should incorporate the URCG; if they desire moderate protection, they should incorporate the

UNCITRAL Convention; and if they only want minimal protection, they should incorporate the URDG.

From the above, it seems that we are back to square one. Banks need a simple device in terms of which they will have to pay without having to make difficult considerations and to take hard decisions based on unclear evidence. Beneficiaries need a device in terms of which they get paid against a simple demand or against a simple document without risking various obscure objections. Principals, however, are interested in having some safety mechanism in the system so as to prevent unfair callings. Although the international initiatives, discussed above, are laudable, they are unlikely to bring about a clear and practical solution to the problem of unfair calls, given the opposing nature of commercial and political interests and motives. The problem with all of these international initiatives, however, is that their effectiveness is limited to the extent to which the international community is prepared to adopt them in practice.



## CHAPTER 5: THE FRAUD EXCEPTION TO THE AUTONOMY PRINCIPLE

### 5.1 INTRODUCTION

It is often said that letters of credit and demand guarantees are ‘as good as cash’ because the bank’s obligation under them is independent of its customer’s (applicant’s/principal’s) obligation to its trading partner (beneficiary) under the underlying contract. Therefore, even if the beneficiary is in breach of the underlying contract or that contract has been terminated for repudiatory breach, the bank must, in principle, still pay if the demand complies with the instrument’s requirements.<sup>1</sup>

A vital issue in the law regarding commercial/standby letters of credit and demand guarantees is what happens in the case where the beneficiary (e.g., seller) renders defective, or even no, performance at all in terms of the underlying contract, but still presents documents that comply with the credit/guarantee. Will the bank be allowed to refuse to pay under the letter of credit/demand guarantee in these circumstances? When determining this issue, two conflicting and competing principles need to be taken into consideration.<sup>2</sup>

At the one end, there is the principle of independence that applies to letters of credit and demand guarantees.<sup>3</sup> This principle entails that the bank is not allowed or obliged to take notice of the provisions of the underlying contract in considering whether it must pay the credit/guarantee.<sup>4</sup>

At the other end, it seems unacceptable, on the grounds of reasonableness and fair dealing, that a beneficiary that deliberately falsifies the documents so as to comply with the requirements of the underlying contract and the letter of credit/demand guarantee, while in reality rendering defective, or even no, performance under the underlying contract, should be able to claim payment under the credit/guarantee.<sup>5</sup>

To solve the unsatisfactory situation that the beneficiary may benefit from its own fraudulent conduct in letter of credit and demand guarantee transactions, a limited number of exceptions to the autonomy principle have come to be acknowledged and accepted in

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<sup>1</sup> See G Clark ‘As Good as Cash? Injuncting Calls on Letters of Credit and Performance Guarantees’ (a paper delivered at a seminar organised by the Professional Solutions Training and Consultancy held at the Discussion Conference Centre in London on 15 May 2006) (unpublished) in para 2 at 3. It should also be borne in mind that in one important regard the demand guarantee and the letter of credit both resemble a negotiable instrument. In all three cases, the ‘holder in due course of a negotiable instrument’ and ‘the beneficiary of a demand guarantee/letter’ is not subject to defences arising out of the underlying contract (see also J F Dolan *The Law of Letters of Credit: Commercial and Standby Credits* Revised Edition (loose-leaf) (1996) (hereinafter ‘*Dolan: The Law of Letters of Credit*’) in para 3.03[6].

<sup>2</sup> See J P van Niekerk and W G Schulze *The South African Law of International Trade: Selected Topics* 2 ed (2006) at 311.

<sup>3</sup> For a full discussion of the autonomy principle, see para 2.5.2.2 in Chapter 2.

<sup>4</sup> See Van Niekerk and Schulze *op cit* note 2 at 311.

<sup>5</sup> *Idem*.

practice. Therefore, in certain circumstances, the autonomy of demand guarantees and letters of credit may be ignored by the bank and regard may be had to the terms and conditions of the underlying contract. The main exceptions concern fraud<sup>6</sup> and illegality.<sup>7</sup> Therefore, a more detailed discussion of these two main exceptions follows.

Certain jurisdictions also accept that there are, or may also be, other exceptions.<sup>8</sup> Many of these exceptions are still very controversial and many uncertainties exist regarding their

<sup>6</sup> See the discussion in this chapter below.

<sup>7</sup> See the discussion in Chapter 6. See also Van Niekerk and Schulze *op cit* note 2 at 311–312.

<sup>8</sup> For a further discussion of these possible exceptions, see N Enonchong ‘The Problem of Abusive Calls on Demand Guarantees’ (2007) *Lloyd’s Maritime and Commercial Law Quarterly* 83; J Bailey ‘Unconditional Bank Guarantees’ (2003) 20 *International Construction Law Review* 240; A Ganotaki ‘Unconscionability and Bank Guarantees’ (2004) *Lloyd’s Maritime and Commercial Law Quarterly* 148; and Q Loh and T H Wu ‘Injunctions Restraining Calls on Performance Bonds – Is Fraud the Only Ground in Singapore?’ (2000) *Lloyd’s Maritime and Commercial Law Quarterly* 348. In these articles the possibility of various other exceptions to the autonomy principle are discussed and they also contain references to court cases in Australia, Singapore and Malaysia where some of these grounds have been considered as possibilities. Some of these exceptions include, e.g., the ground that making a demand constitutes unconscionable conduct (in Singapore, unconscionability on part of a beneficiary is accepted as an exception, see e.g., *GHL Pte Ltd v Unitrack Building Construction Pte Ltd and Anor* (1999) 4 SLR 604 (Sing CA); *Samwoh Asphalt Premix Pte Ltd v Sum Cheong Piling Pte Ltd and Anor* (2001) 3 SLR 447, (2002) 1 SLR 1, and [2002] Build LR 459 (Sing CA); and *McConnell Dowell Constructors (Aus) Pty Ltd v Sembcorp Engineers and Constructors Pte Ltd* [2002] 1 SLR 199 (Sing HC), [2002] Build LR 450 (Sing HC)); the ground that no underlying contract exists or it has been terminated or became unenforceable (in *Manx Electricity Authority v JP Morgan Chase* (No. 2) 2003 WL 22187638 it was confirmed that in the English law the fact that the underlying contract had been terminated or otherwise became unenforceable did not permit the bank to refuse to pay on a letter of credit/demand guarantee (for a discussion of this case, see Clark *op cit* note 1 in paras 35–36 at 11–12)); there is a breach of a negative stipulation in the underlying contract (in this regard see also, *Sirius International Insurance Co (Publ) v FAI General Insurance Ltd and Others* [2003] 1 WLR 87 (first instance); [2003] 1 WLR 2214 (CA) ([2003] EWCA Civ 470 (CA) and [2005] 1 All ER 191 (HL) ([2004] UKHL 54; and [2004] 1 WLR 3251 (HL)) and for a discussion, of the Court of Appeal’s judgment, see C Hugo ‘Documentary Credits and Independent Guarantees’ *ABLU* 2005 (a paper delivered at the 2005 Annual Banking Law Update held at the Indaba Hotel, Johannesburg on 20 April 2005) (unpaginated) (hereinafter ‘*ABLU 2005*’) at 16–20); and cf *Union Carriage and Wagon Company Ltd v Nedcor Bank Ltd* 1996 CLR 724 (W) at 734–735); or there is a lack of good faith or absence of reasonableness when the demand was made. Another possibility to the autonomy exception that has arisen in the United Kingdom in recent years, is the ‘nullity exception’ (i.e., where a document that is presented under a letter of credit/demand guarantee has been forged it is deemed to be a ‘nullity’ in the sense that it is not genuine and therefore has no commercial value) (in this regard, see *Montrod Ltd v Grundkötter Fleischvertriebs GmbH* [2001] 1 All ER (Comm) 368 (QBD); and [2002] 3 All ER 697 (CA) ([2002] 1 WLR 1975 (CA)) where it was held that in English law there is no nullity exception separate from the fraud exception (for a discussion of the judgment by the court *a quo* and the Court of Appeal respectively, see A N Oelofse ‘Developments in the Law of Letters of Credit’ *ABLU* 2002 (a paper delivered at the 2002 Annual Banking Law Update held at the Indaba Hotel, Johannesburg on 24 April 2002) (unpaginated) (hereinafter ‘*ABLU 2002*’) at 8–13; C Hugo ‘Documentary Credits and Independent Guarantees’ *ABLU* 2004 (a paper delivered at the 2004 Annual Banking Law Update held at the Indaba Hotel, Johannesburg on 21 April 2004) (unpaginated) (hereinafter ‘*ABLU 2004*’) at 10–16; and M Williams ‘Documentary Credits and Fraud: English and Chinese Law Compared’ (2004) *Journal of Business Law* 155 at 161–163). In *Mariteknik Shipbuilders (S) Pte Ltd v SNC Passion and Sarl Transport Maritime Brudey Frènes (The Passion)* (Claim No 2004 Folio 835 (Unreported, Commercial Court, 13 October 2004)), an unreported case in the United Kingdom, Gloster J granted an interim injunction where there were allegations that the underlying contract and the performance guarantee had been frustrated. As this was an interim injunction case, it was not reported and a reasoned judgment was also not given. Therefore, it is still unclear whether this would constitute exceptions to the autonomy principle in the English law. However, for a detailed discussion of this case by the barrister who represented the applicant in this case, see G Clark ‘Injuncting Calls on a Performance Guarantee in the Absence of Fraud: The Passion’ (2005) *Journal of International Banking Law and Regulation* 338. See also note 33 in Chapter 1; and notes 162 and 357 in Chapter 2.

existence, scope and application. Therefore, a further discussion of these possible exceptions falls beyond the scope of this thesis.

The idea in the documentary credit transaction/demand guarantee transaction is that if the documents presented are in line with the terms of the credit/guarantee, the bank has to pay, and if the documents do not correspond with the requirements, the bank must not pay.<sup>9</sup> That excludes situations where there is fraud or abuse of rights. Therefore, in principle, a breach of contract of the underlying contract will not affect the bank's obligation to pay, but if there is clear fraud the situation is quite different.<sup>10</sup> During the 1920s there were some cases showing the limits of a bank's duty to pay commercial letters of credit in such situations.<sup>11</sup> However, it was not until 1941 that a court in the United States gave a landmark judgment on this issue in *Sztejn v J Henry Schroder Banking Corporation*.<sup>12</sup> Later during the 1970s and 1980s the problem of fraudulent calls being made on demand guarantees and documentary credits increased. By that time, there were a number of cases in documentary credit transactions and demand guarantee transactions that indicated a reluctance, particularly on the part of English courts, to interfere with banks' payment obligations under a documentary credit, except under special conditions and maybe even greater reluctance in the case of demand guarantees.<sup>13</sup>

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<sup>9</sup> See C F Hugo *The Law Relating to Documentary Credits from a South African Perspective with Special Reference to the Legal Position of the Issuing and Confirming Banks* (published LLD, University of Stellenbosch (1996)) (1997) (hereinafter *Hugo: The Law Relating to Documentary Credits*) at 114; and *Lorne Stewart Plc v Hermes Kreditversicherungs AG* [2001] All ER (D) 286. The presentation of non-conforming documents is a valid defence available to a bank against the beneficiary for not paying a demand guarantee/letter of credit (for a full discussion, see para 2.11 in Chapter 2).

<sup>10</sup> The obligation of the bank to pay under a letter of credit/demand guarantee could also be compared to the payment obligation of an acceptor of a bill of exchange. For a full discussion of the position of an acceptor, see F R Malan and J T Pretorius (assisted by S F du Toit) *Malan on Bills of Exchange, Cheques and Promissory Notes* 4 ed (2002) in paras 143–149; and F R Malan *et al Provisional Sentence on Bills of Exchange, Cheques and Promissory Notes* (1986) at 139–145 (hereinafter 'Malan *et al*'); and cf section 52 of the Bills of Exchange Act 34 of 1964. Furthermore, section 72A of the Bills of Exchange Act 34 of 1964 indicates that the liability of a drawee bank that has certified a cheque on the instrument itself (i.e., a bank-guaranteed cheque) is similar to that of an acceptor of a bill of exchange (for a full discussion, see Malan and Pretorius *op cit* note 10 in para 196). Therefore, the position of the bank (issuing/guarantor of a letter of credit/demand guarantee) could also be equated with the position of a bank that has guaranteed a cheque. This means that decisions where the fraud exception has been raised against the payment obligation of the acceptor of a bill of exchange or bank of a bank-guaranteed cheque can also be of assistance in similar cases dealing with demand guarantees or letters of credit (see also Malan and Pretorius *op cit* in para 143 at 225).

<sup>11</sup> See *Societe Metallurgique D'aubrives and Villerupt v British Bank for Foreign Trade* (1922) 11 Lloyd's L Rep 168 (KB); *Maurice O'Meara Co v National Park Bank of New York* 146 NE 636 (NYCA 1925) (239 NY 386 (CA 1925)); and *Old Colony Trust Co v Lawyers' Title and Trust Co* 297 F 152 (1924). See also L Gorton 'Draft UNCITRAL Convention on independent guarantees' (May 1997) *Journal of Business Law* 240 at 248.

<sup>12</sup> 31 NYS 2d 631 (Supreme Court, Special Term, New York County (1941)). See the full discussion in para 5.3.3 below.

<sup>13</sup> See for instance, *Edward Owen Engineering Ltd v Barclays Bank International Ltd and Another* [1978] 1 QB 159 (CA); *United City Merchants (Investments) Ltd and Glass Fibres and Equipments Ltd v Royal Bank of Canada (incorporated in Canada), Vitrorefuerzos SA and Banco Continental SA* [1983] AC 168 (HL) ([1982] 2 Lloyd's Rep 1 (HL)); and *R D Harbottle (Mercantile) Ltd v National Westminster Bank Ltd and Others* [1978] 1 QB 146 (CA). See also Gorton *op cit* note 11 at 248. For a full discussion of the cases that featured during the 1970s and 1980s, see paras 5.3.4, 5.4.1, 5.5.2.1, and 5.6.1 below.

The fraud exception to the doctrine of the autonomy of the letter of credit/demand guarantee and also to the doctrine of strict compliance – which includes the principle that the bank deals purely with documents – is well established and recognised.<sup>14</sup> Fraud is certainly the most proclaimed exception to the autonomy principle and the absolute detachment of demand guarantees and documentary credits from their underlying contracts.<sup>15</sup> Although fraud is dutifully acknowledged as an exception, it will be seen from the discussion below that it remains elusive to the point of being in practice illusory, save in the most exceptional circumstances. In fact, the defence of fraud has been pleaded successfully in England in only a very small minority of cases.<sup>16</sup> English courts have traditionally adopted a non-interventionist approach that seeks to uphold the sanctity of the principle of autonomy of demand guarantees and to maintain commercial certainty.<sup>17</sup> Through the years a large volume of case law concerning the issue of fraud has appeared.<sup>18</sup> Legal writing on this topic has also increased dramatically.<sup>19</sup> It will be seen from the discussion in this chapter and the following chapters that, in practice, fraud is virtually the only defence available when one seeks to escape payment under a demand guarantee.

During the Iranian revolution in 1979, and because of the resulting political conflict that arose between Iran and the United States, there were considerable fraudulent callings of standby letters of credit by Iranian and other beneficiaries, especially those that were issued by American banks for the account of American exporters ('Iranian cases').<sup>20</sup> These calls came about possibly for political reasons unconnected with default in the underlying contracts. Principals (applicants) litigated, often unsuccessfully, in attempts to prevent the banks from making payment.<sup>21</sup> The attitude of the courts generally was to enforce the

<sup>14</sup> See Van Niekerk and Schulze *op cit* note 2 at 313; and J F Dolan 'Tethering the Fraud Inquiry in Letter of Credit Law' (2006) 21 *Banking and Finance Law Review* 479 at 480 and 485. A detailed discussion of all the different 'types' of fraud that could possibly be committed would far exceed the parameters of this thesis, and therefore, fraud in a more general sense is dealt with here. However, for a full discussion of some of the possible types of fraud that could be committed, see R Bertrams *Bank Guarantees in International Trade: The Law and Practice of Independent (First Demand) Guarantees and Standby Letters of Credit in Civil Law and Common Law Jurisdictions* 3 ed (2004) at 335–393.

<sup>15</sup> See E Eitelberg 'Autonomy of Documentary Credit Undertakings in South African Law' (2002) 119 *South African Law Journal* 120 at 126.

<sup>16</sup> See H N Bennett 'Performance bonds and the principle of autonomy' (1994) *Journal of Business Law* 574 at 581–582; and I Ndekugri 'Performance Bonds and Guarantees: Construction Owners and Professionals Beware' (November/December 1999) 125 *Journal of Construction Engineering and Management* 428 at 433. See also *Themehelp Ltd v West and Others* [1996] QB 84 (CA) ([1995] All ER 215 (CA) and [1995] 3 WLR 751 (CA)); and *Kvaerner John Brown v Midlands Bank Plc* [1998] CLC 446.

<sup>17</sup> See also, Enonchong *op cit* note 8 at 85.

<sup>18</sup> There are numerous cases dealing with fraud as an exception to the autonomy principle and, because it would nearly be impossible to discuss and refer to all of them here, reference has been made only to the most important decisions in this regard in the English, American and South African jurisdictions.

<sup>19</sup> Owing to the vast number of articles and books published on this topic, it is impossible to refer to all of them here. Where appropriate, I have selectively referred to some of them in this chapter and in other chapters (e.g., Chapter 7).

<sup>20</sup> See B V McCullough *Letters of Credit* (loose-leaf edition) (1987–) at 5-2. For a full list of the American cases, see H A Getz 'Enjoining the International Standby Letter of Credit: The Iranian Letter of Credit Cases' (1980) 21 *Harvard International Law Journal* 189 at 248–252. See also the discussion of the Iranian revolution and the Iranian cases in paras 5.5.2.1 and 5.5.4.3 below; and para 7.3 in Chapter 7.

<sup>21</sup> See F De Ly 'The UN Convention on Independent Guarantees and Stand-by Letters of Credit' (Fall 1999) 33 *International Lawyer* 831 at 833. See also the discussion in paras 5.5.2.1, 5.5.4.3, and 5.5.6 below; and para 7.3 in Chapter 7.



instruments in accordance with their terms.<sup>22</sup> Although the law of bank demand guarantees and standby letters of credit was strongly tested during the Iranian litigation of the 1980s, its foundations remained generally intact, and bank demand guarantees and standby letters of credit managed to survive relatively well.<sup>23</sup>

The question of fraud arises if a defence against payment is made which is usually based on grounds derived from the underlying transaction. Case law and legal writing sometimes treat non-compliance with the terms and conditions of the demand guarantee as an exception to the bank's payment obligation on the same footing as fraud. This is confusing, as well as incorrect, since this defence is solely and directly based on the terms of the guarantee itself with the result that the payment obligation does not materialise. Non-compliance with the terms of the demand guarantee has nothing to do with fraud.<sup>24</sup>

From the discussion below, it is clear that the most common type of fraud in letter of credit transactions is where the beneficiary has forged or deliberately falsified the documents so as to comply with the requirements of the letter of credit, while the goods in reality do not conform to their description. It is common cause that the beneficiary should not receive payment on the basis of forged or falsified documents.<sup>25</sup> Owing to the fact that demand guarantees often require only that a written demand for payment be made, without submitting any other additional documents, this type of fraud does not often occur in practice in relation to demand guarantees.

It has been said that where one deals with the fraud exception, one should distinguish between fraud committed by the beneficiary on the documents ('fraud in the narrow sense') and fraud committed by the beneficiary which does not relate to documents, for example, by intentionally dispatching goods of an inferior quality ('fraud in the wide sense').<sup>26</sup>

For the purposes of the fraud exception, cases relating to demand guarantees have been treated by the English and other courts as involving the same principles as commercial letters of credit.<sup>27</sup> When dealing with the concept of fraud, the courts in South Africa, like the English courts, do not distinguish between commercial letters of credit, standby letters of credit or demand guarantees. However, it will be seen from the discussion below that compared with commercial letters of credit, fraud in the form of forged or fraudulent documents is of minor significance to demand guarantees.

The question of fraud can arise in different scenarios. In most cases (and the scenario relevant for purposes of this thesis) the principal raises the defence in proceedings in which

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<sup>22</sup> See R Perrignon 'Performance Bonds and Standby Letters of Credit: The Australian Experience' (1991) *Journal of Banking and Finance Law and Practice* 157 at 161.

<sup>23</sup> See De Ly *op cit* note 21 at 833.

<sup>24</sup> See Bertrams *op cit* note 14 at 336. The presentation of non-conforming documents is a valid defence available to a bank against the beneficiary and this defence is fully discussed in para 2.11 in Chapter 2.

<sup>25</sup> See Van Niekerk and Schulze *op cit* note 2 at 313.

<sup>26</sup> *Idem.*

<sup>27</sup> See R Jack, A Malek and D Quest *Documentary Credits: The Law and Practice of Documentary Credits including Standby Credits and Demand Guarantees* 3 ed (2001) (hereinafter 'Jack') in para 9.5 at 259; and see also D Warne and N Elliott *Banking Litigation* 2 ed (2005) at 285.

he applies for an injunction (interdict under the South African law)<sup>28</sup> against the bank restraining it from effecting payment, and/or applies for an injunction against the beneficiary (and/or other bank, in the case of indirect demand guarantees) restraining him (them) from calling on the (counter-) guarantee. Both types of preventative actions will be referred to as applications for restraining or stop payment orders. These applications are made in proceedings known as provisional, interim, preliminary or interlocutory proceedings. Therefore, should the principal hear that the beneficiary intends to make a fraudulent call on a demand guarantee, an interlocutory injunction (i.e., an interim interdict) may be sought either against the guarantor (i.e., bank) preventing payment,<sup>29</sup> and/or against the beneficiary preventing the making of a demand on the guarantor.<sup>30</sup> Another means of preventing payment is the application of the United Kingdom freezing order (previously known as the *Mareva* injunction) or the South African anti-dissipation interdict (i.e., the South African equivalent of the United Kingdom freezing order). Attempts to secure injunctions through full-length main proceedings are often futile, since payment will already have been effected by the time a favourable judgment might be rendered.<sup>31</sup>

The principal could also raise the defence of fraud after payment by the bank when the bank claims reimbursement or when the principal seeks to undo the debiting of his account by the bank.<sup>32</sup> However, this strategy is rarely pursued and therefore a further discussion of this issue will not be relevant for purposes of this thesis. The aim here is to discuss fraud as a ground upon which payment of the demand guarantee may be restrained.<sup>33</sup>

The defence of fraud can also arise where the guarantor (i.e., bank) of a demand guarantee refuses to pay a beneficiary based on fraud on part of the beneficiary and the beneficiary then takes legal action against the guarantor (e.g., seeks summary judgment against the guarantor).<sup>34</sup> In these cases, the high standard of proof that applies to the fraud exception to

<sup>28</sup> See Van Niekerk and Schulze *op cit* note 2 at 313.

<sup>29</sup> Where the forgery or falsification appears from the face of the documents, the bank is entitled to refuse payment even without a court interdict (see Van Niekerk and Schulze *op cit* note 2 at 313).

<sup>30</sup> See Bennett *op cit* note 16 at 581–582; and W G Schulze ‘Attachment *Ad Fundandam Jurisdictionem* of the Rights Under a Documentary Letter of Credit – Some Questions Answered, Some Questions Raised’ (2000) 63 *Tydskrif vir Hedendaagse Romeins-Hollandse Reg* 672 at 677.

<sup>31</sup> See Bertrams *op cit* note 14 at 336. For a full discussion of injunctions/interdicts, see Chapter 7.

<sup>32</sup> For a discussion of this and the relationship between the applicant/principal and the issuing bank, see Van Niekerk and Schulze *op cit* note 2 at 296–299, and 313.

<sup>33</sup> The scope of the thesis does not entail a discussion of the issues relating to the relationship, including the reimbursement agreement, between the principal and the bank (guarantor).

<sup>34</sup> See, e.g., *Society of Lloyd’s v Canadian Imperial Bank of Commerce* [1993] 2 Lloyd’s Rep 579 (QB) (Com Ct) (and for a discussion hereof, see C F Hugo ‘Letters of Credit: Reflections on Recent Developments *ABLU* 1994 (a paper delivered at the 1994 Annual Banking Law Update held at the Indaba Hotel, Johannesburg) (unpaginated) (hereinafter ‘*ABLU 1994*’) at 2–3 of his article). More recent cases include, for example, *Balfour Beatty Civil Engineering and Another v Technical and General Guarantee Co Ltd* (2000) 68 Con LR 180 ([2000] CLC 252; and [2000] CILL 1574); *Safa Ltd v Banque du Caire* [2000] 2 Lloyd’s Rep 600 (CA) (for a discussion, see A N Oelofse ‘Developments in the Law of Letters of Credit’ *ABLU* 2001 (a paper delivered at the 2001 Annual Banking Law Update held at the Indaba Hotel, Johannesburg on 25 April 2001) (unpaginated) (hereinafter ‘*ABLU 2001*’) at 14–16 of his article); *Solo Industries UK Ltd v Canara Bank* [2001] 2 Lloyd’s Rep 578 (CA) ([2001] 1 WLR 1800 (CA)); and *Standard Bank (London) Ltd v Canara Bank* [2002] All ER (D) 340 (May) ([2002] EWHC 1032 (Comm) (QB)). In all four these recent cases the beneficiary was seeking summary judgment against the bank for its refusal to pay in the face of a compliant demand. The circumstances were strange in that in each case it was the bank itself, not its

the principle of autonomy when a principal tries to prevent payment<sup>35</sup> apparently does not apply and all that a bank needs to show is a reasonable or real prospect of establishing fraud in order, for example, to avoid summary judgment.<sup>36</sup>

Furthermore, the issue of fraud can also arise in cases where banks have claimed damages from the parties concerned (other than the applicant/principal) after they have made payments against fraudulent documents (i.e., document containing a misrepresentation) concerning a letter of credit<sup>37</sup> or demand guarantee. Lastly, the issue of fraud can also arise in cases where the applicant/principal tries to recover damages from the beneficiary after

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customer, which argued it was not obliged to pay. Usually, it is in the bank's interest to pay against a compliant demand, because its reputation as a issuer of letter of credit and demand guarantee is at stake and it has a secured right to be indemnified by its customer (i.e., applicant/principal) if it does so. However, in three of these cases, the bank did not have adequate security and stood to bear significant losses if it had paid the beneficiary (see Clark *op cit* note 1 in para 53 at 18). *5 East 59th Street Holding Co v Farmers and Merchants Bank of Eatonton Ga* 816 NYS 2d 68 (NY App Div 2006), is a recent US case, where the beneficiary of a standby letter of credit sued the issuing bank when it had dishonoured the letter of credit, and where the bank then raised the fraud defence. However, in this case the defence of fraud failed (for a summary of this case, see J E Byrne and C S Byrnes (eds) *2007 Annual Survey of Letter of Credit Law and Practice* (2007) (hereinafter '2007 Annual Survey') at 128–129). See also the following US cases: *Western Surety Co v Bank of Southern Oregon* 257 F 3d 933 (9th Cir 2001) (44 UCC Rep Serv 2d (West) 1239 (9th Cir 2001)) (see the discussion of this case in para 5.5.4.4 below); and *Pacific Gas and Electric Co v Banca Nazionale Del Lavoro* No 604225 (NY Sup Ct 7 May 2003) *aff'd* No 3869, 3869A, 2004 NY App Div LEXIS 7951 (NY App Div 10 June 2004).

<sup>35</sup> See the discussion in paras 5.4.3, 5.5.4, and 5.6.3 below.

<sup>36</sup> See, e.g., *Solo Industries UK Ltd v Canara Bank* [2001] 2 Lloyd's Rep 578 (CA) ([2001] 1 WLR 1800 (CA)) (for a full discussion, see *ABLU 2002 op cit* note 8 at 15–17 of the article). However, a contrary view was held by Arden LJ in *Banque Saudi Fransi v Lear Siegler Services Inc* [2007] 2 Lloyd's Rep 47 (CA) (for a full discussion, see C Hugo 'Documentary Credits and Independent Guarantees' *ABLU 2008* (a paper delivered at the 2008 Annual Banking Law Update held at the Indaba Hotel, Johannesburg on 23 April 2008) (hereinafter '*ABLU 2008*') 94 at 94–98). In this case she found that when a bank raises the defence of fraud for not paying under a demand guarantee (performance bond) and is later sued for summary judgment under the guarantee (performance bond), the bank, in order successfully to avoid judgment against it, not only has to comply with the test set out in CPR (Civil Procedural Rule) 24.2, but also has to meet the test set out in *United Trading Corporation SA and Murray Clayton Ltd v Allied Arab Bank Ltd and Others* [1985] 2 Lloyd's Rep 554 (CA) At 561 (i.e., that the only realistic inference was that the demand was fraudulent) (see the full discussion of this test in para 5.4.3 below). Arden LJ, also stated that a different test applied when the case involved a claim under a counter-guarantee (in this case the counter-guarantee was given as security for reimbursement of the bank) than when the claim involved a case where a bank was sued for summary judgment on a demand guarantee that the bank had issued. In her view a less stringent test may apply in the counter-guarantee situation. Hugo is reluctant to accept such different tests. He correctly states that once it is clear that one is dealing with an autonomous instrument of payment or guarantee and the fraud exception to the principle of independence arises, the standard of proof or threshold test should not depend on whether the autonomous instrument is a counter guarantee or a demand guarantee/letter of credit (see *ABLU 2008 op cit* note 36 at 99).

<sup>37</sup> See, e.g., *Standard Chartered Bank v Pakistan National Shipping Corporation and Others* [1998] 1 Lloyd's Rep 684; [1999] 1 Lloyd's Rep 747; and [2000] 1 Lloyd's Rep 218 (CA) (for a discussion of these judgments, see A N Oelofse 'Developments in the Law of Documentary Letters of Credit' *ABLU 2000* (a paper delivered at the 2000 Annual Banking Law Update held at the Indaba Hotel, Johannesburg) (unpaginated) (hereinafter '*ABLU 2000*') at 10–14 of his article; and *ABLU 2001 op cit* note 34 at 1–6 of the article); *KBC Bank v Industrial Steels (UK) Ltd* [2001] All ER (Comm) 409 (for a discussion of it, see *ABLU 2002 op cit* note 8 at 14–15 of the article); and *Komerčni Banka AS v Stone and Rolls Ltd and Another* [2003] 1 Lloyd's Rep 383 (QB (Com Ct)) (for a full discussion, see *ABLU 2004 op cit* note 8 at 16–22 of the article).

the bank has paid against, for example, fraudulent documents.<sup>38</sup> A further discussion of fraud in these type of instances also falls beyond the scope of the thesis.

Most, if not all, jurisdictions acknowledge the principle that fraud by the beneficiary constitutes a defence against payment, despite formal compliance with the terms and conditions of the guarantee, and that it may be a basis for injunctive relief for the principal. The major issue though is to define what kind of facts and what kind of conduct in which circumstances render a demand for payment fraudulent such as to justify judicial intervention.<sup>39</sup> From the discussion below it will be seen that the ambit of the fraud exception and the ensuing consequences for the beneficiary and/or the banks (guarantors) may differ from one local jurisdiction to another. In the end it is up to domestic courts to protect the interests of all *bona fide* parties concerned fairly. It is basically domestic law that governs fraud in demand guarantee, standby letter of credit and commercial letter of credit transactions.

This chapter provides an overview of the fraud exception to the autonomy principle as it applies to demand guarantees. It is concerned with the concept of fraud on the part of the beneficiary, the standard of proof that is required and, more specifically, with the substantive elements and the aspects of evidence of fraud as they have emerged in case law and legal writing in the United Kingdom, the United States and South Africa. Specific attention is also given to the questions of whether fraud is to be determined by having regard to the underlying relationship (i.e., fraud in the underlying contract ('fraud in the wide sense')) or whether it is to be restricted to fraudulent acts within the confines of the contract of guarantee (i.e., fraud in the documents ('fraud in the narrow sense')). This chapter does not attempt to deal with all issues pertaining to the fraud exception.<sup>40</sup> For instance, it does not deal with the position where certain parties (e.g., holder in due course of a bill of exchange) may be protected (i.e., immune) from the fraud exception.<sup>41</sup> This issue is not dealt with here, as this is an issue that is more relevant to commercial letters of credit than to demand guarantees, particularly because bills of exchange are not usually presented with a demand for payment under a demand guarantee.

Furthermore, as the fraud rule can be applied only when fraud is found to have been committed, the main issue that a court handling a case of demand guarantee fraud therefore has to determine is whether or not fraud has actually been committed. In determining this, the court must firstly answer the following question: 'what kind of fraud can invoke the

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<sup>38</sup> See, e.g., *Hyosung America Inc v Sumagh Textile Co Ltd* 25 F Supp 2d 376 (SDNY 1998) (for a full discussion, see *ABLU 2000 op cit* note 37 at 9–10 of the article).

<sup>39</sup> See *Bertrams op cit* note 14 at 353.

<sup>40</sup> For a comprehensive discussion of the fraud rule in relation to commercial letters of credit (and a limited discussion regarding the fraud rule and demand guarantees) in the United Kingdom, United States, Canada, Australia, China and the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit (1996) (hereinafter 'the Convention' or 'the UNCITRAL Convention'), see Xiang Gao *The Fraud Rule in the Law of Letters of Credit: A Comparative Study* (2002); and Xiang Gao and R P Buckley 'A Comparative Analysis of the Standard of Fraud Required under the Fraud Rule in Letter of Credit Law' (2003) *Journal of Comparative and International Law* 293. Xiang Gao *The Fraud Rule in the Law of Letters of Credit: A Comparative Study* (2002) is currently the most comprehensive work dealing exclusively with the fraud exception. No other work deals with the fraud exception in such depth, therefore this thesis contains various references to this specific work.

<sup>41</sup> For a full discussion of presenters that will be immune from the fraud rule, see Xiang Gao *The Fraud Rule in the Law of Letters of Credit: A Comparative Study* (2002) at 137–165.

fraud rule or, put differently, what does fraud mean under the fraud rule in the law governing demand guarantees?<sup>42</sup> In other words, what is the standard of proof in the case of fraud? This chapter will also investigate how these questions have been answered and dealt with in the chosen jurisdictions.<sup>43</sup>

## 5.2 MEANING OF AND RATIONALE FOR THE FRAUD EXCEPTION

It has been said that, in general, the fraud rule in the law governing letters of credit (and by implication also demand guarantees) was a developing area, and it was still not possible to state some of the aspects of the law with certainty.<sup>44</sup>

In accordance with current law and practice, the fraud rule may be summarised as a rule under which, although documents/demands presented are on their face in strict compliance with the terms and conditions of the letter of credit/demand guarantee, payment thereunder may be stopped if fraud is found to have been committed in the transaction before payment is made, provided that the presenter or party demanding payment does not belong to a protected class.<sup>45</sup>

The fraud rule is an extraordinary rule, because it represents a departure from the cardinal principle of autonomy regarding letters of credit and demand guarantees. It allows the issuer/guarantor (i.e., the bank) or a court to view the facts behind the face of the conforming documents and to disrupt the payment of a letter of credit/guarantee when fraud is seen to be involved in the transaction. For purposes of establishing fraud, the court may, contrary to the general principle, take into account extraneous evidence, that is, evidence apart from the terms of the credit and the contents of the documents themselves. It has even been said that the fraud rule is the ‘most controversial and confused area’<sup>46</sup> in the law governing letters of credit, mainly because the standard of fraud is so hard to define.<sup>47</sup>

There seem to be at least three reasons why it is necessary to have this controversial fraud rule: (1) to close a loophole in the law; (2) to protect public policy for the control of fraud; and (3) to maintain the commercial utility of letters of credit (and by implication also demand guarantees).<sup>48</sup>

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<sup>42</sup> See Xiang Gao *op cit* note 41 at 65.

<sup>43</sup> Chapter 7 deals with preventative restraining orders (interim injunctions/interdicts) against the bank and/or beneficiary, and *Mareva*-type injunctions (freezing orders) and anti-dissipation interdicts, where the matter relates to a fraudulent call being made.

<sup>44</sup> See Xiang Gao *op cit* note 41 at 29; and *Jack op cit* note 27 in para 9.1 at 257.

<sup>45</sup> See *Jack op cit* note 27 in para 9.3 at 258; and Xiang Gao *op cit* note 41 at 29.

<sup>46</sup> See Anon ‘“Fraud in the Transaction”: Enjoining Letters of Credit during the Iranian Revolution’ (1980) 93 *Harvard Law Review* 992.

<sup>47</sup> See Xiang Gao *op cit* note 41 at 29 and 98; and *Jack op cit* note 27 in para 9.3 at 258.

<sup>48</sup> See Xiang Gao *op cit* note 41 at 30. Although Xiang Gao specifically discussed the rationale for the development of the fraud rule in the use of letters of credit, the same rationale also applies to the fraud rule as used in relation to demand guarantees. As already mentioned, this is so, because courts in England and United States, for purposes of the fraud exception, have treated cases dealing with demand guarantees as having the same principles as commercial letters of credit. Therefore, when dealing with the concept of fraud, these courts do not distinguish between commercial letters of credit, standby letters of credit or demand

### 5.2.1 Closing a Loophole in the Law Relating to Letters of Credit and Demand Guarantees

In terms of the principle of autonomy in relation to letters of credit/demand guarantees, all parties under a credit/guarantee transaction are dealing in documents, not goods or services to which the documents relate.<sup>49</sup> If documents/demands tendered/presented appear on their face to be in strict compliance with the terms and conditions stipulated in the credit/guarantee, the issuer/guarantor will make the payment, irrespective of any disputes or claims regarding other related transactions. The issuer/guarantor is entitled to make payment with full recourse against the applicant/principal, even if the document received turns out to be a forgery or includes fraudulent statements. The issuer's/guarantor's only duty is to exercise reasonable care to ensure that the documents tendered on their face comply with the terms and conditions of the credit/guarantee.<sup>50</sup> This doctrine generally serves commerce well, and facilitates the commercial utility of letters of credit and demand guarantees.<sup>51</sup>

However, it has been said that the principle of autonomy may in some instances produce harsh results, which can be counterproductive to the original purpose of the principle. This happens when there is fraud involved in the transaction. Owing to the documentary nature of letters of credit and demand guarantees, beneficiaries demanding payment under these instruments do not have to show that they have properly performed their duties in the underlying contracts; all they have to do is to produce documents that conform on their face. The separation of the documents from the actual performance of the underlying contract creates a loophole in law for those unscrupulous beneficiaries to abuse the system. This allows beneficiaries to run away with others' money by presenting forged or fraudulent documents or making fraudulent demands. If the fraud rule is applied, the loophole in the letter of credit and demand guarantee system is shrunk. The fraud rule will not prevent every injustice that fraud can cause, but its effects are at least minimised.<sup>52</sup>

### 5.2.2 Public Policy for the Control of Fraud

Developing the fraud rule not only closes the loophole in the law of letters of credit and demand guarantees, but also fills a public policy requirement.<sup>53</sup> It has been said that fraud is wrong and should be prevented. The rationale for the fraud exception appears to lie in the notion that an unscrupulous beneficiary should not be able to rely on the principle of the independence of the letter of credit/demand guarantee to obtain payment notwithstanding its own forgery or falsification.<sup>54</sup> Lord Diplock in *United City Merchants*

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guarantees. As the focus of this thesis is on demand guarantees, I have adapted Xiang Gao's rationale to also refer to demand guarantees.

<sup>49</sup> See also para 2.5.2.4 in Chapter 2 for a discussion of the documentary nature of demand guarantees and letters of credit.

<sup>50</sup> For a full discussion hereof see paras 2.5.2.6 and 2.5.2.7 in Chapter 2.

<sup>51</sup> See Xiang Gao *op cit* note 41 at 30.

<sup>52</sup> *Idem*.

<sup>53</sup> See M S Kurkela *Letters of Credit and Bank Guarantees Under International Trade Law* 2 ed (2008) at 181.

<sup>54</sup> See Van Niekerk and Schulze *op cit* note 2 at 314. See also N Enonchong 'The Autonomy Principle of Letters of Credit: An Illegality Exception?' (2006) *Lloyd's Maritime and Commercial Law Quarterly* 404 at 405.

*v Royal Bank of Canada*<sup>55</sup> stated that the basis for the exception is that the courts will not allow their process to be used by a dishonest person to carry out a fraud, relying on the doctrine *ex turpi causa non oritur*. It is settled law in England, the United States and South Africa that established fraud is an exception to the autonomy principle of letters of credit and demand guarantees, and that ‘fraud unravels all’.<sup>56</sup> Judge Edenfield in *Dynamics Corporation of America v The Citizens and Southern National Bank*<sup>57</sup> stated: ‘There is as much public interest in discouraging fraud as in encouraging the use of letters of credit.’ Therefore, the fraud rule is part of a sound legal system that upholds the public policy of limiting fraud.<sup>58</sup>

### 5.2.3 Maintaining the Utility of Letters of Credit and Demand Guarantees

Fraud in the letter of credit not only conflicts with the public policy against fraud, but also poses ‘an equally serious potential threat to the commercial utility of letters of credit’.<sup>59</sup> The same also holds to true for fraud in demand guarantees. The popularity of the letter of credit lies in the fact that it can provide a fair balance of competing interest among the parties involved. The normal operation of the letter of credit not only provides the beneficiary with safe and speedy access to the purchase price or a sum of money, but also provides the applicant with credit and/or other commercial benefits. For example, it protects the applicant against inappropriate calls on the credit by requiring the beneficiary to present documents indicating that he has properly performed his obligations under the underlying transactions and, more importantly, assists the applicant with realising his commercial goal.<sup>60</sup>

The demand guarantee, contrary to a commercial letter of credit, will only be used if a risk occurs that is to be covered by that guarantee, for instance, if the goods are not delivered in time. The parties do not expect that such a risk will materialise and the principal that furnishes the guarantee hopes that it will never be used. Therefore, payment on a demand guarantee is the exception rather than the rule. The principal is primarily responsible for the performance to which the demand guarantee refers, and the agreement between the principal and the beneficiary requires, expressly or by implication, that the beneficiary resorts to the bank only if the principal defaults. Therefore, if the beneficiary is allowed to call on the demand guarantee fraudulently, despite the fact that the principal has not committed a breach of the underlying contract, it will hurt the principal. It could also damage the interest of the guarantor, because if it pays under such circumstances the

<sup>55</sup> 1983] AC 168 (HL) ([1982] 2 Lloyd’s Rep 1 (HL)).

<sup>56</sup> See *United City Merchants v Royal Bank of Canada* [1983] AC 168 (HL) ([1982] 2 Lloyd’s Rep 1 (HL)) as per Lord Diplock at 184A. The leading case on the fraud exception in England is *United City Merchants v Royal Bank of Canada* [1983] AC 168 (HL) ([1982] 2 Lloyd’s Rep 1 (HL)) (see the discussion of this case in paras 5.4.1 and 5.4.2 below) which was based on the ground-breaking American case, *Sztejn v J Henry Schroder Banking Corporation* 31 NYS 2d 631 (1941) (see the discussion of this case in para 5.3.3 below). See also N Enonchong *op cit* note 54 at 405; Kurkela *op cit* note 53 at 173; Jack *op cit* note 27 in para 9.5 at 259; and Dolan: *The Law of Letters of Credit op cit* note 1 in para 7.03[1] at 7-6. See also the full discussion in paras 5.4, 5.5, and 5.6 below.

<sup>57</sup> 356 F Supp 991 (ND Ga 1973) at 1000.

<sup>58</sup> See Xiang Gao *op cit* note 41 at 30–31; and Jack *op cit* note 27 in para 9.12 at 265.

<sup>59</sup> See G W L Smith ‘Irrevocable Letters of Credit and Third Party Fraud: The American Accord’ (1983) 24 *Virginia Journal of International Law* 55 at 96.

<sup>60</sup> See Xiang Gao *op cit* note 41 at 31.

principal could refuse to reimburse the guarantor for having paid under a fraudulent demand and this could then also lead to a lengthy and costly court battle.

If one party uses the loophole (as discussed above) in the letter of credit and demand guarantee system and defrauds other parties concerned by presenting forged or fraudulent documents (or by making a fraudulent demand in the case of a demand guarantee), it harms the interests of the other parties and undermines the balance assumed in the letter of credit and demand guarantee scheme. For example, in a commercial letter of credit transaction where the seller ships nothing, but gets paid by presenting fraudulent documents, it will hurt the applicant (i.e., the buyer). Although it is true that the applicant will be able to proceed against the seller based on fraud in the underlying contract, such a proposition is usually not attractive because the seller often absconds before the fraud or forgery is discovered. In such a case, the seller's fraudulent conduct may also damage the interest of the issuer (i.e., the bank). Banks often agree that they will issue the letter of credit on condition that the goods will serve as security for its honour of the letter of credit. If nothing is shipped, the issuer's security interest over the goods fails too.<sup>61</sup>

Like the success of any commercial instrument, the popularity of the letter of credit and demand guarantee is based on the faith of their users. If the possibility of the abuse of the letter of credit/demand guarantee system is not curtailed, or fraud can frequently be repeated without a proper remedy, faith in the system of letters of credit/demand guarantees will fade, as will the commercial utility of letters of credit/demand guarantees.<sup>62</sup>

With the fraud rule limiting fraudsters from abusing the letter of credit/demand guarantee system, honest credit/guarantee users will be more comfortable using it. Therefore, the fraud rule also helps to maintain the commercial utility of the letter of credit and demand guarantee.<sup>63</sup>

### 5.3 BRIEF HISTORICAL DEVELOPMENT OF THE FRAUD EXCEPTION

As the commercial letter of credit was used long before the fairly recently developed demand guarantee, it is to be expected that the fraud rule developed from the earliest cases involving letters of credit. For this reason, it is thus important also to refer to these early cases that dealt with the fraud rule in relation to letters of credit and played an important

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<sup>61</sup> See Xiang Gao *op cit* note 41 at 31–32.

<sup>62</sup> See Xiang Gao *op cit* note 41 at 32. Kozolchyk stated it as follows (see B Kozolchyk 'The Immunization of Fraudulently Procured Letter of Credit Acceptances: *All Services Exportacao, Importacao Comercio, S.A. v Banco Bamerindus Do Brazil, S.A. and First Commercial v Gotham Originals*' (1992) 58 *Brooklyn Law Review* 369 at 370):

The certainty of payment of a letter of credit is crucial for those who, as beneficiaries, supply their money, goods or services to applicants. The question thus arises: "Why not make the letter of credit draft or demand for payment injunction-proof?" Yet what about the applicant? To leave the applicant without a remedy against fraud would equally frustrate the applicant's expectations of the letter of credit. After all, why should a good faith applicant agree to procure the issuance of a letter of credit and reimburse the issuing bank if the letter of credit becomes an automatic and unstoppable vehicle for the perpetration of fraud? As is true with other commercial legal institutions, an approach that favors one party at the expense of the other undermines the viability of the institution.

<sup>63</sup> See Xiang Gao *op cit* note 41 at 32.



role in its development, before dealing with the rule's application in cases involving demand guarantees. Furthermore, as the English courts (and many other courts), for the purposes of the fraud exception, have treated cases relating to demand guarantees as involving the same principles as commercial letters of credit and standby letters of credit, a discussion of the relevant cases dealing with fraud and letters of credit is necessary in order to provide an comprehensive overview of the fraud rule in relation to demand guarantees.

### 5.3.1 The Earliest Cases

It seems to be difficult to trace the precise time when fraud became an issue in the law governing letters of credit.<sup>64</sup> However, 'the idea that fraud upsets the usual rules of credits is an old one'.<sup>65</sup> One of the first apparent cases that demonstrated that fraud has never been tolerated in the letter of credit system, was an English case decided in 1765, more than two hundred years ago. In *Pillans and Rose v Van Mierop and Hopkins*<sup>66</sup> one White, a merchant in Ireland, wanted to draw a bill upon Pillans and Rose, the plaintiffs, who were merchants in Holland, for a sum of money. Pillans and Rose indicated that they would accept the bill, provided that a respectable house in London issued a confirmed credit for their reimbursement. White named the house of Van Mierop and Hopkins, the defendants. White and the plaintiffs (Pillans and Rose) both wrote to the defendants (Van Mierop and Hopkins) asking whether they would agree to the arrangement, and the defendants indicated that they did. Later when the plaintiffs drew on the defendants to reimburse them for paying under the bill, they refused to honour the plaintiffs' bills, because White had subsequently become insolvent.<sup>67</sup>

During the trial, judgment was made in favour of the defendants, but the plaintiffs appealed. On appeal, the defendants first contended that their promise to the plaintiffs was a void undertaking as the consideration under the transaction was not appropriate.<sup>68</sup> Lord Mansfield rejected this argument based on the fact that the transaction was a commercial one.<sup>69</sup> However, Lord Mansfield at the same time stated that the defendants (i.e., Van Mierop and Hopkins) were bound by their letter of credit, but remarked that the defendants' dishonour could have been justified if fraud had been involved in the transaction.<sup>70</sup>

After Lord Mansfield had made his observation, the defendants further argued that White as well as the plaintiffs had fraudulently concealed certain facts from them.<sup>71</sup> Lord Mansfield, however, rejected this argument of the defendants, stating:<sup>72</sup>

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<sup>64</sup> *Idem*.

<sup>65</sup> See *Dolan: The Law of Letters of Credit op cit* note 1 in note 22 at 7–6 and the authorities referred to.

<sup>66</sup> (1765) 97 Eng Rep 1035 (3 BURR 1666). For a full discussion of this case, see Xiang Gao *op cit* note 41 at 33–34.

<sup>67</sup> See at 1035.

<sup>68</sup> See at 1035.

<sup>69</sup> See at 1038.

<sup>70</sup> At 1036.

<sup>71</sup> At 1037.

<sup>72</sup> At 1038.

If there was any kind of fraud in this transaction, the collusion and mala fides would have vacated the contract [the credit]. But from these letters, it seems to me clear, that there was none . . . Both the plaintiffs and White wrote to Van Mierop and Company. They answered “that they would honour the plaintiffs’ draughts.” So that the defendants assent to the proposal made by White, and ratify it. And it does not seem at all that the plaintiffs then doubted of White’s sufficiency, or meant to conceal any thing from the defendants.

In 1765 when the *Pillans* case was decided, the letter of credit was still in its developing stage. It was mainly litigated and decided upon the principles of the law of contract and the fraud rule was not explored in any detail. However, the case did convey one clear message, namely that fraudulent conduct was prohibited under the law of letters of credit; and fraudulent conduct could disrupt the normal operation of the letter of credit. The case also reflected that fraud has never been tolerated in the letter of credit system, and the seed of the fraud rule was planted during a period when letters of credit were at their infant stage.<sup>73</sup>

In 1919 in the United States the fraud rule in relation to letters of credit surfaced again. In *Higgins v Steinhardter*<sup>74</sup> a letter of credit was going to be used to pay for a shipment of walnuts that was to be shipped on or before 7 November 1918. The plaintiff (purchasers) applied for an injunction to restrain the beneficiaries (sellers) from collecting and John Monroe & Co, the issuer, from accepting and paying the draft (bill) drawn against the letter of credit in favour of the defendants (sellers), and for the cancellation of the credit, based on the fact that the beneficiaries had defaulted on the contract in that the goods were not shipped until December 1918. The plaintiffs also alleged that the beneficiaries had procured the bill of lading falsely, stating that the shipment was made on 30 October 1918 and the issuer, although notified of the said facts, had affirmed that upon presentation of drafts accompanied by facially conforming bills of lading it would accept and pay the same.<sup>75</sup>

The Supreme Court of New York County stated that it was clear that the plaintiff authorised a credit to apply only to a shipment made on or before 7 November 1918. Therefore, if the shipment was made after that date, a payment made against said credit would not be authorised and it would become an unused credit that had expired. Accordingly, the court granted the requested injunction.

The issuer, during litigation, argued that it might have become forced to pay the drafts drawn against the letter of credit in any event, because of the transfer of such drafts to third parties. However, the court did not accept the issuer’s contention. It confirmed that the plaintiffs had authorised payment only on account of a shipment made by a certain date. Therefore, if the defendant’s agent had accepted in proof of such shipment a bill of lading, which was, in fact, false as to the time of shipment, his conduct would be a proximate cause of any risk of loss by the issuance of drafts against the said credit.<sup>76</sup>

The *Higgins* case was litigated and decided at a time when letters of credit were developing into their modern form. It has been said that in this case the fact that the bill of

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<sup>73</sup> See Xiang Gao *op cit* note 41 at 33–34.

<sup>74</sup> 175 NYS 279 (1919). For a full discussion of this case, see Xiang Gao *op cit* note 41 at 34–35.

<sup>75</sup> See 175 NYS 279 (1919) at 280.

<sup>76</sup> See at 280.

lading was found to have been fraudulently predated could have become an obvious ground for the plaintiffs' pleadings and the court's application of the fraud rule under the present law of letters of credit, but the plaintiffs and the court both did not pursue the case in relation to the fraud rule.<sup>77</sup>

Even though the plaintiffs mentioned in their complaint that the bill of lading contained a false statement, it appears that they did so simply as a matter of fact, not as a cause of action, as their primary argument was that the beneficiaries had defaulted on the contract. They did not base their argument on the fraud committed. Although the factual ground for the court's decision was the beneficiaries' fraudulent statement in the bill of lading, it did not base its judgment on the fraud rule, but justified it on another legal basis, namely that payment against a bill of lading with a false statement would be 'unauthorised'. When the court discarded the issuer's contention that it might have to pay innocent third parties involved, it ignored one vital element of the present fraud rule – protecting innocent third parties.<sup>78</sup>

It has been pointed out that when *Higgins* was adjudicated it is clear that the fraud rule in the law of letters of credit was still in a very early stage of its development and parties to such transactions did not comprehend its relevance, and therefore any disputes were treated as a default under the contract.<sup>79</sup>

### 5.3.2 Fraud Cases in the 1920s

However, it was not until the 1920s that more and more English and American cases started to appear which dealt with the development of the fraud rule. These cases created the platform for the development of the fraud rule in the landmark case of *Sztejn v J Henry Schroder Banking Corporation*<sup>80</sup> in 1941. The first of these cases was *Societe Metallurgique D'aubrives and Villerupt v British Bank for Foreign Trade*,<sup>81</sup> decided in England in 1922. The plaintiffs (sellers) sold pig iron to a specific buyer and payment was to be made by way of an irrevocable letter of credit. The issuer (the defendant) of the letter of credit paid the price of the first batch. Later the buyer instructed the issuer (defendant) not to pay further on the presentation of documents, because the pig iron was not of the quality contracted for. The plaintiffs then brought an action for damages based on a breach of the contract against the issuer. In defence, the issuer argued that not only were the goods not up to the contracted quality, but the documents presented were also not in order.<sup>82</sup> Bailhache J of the King's Bench Division, however, rejected both these arguments and found in favour of the plaintiffs (sellers).<sup>83</sup> When Bailhache J considered the issue of quality of goods, he mentioned in *dicta* the issue of fraud and stated:<sup>84</sup>

<sup>77</sup> See Xiang Gao *op cit* note 41 at 34–35.

<sup>78</sup> See Xiang Gao *op cit* note 41 at 35.

<sup>79</sup> See Xiang Gao *op cit* note 41 at 35, note 18 in particular.

<sup>80</sup> 31 NYS 2d 631 (1941).

<sup>81</sup> (1922) 11 Lloyd's L Rep 168 (KB). For a full discussion of this case, see Xiang Gao *op cit* note 41 at 35–36.

<sup>82</sup> See (1922) 11 Lloyd's L Rep 168 (KB) at 168–169.

<sup>83</sup> See at 169–170.

<sup>84</sup> At 170.

But there was a good deal of evidence given as to the actual quality of the iron, and in any action against a bank for failure to honour credit for goods which are not in order the question of quality only comes in on one or other of two ways. First of all, did the person presenting misdescribe the goods in such a way as to be guilty of fraud. If that were so, then the bank in refusing to pay would be justified. But nothing of that sort is suggested in this case.

The *Societe Metallurgique* case was different from the *Higgins*<sup>85</sup> case, in that fraud was neither alleged nor did it exist in that case. In *Societe Metallurgique* the dispute was whether or not the goods complied with the contracted quality and whether the documents that were presented under the credit were in order. Nevertheless, the statement made by Bailhache J (quoted above) suggests that the court might have been willing to step in and interfere with the payment of the letter of credit had it been found that fraud had been committed in the transaction. It basically confirmed the English position expressed in the *Pillans*<sup>86</sup> case. Unfortunately, the *Societe Metallurgique* case did little for the development of the fraud rule, as it did not indicate how it would have formulated its judgment if fraud had been found.<sup>87</sup>

Then during 1924 to 1925 two cases appeared in the United States that clearly indicted the possibility that fraud might disrupt the normal payment of a letter of credit. These cases also illustrated how underdeveloped the fraud rule was at the time of their adjudication. The first was *Old Colony Trust Co v Lawyers' Title and Trust Co*<sup>88</sup> and the second was *Maurice O'Meara Co v National Park Bank of New York*.<sup>89</sup>

In *Old Colony* the plaintiffs paid vast amounts to a sugar seller and as collateral security they received the letter of credit issued by the defendant. The letter of credit provided that drafts should be drawn only against 'net landed weights', prior to 30 November 1920, together with negotiable delivery orders or warehouse receipts. Net landed weight could be established only after the goods had been landed and weighed by customs officials to determine the duty payable on the importation, and warehouse receipts could only be issued once the goods were in the physical possession of the warehouseman. All of the shipments did not in fact clear until 3 December 1920 at the earliest. However, drafts, together with documents that complied on their face were presented for payment before the expiry date of the letter of credit. Accordingly, the defendant (issuer) refused to honour the drafts, because the documents did not comply with the provisions of the letter of credit. The plaintiffs instituted an action against the defendant for damages based on their breach of contract. The claim was rejected by the trial court, and affirmed on appeal by the Second Circuit Court of Appeals.

The Second Circuit Court of Appeals stated that as the invoice presented with the drafts contained a false statement that certain import duty was paid, there was in fact no compliance with the letter of credit. The court continued:<sup>90</sup>

<sup>85</sup> 175 NYS 279 (1919).

<sup>86</sup> (1765) 97 Eng Rep 1035 (3 BURR 1666).

<sup>87</sup> See Xiang Gao *op cit* note 41 at 36.

<sup>88</sup> 297 F 152 (1924). For a full discussion of this case, see Xiang Gao *op cit* note 41 at 36–37.

<sup>89</sup> 146 NE 636 (1925) (239 NY 386 (1925)).

<sup>90</sup> See 297 F 152 (1924) at 156–158.

The invoice . . . presented with the drafts each stated so many lbs. “. . . weights duty paid New York.”

As this statement was false, there was failure of compliance with the letter of credit . . .

Obviously, when the issuer of a letter of credit knows that a document, although correct in form, is, in point of fact, false or illegal, he cannot be called upon to recognise such a document as complying with the terms of a letter of credit.

It is apparent that the *Old Colony* case is similar to the *Higgins* case in many respects. Both cases involved a fraudulent document, all plaintiffs litigated on the grounds of breach of contract and both courts also indicated that courts would allow an interruption of payment under letters of credit because of fraud. Furthermore, neither of the courts used the fraud rule as an independent weapon for fighting fraud, thereby illustrating that the fraud rule was not fully developed yet. However, there is one vital difference between the reasoning of the two courts. The court in *Higgins* argued that payment against a fraudulent bill of lading would be ‘unauthorised’, whereas the court in *Old Colony* based its decision on the ground that fraudulent documents could not be considered as complying documents.<sup>91</sup>

In *Maurice O’Meara Co v National Park Bank of New York*,<sup>92</sup> the other United States case, the underlying contract was for the sale of newsprint paper of a particular tensile strength. When the beneficiary (the plaintiff) presented documents that complied on their face and required payment against the letter of credit, the defendant bank (the issuing bank) refused to pay the drafts, stating that a reasonable doubt had arisen in relation to the quality of the paper. The beneficiary then brought an action against the issuing bank for damages it had incurred. In defending the action, the issuing bank alleged that it had not paid because the paper was not of the quality that was contracted for.

The Court of Appeals of New York rejected the issuing bank’s allegations and found in favour of the beneficiary. In delivering its majority judgment, the court stated that the bank was concerned only with the drafts and the documents accompanying them. If the drafts, when presented, were accompanied by the proper documents, then the bank was absolutely bound to make the payment under the letter of credit irrespective of whether it knew, or had reason to believe, that the paper was not of the tensile strength contracted for. To hold otherwise, the court said, was to read into the letter of credit something that was not there, and this the court should not do, because it would impose upon a bank a duty which in many cases would defeat the primary purpose of a letter of credit.<sup>93</sup>

<sup>91</sup> See Xiang Gao *op cit* note 41 at 37.

<sup>92</sup> 146 NE 636 (1925) (239 NY 386 (1925)). For a discussion of the case, see Xiang Gao *op cit* note 41 at 37–39; Anon ‘Banks and Banking – Letters of Credit – Defences Available to Bank’ (1925) 25 *Columbia Law Review* 829; Anon ‘The Rights of the Seller Under a Documentary Letter of Credit’ (1925) 34 *Yale Law Journal* 775; and Anon ‘Banks and Banking – Letters of Credit – Issuing Bank’s Liability’ (1925) 9 *Minnesota Law Review* 657.

<sup>93</sup> 146 NE 636 (1925) at 639.

In the minority judgment, Cardozo J also affirmed the general rule that the issuing bank had no duty to investigate the performance of the underlying contract, but disagreed with the majority's view. He observed:<sup>94</sup>

I dissent from the view that, if it [the bank] chooses to investigate and discovers thereby that the merchandise tendered is not in truth the merchandise which the documents describe, it may be forced by the delinquent seller to make payment of the price irrespective of its knowledge. We are to bear in mind that this controversy is not one between the bank on the one side and on the other a holder of the drafts who has taken them without notice and for value. The controversy arises between the bank and a seller who has misrepresented the security upon which advances are demanded. Between parties so situated payment may be resisted if the documents are false.

I think we lose sight of the true nature of the transaction when we view the bank as acting upon the credit of its customer to the exclusion of all else. It acts not merely upon the credit of its customer, but upon the credit also of the merchandise which is to be tendered as security . . . I cannot accept the statement of the majority opinion that the bank was not concerned with any question as to the character of the paper. If that is so, the bales tendered might have been rags instead of paper, and still the bank would have been helpless, though it had knowledge of the truth, if the documents tendered by the seller were sufficient on their face.

The reasoning in the *Maurice O'Meara* case is much more sophisticated than the earlier cases (discussed above). Its effect is also more significant for the development of the fraud rule. The minority judgment is important because Cardozo J was not only of the view that 'payment may be resisted if the documents are false' under a letter of credit transaction, but he was also concerned with the interest of an innocent third party, or 'a holder of the drafts who has taken them without notice and for value', and the issuer's security interest in the goods represented by the documents. Another important aspect of this case was the fact that, contrary to the earlier cases, it was both litigated and decided on the basis of the law of letters of credit and not the law of contract. It has also been said that if one looks at the majority judgment and the dissenting opinion of Cardozo J jointly, then the reasoning in *Maurice O'Meara* is very similar to the reasoning of a modern letter of credit fraud case, where the court generally first stresses the significance of the principle of independence, and then sets out the elements of the fraud rule and applies them. However, the case was still not pleaded or adjudicated based on the fraud rule.<sup>95</sup>

From the above it is clear that although the issue of the fraud rule in the law of letters of credit was already raised in the 1760s, the fraud rule was still not well developed by the 1920s. In none of the earlier cases did the parties plead the fraud rule. The court also did not decide these cases based on the fraud rule. All the earlier cases, in particular the cases of *Higgins* and *Old Colony*, demonstrate that parties, especially victims of fraud, were not aware of the fraud rule and they did not use it as a legal weapon to argue their cases at the time. However, one issue that was mentioned in all the cases was that the documents tendered by the beneficiary under a letter of credit had to be both genuine and honest, and

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<sup>94</sup> 146 NE 636 (1925) at 641. For a criticism of the minority view, see Anon 'The Rights of the Seller Under a Documentary Letter of Credit' (1925) 34 *Yale Law Journal* 775 at 781.

<sup>95</sup> See Xiang Gao *op cit* note 41 at 38.

the issuer accordingly should not be forced to accept documents which it knew to be false or fraudulent.<sup>96</sup>

### 5.3.3 The First Landmark Case: The *Sztejn* Case

A breakthrough in the development of the fraud rule in the law of letters of credit came only in 1941, when a court in the United States delivered its judgment in *Sztejn v J Henry Schroder Banking Corporation*.<sup>97</sup> This case was so ground breaking that the fraud rule that had manifested from it was later codified in the 1962 version of the American Uniform Commercial Code ('UCC').<sup>98</sup> The fraud rule was set out in article 5 section 5-114(2) ('Prior UCC article 5')<sup>99</sup> of this version of the UCC. The *Sztejn* case has not only been followed by nearly all subsequent letter of credit fraud cases in the United States, but has also been cited with approval or followed outside the United States throughout the common law world. Therefore, because of its significance, the case requires special attention.<sup>100</sup>

#### 5.3.3.1 Facts and Judgment

In *Sztejn v J Henry Schroder Banking Corporation*<sup>101</sup> the plaintiff, Sztejn, and one of his associates, one Schwarz, contracted to purchase a quantity of bristles from the defendant Transea Traders Ltd (hereafter 'Transea'), an Indian company. In order to pay for the goods, Sztejn and Schwarz asked J Henry Schroder Banking Corporation (hereinafter 'Schroder'), the issuing bank, to issue an irrevocable letter of credit in favour of Transea (i.e., the seller). The letter of credit provided that drafts by Transea for a specified portion of the purchase price would be paid by Schroder upon shipment of the described goods and presentation of an invoice and a bill of lading covering the shipment, made out to the order of Schroder.<sup>102</sup>

After Schroder's correspondent bank in India had delivered the letter of credit to Transea, Transea placed 50 cases of material on board a ship, procured the documents required by the letter of credit and drew a draft under the letter of credit to the order of Chartered Bank, and delivered the draft and the documents to the Chartered Bank in India for collection for the account of Transea. Chartered Bank presented the draft together with the required documents to Schroder for payment. Before payment had been made, Sztejn instituted an action for a judgment declaring that the letter of credit and the drafts thereunder were null and void, and for an injunction to prevent the payment of the draft, alleging that the beneficiary had, in fact, filled the 50 cases with 'cowhair, other worthless material and

<sup>96</sup> See Xiang Gao *op cit* note 41 at 38–39.

<sup>97</sup> 31 NYS 2d 631 (1941).

<sup>98</sup> Hereinafter the 'UCC'.

<sup>99</sup> For a discussion of the background to Prior UCC article 5 section 5-114(2), see paras 3.4.2 and 3.4.2.2 in Chapter 3 and for a full discussion, see paras 5.5.2.1, 5.5.3, 5.5.4.2, and 5.5.4.3 below.

<sup>100</sup> See Xiang Gao *op cit* note 41 at 39.

<sup>101</sup> 31 NYS 2d 631 (1941). For a discussion of the *Sztejn* case, see *Dolan: The Law of Letters of Credit op cit* note 1 in para 7.04[2]; *Jack op cit* note 27 in para 9.6 at 260–261; Xiang Gao *op cit* note 41 at 39–42; and McCullough *op cit* note 20 in para 5.04[2][b].

<sup>102</sup> See *Sztejn* 31 NYS 2d 631 (1941) at 633.

rubbish with intent to simulate genuine merchandise and defraud the plaintiff'.<sup>103</sup> Sztejn claimed that the documents accompanying the drafts were fraudulent in that they did not represent actual merchandise, but instead cover boxes fraudulently filled with worthless material by Transea.<sup>104</sup> Sztejn also argued that the presenting bank (Chartered Bank) was merely a collecting bank for Transea and not an innocent holder of the draft for value. Chartered Bank instituted a motion to dismiss the supplemental complaint (action) of Sztejn on the ground that it failed to state a cause of action against the moving defendant because 'the Chartered Bank is only concerned with the documents and on their face these conform to the requirements of the letter of credit'.<sup>105</sup>

For the purpose of hearing the motion, Shientag J of the Supreme Court of New York County assumed that all the allegations of the complaint (action) were true, namely that Transea was engaged in a scheme to defraud the plaintiff (Sztejn); that the goods shipped by Transea were worthless rubbish; and that the Chartered Bank was not an innocent holder of the draft for value, but was merely attempting to procure payment of the draft for Transea's account.<sup>106</sup>

The court bluntly denied the Chartered Bank's motion to dismiss Sztejn's complaint based on the 'established' facts that fraud had been committed in the transaction and therefore found in favour of the plaintiff (Sztejn).<sup>107</sup> Before reaching his conclusion, Shientag J acknowledged the importance of the principle of independence in the law of letter of credit, stating:<sup>108</sup>

It is well established that a letter of credit is independent of the primary contract of sale between the buyer and the seller. The issuing bank agrees to pay upon presentation of documents, not goods. This rule is necessary to preserve the efficiency of the letter of credit as an instrument for the financing of trade. One of the chief purposes of the letter of credit is to furnish the seller with a ready means of obtaining prompt payment for his merchandise. It would be a most unfortunate interference with business transactions if a bank before honoring drafts drawn upon it was obliged or even allowed to go behind the documents, at the request of the buyer and enter into controversies between the buyer and the seller regarding the quality of the merchandise shipped. If the buyer and the seller intended the bank to do this they could have so provided in the letter of credit itself, and in the absence of such a provision, the court will not demand or even permit the bank to delay paying drafts which are proper in form.

Shientag J, then briefly stipulated the reasons for deciding in a manner that might have appeared to be contrary to the principle of independence by stating:<sup>109</sup>

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<sup>103</sup> See *Sztejn* 31 NYS 2d 631 (1941) at 633.

<sup>104</sup> See *Sztejn* 31 NYS 2d 631 (1941) at 632.

<sup>105</sup> See *Sztejn* 31 NYS 2d 631 (1941) at 632.

<sup>106</sup> See *Sztejn* 31 NYS 2d 631 (1941) at 633.

<sup>107</sup> See *Sztejn* 31 NYS 2d 631 (1941) at 635.

<sup>108</sup> *Sztejn* 31 NYS 2d 631 (1941) at 633.

<sup>109</sup> *Sztejn* 31 NYS 2d 631 (1941) at 634.



Of course, the application of this doctrine presupposes that the documents accompanying the draft are genuine and conform in terms to the requirements of the letter of credit . . .

However, I believe that a different situation is presented in the instant action. This is not a controversy between the buyer and seller concerning a mere breach of warranty regarding the quality of the merchandise; on the present motion, it must be assumed that the seller has intentionally failed to ship any goods ordered by the buyer. In such a situation, where the seller's fraud has been called to the bank's attention before the drafts and documents have been presented for payment, the principle of the independence of the bank's obligation under the letter of credit should not be extended to protect the unscrupulous seller. It is true that even though the documents are forged or fraudulent, if the issuing bank has already paid the draft before receiving notice of the seller's fraud, it will be protected if it exercised reasonable diligence before making such payment.

The court also pointed out that in this case Schroder had received notice of Transea's active fraud before it accepted or paid the draft. The Chartered Bank, which under the allegations of the complaint stood in no better position than Transea, should not have been heard to complain, as Schroder was not forced to pay the draft accompanied by documents covering a transaction that it had reason to believe was fraudulent.<sup>110</sup>

The learned judge continued and stated that although courts in the United States had used broad language to the effect that a letter of credit was independent of the primary contract between the buyer and seller, that language had been used in cases concerning alleged breaches of warranty. Furthermore, no case had been brought to his attention on this point involving an intentional fraud on the part of the seller which was brought to the bank's notice with the request that it withhold payment of the draft on a specific account.<sup>111</sup>

The court not only condemned the fraudulent act of the beneficiary and stipulated the basis upon which the payment under the letter of credit in this case should be stopped, but also considered the interests of the other parties, such as the issuing bank and the presenting bank. It acknowledged that the fraudulent act of the seller might also work to the detriment of the issuing bank's security interest. The court stressed that although the primary factor that an issuing bank considered when deciding to issue a letter of credit was the credit standing of the applicant (i.e., the buyer), the security afforded by the merchandise was also taken into account. In reality, the letter of credit required a bill of lading made out to the order of the bank and not the buyer. Although the issuing bank was not interested in the precise detailed performance of the contract of sale, it was vitally interested in assuring itself that there were some goods represented by the documents.<sup>112</sup>

As regards the position of Chartered Bank, the presenting bank, the court stated:<sup>113</sup>

No hardship will be caused by permitting the bank to refuse payment where fraud is claimed, where the merchandise is not merely inferior in quality but

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<sup>110</sup> See *Sztejn* 31 NYS 2d 631 (1941) at 634.

<sup>111</sup> See *Sztejn* 31 NYS 2d 631 (1941) at 634–635.

<sup>112</sup> See *Sztejn* 31 NYS 2d 631 (1941) at 635.

<sup>113</sup> *Sztejn* 31 NYS 2d 631 (1941) at 635.

consists of worthless rubbish, where the draft and the accompanying documents are in the hands of one who stands in the same position as the fraudulent seller, where the bank has been given notice of the fraud before being presented with the drafts and documents for payment, and where the bank itself does not wish to pay pending an adjudication of the rights and obligations of the other parties.

The court continued and mentioned that as it was only the complaint that was before it during this motion, it was bound by the allegation that Chartered Bank was not a holder in due course, but a mere agent for collection for the account of the seller charged with fraud. Therefore, Chartered Bank's motion had to be denied. However, if it had appeared from the face of the complaint that the presenting bank was a holder in due course of the draft, its claim against the issuing bank would not be defeated even though the underlying transaction had been tainted with fraud.<sup>114</sup>

Therefore, based upon the analysis given above, the court denied Chartered Bank's motion to dismiss the complaint and acknowledged a right to enjoin payment under the letter of credit.<sup>115</sup>

### 5.3.3.2 *The Significance and Limits of Sztejn*

When the *Sztejn* case is compared with the earlier cases, as discussed above, it becomes clear why it is universally regarded as the revolutionary case in the development of the fraud rule. It has been followed in England<sup>116</sup> and South Africa.<sup>117</sup> *Sztejn* is important because it represents a typical situation, and its pleadings and judgment provide clear guidance to future cases that involve letter of credit fraud. In earlier cases the matters were either pleaded and/or decided on the principles of the law of contracts, whereas in *Sztejn* the matter was both pleaded and decided on the principles of the law of letters of credit. The *Sztejn* case illustrates how a frustrated applicant who has been defrauded by a dishonest beneficiary can rely on the fraud rule to protect his interest.<sup>118</sup>

What is even more significant about *Sztejn*, is the fact that it was the first case to articulate the major elements of the fraud rule.<sup>119</sup> It established three principles of vital importance:<sup>120</sup>

1. Payment under a letter of credit may only be interrupted in a case of fraud; mere allegation of breach of warranty cannot be an excuse for such an interruption.
2. Payment under a letter of credit can only be interrupted when fraud is proven or established; mere allegation of fraud should not be an excuse for such an interruption.

<sup>114</sup> See *Sztejn* 31 NYS 2d 631 (1941) at 635–636.

<sup>115</sup> See also see McCullough *op cit* note 20 in para 5.04[2][b] at 5-19.

<sup>116</sup> See *Jack op cit* note 27 in para 9.6 at 260.

<sup>117</sup> See Malan *et al op cit* note 10 at 142. The *Sztejn* case is also relevant in the instance where the acceptor of a bill of exchange raises the fraud defence against a holder of a bill (see Malan and Pretorius *op cit* note 10 in para 143 at 225; and Malan *et al op cit* note 10 at 141–143).

<sup>118</sup> See Xiang Gao *op cit* note 41 at 41–42.

<sup>119</sup> See also *Jack op cit* note 27 in para 9.6 at 261.

<sup>120</sup> See Xiang Gao *op cit* note 41 at 42.

3. Payment should be made in accordance with the terms of the credit, despite the existence of the proven fraud, if demand for payment is made by a holder in due course (of the draft) or a presenter with similar status.

As *Sztejn* involved a motion to dismiss the plaintiff's complaint, all the allegations of the complaint were deemed to be true and therefore whole issues such as the extent and onus of proof, and the standard of degree of fraud in the application of the fraud rule were not addressed. It has been said that those untouched issues comprise the restrictions of the case and have echoed throughout the subsequent development of the fraud rule in the United States as well as elsewhere in the world.<sup>121</sup>

### 5.3.4 Later Fraud Cases

Quite a few cases in England and the United States dealing with the issue of fraud followed after *Sztejn v J Henry Schroder Banking Corporation*.<sup>122</sup> However, it was not until the 1970s and 1980s that the problem of fraudulent calls being made on demand guarantees and documentary credits increased dramatically. By that time there were a number of cases in documentary credit transactions and demand guarantee transactions that indicated the willingness of courts to interfere with banks' payment obligations under commercial letters of credit and demand guarantees where fraud was involved. It was during this time that the fraud rule developed into the modern fraud rule as it is known today. A few of the more important decisions made during this period are discussed below.

## 5.4 ENGLISH LAW

### 5.4.1 A General Overview

Today the fraud exception is generally acknowledged in England.<sup>123</sup> It is interesting that the English law has not developed the fraud rule to any great extent in relation to commercial letters of credit. Most of the cases on the fraud rule concern demand guarantees where slightly different issues arise (see cases discussed below). However, many of the principles stated in the demand guarantee cases are applicable to commercial letters of credit and *vice versa*.<sup>124</sup>

English courts have recognised, as a matter of principle, that the rule of independence ceases to apply where fraud is involved in a letter of credit/demand guarantee transaction. Despite its acknowledgement, the English courts, particularly in the earlier cases, have not often applied the fraud rule. The English courts have traditionally been very reluctant to interfere with the operation of a letter of credit/demand guarantee, and have adopted a relatively inflexible and narrow approach towards the application of the fraud rule.<sup>125</sup> The

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<sup>121</sup> *Idem*.

<sup>122</sup> 31 NYS 2d 631 (1941).

<sup>123</sup> See *Jack op cit* note 27 in para 9.6 at 260. For a full discussion of the fraud exception and injunctions, see *Jack op cit* note 27 at 256–303.

<sup>124</sup> See *Warne and Elliott op cit* note 27 at 260.

<sup>125</sup> See *Enonchong op cit* note 8 at 85; and *Xiang Gao op cit* note 41 at 48.

reason for this strict approach was clearly explained in 1958 by the Court of Appeal in *Hamzeh Malas and Sons v British Imex Industries Ltd*:<sup>126</sup>

[I]t seems to be plain enough that the opening of a confirmed letter of credit constitutes a bargain between the banker and the vendor of the goods, which imposes upon the banker an absolute obligation to pay, irrespective of any dispute there may be between the parties as to whether the goods are up to contract or not. An elaborate commercial system has been built up on the footing that bankers' confirmed credits are of that character, and, in my judgment, it would be wrong for this court in the present case to interfere with that established practice . . . That system of financing . . . would break down completely if a dispute as between the vendor and the purchaser was to have the effect of "freezing," if I may use that expression, the sum in respect of which the letter of credit was opened.

Adhering to the strict non-interference approach, English courts have saddled plaintiffs with a great burden of proof, requiring them to establish the existence of 'clear' or 'obvious' fraud also known to the issuer (i.e., the bank) in order to invoke the fraud rule.<sup>127</sup> Courts will also possibly prevent payment under a demand guarantee, where a bank was induced by fraud to issue the demand guarantee.<sup>128</sup>

The first English case to cite *Sztejn v J Henry Schroder Banking Corporation*<sup>129</sup> with approval and to demonstrate the difficulty of meeting the high standard of proof of fraud was *Discount Records Ltd v Barclays Bank Ltd and Barclays Bank International Ltd*.<sup>130</sup> In that case, the plaintiff, an English buyer, concluded a contract with a French company, Promodisc (i.e., the seller), to buy a certain amount of gramophone records and cassettes. The buyer instructed the defendant to issue an irrevocable letter of credit in favour of the seller. The seller shipped goods pretending to be those ordered and presented the draft with documents regular on their face to the confirming bank in Paris, which the bank accepted. When the goods arrived, the buyer inspected the goods in the presence of a representative of the issuer. The inspection revealed that fewer goods had been shipped, a large portion of the shipment was either rubbish or empty containers, and most of the goods shipped were either rejects or unsaleable. The buyer instructed the issuer not to pay on the credit. However, the issuer alleged that as it was an irrevocable confirmed letter of credit, it seemed that there was no way that it could avoid making the payment and refused to give an undertaking not to pay. Therefore, the buyer, relying on *Sztejn*, attempted, *inter alia*, to

<sup>126</sup> [1958] 2 QB 127 (QB) ([1958] 1 All ER 262 (QB) and [1958] 2 WLR 100 (QB)) at 129.

<sup>127</sup> See *Edward Owen Engineering Ltd v Barclays Bank International Ltd and Another* [1978] 1 QB 159 (CA) ([1978] 1 Lloyd's Rep 166 (CA)); and [1978] 1 All ER 976 (CA)); *R D Harbottle (Mercantile) Ltd v National Westminster Bank Ltd and Others* [1978] 1 QB 146 (CA) ([1977] 2 All ER 862 (CA)); *Bolivinter Oil SA v Chase Manhattan Bank, Commercial Bank of Syria and General Company of Homes Refinery* [1984] 1 Lloyd's Rep 251 (CA) ([1984] 1 All ER 351 (CA)); and [1984] 1 WLR 392 (CA)). See also Gao *op cit* note 41 at 48; and Enonchong *op cit* note 8 at 85.

<sup>128</sup> See *Solo Industries UK Ltd v Canara Bank* [2001] 2 Lloyd's Rep 578 (CA) ([2001] 1 WLR 1800 (CA)); and G Clark 'Injuncting Calls on a Performance Guarantee in the Absence of Fraud: The Passion' (2005) *Journal of International Banking Law and Regulation* 338 at 338.

<sup>129</sup> 31 NYS 2d 631 (1941).

<sup>130</sup> [1975] 1 Lloyd's Rep 444 (Ch D) ([1975] 1 WLR 315; and [1975] 1 All ER 1071).

enjoin the issuer from honouring the seller's drafts drawn upon the letter of credit, contending that the seller was guilty of fraud.<sup>131</sup>

Megarry J rejected the buyer's claim, and said that the case before him was different from the *Sztejn* case. He pointed out that in the *Sztejn* case the proceedings consisted of a motion to dismiss the formal complaint on the ground that it disclosed no cause of action. Therefore, the court there had to assume that the facts stated in the complaint were true. The complaint alleged fraud and, accordingly, the court there was dealing with a case of established fraud. However, in the present case there was no established fraud, but merely an allegation of fraud. Therefore, the defendants in this case, who were not concerned with that matter, have understandably adduced no evidence on the issue of fraud here. Megarry J further stated that it seemed unlikely that any action to which Promodisc (i.e., the seller) was not a party would contain the evidence required to resolve this issue. He therefore found that the matter had to be dealt with on the footing that this was a case in which fraud was alleged but had not been established.<sup>132</sup>

Furthermore, Megarry J also pointed out that he would be slow to interfere with bankers' irrevocable credits, especially in the sphere of international banking, unless a sufficiently grave cause was shown. He also stressed that if courts were too ready to intervene or intervened too frequently, it would gravely impair the reliance which, quite properly, was placed on such credits.<sup>133</sup>

In the end the court found that the present case fell far short of establishing any grounds upon which it would be right for the court to intervene by granting the interlocutory injunction claimed. Accordingly, the motion failed and was dismissed.<sup>134</sup>

In *Discount Records Ltd v Barclays Bank Ltd*, the buyer (plaintiff) obtained his evidence in the presence of the issuer, indicating that a large portion of the shipment was either rubbish or empty containers, but it was astonishing to hear the court say that there was no established fraud, but merely an allegation of fraud. In a case like this where the plaintiff is merely regarded as having only produced 'an allegation of fraud', it is not difficult to picture how hard it was to establish fraud in the English court in a letter of credit fraud case.<sup>135</sup>

To the extent that the substantive concept of fraud is concerned, it appears from the forbidding language and the way the independence principle has been applied in leading cases<sup>136</sup> that English courts also employ a very restricted concept of fraud, which is perhaps even narrower than that in other jurisdictions.<sup>137</sup>

<sup>131</sup> See *Discount Records v Barclays Bank* [1975] 1 Lloyd's Rep 444 (Ch D) ([1975] 1 WLR 315; and [1975] 1 All ER 1071) at 444–446. See also Xiang Gao *op cit* note 41 at 49.

<sup>132</sup> See *Discount Records v Barclays Bank supra* note 131 at 447.

<sup>133</sup> See *Discount Records v Barclays Bank supra* note 131 at 448.

<sup>134</sup> See *Discount Records v Barclays Bank supra* note 131 at 448.

<sup>135</sup> See Xiang Gao *op cit* note 41 at 49–50.

<sup>136</sup> See, e.g., *R D Harbottle (Mercantile) Ltd v National Westminster Bank Ltd and Others* [1978] 1 QB 146 (CA) ([1977] 2 All ER 862 (CA)); *Edward Owen Engineering Ltd v Barclays Bank International Ltd and Another* [1978] 1 QB 159 (CA) ([1978] 1 Lloyd's Rep 166 (CA); and [1978] 1 All ER 976 (CA)); *Howe Richardson Scale Co Ltd v Polimex-Cekop and National Westminster Bank Ltd* [1978] 1 Lloyd's Rep 161 (CA); *Intraco Ltd v Notis Shipping Corporation (The 'Bhoja Trader')* [1981] 2 Lloyd's Rep 256 (CA); and

In *R D Harbottle (Mercantile) Ltd v National Westminster Bank Ltd and Others*<sup>138</sup> Kerr J stated:<sup>139</sup>

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 or stipulated in the contracts . . . The machinery and commitments of banks are on a different level. They must be allowed to be honoured, free from interference by the courts. Otherwise, trust in international commerce could be irreparably damaged.

The statements made in the *Harbottle* case have been cited with approval in *Edward Owen Engineering Ltd v Barclays Bank International Ltd and Another*.<sup>140</sup> It is commonly accepted that the *Edward Owen* case is the most striking case dealing with demand guarantees, as it was in this case that the Court of Appeal expressly recognised that the fraud exception also applied to demand guarantees. In this case Lord Denning MR stated:<sup>141</sup>

A performance bond is a new creature so far as we are concerned. It has many similarities to a letter of credit, with which of course we are very familiar. It has been long established that when a letter of credit is issued and confirmed by a bank, the bank must pay it if the documents are in order and the terms of the credit are satisfied. Any dispute between buyer and seller must be settled between themselves. The bank must honour the credit . . . To this general principle there is an exception in the case of what is called established or obvious fraud to the knowledge of the bank.

Lord Denning MR also referred to *Sztejn v J Henry Schroder Banking Corporation*<sup>142</sup> and indicated that the case showed that there was this exception to the strict rule: the bank should not have to pay under the credit, if it knew that the documents were forged or that the request for payment was made fraudulently in circumstances where there was no right to payment.<sup>143</sup> This reference to *Sztejn* indicates that the fraud rule is recognised in England and that this American case is the ‘foundation stone of English law in this area’.<sup>144</sup>

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*Bolivinter Oil SA v Chase Manhattan Bank, Commercial Bank of Syria and General Company of Homes Refinery* [1984] 1 Lloyd’s Rep 251 (CA) ([1984] 1 All ER 351 (CA); and [1984] 1 WLR 392 (CA)).

<sup>137</sup> See Bertrams *op cit* note 14 at 345–346.

<sup>138</sup> [1978] 1 QB 146 (CA) ([1977] 2 All ER 862 (CA)).

<sup>139</sup> [1978] 1 QB 146 (CA) at 155G–156A.

<sup>140</sup> [1978] 1 QB 159 (CA) ([1978] 1 Lloyd’s Rep 166 (CA); and [1978] 1 All ER 976 (CA)) at 171C–F.

<sup>141</sup> [1978] 1 QB 159 (CA) at 169A–D.

<sup>142</sup> 31 NYS 2d 631 (1941). See also the discussion of this case in para 5.3.3 above.

<sup>143</sup> [1978] 1 QB 159 (CA) at 169D–G.

<sup>144</sup> See *Jack op cit* note 27 at 260; and *Xiang Gao op cit* note 41 at 48.

Lord Denning MR continued and also said:<sup>145</sup>

So, as one takes instance after instance, these performance guarantees are virtually promissory notes payable on demand. So long as the Libyan customers make an honest demand, the banks are bound to pay: and the banks will rarely, if ever, be in a position to know whether the demand is honest or not. At any rate they will not be able to prove it to be dishonest. So they will have to pay.

All this leads to the conclusion that the performance guarantee stands on a similar footing to a letter of credit. A bank which gives a performance guarantee must honour that guarantee according to its terms. It is not concerned in the least with the relations between the supplier and the customer; nor with the question whether the supplier has performed his contracted obligation or not; nor with the question whether the supplier is in default or not. The bank must pay according to its guarantee, on demand, if so stipulated, without proof or conditions. The only exception is when there is clear fraud of which the bank has notice.

He thus clearly indicated that the only exception where a bank did not have to pay under a demand guarantee was where there was clear fraud of which the bank had notice.<sup>146</sup> Furthermore, Browne LJ in this regard also observed that it was certainly not enough merely to allege fraud, as it had to be very clearly established.<sup>147</sup> He also added that the fraud exception entailed that where the documents under the credit were presented by the beneficiary himself and the bank knew when the documents were presented that they were forged or fraudulent, the bank was entitled to refuse payment.<sup>148</sup>

Lane LJ in the *Edward Owen* case also made a comment in this regard. He said that the only circumstances that would justify the bank not complying with a demand made under that agreement would be those that would absolve them under similar circumstances if they had entered into a letter of credit, and that is this; if it had been clear and obvious to the bank that the buyers had been guilty of fraud.<sup>149</sup>

Although the court in the *Edward Owen* case accepted that the principal had not been in default and that it was the beneficiary who had failed to comply with its contractual obligations, it, nevertheless, concluded that the principal was a long way from establishing fraud.

The most prominent English case on the fraud rule in relation to commercial letters of credit is *United City Merchants (Investments) Ltd and Glass Fibres and Equipments Ltd v Royal Bank of Canada (incorporated in Canada), Vitrorefuerzos SA and Banco Continental SA*.<sup>150</sup> Here the seller sold manufacturing equipment to a Peruvian buyer and

<sup>145</sup> [1978] 1 QB 159 (CA) at 170H–171B.

<sup>146</sup> See [1978] 1 QB 159 (CA) at 171B.

<sup>147</sup> See [1978] 1 QB 159 (CA) at 173A.

<sup>148</sup> See [1978] 1 QB 159 (CA) at 172H.

<sup>149</sup> See [1978] 1 QB 159 (CA) at 175E.

<sup>150</sup> [1979] 1 Lloyd's Rep 267 (QB (Com Ct)); on appeal *sub nom* [1981] 1 Lloyd's Rep 604 (CA) ([1982] QB 208 (CA)); and *revid sub nom* [1983] AC 168 (HL) ([1982] 2 Lloyd's Rep 1 (HL)). For a discussion of this case (i.e., the various judgments), see, e.g., R M Goode 'Reflections on Letters of Credit – I' [1980] *Journal of Business Law* 291 at 294; E P Ellinger 'Fraud in Documentary Credit Transactions' (1981) *Journal of*

agreed to double the price to enable the buyer to breach Peruvian exchange control regulations. A letter of credit was issued in Peru and confirmed by the Royal Bank of Canada in London. The goods were shipped on 16 December 1976, a day after the permitted date under the credit. The loading brokers (a third party), not acting for the beneficiaries (sellers) and their assignee, then fraudulently entered the earlier date as the date of shipment on a notation stamped on the bill of lading. The confirming bank rejected the documents on presentation and the beneficiaries (sellers) sued for wrongful dishonour.<sup>151</sup>

The beneficiaries (sellers) succeeded at first instance before Mocatta J.<sup>152</sup> The confirming bank invoked the fraud exception as a ground for dishonouring. Mocatta J held that the fraud exception applied on the principle of *ex turpi causa non oritur actio*. However, because the sellers had not been party to the fraud by the broker (third party) who had misdated the bill of lading, the sellers were not affected by the fraud.

The Court of Appeal in this case<sup>153</sup> applied a ‘half-way house’ position, namely that since the date stamp was false, the document was a nullity and therefore the bank was entitled to refuse to pay.<sup>154</sup>

The House of Lords found that Mocatta J’s judgment, based on the facts of the case, had been correct. The House of Lords considered the question of fraud which would entitle a bank to refuse to pay under a letter of credit, notwithstanding the rule requiring payment when the documents were in order on their face. In delivering its judgment (per Lord Diplock) the court first acknowledged the principle of independence and then confirmed that established fraud would provide an exception to that principle. Furthermore, Lord Diplock also indicated that the English law recognised the *prima facie* right of the issuer to be the sole arbiter on the question whether payment under the credit should be refused on the basis of fraud. In the course of his opinion (with which the other members of the House agreed) and before he dealt with third-party fraud, he said:<sup>155</sup>

[T]he parties to it, the seller and the conforming bank, “deal in documents and not in goods” . . . If, on their face, the documents presented to the confirming bank by the seller conform with the requirements of the credit as notified to him

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*Business Law* 258 at 261; A Arora ‘False and Forged Documents under a Letter of Credit’ (1981) 2 *Company Lawyer* 66 at 67, and ‘Documentary Fraud: The United City Merchants Case’ (1984) 5 *Company Lawyer* 131; J F Dolan ‘Documentary Credit Fundamentals: Comparative Aspects’ (1989) 3 *Banking and Finance Law Review* 134; L Sarna ‘Letters of Credit: Bankruptcy, Fraud and Identity of Parties’ (1986) 65 *Canadian Bar Review* 303 at 318; G P Miller ‘Fraudulent Documents and Bank Liability: A Hong Kong Perspective’ (1993) 4 *Company Lawyer* 146 at 147; M Williams ‘Documentary Credits and Fraud: English and Chinese Law Compared’ (2004) *Journal of Business Law* 155 at 160–161; and Xiang Gao *op cit* note 41 at 121–134.

<sup>151</sup> See *United City Merchants v Royal Bank of Canada* [1983] AC 168 (HL) ([1982] 2 Lloyd’s Rep 1 (HL)) at 180–182. This case did not involve an interlocutory dispute; it concerned the liability at trial of a bank under a letter of credit, when documents had been presented and payment refused.

<sup>152</sup> See *United City Merchants v Royal Bank of Canada* [1979] 1 Lloyd’s Rep 267 (QB (Com Ct)).

<sup>153</sup> See *United City Merchants v Royal Bank of Canada* [1981] 1 Lloyd’s Rep 604 (CA) ([1982] QB 208 (CA)).

<sup>154</sup> See also *Jack op cit* note 27 at 264.

<sup>155</sup> *United City Merchants v Royal Bank of Canada* [1983] AC 168 (HL) ([1982] 2 Lloyd’s Rep 1 (HL)) at 183D–F. See also Xiang Gao *op cit* note 41 at 47–48.



by the confirming bank, that bank is under a contractual obligation to the seller to honour the credit, notwithstanding that the bank has knowledge that the seller at the time of presentation of the conforming documents is alleged by the buyer to have, and in fact has already, committed a breach of his contract with the buyer for the sale of the goods to which the documents appear on their face to relate, that would have entitled the buyer to treat the contract of sale as rescinded and to reject the goods and refuse to pay the seller the purchase price. The whole commercial purpose for which the system of confirmed irrevocable documentary credits has been developed in international trade is to give to the seller an assured right to be paid before he parts with control of the goods that does not permit of any dispute with the buyer as to the performance of the contract of sale being used as a ground for non-payment or reduction or deferment of payment.

He continued as follows:<sup>156</sup>

To this general statement of principle [of independence] . . . there is one established exception: that is, where the seller, for the purpose of drawing on the credit, fraudulently presents to the confirming bank documents that contain, expressly or by implication, material representations of fact that to his knowledge are untrue. Although there does not appear among the English authorities any case in which this exception has been applied, it is well established in the American cases of which the leading or “landmark” case is *Sztejn v. J. Henry Schroder Banking Corporation* . . . This judgment of the New York Court of Appeals was referred to with approval by the English Court of Appeal in *Edward Owen Engineering Ltd. v. Barclays Bank International Ltd* . . . though this was actually a case about a performance bond under which a bank assumes obligations to a buyer analogous to those assumed by a confirming bank to the seller under a documentary credit. The exception for fraud on the part of the beneficiary seeking to avail himself of the credit is a clear application of the maxim *ex turpi causa non oritur actio* or, if plain English is to be preferred, “fraud unravels all.” The courts will not allow their process to be used by a dishonest person to carry out a fraud.

Lord Diplock thus clearly considered the extent of the fraud exception and held that a confirming bank was required to pay a beneficiary who presented fraudulent documents, unless the beneficiary was a party to the fraud or the fraud was apparent on the face of the documents.<sup>157</sup> The House of Lords also clearly explained the principle that ‘fraud unravels all’ and further made it clear that the courts would not allow their process to be used by a dishonest person to perpetrate a fraud. As the beneficiaries (sellers) were not party to the fraud, this principle did not apply.<sup>158</sup>

<sup>156</sup> *United City Merchants v Royal Bank of Canada* [1983] AC 168 (HL) ([1982] 2 Lloyd’s Rep 1 (HL)) at 183F–184B.

<sup>157</sup> See *United City Merchants v Royal Bank of Canada* [1983] AC 168 (HL) ([1982] 2 Lloyd’s Rep 1 (HL)) at 183. See also M Coleman ‘Performance Guarantees’ (1990) *Lloyd’s Maritime and Commercial Law Quarterly* 223 at 234. Therefore, under English law, the fraud must be committed by the beneficiary. Compare this to the contrary approach in the American law (see para 5.5.2.1 (particularly note 323) and para 5.5.2.2 (particularly note 401) below). For a full discussion of what the identity of the fraudulent party must be for the fraud exception to apply, see Xiang Gao *op cit* note 41 at 115–135, where he discusses the position under the English law, American law and the UNCITRAL Convention fully.

<sup>158</sup> See Warne and Elliott *op cit* note 27 at 260.

Therefore, a court will only grant an injunction to the principal to prevent a call on a demand guarantee where there is clear evidence of fraud available to the bank to which the beneficiary or his agent with his actual knowledge is a party.<sup>159</sup> Therefore, even if document presented to a bank could be a nullity because of forgery or fraud, the bank is still under an obligation to pay if the beneficiary is not a party to that fraud.<sup>160</sup> It is clearly the English courts' view that banks must pay for documents that are nullities, provided the beneficiary (i.e., seller and his agents) have acted in good faith and the documents appear to conform.<sup>161</sup>

The *United City Merchants (Investments) Ltd v Royal Bank of Canada* case, just like the *Edward Owen* case, also confirms that the fraud rule exists in England and that the *Sztejn* case forms the basis for this rule in the English law.<sup>162</sup>

In *Howe Richardson Scale Co Ltd v Polimex-Cekop and National Westminster Bank Ltd*,<sup>163</sup> a Court of Appeal case dealing with a demand guarantee, important statements regarding the fraud rule and the principle of independence were also made by Roskill LJ. He stated that the bank, in principle, was in a position not identical, but very similar to the position of a bank that had opened a confirmed irrevocable letter of credit. He pointed out that whether the obligation arose under a letter of credit or under a guarantee, the obligation of the bank was to perform that which it was required to perform by that specific contract. That obligation did not generally depend on the correct resolution of a dispute as to the sufficiency of performance by the seller to the buyer or by the buyer to the seller as the case may be under the sale and purchase contract. Here the bank was simply concerned to see whether the event had happened upon which its obligation to pay had arisen.<sup>164</sup>

It was Roskill LJ's view that it would have been quite wrong for the court to interfere with the beneficiary's apparent right under the bank guarantee to demand payment from the bank, because to have done so would have involved putting upon the bank an obligation to inquire whether or not there had been timeous performance of the seller's obligations under the contract of sale.<sup>165</sup>

In *Intraco Ltd v Notis Shipping Corporation (The 'Bhoja Trader')*<sup>166</sup> the Court of Appeal agreed with the court of first instance's decision to follow the well-established general

<sup>159</sup> In *American Cyanamid Co v Ethicon Ltd* [1975] AC 396 (HL) ([1975] 1 All ER 504 (HL)), it was considered that the bank should pay the beneficiary under the letter of credit despite the forged documents, because the beneficiary was not privy to the forgery (see also J C T Chuah *Law of International Trade* 3 ed (2005) in para 10-38 at 490).

<sup>160</sup> See *Montrod Ltd v Grundkötter Fleischvertriebs GmbH* [2001] 1 All ER (Comm) 368 (QBD); and [2002] 3 All ER 697 (CA) ([2002] 1 WLR 1975 (CA)). The position is different where a demand guarantee was procured by fraudulently inducing the bank to issue it, in such an instance an injunction will more readily be granted (see *Solo Industries UK Ltd v Canara Bank* [2001] 2 Lloyd's Rep 578 (CA) ([2001] 1 WLR 1800 (CA)); and Ganotaki *op cit* note 8 in note 3 at 148).

<sup>161</sup> See *Montrod Ltd v Grundkötter Fleischvertriebs GmbH supra* note 160; and Williams *op cit* note 150 at 159–163.

<sup>162</sup> See Xiang Gao *op cit* note 41 at 48.

<sup>163</sup> [1978] 1 Lloyd's Rep 161 (CA).

<sup>164</sup> See [1978] 1 Lloyd's Rep 161 (CA) at 165.

<sup>165</sup> [1978] 1 Lloyd's Rep 161 (CA) at 165.

<sup>166</sup> [1981] 2 Lloyd's Rep 256 (CA).

principle not to interfere with the beneficiary's right to call upon the bank to make payment under its guarantee, unless fraud was involved. In this regard, the Court of Appeal stated:<sup>167</sup>

Irrevocable letters of credit and bank guarantees given in circumstances such that they are the equivalent of an irrevocable letter of credit have been said to be the life blood of commerce. Thrombosis will occur if, unless fraud is involved, the Courts intervene and thereby disturb the mercantile practice of treating rights thereunder as being the equivalent of cash in hand.

In another case heard by the Court of Appeal, *Bolivinter Oil SA v Chase Manhattan Bank, Commercial Bank of Syria and General Company of Homes Refinery*,<sup>168</sup> Donaldson MR specifically stated that a principal of a demand guarantee should only be allowed to apply for an injunction against the bank restraining it from honouring its undertaking in exceptional circumstances. If a principal was to be allowed to obtain one more frequently, he would undermine the bank's greatest asset, namely its reputation for financial and contractual probity. Furthermore, if this happened too frequently, the value of all irrevocable letters of credit and performance bonds and guarantees would be undermined.<sup>169</sup>

In conclusion, Donaldson MR said:<sup>170</sup>

The wholly exceptional case where an injunction may be granted is where it is proved that the bank knows that any demand for payment already made or which may thereafter be made will clearly be fraudulent. But 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 upon the uncorroborated statement of the customer, for irreparable damage can be done to a 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.

According to the Court of Appeal in *Bolivinter*, the fraud exception can only be invoked where there is *clear evidence* as to (1) the fact of the fraud and (2) as to the bank's knowledge of the fraud at the time of the demand.

The statements in the aforementioned cases have been referred to with approval in various subsequent cases.<sup>171</sup> From the aforementioned cases, it would appear that English courts

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<sup>167</sup> [1981] 2 Lloyd's Rep 256 (CA) at 257.

<sup>168</sup> [1984] 1 Lloyd's Rep 251 (CA) ([1984] 1 All ER 351 (CA); and [1984] 1 WLR 392 (CA)).

<sup>169</sup> See [1984] 1 Lloyd's Rep 251 (CA) at 257.

<sup>170</sup> [1984] 1 Lloyd's Rep 251 (CA) at 257.

<sup>171</sup> See, e.g., *Deutsche Rückversicherung AG v Walbrook Insurance Co Ltd and Others; Group Josi Re (formerly known as Group Josi Reassurance SA) v Walbrook Insurance Co Ltd and Others* [1994] 4 All ER 181 (QBD) (for a full discussion of this case, see A N Oelofse 'Developments in the Law of Documentary Letters of Credit' (1996) 8 *South African Mercantile Law Journal* 56 at 63–64); *Group Josi Re v Walbrook Insurance Co Ltd and Others* [1996] 1 Lloyd's Rep 345 (CA) ([1996] 1 WLR 1152; and [1996] 1 All ER 791); *Czarnikow-Rionda Sugar Trading Inc v Standard Bank London Ltd and Others* [1999] 2 Lloyd's Rep 187 ([1999] Lloyd's Rep Bank 197) (for a discussion of this case, see *ABLU 2000 op cit* note 37 at 5–7 of the article); *Balfour Beatty Civil Engineering v Technical and General Guarantee Co Ltd* (2000) 68 Con LR 180 ([2000] CLC 252; and [2000] CILL 1574); and *Kvaerner John Brown v Midlands Bank Plc* [1998] CLC 446.

have a very strict approach to the concept of fraud. They are inclined to treat the fraud exception as a principle of a rather theoretical nature that ought not be put into practice. English courts are extremely hesitant to interfere with the bank's 'absolute and unconditional' undertaking, and to allow an exception to the principle of independence if this would affect the position of the bank, for instance, in the case of an application by the principal for a restraining order against the bank to prevent it from paying. A possible reason for this very strict approach in relation to demand guarantees is the fact that courts treat demand guarantees in the same way as letters of credit.<sup>172</sup>

Although the court did not depart from previous case law, a less rigid approach is illustrated in *United Trading Corporation SA and Murray Clayton Ltd v Allied Arab Bank Ltd and Others*,<sup>173</sup> where Ackner LJ took the opportunity to voice some uncertainties about judicial statements made in previous cases. He stated that although it was true that letters of credit and performance bonds were part of the essential machinery of international commerce, and that delaying their payment struck not only at the proper working of international commerce, but also at the reputation and standing of the international banking community, he pointed out that the strength of these arguments was often over-emphasised.<sup>174</sup>

Furthermore, Ackner LJ observed, in referring to the greater ease with which interim relief could be obtained in the United States, as follows:<sup>175</sup>

There is no suggestion that this more liberal approach has resulted in the commercial dislocation which has, by implication at least, been suggested would result from rejecting the respondent's submissions as to the standard of proof required from the plaintiffs. Moreover, we would find it an unsatisfactory position if, having established an important exception to what had previously been thought an absolute rule, the Courts in practice were to adopt so restrictive an approach to the evidence required as to prevent themselves from intervening. Were this to be the case, impressive and high-sounding phrases such as "fraud unravels all" would become meaningless.

However, there was an odd earlier case, in the 1980s, where a more liberal view of the scope of the fraud exception was taken by Eveleigh LJ in *Potton Homes Ltd v Coleman*

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In *Czarnikow-Rionda Sugar Trading Inc v Standard Bank London Ltd and Others* [1999] 2 Lloyd's Rep 187 ([1999] Lloyd's Rep Bank 197) Rix J stated (at 202):

The interest in the integrity of banking contracts under which banks make themselves liable on their letters of credit or their guarantees is so great that not even fraud can be allowed to intervene unless the fraud comes to the notice of the bank (a) in time, i.e. in any event before the beneficiary is paid, and (b) in such a way that it can be said that the bank had knowledge of the fraud. Whether that interest is viewed in terms of the importance that must be attached to the honouring of banking commitments, or in terms of the lifeblood of commerce and in particular international commerce, it has been amply recognized in case after case. Unless the banking commitment can be insulated from disputes between merchants, international trade would become impossible.

<sup>172</sup> See Bertrams *op cit* note 14 at 346–347.

<sup>173</sup> [1985] 2 Lloyd's Rep 554 (CA).

<sup>174</sup> See [1985] 2 Lloyd's Rep 554 (CA) at 561.

<sup>175</sup> At 561. See also Bertrams *op cit* note 14 at 347.

*Contractors Ltd.*<sup>176</sup> It involved a case where there were allegations of defective products (i.e., prefabricated building units) being delivered to the beneficiary (i.e., purchaser) and money being owed to the principals (i.e., the suppliers of prefabricated building units). The principals instituted proceedings under the underlying contract. The principals also obtained an interim injunction restraining the beneficiaries from calling on the demand guarantee (performance bond). The principals applied for summary judgment in respect of their claim. The Queen's Bench Division gave judgment for the principals, but ordered a stay of execution. It also found that it did not have the power to restrain the beneficiary from calling on the guarantee, and the proceeds of the call on the guarantee were frozen and paid into a joint account. The beneficiaries appealed and the principals argued that the Queen's Bench Division did have the necessary authority to grant an injunction. Eveleigh LJ of the Court of Appeal indicated that there were limited situations in which a court could restrain a beneficiary from calling on a demand guarantee. He held:<sup>177</sup>

As between buyer and the seller, the underlying contract cannot be disregarded so easily. If the seller has lawfully avoided the contract *prima facie*, it seems to me he should be entitled to restrain the buyer from making use of the performance bond. Moreover, in principle I do not think it possible to say that in *no circumstances whatsoever, apart from fraud*, will the court restrain the buyer. The facts of each case must be considered. *If the contract is avoided or there is failure of consideration between buyer and seller* for which the seller undertook to procure the issue of the performance bond, I do not see why, as between seller and buyer, the seller should not be unable to prevent a call upon the bond by mere assertion that the bond is to be treated as cash in hand. (Emphasis added.)

Eveleigh LJ suggested that if a principal had established that there had been no breaches of the underlying contract, a demand under the demand guarantee (performance guarantee) would have been fraudulent. He, however, left open the question of the standard of proof required.<sup>178</sup> On the facts in this case, he found no grounds for granting an injunction. May LJ, the other judge in this Court of Appeal case, did not share all Eveleigh LJ's views, but he also reached the same conclusion that an injunction should not be granted.

Both judges agreed that, as far as the bank issuing the demand guarantee was concerned, the underlying contract was irrelevant and the bank was under an obligation to honour the guarantee when a call was made. In this regard, the bank was in the same position as a bank that had issued an irrevocable credit, when the correct documents were tendered timely. The only instance in which the bank should not honour the guarantee or credit is that of proven fraud to which the beneficiary is a party.<sup>179</sup> The difference between the two judges relates to the situation in which a dispute arose between the seller and purchaser relating to the underlying contract and this dispute extended to the guarantee facility. Eveleigh LJ was prepared to admit certain defences arising from the underlying contract, in addition to fraud, whereas May LJ adopted the principle of strict autonomy that applies to

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<sup>176</sup> (1984) 28 BLR 19 (CA). For a full discussion of this case, see C M Schmitthoff 'Performance Bonds and Letters of Credit' (1984) *Journal of Business Law* 106; and L Hsu 'Autonomy of Performance Bonds in Singapore' (1992) *Lloyds's Maritime and Commercial Law Quarterly* 297 at 299–301.

<sup>177</sup> (1984) 28 BLR 19 (CA) at 28.

<sup>178</sup> See also Coleman *op cit* note 157 at 236.

<sup>179</sup> See Schmitthoff *op cit* note 176 at 108.

the demand guarantee and would not admit such additional defences.<sup>180</sup> However, as there were only two members of the Court of Appeal who sat in this case, it is impossible to say that one view formed the majority.<sup>181</sup> It seems that the stricter view of May LJ is deemed to be the more correct view.<sup>182</sup>

In the past it was often thought that a higher degree of protection against fraud was provided in cases where payment of a demand guarantee or letter of credit was conditional on the production of a third-party certificate, such as an engineering or architect's notice of default. It was thought that it would be easier to prove fraud where third-party certificates or customer certificates were required as a condition of payment. In such cases it would then be open to the principal to establish that the certificates were issued fraudulently. This, however, did not prove to be necessarily true.<sup>183</sup> In *Tukan Timber Ltd v Barclays Bank Plc*<sup>184</sup> such a requirement in a letter of credit did not prevent the making of a fraudulent demand. In this case, a letter of credit provided for payment to be made against a receipt signed by the principal. The bank had previously declined to pay against demands made by the beneficiaries because the demand had not been made in the proper form. At least one of the previous presentations had been fraudulent and the principal sought an injunction enjoining the bank from paying against future demands. The bank opposed the application and in an affidavit it set out its concerns should the fraud exception be made widely available for the benefit of the principal.<sup>185</sup>

The reputation of Barclays depends on strict compliance with its obligations. This has always been an essential feature of banking practice. Barclays has widespread connections with banks and trading concerns in South America – indeed all over the world. Its reputation is part of its stock in trade and depends on prompt scrupulous fulfilment of its obligations. The machinery of irrevocable obligations assumed by banks is essential to international commerce. Unless such commitments by banks can be honoured, trust in international commerce could be irreparably damaged.

In the end the court in *Tukan Timber Ltd v Barclays Bank* held that it was clearly established by the authorities that a letter of credit was autonomous and that the bank was not in the least concerned with the merits or demerits of the underlying contract and only in the most extremely exceptional circumstances should the court interfere with the paying bank honouring a letter of credit in accordance with its terms.<sup>186</sup> It also confirmed (relying on the *Edward Owen* case) that the court could only interfere where the bank had notice of clear fraud committed by the beneficiaries.<sup>187</sup>

The court declined the principal's application for an injunction. Hirst J considered that they had failed to prove with the high burden of proof required that further fraudulent demands

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<sup>180</sup> *Idem.*

<sup>181</sup> See Hsu *op cit* note 176 at 299.

<sup>182</sup> See Schmitthoff *op cit* note 176 at 108.

<sup>183</sup> See Coleman *op cit* note 157 at 229 and 235.

<sup>184</sup> [1987] 1 Lloyd's Rep 171 (QB).

<sup>185</sup> [1987] 1 Lloyd's Rep 171 (QB) at 174.

<sup>186</sup> See at 174.

<sup>187</sup> See at 174.

would be made.<sup>188</sup> He did, however, leave open the possibility that, in the event of a further fraudulent demand being made, the court would issue an injunction preventing payment, but such remedy would be of little help unless the bank was required to inform the principal of each demand it received before making the payment.<sup>189</sup>

Some of the more recent cases have also indicated that the English courts might have started to move away from the strict non-interference approach.<sup>190</sup> So far, English courts have produced limited examples where they have accepted that a sufficient case of fraud had been made out in relation to demand guarantees.<sup>191</sup> This would include, for example, the following two cases: *Themehelp Ltd v West and Others*<sup>192</sup> and *Kvaerner John Brown v Midlands Bank Plc*.<sup>193</sup>

In *Themehelp v West*<sup>194</sup> the purchasers agreed to buy the sellers' share capital in a certain company whose main business activity was the manufacture of stands for television sets. The purchase price was negotiated on the basis of profit projections prepared on an assumption that demand from Sony, a major customer of the business, would continue. Part of the purchase price was payable on completion of the contract and the balance by subsequent instalments at specific dates. The third (and the largest) instalment was secured by a demand guarantee (i.e., performance guarantee).<sup>195</sup>

After the first two instalments had been paid, the purchasers initiated proceedings for rescission of the contract and damages on the basis of alleged fraudulent misrepresentation by the sellers. The purchasers argued that the sellers had concealed vital information about the business, having become aware by the date of the execution of the contract that there was no longer any ground for the assumption used for calculating the purchase price, because Sony had decided to order future goods from a competitor of the sellers. The sellers denied the allegation and proposed to give notice to the guarantors to enforce the guarantee. In the proceedings, the purchasers applied for an interlocutory injunction to restrain the sellers from giving notice to the guarantors to enforce the demand guarantee

<sup>188</sup> See at 176–177.

<sup>189</sup> See Coleman *op cit* note 157 at 236.

<sup>190</sup> See Xiang Gao *op cit* note 41 at 50.

<sup>191</sup> In *Banco Santander SA v Bayfern Ltd* ([1999] Lloyd's Rep Bank 239 ([1999] EWHC 284 (Comm)) and affirmed in [2000] Lloyd's Rep Bank 165 ([2000] EWCA Civ 57)) the Court of Appeal in dealing with certain preliminary issues regarding a letter of credit, accepted that the case involved a matter where the fraud was 'established'.

<sup>192</sup> [1996] QB 84 (CA) ([1995] All ER 215 (CA) and [1995] 3 WLR 751 (CA)). For a discussion of this case, see A N Oelofse 'Developments in the Law of Documentary Letters of Credit' *ABLU* 1996 (a paper delivered at the 1996 Annual Banking Law Update held at the Indaba Hotel, Johannesburg) (unpaginated) (hereinafter '*ABLU* 1996') at 10–12 of his article; and A N Oelofse 'Developments in the Law of Documentary Letters of Credit' (1996) 8 *South African Mercantile Law Journal* 286 at 300–302.

<sup>193</sup> [1998] CLC 446. Commentators have also gone as far as to say that in *Themehelp Ltd v West supra* note 192 and *Kvaerner v Midlands Bank* both the nature of the fraud and the evidence thereof were rather doubtful. In *Czarnikow-Rionda Sugar Trading Inc v Standard Bank London* [1999] 2 Lloyd's Rep 187 ([1999] Lloyd's Rep Bank 197) the decisions were criticised (see also Bertrams *op cit* note 14 at 349)).

<sup>194</sup> For a discussion of the case, see A Pugh-Thomas 'Letters of Credit – Injunctions – The Purist and the Pragmatist: Can a Buyer Bypass the Guarantor and Stop the Seller from Demanding Payment from the Guarantor?' (1996) 5 *Journal of International Banking Law* 210.

<sup>195</sup> See [1996] QB 84 (CA) at 84–85. See also Xiang Gao *op cit* note 41 at 50.

until the trial of the action. The guarantors were not a party to the proceedings. The court of first instance, relying on the ‘standard of proof of fraud’ test set out by Ackner LJ in *United Trading Corporation SA and Murray Clayton Ltd v Allied Arab Bank Ltd and Others*,<sup>196</sup> granted the injunction on the ground that it was satisfied that the evidence was sufficient to raise a seriously arguable case at trial that the only reasonable inference that could be drawn from the circumstances was that the sellers had been fraudulent. The sellers appealed against that order to the Court of Appeal.<sup>197</sup> The Court of Appeal dismissed the seller’s appeal and affirmed the decision of the court *a quo*.<sup>198</sup>

#### 5.4.2 The Concept of Fraud: Fraud in the Narrow and Wide Sense

Notwithstanding the various expressions regarding fraud in case law, the question as to what precise kind of fact situation, if proven, amounts to fraud has largely remained unexplored and the substantive concept of fraud therefore remains rather vague.<sup>199</sup> One thing that is certain is the fact that the expression ‘fraud’ connotes a huge variety of different schemes all of which involve some degree of dishonesty.<sup>200</sup> In *State Trading Corpn of India Ltd v ED and F Man (Sugar) Ltd and ANR*<sup>201</sup> Lord Denning MR stated that the only term that was to be imported was that the buyer, when giving notice of default, should honestly believe that there had been a default on the part of the seller. According to him honest belief was enough. If there was no honest belief, it might be evidence of fraud. Therefore, if there was sufficient evidence of fraud, the court might intervene and grant an injunction.<sup>202</sup>

The Court of Appeal in *GKN Contractors Ltd v Lloyds Bank plc*<sup>203</sup> stated the following with reference to the fraud that may be committed in relation to demand guarantees:<sup>204</sup>

Fraud was common law fraud, ie where the beneficiary presented a claim which he knows at the time to be invalid, representing to the bank that it was valid. However, before the principal can rely on it, it must be shown that the bank was clearly aware of the fraud at the time that he paid and passed on the demand or that the circumstances were such that the only reasonable inference was that the original demand was fraudulent. Where the claim was presented in good faith and honesty but was an invalid claim because of some mistake then if the invalidity of the claim was known to the bank and the bank were to pass on the claim as a valid claim and demand payment, it would be guilty of fraud which would justify non-payment of the demand, notwithstanding that the demand on its face appeared to be valid.

<sup>196</sup> [1985] 2 Lloyd’s Rep 554 (CA) at 561. See also the discussion of this case in para 5.4.3 below.

<sup>197</sup> [1996] QB 84 (CA) at 86 and 88. See also Xiang Gao *op cit* note 41 at 50.

<sup>198</sup> Waite LJ delivered the judgment, Balcombe LJ agreed, and Evans LJ dissented.

<sup>199</sup> See Bertrams *op cit* note 14 at 347.

<sup>200</sup> See Warne and Elliott *op cit* note 27 at 260.

<sup>201</sup> [1981] Com LR 235 (CA).

<sup>202</sup> See [1981] Com LR 235 (CA) at 236.

<sup>203</sup> (1985) 30 BLR 48 (CA).

<sup>204</sup> At 49.



It would thus seem that an intention on the part of the beneficiary to deceive is inherent in this meaning of fraud. However, if one considers the statement quoted above in *GKN Contractors Ltd v Lloyds Bank plc*, it would seem to suggest another ground for departure from the autonomy principle in applications to enjoin the bank from paying. That is where the beneficiary wrongly believes that the claim is valid, but the bank knows otherwise.<sup>205</sup>

The concept of fraud as meaning ‘dishonesty’ can also be found in more recent cases.<sup>206</sup> In *Deutsche Rückversicherung AG v Walbrook Insurance Co Ltd and Others; Group Josi Re (formerly known as Group Josi Reassurance SA) v Walbrook Insurance Co Ltd and Others*<sup>207</sup> Phillips J stated that there is no fraud if the beneficiary ‘has a bona fide claim to payment under the underlying contract’<sup>208</sup> and that beneficiaries ‘will be acting fraudulently in that they will be claiming payment to which they know they have no entitlement’.<sup>209</sup> However, there are no indications that there must be actual proof of ‘dishonest’, or ‘*mala fide*’ intentions on the part of the beneficiary or evidence of the beneficiary’s actual knowledge that he has no entitlement to payment.<sup>210</sup> The existence of such knowledge, dishonesty or *mala fide* conduct on the part of the beneficiary is simply derived from the established facts, as is clearly illustrated in *Themehelp Ltd v West and Others*<sup>211</sup> and *Kvaerner John Brown v Midlands Bank Plc*,<sup>212</sup> which are among the rare examples in English case law where the fraud exception was actually applied.<sup>213</sup>

In *Deutsche Rückversicherung AG v Walbrook Insurance Co Ltd and Others; Group Josi Re (formerly known as Group Josi Reassurance SA) v Walbrook Insurance Co Ltd and Others*<sup>214</sup> there are indications in Phillips J’s judgment that in his view the possibility of obtaining an injunction against payment is not limited to the case of fraud in connection with the documents themselves, but that fraud relating purely and simply to the underlying contract could also form the basis of such an injunction.<sup>215</sup> In *Themehelp Ltd v West and Others* the Court of Appeal decided, by a majority, that in appropriate circumstances the court may issue an interlocutory injunction against the calling of a demand guarantee by a beneficiary. The majority judgment implies that the fraud does not have to relate to the documents. At the stage of the proceedings there was no notice of default (i.e., the required

<sup>205</sup> See Ndekugri *op cit* note 16 at 433.

<sup>206</sup> See, e.g., *Balfour Beatty Civil Engineering v Technical and General Guarantee Co Ltd* (2000) 68 Con LR 180 ([2000] CLC 252; and [2000] CILL 1574); and *Kvaerner John Brown v Midlands Bank Plc* [1998] CLC 446.

<sup>207</sup> [1994] 4 All ER 181 (QBD).

<sup>208</sup> See [1994] 4 All ER 181 (QBD) at 196E.

<sup>209</sup> At 197E.

<sup>210</sup> It has been said that the references to ‘dishonesty’ and ‘*mala fide*’ intentions are without a doubt derived from the general concept of fraud. See Bertrams *op cit* note 14 at 348, note 46 in particular.

<sup>211</sup> [1996] QB 84 (CA) ([1995] All ER 215 (CA)); and [1995] 3 WLR 751 (CA)). For a full discussion of this case, see *ABLU 1996 op cit* note 192 at 10–12.

<sup>212</sup> [1998] CLC 446.

<sup>213</sup> See Bertrams *op cit* note 14 at 347–348.

<sup>214</sup> [1994] 4 All ER 181 (QBD).

<sup>215</sup> See *ABLU 1996 op cit* note 192 at 10 of the article; and A N Oelofse ‘Developments in the Law of Documentary Letters of Credit’ (1996) 8 *South African Mercantile Law Journal* 286 at 300.

demand document was not presented). Therefore, there was no fraudulent document involved. The fraud alleged by the principal (i.e., buyer) was that the beneficiary (i.e., seller) had made misrepresentations in the contract of sale between them (i.e., fraud in the underlying contract). The alleged misrepresentation took the form of non-disclosure, amounting to fraud in the underlying transaction.<sup>216</sup>

However, the words of Lord Diplock in *United City Merchants v Royal Bank of Canada*<sup>217</sup> suggest that fraud in this context must mean misrepresentation and it would appear that fraud is restricted to fraud in the documents (i.e., fraud in the narrow sense).<sup>218</sup> Based on this, it has been said that it is an open question whether or not fraud in this context has a wider meaning than 'misrepresentation'. This point has not yet been decided and it is at the least highly debatable that fraud has a wider meaning in this context than dishonesty or deceit. However, since the basis of the fraud exception is public policy, there is no reason why the exception should be limited to misrepresentations. If the beneficiary's demand is tainted by some form of fraud other than misrepresentation, why should the principle of 'fraud unravels all' not also be invoked? The *United City Merchants v Royal Bank of Canada* case involved a misrepresentation and so it is not surprising that Lord Diplock had expressed himself as he did.<sup>219</sup>

A term in a demand guarantee may require that a demand should be accompanied by a beneficiary's own certificate stating that the principal is in default of his obligations under the underlying contract.<sup>220</sup> Then when the beneficiary provides the certificate or gives notice of default, he is necessarily representing that he honestly believes that there has been a default on the part of the principal.<sup>221</sup> However, if he knows that this is false, he will be guilty of fraud.<sup>222</sup>

Furthermore, a term in a demand guarantee may also require that a demand should be accompanied by a certificate or memorandum issued by an independent expert such as an engineer or an architect. Therefore, should the beneficiary then make a demand and there is clear evidence that the beneficiary had the certificate issued fraudulently or had forged the

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<sup>216</sup> See *Hugo: The Law Relating to Documentary Credits op cit* note 9 at 279–280; and *ABLU 1996 op cit* note 192 at 11 of the article.

<sup>217</sup> [1983] AC 168 (HL) at 183F–G: 'there is one established exception: that is, where the seller, for the purpose of drawing on the credit, fraudulently presents to the confirming bank documents that contain, expressly or by implication, material representations of fact that to his knowledge are untrue.'

<sup>218</sup> See *Hugo: The Law Relating to Documentary Credits op cit* note 9 at 280.

<sup>219</sup> See *Warne and Elliott op cit* note 27 at 260–261.

<sup>220</sup> See, e.g., the performance bonds in *State Trading Corp'n of India Ltd v ED and F Man (Sugar) Ltd and ANR* [1981] Com LR 235 (CA); and the standby letter of credit in *Kvaerner John Brown v Midlands Bank Plc* [1998] CLC 446. See also article 20(a) of the Uniform Rules for Demand Guarantees (*ICC Publication No 458, Paris (April 1992)*) (hereinafter the 'URDG').

<sup>221</sup> See, e.g., *State Trading Corp'n of India Ltd v ED and F Man (Sugar) Ltd and ANR supra* note 220 at 236; and *United Trading Corporation SA and Murray Clayton Ltd v Allied Arab Bank Ltd and Others* [1985] 2 Lloyd's Rep 554 (CA) at 559.

<sup>222</sup> See *State Trading Corp'n of India Ltd v ED and F Man (Sugar) Ltd and ANR supra* note 220 at 236; *Esal (Commodities) Ltd and Reltor Ltd v Oriental Credit Ltd and Wells Fargo Bank NA; Banque du Caire SAE v Wells Fargo Bank NA* [1985] 2 Lloyd's Rep 546 (CA) at 550; and *Kvaerner John Brown v Midlands Bank Plc* [1998] CLC 446. See also *Enonchong op cit* note 8 at 87.

certificate, the bank might be able to refuse payment on the ground of the fraud exception.<sup>223</sup>

While, as mentioned, the substantive concept of fraud in England has only been described in general formulas that lack precision, it is apparent that whatever fraud may mean, it is to be determined by reference to the underlying transaction.<sup>224</sup>

### 5.4.3 Standard of Proof of fraud

The ordinary standard of proof in civil cases is that of the balance of probabilities.<sup>225</sup> This standard also applies in a case of fraud, but the court ‘weighs the evidence with due regard to the gravity of the particular allegation’.<sup>226</sup> Therefore, the degree of probabilities depends upon the subject matter and it is clear that a very high degree of probability is required in this context.<sup>227</sup> In *Rafsanjan Pistachio Producers Co-Operative v Bank Leumi (UK) Plc*<sup>228</sup> Hirst J said that ‘a very heavy burden of proof rests upon the defendants to establish their case to the highest level of probability’.

With regard to the standard of proof of fraud, the general formulas are that the fraud must be ‘very clearly established’ or the fraud must be ‘clear and obvious’, and the proof must be immediately available without the need for lengthy and in-depth investigation into the underlying transaction.<sup>229</sup> Even the fact that the beneficiary has made previous attempts to claim under fraudulent demands in the past is not enough evidence that a future demand under the same instrument will be fraudulent.<sup>230</sup> Elaborating on these well-established, but general formulas Ackner LJ in *United Trading Corporation SA and Murray Clayton Ltd v Allied Arab Bank Ltd and Others*<sup>231</sup> went on to provide more specific guidance as to the standard of evidence:<sup>232</sup>

The evidence of fraud must be clear, both as to the fact of fraud and as to the bank’s knowledge. The mere assertion or allegation of fraud would not be

<sup>223</sup> See also *Enonchong op cit* note 8 at 87–88.

<sup>224</sup> See *Bertrams op cit* note 14 at 348.

<sup>225</sup> See *Hugo: The Law Relating to Documentary Credits op cit* note 9 at 278.

<sup>226</sup> See *Themehelp Ltd v West and Others* [1996] QB 84 (CA) ([1995] All ER 215 (CA); and [1995] 3 WLR 751 (CA)) at 99. See also *Warne and Elliott op cit* note 27 at 261.

<sup>227</sup> See *Hugo: The Law Relating to Documentary Credits op cit* note 9 at 278.

<sup>228</sup> [1992] 1 Lloyd’s Rep 513 (QB) at 525. See also the discussion of the case in para 5.4.4 below.

<sup>229</sup> See in particular, *R D Harbottle (Mercantile) Ltd v National Westminster Bank Ltd and Others* [1978] 1 QB 146 (CA) ([1977] 2 All ER 862 (CA)); *Edward Owen Engineering Ltd v Barclays Bank International Ltd and Another* [1978] 1 QB 159 (CA) ([1978] 1 Lloyd’s Rep 166 (CA) and [1978] 1 All ER 976 (CA)); and *Bolivinter Oil SA v Chase Manhattan Bank, Commercial Bank of Syria and General Company of Homes Refinery* [1984] 1 Lloyd’s Rep 251 (CA) ([1984] 1 All ER 351 (CA) and [1984] 1 WLR 392 (CA)).

<sup>230</sup> See *Tukan Timber Ltd v Barclays Bank Plc* [1987] 1 Lloyd’s Rep 171 (QB). See *Enonchong op cit* note 8 at 85–86.

<sup>231</sup> [1985] 2 Lloyd’s Rep 554 (CA).

<sup>232</sup> [1985] 2 Lloyd’s Rep 554 (CA) at 561. Penn, however, is of the opinion that the judgment of Ackner LJ in *United Trading Corporation v Allied Arab Bank* has rendered the fraud exception impotent (see G Penn ‘On-demand Bonds – Primary or Secondary Obligations?’ [1986] 4 *Journal of International Banking Law* 224 at 229)

sufficient (see *Bolivinter Oil S.A. v. Chase Manhattan Bank N.A. . . .*). 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 buyer. In general, for the evidence of fraud to be clear, we would also expect the buyer to have been given an opportunity to answer the allegation and to have failed to provide any, or any adequate answer in circumstances where one could properly be expected. If the Court considers that *on the material before it the only realistic inference to draw is that of fraud*, then the seller would have made out a sufficient case of fraud. (Emphasis added.)

The court in *United Trading Corporation v Allied Arab Bank* found that the principals (i.e., plaintiffs) had failed to meet the test (i.e., ‘sole realistic inference’ test),<sup>233</sup> although the plaintiffs had provided, on the available material, a seriously arguable case that there was good reason to suspect, certainly in regard to some of the contracts, that the demands on the demand guarantees (i.e., performance bonds) had been made dishonestly. They, however, did not establish a strong arguable case that the only realistic inference was that the demands were fraudulent.<sup>234</sup>

The standard laid down in *United Trading Corporation v Allied Arab Bank* (i.e., ‘sole realistic inference’ test), which is quoted above, has become the generally accepted formula for the evidence that is required in order to establish fraud.<sup>235</sup> In *Themehelp v West* the Court of Appeal stated that for purposes of the appeal before it, it was unnecessary to decide whether the ‘sole realistic inference’ test introduced in *United Trading Corporation v Allied Arab Bank* involved a more burdensome standard of proof than the standard generally applied to proof of fraud, namely that fraud must be established on the balance of probabilities after weighing the evidence with due regard to the gravity of the particular allegation; or to decide whether the judge of the court of first instance (Queen’s Bench Division) was right to have treated the former test, rather than the latter, as applying in this case.<sup>236</sup>

In *Turkiye IS Bankasi AS v Bank of China*<sup>237</sup> the question before the Queen’s Bench Division (Commercial Court) was whether on the facts the fraud exception could be invoked by the bank that was sought to be made liable under a demand guarantee (a counter-performance guarantee). In dealing with this matter, Waller J stated that it was

<sup>233</sup> However, in *GKN Contractors Ltd v Lloyds Bank plc* (1985) 30 BLR 48 (CA) at 49, Parker LJ formulated the test of clear fraud to include cases where the *only reasonable inference* to be drawn from the circumstances of the call is that it is being made fraudulently.

<sup>234</sup> See [1985] 2 Lloyd’s Rep 554 (CA) at 565.

<sup>235</sup> See for instance, *Turkiye IS Bankasi AS v Bank of China* [1996] 2 Lloyd’s Rep 611 (QB (Com Ct)); and [1998] 1 Lloyd’s Rep 250 (CA); *Group Josi Re v Walbrook Insurance Co Ltd and Others* [1996] 1 Lloyd’s Rep 345 (CA) ([1996] 1 WLR 1152; and [1996] 1 All ER 791); *Themehelp Ltd v West and Others* [1996] QB 84 (CA) ([1995] All ER 215 (CA); and [1995] 3 WLR 751 (CA)); *Kvaerner John Brown v Midlands Bank Plc* [1998] CLC 446; *Czarnikow-Rionda Sugar Trading Inc v Standard Bank London* [1999] 2 Lloyd’s Rep 187 ([1999] Lloyd’s Rep Bank 197); *Balfour Beatty Civil Engineering v Technical and General Guarantee Co Ltd* (2000) 68 Con LR 180 ([2000] CLC 252; and [2000] CILL 1574); and *Solo Industries UK Ltd v Canara Bank* [2001] 2 Lloyd’s Rep 578 (CA) ([2001] 1 WLR 1800 (CA)). See also Bertrams *op cit* note 14 at 348–349.

<sup>236</sup> See [1996] QB 84 (CA) at 99E–F.

<sup>237</sup> [1996] 2 Lloyd’s Rep 611 (QB (Com Ct)). For a full discussion of this case, see A N Oelofse the Law of Documentary Letters of Credit’ *ABLU* 1997 (a paper delivered at the 1997 Annual Banking Law Update held at the Indaba Hotel, Johannesburg) (unpaginated) (hereinafter ‘*ABLU 1997*’) at 4–5 of his article.

not for a bank to make enquiries about the allegations that were being made one side against the other. If a party wished to establish that a demand was fraudulent, he had to put the irrefutable evidence in front of the bank. He should not merely make allegations and expect the bank to check whether those allegations were founded or not. Waller J stressed that it was not the role of a bank to examine the merits of allegations and counter-allegations of breach of contract. To hold a different view would place banks in a position where they would in effect have to act as courts in deciding whether to make payment or not. However, he also pointed out that a totally different situation would arise in an instance where a beneficiary admitted to the bank that it had no right to make the demand.<sup>238</sup>

Waller J, rejected the defence that there was clear evidence of fraud. He found that the mere allegation of fraud was not sufficient, as ‘irrefutable’ evidence that the claimant was dishonest was required, before the reasonable banker could refuse to pay under the demand. The Court of Appeal also upheld this decision.<sup>239</sup> The Court of Appeal found that the use of the adjective ‘irrefutable’ in the court of first instance was merely intended to epitomise the *Edward Owen* test and not to depart from that test.<sup>240</sup>

#### 5.4.4 The Time at Which Knowledge of Fraud Must be Proved

When dealing with the fraud exception, it is important to establish the exact time at which the fraud must be clear to the beneficiary and the bank. It has often been said it has to be clear evidence of fraud *at the time of presentation of the documents*. In *Group Josi Re v Walbrook Insurance Co Ltd and Others*<sup>241</sup> Staughton LJ said that the decision in *United City Merchants v Royal Bank of Canada*<sup>242</sup> showed that it did not matter that at the time of trial the beneficiary and the bank knew that the documents presented under the letter of credit were not truthful in a material respect. He stressed that it was the time of presentation that was critical.<sup>243</sup>

It has been said that it is doubtful whether the full *dictum* is correct, or follows from the decision of the House of the Lords in *United City Merchants v Royal Bank of Canada*.<sup>244</sup> Undoubtedly, the beneficiary must know of the fraud at the time of the presentation. If the beneficiary does not have such knowledge he obviously cannot be party to the fraud. However, it is debatable that the bank does not need to know of the fraud at the time of presentation.<sup>245</sup> For instance, if the bank rejects on the grounds of non-conformity at the time of presentation and later finds out prior to trial that the beneficiary had committed a

<sup>238</sup> See [1996] 2 Lloyd’s Rep 611 (QB (Com Ct)) at 617.

<sup>239</sup> See *Turkiye IS Bankasi AS v Bank of China* [1998] 1 Lloyd’s Rep 250 (CA).

<sup>240</sup> See at 253.

<sup>241</sup> [1996] 1 Lloyd’s Rep 345 (CA) ([1996] 1 WLR 1152; and [1996] 1 All ER 791).

<sup>242</sup> [1983] AC 168 (HL) ([1982] 2 Lloyd’s Rep 1 (HL)).

<sup>243</sup> See [1996] 1 Lloyd’s Rep 345 (CA) at 360.

<sup>244</sup> [1983] AC 168 (HL) ([1982] 2 Lloyd’s Rep 1 (HL)).

<sup>245</sup> In *Deutsche Ruckversicherung AG v Walbrook Insurance Co Ltd and Others; Group Josi Re (formerly known as Group Josi Reassurance SA) v Walbrook Insurance Co Ltd and Others* [1994] 4 All ER 181 (QBD) ([1995] 1 WLR 1017 (QBD)) at 195, Phillips J correctly stated that evidence of the bank’s knowledge of the beneficiary’s fraud was an academic issue in applications for injunctions once that fraud has been established to the satisfaction of the court.

fraud at the time of presentation, it would be irrational if the bank could not rely on the fraud exception, given that the exception is based on public policy. Therefore, it is submitted that whilst the beneficiary must be a party to the fraud at the time of presentation, and so must necessarily have knowledge of the fraud, the bank may still rely on the beneficiary's fraud, if, for instance, it rejects for some other reason such as non-conformity, and consequently discovers the fraud. It would be odd if the bank were unable to rely on the fraud exception simply because by reason of the efficacy of the fraud it did not know of the fraud at the time it rejected the documents. This view is supported by the decision in *Rafsanjan Pistachio Producers Co-Operative v Bank Leumi (UK) Plc.*<sup>246</sup>

In *Rafsanjan v Bank Leumi* the applicant and the beneficiary caused the issuing bank to open the documentary credit on a false basis. The bank was told that the transactions were new transactions, when in reality they were not. The court found that the agent of the beneficiary intended to deceive the bank. The bank was entitled to refuse payment on the grounds of fraud. However, the bank also refused payment on the grounds of discrepancies in the documents presented under the credits. This case demonstrates how banks will often reject in the first instance on the grounds of discrepancies and thereafter will justify such rejection on the fraud exception as well. Although article 16(c)(ii) of UCP 600<sup>247</sup> provides that a bank must state all the discrepancies in respect of which the bank refuses the documents, this does not apply to the fraud exception, because at common law a contract can be set aside for fraud even if that was not the original justification for the refusal to perform. In any case, the evidence of the fraud may only transpire at a later stage. Fraud is often used as an additional reason for non-payment where the documents had initially only been rejected as non-conforming.<sup>248</sup>

This issue was directly addressed in *Balfour Beatty Civil Engineering and Another v Technical and General Guarantee Co Ltd.*<sup>249</sup> This was an appeal from an application for summary judgment on a demand guarantee (i.e., a performance guarantee). The defence of the surety for not paying under the performance bond was that the beneficiary had no honest belief that there had been a default under the underlying contract, giving rise to the ability to make a valid presentation. The question that arose was what the position would be if the surety (or bank) had rejected at the time of presentation, without sufficient evidence of fraud, but the evidence later become available.<sup>250</sup>

Waller LJ (with the concurrence of the court) held that:<sup>251</sup>

If at the Ord 14 stage the bank can show that the only proper inference is fraud it would be absurd to think that the bank would have judgment entered against it. It would not seem right to hold that since the bank can recover from its customer, it is legitimate to give judgment in favour of the fraudster allowing recovery from the fraudster only at the suit of the customer.

<sup>246</sup> [1992] 1 Lloyd's Rep 513 (QB). See also Warne and Elliott *op cit* note 27 at 261–262.

<sup>247</sup> See also article 14(d)(ii) of UCP 500.

<sup>248</sup> See also Warne and Elliott *op cit* note 27 at 267.

<sup>249</sup> See (2000) 68 Con LR 180 ([2000] CLC 252; and [2000] CILL 1574).

<sup>250</sup> See also Warne and Elliott *op cit* note 27 at 262.

<sup>251</sup> See (2000) 68 Con LR 180 at 189. See also Warne and Elliott *op cit* note 27 at 262.

The answer, as it seems to me, is that on analysis if a bank or surety has a clear case at the Ord 14 stage which it did not have at the demand stage, that the demand was fraudulent, the bank has a counterclaim against the fraudster which it is capable of establishing for the return of the money. Just to expand on that theme a little. It is clear that simply because after demand on a bond it turns out that no sum was due from the customer to his contractor, that does not lead to the bank or surety having any remedy against the beneficiary of the bond. The customer who of course must indemnify the bank or surety may have a right as against the beneficiary under the contract but that is all. If however the beneficiary has made a fraudulent representation to the bank in order to obtain money under the bond, I cannot see why in addition to any remedy that the bank's customer may have (if the customer has been forced to indemnify the bank), the bank does not have its own remedy directly against the beneficiary.<sup>252</sup>

Colman J in *Mahonia Ltd v JP Morgan Chase Bank and Another*<sup>253</sup> takes the view that the earlier cases did not intend restricting the time by which the evidence of fraud must be available to the extent of negating evidence of fraud that has come to light after presentation of the documents, but before hearing the case. The point was rather that the bank would have to reach a decision on whether to pay or not, soon after presentation of the documents. Usually it will only refuse payment in the light of compelling evidence available to it at that stage. However, if the bank refuses to pay on a suspicion of fraud and is sued, and prior to hearing the case acquires evidence, this evidence should be admissible.<sup>254</sup>

Whereas previously the rule that the bank was obliged to pay against a demand that complied with the terms of the letter of credit or performance guarantee unless, *at the time of presentation*, the bank had clear evidence from which the only inference that could be drawn was that it was fraudulent, it now seems, as a result of more recent decisions,<sup>255</sup> that a bank may also be entitled to rely on knowledge it obtained *between the demand and the hearing* that (1) the demand was fraudulent; or (2) that the letter of credit or performance guarantee was voidable for fraudulent misrepresentation when the demand was made, as grounds for refusing to pay the beneficiary.<sup>256</sup>

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<sup>252</sup> This *dictum* was considered by the Court of Appeal in *Solo Industries UK Ltd v Canara Bank* [2001] 2 Lloyd's Rep 578 (CA) ([2001] 1 WLR 1800 (CA)) who held that the true explanation as to why a bank should be able to rely on evidence of fraud obtained after the presentation of documents is that 'fraud unravels all'. Therefore, as a matter of principle a court will not allow a claim that is based on fraud to succeed (see also Warne and Elliott *op cit* note 27 at 262–263).

<sup>253</sup> [2003] 2 Lloyd's Rep 911 (QB (Com Ct)).

<sup>254</sup> See also *ABLU 2004 op cit* note 8 at 9 of the article.

<sup>255</sup> See, e.g., *Balfour Beatty Civil Engineering and Another v Technical and General Guarantee Co Ltd* (2000) 68 Con LR 180 ([2000] CLC 252; and [2000] CILL 1574); *Safa Ltd v Banque du Caire* [2000] 2 Lloyd's Rep 600 (CA); *Solo Industries UK Ltd v Canara Bank* [2001] 2 Lloyd's Rep 578 (CA) ([2001] 1 WLR 1800 (CA)); and *Standard Bank (London) Ltd v Canara Bank* [2002] All ER (D) 340 (May) ([2002] EWHC 1032 (Comm) (QB)). For a full discussion of all these cases, see Clark *op cit* note 1 in paras 53–71 at 18–23.

<sup>256</sup> See also Clark *op cit* note 1 in paras 51 and 71–72 at 17 and 23.

### 5.4.5 Fraud as Basis for Injunctive Relief<sup>257</sup>

The fraud exception is normally invoked as a defence of last resort where there is no other means of preventing payment being made under the instrument. Before resorting to this difficult defence, the question of whether there is a contractual basis for refusing payment under the terms of the instrument itself must be fully explored.<sup>258</sup>

A main factor that limits the availability of the fraud exception is the high standard of proof that is required. For the exception to apply, the evidence of fraud must be clear or obvious.<sup>259</sup> This requires that at an interlocutory stage the claimant must show that there is a real prospect of establishing that on the material available the ‘only realistic inference to draw is that of fraud’.<sup>260</sup> A mere allegation of fraud is not enough, nor is it enough to show that there is good reason to suspect fraud. Even the fact that the beneficiary has made previous attempts to claim under fraudulent demands in the past is not enough evidence that a future demand under the same instrument will be fraudulent.<sup>261</sup> Furthermore, where the injunction is against the bank, even if fraud on the part of the beneficiary is clearly established, that is not sufficient; it must, in addition, be shown that the bank was clearly aware of the fraud.<sup>262</sup>

Most cases involving demand guarantees and the fraud exception concern unsuccessful attempts by the principal to prevent the bank (guarantor) by injunction from making a payment under the guarantee, where demand has been made in a proper form, and within time.<sup>263</sup> *Edward Owen Engineering Ltd v Barclays Bank International Ltd and Another*;<sup>264</sup> *United Trading Corporation SA and Murray Clayton Ltd v Allied Arab Bank Ltd and Others*;<sup>265</sup> and *Bolivinter Oil SA v Chase Manhattan Bank, Commercial Bank of Syria and General Company of Homes Refinery*,<sup>266</sup> were all cases concerned with obtaining an injunction preventing payment under a demand guarantee.<sup>267</sup> In all these cases the applicant (i.e., principal) was unsuccessful in obtaining an interlocutory injunction. A few

<sup>257</sup> For a full discussion of injunctive relief, see Chapter 7.

<sup>258</sup> See Warne and Elliott *op cit* note 27 at 285.

<sup>259</sup> See para 5.4.3 above.

<sup>260</sup> See *United Trading Corporation SA and Murray Clayton Ltd v Allied Arab Bank Ltd and Others* [1985] 2 Lloyd’s Rep 554 (CA) at 561

<sup>261</sup> See *Tukan Timber Ltd v Barclays Bank Plc* [1987] 1 Lloyd’s Rep 171 (QB).

<sup>262</sup> See Enonchong *op cit* note 8 at 85–86.

<sup>263</sup> See, e.g., *Edward Owen Engineering Ltd v Barclays Bank International Ltd and Another* [1978] 1 QB 159 (CA) ([1978] 1 Lloyd’s Rep 166 (CA) and [1978] 1 All ER 976 (CA)); *United Trading Corporation SA and Murray Clayton Ltd v Allied Arab Bank Ltd and Others supra* note 260; and *Bolivinter Oil SA v Chase Manhattan Bank* [1984] 1 Lloyd’s Rep 251 (CA) ([1984] 1 All ER 351 (CA) and [1984] 1 WLR 392 (CA)). A similar commercial letter of credit case, include *Discount Records Ltd v Barclays Bank Ltd and Barclays Bank International Ltd* [1975] 1 Lloyd’s Rep 444 (Ch D) ([1975] 1 WLR 315; and [1975] 1 All ER 1071).

<sup>264</sup> [1978] 1 QB 159 (CA) ([1978] 1 Lloyd’s Rep 166 (CA) and [1978] 1 All ER 976 (CA)).

<sup>265</sup> *Supra* note 260.

<sup>266</sup> [1984] 1 Lloyd’s Rep 251 (CA) ([1984] 1 All ER 351 (CA) and [1984] 1 WLR 392 (CA)).

<sup>267</sup> A similar case dealing with commercial letters of credit includes *Discount Records Ltd v Barclays Bank Ltd and Barclays Bank International Ltd* [1975] 1 Lloyd’s Rep 444 (Ch D) ([1975] 1 WLR 315; and [1975] 1 All ER 1071).



of the more recent cases, such as *Themehelp Ltd v West and Others*<sup>268</sup> and *Kvaerner John Brown v Midlands Bank Plc*<sup>269</sup> concern successful attempts made by the principal to obtain an injunction to prevent the beneficiary from making a demand. Such cases are interlocutory (interim) decisions where the court is being requested to give injunctive relief on the basis of the facts that are apparent at that early stage in the litigation. In order for the fraud exception to apply in the English law at the interlocutory stage or trial, there must be clear evidence of fraud to the knowledge of the bank (guarantor/issuing bank in the case of a letter of credit) prior to the payment being made.<sup>270</sup>

If the principal fears that a fraudulent demand is going to be made under the demand guarantee, he should inform the bank of the evidence of fraud immediately. The bank will then need to decide whether the evidence of fraud is sufficient for it to refuse payment in the event of a demand being made. If the bank refuses to pay, it may damage its own reputation and become the defendant to litigation by the beneficiary to enforce the instrument. Conversely, if the bank rejects the evidence of clear and obvious fraud and makes payment, then it would be liable to the principal if it were subsequently held that it should have invoked the fraud exception on the materials available at the time. The principal would also then be entitled to refuse to indemnify the bank (guarantor).<sup>271</sup>

However, if the principal (applicant) obtains an injunction restraining the making of payment, then the bank may avoid damage to its reputation, because the bank will not be held responsible for having complied with a court order. Where there is evidence of fraud, a short-term injunction may at least freeze the position for a short period of time during which the beneficiary may be forced either to abandon the attempt to obtain payment or to produce evidence countering the allegations of fraud. Banks who find themselves in the above predicament often invite applications for injunctions from the applicant (principal) informally, because such an injunction in the short term is both in the interests of the bank and of the customer (principal).<sup>272</sup>

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<sup>268</sup> [1996] QB 84 (CA) ([1995] All ER 215 (CA) and [1995] 3 WLR 751 (CA)). It was stated that this case was exceptional, in that here the relief was sought at an earlier stage than usual, that is to say a restraint against the beneficiaries alone in proceedings to which the guarantor was not a party, to prevent the exercise by the beneficiaries of their power to enforce the guarantee by giving notice of the other party's alleged default in discharging the liability which was the subject-matter of the guarantee. At the time, it was uncertain whether or not an application of that nature was one which the court had power to grant, and what principles should have been applied to it. The Court of Appeal confirmed the court of first instance decision that the court did have the jurisdiction to entertain such an application (see *Themehelp Ltd v West* [1996] QB 84 (CA) ([1995] All ER 215 (CA) and [1995] 3 WLR 751 (CA)) at 97A–B and 98–99). An earlier case dealing with a similar issue was *Elian and Rabbath (trading as Elian & Rabbath) v Matsas and Matsas; JD McLaren and Co Ltd; and Midland Bank Ltd* [1966] 2 Lloyd's Rep 495 (CA). Here the principal of a (ordinary bank) guarantee also attempted to only restrain the beneficiary or their agents from making a demand under the guarantee. Here the validity of the guarantee was disputed, though not apparently on grounds of fraud. The court of first instance granted an interlocutory injunction. The beneficiaries and their agents appealed, but the Court of Appeal dismissed their appeal and confirmed the injunction. The injunction had been granted on the ground that the beneficiary/shipowner had refused to release the goods, which he had promised to do in consideration of the principal/shipper putting up the guarantee. The Court of Appeal indicated that this was a special case in which an injunction should have been granted (see at 497).

<sup>269</sup> [1998] CLC 446.

<sup>270</sup> See Warne and Elliott *op cit* note 27 at 285–286.

<sup>271</sup> See Warne and Elliott *op cit* note 27 at 286.

<sup>272</sup> *Idem*.

As mentioned above, English courts have produced limited cases where they have accepted that a sufficient case of fraud had been made out in relation to demand guarantees and commercial letters of credit: *Themehelp Ltd v West and Others*;<sup>273</sup> *Kvaerner John Brown v Midlands Bank Plc*;<sup>274</sup> and *Banco Santander SA v Bayfern Ltd*.<sup>275</sup> In these cases, none of them involved actions brought by the applicant (principal) against the bank (guarantor). They are cases involving either actions against the bank's dishonour, such as in *Banco v Bayfern*, or actions against the beneficiary's demand for payment, such as in *Themehelp v West*.

From case law and legal writing it might appear that English courts have taken a different approach in letter of credit cases where the applicant takes an action against the issuer for an injunction preventing him from honouring a letter of credit from cases where the beneficiary takes an action against the issuer for wrongful dishonour, or cases where the applicant takes an action against the beneficiary to prevent him from demanding payment.<sup>276</sup> This seems to have been implied by Megarry J in *Discount Records v Barclays Bank*, a case where the applicant applied for an injunction preventing the issuer (bank) from paying under a letter of credit, when he said that in this case there was no established fraud, but merely an allegation of fraud. He pointed out that the defendants (i.e., the issuers), who were not concerned with that matter, had understandably adduced no evidence on the issue of fraud. He then stated that it seemed unlikely that any action to which the beneficiary was not a party would contain the evidence required to resolve this issue.<sup>277</sup>

It also seems that Goode supports this view. He said that a distinction must be drawn between the evidence necessary to obtain an interlocutory injunction and the evidence necessary to entitle a bank that had refused to pay to justify its refusal in proceedings against it. In the latter case, he explained that all that the bank had to show at the trial was that on a balance of probabilities the beneficiary was guilty of fraud. Whereas in proceedings against the bank for an injunction, either the fraud must be established or the evidence of it must be compelling.<sup>278</sup>

In *Group Josi Re v Walbrook Insurance Co Ltd and Others*<sup>279</sup> the applicant applied for an injunction to restrain the beneficiary from presenting documents under a letter of credit. Here it was argued that different principles applied where the injunction sought would merely prevent presentation (i.e., demand payment) and would not interfere with the obligation of a bank to make payment. The Court of Appeal rejected this argument and relied on another judgment given by the Court of Appeal in *Dong Jin Metal Co Ltd v*

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<sup>273</sup> [1996] QB 84 (CA) ([1995] All ER 215 (CA) and [1995] 3 WLR 751 (CA)).

<sup>274</sup> [1998] CLC 446.

<sup>275</sup> [1999] Lloyd's Rep Bank 239 ([1999] EWHC 284 (Comm)) and affirmed in [2000] Lloyd's Rep Bank 165 ([2000] EWCA Civ 57).

<sup>276</sup> However, it appears that no such distinction has been made in the US (see also Xiang Gao *op cit* note 41 at 51). For a discussion of what the position in the US is, see para 5.5.6 below.

<sup>277</sup> [1975] 1 Lloyd's Rep 444 (Ch D) ([1975] 1 WLR 315; and [1975] 1 All ER 1071) at 447.

<sup>278</sup> See Goode *op cit* note 150 at 294. See also Xiang Gao *op cit* note 41 at 51.

<sup>279</sup> [1996] 1 Lloyd's Rep 345 (CA) ([1996] 1 WLR 1152; and [1996] 1 All ER 791).

*Raymet Ltd*<sup>280</sup> where Lloyd LJ said (and with which Lords Justices Beldam and Rose had agreed):<sup>281</sup>

It is this ability on the part of the seller to raise money on the strength of a letter of credit, and indeed to treat the letter of credit like a bill of exchange, as being the equivalent of cash, which has been described in subsequent cases as “the life blood of commerce”. As soon as the letter of credit is opened and confirmed, the courts should be reluctant to interfere with the course of business between the parties under the letter of credit at any subsequent stage of the transaction. I would therefore reject the distinction.

In *Dong Jin Metal Co Ltd v Raymet Ltd* the Court of Appeal thus found that there was therefore no distinction to be drawn between cases where it was sought to restrain the beneficiary and cases where it was sought to restrain the bank.<sup>282</sup>

The Court of Appeal in the *Group Josi* case therefore put an end to that view, and it was also buried in *Czarnikow-Rionda Sugar Trading Inc v Standard Bank London Ltd and Others*<sup>283</sup> on the grounds that the effect on the ‘life blood of commerce’ would be the same whether the bank is restrained from paying or the beneficiary is restrained from asking for payment.<sup>284</sup>

Other commentators have also said that the distinction is an impossible one, because there are many cases where a third party such as a negotiating bank stands in the shoes of a beneficiary and has the right to present documents. It would therefore make no sense to apply different principles to the granting of an injunction depending on the chance event of whether or not the documents had been negotiated.<sup>285</sup>

When dealing with demand guarantees, the opinion has been expressed that different principles apply to demand guarantees, because there is an important distinction between an injunction preventing the beneficiary thereof from making a demand in the requisite form, and an injunction preventing the bank from making payment upon such demand having been given. *Themehelp v West* involved such an action by the principal against the beneficiary’s demand for payment under a demand guarantee.<sup>286</sup> However, Rix J in *Czarnikow-Rionda Sugar Trading Inc v Standard Bank London Ltd and Others*<sup>287</sup> seriously doubted that such a distinction existed. He held that the judgment in *Themehelp v West* was

<sup>280</sup> 13 July 1993 (CA) (Lexis Nexis). In this case the plaintiffs sought to restrain the defendants as sellers of goods from presenting documents under a letter of credit in circumstances where the goods had not been shipped. See the reference to this case in *Group Josi Re v Walbrook Insurance* [1996] 1 Lloyd’s Rep 345 (CA) ([1996] 1 WLR 1152; and [1996] 1 All ER 791) at 361.

<sup>281</sup> See the quotation as provided in *Group Josi Re v Walbrook Insurance supra* note 280 at 351.

<sup>282</sup> See *Group Josi Re v Walbrook Insurance Co Ltd and Others supra* note 280 at 351. See also Warne and Elliott *op cit* note 27 at 268–269.

<sup>283</sup> [1999] 2 Lloyd’s Rep 187 ([1999] Lloyd’s Rep Bank 197).

<sup>284</sup> See Clark *op cit* note 128 at 338.

<sup>285</sup> See also Warne and Elliott *op cit* note 27 at 269.

<sup>286</sup> This view that different principles apply depending on the circumstances has been supported by Lord Justice Balcombe and Lord Justice Waite in *Themehelp v West* [1996] QB 84 (CA) ([1995] All ER 215 (CA) and [1995] 3 WLR 751 (CA)), and to a very limited extent also by Lord Justice Evans.

<sup>287</sup> [1999] 2 Lloyd’s Rep 187 ([1999] Lloyd’s Rep Bank 197).

based either on a genuine distinction that the claim was made against the beneficiary alone at an early stage, well before the question of enforcement of the demand guarantee arose, or on the basis of a wrong concession made that a claim against the beneficiary, as opposed to against the bank, was not covered by prior authority (case law).<sup>288</sup>

However, as the number of cases in which the fraud exception has been applied is very limited, it is too soon to draw such conclusions.<sup>289</sup> There also appears to be conflicting views on whether or not a distinction should be made in the different situations and therefore it still remains a debatable issue. Hopefully, the House of Lords will soon put an end to this debate.

Where a principal does succeed in establishing fraud, an injunction will not be granted unless the principal can also satisfy the ‘balance of convenience test’. This test is part of the general requirement for an application for an interim injunction.<sup>290</sup> The test aims to determine whether the balance of convenience favours the granting or refusal of an injunction. In the context of an application to prevent payment under a demand guarantee the applicant faces ‘an insuperable difficulty’<sup>291</sup> where the application is against the bank.<sup>292</sup> This is so, because in such a case an injunction would be an inappropriate remedy as it interferes with the bank’s undertaking to pay; an injunction might cause greater damage to the bank than the principal could pay on his undertaking as to damages; and in such a case damages would be an adequate remedy.<sup>293</sup> Even where the principal applies for an injunction against the beneficiary rather than the bank, and the beneficiary is a large company with considerable assets within the jurisdiction, the balance of convenience test will still weigh heavily against the claimant (principal).<sup>294</sup> It follows that, because of the difficulty of establishing fraud in the first place, and then also satisfying the balance of convenience test in order to obtain an injunction to restrain the beneficiary from making a demand or the bank from paying, it is extremely rare for a principal to be protected from an abusive call through recourse to the fraud exception.<sup>295</sup>

#### 5.4.6 Summary and Conclusion

The fraud exception is generally acknowledged in the United Kingdom and English courts have recognised, as a matter of principle, that the rule of independence ceases to apply where fraud is involved in a letter of credit/demand guarantee transaction. However, the English law has not developed the fraud rule to any great extent in relation to commercial letters of credit. Most of the cases on the fraud rule concern demand guarantees where slightly different issues arise.

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<sup>288</sup> *Supra* note 287 at 202. See also Warne and Elliott *op cit* note 27 at 269.

<sup>289</sup> See Xiang Gao *op cit* note 41 at 51.

<sup>290</sup> See *American Cyanamid Co v Ethicon Ltd* [1975] AC 396 (HL) ([1975] 1 All ER 504 (HL)). For a full discussion, see para 7.2.4 in Chapter 7.

<sup>291</sup> See *R D Harbottle (Mercantile) Ltd v National Westminster Bank Ltd* [1978] 1 QB 146 (CA) at 155B.

<sup>292</sup> See Enonchong *op cit* note 8 at 86.

<sup>293</sup> See Enonchong *op cit* note 8 in note 31 at 86.

<sup>294</sup> See, e.g., *State Trading Corpn of India Ltd v ED and F Man (Sugar) Ltd and ANR* [1999] 2 Lloyd’s Rep 187 ([1999] Lloyd’s Rep Bank 197).

<sup>295</sup> See Enonchong *op cit* note 8 at 86–87.

English courts have taken the most stringent view as regards the concept of fraud and the evidence thereof, at least in the context of applications for injunctive relief against banks. The English courts have traditionally been very reluctant to interfere with the operation of a letter of credit/demand guarantee, and have adopted a relatively inflexible and narrow approach towards the application of the fraud rule. This stems from the extreme reluctance of English courts to interfere with what is perceived as the absolute and independent nature of the bank's obligations.<sup>296</sup> English courts have saddled plaintiffs with a great burden of proof, requiring them to establish the existence of 'clear' or 'obvious' fraud also known to the issuer in order to invoke the fraud rule. Undoubtedly, the beneficiary must also know of the fraud at the time of the presentation, because in the absence of such knowledge the beneficiary cannot be party to the fraud. The ordinary standard of proof in civil cases is that of the balance of probabilities. This standard also applies in a fraud case, but the court will weigh the evidence with due regard to the gravity of the particular allegation. It has become the generally accepted formula for the evidence, which is required in order to establish fraud – that it should be the only realistic inference to draw that the demand was fraudulent. The proof must also be immediately available without the need for lengthy and in-depth investigation into the underlying contract. Therefore, the only exception where a bank does not have to pay under a demand guarantee is where there is clear fraud of which the bank has notice and to which the beneficiary was a party.

When it comes to the substantive concept of fraud, it appears from the forbidding language and the way the independence principle has been applied in leading cases that the English courts employ a very restricted concept of fraud, which is maybe even narrower than that in other jurisdictions. There are a number of cases that have indicated a reluctance on the part of English courts to interfere with banks' payment obligations under a documentary credit, except under special conditions, and maybe even greater reluctance in the case of demand guarantees.

The English law accepts that there is an exception to the strict principle of independence of letters of credit – the bank should not have to pay under a letter of credit, if it knew that the documents presented were forged or that the request for payment was made fraudulently in circumstances when there was no right to payment. This also applies to demand guarantees.<sup>297</sup> Although fraud in the form of forged or fraudulent documents presented is quite relevant in relation to commercial letters of credit, it is of minor significance to demand guarantees, because many demand guarantees are payable on first demand without any additional documents. From the case law discussed above, it is clear that fraud in relation to demand guarantees usually do not involve a forged document, but rather a demand that is fraudulent based on grounds derived from the underlying contract. Therefore, the question of fraud regarding a demand guarantee often arises if a defence against payment is made which is based on grounds derived from the underlying transaction.<sup>298</sup>

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<sup>296</sup> As mentioned before, the only cases where an injunction was granted are *Elian and Rabbath (trading as Elian & Rabbath) v Matsas and Matsas*; *JD McLaren and Co Ltd*; and *Midland Bank Ltd* [1966] 2 Lloyd's Rep 495 (CA) (against the beneficiary and bank); *Themehelp Ltd v West and Others* [1996] QB 84 (CA) ([1995] All ER 215 (CA) and [1995] 3 WLR 751 (CA)); and *Kvaerner John Brown v Midlands Bank Plc* [1998] CLC 446 (against the beneficiary and bank). See also *Bertrams op cit* note 14 at 354.

<sup>297</sup> See paras 5.4.1 and 5.4.2 above.

<sup>298</sup> See paras 5.1, 5.4.1 and 5.4.2 above and para 2.1 in Chapter 2.

The defence of fraud in relation to demand guarantees has been pleaded successfully in the England in only a very small minority of cases. However, some of the more recent cases have also indicated that the English courts might have started to move away from the strict non-interference approach.

Notwithstanding the various expressions regarding fraud in case law, the question as to what precise kind of factual situation, if proven, amounts to fraud has largely remained unexplored and the substantive concept of fraud therefore remains rather vague. However, it would seem that the concept of fraud means some form of ‘dishonesty’. Furthermore, although the English law does not provide exactly what the concept of fraud might entail, it can be determined by reference to the underlying relationship. There are also no indications that there must be actual proof of ‘dishonest’, or ‘*mala fide*’ intentions on the part of the beneficiary or evidence of the beneficiary’s actual knowledge that he has no entitlement to payment. The judgment in *United City Merchants v Royal Bank of Canada*<sup>299</sup> suggests that fraud in this context must mean misrepresentation and it would appear that fraud is restricted to fraud in the documents (i.e., fraud in the narrow sense). Based on this, it has been said that it is an open question whether or not fraud in this context has a wider meaning than ‘misrepresentation’. This point is not yet decided and it is at the least highly debatable that fraud has a wider meaning in this context than dishonesty or deceit. However, since the basis of the fraud exception is public policy, there is no reason why the exception should be limited to misrepresentations. It is suggested that if the beneficiary’s demand is tainted by some form of fraud other than misrepresentation, there is no reason that the fraud exception should not be invoked.

Most cases involving demand guarantees and the fraud exception concern unsuccessful attempts by the principal to prevent the bank (i.e., guarantor) by injunction from making a payment under the guarantee, where demand has been made in a proper form, and within time. It is mainly because of the strict requirements regarding the evidence of fraud that most applications for interlocutory injunctions have failed. However, a few of the more recent cases concern successful attempts made by the principal to obtain an injunction to prevent the beneficiary from making a demand.

A main factor that limits the availability of the fraud exception under the English law is the high standard of proof that is required. For the exception to apply, the evidence of fraud must be clear or obvious. This requires that at an interlocutory stage the claimant must show that there is a real prospect of establishing that on the material available the only realistic inference to draw is that of fraud. A mere allegation of fraud is not enough, nor is it enough to show that there is good reason to suspect fraud. Therefore, where a principal applies for an injunction against the bank to restrain it from paying, it will not be enough if he merely proves clear fraud on the part of the beneficiary, as he must also show that the bank was clearly aware of the fraud.<sup>300</sup> Practically, however, the fraud exception does not afford satisfactory protection against abusive calls due to the notorious difficulty in, firstly,

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<sup>299</sup> [1983] AC 168 (HL) ([1982] 2 Lloyd’s Rep 1 (HL)) at 183F–G.

<sup>300</sup> See *Enonchong op cit* note 8 at 85–86.

establishing fraud<sup>301</sup> and, secondly, satisfying the balance of convenience test in order to obtain an injunction to restrain payment.<sup>302</sup>

## 5.5 AMERICAN LAW

### 5.5.1 Introduction

As mentioned above,<sup>303</sup> before *Sztejn v J Henry Schroder Banking Corporation*<sup>304</sup> was decided, a number of letter of credit cases in the United States merely touched on the issue of fraud, but none of them considered the fraud exception in any detail, due to the underdevelopment of the fraud rule at the time. Therefore, not much discussion appeared in those cases about what kind of fraud might invoke the fraud rule.<sup>305</sup>

As already mentioned,<sup>306</sup> a breakthrough in the development of the fraud rule in the law of letters of credit came only in 1941, when a United States court delivered its judgment in *Sztejn v J Henry Schroder Banking Corporation*. This case was so ground breaking that the fraud rule that had manifested from it was later codified for the first time in Prior UCC article 5 section 5-114(2).<sup>307</sup> Although the fraud exception was codified for the first time in the UCC in 1964, it was rarely used until the Iranian revolution in 1979. The Iranian crisis brought with it an abundance of cases demanding relief from fraudulent draws under standby letters of credit running into several hundred millions of dollars.<sup>308</sup>

Prior UCC article 5 section 5-114(2) was later revised and the fraud exception is now codified in article 5 section 5-109 of the 1995 version of the UCC ('Revised UCC article 5').<sup>309</sup>

### 5.5.2 Position Under the Uniform Commercial Code

As already mentioned, *Sztejn v J Henry Schroder Banking Corporation*<sup>310</sup> or the fraud rule that had manifested from it was codified in Prior UCC article 5 section 5-114(2) (i.e., the

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<sup>301</sup> See the discussion in paras 5.4.1 and 5.4.3 above.

<sup>302</sup> See the discussions in para 5.4.5 above and in para 7.2.4 in Chapter 7. See also *Enonchong op cit* note 8 at 85.

<sup>303</sup> See paras 5.3.1 and 5.3.2 above.

<sup>304</sup> 31 NYS 2d 631 (1941); and for a full discussion, see para 5.3.3 above.

<sup>305</sup> See *Xiang Gao op cit* note 41 at 66.

<sup>306</sup> See para 5.3.3 above.

<sup>307</sup> See the full discussion of Prior UCC article 5 section 5-114(2) in paras 5.5.2.1, 5.5.3, 5.5.4.2 and 5.5.4.3 below; and for a discussion of the background to Prior UCC article 5 section 5-114(2), see in paras 3.4.2 and 3.4.2.2 in Chapter 3.

<sup>308</sup> See *McCullough op cit* note 20 in para 5.04[3][b]. See also the discussion in para 5.5.4.3 below and in para 7.3 in Chapter 7.

<sup>309</sup> See the full discussion of Revised UCC article 5 section 5-109 in paras 5.5.2.2, 5.5.3, and 5.5.4.4 below, and for a discussion of the background to Revised UCC article 5 section 5-109, see in paras 3.4.2 and 3.4.2.2 in Chapter 3.

<sup>310</sup> 31 NYS 2d 631 (1941).

1962 version).<sup>311</sup> Therefore, the relevant provisions of the previous article 5 section 5-114(2) ought to be considered first whenever the Revised UCC article 5 section 5-109 (i.e., the 1995 version), the current fraud rule in the United States, is examined.<sup>312</sup>

### 5.5.2.1 Position Under Prior UCC Article 5 Section 5-114(2)<sup>313</sup>

Prior UCC article 5 section 5-114 clearly provided for the fraud exception to the independence principle of letters of credit. Section 5-114(1) first confirmed the independence principle and stated that the issuing bank had to honour a demand for payment complying with the terms of the credit 'regardless of whether the goods or documents conform to the underlying contract for sale or other contract between the customer and the beneficiary.'<sup>314</sup> The fraud rule was then embodied in section 5-114(2), which provided as follows:

Unless otherwise agreed when documents appear on their face to comply with the terms of a credit but a required document does not in fact conform to the warranties made on negotiation or transfer of a document of title (Section 7-507) or of a certified security (Section 8-108) or is forged or fraudulent or there is fraud in the transaction:

- (a) the issuer must honor the draft or demand for payment if honor is demanded by a negotiating bank or other holder of the draft or demand which has taken the draft or demand under the credit and under circumstances which would make it a holder in due course (Section 3-302) and in an appropriate case would make it a person to whom a document of title has been duly negotiated (Section 7-502) or a bona fide purchaser of a certificate security (Section 8-302); and
- (b) in all other cases as against its customer, an issuer acting in good faith may honor the draft or demand for payment despite notification from the customer of fraud, forgery or other defect not apparent on the face of the documents but a court of appropriate jurisdiction may enjoin such honor.

Section 5-114(2) was, in essence, a restatement of the spirit of the *Sztejn* case.<sup>315</sup> Xiang Gao said that if one looked from the viewpoint of the development of the fraud rule, the effect of putting the fraud rule into the UCC was far more significant in quite a few regards than just the case law in *Sztejn* would have been by itself.<sup>316</sup>

1. By placing the fraud rule into the UCC, a statute, it clearly told the victims of letters of credit fraud that they could effectively protect their interest by using the weapon of the fraud rule. Such victims no longer had to structure their cases using other

<sup>311</sup> For a discussion of this case, see para 5.3.3 above. See also A N Oelofse *The Law of Documentary Letters of Credit in Comparative Perspective* (1997) (hereinafter '*Oelofse: The Law of Documentary Letters of Credit*') at 421.

<sup>312</sup> See Xiang Gao *op cit* note 41 at 42.

<sup>313</sup> For a detailed discussion, see also McCullough *op cit* note 20 in para 5.04[2][c]-5.04[3][d].

<sup>314</sup> See also Hugo: *The Law Relating to Documentary Credits op cit* note 9 at 284.

<sup>315</sup> See *Oelofse: The Law of Documentary Letters of Credit op cit* note 311 at 421.

<sup>316</sup> See Xiang Gao *op cit* note 41 at 43.



- principles, such as the law of contracts as in *Higgins v Steinhardter*,<sup>317</sup> or arguments, such as by saying that the documents were non-conforming as in *Old Colony Trust Co v Lawyers' Title and Trust Co*.<sup>318</sup>
2. Section 5-114(2) specified that the fraud rule could be applied in two settings, something not indicated in any of the earlier cases, including *Sztejn*:
    - i. a court of competent jurisdiction could enjoin an issuer from honouring a letter of credit if 'documents appear on their face to comply with the terms of a credit but a required document . . . is forged or fraudulent or there is fraud in the transaction'; and
    - ii. the issuer 'may' voluntarily invoke the fraud rule and dishonour a draft or demand for payment if fraud as above was brought to its attention.<sup>319</sup>
  3. This codification, despite its modest form, played a very important role in the harmonisation and unification of the fraud rule in the letters of credit. After promulgation, section 5-114(2) was regularly cited and utilised by courts and letter of credit users in the United States. The section served as a good uniform guideline to parties dealing with letter of credit fraud disputes and in many areas unified earlier conflicting practices.<sup>320</sup>
  4. By codifying the case law into a statute, the position of the fraud rule was strengthened in the law of letters of credit. The promulgation of section 5-114(2) has greatly promoted study of the fraud rule. This is illustrated by a large increase in the volume of case law on letter of credit fraud and legal writings<sup>321</sup> on the fraud rule worldwide since the section's promulgation.<sup>322</sup>

Prior UCC article 5 section 5-114(2) proceeded from the basis that if on their face the documents conformed, the bank had to pay. The section did not precisely state any exceptions to this principle. However, what the section did state, was that despite the fact that in a specific case the documents (1) did not conform to statutory warranties made on negotiation or transfer of certain documents, or were (2) forged, or (3) fraudulent, or (4) if there was 'fraud in the transaction',<sup>323</sup> the bank, nevertheless, had to honour the credit against a *bona fide* holder for value of the documents (that could either be a negotiating

<sup>317</sup> 175 NYS 279 (1919). See the discussion of this case in para 5.3.1 above.

<sup>318</sup> 297 F 152 (1924). See Xiang Gao *op cit* note 41 at 43; and cf the discussion of this case in para 5.3.2 above.

<sup>319</sup> See Xiang Gao *op cit* note 41 at 43. It is important to note that the issuer was not obliged to invoke the fraud rule and to dishonour a draft or demand for payment if fraud was brought to its attention, but it merely could do so if it so wished. However, in practice, banks were more likely to pay than to refuse to pay because doing the latter might have damaged their reputation, their largest asset. In many cases they even opposed applicants' applications for injunctions, because by obtaining an injunction restraining the bank from honouring that undertaking, the applicant would undermine what was the bank's biggest asset, however large and rich it may be, namely its reputation for financial and contractual probity (see Xiang Gao *op cit* note 41 in note 38 at 43; and *Bolivinter Oil SA v Chase Manhattan Bank* [1984] 1 Lloyd's Rep 251 (CA) ([1984] 1 All ER 351 (CA); and [1984] 1 WLR 392 (CA)).

<sup>320</sup> See Xiang Gao *op cit* note 41 at 44.

<sup>321</sup> A great deal, too much to list here, has already been written about the fraud exception.

<sup>322</sup> See Xiang Gao *op cit* note 38 at 44.

<sup>323</sup> Section 5-114(2) was ambiguous in that it did not mention the identity of the fraudulent party. It has been said that the provision focused on the nature of the documents tendered and totally neglected the identity of the fraudster. Therefore, the fraud exception was applicable whenever 'documents' or 'a required document' was forged or fraudulent. In other words, under section 5-114(2), the nature of the documents tendered was the only concern in a case of fraud (see Xiang Gao *op cit* note 41 at 116 and the authority cited).

bank, a holder in due course of the draft, a person to whom a document of title had been duly negotiated; or a *bona fide* purchaser of security). Thus, by negative stipulation, as against the beneficiary himself, the bank could refuse to honour the credit in these specific situations. However, the bank was not obliged (merely entitled) to refuse payment in these circumstances. In fact, as against its client (i.e., applicant of the letter of credit), the section specifically authorised the bank to honour the demand, provided it did so in good faith. However, the bank could also be enjoined from paying under these circumstances.<sup>324</sup>

Therefore, in the case of non-conformance with the statutory warranties, or in the case where a document was forged or fraudulent, or when there was ‘fraud in the transaction’, the issuing bank could dishonour or be enjoined from honouring a letter of credit. However, the exact meaning of, and distinction between, these different exceptions were by no means clear.<sup>325</sup>

The first exception (the statutory warranties) related to documents of title and securities. The warranties that arose on presentation of documents of title included: ‘a warranty to the issuer that the document is genuine, that the presenting party has no knowledge of any fact that would impair its validity or worth, and that negotiation and transfer is rightful and effective’. In the instance of the presentation of a security, the presenter warranted in addition ‘that the security has not been altered materially’.<sup>326</sup> The second exception related to forged documents. A forged document is one ‘that includes a forged signature’.<sup>327</sup> There was a clear overlap with the first exception as the presentation of a forged document of title (e.g., a bill of lading) or security would clearly not conform to the warranties. However, the second exception also extended to documents other than documents of title and securities such as commercial invoices or certificates of inspection.<sup>328</sup>

The third exception related to fraudulent documents. According to White and Summers,<sup>329</sup> a ‘fraudulent document’ is ‘one that is specious, conjured up out of whole cloth, or one that has been materially altered’.<sup>330</sup> They also point out that the line between ‘fraudulent

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<sup>324</sup> See *Hugo: The Law Relating to Documentary Credits op cit* note 9 at 285 and authorities cited. For a discussion of injunctions under Prior UCC article 5 section 5-114(2)(b), see para 5.5.6 below and para 7.3 in Chapter 7.

<sup>325</sup> See *Hugo: The Law Relating to Documentary Credits op cit* note 9 at 285.

<sup>326</sup> See *Dolan: The Law of Letters of Credit op cit* note 1 in para 7.04[3].

<sup>327</sup> See J J White and R S Summers *Handbook of the Law under the Uniform Commercial Code* 2 ed (1980) at 735. McCullough states that a forged document is one bearing a forged or otherwise unauthorised signature, and probably includes a document bearing a genuine or authorised signature but which is otherwise forged as to content or authenticity (see McCullough *op cit* note 20 in para 5.04[2][c][ii] at 5-22).

<sup>328</sup> See *Dolan: The Law of Letters of Credit op cit* note 1 in para 7.04[3]. See also *Hugo: The Law Relating to Documentary Credits op cit* note 9 at 285–286.

<sup>329</sup> See White and Summers *op cit* note 327 at 735. As an example they refer to *Dynamics Corporation of America v The Citizens and Southern National Bank* 356 F Supp 991 (ND Ga 1973) (see discussion of case below).

<sup>330</sup> McCullough states that a fraudulent document is one which appears on its face to be proper and authentic, but which is false or counterfeit, and probably includes a document which has been materially altered. He also points out that forged documents are probably also fraudulent, but fraudulent documents may not necessarily be forged. Furthermore, a document of title is fraudulent if it misdescribes the goods covered and if the presenter of the document knows of this misdescription. However, a document which misdescribes the goods through error is not a fraudulent document (see McCullough *op cit* note 20 in para 5.04[2][c][iii] at 5-22). *Merchants Corporation v Chase Manhattan Bank NA* 5 UCC Rep Serv 196 (NY Sup Ct 1968); and

documents' and 'fraud in the transaction' is not always clear, as a 'fraudulent transaction' may be held to generate what would also qualify as 'fraudulent documents'.<sup>331</sup> For example, *Sztejn v J Henry Schroder Banking Corporation*<sup>332</sup> was a case that involved fraudulent documents and fraud in the transaction.<sup>333</sup>

The fourth exception was where there was 'fraud in the transaction'. As seen below, this phrase was particularly problematic due to a diversity of opinion as to the exact meaning of the term.<sup>334</sup>

As section 5-114(2) was drafted merely as a basis for future development and because it was drafted nearly 50 years ago, the provisions of the section were not perfect, and in some cases it even led to confusion among courts and letter of credit users. Some of the problems experienced with section 5-114(2) included the following:<sup>335</sup>

- The section failed to mention what constituted fraud under the fraud rule, so different standards of fraud were subsequently applied in different cases.
- The section provided that the fraud rule should be applied 'when . . . a required document . . . is forged or fraudulent' or 'there is fraud in the transaction'. Placing the two quotations parallel led to unnecessary confusion about where fraud needed to be located.
- The section named three types of parties that might be immune from the fraud rule:<sup>336</sup> (1) a holder in due course stipulated in section 3-302 of the UCC; (2) a holder of a document of title duly negotiated according to section 7-502 of the UCC; and (3) a *bona fide* purchaser of certified security under section 8-302 of the UCC. In fact, only the status named in item (1) 'a holder in due course', has proven to be relevant to the application of the fraud rule.<sup>337</sup> The Task Force, which was formed for

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*Regent v Azmat Bangladesh Ltd* 686 NYS 2d 24, 38 UCC Rep Serv 2d 131 (1999) both involved cases where fraudulent documents were presented and whereupon applications for injunctions were made.

<sup>331</sup> See White and Summers *op cit* note 327 at 736. For excellent explanations of this problem, see J J Krimm 'U.C.C. – Letters of Credit and "Fraud in the Transaction"' (1986) 60 *Tulane Law Review* 1088 at 1097–1098; and Getz *op cit* note 20 at 208–209.

<sup>332</sup> 31 NYS 2d 631 (1941). See the discussion of this case, in para 5.3.3 above.

<sup>333</sup> See Dolan: *The Law of Letters of Credit op cit* note 1 in para 7.04[3]; White and Summers *op cit* note 327 at 736; and Krimm *op cit* note 331 at 1097–1098. See also Hugo: *The Law Relating to Documentary Credits op cit* note 9 at 286.

<sup>334</sup> See also Hugo: *The Law Relating to Documentary Credits op cit* note 9 at 286. For a full discussion, see McCullough *op cit* note 20 in para 5.04[2][c][vi].

<sup>335</sup> See Xiang Gao *op cit* note 41 at 44–45.

<sup>336</sup> For a full discussion of presenters that will be immune from the fraud rule, see Xiang Gao *op cit* note 41 at 137–165; Xiang Gao 'The Identity of the Fraudulent Party Under the Fraud Rule in the Law of Letters of Credit' (as reprinted in J E Byrne and C S Byrnes (eds) 2003 *Annual Survey of Letter of Credit Law and Practice* (2003) (hereinafter '2003 Annual Survey') at 62–79); and Xiang Gao 'Presenters Immune From the Fraud Rule in the Law of Letters of Credit' (as reprinted in 2003 *Annual Survey op cit* note 336 at 80–104).

<sup>337</sup> Oelofse refers to this as the 'cutting off' of the fraud exception in certain circumstances. In his view, it was a shining example of bad logic and made little commercial sense. According to him, there was no reason why the 'fraud defence' should become unavailable or the possibility of enjoining payment be excluded merely because someone has taken transfer of a document of title or has become a holder in due course of a draft drawn under the credit. He points out that the basic principle is that a transferee of rights cannot be in a stronger position than the transferor. He acknowledges that the law of negotiable instruments of course provides a significant exception to the basic principle, but in this context this could make a difference, seen

the revision of section 5-114(2),<sup>338</sup> found during their investigation that there were no cases that had applied UCC article 7 or 8 in the context of section 5-114(2).

As already mentioned above, the phrase ‘fraud in the transaction’ had been the source of considerable uncertainty and conflicting views.<sup>339</sup> It was not apparent whether the ‘transaction’ referred to the relationship between the beneficiary and the issuer or to the underlying contract between the beneficiary and the applicant or to both.<sup>340</sup> From many cases it was totally unclear what the courts understood under ‘fraud in the transaction’.<sup>341</sup> In *Roman Ceramics Corporation v Peoples National Bank*<sup>342</sup> it was held that if a beneficiary presented a required statement of non-payment of an invoice, knowing that the invoice had, in fact, been paid, it constituted ‘fraud in the transaction’. This hardly took the matter any further, since the document itself was also a fraudulent one.<sup>343</sup> In other cases the exact scope of the phrase ‘fraud in the transaction’ was eventually left open.<sup>344</sup> While yet other cases paid little or no attention to the source of the fraud, but rather pointed out that the fraud had to be ‘serious’ before an injunction could be granted.<sup>345</sup> According to

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from the point of view of the issuing bank and the applicant, *only* if the issuing bank had *bound itself on the negotiable instrument* (e.g., by accepting the bill of exchange). He indicates that the wide wording of section 5-114(2)(a) suggested that the holder in due course of a bill of exchange drawn by a fraudulent beneficiary under a letter of credit could acquire an indefeasible right against the issuing bank, despite the fact that the bank had incurred no liability on the bill of exchange itself. He submitted that the issuing bank’s (and therefore indirectly the applicant’s) ‘fraud defence’ could have been ‘cut off’ only as against a holder in due course to whom the bank was liable *on the negotiable instrument*, or as against the reimbursement claim of a nominated, confirming or negotiating bank which has been paid before the appropriate steps could have been taken to prevent payment (see *Oelofse: The Law of Documentary Letters of Credit op cit* note 311 at 425). There is merit in Oelofse’s arguments. However, the American courts assumed that this unacceptable result was correct (see *United Bank Ltd v Cambridge Sporting Goods Corp* 360 NE 2d 943 (NYCA 1976); *Menard Inc v King de Son Co Ltd* 467 NW 2d 34 (1991); and *Scarsdale National Bank and Trust Company v The Toronto-Dominion Bank* 533 F Supp 378 (1982)) (for a discussion of this case, see McCullough *op cit* note 20 in para 5.04[2][c][iv] at 5-25–5-26 ). Revised UCC article 5 section 5-109, largely eliminated these deficiencies, pointed out by Oelofse, in Prior UCC article 5 section 5-114(2)(a) (see the discussion in para 5.5.2.2 below and see also note 423 below).

<sup>338</sup> See the Report of the Task Force on the Study of UCC Article 5 ‘An Examination of UCC Article 5 (Letters of Credit)’ (1990) 45 *The Business Lawyer* 1521 (hereinafter the ‘Task Force Report’) at 1621.

<sup>339</sup> See *Dolan: The Law of Letters of Credit op cit* note 1 in para 7.04[3][b]; and McCullough *op cit* note 20 in para 5.04[2][c]; and W C Hillman *Letters of Credit: Current Thinking in America* (1987) at 38–58. See also *Oelofse: The Law of Documentary Letters of Credit op cit* note 311 at 421; and *Hugo: The Law Relating to Documentary Credits op cit* note 9 at 286.

<sup>340</sup> See also McCullough *op cit* note 20 in para 5.04[2][c][iv].

<sup>341</sup> See e.g. *Werner v AL Grootemaat and Sons* 259 NW 2d 310 (1977); *Bossier Bank and Trust Company v Union Planters National Bank of Memphis* 550 F 2d 1077 (1977); *KMW International v Chase Manhattan Bank NA* 606 F 2d 10 (2nd Cir 1979); *Banque Worms, New York Branch v Banque Commerciale Privee* 679 F Supp 1173 (SDNY 1988) (for a discussion of this case, see McCullough *op cit* note 20 in para 5.04[3][f] at 5-64–5-65); and *Ultra Scope International Inc v Extebank* 599 NYS 2d 361 (1992). See also *Oelofse: The Law of Documentary Letters of Credit op cit* note 311 at 421–422.

<sup>342</sup> 714 F 2d 1207 (3d Cir 1983).

<sup>343</sup> See also *Oelofse: The Law of Documentary Letters of Credit op cit* note 311 in note 242 at 422.

<sup>344</sup> See *American Bell International Inc v The Islamic Republic of Iran* 474 F Supp 420 (SDNY 1979) at 424 (for a full discussion of this case, see P C Reed ‘A Reconsideration of *American Bell International Inc v Islamic Republic of Iran* 474 F Supp 420 (S.D.N.Y 1979)’ 1981 *Columbia Journal of Transnational Law* 301); and *Northwestern Bank v NCF Financial Corporation* 365 SE 2d 14 (1988) at 20.

<sup>345</sup> See e.g., *GATX Leasing Corporation v DBM Drilling Corporation* 657 SW 2d 178 (1983).

McCullough,<sup>346</sup> the *Sztejn* case was primarily a case of fraud in the underlying contract and the fact that the documents in that case were also fraudulent were merely incidental. To this, Oelofse added that if McCullough was correct, and if the *Sztejn* case should be regarded as codified in Prior UCC article 5 section 5-114(2), it would follow that ‘fraud in the transaction’ was not limited to fraud impacting on the relationship between issuer and beneficiary (which would usually be ‘fraud in the documents’), but also covered fraud that was limited to the underlying relationship between applicant and beneficiary.<sup>347</sup> This was the ‘broad’ view of ‘fraud in the transaction’.<sup>348</sup>

In general, there was a distinction between two different approaches, namely, a narrow approach and a broad one.<sup>349</sup> The narrow approach as supported by, *inter alia*, Harfield<sup>350</sup> and Dolan<sup>351</sup> required that the fraud had to be ‘in the letter of credit transaction or in a transaction so intimately related to the letter of credit transaction as to be an implied term of it’.<sup>352</sup> The broad approach, as supported by, *inter alia*, Krimm<sup>353</sup> and Van Houten<sup>354</sup> took a less strict view and accepted that fraud in the underlying transaction could be sufficient.<sup>355</sup> One of the arguments in this regard was that the other exceptions (referred to

<sup>346</sup> See McCullough *op cit* note 20 in para 5.04[2][c][iv].

<sup>347</sup> See Oelofse: *The Law of Documentary Letters of Credit op cit* note 311 at 422.

<sup>348</sup> *Idem*.

<sup>349</sup> This is the terminology used by Dolan (see *Dolan: The Law of Letters of Credit op cit* note 1 in para 7.04[3][b]), while Getz on the other hand differentiates between a ‘strict’ and a ‘more flexible equitable approach’ (see Getz *op cit* note 20 at 206). For a very comprehensive review of the many US cases in this regard, see Dolan: *The Law of Letters of Credit op cit* note 1 in para 7.04[4][a]–[e]. See also Getz *op cit* note 20; H Harfield *Bank Credits and Acceptances* 5 ed (1974) 80–83; Krimm *op cit* note 331; and Sarna *op cit* note 150 and *Letters of Credit* 3d (loose-leaf edition) (1989) in para 5(3)(c).

<sup>350</sup> See Harfield *op cit* note 349 at 82–83.

<sup>351</sup> See Dolan: *The Law of Letters of Credit op cit* note 1 in para 7.04[3][b].

<sup>352</sup> See *Bank of Nova Scotia v Angelica-Whitewear Ltd* (1987) 36 DLR (4<sup>th</sup>) 161 (SCC) (Supreme Court of Canada) at 170. See also the *Task Force Report op cit* note 338 at 1622. For some cases adopting this narrow view, see, e.g., *Dynamics Corporation of America v The Citizens and Southern National Bank* 356 F Supp 991 (ND Ga 1973); *Intraworld Industries Inc v Girard Trust Bank* 461 Pa 343, 336 A 2d 316 (Pa 1975); *Bossier Bank and Trust Company v Union Planters National Bank of Memphis* 550 F 2d 1077 (1977) (for a discussion of this case, see Xiang Gao *op cit* note 41 at 108–109); *Foreign Venture Limited Partnership v Chemical Bank* 399 NYS 2d 114 (1977); *Shaffer v Brooklyn Park Garden Apartments* 250 NW 2d 172 (1977) (for a discussion of this case, see McCullough *op cit* note 20 in para 5.04[3][a]); *O’Grady v First Union National Bank* 250 SE 2d 587 (1978) (for a discussion of this case, see Xiang Gao *op cit* note 41 at 109–110); *Federal Deposit Insurance Corporation v Bank of San Francisco* 817 F 2d 1395 (9<sup>th</sup> Cir 1987); and *Xantech Corporation v Ramco Industries Inc* 643 NE 2d 918 (1994). For comments on this view, see also J B Justice ‘Letters of Credit: Expectations and Frustrations – Pts 1 & 2’ (1977) 94 *Banking Law Journal* 424 at 493; and H Harfield ‘Enjoining Letter of Credit Transaction’ (1978) 95 *Banking Law Journal* 596 at 606.

<sup>353</sup> See Krimm *op cit* note 331 at 1101.

<sup>354</sup> S H Van Houten ‘Letters of Credit and Fraud: A Revisionist View’ (1978) 62 *Canadian Bar Review* 371 at 384–388.

<sup>355</sup> See also the *Task Force Report op cit* note 338 at 1624. For some cases adopting this broad view, see, e.g., *United Bank Ltd v Cambridge Sporting Goods Corp* 360 NE 2d 943 (NYCA 1976); *United Technologies Corporation v Citibank NA* 469 F Supp 473 (1979); *NMC Enterprises Inc v Columbia Broadcasting System Inc* 14 UCC Rep Serv 1427 (NYSC 1974); *American Bell International Inc v The Islamic Republic of Iran* 474 F Supp 420 (SDNY 1979); *Cromwell v Commerce and Energy Bank of Lafayette* 464 So 2d 721 (La 1985) (for a discussion of this judgment, see McCullough *op cit* note 20 in para 5.04[3][c] at 5-60–5-61) (the court *a quo* in the *Cromwell* case (see 450 So 2d 1 (La App 3d Cir 1984))

above) covered all forms of fraud in the documentary credit transaction. Therefore, for ‘fraud in the transaction’ not to have been redundant in the context of section 5-114(2), it necessarily also had to refer to fraud in the underlying transaction.<sup>356</sup>

In *Dynamics Corporation of America v The Citizens and Southern National Bank*<sup>357</sup> it seemed that the court took a ‘narrow view’ of the fraud exception as it was set out in the *Sztejn* case and the Prior UCC article 5 section 5-114(2).<sup>358</sup> In this case the beneficiary of a standby letter of credit presented a certificate of default and claimed payment. The applicant (i.e., customer of the bank) sought an injunction against the bank on the basis that he was not in default, that the beneficiary knew this and that his frustrations stemmed from factors that could not be attributed to the applicant (i.e., an embargo imposed by the United States due to the Indo-Pakistani war). The court found that the certificate of default was ‘a *pro forma* declaration’ with ‘absolutely no basis in fact’ and was therefore a fraudulent document.<sup>359</sup> In this case and in *Intraworld Industries Inc v Girard Trust Bank*<sup>360</sup> the court seemed to limit the fraud exception to fraud impacting on the issuer–beneficiary relationship – in particular to fraudulent statements in the documents. In *Intraworld* the lessee (applicant of letter of credit) of a Swiss Hotel had arranged for a standby letter of credit to be issued to guarantee payment of a certain period of rent in advance as liquidated damages for its non-performance under the lease. The beneficiary demanded payment under the letter of credit. The lessee sought an injunction to restrain the bank from paying. The lessee alleged that the demand was fraudulent because no rent was due as the contract had been terminated by the beneficiary (lessor); and the claim was not one for rent, but for a stipulated penalty under the lease.<sup>361</sup> The court did not attempt to establish whether, in

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seemed to favour the narrow view (for a discussion of both these judgments of *Cromwell*, see Xiang Gao *op cit* note 41 at 105–106)); *Harris Corporation v National Iranian Radio and Television* 691 F 2d 1344 (11th Cir 1982) at 1355; *Pubali Bank v City National Bank* 676 F 2d 1326 (USCA 9th Cir 1982); *Rockwell International Systems Inc v Citibank NA and Bank Tejarat* 719 F 2d 583 (USCA 2nd Cir 1983) at 588–589; *Roman Ceramics Corporation v Peoples National Bank* 714 F 2d 1207 (3d Cir 1983); *Itek Corporation v First National Bank of Boston* 730 F 2d 19 (1984); *Bank of Newport v First National Bank and Trust Company of Bismarck* 687 F 2d 1257 (1982) (for a discussion of this case, see Xiang Gao *op cit* note 41 at 107–108); *Emery-Waterhouse Co v Rhode Island Hospital Trust National Bank* 757 F 2d 399 (1985); *Airline Reporting Corporation v First National Bank of Holly Hill* 832 F 2d 823 (4th Cir 1987); *Recon/Optical Inc v Government of Israel* 816 F 2d 854 (2nd Cir 1987); *InterFirst Bank Greenspoint v First Federal Savings and Loan Association Beloit* 747 P 2d 129 (Kan 1987); *Ciambotti v Decatur-St Louis Lupin Properties Ventures* 746 SW 2d 897 (Tex Ct App 1988); and *The Village of Long Grove v Austin Bank of Chicago* 694 NE 2d 456 (1994). For comments on this view, see also Anon ‘Letters of Credit: Injunction As a Remedy for Fraud in UCC Section 5-114’ (1979) 63 *Minnesota Law Review* 487 at 502; and Getz *op cit* note 20 at 208.

<sup>356</sup> See Getz *op cit* note 20 at 208. However, for a contrary view, see *Dolan: The Law of Letters of Credit op cit* note 1 in para 7.04[3]. See also *Hugo: The Law Relating to Documentary Credits op cit* note 9 at 287.

<sup>357</sup> 356 F Supp 991 (ND Ga 1973). For a discussion of this case, see McCullough *op cit* note 20 in para 5.04[3][a].

<sup>358</sup> See *Oelofse: The Law of Documentary Letters of Credit op cit* note 311 at 422.

<sup>359</sup> See *Dynamics Corporation of America v The Citizens and Southern National Bank* 356 F Supp 991 (ND Ga 1973) at 999. See also *Hugo: The Law Relating to Documentary Credits op cit* note 9 in note 197 at 286.

<sup>360</sup> 461 Pa 343, 336 A 2d 316 (Pa 1975). For a discussion of this case, see *Dolan: The Law of Letters of Credit op cit* note 1 in para 7.04[4][b]; Getz *op cit* note 20 at 209; McCullough *op cit* 20 in para 5.04[3][a]; and E L Symons ‘Letters of Credit: Fraud, Good Faith and the Basis for Injunctive Relief’ (1980) 54 *Tulane Law Review* 338 at 370–371.

<sup>361</sup> See *Intraworld Industries Inc v Girard Trust Bank* 461 Pa 343, 336 A 2d 316 (Pa 1975) at 324.

fact, rent was due (a question it considered to be a matter to be settled by a Swiss court).<sup>362</sup> The court did, however, refuse the injunction and said:<sup>363</sup>

In light of the basic rule of the independence of the issuer's engagement and the importance of this rule to the effectuation of the purpose of the letter of credit, we think that 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 purpose of the independence of the issuer's obligation would no longer be served. (Emphasis added.)

In *Federal Deposit Insurance Corporation v Bank of San Francisco*,<sup>364</sup> a later case, a similar view was expressed. Here the court limited the fraud exception to 'fraud in the presentation of the required documents'.<sup>365</sup> One more apparent example of the narrow view is found in the judgment of the Court of Appeals in Indiana in *Xantech Corporation v Ramco Industries*.<sup>366</sup> In the *Xantech* case, the court stated that the 'fraud in the transaction' exception to the autonomy principle applied only where a fraudulent 'credit transaction' was alleged, as opposed to fraud in the 'underlying contract'.<sup>367</sup> Harfield<sup>368</sup> was also of the view that 'mere' fraud inducing the underlying contract would probably be insufficient under the United States law to justify an order restraining payment.<sup>369</sup>

There was also support for the broad view.<sup>370</sup> It has also been said that jurisprudence and literature, 'recognize and illustrate the need to extend the meaning of "fraud in the

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<sup>362</sup> See at 326.

<sup>363</sup> See at 324–325. It also appeared from this *dictum* in *Intraworld* that the 'fraud in the transaction' exception was to be limited to fraud by the beneficiary as opposed to that by a third party. There was also additional support for this view in the US case law. Therefore, in the event of a forged or fraudulent document, however, the beneficiary, due to certain statutory warranties, would seldom have been able to rely on the fact that the forgery or fraud was that of a third party. In addition to the warranties regarding the documents of title and securities under section 5-114 itself, in terms of section 5-111(1) 'the beneficiary by transferring or presenting a documentary draft or demand for payment warrants to all interested parties that the necessary conditions of the credit have been complied with' (see also *Hugo: The Law Relating to Documentary Credits op cit* note 9 at 289 and the authorities cited). Hugo also points out that if *United City Merchants v Royal Bank of Canada* [1983] AC 168 (HL) ([1982] 2 Lloyd's Rep 1 (HL)) (the English case discussed in para 5.4 above), were to be decided under Prior UCC article 5 section 5-114(2), the case would have been decided quite differently.

<sup>364</sup> 817 F 2d 1395 (9th Cir 1987) at 1399.

<sup>365</sup> Oelofse points out that the involvement of the rights of the Federal Deposit Insurance Corporation also played a role in the court's conclusion (see *Oelofse: The Law of Documentary Letters of Credit op cit* note 311 in note 248 at 423).

<sup>366</sup> 643 NE 2d 918 (1994) at 921.

<sup>367</sup> See *Oelofse: The Law of Documentary Letters of Credit op cit* note 311 at 423.

<sup>368</sup> See H Harfield 'Identity Crises in Letter of Credit Law' (1982) *Arizona Law Review* 239 at 245.

<sup>369</sup> This view was also defended by Dolan (see *Dolan: The Law of Letters of Credit op cit* note 1 in para 7.04[3][c] at 7-57); and Thorup A R 'Injunctions against Payment of Standby Letters of Credit: How Can Banks Best Protect Themselves?' (1984) *Banking Law Journal* 6 at 16.

<sup>370</sup> See, in general, Anon "Fraud in the Transaction": Enjoining Letters of Credit during the Iranian Revolution' (1980) 93 *Harvard Law Review* 992. See, e.g., *United Bank Ltd v Cambridge Sporting Goods Corp* 360 NE 2d 943 (NYCA 1976); *United Technologies Corporation v Citibank NA* 469 F Supp 473 (1979); *Cromwell v Commerce and Energy Bank of Lafayette* 464 So 2d 721 (La 1985); and *The Village of Long Grove v Austin Bank of Chicago* 694 NE 2d 456 (1994).



transaction” at least a step beyond the fraudulent documentation’.<sup>371</sup> It also seemed that the majority of case law favoured the ‘broad’ view.<sup>372</sup> In *United Bank Ltd v Cambridge Sporting Goods Corp*<sup>373</sup> the court rejected a ‘dogmatic’ approach to ‘fraud in the transaction’ in favour of a ‘flexible standard to be applied as the circumstances of a particular situation mandate’.<sup>374</sup> In this case the court also pointed out that the original version of Prior UCC article 5 section 5-114 referred only to ‘fraud in a required document’, but this was then extended to provide for both a fraudulent document and ‘fraud in the transaction’.<sup>375</sup> Oelofse indicated that the court obviously regarded this as a strong indication of an intention to include fraud in the underlying transaction under the ‘fraud exception’.<sup>376</sup> The *United Bank v Cambridge Sporting Goods* case was concerned with a shipment of boxing gloves. The seller had apparently shipped old, unpadded, ripped and mildewed gloves in place of the newly manufactured gloves as agreed upon. Oelofse pointed out that if that was so, it was most likely that, as in the *Sztejn* case, the documents presented under the credit were ‘fraudulent documents’ in any event, with the result that it was unnecessary to rely on a broad view of ‘fraud in the transaction’ in order to justify the granting of an injunction against payment.<sup>377</sup> The *United Bank v Cambridge Sporting Goods* case was a clear indication that fraud in the underlying transaction could form the basis for injunctive relief.<sup>378</sup>

The broad view was also adopted in some of the standby letter of credit cases arising from the Iranian revolution of 1979.<sup>379</sup> Although the fraud exception was codified for the first time in the UCC in 1964, it was rarely used until the Iranian revolution in 1979. The Iranian crisis brought with it an abundance of cases demanding relief from fraudulent draws under standby letters of credit running into hundreds of millions of dollars. The response of the courts in the United States was markedly different before and after the

<sup>371</sup> See *Cromwell v Commerce and Energy Bank of Lafayette supra* note 370 at 733.

<sup>372</sup> See J F Dolan ‘Documentary Credit Fundamentals: Comparative Aspects’ (1988) 2 *Banking and Finance Law Review* 121 at 132–133; G T McLaughlin ‘Letters of Credit and Illegal Contracts: The Limits of the Independence Principle’ (1989) 49 *Ohio State Law Journal* 1197 at 1202; and Xiang Gao *op cit* note 41 at 101.

<sup>373</sup> 360 NE 2d 943 (NYCA 1976) at 949. For a discussion of this case, see McCullough *op cit* note 20 in para 5.04[3][a].

<sup>374</sup> The court said (*supra* note 373 at 949):

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.

This was quoted with approval by the court in *United Technologies Corporation v Citibank NA supra* note 370.

<sup>375</sup> *Supra* note 373 at 949 and in particular note 5 at 949.

<sup>376</sup> See Oelofse: *The Law of Documentary Letters of Credit op cit* note 311 in note 253 at 423–424.

<sup>377</sup> See Oelofse: *The Law of Documentary Letters of Credit op cit* note 311 in note 253 at 424.

<sup>378</sup> See also Hugo: *The Law Relating to Documentary Credits op cit* note 9 at 288.

<sup>379</sup> See, e.g., *Harris Corporation v National Iranian Radio and Television* 691 F 2d 1344 (11th Cir 1982) at 1355; *Rockwell International Systems Inc v Citibank NA and Bank Tejarat* 719 F 2d 583 (USCA 2nd Cir 1983) at 588–589; and *Itek Corporation v First National Bank of Boston* 730 F 2d 19 (1984). However, for a full discussion of the Iranian crisis and the relevant cases, see McCullough *op cit* note 20 in para 5.04[3][b][i]–[ii] at 5-35–5-52.



seizure of the American hostages in Iran.<sup>380</sup> *Rockwell International Systems Inc v Citibank NA and Bank Tejarat*<sup>381</sup> dealt with a case where a demand was made under a standby (performance) credit. The court found that it was ‘fraud in the transaction’ on the part of the beneficiary first to cause the applicant’s default under the underlying contract and then to make a call under the credit based on such default. In *Itek Corporation v First National Bank of Boston*<sup>382</sup> the court explicitly said that it is ‘fraud in the transaction’ for the beneficiary to make a call under a letter of credit ‘under circumstances where the underlying contract plainly shows that he is not to do so’.<sup>383</sup> In this case the court found that the applicant had cancelled the underlying contract under its *force majeure* provisions, that the beneficiary knew that the applicant had done so, had been permitted to do so, and that the call under the credit was thus ‘fraudulent’.<sup>384</sup>

As Prior UCC article 5 section 5-114(2) failed to mention the required standard of fraud, vastly different opinions as to the standard of fraud required developed.<sup>385</sup> There was much support for the view that only egregious fraud, that is, ‘fraud which taints the entire transaction’,<sup>386</sup> would suffice. However, there was also support for the standard of ‘ordinary’ or ‘intentional fraud’ (i.e., fraud ‘in the sense of common law deceit requiring scienter’; i.e., one requires knowledge as a condition of fraud),<sup>387</sup> as well as for the even broader, more flexible ‘constructive fraud’ standard.<sup>388</sup>

In *NMC Enterprises Inc v Columbia Broadcasting System Inc*<sup>389</sup> the applicant of a letter of credit (i.e., customer/purchaser) sought a preliminary injunction enjoining the bank from honouring a draft drawn in terms of the documentary credit. The underlying transaction was for the purchase of various stereo receivers. The receivers were delivered, but the applicant alleged that they were considerably less powerful than specified in the brochures which, according to the applicant, was the grounds upon which he had contracted. There was also evidence before the court that the beneficiary had known this prior to the conclusion of the contract. The court found that these allegations established ‘a substantial prima facie case of fraud in the inducement of the contract’, because although the quality of the goods could not form the ground for an injunction, ‘where the documents or the *underlying transaction are tainted with intentional fraud*, the draft need not be honoured by the bank, even though the documents conform on their face’.<sup>390</sup>

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<sup>380</sup> See McCullough *op cit* note 20 in para 5.04[3][b].

<sup>381</sup> *Supra* note 379.

<sup>382</sup> *Supra* note 379 at 24.

<sup>383</sup> This was also expressly confirmed by the same court in *Ground Air Transfer Inc v Westates Airlines Inc* 899 F 2d 1269 (1st Cir 1990) at 1272–1273. See also *Oelofse: The Law of Documentary Letters of Credit op cit* note 311 in note 253 at 424.

<sup>384</sup> See *Oelofse: The Law of Documentary Letters of Credit op cit* note 311 in note 255 at 424.

<sup>385</sup> See *Hugo: The Law Relating to Documentary Credits op cit* note 9 at 287.

<sup>386</sup> See *Krimm op cit* note 331 at 1099.

<sup>387</sup> See *Symons op cit* note 360 at 339. Scienter in this sense means knowingly or wilfully. A degree of knowledge that makes an individual legally responsible for the consequences of his act.

<sup>388</sup> See *Symons op cit* note 360 at 340; *Krimm op cit* note 331 at 1099–1100; and *Getz op cit* note 20 at 207.

<sup>389</sup> 14 UCC Rep Serv 1427 (NYSC 1974). For a discussion of this case, see McCullough *op cit* note 20 in para 5.04[3][a].

<sup>390</sup> *NMC Enterprises Inc v Columbia Broadcasting System Inc supra* note 389 at 1429 (emphasis added).

Analyses of the numerous American cases dealing with these issues did not lead to anything approaching a *communis opinio*.<sup>391</sup> Getz mentioned correctly that ‘a precise resolution . . . is neither possible or justifiable on the basis of the litigated cases’.<sup>392</sup>

Whatever uncertainty there might have existed regarding the scope of the fraud exception (and the standard of fraud required) set out in Prior UCC article 5 section 5-114(2) was eliminated when the Revised UCC article 5 section 5-109<sup>393</sup> came into operation. This new section makes it quite clear that payment may be refused or interdicted not only in the case of forged or fraudulent documents, but also in the case of any other ‘material fraud by the beneficiary on the issuer *or applicant*’.<sup>394</sup> Revised UCC article 5 section 5-109 therefore constitutes a clear choice in favour of the broad view of the fraud exception.<sup>395</sup>

### 5.5.2.2 *Position Under the Revised UCC Article 5 Section 5-109*<sup>396</sup>

Together with the whole of the 1962 version of the UCC, section 5-114(2) (i.e., Prior UCC article 5 section 5-114(2))<sup>397</sup> was also thoroughly revised in 1995 to rectify the weaknesses, gaps and errors in the original statute which compromised its relevance and to meet the challenges of the constant development of letters of credit.<sup>398</sup> The fraud rule is now embodied in Revised UCC article 5 section 5-109, which reads as follows:

- (a) If a presentation is made that appears on its face strictly to comply with the terms and conditions of the letter of credit, but a required document is forged or materially fraudulent, or honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant:
  - (1) the issuer shall honor the presentation, if honor is demanded by
    - (i) a nominated person who has given value in good faith and without notice of forgery or material fraud, (ii) a confirmer who has honored its confirmation in good faith, (iii) a holder in due course of a draft drawn under the letter of credit which was taken after acceptance by the issuer or nominated person, or (iv) an assignee of the issuer’s or nominated person’s deferred obligation that was taken for value and without notice of forgery or material fraud after the obligation was incurred by the issuer or nominated person; and
    - (2) the issuer, acting in good faith, may honor or dishonor the presentation in any other case.
  - (b) If an applicant claims that a required document is forged or materially fraudulent or that honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant, a court of competent

<sup>391</sup> See *Hugo: The Law Relating to Documentary Credits op cit* note 9 at 287.

<sup>392</sup> See *Getz op cit* note 20 at 209.

<sup>393</sup> See the full discussion of Revised UCC article 5 section 5-109 in para 5.5.2.2 below.

<sup>394</sup> Emphasis added.

<sup>395</sup> See *Oelofse: The Law of Documentary Letters of Credit op cit* note 311 at 424.

<sup>396</sup> For a detailed discussion, see also *McCullough op cit* note 20 in para 5.04[2][c]–5.04[3][d].

<sup>397</sup> See the full discussion in para 5.5.2.1 above.

<sup>398</sup> See *Xiang Gao op cit* note 41 at 45.

jurisdiction may temporarily or permanently enjoin the issuer from honouring a presentation or grant similar relief against the issuer or other persons only if the court finds that:

- (1) the relief is not prohibited under the law applicable to an accepted draft or deferred obligation incurred by the issuer;
- (2) a beneficiary, issuer, or nominated person who may be adversely affected is adequately protected against loss that it may suffer because the relief is granted;
- (3) all of the conditions to entitle a person to the relief under the law of this State have been met; and
- (4) on the basis of the information submitted to the court, the applicant is more likely than not to succeed under its claim of forgery or material fraud and the person demanding honor does not qualify for protection under subsection (a)(1).

The consequences of fraud and forgery in letters of credit have been significantly revised in Revised UCC article 5 section 5-109. This revised section deals in the first instance with the position of the issuer who is confronted by a situation of forgery or fraud (section 5-109(a)), and in the second instance with injunctions by the applicant against the issuer in situations of forgery and fraud (section 5-109(b)).<sup>399</sup>

The general rule against which the fraud and forgery exceptions must be considered reads:<sup>400</sup> ‘Except as otherwise provided in Section 5-109, an issuer shall honor a presentation that, as determined by the standard practice referred to in subsection (e) appears on its face strictly to comply with the terms and conditions of the letter of credit’.

Revised UCC article 5 section 5-109(a) admits three exceptions to this general rule:

1. Where a required document has been forged;
2. Where a required document is materially fraudulent; and
3. Where honour of the presentation ‘would facilitate a material fraud by the beneficiary on the issuer or applicant’.<sup>401</sup>

<sup>399</sup> See *Hugo: The Law Relating to Documentary Credits op cit* note 9 at 290.

<sup>400</sup> See section 5-108(a) of the 1995 version of the UCC.

<sup>401</sup> A few commentators have noted that because Revised UCC article 5 section 5-109 refers to the term ‘beneficiary’ in saying that the fraud rule will be invoked if ‘a required document is forged or materially fraudulent or that honor of the presentation would facilitate a material fraud *by the beneficiary*’ (emphasis added), it means that the section requires either forgery or material fraud by the beneficiary. Therefore, if fraud is perpetrated by someone else, an injunction is not authorised (see B Wunnicke, D B Wunnicke and P S Turner *Standby and Commercial Letters of Credit* 2 ed (1996) at 163). Xiang Gao, however, strongly disagrees. He points out that under article 5-109, the fraud exception applies in two instances: (1) ‘a required document’ presented is forged or materially fraudulent; or (2) ‘honor of the presentation’ for payment would facilitate fraud by the beneficiary. Although the perpetrator will be the beneficiary in the latter case, he stresses that this will not necessarily be so in the former case. He states that a forged or fraudulent document can be produced by somebody other than the beneficiary (e.g., by the carrier or insurer of the goods). Therefore, section 5-109 has not totally ruled out the application of the fraud exception when fraud is perpetrated by someone other than the beneficiary. Like its predecessor (see note 323 above), section 5-109, is fundamentally concerned with the nature of the documents tendered, rather than the identity of the fraudulent party (see Xiang Gao *op cit* note 41 at 116–117). This is contrary to the English position, where the fraud must be committed by the beneficiary (see *United City Merchants v Royal Bank of Canada* [1983] AC 168 (HL) ([1982] 2 Lloyd’s Rep 1 (HL)) and the discussion in para 5.4.1 and in note 323 above).

As in the case of its predecessor (i.e., Prior UCC article 5 section 5-114(2)) Revised UCC article 5 section 5-109(a) then states that despite the fact that the presentation falls within one of the above exceptions, the issuer is nevertheless obliged to honour the presentation as against third parties who have given value in good faith.<sup>402</sup> In any other instance a forged or fraudulent presentation may be honoured or dishonoured by the issuer acting in good faith.<sup>403</sup> Therefore, it makes it clear that an issuer may dishonour and defend that dishonour by showing fraud or forgery of the kind stated in section 5-109(a).<sup>404</sup>

If one compares Prior UCC article 5 section 5-114(2), with Revised UCC article 5 section 5-109, it is clear that the fraud rule has been fine-tuned in a number of areas in the revised section.<sup>405</sup> The new section also differs from its predecessor in several important aspects.<sup>406</sup>

First, section 5-109, has expressly declared that when fraud is found, the normal operation of a letter of credit may be disrupted in two different ways: (1) by the issuer refusing to honour a presentation,<sup>407</sup> or (2) by the applicant requesting a court to enjoin the payment or presentation.<sup>408</sup>

Second, breach of the statutory warranties regarding documents of title and securities no longer forms part of the exceptions. Warranties are dealt with in section 5-110 of the 1995 version of the UCC. As against the issuer (or any other party to whom presentation is made) and the applicant the beneficiary warrants that there is no fraud or forgery as described in section 5-109. However, these warranties only become operational if the presentation is honoured.<sup>409</sup> Therefore, as pointed out in the Official Comment,<sup>410</sup> ‘no breach of warranty . . . can be a defense to dishonor by the issuer’ under the new revision.<sup>411</sup>

Third, Revised UCC article 5 section 5-109 addresses two of the most controversial issues raised in the application of the fraud rule since the promulgation of Prior UCC article 5 section 5-114(2), namely the standard of fraud and the concept of

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<sup>402</sup> These are: (1) a nominated person who has given value in good faith and without notice of forgery or material fraud; (2) a confirmer who has honoured its confirmation in good faith; (3) a holder in due course of a draft drawn under the letter of credit which was taken after acceptance by the issuer or nominated person; and (4) an assignee of the issuer’s or nominated person’s deferred obligation that was taken for value and without notice of forgery or material fraud after the obligation was incurred by the issuer or nominated person (see section 5-109(a)(1)).

<sup>403</sup> See section 5-109(a)(2). The election of honour or dishonour in these instances was not expressly stated in Prior UCC article 5 section 5-114(2), but was assumed by way of a by negative stipulation (see the discussion of this in para 5.5.2.1 above). See also Official Comment 2 to section 5-109; and *Hugo: The Law Relating to Documentary Credits op cit* note 9 at 290–291.

<sup>404</sup> See Official Comment 2 to section 5-109.

<sup>405</sup> See Xiang Gao *op cit* note 41 at 46.

<sup>406</sup> See *Hugo: The Law Relating to Documentary Credits op cit* note 9 at 291.

<sup>407</sup> Section 5-109(a)(2). See Official Comment 2 on Revised UCC article 5 section 5-109.

<sup>408</sup> Section 5-109(b). See also Xiang Gao *op cit* note 41 at 46.

<sup>409</sup> See section 5-110(a).

<sup>410</sup> See Official Comment 1 to section 5-110.

<sup>411</sup> See *Hugo: The Law Relating to Documentary Credits op cit* note 9 at 291.

fraud. Regarding the former, section 5-109 provides that to invoke the fraud rule, the fraud involved has to be ‘material’. As for the latter, the section indicates that the fraud considered includes fraud in the underlying transaction.<sup>412</sup> The phrase ‘fraud in the transaction’ had been abandoned. In its place section 5-109 refers to a situation where ‘honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant’. This exception is phrased widely and it is submitted that it clearly includes fraud in the underlying transaction. This view is also strengthened by the introduction of the requirement that the fraud must be ‘material’.<sup>413</sup> In this regard the Official Comment reads:<sup>414</sup>

Necessarily courts must decide the breadth and width of “materiality”. The use of the word requires that the fraudulent aspect of a document be material to a purchaser of that document or that the fraudulent act be significant to the participants in the underlying transaction . . . The courts must examine the underlying transaction when there is an allegation of material fraud, for only by examining that transaction can one determine whether a document is fraudulent or the beneficiary has committed fraud and, if so, whether the fraud was material.

Although ‘the breadth and width’ of materiality is left for the courts to decide, the Official Comment<sup>415</sup> stipulates that material fraud by the beneficiary occurs only when he ‘has no colourable right to expect honor and where there is no basis in fact to support such a right to honor’.<sup>416</sup> As such, the section is regarded as endorsing articulations such as those stated in *Intraworld Industries Inc v Girard Trust Bank*,<sup>417</sup> *Roman Ceramics Corporation v Peoples National Bank*,<sup>418</sup> and similar decisions, and embraces certain decisions under Prior UCC article 5 section 5-114(2) that relied on the phrase ‘fraud in the transaction’.<sup>419</sup>

Fourth, section 5-109(a)(1), has listed four types of parties who may be immune from the fraud rule:<sup>420</sup>

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<sup>412</sup> This is indicated in Official Comment 1 on Revised UCC article 5: ‘This recodification makes clear that fraud must be found either in the documents or must have been committed by the beneficiary on the issuer or applicant’. Furthermore it is also indicated by Official Comment 2 that specifically provides:

The courts must examine the underlying transaction when there is an allegation of material fraud, for only by examining that transaction can one determine whether a document is fraudulent or the beneficiary has committed fraud and, if so, whether the fraud was material. (Emphasis added.)

See also Xiang Gao *op cit* note 41 at 46 and 111.

<sup>413</sup> See *Hugo: The Law Relating to Documentary Credits op cit* note 9 at 291.

<sup>414</sup> See Official Comment 1 to section 5-109.

<sup>415</sup> See Official Comment 1 to section 5-109.

<sup>416</sup> See also *Hugo: The Law Relating to Documentary Credits op cit* note 9 at 291–292.

<sup>417</sup> 461 Pa 343, 336 A 2d 316 (Pa 1975).

<sup>418</sup> 714 F 2d 1207 (3d Cir 1983).

<sup>419</sup> See Official Comment 1 to section 5-109. See also the full discussion in para 5.5.4.4 below.

<sup>420</sup> See Xiang Gao *op cit* note 41 at 46–47. For a full discussion of presenters that will be immune from the fraud rule, see Xiang Gao *op cit* note 41 at 137–165.

1. a nominated person who has given value in good faith and without notice of forgery or material fraud,<sup>421</sup>
2. a confirmer who has honoured its confirmation in good faith;<sup>422</sup>
3. a holder in due course of a draft drawn under the letter of credit which was taken after acceptance by the issuer or nominated person;<sup>423</sup> or
4. an assignee of the issuer's or nominated person's deferred obligation that was taken for value and without notice of forgery or material fraud after the obligation was incurred by the issuer or nominated person.<sup>424</sup>

Unlike Prior UCC article 5 section 5-114(2)(a), which named three groups of parties who should be protected under the fraud rule, only one of which proved to be relevant, all four groups named under Revised UCC article 5-109, are relevant to the fraud rule which has been considered to be a great improvement.<sup>425</sup> It also largely eliminated the deficiencies in Prior UCC article 5 section 5-114(2)(a) that was pointed out by Oelofse.<sup>426</sup>

Fifth, section 5-109(b) has specified four conditions that must be met when a court considers an injunction. The section provides that if an applicant claims that a required document is materially fraudulent, forged, or would facilitate fraud by the beneficiary on the issuer or applicant, a court of competent jurisdiction may temporarily or permanently enjoin the issuer from honouring a presentation or grant similar relief against the issuer or other persons only if the court determines that

- the law applicable to an accepted draft or deferred obligation incurred by the issuer does not prohibit the relief;
- a beneficiary, nominated person, or issuer who might be affected adversely is sufficiently protected against losses it may suffer from the relief if granted;

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<sup>421</sup> Section 5-109(a)(1)(i).

<sup>422</sup> Section 5-109(a)(1)(ii).

<sup>423</sup> Section 5-109(a)(1)(iii). The requirements specified in Revised UCC article 5 section 5-109 to render a holder in due course immune from the fraud rule are different from those mentioned in Prior UCC article 5 section 5-114(2)(a). While a holder in due course under Prior UCC article 5 might have been a negotiating bank or any other holder of a draft or demand who could meet the requirements for a holder in due course stipulated in section 3-302 of the UCC, a holder in due course under Revised UCC article 5 should be a holder of a draft taken after acceptance by the issuer or nominated person. Compared with Prior UCC article 5, Revised UCC article 5 has narrowed the scope of immunity for parties who are holders in due course. In other words, to be entitled to the immunity two conditions have to be met: (1) the party must qualify as a holder in due course under the terms set out in article 3 of the UCC; and (2) the draft must have been accepted by the issuer or nominated person (see also Xiang Gao *op cit* note 41 in note 50 at 46). See also the deficiencies regarding Prior UCC article 5 section 5-114(2)(a) that was pointed out by Oelofse and which have been discussed in note 337 above.

<sup>424</sup> Section 5-109(a)(1)(iv). Oelofse submits that there is no justification for this instance of 'cutting off' of the fraud defence. He correctly states that if the assignor's claim was open to the fraud defence, it must remain so in the hands of a mere assignee (in contrast to a holder in due course of a negotiable instrument). According to him, the fact that the letter of credit is a deferred payment credit can surely make no difference in principle to the assignee's position (see *Oelofse: The Law of Documentary Letters of Credit op cit* note 311 in note 257 at 426). There is merit in Oelofse's view.

<sup>425</sup> See also Xiang Gao *op cit* note 41 at 47.

<sup>426</sup> See *Oelofse: The Law of Documentary Letters of Credit op cit* note 311 at 424. For a discussion of the deficiencies by Oelofse, see note 337 above.

- all requirements entitling a person to relief under the law of the state in question have been met; or
- the applicant's success in his claim of forgery or material fraud is more likely than not and the person demanding honour does not qualify for protection (by being a nominated person who has given value in good faith and without notice of forgery or material fraud; a confirmer who has honoured its confirmation in good faith; a holder in due course of a draft drawn by the nominated person or issuer; or an assignee of the issuer's or nominated person's deferred obligation that was taken for value and without notice of forgery or material fraud after the obligation was incurred by the issuer or nominated person).

These four conditions are intended to reduce the frequency with which the fraud rule has been used since the late 1970s and illustrate that the 'standard for injunctive relief is high' under Revised UCC article 5,<sup>427</sup> and that the burden remains on the applicant 'to show by evidence and not by mere allegation' that the relief is warranted.<sup>428</sup>

Revised UCC article 5 section 5-109, now stands as the most comprehensive code of the fraud rule in the law of letters of credit in the common law world.<sup>429</sup>

In recent years there has been a decline in the number of cases involving fraud. Barnes and Byrne state that this could be attributed to section 5-109's detailed treatment of fraud claims and defences, better drafting of standby letters of credit, better rules for standbys (reflected in the International Standby Practices ('ISP98')), and, generally favourable economic conditions.<sup>430</sup>

Dolan states that the law must be mindful of the serious threat the fraud exception presents to the independent undertaking (e.g., letter of credit/demand guarantee). Any jurisdiction that fails to craft a narrow fraud exception will face the wrath of the market. If the court of the state or the law of the states renders the fraud exception broad, the market will reject undertakings issued subject to that state's law. According to him, the United States reflects mature compromises on the fraud issue and that independent undertakings subject to the law of its states are acceptable in international markets.<sup>431</sup> Although the law now commands American courts to look to the underlying contract as part of the fraud inquiry, Dolan points out that that command is not an open invitation to use the underlying

<sup>427</sup> See also Xiang Gao *op cit* note 41 at 47.

<sup>428</sup> See Official Comment 4 to section 5-109. See also the discussion of injunctions under the American law in para 5.5.6 below and in para 7.3 in Chapter 7.

<sup>429</sup> See Xiang Gao *op cit* note 41 at 47.

<sup>430</sup> See J G Barnes and J E Byrne 'Letters of Credit' (2007) 62 *Business Lawyer* 1607 at 1611. A few of the more recent cases involving letter-of-credit fraud, includes: *5 East 59th Street Holding Co v Farmers and Merchants Bank of Eatonton Ga* 816 NYS 2d 68 (NY App Div 2006) (involving a case where the beneficiary sued the issuing bank for wrongful dishonour (fraud defence failed) (for a summary of this case, see *2007 Annual Survey op cit* note 34 at 128–129); *Banco Nacional de México SA v Societe Generale* 820 NYS 2d 588 (App Div 2006), revising in part, No 603266104 (NY Sup Ct 20 October 2005) ((fraud defence failed) for a discussion, see J G Barnes and J E Byrne 'Letters of Credit' (2007) 62 *Business Lawyer* 1607 at 1611–1612). For a discussion of the ISP98, see para 3.2.6 in Chapter 3 and para 4.3 in Chapter 4.

<sup>431</sup> See J F Dolan 'The UN Convention on International Independent Undertakings: Do States with Mature Letter-of-credit Regimes Need It?' (1998) 13 *Banking and Finance Law Review* 1 at 20. See also Dolan *op cit* note 14.

transaction inquiry to corrode the independence of letters of credit. He voices the opinion that courts should not engage in wide-ranging fraud inquiries,<sup>432</sup> but should limit the inquiry.<sup>433</sup>

### 5.5.3 The Concept of Fraud: Fraud in the Narrow and Wide Sense

Neither the 1962 version nor the 1995 version of the UCC defined the term ‘fraud’. However, courts in letter of credit cases generally applied the traditional concept and definition of fraud, that is, any deliberate misrepresentation of the truth of a fact in order to profit from another.<sup>434</sup>

Under Prior UCC article 5 section 5-114(2), fraud included instances where the required documents were forged or fraudulent or where there was ‘fraud in the transaction’. However, as already mentioned,<sup>435</sup> despite the adoption of the traditional definition of fraud, the phrase ‘fraud in the transaction’ had been the source of considerable uncertainty and conflicting views.<sup>436</sup> It was not apparent whether the ‘transaction’ referred to the relationship between the beneficiary and the issuer or to the underlying contract between the beneficiary and the applicant or to both. From many cases it was totally unclear what the courts understood under ‘fraud in the transaction’. This also led to two different approaches regarding this phrase, namely (1) a narrow approach and (2) a broad one. The narrow approach required that the fraud had to be in the letter of credit transaction or in a transaction so intimately related to the letter of credit transaction as to be an implied term of it. While the broad approach, took a less strict view and accepted that fraud in the underlying transaction could be sufficient.<sup>437</sup> This uncertainty regarding the fraud exception ended when Revised UCC article 5 section 5-109 was promulgated. Section 5-109 now specifically indicates that the fraud exception will not only apply in instance where a required document has been forged or is materially fraudulent, but also where there is fraud in the underlying transaction. Therefore, the phrase ‘fraud in the transaction’ used in Prior UCC article 5 section 5-114(2) was specifically abandoned. In its place section 5-109 now refers to a situation where ‘honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant’.<sup>438</sup> This exception is phrased widely and, it is submitted, that it clearly includes fraud in the underlying transaction.<sup>439</sup>

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<sup>432</sup> As he points out was done in *Hendricks v Bank of America NA* 408 F 3d 1127 (9th Cir 2005) (for a discussion of this case, see J G Barnes and J E Byrne ‘Letters of Credit’ (2006) 61 *Business Lawyer* 1591 at 1593–1594).

<sup>433</sup> See Dolan *op cit* note 14 at 502.

<sup>434</sup> See McCullough *op cit* note 20 in para 5.04[2][c][iv] at 5-23–5-24. See also *West Virginia Housing Development Fund v Sroka* 415 F Supp 1107 (WD Pa 1976); and *Western Surety Co v Bank of Southern Oregon* 257 F 3d 933 (9th Cir 2001), 44 UCC Rep Serv 2d 1239 (9th Cir 2001).

<sup>435</sup> See the full discussion in para 5.5.2.1 above.

<sup>436</sup> See McCullough *op cit* note 20 in para 5.04[2][c][iv] at 5-24.

<sup>437</sup> See the full discussion in para 5.5.2.1 above.

<sup>438</sup> See, e.g., *Mid-America Tire Inc v PTZ Trading Ltd Import and Export Agents* 95 Ohio St 3d 367 (2002 Ohio – 2427) in paras 117–133.

<sup>439</sup> See the full discussion in para 5.5.2.2 above .



It also needs to be established what constitutes fraud in the American law. In the United States it has been held that where a call was made in circumstances where the breach of the underlying contract relied on was caused by the beneficiary's own breach of such contract, that it constituted a fraudulent call.<sup>440</sup> However, in similar cases in England, it has been held in the past that such calls were not necessarily fraudulent.<sup>441</sup> In the English law honest belief on the part of the beneficiary is enough to exclude fraud.<sup>442</sup> In the United States for courts to intervene on the ground of fraud, it is not necessary for the applicant (account party) to demonstrate that either the bank or the beneficiary acted deceitfully or with malicious intent.<sup>443</sup> Neither Revised UCC article 5 section 5-109 nor its Official Comment suggests that the beneficiary's intention to defraud should be proved, therefore it seems that 'material fraud'<sup>444</sup> under this section looks 'more to the severity of the effect of the fraud on the transaction rather than the state of mind of the beneficiary'.<sup>445</sup>

## 5.5.4 Standard of Proof of Fraud

### 5.5.4.1 Pre-UCC Position

As already mentioned,<sup>446</sup> before *Sztejn v J Henry Schroder Banking Corporation*<sup>447</sup> a few cases in the United States merely touched on the issue of fraud, but none of them considered the fraud rule in detail and, accordingly, not much discussion appeared in those cases regarding what kind of fraud or what the standard of fraud had to be for the fraud rule to apply.<sup>448</sup>

Shientag J in the *Sztejn* case applied the fraud rule where the dispute was not between the buyer and seller concerning a mere breach of warranty regarding the quality of the merchandise, but where the seller had *intentionally* failed to ship any goods ordered by the buyer. Here the merchandise was not merely inferior in quality but consisted of worthless rubbish.<sup>449</sup>

<sup>440</sup> See, e.g., *Penn State Construction Inc v Cambria Savings and Loan Association* 519 A 2d 1034 (1987) (2 UCC Rep Serv 2d 1638 (Pa)) where the injunction was granted.

<sup>441</sup> See, e.g., *Edward Owen Engineering Ltd v Barclays Bank International Ltd and Another* [1978] 1 QB 159 (CA); and *Howe Richardson Scale Co Ltd v Polimex-Cekop and National Westminster Bank Ltd* [1978] 1 Lloyd's Rep 161 (CA).

<sup>442</sup> See the discussion in para 5.4.2 above.

<sup>443</sup> See *Rockwell International Systems Inc v Citibank NA and Bank Tejarat* 719 F 2d 583 (USCA 2nd Cir 1983) at 589. See also *Dynamics Corporation of America v The Citizens and Southern National Bank* 356 F Supp 991 (ND Ga 1973); *Harris Corporation v National Iranian Radio and Television* 691 F 2d 1344 (11th Cir 1982); Enonchong *op cit* note 8 at 86; and Xiang Gao *op cit* note 41 at 97.

<sup>444</sup> See the discussion of 'material fraud' as a standard of fraud under section 5-109 in para 5.5.4.4 below.

<sup>445</sup> See R P Buckley 'The 1993 Revision of the Uniform Customs and Practice for Documentary Credits' (1995) 6 *Journal of Banking and Finance Law and Practice* 77 at 97; and Xiang Gao *op cit* note 41 at 85.

<sup>446</sup> See para 5.3 above.

<sup>447</sup> 31 NYS 2d 631 (1941).

<sup>448</sup> From the minority judgment of Cardoza J in *Maurice O'Meara Co v National Park Bank of New York* 146 NE 636 (NYCA 1925) (239 NY 386 (CA 1925)) at 641 it seems that he viewed fraud as meaning 'misrepresentation'. Xiang Gao also summarises what the different views were of the commentators of that time (see Xiang Gao *op cit* note 41 at 66).

<sup>449</sup> 31 NYS 2d 631 (1941) at 634–635.

Although the word ‘intentionally’ was used in the *Sztejn* case, different views still emerged among courts and commentators regarding the standard of fraud that was adopted in this case.<sup>450</sup> Some said the case referred to a standard of ‘intentional fraud’.<sup>451</sup> Others interpreted this case as meaning an ‘egregious fraud’ standard (i.e., ‘fraud which taints the entire transaction’<sup>452</sup>).<sup>453</sup> Others argued that the apparently severe standard in this case arose out of its special procedure context – a motion to dismiss; and if the case had been heard in the context of an equitable injunction, it would have set forth ‘a more flexible equitable standard of fraud’.<sup>454</sup> There were also those who believed that the *Sztejn* case did not indicate what degree of knowledge of fraud was necessary to justify the issuing bank in refusing to pay.<sup>455</sup>

#### 5.5.4.2 Position Under Prior UCC Article 5 Section 5-114(2)

Neither Prior UCC article 5 section 5-114(2) nor its Official Comments gave any indication as to what type of fraud gave the bank an option to pay or not.<sup>456</sup> Therefore, a number of standards were suggested in the cases applying section 5-114(2).<sup>457</sup> There were vastly different opinions as to what the required standard of fraud was.<sup>458</sup> There was much support for the view that only egregious fraud, that is, ‘fraud which taints the entire transaction’,<sup>459</sup> would suffice. However, there was also support for the standard of

<sup>450</sup> See Xiang Gao *op cit* note 41 at 67.

<sup>451</sup> See Symons *op cit* note 360 at 361.

<sup>452</sup> See also note 459 below for a discussion of what the term ‘egregious fraud’ means.

<sup>453</sup> See H Harfield ‘Enjoining Letter of Credit Transaction’ (1978) 95 *Banking Law Journal* 596 at 603; and G A Fellingner ‘Letters of Credit: The Autonomy Principle and the Fraud Exception’ (1990) 1 *Journal of Banking and Finance Law and Practice* 4 at 12.

<sup>454</sup> See Getz *op cit* note 20 at 206.

<sup>455</sup> See M Megrah ‘Risk Aspects of the Irrevocable Documentary Credit’ (1982) 24 *Arizona Law Review* 255 at 258; and Xiang Gao *op cit* note 41 at 67. It has also been suggested that in *Asbury Park and Ocean Grove Bank v National City Bank of New York* 35 NYS 2d 985 (1942), another case heard by Shientag J, he himself had provided some clue of what he had meant in the *Sztejn* case (31 NYS 2d 631 (1941)), one year earlier. Xiang Gao points out that if it is true that the *Asbury Park* case could lend assistance to the interpretation of the *Sztejn* case, it might have suggested that Shientag J would have applied the fraud rule only in such situations where ‘no goods’ were shipped, ‘common-law fraud’ was involved, or ‘the seller has intentionally failed to ship any goods ordered by the buyer’. Xiang Gao also remarks that it is an open question whether Shientag J would have applied the fraud exception in the *Sztejn* case if the beneficiary’s misconduct were less serious. For a full discussion of the *Asbury Park* case, see Xiang Gao *op cit* note 41 at 67–68.

<sup>456</sup> See also *West Virginia Housing Development Fund v Sroka* 415 F Supp 1107 (WD Pa 1976) at 1114.

<sup>457</sup> See Xiang Gao *op cit* note 41 at 68.

<sup>458</sup> See Hugo: *The Law Relating to Documentary Credits op cit* note 9 at 287.

<sup>459</sup> See Krimm *op cit* note 331 at 1099. The term ‘egregious’ was not commonly used by courts in connection with fraud in relation to letters of credit, but represented a standard advocated by some commentators. The elements of ‘egregious fraud’ were also not exactly clear, but the term had been used to denote very serious misconduct in the context of letter of credit transactions. For instance, one suggested that it meant ‘a flagrant violation of the beneficiary’s obligation under the letter of credit’, while another stated it was a kind of ‘outrageous conduct which shocks the conscience of the court’ (see Xiang Gao *op cit* note 41 at 69 and the authorities referred to). An often cited case for the standard of egregious fraud is *Intraworld Industries Inc v Girard Trust Bank* 461 Pa 343, 336 A 2d 316 (Pa 1975). The term ‘egregious fraud’ was also mentioned in *New York Life Insurance Company v Hartford National Bank and Trust Company* 173 Conn 492, 378 A 2d

‘ordinary’ or ‘intentional fraud’ (i.e., fraud ‘in the sense of common law deceit requiring scienter’; i.e., one requires knowledge as a condition of fraud),<sup>460</sup> as well as for the even broader, more flexible ‘constructive fraud’ standard.<sup>461</sup> The cases applying Prior UCC article 5 section 5-114(2) did not provide a consistent answer to the question of concept or standard of fraud. As Prior UCC article 5 section 5-114(2) was silent as to what kind of fraud could invoke the fraud exception, almost every case applying this section cited the *Sztejn* case as authority and, to no surprise, the standard of fraud adopted by the courts in those cases was as diverse as the views already considered regarding the position expressed in *Sztejn*.<sup>462</sup> Therefore, some courts took a strict and restrictive approach, and adopted an egregious standard of fraud, while others were ready to take a much different approach, adopting a constructive standard of fraud. There were also courts that took an approach that fell somewhere between the two extremes.<sup>463</sup>

### 5.5.4.3 Iranian Cases

The revolution in Iran in late 1979 gave rise to considerable litigation regarding standby letters of credit (the so-called Iranian cases).<sup>464</sup> These cases raised new legal questions and provoked heated discussions regarding the standard of fraud.<sup>465</sup> These cases generally involved standby credits in the form of repayment or performance guarantees issued in favour of the Iranian government or one of its agencies. As a consequence of the Islamic revolution in Iran, the performance of many contracts by American businesses in Iran was disrupted. The American contracting parties (applicants of the standby letters of credit) feared that the new Iranian government would make punitive and unwarranted calls on these standby credits issued on application of the American contracting parties.

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562 (Sc Conn 1977); and 22 UCC Rep Serv 761 (Conn, 1977). For a full discussion of these two cases, see Xiang Gao *op cit* note 41 at 69–70.

<sup>460</sup> See Symons *op cit* note 360 at 339. Symons was of the view that: ‘A careful review of *Sztejn* and other pre-Code cases, the wording and cross references in Section 5-114, and the pervasive standard of good faith in the UCC – defined in Section 1-201(19) as “honesty in fact” – reveal that the middle ground standard, intentional fraud, is the proper interpretation of the pre-Code cases and the UCC’ (see Symons *op cit* note 360 at 340). The standard of ‘intentional fraud’ was articulated in *NMC Enterprises Inc v Columbia Broadcasting System Inc* 14 UCC Rep Serv 1427 (NYSC 1974) (for a full discussion of this case, see Xiang Gao *op cit* note 41 at 71–72; and McCullough *op cit* note 20 in para 5.04[3][a]). See also *American Bell International Inc v The Islamic Republic of Iran op cit* note 342 (for a discussion of this case, see Xiang Gao *op cit* note 41 at 72; and Reed *op cit* note 344).

<sup>461</sup> See Symons *op cit* note 360 at 340; Krimm *op cit* 331 at 1099–1100; and Getz *op cit* note 20 at 207. The term ‘flexible standard’ was used in the case of *United Bank Ltd v Cambridge Sporting Goods Corp* 360 NE 2d 943 (NYCA 1976) (for a full discussion, see Xiang Gao *op cit* note 41 at 75–76). The standard of ‘constructive fraud’ was suggested in *Dynamics Corporation of America v The Citizens and Southern National Bank* 356 F Supp 991 (ND Ga 1973) (for a full discussion, see Xiang Gao *op cit* note 41 at 76–78). For a case where the court did not use any of the standards mentioned (i.e., ‘egregious fraud’, ‘intentional fraud’, ‘flexible standard’ or ‘constructive fraud’) see *Emery-Waterhouse Co v Rhode Island Hospital Trust National Bank* 757 F 2d 399 (1985) (for a full discussion see Xiang Gao *op cit* note 41 at 73–74).

<sup>462</sup> See the discussion in para 5.5.4.1 above.

<sup>463</sup> See Xiang Gao *op cit* note 41 at 78.

<sup>464</sup> See also Oelofse: *The Law of Documentary Letters of Credit op cit* note 311 at 426. For a full list of the US case, see Getz *op cit* note 20 at 248–252. For the background to these cases, see Anon “‘Fraud in the Transaction’: Enjoining Letters of Credit during the Iranian Revolution’ (1980) 93 *Harvard Law Review* 992 at 992–995; and McCullough *op cit* note 20 in para 5.04[3][b].

<sup>465</sup> Xiang Gao *op cit* note 41 at 78.

Accordingly, the applicants of the letters of credit sought injunctions (mostly on the grounds of fraud) against payment.<sup>466</sup>

There was a vast difference between the cases decided before the taking of 52 American hostages at the United States' Embassy in Teheran in Iran on 3 November 1979 and those cases decided afterwards.<sup>467</sup> The post-hostage cases are severe examples of how the fraud exception, if the standard or concept of fraud is not clearly defined, can be misused by the parties and misapplied by the courts.<sup>468</sup> As regards the pre-hostage cases, the applicants of the letters of credit only had marginal success in the courts. For instance, there were only two reported pre-hostage cases in which American companies were granted preliminary injunctions and they were soon vacated.<sup>469</sup> In other pre-hostage cases, injunctions were either denied<sup>470</sup> or only 'notice injunctions' were granted.<sup>471</sup> As far as the concept of fraud was concerned, the courts adopted a narrow view, while setting high standards for the degree of evidence. The argument of irreparable harm (i.e., a requirement for the granting of an injunction) was rejected for the reason that the applicant had more or less accepted this risk and/or because litigation for the recovery of the loss before Iranian courts had been agreed to and was not considered to be totally impractical. As regards the 'balance of convenience'/'balance of hardship' (also a requirement for the granting of an injunction), the courts were of the view that the hardship to the bank, consisting of the impairment of their credibility in the international banking community and in possible measures of retaliation, clearly outweighed the hardship to the applicant of the letter of credit who, as between two innocent parties, must bear the consequences of the contract he has chosen to conclude.<sup>472</sup>

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<sup>466</sup> See also *Oelofse: The Law of Documentary Letters of Credit op cit* note 311 at 426–427; and *Xiang Gao op cit* note 41 at 78–79.

<sup>467</sup> See *McCullough op cit* note 20 in para 5.04[3][b]; *Oelofse: The Law of Documentary Letters of Credit op cit* note 311 at 427; and *Xiang Gao op cit* note 41 at 79.

<sup>468</sup> See *Xiang Gao op cit* note 41 at 79.

<sup>469</sup> See *KMW International v Chase Manhattan Bank NA* 606 F 2d 10 (2nd Cir 1979) (for a discussion of this case, see *McCullough op cit* note 20 in para 5.04[3][b][i] at 5-41); and *John Carl Warnecke and Assocs v Bank of America National Trust and Savings Association* No 749626 (ND Cal 17 April 1979). See also M P Zimmet 'Standby Letters of Credit in the Iran Litigation: Two Hundred Problems in Search of a Solution' (1984) 16 *Law and Policy in International Business* 927 at 930; and *Xiang Gao op cit* note 41 at 79.

<sup>470</sup> For instance, in *American Bell International Inc v The Islamic Republic of Iran* 474 F Supp 420 (SDNY 1979) the court rejected the applicant's claim of fraud because it failed to meet the test of intentional fraud by showing the beneficiary had 'evil intent' or 'fraudulent intent to mulct' him (for a full discussion of this case, see *McCullough op cit* note 20 in para 5.04[3][b][i] at 5-41–5-44). See also *United Technologies Corporation v Citibank NA* 469 F Supp 473 (1979).

<sup>471</sup> See *Zimmet op cit* note 469 at 937. Notice injunctions were extensively used in the Iranian cases. They were injunctions under which the applicant (claimants) were not seeking injunctions to prevent payment, but only that they be given immediate notice of any demand for payment before payment by the issuer so that they could investigate the facts and determine whether the demand for payment was fraudulent or not. In terms of this injunction, the issuer after it had given notice of the demand to the applicant normally had to wait three to ten days before making the payment (see *Xiang Gao op cit* note 41 in note 53 at 80; and *McCullough op cit* note 20 in para 5.04[3][b][i] at 5-39). For an example, where a notice injunction was granted, see *Stromberg-Carlson Corporation v Bank Melli Iran* 467 F Supp 530 (SDNY 1979), and for a full list of similar cases, see *McCullough op cit* note 20 in note 86 at 5-39.

<sup>472</sup> See *Bertrams op cit* note 14 in note 46 at 415. See also the discussions in para 5.5.6 below and para 7.3 in Chapter 7.

However, in the post-hostage cases the courts changed their attitudes dramatically.<sup>473</sup> In these cases the courts issued preliminary and even permanent injunctions when an applicant applied for injunctions after the hostage crisis. In many instances payment were enjoined by courts without an opinion. For instance, out of at least fifteen applications for preliminary injunctions, only two were denied<sup>474</sup> and thirteen were granted.<sup>475</sup> Of those that were granted, only three were issued with written opinions<sup>476</sup> and eight were decided without a written opinion,<sup>477</sup> which is an indication of the relative ease with which these orders were granted.<sup>478</sup> One case was even decided without a formal written judgment. No-opinion judgments were not only given by federal courts, but also by some of the state courts.<sup>479</sup> The surrounding facts of the cases and the conduct of the Iranian beneficiaries and American applicants were similar to those in the pre-hostage cases. The courts either adopted a less stringent view of fraud or did not bother to pronounce on the exact meaning of it. This attitude is also instructive for the standard of proof, as the evidence adduced was no more compelling than it had been in the pre-hostage cases.<sup>480</sup> In fact, Bertrams points out that the courts made no statements in respect of the standard of proof and confined themselves to perfunctory remarks that the evidence was sufficient to support a conclusion that there was a substantial likelihood of irreparable harm prevailing on the merits. Apparently, the applicants also succeeded on all the other requirements for preliminary

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<sup>473</sup> Besides, litigation, other channels were also created for American companies to block payments under standby letters of credit after the American hostages were taken. For instance, on 14 November 1979 the American President issued an Executive Order blocking all property and interest in property of the Government of Iran (see Executive Order No 12, 170, 44 Fed Reg 65, 729 (Nov 14, 1979), reprinted in 50 USC section 1701 (Supp IV 1980)). In order to implement this order, the United States Treasury promulgated the Iranian Assets Control Regulations (31 CFR Part 535 (1979) that at first allowed American issuing banks to discharge their liabilities under their standby letters of credit by paying into blocked accounts of the Iranian beneficiaries, but later a new Regulation (31 CFR 535.568) directed blocked payment of the standby letters of credit themselves. Later on 19 January 1981, as part of the agreement to release the American hostages, the United States and Iran agreed to establish the Iran–United States Claims Tribunal at the Hague, for dealing with claims and counterclaims of American nationals against Iran and *vice versa*. For full discussion of these developments, see McCullough *op cit* note 20 in para 5.04[3][b][ii] at 5-44–5-48; and Xiang Gao *op cit* note 41 in note 51 at 78–79.

<sup>474</sup> *Werner Lehara Int v Harris Trust and Savings Bank* 484 F Supp 65 (WD Mich 1980) was one such a case (apparently on the ground that no demand for payment was made). See Bertrams *op cit* note 14 at 415; and Xiang Gao *op cit* note 41 at 80.

<sup>475</sup> See, e.g., *Harris Corporation v National Iranian Radio and Television* 691 F 2d 1344 (11th Cir 1982); *Itek Corporation v First National Bank of Boston* 730 F 2d 19 (1984); *Wyle v Bank Melli of Teheran Iran* 577 F Supp 1148 (ND Cal 1983); *Rockwell International Systems Inc v Citibank NA and Bank Tejarat* 719 F 2d 583 (USCA 2nd Cir 1983); and *Touche Ross and Co v Manufacturers Hanover Trust Company* 434 NYS 2d 575 (1980).

<sup>476</sup> Even where written opinions were given, they were not convincing at all (see Xiang Gao *op cit* note 41 at 80). See, e.g., *Touche Ross and Co v Manufacturers Hanover Trust Company supra* note 475 (for a full discussion of this case, see Xiang Gao *op cit* note 41 at 80–82; and McCullough *op cit* note 20 in para 5.04[3][b][ii] at 5-46).

<sup>477</sup> See Bertrams *op cit* note 14 in note 48 at 416.

<sup>478</sup> *Idem*.

<sup>479</sup> See Xiang Gao *op cit* note 41 at 80.

<sup>480</sup> The impact of the Iranian cases also influenced the judgments of other courts which were not involved in any of the Iranian case, see e.g., *American National Bank and Trust Co of Chicago v Hamilton Industries International Inc* 583 F Supp 164 (ND Ill 1984); and *Paccar International Inc v Commercial Bank of Kuwait* 587 F Supp 783 (CD Cal 1984), revised on other grounds, 757 F 2d 1058 (9th Cir 1985) (for a discussion of these two cases, see McCullough *op cit* note 20 in para 5.04[3][c] at 5-52–5-54).

injunctions.<sup>481</sup> Furthermore, in *Harris Corporation v National Iranian Radio and Television*<sup>482</sup> and *Itek Corporation v First National Bank of Boston*<sup>483</sup> the court also observed that public interest and the utility of (standby) letters of credit would not be disserved by granting preliminary injunctions under the circumstances of a specific case.<sup>484</sup>

From the post-hostage cases, it therefore appeared that the courts in the United States looked at the identity of the beneficiary and not at what the beneficiary had done. Bertrams<sup>485</sup> remarked that these ‘less strict’ cases are not representative of current case law and can only be explained with a view to the political turmoil at that specific time. However, Xiang Gao has pointed out that whatever the reasons for the Iranian cases were, these cases clearly illustrated that the fraud exception needed urgent improvement by the provision of a proper definition or standard of fraud.<sup>486</sup>

#### 5.5.4.4 Position Under Revised UCC Article 5 Section 5-109<sup>487</sup>

Revised UCC article 5 section 5-109 specifically sets out what the required standard of fraud is.<sup>488</sup> Section 5-109 provides that to invoke the fraud rule, the fraud involved has to be ‘material’.<sup>489</sup> Therefore, ‘material fraud’ has been adopted as the standard of fraud under the fraud exception.<sup>490</sup> Section 5-109 does not define ‘material fraud’ and although ‘the breadth and width’ of materiality are left for the courts to decide, the Official Comment on the section has made some attempt to explain it. Official Comment 1 to section 5-109 provides as follows:

Necessarily courts must decide the breadth and width of “materiality”. The use of the word requires that the fraudulent aspect of a document be material to a purchaser of that document or that the fraudulent act be significant to the participants in the underlying transaction. Assume, for example, that the beneficiary has a contract to deliver 1,000 barrels of salad oil. Knowing that it has delivered only 998, the beneficiary nevertheless submits an invoice showing 1,000 barrels. If two barrels in a 1,000 barrel shipment would be an insubstantial and immaterial breach of the underlying contract, the beneficiary’s

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<sup>481</sup> See Bertrams *op cit* note 14 in note 49 at 416; and see also the discussion in para 5.5.6 below and para 7.3 in Chapter 7.

<sup>482</sup> 691 F 2d 1344 (11th Cir 1982).

<sup>483</sup> 730 F 2d 19 (1st Cir 1984) (for a discussion of this judgment and those of the earlier courts (see 511 F Supp 1341 (D Mass 1981) where the injunction was vacated and remanded on other grounds, and 704 F 2d 1 (1st Cir 1983) where the preliminary injunction was reinstated), see McCullough *op cit* note 20 in para 5.04[3][b][ii] at 5-48–5-51).

<sup>484</sup> See Bertrams *op cit* note 14 in note 49 at 416.

<sup>485</sup> See Bertrams *op cit* note 14 at 416.

<sup>486</sup> See Xiang Gao *op cit* note 41 at 80.

<sup>487</sup> For a full discussion of the standard of fraud that is required under section 5-109, see Xiang Gao *op cit* note 41 at 82–88.

<sup>488</sup> The Task Force, which was formed for the revision of Prior UCC article 5 section 5-114(2) investigated the standard of proof that was applied by the courts and they made various observations and recommendation in this regard (see the *Task Force Report op cit* note 338 at 1613–1615 and for a discussion thereof see, Xiang Gao *op cit* note 41 at 82–83).

<sup>489</sup> Official Comment 1 to section 5-109.

<sup>490</sup> See Xiang Gao *op cit* note 41 at 84.

act, though possibly fraudulent, is not materially so and would not justify an injunction. Conversely, the knowing submission of those invoices upon delivery of only five barrels would be materially fraudulent. The courts must examine the underlying transaction when there is an allegation of material fraud, for only by examining that transaction can one determine whether a document is fraudulent or the beneficiary has committed fraud and, if so, whether the fraud was material.

From this it follows that for commercial letters of credit, the Official Comment has indicated that material fraud ‘requires that the fraudulent aspect of a document be material to a purchaser of that document or that the fraudulent act be significant to the participants in the underlying transaction’.<sup>491</sup>

For standby letters of credit, the Official Comment stipulates that material fraud by the beneficiary occurs only when he ‘has no colourable right to expect honor and where there is no basis in fact to support such a right to honor’.<sup>492</sup> As such, section 5-109 is regarded as indorsing articulations such as those stated in *Intraworld Industries Inc v Girard Trust Bank*,<sup>493</sup> *Roman Ceramics Corporation v Peoples National Bank*,<sup>494</sup> and similar decisions, and embraces certain decisions under Prior UCC article 5 section 5-114(2) that relied on the phrase ‘fraud in the transaction’.<sup>495</sup> Some of the decisions in these cases have been summarised in *Ground Air Transfer Inc v Westates Airlines Inc*<sup>496</sup> as follows:<sup>497</sup>

We have said throughout that courts may not “normally” issue an injunction because of an important exception to the general “no injunction” rule. The exception, as we also explained in *Itek*, 730 F.2d at 24–25, concerns “fraud” so serious as to make it obviously pointless and unjust to permit the beneficiary to obtain the money. Where the circumstances “plainly” show that the underlying contract forbids the beneficiary to call a letter of credit, *Itek*, 730 F.2d at 24; where they show that the contract deprives the beneficiary of even a “colorable” right to do so, *id.* at 25; where the contract and circumstances reveal that the beneficiary’s demand for payment has “absolutely no basis in fact,” *id.*; see *Dynamics Corp of America*, 356 F.Supp. at 999; where the beneficiary’s conduct has “so vitiated the entire transaction that the legitimate purpose of the independence of the issuer’s obligation would no longer be served,” *Itek*, 730 F.2d at 25 (quoting *Roman Ceramics Corp. v. Peoples National Bank*, 714 F.2d

<sup>491</sup> *Idem.*

<sup>492</sup> See Official Comment 1 to section 5-109. See also Xiang Gao *op cit* note 41 at 84 and *Hugo: The Law Relating to Documentary Credits op cit* note 9 at 291–292. The Task Force, which was formed for the revision of Prior UCC article 5, *inter alia*, recommended that a different standard of fraud should apply for commercial letters of credit as to standby letters of credit. For commercial letters of credit, they pointed out that the focus should be whether ‘the purpose of the underlying transaction must be rendered virtually without value’. For standby letters of credit, the question should be ‘whether the drawing has occurred with no colourable basis whatsoever’ (see the *Task Force Report op cit* note 338 at 1615).

<sup>493</sup> 461 Pa 343, 336 A 2d 316 (Pa 1975).

<sup>494</sup> 714 F 2d 1207 (3d Cir 1983).

<sup>495</sup> See Official Comment 1 to section 5-109.

<sup>496</sup> 899 F 2d 1269 (1st Cir 1990) at 1272–1273.

<sup>497</sup> Xiang Gao pointed out that the example provided for the illustration (i.e., *Ground Air Transfer Inc v Westates Airlines Inc* 899 F 2d 1269 (1st Cir 1990) at 1272–1273) of the meaning of the standard of fraud for standby letter of credit cases was not as typical as it might be. For a full discussion of his criticism in this regard, see Xiang Gao *op cit* note 41 at 85.

1207, 1212 n. 12, 1215 (3d Cir. 1989) (quoting *Intraworld Industries, Inc.*, 336 A.2d at 324–25)); *then* a court may enjoin payment. (Emphasis in the original.)

Neither Revised UCC article 5 section 5-109 nor its Official Comment suggests that the beneficiary's intention to defraud should be proved.<sup>498</sup> Therefore, it seems that 'material fraud' under section 5-109 looks 'more to the severity of the effect of the fraud on the transaction rather than the state of mind of the beneficiary'.<sup>499</sup>

Although the revision of article 5 of the UCC was completed more than ten years ago and all 50 states of the United States, the District of Columbia, Puerto Rico and the United States Virgin Islands have adopted Revised article 5 of the UCC in some version,<sup>500</sup> the standard of fraud as set out in section 5-109 has not often been tested.<sup>501</sup> The first time the courts in the United States applied section 5-109 was in September 1997.<sup>502</sup>

In *Western Surety Co v Bank of Southern Oregon*<sup>503</sup> Western Surety Company issued performance bonds on behalf of Black Oak Construction Company ('Black Oak') for work it was performing for a school district in the Washington State. Western Surety Company also issued performance bonds for work Black Oak was doing in Oregon. As a condition of issuance of the performance bonds, the Bank of Southern Oregon (the Bank) issued two irrevocable letters of credit in favour of Western Surety Company to serve as security for losses Western Surety Company might incur in the event of a default by Black Oak. The language of the letters of credit was basically the same, but they had different issuing numbers, issuing dates, expiration dates and aggregate amounts. The terms of the letters of credit did not mention that they referred to a specific project. Black Oak defaulted on its project in Washington, causing Western Surety Company to undertake completion of the project and to make payment on the performance bonds. Accordingly, the Western Surety Company presented the Bank with drafts under the letters of credit for payment. The Bank dishonoured on the grounds that it believed one of the letters of credit was issued for the project in Oregon and had nothing to do with the project in Washington. Thereafter, the Western Surety Company (i.e., the beneficiary of the letters of credit) instituted an action (summary judgment) against the Bank for wrongful dishonour. The court *a quo* granted the summary judgment, but the Bank appealed. The Bank claimed that there was a genuine issue of material fact on its defence that Western Surety Company fraudulently sought payment on one letter of credit. The court ruled in favour of the Western Surety Company,

<sup>498</sup> See the discussion in para 5.5.3 above.

<sup>499</sup> See Buckley *op cit* note 445 at 97; and Xiang Gao *op cit* note 41 at 85.

<sup>500</sup> On 27 March 2006, Wisconsin became the latest and last American state to enact Revised article 5 of the UCC. After the enactment of Revised article 5 of the UCC, Wisconsin published Revised article 5 on 10 April 2006 and it became effective on 1 July 2006 (see Electronic Newsletter *Letter of Credit Update* (LCU) (2006) Issue 6 issued by the Institute of International Banking Law and Practice Inc).

<sup>501</sup> See, e.g., *Western Surety Co v Bank of Southern Oregon* 257 F 3d 933 (9th Cir 2001), 44 UCC Rep Serv 2d (West) 1239, and *aff'd* (2001) US App LEXIS 15565; *Mid-America Tire Inc v PTZ Trading Ltd Import and Export Agents* (2000) 43 UCC Rep Serv 2d (Callaghan) 964, 95 Ohio St 3d 367 (2002 Ohio – 2427), and (2000) Ohio App LEXIS 5402; and *New Orleans Brass v Whitney National Bank* 818 So 2d 1057, 48 UCC Rep Serv 2d (West) 294 (LA Ct App 2002), 2002 WL 1018964 (La App 4th Cir) 15 May 2002, and (2002) La App LEXIS 1764.

<sup>502</sup> See Xiang Gao *op cit* note 41 at 85–86.

<sup>503</sup> 257 F 3d 933 (9th Cir 2001), 44 UCC Rep Serv 2d (West) 1239, *aff'd* (2001) US App LEXIS 15565.



because the Bank could not prove that the letter of credit was limited to a specific project. The court applied the standard of ‘material fraud’ set out in section 5-109 and said:<sup>504</sup>

The relevant Oregon statute provides that an issuing bank, acting in good faith, may dishonour a draft on a letter of credit, if the presentation of the draft would facilitate a material fraud by the beneficiary . . .

However, fraud, as an affirmative defense to the obligation under a letter of credit is to be narrowly construed . . . Fraud is not a viable defense if the beneficiary has even a colorable claim or any basis in fact to funds from the letter of credit.

It has been said that although the court in *Western Surety Co v Bank of Southern Oregon* claimed that it was adopting the standard of ‘material fraud’ set out in section 5-109, it seemed that its approach in actual fact was similar to that taken in cases of ‘egregious’ fraud.<sup>505</sup>

Another case dealing with section 5-109 is *New Orleans Brass LLC v Whitney National Bank*.<sup>506</sup> In this case, New Orleans Brass (‘Brass’) applied for a standby letter of credit with the Whitney Bank (‘the Bank’) in favour of the Louisiana Stadium and Exposition District (‘the beneficiary’) as a guarantee for rental payments. A dispute arose about the rental payments and the beneficiary presented documents under the letter of credit. Brass, the applicant of the letter of credit, sought an injunction to prevent the honouring of the letter of credit on the basis that the documents submitted contained false representations and that drawing on the letter of credit would cause irreparable injury. The application for an injunction was denied by the court *a quo* and the matter went on appeal (Louisiana Court of Appeals, Fourth Circuit).<sup>507</sup>

On appeal, the Fourth Circuit Court found that there was no ‘material fraud’ as defined in section 5-109 and therefore the judgment of the court *a quo* was affirmed. In arriving at its conclusion, the court applied the standard of ‘material fraud’ as stipulated in section 5-109 and in particular as it is elaborated on in the Official Comment. The court also cited the paragraph quoted above in *Ground Air Transfer Inc v Westates Airlines Inc*<sup>508</sup> to the effect that the fraud exception could only be invoked when the demand for payment had ‘absolutely no basis in fact’ or the beneficiary’s conduct had so ‘vitiating the entire transaction that the legitimate purpose of the independence of the issuer’s obligation would no longer be served’. With this ruling, Xiang Gao indicted that the court took a similar view to the court in *Western Surety Co v Bank of Southern Oregon*, namely, an approach that closely resembled the approach by the courts in ‘egregious’ fraud cases.<sup>509</sup>

<sup>504</sup> (2001) US App LEXIS 15565. See also Xiang Gao *op cit* note 41 at 86.

<sup>505</sup> See Xiang Gao *op cit* note 41 at 86. See also the discussion of the standard of ‘egregious fraud’ in paras 5.5.2.1, 5.5.4.2 and 5.5.4.3 above.

<sup>506</sup> 818 So 2d 1057; 48 UCC Rep Serv 2d (West) 294 (LA Ct App 2002); 2002 WL 1018964 (La App 4th Cir) 15 May 2002; and (2002) La App LEXIS 1764. This report was not available to me and I have relied on the discussion of the case by Xiang Gao *op cit* note 41 at 86–87.

<sup>507</sup> See Xiang Gao *op cit* note 41 at 86–87.

<sup>508</sup> 899 F 2d 1269 (1st Cir 1990) at 1272–1273.

<sup>509</sup> See Xiang Gao *op cit* note 41 at 87.

The question of how ‘material fraud’ should be interpreted specifically arose in *Mid-America Tire Inc v PTZ Trading Ltd Import and Export Agents*.<sup>510</sup> A dispute arose from extensive international negotiations for the purchase of specific Michelin tyres by Mid-America Tire and another party (i.e., the purchasers and applicants for the letter of credit) from a company (PTZ Trading Ltd) in Guernsey in the Channel Island through its agents. To pay for the tyres, the purchasers arranged for a letter of credit to be issued. During the negotiations, the agents of the seller made specific representations to the purchasers regarding the quality, quantity and price of the tyres. However, when the agreement was made, the quality, quantity and the price of the goods failed to meet what had been promised by the agents (the tyres also did not have the United States Department of Transportation identification numbers, making them illegal to sell in the United States). The purchasers discovered the fraud after the letter of credit had been issued and instructed the seller (beneficiary) not to ship the tyres. The purchasers obtained a temporary injunction preventing the letter of credit from being honoured, but despite the temporary injunction, the sellers shipped the tyres and presented conforming documents (its invoice and shipping documents) for payment under the letter of credit. In the meantime, the trial court granted the preliminary injunction to prevent honour. At the hearing on the permanent injunction, the trial court held that the documents strictly conformed to the terms and conditions of the letter of credit, but issued the permanent injunction on the grounds that the fraud exception in the 1995 UCC allowed an injunction on the basis of fraud in the underlying contract (i.e., the seller’s agent had made material misrepresentations to the buyers). However, on appeal the decision was reversed by a majority.<sup>511</sup>

The court of appeals dealt with the issue of how the term ‘material fraud’ had to be interpreted.<sup>512</sup> After a long discussion, the court found that it ‘must be narrowly limited to situations of fraud in which the wrongdoing of the beneficiary has . . . vitiated the entire transaction’<sup>513</sup> and/or the demand for payment under the letter of credit ‘has absolutely no basis in fact’.<sup>514</sup> The court found that there was no fraud in the presentment of the

<sup>510</sup> 43 UCC Rep Serv 2d 964 (2000) ((2000) Ohio App LEXIS 5402) (for a discussion thereof, see McCullough *op cit* note 20 in para 5.04[2][c][iv]; and G Barnes and J E Byrne ‘Letters of Credit: 2000 Cases’ (2001) 56 *Business Lawyer* 1805 at 1811–1812); and 95 Ohio St 3d 367 (2002-Ohio-2427) ((47 UCC Rep Serv 2d (West) 853 (Ohio 2002)).

<sup>511</sup> See also Xiang Gao *op cit* note 41 at 87.

<sup>512</sup> (2000) 43 UCC Rep Serv 2d (Callaghan) 964; and (2000) Ohio App LEXIS 5402.

<sup>513</sup> The court cited *Roman Ceramics Corporation v Peoples National Bank* 714 F 2d 1207 (3d Cir 1983) in note 12 at 1212–1213 which was in turn quoting *Intraworld Industries Inc v Girard Trust Bank* 461 Pa 343, 336 A 2d 316 (Pa 1975) at 324–325.

<sup>514</sup> However, Valen J disagreed with the majority view and said:

By committing fraud, it is my opinion that PTZ violated its obligations of “good faith, diligence, reasonableness, and care” . . . if the beneficiary, PTZ, fails to act in good faith in its dealings and perpetrates a fraud upon the applicant, MAT, the letter of credit may be enjoined. (Emphasis added.)

It has been said that by regarding the beneficiary’s violation of its obligation of ‘good faith, diligence, reasonableness and care’ as the commitment of ‘material fraud’ Valen J has inadequately advocated ‘an overly broad fraud exception based on a lack of good faith. Furthermore, ‘material fraud under revised U.C.C. section 5-109 is explained in the official comments, and nowhere is that concept equated with the concept of “good faith”’ (see J G Barnes and J E Byrne ‘Letters of Credit: 2000 Cases’ (2001) 56 *Business Lawyer* 1805 at 1812; and Xiang Gao *op cit* note 41 at 87–88). Xiang Gao points out that this interpretation

documents and no fraud that would vitiate the entire transaction and therefore the independence principle took preference and no injunctive relief was available. It seems that the court of appeals took the exact same approach to the standard of fraud as was adopted by the court in *New Orleans Brass v Whitney National Bank*.<sup>515</sup>

However, the *Mid-America Tire* case went on further appeal to the Ohio Supreme Court<sup>516</sup> and the judgment of the court of appeals was reversed and the permanent injunction as granted by the trial court was reinstated. Regarding the standard of material fraud, the Ohio Supreme Court stated:<sup>517</sup>

Thus, we hold that “material fraud” . . . means fraud that has so vitiated the entire transaction that the legitimate purpose of the independence of the issuer’s obligation can no longer be served.

The court of appeals actually did rely on *Sztejn . . . Inraworld Indus . . .* and *Roman Ceramics Corp . . .* to establish its so-called “vitiating exception”, but construed the exception so narrowly as to preclude relief where the beneficiary’s fraudulent conduct occurs solely in the underlying transaction. Thus, the court of appeals relied on the right cases for the wrong reasons.

From the different cases discussed above, it follows that the courts in applying the standard of ‘material fraud’ as set out in article 5-109 seem generally to have taken a similar approach to the ‘egregious’ fraud cases (as mentioned above). They have taken the position that the fraud exception may only be applied in limited situations where the demand for payment under the letter of credit ‘has absolutely no basis in fact’.<sup>518</sup> It has been said that this is ‘an unduly narrow approach’.<sup>519</sup>

### 5.5.5 The Bank’s Knowledge of Fraud

Unlike the position in England,<sup>520</sup> the question of whether the bank was aware of the beneficiary’s fraud has never been regarded as a relevant issue in the United States when an application has been made for an injunction against the bank.<sup>521</sup>

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by Valen J is close to the standard of ‘constructive fraud’ (mentioned above), and totally inappropriate (see Xiang Gao *op cit* note 41 at 88).

<sup>515</sup> See also Xiang Gao *op cit* note 41 at 87.

<sup>516</sup> See *Mid-America Tire Inc v PTZ Trading Ltd Import and Export Agents* 95 Ohio St 3d 367 (2002-Ohio-2427).

<sup>517</sup> See *Mid-America Tire Inc v PTZ Trading Ltd Import and Export Agents* 95 Ohio St 3d 367 (2002-Ohio-2427) in para 139–140 (citations omitted).

<sup>518</sup> See also Xiang Gao *op cit* note 41 at 88.

<sup>519</sup> See J G Barnes and J E Byrne ‘Letters of Credit: 2000 Cases’ (2001) 56 *Business Lawyer* 1805 at 1812.

<sup>520</sup> See the discussion in para 5.4.4 above.

<sup>521</sup> See Bertrams *op cit* note 14 at 416–417.

### 5.5.6 Fraud as Basis for Injunctive Relief<sup>522</sup>

Revised UCC article 5 section 5-109 specified four conditions that must be met when a court considers an injunction. The section provides that if an applicant claims that a required document is materially fraudulent, forged, or would facilitate fraud by the beneficiary on the issuer or applicant, a court of competent jurisdiction may temporarily or permanently enjoin the issuer from honouring a presentation or grant similar relief against the issuer or other persons only if the court determines that

1. the law applicable to an accepted draft or deferred obligation incurred by the issuer does not prohibit the relief;
2. a beneficiary, nominated person, or issuer that might be affected adversely is sufficiently protected against losses it may suffer from the relief if granted;
3. all requirements entitling a person to relief under the law of the state in question have been met; or
4. the applicant's success in his claim of forgery or material fraud is more likely than not and the person demanding honour does not qualify for protection (by being a nominated person who has given value in good faith and without notice of forgery or material fraud; a confirmer who has honoured its confirmation in good faith; a holder in due course of a draft drawn by the nominated person or issuer; or an assignee of the issuer's or nominated person's deferred obligation that was taken for value and without notice of forgery or material fraud after the obligation was incurred by the issuer or nominated person).

These four conditions are intended to reduce the frequency with which the fraud rule has been used since the late 1970s<sup>523</sup> and illustrate that the 'standard for injunctive relief is high', under Revised UCC article 5<sup>524</sup> and that the burden remains on the applicant 'to show by evidence and not by mere allegation' that the relief is warranted.<sup>525</sup> For instance, in the past one American case granted an injunction to restrain payment, even though the court found that the evidence only indicated that the beneficiary's demand 'was made in a situation that was subtly suggestive of fraud'.<sup>526</sup> Although there was the notion that

<sup>522</sup> For a full discussion, see para 7.3 in Chapter 7.

<sup>523</sup> See the discussion in para 5.5.4.3 above.

<sup>524</sup> See also Xiang Gao *op cit* note 41 at 47.

<sup>525</sup> See Official Comment 4 to section 5-109. See also the discussion of injunctions under the American law in para 7.3 in Chapter 7. For instance, in *Commco Technology LLC v Science Applications International Corp (In re Commco Technology LLC)* 258 BR 63, 45 UCC Rep Serv 2d (West) 186 (Bankr D Conn 2001) the court vacated a preliminary injunction against honour of a standby letter of credit. In this case, the claimant failed to show either material fraud or irreparable harm as required by section 5-109(b) (it was also affirmed in *Katz v Science Applications International Corporation (In re Commco Technology LLC)* 60 Fed Appx 881 No 02-5014; 2003 WL 1895203 (2nd Cir 2003). In the following cases, the New York courts also declined preliminary injunctions to restrain honour of standby letters of credit, because the claimants did not sufficiently prove that fraud was involved: *Kvaerner US Inc v Merita Bank PLC* 732 NYS 2d 215 (NY App Div 2001); and *Joseph v Solow Building Co* 726 NYS 2d 642 (NY App Div 2001). In *Synergy Center Ltd v Lone Star Franchising Inc* 63 SW 3d 561 (Tex App 2001) the court terminated a temporary injunction against a drawing because the claimant failed to show that the beneficiary's drawing would qualify as 'severe, vitiating fraud'. See also J G Barnes and J E Byrne 'Letters of Credit: 2001 Cases' (2002) 57 *Business Lawyer* 4 (as reprinted in 2003 *Annual Survey op cit* note 336 12–18 at 14).

<sup>526</sup> See *Harris Corporation v National Iranian Radio and Television* 691 F 2d 1344 (11th Cir 1982) at 1356; and see also *Itek Corporation v First National Bank of Boston* 511 F Supp 1341 (1981) (566 F Supp 1210 (1983)) at 1351. See also Enonchong *op cit* note 8 at 86.

American courts were promiscuous in interfering (particularly during the Iranian crises)<sup>527</sup> with payment under American bank letters of credit, it would seem based on more recent decisions,<sup>528</sup> that this notion no longer holds true.<sup>529</sup> Accordingly, it is no longer so easy to obtain an injunction in American courts.

As already mentioned above,<sup>530</sup> from case law and legal writing, it appeared that English courts initially took a different approach in letter of credit cases where the applicant took action against the issuer for an injunction preventing it from honouring a letter of credit to cases where the beneficiary took action against the issuer for wrongful dishonour or to cases where the applicant took action against the beneficiary to prevent him from demanding payment. When dealing with demand guarantees, English writers have expressed the view that different principles apply to demand guarantees, because there is an important distinction between an injunction preventing the beneficiary thereof making a demand in the requisite form and an injunction preventing the bank making payment upon such demand having been given. However, it appears that no such distinction has been made in the United States when dealing with commercial or standby letters of credit.<sup>531</sup> This has been inferred from the Official Comment on Revised UCC article 5 section 5-109:<sup>532</sup>

Although the statute deals principally with injunctions against honor, it also cautions against granting “similar relief” and the same principles apply when the applicant or issuer attempts to achieve the same legal outcome by injunction against presentation . . . interpleader, declaratory judgment, or attachment.

Under the English law, an injunction will not be granted unless the principal (claimant) can in addition to proving fraud, also satisfy the ‘balance of convenience’ test. The balance of convenience test is similar to the American ‘balance of hardships’ test.<sup>533</sup> However, contrary to the position in England, in the United States it is not very difficult for a principal to satisfy the test and the American courts have been able to grant injunctions in many cases despite this test.<sup>534</sup>

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<sup>527</sup> See the discussion in para 5.5.4.3 above.

<sup>528</sup> See, e.g., *5 East 59th Street Holding Co v Farmers and Merchants Bank of Eatonton* 816 NYS 2d 68 (NY App Div 2006); and *Banco Nacional de México SA v Societe Generale* 820 NYS 2d 588 (App Div 2006), revising in part, No 603266/04 (NY Sup Ct 20 October 2005) (for a discussion, see J G Barnes and J E Byrne ‘Letters of Credit’ (2006) 61 *Business Lawyer* 1591 at 1595–1596).

<sup>529</sup> See J G Barnes and J E Byrne ‘Letters of Credit’ (2007) 62 *Business Lawyer* 1607 at 1612.

<sup>530</sup> See para 5.4.5 above for a full discussion.

<sup>531</sup> See also Xiang Gao *op cit* note 41 at 51.

<sup>532</sup> See Official Comment 5 the Revised UCC article 5 section 5-109.

<sup>533</sup> See *Caulfield v Board of Education* 583 F 2d 605 (2nd Cir 1978) as applied in *American Bell International Inc v The Islamic Republic of Iran* 474 F Supp 420 (SDNY 1979) at 425–426; and *KMW International v Chase Manhattan Bank NA* 606 F 2d 10 (2nd Cir 1979). For a full discussion, see para 7.3 in Chapter 7.

<sup>534</sup> See, e.g., *Itek Corporation v First National Bank of Boston* 730 F 2d 19 (1984); *Harris Corporation v National Iranian Radio and Television* 691 F 2d 1344 (11th Cir 1982) at 1357; and *Rockwell International Systems Inc v Citibank NA and Bank Tejarat* 719 F 2d 583 (USCA 2nd Cir 1983). See also Enonchong *op cit* note 8 at 86–87.

### 5.5.7 Summary and Conclusion

A breakthrough in the development of the fraud rule in the law of letters of credit came only in 1941, when the Supreme Court of New York County delivered its judgment in *Sztejn v J Henry Schroder Banking Corporation*.<sup>535</sup> The *Sztejn* case was so groundbreaking that the fraud rule that had manifested from it was later codified for the first time in Prior UCC article 5 section 5-114(2).

Prior UCC article 5 section 5-114 clearly provided for the fraud exception to the independence principle of letters of credit. However, the section failed to mention what constituted fraud under the fraud rule and therefore various different standards of fraud were subsequently applied in different cases. Therefore, a number of standards were suggested in the cases applying section 5-114(2). This led to various different opinions as to the standard of fraud required. There was much support for the view that only ‘egregious fraud’, that is, ‘fraud that taints the entire transaction’, would suffice. However, there was also support for the standard of ‘ordinary’ or ‘intentional fraud’ (i.e., fraud ‘in the sense of common law deceit requiring scienter’), as well as for the even broader, more flexible ‘constructive fraud’ standard. Unfortunately, the cases applying Prior UCC article 5 section 5-114(2) did not provide a consistent answer to the concept or standard of fraud.<sup>536</sup>

Prior UCC article 5 section 5-114 provided that the fraud rule should be applied ‘when . . . a required document . . . is forged or fraudulent’ or ‘there is fraud in the transaction’. The phrase ‘fraud in the transaction’ was particularly problematic due to a diversity in opinion as to the exact meaning of the phrase. It was not apparent whether the ‘transaction’ referred to the relationship between the beneficiary and the issuer or to the underlying contract between the beneficiary and the applicant or to both. There was thus uncertainty as to whether fraud related to fraud committed by the beneficiary on the documents (‘fraud in the narrow sense’), or whether it also referred to fraud committed by the beneficiary, which does not relate to documents, but relates to the underlying contract, for example, where a beneficiary intentionally dispatches goods of an inferior quality (‘fraud in the wide sense’).

Most of the uncertainty that might have existed regarding the concept and standard of the fraud exception set out in Prior UCC article 5 section 5-114(2) was eliminated when the Revised UCC article 5 section 5-109 came into operation. This section now stands as the most comprehensive code of the fraud rule in the law of letters of credit in the common law world. Revised UCC article 5 section 5-109 has addressed two of the most controversial issues raised in the application of the fraud rule since the promulgation of Prior UCC article 5 section 5-114(2), namely the standard of fraud and the concept of fraud. Regarding the former, section 5-109 provides that to invoke the fraud rule, the fraud involved has to be ‘material’. From the cases discussed above,<sup>537</sup> it follows that the courts in applying the standard of ‘material fraud’ as set out in section 5-109 seem generally to

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<sup>535</sup> 31 NYS 2d 631 (1941).

<sup>536</sup> See the full discussion in paras 5.5.2.1 and 5.5.4.2.

<sup>537</sup> See, e.g., *Western Surety Co v Bank of Southern Oregon* 257 F 3d 933 (9th Cir 2001), 44 UCC Rep Serv 2d (West) 1239, and aff’d (2001) US App LEXIS 15565; *Mid-America Tire Inc v PTZ Trading Ltd Import and Export Agents* (2000) 43 UCC Rep Serv 2d (Callaghan) 964, 95 Ohio St 3d 367 (2002 Ohio – 2427), and (2000) Ohio App LEXIS 5402; and *New Orleans Brass v Whitney National Bank* 818 So 2d 1057, 48 UCC Rep Serv 2d (West) 294 (LA Ct App 2002), 2002 WL 1018964 (La App 4th Cir) 15 May 2002, and (2002) La App LEXIS 1764.

have taken a similar approach to the ‘egregious’ fraud cases (as mentioned above). They have taken the position that the fraud exception may only be applied in limited situations where the demand for payment under the letter of credit ‘has absolutely no basis in fact’.<sup>538</sup> However, in the minority judgment in *Mid-America Tire Inc v PTZ Trading Ltd Import and Export Agents*<sup>539</sup> Valen J indicated that the standard of ‘material fraud’ is equivalent to a violation of the beneficiary’s obligation of ‘good faith, diligence, reasonableness, and care’. This type of view is similar to the standard of ‘constructive fraud’ (as mentioned above). The aforesaid indicates that different views as to the standard of fraud may still appear in the United States in future, although a uniform and appropriate standard of ‘material fraud’ is stipulated in Revised UCC article 5 section 5-109.<sup>540</sup>

As far as the concept of fraud is concerned, section 5-109 indicates that the fraud can relate to forgeries or to fraud in the underlying transaction. Therefore, it is now clear that American law accepts that the fraud exception relates to fraud committed by the beneficiary on the documents (fraud in the narrow sense), and fraud committed by the beneficiary which does not relate to documents, but relates to the underlying transaction (fraud in the wide sense).

Under English law, the fraud must have been committed by the beneficiary, before the fraud exception will be applied.<sup>541</sup> This is contrary to the approach in the American law. Prior UCC article 5 section 5-114(2) was ambiguous in that it did not mention the identity of the fraudulent party. It has been said that the provision focused on the nature of the documents tendered and totally neglected the identity of the fraudster. Therefore, the fraud exception was applicable whenever ‘documents’ or ‘a required document’ was forged or fraudulent. In other words, under section 5-114(2), the nature of the documents tendered was the only concern in a case of fraud.<sup>542</sup> Clarity on this issue was not brought by Revised UCC article 5 section 5-109. It seems that section 5-109 has not totally ruled out the application of the fraud exception when fraud is perpetrated by someone other than the beneficiary. Like its predecessor, it seems that section 5-109, is also fundamentally concerned with the nature of the documents tendered, rather than the identity of the fraudulent party.<sup>543</sup>

A further difference between the English law and the American law is found in the requirement that the bank has to have knowledge of the beneficiary’s fraud. Unlike the position in England,<sup>544</sup> the question of whether the bank was aware of the beneficiary’s fraud has never been regarded as a relevant issue in the United States when an application has been made for an injunction against the bank.<sup>545</sup>

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<sup>538</sup> See also Xiang Gao *op cit* note 41 at 88.

<sup>539</sup> See note 514 above.

<sup>540</sup> See also Xiang Gao *op cit* note 41 at 88.

<sup>541</sup> See *United City Merchants v Royal Bank of Canada* [1983] AC 168 (HL) ([1982] 2 Lloyd’s Rep 1 (HL)) and the discussion in para 5.4.1 above.

<sup>542</sup> See note 323 above.

<sup>543</sup> See note 401 above.

<sup>544</sup> See the discussion in para 5.4.4 above.

<sup>545</sup> See para 5.5.5 above.

The stringent approach of the English courts with regard to the standard of proof may be contrasted with the more relaxed approach of the courts in the United States. In the United States it has been explicitly stated that the fraud exception ‘is flexible’.<sup>546</sup> For instance, in one American case an injunction was granted to restrain payment, even though the court found that evidence only indicated that the beneficiary’s demand ‘was made in a situation that was subtly suggestive of fraud’.<sup>547</sup>

## 5.6 SOUTH AFRICAN LAW

### 5.6.1 A General Overview

The fraud exception to the independence principle of the commercial and standby letter of credit has been considered or referred to in only a few South African cases.<sup>548</sup> There are no cases dealing specifically with the fraud exception in relation to demand guarantees and therefore guidance is found in the relevant cases dealing with letters of credit.

The South African courts distinguish between ‘fraud’, on the one hand, and ‘innocent breach of contract’, on the other hand. So far the courts have not yet indicated that they will not be prepared to interdict a bank from paying in the case of fraud concerning the performance by the beneficiary in terms of the underlying contract. In fact, there is reason

<sup>546</sup> See *United Bank Ltd v Cambridge Sporting Goods Corp* 360 NE 2d 943 (NYCA 1976) at 949.

<sup>547</sup> See *Harris Corporation v National Iranian Radio and Television* 691 F 2d 1344 (11th Cir 1982) at 1356; and see also *Itek Corporation v First National Bank of Boston* 511 F Supp 1341 (D Mass 1981) at 1351. See also Enonchong *op cit* note 8 at 86.

<sup>548</sup> See *Phillips and Another v Standard Bank of South Africa Ltd and Others* 1985 (3) SA 301 (W) (for a discussion of this case, see J H de V Dijkman ‘The Autonomy Principle in Documentary Letter of Credit Transactions: The First South African Decision’ (1985) 102 *South African Law Journal* 379); *Ex parte Sapan Trading (Pty) Ltd* 1995 (1) SA 218 (W) (for a full discussion of this case, see F R Malan ‘Letters of Credit and Attachment *ad Fundandam Jurisdictionem*’ 1994 *Tydskrif vir Suid-Afrikaanse Reg* 150; A N Oelofse ‘Developments in the Law of Documentary Letters of Credit’ (1996) 8 *South African Mercantile Law Journal* 56 at 65–68; Oelofse: *The Law of Documentary Letters of Credit op cit* note 311 at 465–470; and Hugo: *The Law Relating to Documentary Credits op cit* note 9 at 331–339); *Z Z Enterprises v Standard Bank of South Africa Ltd* 1995 CLD 769 (W); *Loomcraft Fabrics CC v Nedbank Ltd and Another* 1996 (1) SA 812 (A) (for a discussion of this case, see Hugo: *The Law Relating to Documentary Credits op cit* note 9 at 322–326); *Union Carriage and Wagon Company Ltd v Nedcor Bank Ltd* 1996 CLR 724 (W); and *Vereins- UND Westbank AG v Veren Investments and Others* 2000 (4) SA 238 (W) in para 63 and 130. See also *ABLU 2008 op cit* note 36 at 98. As already mentioned in note 10 above, the obligation of the bank to pay under a letter of credit/demand guarantee could also be compared to the payment obligation of an acceptor of a bill of exchange (for a full discussion of the position of an acceptor, see Malan and Pretorius *op cit* note 10 in paras 143–149; and Malan *et al op cit* note 10 at 139–145 and cf section 52 of the Bills of Exchange Act 34 of 1964) or with the position of a bank that has guaranteed the payment of a cheque (i.e., a bank-guaranteed cheque) (see also section 72A of Bills of Exchange Act 34 of 1964; and Malan & Pretorius *op cit* note 10 in para 196). Therefore, cases where the acceptor of a bill of exchange or the bank of a bank-guaranteed cheque raises the fraud defence against a holder (see Malan and Pretorius *op cit* note 10 in para 143 at 225; and Malan *et al op cit* note 10 at 141–143) demanding payment, may also be related in cases where fraudulent demands/claims for payment are made regarding demand guarantees and letters of credit (see Malan and Pretorius *op cit* note 10 in para 143 at 225; and see, e.g., *Wavecrest Enterprises v Cema Africa (Pty) Ltd (In Liquidation) and Others* (1991) 2 CLD 266 (C) ((CPD A1163/88), November 1988) (for a discussion of this case, see J T Pretorius ‘Countermanding Payment of a Certified Cheque’ (1992) 4 *South African Mercantile Law Journal* 210; and A N Oelofse ‘Onlangse Ontwikkelings in die Tjekreg’ (1991) 3 *South African Mercantile Law Journal* 364 at 369). It has been said that a holder of a bill of exchange (by implication also a cheque) who enforces payment fraudulently is acting contrary to the demands of good faith and abusing his right (see Malan and Pretorius *op cit* note 10 in para 143 at 225 and the authorities cited; and Malan *et al op cit* note 10 at 141–143 and the authorities cited).



to believe that the courts will acknowledge fraud in the wide sense as a valid exception to the autonomy principle of the letter of credit and demand guarantee.<sup>549</sup>

The first case to refer briefly to fraud in a documentary credit context was *Phillips v Standard Bank*.<sup>550</sup> Here a South African applicant (Phillips) had imported a number of shoes from an Italian manufacturer and exporter ('the beneficiary'). Payment was to take place by means of an irrevocable letter of credit that was issued by Standard Bank ('the bank'). It appears from the facts that payment in terms of the letter of credit was deferred to a certain number of days after presentation of the documents. When the applicant received the shoes, he discovered, prior to payment in terms of the credit, that a significant number of them were materially defective. He immediately liaised with the beneficiary regarding his dissatisfaction with the goods. The beneficiary was willing to consider the complaints, but was not prepared to postpone payment. The applicant then approached the court to issue an interim interdict against the bank to prevent it from paying on the letter of credit.<sup>551</sup>

The court (per Goldstone J) confirmed that a letter of credit was an independent and separate contract from the underlying contract and referred to prominent cases in England and the United States<sup>552</sup> dealing with the fundamental nature of a letter of credit.<sup>553</sup> The court expressed the view that the South African courts should recognise and give effect to the commercial purpose for which the system of irrevocable letters of credit had been devised, namely to facilitate international trade by giving to the seller, before he parts with his goods, the assurance that he will be paid and that no dispute as to the performance by him of the contract with the purchaser will constitute a ground for non-payment or delayed payment.<sup>554</sup> The court also mentioned that where an irrevocable letter of credit constituted an independent contract between the issuing bank and the beneficiary, the applicant could not go behind the documents and cause payment to be stopped or suspended because of complaints concerning the quality of the goods or other alleged breaches of the underlying contract by the beneficiary.<sup>555</sup> Therefore, the court dismissed the application for an interdict.<sup>556</sup> The court found that no fraud on the part of the beneficiary had been alleged by the applicant. It also held that the facts of this case were quite consistent with an 'innocent breach of contract'.<sup>557</sup> The court, however, specifically refrained from

<sup>549</sup> See Van Niekerk and Schulze *op cit* note 2 at 314.

<sup>550</sup> 1985 (3) SA 301 (W). For a full discussion of this case, see Dijkman *op cit* note 548; C Hugo 'Documentary Letters of Credit: Reflections on Recent Developments ABLU 1993 (a paper delivered at the 1993 Annual Banking Law Update held at the Indaba Hotel, Johannesburg) (unpaginated) (hereinafter 'ABLU 1993') at 4 of his article; Hugo: *The Law Relating to Documentary Credits op cit* note 9 at 321–322; and Oelofse: *The Law of Documentary Letters of Credit op cit* note 311 at 463–464.

<sup>551</sup> See *Phillips v Standard Bank* 1985 (3) SA 301 (W) at 302A–D.

<sup>552</sup> The court in *Phillips v Standard Bank* 1985 (3) SA 301 (W) specifically referred to *Sztejn v J Henry Schroder Banking Corporation* 31 NYS 2d 631 (1941) at 633–4; and *United City Merchants v Royal Bank of Canada* [1983] AC 168 (HL) ([1982] 2 Lloyd's Rep 1 (HL)) at 183–4. The court also stated that the *dicta* of these two cases correctly reflected the South African law (see *Phillips v Standard Bank* at 304B).

<sup>553</sup> See *Phillips v Standard Bank* 1985 (3) SA 301 (W) at 302J–303I, and 304B.

<sup>554</sup> See *Phillips v Standard Bank* 1985 (3) SA 301 (W) at 304 C–D.

<sup>555</sup> See *Phillips v Standard Bank* 1985 (3) SA 301 (W) at 304D–E.

<sup>556</sup> See *Phillips v Standard Bank* 1985 (3) SA 301 (W) at 304.

<sup>557</sup> See *Phillips v Standard Bank* 1985 (3) SA 301 (W) at 303I–304A.

commenting on the extent to which, and the circumstances under which, it would consider the fraud exception.<sup>558</sup>

The *Phillips v Standard Bank* case serves as an illustration that mere breach of the underlying contract by the beneficiary of a letter of credit/demand guarantee will not necessarily entitle the applicant/principal to block payment by acquiring an interdict against the bank.<sup>559</sup> But, sadly, it does not throw any light on the recognition of possible exceptions to the autonomy principle in the South African law.<sup>560</sup>

It was not until *Loomcraft Fabrics v Nedbank*<sup>561</sup> that the South African Appellate Division (as it was then), had the first opportunity to pronounce on the principle of independence and its possible limits in the context of documentary credits. In this regard, the Appellate Division made a few valuable comments on the limitation of the autonomy doctrine by the fraud exception.<sup>562</sup>

In *Loomcraft Fabrics v Nedbank* a South African distribution company, Loomcraft, had imported a quantity of voile fabric from Perfel, a Portuguese textile-manufacturing company. Loomcraft ('the applicant') applied to Nedbank ('the bank') to open an irrevocable letter of credit for deferred payment in favour of Perfel ('the beneficiary'). The letter of credit expired on 18 May 1992 and the latest date for shipment was 8 May 1992. The goods arrived in Durban on 18 June 1992 and were received by the applicant in Johannesburg shortly thereafter. The goods arrived later than the applicant had expected and he was further dissatisfied with the quality of goods.<sup>563</sup> On 4 August 1992 the applicant brought an urgent application in the Witwatersrand Local Division for an interdict to restrain the bank from making payment under the letter of credit. The applicant contended that the transport documents (bills of lading) the beneficiary had presented to the bank, contained a fraudulent misrepresentation of the date of shipment of the goods.<sup>564</sup> The alleged fraud on the documents related to the date stamped on the shipping documents, as well as a dispute as to the actual place where the goods were shipped. Originally, the

<sup>558</sup> See Van Niekerk and Schulze *op cit* note 2 at 314.

<sup>559</sup> See also Hugo: *The Law Relating to Documentary Credits op cit* note 9 at 322.

<sup>560</sup> See Oelofse: *The Law of Documentary Letters of Credit op cit* note 311 at 464. In *Ex parte Sapan Trading (Pty) Ltd* 3 CLD 200 (W) (the court *a quo*) Stegmann J said (at 224):

It seems to me to be a necessary implication . . . that when a buyer such as the applicant promises to be bound irrevocably by the principles currently embodied in articles 3 and 4 of the [1983] UCP [i.e., the independence principle and the principle that the parties deal in documents not in goods], he implicitly waives in advance any right which he may otherwise have acquired afterwards, on any ground (other than fraud on part of the seller), to stop payment of the documentary credit by the issuing bank, or to interfere with the payment by attaching the seller's claim to payment on the part of the issuing bank.

<sup>561</sup> 1996 (1) SA 812 (A). For a full discussion of this case, see Van Niekerk and Schulze *op cit* note 2 at 314–317; Hugo: *The Law Relating to Documentary Credits op cit* note 9 at 322–326; ABLU 1996 *op cit* note 192 at 12–14 of the article; A N Oelofse 'Developments in the Law of Documentary Letters of Credit' (1996) 8 *South African Mercantile Law Journal* 286 at 302–305; and Oelofse: *The Law of Documentary Letters of Credit op cit* note 311 at 470–474.

<sup>562</sup> See Van Niekerk and Schulze *op cit* note 2 at 314.

<sup>563</sup> See *Loomcraft Fabrics v Nedbank* 1996 (1) SA 812 (A) at 814G–815B.

<sup>564</sup> See *Loomcraft Fabrics v Nedbank* 1996 (1) SA 812 (A) at 815B–C.

date 13 May 1992 was stamped on the document. The carrier then also added the words ‘actually on board’, as the goods were then actually on board the ship. Later it was noticed that 13 May 1992 was the wrong date, as the carrier had received the goods earlier. The date of issue was then corrected to reflect 8 May 1992, but due to an oversight, the words ‘actually on board’ were not deleted.<sup>565</sup> The applicant obtained some interim relief,<sup>566</sup> but this was later set aside after the beneficiary had filed opposing affidavits and the matter had been argued. The court *a quo* dismissed the application for an interdict and the applicant appealed.<sup>567</sup>

The Appellate Division confirmed the widely accepted doctrine of the autonomy of the letter of credit. The court also stressed the principle that the bank’s liability to honour its undertaking towards the beneficiary depended on the presentation of a set of documents that corresponded strictly to the requirements in the credit. Where such conforming documents were presented, the bank could not escape its liability to pay, except in the most exceptional circumstances, for example, on proof of fraud on the part of the beneficiary.<sup>568</sup>

Thereafter, the Appellate Division mentioned that the beneficiary’s fraud would have to be established clearly. Furthermore, the burden of proof required was the ordinary civil one that had to be discharged on a balance of probabilities and, as in any other case where fraud was alleged, fraud would not be inferred lightly.<sup>569</sup>

The court also pointed out that in order for the applicant to succeed on the grounds of fraud, he had to prove that the beneficiary, acting through its agent, and with the purpose of drawing on the credit, presented the transport documents (bills of lading) to the bank knowing that they contained material representations of fact upon which the bank would rely and which they (the agents of the beneficiary) knew were untrue. It was also stressed that mere error, misunderstanding or oversight, however unreasonable, could not amount to fraud.<sup>570</sup> However, on the facts before it, the Appellate Division was of the view that there appeared to be an error, rather than fraud, on the part of the beneficiary.<sup>571</sup>

<sup>565</sup> See *Loomcraft Fabrics v Nedbank* 1996 (1) SA 812 (A) at 820–821.

<sup>566</sup> The decision granting the interim interdict was not reported and the *ratio decidendi* is unknown.

<sup>567</sup> See also Van Niekerk and Schulze *op cit* note 2 at 315.

<sup>568</sup> See *Loomcraft Fabrics v Nedbank* 1996 (1) SA 812 (A) at 815F–J. This statement made in *Loomcraft Fabrics v Nedbank* was also confirmed in *Koumantarakis Group CC v Mystic River Investments 45 (Pty) Ltd and Another* [2007] JOL 19699 (D) in para 51. In *Vereins- UND Westbank AG v Veren Investments* 2000 (4) SA 238 (W) Stegmann J (in para 63 at 263) also applied the general rule as set out in *Loomcraft Fabrics v Nedbank* that the contractual obligation under an irrevocable letter of credit on the part of the bank to pay the beneficiary is wholly independent of the underlying contract of sale between the seller and purchaser, subject to one exception, namely established (not merely alleged) fraud on the part of the beneficiary, if it is brought to the attention of the bank before payment to the beneficiary is made. Stegmann also pointed out that it is the bank that has the difficult task to determine whether the alleged fraud is sufficiently well established to justify dishonouring the undertaking made in the letter of credit document (in para 130) (for a full discussion of this case, see C Hugo and O Lambertyn ‘Documentary Credits and Independent Guarantees’ *ABLU* 2007 (a paper delivered at the 2007 Annual Banking Law Update held at the Indaba Hotel, Johannesburg on 18 April 2007) (hereinafter ‘*ABLU* 2007’) 177 at 200–202; and A J Itzikowitz ‘Financial Institutions and Stock Exchange: Case Law – Documentary Credit’ (2000) *Annual Survey of South African Law* at 638–642; and *ABLU* 2001 *op cit* note 34 at 6–12 of the article. See also Van Niekerk and Schulze *op cit* note 2 at 315.

<sup>569</sup> See *Loomcraft Fabrics v Nedbank* 1996 (1) SA 812 (A) at 816–817 and 822H.

<sup>570</sup> See *Loomcraft Fabrics v Nedbank* 1996 (1) SA 812 (A) at 822G–H.

<sup>571</sup> See also Van Niekerk and Schulze *op cit* note 2 at 315.

In *Loomcraft Fabrics v Nedbank* the Appellate Division followed the narrow view of the fraud exception as formulated by the House of Lords in the English case of *United City Merchants v Royal Bank of Canada*.<sup>572</sup>

In *Union Carriage v Nedcor Bank*<sup>573</sup> an applicant (Union Carriage) of a standby letter of credit and two advance payment guarantees issued by Nedbank applied for an interdict to prevent the beneficiary from receiving payments under the instruments. All three instruments were payable on the written statement of the beneficiary (Siemens) that the applicant had failed to fulfil its obligations in terms of the underlying contract. The beneficiary had claimed payment from Nedbank under the instruments and had submitted certificates stating that the applicant had not fulfilled its contractual obligations.<sup>574</sup>

The court stated that payment in terms of the documentary credits had to be made irrespective of the underlying disputes between parties, and provided only that the conditions specified in the credit were met and that there was no fraud involved in their use. The court also mentioned during the course of its judgment that the fact that the applicant had not alleged fraud and had, furthermore, expressly renounced fraud on the part of the beneficiary under the documentary credits, meant that the only question that had to be answered was whether the conditions for the payment of the credits had been complied with.<sup>575</sup> The court found that it was common cause that the conditions for the payment of the credit were fulfilled and therefore no interdict was granted.<sup>576</sup> The court stated that the fact that the interdict was to prevent the beneficiary from receiving payment rather than to prevent the bank from paying did not affect the court's conclusion.<sup>577</sup>

The court in *Union Carriage v Nedcor Bank*, however, remarked by way of an *obiter dictum* that had the beneficiary and the applicant entered into an agreement in terms of which the beneficiary undertook not to draw on the letter of credit (i.e., a *pactum de non cedendo*) and had the beneficiary, nevertheless, sought to extract payment under the letter of credit, it could conceivably have been guilty of fraud. It has been said that although this comment was made *obiter*, it provides an indication that the South African courts may be willing to look beyond the letter of credit documents in considering whether there was any fraud on the part of the beneficiary. It therefore provides support for the view that fraud justifying interference with the beneficiary's claim to payment is not limited to the so-called documentary fraud. This *obiter* statement is contrary to the 'narrow' formulation of the fraud exception by the House of Lords in *United City Merchants v Royal Bank of Canada* and which was apparently adopted by the South African Appellate Division in *Loomcraft Fabrics v Nedbank*, but it is in accordance with the 'wider' formulation of the

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<sup>572</sup> [1983] AC 168 (HL) ([1982] 2 Lloyd's Rep 1 (HL)). See also Van Niekerk and Schulze *op cit* note 2 at 315.

<sup>573</sup> 1996 CLR 724 (W). For a full discussion of this case, see *Oelofse: The Law of Documentary Letters of Credit op cit* note 311 at 474–477 and 'ABLU 1997 *op cit* note 237 at 6–7 of the article.

<sup>574</sup> See *Union Carriage v Nedcor Bank supra* note 573 at 724–728.

<sup>575</sup> See *Union Carriage v Nedcor Bank supra* note 573 at 734–735. See also Van Niekerk and Schulze *op cit* note 2 at 314.

<sup>576</sup> See *Union Carriage v Nedcor Bank supra* note 573 at 735.

<sup>577</sup> See *Union Carriage v Nedcor Bank supra* note 573 at 725 and 734.

fraud exception by later English cases.<sup>578</sup> However, as the existence of such a *pactum de non cedendo* was not alleged, the court did not find it necessary to decide whether it was prepared to grant an interdict on the basis of fraud.<sup>579</sup>

*Z Z Enterprises v Standard Bank*<sup>580</sup> concerned a case where an application was brought for an interdict preventing the bank from paying under a documentary collection.<sup>581</sup> This case dealt with a dispute between a bank and its customer in connection with a documentary collection that was subject to the 1978 version of the ICC Uniform Rules for Collections.<sup>582</sup> In this case, the applicant applied for an interdict and relied on the fraud of the seller ('the beneficiary') to prevent the bank (i.e., Standard Bank) from making payment to the Indian remitting bank. Although *Z Z Enterprises v Standard Bank* did not deal specifically with a letter of credit, but with a documentary collection, it is still relevant for purposes of dealing with documentary credits, especially because of the comments the court had made regarding documentary credits. In this case, the court referred in passing to the autonomy principle as it related to commercial letters of credit. In doing so, the court remarked that courts should give effect to the commercial purpose for which letters of credit had been created. It also stated that as an irrevocable letter of credit constituted an independent contract between the issuing bank and the beneficiary, the applicant could not go behind the documents and cause payment to be stopped or suspended simply because of complaints concerning the quality of the goods or other alleged breaches of contract by the beneficiary. The court, however, said that there was no reason why, in appropriate circumstances, the fraud exception could not be applicable in the South Africa law. Before the exception would be applicable, there would have to be a case of 'clearly established' fraud.<sup>583</sup> The court found that although fraud was alleged, the facts alleged in support of it were equally consistent with a mere breach of contract not necessarily amounting to

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<sup>578</sup> See, e.g., *Deutsche Rückversicherung AG v Walbrook Insurance Co Ltd and Others; Group Josi Re (formerly known as Group Josi Reassurance SA) v Walbrook Insurance Co Ltd and Others* [1994] 4 All ER 181 (QBD); and *Themehelp Ltd v West and Others* [1996] QB 84 (CA) ([1995] All ER 215 (CA); and [1995] 3 WLR 751 (CA)). See also, Oelofse: *The Law of Documentary Letters of Credit op cit* note 311 at 477. In *Deutsche Rückversicherung AG v Walbrook Insurance* there are indications in the judgment of Phillips J that, in his view, the possibility of obtaining an injunction against payment is not limited to the case of fraud regarding the documents themselves, but that fraud relating purely and simply to the underlying contract could also form the basis of such an injunction (see also A N Oelofse 'Developments in the Law of Documentary Letters of Credit' (1996) 8 *South African Mercantile Law Journal* 286 at 300).

<sup>579</sup> See *Union Carriage v Nedcor Bank supra* note 573 at 735. See also Van Niekerk and Schulze *op cit* note 2 at 317.

<sup>580</sup> 1995 CLD 769 (W). For a full discussion of this case, see *ABLU 1996 op cit* note 192 at 14 and 18 of the article; A N Oelofse 'Developments in the Law of Documentary Letters of Credit' (1996) 8 *South African Mercantile Law Journal* 286 at 305 and 310; and Oelofse: *The Law of Documentary Letters of Credit op cit* note 311 at 477–478.

<sup>581</sup> In a documentary collection, a bank collects payment for the seller by delivering documents to the buyer. The seller does not receive payment until payment has been made to the remitting bank by the buyer. The instrument has a high risk element and is used only when the seller and buyer are familiar with each other. It does not qualify as a letter of credit since the relevant bank acts merely as an intermediary between the buyer and seller in order to facilitate payment (see A van Wyk 'Letters of Credit and Attachment Proceedings' (September 1995) *De Rebus* 575 at 575).

<sup>582</sup> ICC Publication No 322, Paris (1978).

<sup>583</sup> See *ABLU 1996 op cit* note 192 in note 81 at 14 of the article.

fraud.<sup>584</sup> Therefore, the application for an interdict was dismissed because there was no proof of at least a *prima facie* case of fraud.<sup>585</sup>

From the above case law it is clear that in appropriate circumstances and provided that the applicant satisfies the burden of proving fraud on the part of the beneficiary, South African courts will not hesitate to interdict a bank from paying under a letter of credit (and by deduction also a demand guarantee) where fraud is involved.<sup>586</sup> However, it is not clear what would constitute appropriate circumstances, nor is it quite settled yet what the exact standard of proof is that would be required.<sup>587</sup> The fraud rule under the South African law is far from being fully developed. So far the fraud exception has not been successfully raised in any letter of credit/demand guarantee case and the South African courts have not had enough opportunities to deal with this exception properly. Given the handful of case law there is in this area, it would seem that even if South African courts are presented with an opportunity to deal fully with the fraud exception, they rather tend to follow the stringent approach of English courts, than deal with the fraud exception afresh. Hopefully, the South African courts will soon start to create their own views on the matter.

### 5.6.2 Concept of Fraud: Fraud in the Narrow and Wide Sense

There is a distinction between fraud committed by the beneficiary on the documents (i.e., ‘fraud in the narrow sense’), and fraud committed by the beneficiary that does not pertain to the documents, but relates to the conduct of the beneficiary regarding the underlying contract, for example, by intentionally dispatching goods of an inferior quality (i.e., ‘fraud in the wide sense’).<sup>588</sup>

As already mentioned above,<sup>589</sup> the leading House of Lords decision in *United City Merchants v Royal Bank of Canada*<sup>590</sup> confined the fraud exception in relation to commercial letters of credit under the English law to fraud in the narrow sense (i.e., fraud committed in the documents). However, more recent English judgments<sup>591</sup> contain indications that the earlier formulation of the fraud exception should not be read too literally. The cases dealing specifically with demand guarantees indicate an acceptance of fraud in the wide sense (i.e., fraud not in relation to the documents, but in relation to the

<sup>584</sup> See *ZZ Enterprises v Standard Bank supra* note 580 at 783.

<sup>585</sup> See *ZZ Enterprises v Standard Bank supra* note 580 at 778–784. See also *ABLU 1996 op cit* note 192 at 18 of his article.

<sup>586</sup> See also Van Niekerk and Schulze *op cit* note 2 at 315.

<sup>587</sup> See para 5.6.3 below.

<sup>588</sup> See Van Niekerk and Schulze *op cit* note 2 at 313–314.

<sup>589</sup> See the full discussion in para 5.1 above.

<sup>590</sup> [1983] AC 168 (HL) ([1982] 2 Lloyd’s Rep 1 (HL)).

<sup>591</sup> See, e.g., *GKN Contractors Ltd v Lloyds Bank plc* (1985) 30 BLR 48 (CA); *Deutsche Rückversicherung AG v Walbrook Insurance Co Ltd and Others; Group Josi Re (formerly known as Group Josi Reassurance SA) v Walbrook Insurance Co Ltd and Others* [1996] 1 Lloyd’s Rep 345 (CA) ([1996] 1 WLR 1152 (CA); and [1996] 1 All ER 791 (CA)); *Themehelp Ltd v West* [1996] QB 84 (CA); [1995] All ER 215 (CA); and [1995] 3 WLR 751 (CA); and *Balfour Beatty Civil Engineering and Another v Technical and General Guarantee Co Ltd* (2000) 68 Con LR 180 ([2000] CLC 252; and [2000] CILL 1574).

conduct by the beneficiary in relation to the underlying contract). However, the precise limits of the fraud exception under the English law have not yet been settled.<sup>592</sup>

In *Loomcraft Fabrics v Nedbank* it seems that the Appellate Division followed the narrow view of the fraud exception as formulated by the House of Lords in *United City Merchants v Royal Bank of Canada*.<sup>593</sup> The *Loomcraft Fabrics v Nedbank* case clearly demonstrated that South African courts are willing to enforce the fraud exception where the forgery or falsification relates to the documents.<sup>594</sup> It has been pointed out that it should be kept in mind that when one is dealing with this Appellate Division case that the court was concerned only with alleged fraud in the documents and that the applicant did not refer to any fraudulent conduct by the beneficiary beyond the documents. Therefore, all the alleged fraudulent aspects that the Appellate Division had to consider concerned only the documents. It was not required of the Appellate Division also to consider fraudulent conduct outside the documents.<sup>595</sup> For this reason, it has been submitted correctly that this judgment cannot be regarded as authority for determining the parameters of the fraud exception.<sup>596</sup> Van Niekerk and Schulze said that the fact that the Appellate Division referred to the House of Lords decision with approval and used that case as authority was neither here nor there. They correctly point out that the *Loomcraft Fabrics v Nedbank* case was delivered at a time when the *United City Merchants v Royal Bank of Canada* case was still the leading case and before more recent English judgments<sup>597</sup> dealing with the fraud exemption in the wider sense were made, and therefore the Appellate Division did not have the advantage of referring to these later cases in its judgment.<sup>598</sup> Van Niekerk and Schulze's argument is sound and cannot be faulted.

It would be interesting to see whether South African courts will also follow this latest trend of the English courts to include fraud in the wider sense when dealing with the fraud exception. As already mentioned, there are indications that the South African courts will acknowledge fraud in the wide sense as a valid exception to the autonomy principle of the letter of credit and demand guarantee,<sup>599</sup> but that they will apparently be less likely to interdict the bank from paying when fraud concerns the performance rendered by the beneficiary in terms of the underlying contract.<sup>600</sup> However, there is currently no case law supporting this deduction and it seems to be mere speculation.

Van Niekerk and Schulze submit that a wide approach to the fraud exception makes sense and will be in accordance with judicial developments elsewhere. They mention a number of valid considerations that substantiate such an expansion of the fraud exception. According to them, it does not make any sense for courts to consider one type of fraud,

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<sup>592</sup> See also Van Niekerk and Schulze *op cit* note 2 at 316.

<sup>593</sup> See also Van Niekerk and Schulze *op cit* note 2 at 315.

<sup>594</sup> See also Van Niekerk and Schulze *op cit* note 2 at 316.

<sup>595</sup> *Idem*

<sup>596</sup> See also Van Niekerk and Schulze *op cit* note 2 at 317.

<sup>597</sup> See the cases referred to in note 591 above.

<sup>598</sup> See also Van Niekerk and Schulze *op cit* note 2 at 317.

<sup>599</sup> See, e.g., *Union Carriage and Wagon Company Ltd v Nedcor Bank Ltd* 1996 CLR 724 (W); and cf Van Niekerk and Schulze *op cit* note 2 at 314.

<sup>600</sup> See also Van Niekerk and Schulze *op cit* note 2 at 316.

namely fraud on the documents, but not also fraud outside the documents. Furthermore, in accepting the wide approach to the fraud exception, it should be kept in mind that it remains the duty of the applicant/principal (and not the bank) to allege and prove the fraud and that there is no duty on the bank to investigate the possibility of fraud outside the documents. Should an applicant/principal of a letter of credit/demand guarantee allege that fraud has taken place outside the documents, he will still have to comply with the requirements set out in the *Loomcraft Fabrics v Nedbank* case. They also indicated that based on the strict test for fraud that has been set out in *Loomcraft Fabrics v Nedbank*, it could be expected that frivolous and applicant-principal-inspired litigation based on the fraud exception would be kept to a minimum.<sup>601</sup>

However, it has been argued that South African banks would probably prefer it if the courts followed a narrow approach to the fraud exception, because the mere existence of any exception to the autonomy principle creates difficulties for banks, especially for those that act as intermediaries between the applicant and the beneficiary in the payment process.<sup>602</sup>

### 5.6.3 Standard of Fraud

The Appellate Division in *Loomcraft Fabrics v Nedbank*<sup>603</sup> observed that the beneficiary's fraud would have to be established clearly. Furthermore, the burden of proof required was the ordinary civil one which has to be discharged on a balance of probabilities and, as in any other case where fraud is alleged, fraud will not be inferred lightly.<sup>604</sup> In *Z Z Enterprises v Standard Bank*<sup>605</sup> the court also mentioned that there would have to be a case of 'clearly established' fraud before the exception will apply.<sup>606</sup> However, precisely

<sup>601</sup> See also Van Niekerk and Schulze *op cit* note 2 at 317.

<sup>602</sup> See Van Niekerk and Schulze *op cit* note 2 at 316.

<sup>603</sup> 1996 (1) SA 812 (A).

<sup>604</sup> See *Loomcraft Fabrics v Nedbank* 1996 (1) SA 812 (A) at 817F–G. The Appellate Division also referred to *Gates v Gates* 1939 AD 150 at 155 where Watermeyer JA stated:

It is true that in certain cases more especially in those in which charges of criminal or immoral conduct are made, it has repeatedly been said that such charges must be proved by the "clearest" evidence, or "clear and satisfactory" evidence, or "clear and convincing" evidence, or some similar phrase. There is not, however, in truth any variation in the standard of proof required in such cases. The requirement is still proof sufficient to carry conviction to a reasonable mind, but the reasonable mind is not so easily convinced in such cases because in a civilised community there are moral and legal sanctions against immoral and criminal conduct and consequently probabilities against such conduct are stronger than they are against conduct which is not immoral or criminal.

Reference was also made to *Gilbey Distillers and Vintners (Pty) Ltd and Others v Morris NO and Another* 1990 (2) SA 217 (SE) at 226A. Therefore, the approach of the Appellate Division in *Loomcraft Fabrics v Nedbank* to the proof of fraud in general has been firmly established in the South African case law (see also *Hugo: The Law Relating to Documentary Credits op cit* note 9 in note 398 at 324).

<sup>605</sup> 1995 CLD 769 (W).

<sup>606</sup> It has been mentioned that the court in *Z Z Enterprises v Standard Bank* 1995 CLD 769 (W) may have used the words 'clearly established' to indicate that no *prima facie* right had been proved (see Van Niekerk and Schulze *op cit* note 2 at 316). However, it is also quite possible that the court merely used those words, because it was often used by English courts, and it merely wanted to indicate that the same high standard would apply here.



how much more convincing the evidence must be, remains uncertain in South African law.<sup>607</sup>

The Appellate Division in *Loomcraft Fabrics v Nedbank* confirmed that no special standard of proof applied to cases where the applicant sought to interdict the bank from paying on the letter of credit. However, it has been argued that the Appellate Division's view that fraud would not lightly be inferred created the impression that, in practice, something substantially more will be required than simply proof on a balance of probabilities or a mere *prima facie* right.<sup>608</sup>

#### 5.6.4 The Time at Which Knowledge of Fraud Must be Proved

The few South African cases, discussed above, where the fraud exception was referred to or acknowledged did not deal with at what time the fraud had to be clear to the beneficiary and the bank. Therefore, there is no authority on this issue. The deduction is, however, made that in this regard South Africa would probably follow the English courts.<sup>609</sup>

#### 5.6.5 Fraud and Interdicts<sup>610</sup>

From the case law above, it is clear that in appropriate circumstances, and provided that the applicant satisfies the burden of proving fraud, South African courts will not hesitate to interdict a bank from paying under a letter of credit (and probably also a demand guarantee) where fraud is involved.<sup>611</sup> However, the courts have indicated that an interdict restraining a bank from paying under a documentary credit or a beneficiary from making a demand would only be granted in exceptional circumstances.<sup>612</sup> Of course, the question of fraud only becomes relevant in cases where it is discovered before payment by the bank has taken place. In that instance, an applicant/principal of a letter of credit/demand guarantee has the option of applying for an interdict restraining the bank from paying and/or restraining the beneficiary from making a demand or receiving payment. However, if fraud is discovered only after the payment has taken place, the applicant's/principal's remedy lies in a civil action against the beneficiary.<sup>613</sup> Irrespective of whether the payment has been made or not, the applicant/principal may also apply for an anti-dissipation interdict to prevent the beneficiary from dissipating his assets until such time as the matter of fraud is finally settled between the parties.<sup>614</sup>

<sup>607</sup> See *Oelofse: The Law of Documentary Letters of Credit op cit* note 311 at 480. It has been said that a holder of a bill of exchange (by implication also a cheque) who enforces payment fraudulently is acting contrary to the demands of good faith and abusing his right (see *Malan and Pretorius op cit* note 10 in para 143 at 225 and the authorities cited; and *Malan et al op cit* note 10 at 141–143 and the authorities cited). See also note 10 above.

<sup>608</sup> See also *Van Niekerk and Schulze op cit* note 2 at 315.

<sup>609</sup> See the discussion in para 5.4.4 above.

<sup>610</sup> For a full discussion of relief by way of an interdict, see para 7.4 in Chapter 7.

<sup>611</sup> See also *Van Niekerk and Schulze op cit* note 2 at 315; and *Oelofse: The Law of Documentary Letters of Credit op cit* note 311 at 479.

<sup>612</sup> See *Union Carriage v Nedcor Bank* 1996 CLR 724 (W) at 732; and *Loomcraft Fabrics v Nedbank* 1996 (1) SA 812 (A) at 816–817.

<sup>613</sup> See also *Van Niekerk and Schulze op cit* note 2 at 317.

<sup>614</sup> For a full discussion of the anti-dissipation interdict, see para 7.4.5 in Chapter 7.

So far there have only been two cases dealing with the situation where an applicant has tried to interdict the bank from paying under a letter of credit. In *Phillips v Standard Bank*<sup>615</sup> and *Loomcraft Fabrics v Nedbank*<sup>616</sup> all the applicants tried unsuccessfully to restrain the banks from paying. Although *Z Z Enterprises v Standard Bank*<sup>617</sup> did not deal with a letter of credit, but with a documentary collection, it is still relevant for purposes of dealing with documentary credits. In *Z Z Enterprises v Standard Bank* the applicant of a documentary collection that was subject to the 1978 ICC Uniform Rules for Collections, brought an application for an interdict to prevent the bank from paying under it. In *Loomcraft Fabrics v Nedbank* as well as in *Z Z Enterprises v Standard Bank* the courts stated that the fraud on the part of the beneficiary had to be established clearly before an interdict could be issued. In both these cases fraud was not clearly established. Although the courts have expressed that they would be willing to issue interdicts in appropriate circumstances (i.e., where fraud is clearly established), it is too early to say whether they will also follow such a stringent approach similar to the English courts. A deduction will only be possible, where a case of clear fraud is established by an applicant/principal and he applies for an interdict restraining the bank from paying under the letter of credit/demand guarantee.

To date there has been only one case dealing with the situation where an application for an interdict has been made against a beneficiary restraining him from receiving payment under a letter of credit/demand guarantee. In *Union Carriage v Nedcor Bank*<sup>618</sup> the application for an interdict against the beneficiary was unsuccessful. This case illustrates that South African courts are willing to grant such interdicts in appropriate circumstances, but only in the most exceptional circumstances.<sup>619</sup>

Of course, in addition to proving that there is established fraud, an applicant or principal applying for an interdict against the bank and/or the beneficiary will also have to satisfy all the other requirements before an interim interdict will be granted.<sup>620</sup> For example, in *Z Z Enterprises v Standard Bank* it was found that although fraud was alleged, the facts alleged in support of it were equally consistent with a mere breach of contract not

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<sup>615</sup> 1985 (3) SA 301 (W).

<sup>616</sup> 1996 (1) SA 812 (A).

<sup>617</sup> 1995 CLD 769 (W).

<sup>618</sup> 1996 CLR 724 (W).

<sup>619</sup> See *Union Carriage v Nedcor Bank supra* note 618 at 732. As already mentioned in notes 10 and 548 above, the obligation of the bank to pay under a letter of credit/demand guarantee could also be compared to the payment obligation of a bank that has guaranteed the payment of a cheque (i.e., a bank-guaranteed cheque). Therefore, cases where the drawer of a bank-guaranteed cheque applies for an interdict to prevent the bank from paying where a fraudulent demand is made, may also be comparable to similar cases dealing with demand guarantees and letters of credit and may provide importance guidance in such cases (see Malan and Pretorius *op cit* note 10 in para 143 at 225; and see, e.g., *Wavecrest Enterprises v Cema Africa (Pty) Ltd (In Liquidation) and Others* (1991) 2 *Commercial Law Digest* 266 (C) ((CPD A1163/88), November 1988) (for a discussion of this case, see J T Pretorius 'Countermanding Payment of a Certified Cheque' (1992) 4 *South African Mercantile Law Journal* 210; and A N Oelofse 'Onlangse Ontwikkelings in die Tjekreg' (1991) 3 *South African Mercantile Law Journal* 364 at 369)). It is important that courts bear this in mind in future, especially in view of the fact that South Africa currently has very few cases specifically dealing with the fraud exception regarding demand guarantees and letters of credit.

<sup>620</sup> For a full discussion of the requirements that need to be complied with before an interdict may be granted, see para 7.4.2 in Chapter 7.

amounting to fraud. Therefore, the application for an interdict was dismissed because there was no proof of at least a *prima facie* case of fraud. The application for an interdict also failed, *inter alia*, on the grounds that an apprehension of irreparable harm and the absence of another satisfactory remedy had not been shown, because the applicant could very well have recovered the moneys that he sought from its foreign contract partner.<sup>621</sup>

Therefore, should an applicant/principal of a letter of credit/demand guarantee ever succeed in proving established fraud on the part of the beneficiary, he will also have to comply with all the other requirements for obtaining an interim interdict. From case law this seems rather difficult to do.

### 5.6.6 Summary and Conclusion

In the 1970s and 1980s the problem of fraudulent calls being made on demand guarantees and documentary credits in England increased dramatically. Therefore, by that time there were already a number of cases in documentary credit transactions, as well as demand guarantee transactions, in England that indicated the English courts' willingness to interfere with banks' payment obligations under commercial letters of credit and demand guarantees where fraud was involved. Although the courts in England have had numerous opportunities since the 1970s to pronounce on the limits and the application of the fraud exception, it is interesting that the English law has still not developed the fraud rule fully in relation to letters of credit and demand guarantees.

The first time the South African courts briefly referred to fraud was in 1985 in *Phillips v Standard Bank*.<sup>622</sup> However, it was not until the *Loomcraft Fabrics v Nedbank*<sup>623</sup> case in 1995 that the courts really acknowledged and dealt with the fraud exception in the South African law. The Appellate Division in *Loomcraft Fabrics v Nedbank* provided merely a basis for the fraud rule and has left many uncertainties regarding, specifically, the concept of fraud and the standard of proof that is required. However, the value of this decision lies in the fact that the Appellate Division did make it clear that

- South African courts would consider intervening and issue interdicts restraining payment in cases where the fraud was clearly established; and
- South African courts would be willing to enforce the fraud exception where the forgery or falsification concerned the documents (i.e., where there was fraud in the narrow sense).

However, since 1995 there have been no other South African cases specifically dealing with the fraud rule. The South African fraud rule has thus remained stagnant for more than a decade and it is unclear how the courts would apply the fraud rule today. For instance, the courts have not yet indicated that they will not be prepared to interdict a bank from paying in the case of fraud concerning the performance by the beneficiary in terms of the underlying contract (i.e., in cases of fraud in the wide sense). But, if one takes into consideration the *obiter dictum* made in *Union Carriage v Nedcor Bank*,<sup>624</sup> referred to

<sup>621</sup> See *Z Z Enterprises v Standard Bank* 1995 CLD 769 (W) at 783–784.

<sup>622</sup> 1985 (3) SA 301 (W).

<sup>623</sup> 1996 (1) SA 812 (A).

<sup>624</sup> 1996 CLR 724 (W).

above, there is strong reason to believe that the South African courts will acknowledge fraud in the wide sense as a valid exception to the autonomy principle of the letter of credit and demand guarantee. The South African law regarding the fraud exception is far from being settled. From the very limited (and old) case law that is available at this time, one can see strong correlations with the English law in South African courts' application of the fraud exception. However, there are still many uncertainties regarding the limits of the fraud rule in South African law and there is much speculation as to how it will be applied by the country's courts. As the obligation of the bank to pay under a letter of credit/demand guarantee can also be compared to the payment obligation of an acceptor of a bill of exchange or that of a bank of a bank-guaranteed cheque, it is possible that decisions where the fraud exception has been raised against the payment obligation of the acceptor of a bill of exchange or bank can also be of assistance in similar cases dealing with demand guarantees or letters of credit.<sup>625</sup> Therefore, the South African courts should bear this in mind in future, especially in view of the fact that there are only a limited number of cases dealing specifically with the fraud exception regarding demand guarantees/letters of credit.

*Phillips v Standard Bank* clearly established the principle that a mere breach of the contract of sale could not provide a basis for blocking payment in terms of a letter of credit by a prohibitory interdict against the bank. Of course, the position might be different where the breach of contract also involved fraud on the part of the beneficiary. If this is the case and South African courts decide to apply the wide interpretation of fraud, then a case where there is established clear fraud on the part of the beneficiary involved in the breach of the underlying contract, there are strong indications that the courts would be inclined also to accept fraud in the wide sense as an established exception.

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<sup>625</sup> See notes 10, 548 and 619 above.

## CHAPTER 6: ILLEGALITY AS AN EXCEPTION TO THE AUTONOMY PRINCIPLE

### 6.1 INTRODUCTION

Established fraud is the main accepted international exception that exists to the autonomy principle and the absolute detachment of demand guarantees from their underlying contracts.<sup>1</sup> Certain jurisdictions also accept that there are or may also be other exceptions.<sup>2</sup> For a long time it has been a question of doubt and uncertainty as to whether illegality in the underlying contract was also an exception. Another question that was often asked was whether it was an exception to the autonomy principle if the demand guarantee itself and/or its underlying contract was contrary to the law,<sup>3</sup> good morals or public policy. In determining whether or not these grounds will constitute an exception to the autonomy principle of the demand guarantee, one needs to distinguish clearly between instances where the demand guarantee itself is against the law, good morals or public policy; and where the underlying contract is illegal, or against the good morals or public policy.<sup>4</sup>

In this chapter attention will be given to whether England, the United States and South Africa consider illegality in the underlying contract to be a valid exception to the autonomy principle of demand guarantees.<sup>5</sup> From the discussion that follows it will be seen that illegality as an exception is very controversial and its scope is still uncertain.<sup>6</sup>

<sup>1</sup> See Chapter 5; and N Enonchong 'The Autonomy Principle of Letters of Credit: An Illegality Exception?' (2006) *Lloyd's Maritime and Commercial Law Quarterly* 404 at 405.

<sup>2</sup> See, e.g., note 33 in Chapter 1, notes 162 and 357 in Chapter 2, and note 8 in Chapter 5.

<sup>3</sup> Article 7(a) of the Uniform Rules for Demand Guarantees (see *ICC Publication* No 458 published in April 1992 (hereinafter the 'URDG')) (for a full discussion of these rules see para 3.2.5 in Chapter 3 and para 4.2.3 in Chapter 4) provides:

Where a Guarantor has been given instructions for the issue of a Guarantee but the instructions are such that, if they were to be carried out, the Guarantor would by reason of law or regulation in the Country of issue be unable to fulfil the terms of the Guarantee, the instructions shall not be executed.

This article terminates instructions for the issue of a guarantee when payment under the guarantee would be unlawful under the law of the country of its issue. It is confined to cases in which the restriction to payment is created by the law of the country of issue of the guarantee. Cases where the prohibition of payment arises under the law of the beneficiary's country or of a third country through which the payments are to be routed are outside the ambit of Article 7(a) and have to be resolved by referring to the applicable law determined by the rules of private international law of the country in which the disputed case is being heard (see R Goode *Guide to the ICC Uniform Rules for Demand Guarantees* (1992) *ICC Publication* No 510 (hereinafter the 'Guide to the URDG') at 60–61).

<sup>4</sup> See also Enonchong *op cit* note 1 at 406.

<sup>5</sup> For a full discussion of the illegality exception in England and the United States, see Enonchong *op cit* note 1 at 404.

<sup>6</sup> See also J Ulph 'The UCP600: Documentary Credits in the Twenty-first Century' (2007) *Journal of Business Law* 355 at 372.

## 6.2 ENGLISH LAW

### 6.2.1 Demand Guarantee Itself is Illegal

If a contract is contrary to the law, good morals or public policy, it is illegal and, consequently, void in terms of the general principles of the law of contract applicable under the English law. Therefore, if it is the letter of credit/demand guarantee itself that is contrary to the law, good morals or public policy (i.e., the law of the country that applies to the guarantee/credit or the law of the country where the guarantee/credit is to be performed) it will likewise not be enforceable. A demand guarantee/letter of credit itself may be illegal where, for instance, the issuing of the guarantee/credit is prohibited.<sup>7</sup> This will, for instance, be the case where it is against a specific statute to issue a demand guarantee/letter of credit in favour of beneficiaries from certain countries (e.g., where the beneficiary is a citizen of a country deemed to be a foreign enemy of the State or where the outbreak of war renders the beneficiary such a foreign enemy). A demand guarantee/letter of credit itself may also be illegal because of a supervening prohibition.<sup>8</sup> A supervening prohibition may take place where at the time of issue the issuing of the guarantee/credit was lawful, but by the time of payment it has become illegal for the bank to pay by reason of a government or judicial order.<sup>9</sup> The position will also be the same where the order against payment of the demand guarantee/letter of credit is that of a foreign government or court,<sup>10</sup> provided it is the government or court in the country where the bank's payment obligation is to be performed or the country whose law is the proper law of the credit/guarantee.<sup>11</sup> For instance, where the demand guarantee is governed by the law of one country (e.g., England), but the court of another country (that is not the place of performance, e.g., South Africa) makes an order prohibiting payment under the guarantee, the English courts are not obliged to recognise the order made by the other court (i.e., South African court).<sup>12</sup> Therefore, in such an instance, if the demand guarantee/letter of credit is valid under its proper law and the law of the place of performance, the English courts will enforce it and ignore the illegality resulting from the foreign court order.<sup>13</sup> For instance, in *Power Curber International Ltd v National Bank of Kuwait SAK*<sup>14</sup> the English court enforced a letter of credit that was governed by the law of North Carolina and also

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<sup>7</sup> Although *International Dairy Queen Inc v Bank of Wadley* 407 F Supp 1270 (MD Ala 1976) is an American case, it illustrates an instance where the issuance was prohibited.

<sup>8</sup> See Enonchong *op cit* note 1 at 406.

<sup>9</sup> *Idem*.

<sup>10</sup> For instance, in *Chudian v Philippine National Bank* 734 F Supp 415 (1992); and aff'd 976 F 2d 561 an American court refused to enforce a letter of credit (to be performed in the Philippines and governed by Filipino law), because the payment had become prohibited under Philippine law. In *Banco de Vizcaya SA v First National Bank of Chicago* 514 F Supp 1280 (ND Ill 1981) another American court ordered the bank's home office to pay under a letter of credit issued by the bank's Abu Dhabi branch despite an Abu Dhabi court's injunction against the payment. See also R Jack, A Malek and D Quest *Documentary Credits: The Law and Practice of Documentary Credits Including Standby Credits and Demand Guarantees* 3 ed (2001) (hereinafter 'Jack') in paras 13.41–13.55.

<sup>11</sup> See Enonchong *op cit* note 1 at 406–407; and *Jack op cit* note 10 in paras 13.41–13.55.

<sup>12</sup> See Enonchong *op cit* note 1 in note 16 at 407.

<sup>13</sup> *Idem*.

<sup>14</sup> [1981] 1 WLR 1233 (CA); and [1981] 3 All ER 607 (CA).

payable there, despite a Kuwaiti court order prohibiting payment.<sup>15</sup> In the aforementioned cases, the defence of illegality will apply to the demand guarantee/letter of credit as it would to any other contract that is found to be illegal.<sup>16</sup> Where the demand guarantee/letter of credit itself is illegal (and the underlying contract legal), the principle of autonomy does not come into play and no difficulty arises as a result of that principle.<sup>17</sup>

The situation may also arise where the demand guarantee/letter of credit itself, as well as the underlying contract are illegal under the same prohibition.<sup>18</sup> In such cases, illegality of the demand guarantee/letter of credit is not affected by the autonomy principle because the guarantee/credit is illegal in itself rather than through illegality in the underlying contract.<sup>19</sup>

## 6.2.2 Illegality in the Underlying Contract

The position becomes uncertain in the situation where the illegality is in the underlying contract only (e.g., the sale of illegal ammunition). In other words, this is the situation where the prohibition that makes the underlying contract illegal, does not directly affect the

<sup>15</sup> Another example is found in *J Zevi and Sons Ltd v Grindlays Bank (Uganda) Ltd* 37 NY 2d 220 (1975), an American case, where the Uganda Government ordered the issuing bank not to make payment under letters of credit issued for the benefit of Israelis. The Court of Appeal of New York refused to give effect to the order, because the place of payment was New York and the applicable law was New York Law (see also Enonchong *op cit* note 1 in note 16 at 407).

<sup>16</sup> See Enonchong *op cit* note 1 at 406; and E P Ellinger *Ellinger's Modern Banking Law* 4 ed (2006) at 851. For a discussion of illegality in contracts in general, see R P Buckley *Illegality and Public Policy* (2002); and N Enonchong *Illegal Transactions* (1998). The English law also specifically recognises that where the demand guarantee or letter of credit itself constitutes an infringement of international obligations, it will also be allowed as an acceptable ground for the bank to refuse payment (see H N Bennett 'Performance Bonds and the Principle of Autonomy' (1994) *Journal of Business Law* 574 at 581).

<sup>17</sup> As illegality of the demand guarantee itself does not affect the autonomy principle of the guarantee, a detailed discussion of this is not required here.

<sup>18</sup> See, e.g., *Wahda Bank v Arab Bank Plc* (1992) 2 Bank LR 233; and *United City Merchants (Investments) Ltd and Glass Fibres and Equipments Ltd v Royal Bank of Canada (incorporated in Canada), Vitrorefuerzos SA and Banco Continental SA* [1983] AC 168 (HL) ([1982] 2 Lloyd's Rep 1 (HL)). In *United City Merchants* it was held that the whole transaction (the underlying contract as well as the letter of credit itself) was in breach of Peruvian exchange control regulations and was therefore unenforceable in England under article VIII(2)(b) of the Bretton Woods Agreements (see Bretton Woods Agreements Act 1945 and the Bretton Woods Agreements Order in Council 1946) as implemented in England. Although it is true that the effect of article VIII(2)(b) was to render the transactions in this case unenforceable rather than illegal, the point is still that both the underlying contract as well as the letter of credit itself directly contravened the relevant legislation (see Enonchong *op cit* note 1 at 407; *Jack op cit* note 10 in para 13.52; and see also *Group Josi Re v Walbrook Insurance Co Ltd and Others* [1996] 1 Lloyd's Rep 345 (CA) ([1996] 1 WLR 1152 (CA); and [1996] 1 All ER 791 (CA)) at 352–253). Various countries, including England, are members of the International Monetary Fund. The International Monetary Fund Agreement is generally known as the Bretton Woods Agreement and it is made part of the English law by the Bretton Woods Agreements Order in Council 1946 (SR & O 1946 No 36) (for a full discussion of this agreement and case law dealing with it, see *Jack op cit* note 10 in paras 13.50–13.55). Article VIII(2)(b) of the Bretton Woods Agreements provides that:

Exchange contracts which involve the currency of any member and which are contrary to the exchange control regulations of any member maintained or imposed consistently with this agreement shall be unenforceable in the territories of any member.

Therefore, exchange contracts involving the currency of any member of the International Monetary Fund and contrary to that member's exchange control regulations are unenforceable in England because of the Bretton Woods Agreement and related legislation (see *Jack op cit* note 10 in para 13.42 at 412)

<sup>19</sup> See Enonchong *op cit* note 1 in note 16 at 407.

demand guarantee/letter of credit. Where the underlying contract is illegal, it is important to establish whether that illegality will also extend to and influence the demand guarantee/letter of credit itself. If the demand guarantee/letter of credit is affected by the illegality in the underlying contract, there might be instances where the principle of autonomy of the guarantee/credit will have to be infringed.<sup>20</sup> Just as with the fraud exception, there are two conflicting policy considerations that arise in these circumstances. On the one hand there is the policy in favour of preserving the sanctity of demand guarantees and letters of credit and, on the other hand, there is the policy against enforcing any transaction entered into in furtherance of an illegal purpose.<sup>21</sup> The first policy presses for maximum autonomy of demand guarantees and letters of credit, and the second policy requires that the principle of autonomy be infringed in certain circumstances.<sup>22</sup>

The English law has commonly recognised only a few established exceptions to the autonomy principle, and the absolute detachment of demand guarantees and letters of credit from their underlying contracts. Established fraud of which the bank has knowledge is basically the only accepted exception,<sup>23</sup> and it was the first exception to acknowledge that the autonomy principle of demand guarantees and letters of credit were not absolute. Initially, there was some hesitation and uncertainty<sup>24</sup> as to whether illegality in the underlying contract was also a distinct exception to the autonomy principle.<sup>25</sup> So far, neither the English Court of Appeal nor the House of Lords has recognised an illegality exception to the autonomy principle. However, other English High Courts have indicated that such an exception exists, but have neglected to indicate to what extent illegality can provide the basis for a defence to a claim under a letter of credit and demand guarantee.<sup>26</sup> Despite this, some are still saying that it is arguable whether there is a further exception

<sup>20</sup> See Enonchong *op cit* note 1 at 407.

<sup>21</sup> See, e.g., *Mahonia Ltd v JP Morgan Chase Bank and Another* [2003] 2 Lloyd's Rep 911 (QB (Com Ct)) at 927.

<sup>22</sup> See Enonchong *op cit* note 1 at 407–408.

<sup>23</sup> See Bennett *op cit* note 16 at 581; and Chapter 5 for a full discussion. Currently, I am not aware of any reported English case of an injunction being granted on the grounds that the letter of credit or performance guarantee is invalid or unenforceable on grounds other than fraud. The only unreported case (see *Mariteknik Shipbuilders (S) Pte Ltd v SNC Passion and Sarl Transport Maritime Brudey Frènes (The Passion)*, Claim No 2004 Folio 835 (Unreported, Commercial Court, 13 October 2004) where an interim injunction was granted related to an instance where there were allegations that the demand guarantee (performance guarantee) and the underlying contract had been frustrated. In this case, Gloster J granted an interim injunction. However, as this was an interim injunction case it was not reported, and a reasoned judgment was also not given. Therefore, it is still unclear whether this would constitute exceptions to the autonomy principle in the English law. However, for a detailed discussion of this case by the barrister that appeared for the applicant, see G Clark 'Injuncting Calls on a Performance Guarantee in the Absence of Fraud: The Passion' (2005) *Journal of International Banking Law and Regulation* 338; and G Clark 'As Good as Cash? Injuncting Calls on Letters of Credit and Performance Guarantees' (a paper delivered at a seminar organised by the Professional Solutions Training and Consultancy held at the Discussion Conference Centre in London on 15 May 2006) (unpublished) in paras 74–90 at 24–28.

<sup>24</sup> See, e.g., *Group Josi Re v Walbrook Insurance Co Ltd and Others* [1996] 1 Lloyd's Rep 345 (CA) ([1996] 1 WLR 1152 (CA); and [1996] 1 All ER 791 (CA)) at 362 and 368 where the discussion of the Court of Appeal was inconclusive; and see also the decision of the court *a quo* in *Deutsche Ruckversicherung AG v Walbrook Insurance Co Ltd and Others; Group Josi Re (formerly known as Group Josi Reassurance SA) v Walbrook Insurance Co Ltd and Others* [1995] 1 WLR 1017 (QBD) ([1994] 4 All ER 181 (QBD)) at 1027.

<sup>25</sup> See Enonchong *op cit* note 1 at 409.

<sup>26</sup> See Enonchong *op cit* note 1 at 405; and M Brindle and R Cox (eds) *Law of Bank Payments* 3 ed (2004) in para 8–037.



where the demand guarantee/letter of credit is tainted by illegality in the underlying contract.<sup>27</sup>

*Group Josi Re v Walbrook Insurance Co Ltd and Others*<sup>28</sup> was a case that dealt with letters of credit of which the underlying contracts were reinsurance contracts said to be illegal. Initially the case involved various plaintiffs (including Group Josi) and defendants. The plaintiffs were reinsurance companies who had entered into reinsurance contracts with the defendants. Later one of the reinsurer companies and plaintiff of this case, Group Josi, made an arrangement with one of the defendants whereby the defendant would pay over to Group Josi (i.e., the plaintiff) certain loss reserves held regarding the reinsurance contracts. In turn for such payments, Group Josi had to arrange for the opening of letters of credit. The relevant letters of credit were payable in the event that the defendant presented a debit note to the issuing bank stating that Group Josi was liable for the amounts in question. Group Josi contended that for the insurance companies (the insurers and also the beneficiaries of the letters of credit (i.e., defendants)) to issue such a debit note would necessarily involve an attempt at enforcing a reinsurance contract which was illegal under the English law (because the plaintiff was not legally authorised to conduct insurance business).<sup>29</sup> Initially Group Josi and another reinsurer applied *ex parte* for injunctions restraining the beneficiaries (there were various insurers) of the letters of credit from drawing on the letters of credit. In the action originally pleaded the reinsurers (applicants of the letters of credit) claimed a declaration that the reinsurance contracts with the insurers (beneficiaries of the letters of credit) were illegal and void. These injunctions were granted, but they were later set aside on the ground that the illegality of the underlying reinsurance contracts did not taint the letters of credit. However, just before that hearing Group Josi (i.e., the reinsurer and plaintiff) dropped its reliance on illegality, amended its particulars of claim to the effect that the contract of reinsurance had been cancelled due to fraudulent misrepresentation on the part of the insurer's (beneficiary's) agent in concluding the contract of reinsurance. It then claimed an injunction against the beneficiary (insurer) on this basis (for present purposes it is unnecessary to refer to the actual fraud or the disputes in that regard). This hearing based on the new allegations eventually came before Phillips J in the Queen's Bench Division (commercial court) (the court *a quo*) and he refused to grant an injunction.<sup>30</sup> Group Josi (applicant of the letter of credit) then appealed against this decision,<sup>31</sup> but the Court of Appeal held that the payment under the reinsurance contracts was not illegal.

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<sup>27</sup> See D Warne and N Elliott *Banking Litigation* 2 ed (2005) at 259.

<sup>28</sup> [1996] 1 Lloyd's Rep 345 (CA) ([1996] 1 WLR 1152; and [1996] 1 All ER 791 (CA)). For a discussion of this case, see *Jack op cit* note 10 in paras 13.56–13.57; A N Oelofse 'Developments in the Law of Documentary Letters of Credit' *ABLU* 1997 (a paper delivered at the 1997 Annual Banking Law Update held at the Indaba Hotel, Johannesburg) (unpaginated) (hereinafter '*ABLU 1997*') at 3–4 of his article.

<sup>29</sup> See also Warne and Elliott *op cit* note 27 at 271.

<sup>30</sup> See also the earlier decision in *Deutsche Rückversicherung AG v Walbrook Insurance Co Ltd and Others; Group Josi Re (formerly known as Group Josi Reassurance SA) v Walbrook Insurance Co Ltd and Others* [1995] 1 WLR 1017 (QBD) ([1994] 4 All ER 181 (QBD)). For a discussion of this case, see A N Oelofse 'Developments in the Law of Documentary Letters of Credit' (1996) 8 *South African Mercantile Law Journal* 56 at 63–64.

<sup>31</sup> See *Group Josi Re v Walbrook Insurance Co Ltd and Others* [1996] 1 Lloyd's Rep 345 (CA) ([1996] 1 WLR 1152 (CA); and [1996] 1 All ER 791 (CA)).

In this Court of Appeal case Staughton LJ stated *obiter* that illegality in the underlying contract may be a defence under English law to an issuing bank in refusing to make payment under a letter of credit. Lord Justice Staughton said:<sup>32</sup>

[I]n my judgment illegality is a separate ground for non-payment under a letter of credit. That may seem a bold assertion, when Lord Diplock in the *United City Merchants* case said that there was “one established exception” [i.e., fraud]. But in that very case the House of Lords declined to enforce a letter of credit contract in part for another reason [besides fraud], that is to say the exchange control regulations of Peru as applied by the Bretton Woods Agreements Order in Council 1946.<sup>33</sup> I agree that the Bretton Woods point may well have been a kind of its own, and not an indication that illegality generally is a defence under a letter of credit. But it does perhaps show that established fraud is not necessarily the only exception.

It seems to me that there must be cases when illegality can affect a letter of credit. Take for example a contract for the sale of arms to Iraq, at a time when such a sale is illegal. The contract provides for the opening of a letter of credit, to operate on presentation of a bill of lading for 1000 kalashnikov rifles to be carried to the port of Basra. I do not suppose that a Court would give judgment for the beneficiary against the bank in such a case.<sup>34</sup> (Emphasis in original.)

Lord Justice Staughton was also of the view that before illegality could operate as a defence, or a ground for restraining payment by the bank, it, like fraud, had to be clearly established and known to the bank.<sup>35</sup> In dealing with the case before him, he also added:<sup>36</sup>

Turning to the present case, if the reinsurance contracts are illegal, and if the letters of credit are being used as a means of paying sums due under those contracts, and if all that is clearly established, would the Court restrain the bank from making payment or the beneficiary from demanding it? In my judgment the Court would do so. That would not be because the letter of credit contracts were *themselves illegal, but because they were being used to carry out an illegal transaction.* (Emphasis added.)

Oelofse has said that if the emphasised part of the above statement is indeed the reason for letting the ‘underlying’ illegality ‘work through’ to the letter of credit, then it is hard to picture a form of ‘underlying’ illegality that would *not* be allowed to affect the letter of

<sup>32</sup> [1996] 1 Lloyd’s Rep 345 (CA) at 362 (note included for clarity).

<sup>33</sup> See the discussion of this issue in *United City Merchants (Investments) Ltd and Glass Fibres and Equipments Ltd v Royal Bank of Canada (incorporated in Canada), Vitrorefuerzos SA and Banco Continental SA* [1983] AC 168 (HL) ([1982] 2 Lloyd’s Rep 1 (HL)) in note 18 above, and, see also the the discussion of this case in paras 5.4.1 and 5.4.2 in Chapter 5.

<sup>34</sup> It has been said that this practical example, given by Staughton regarding an illegal arms deal, illustrates a real practical problem for banks. Apparently nominated and confirming banks are becoming increasingly concerned regarding the practice in certain letters of credit to describe goods as ‘goods as *per* proforma invoice . . . no . . . dated . . .’. The banks will normally not have seen the invoice which may refer to arms or other such goods. Difficulties will arise where a bank agrees to confirm a credit in such cases and later finds there is an illegal shipment of arms. In such a case, it has been said, the defence of illegality is likely to apply (see Warne and Elliott *op cit* note 27 at 272).

<sup>35</sup> See [1996] 1 Lloyd’s Rep 345 (CA) at 362.

<sup>36</sup> [1996] 1 Lloyd’s Rep 345 (CA) at 362–363 (emphasis added).

credit. Since Staughton LJ himself was not prepared to recognise *any* form of ‘underlying’ illegality as sufficient to affect the letter of credit, it seems that this part of his statement cannot be taken as the real reason for the conclusion he had reached. If that is so, this judgment brought little clarity to this issue.<sup>37</sup> The discussion by the Court of Appeal as to whether illegality was a distinct and separate exception was therefore inconclusive.<sup>38</sup>

However, it seems that judicial opinion in England is now in favour of recognising illegality in the underlying contract as a distinct and separate exception to the autonomy principle of letters of credit.<sup>39</sup> The question whether illegality can ever be a defence to a bank sued under a credit arose directly for decision in *Mahonia Ltd v JP Morgan Chase Bank and Another*.<sup>40</sup> This case stemmed from the huge Enron fraud. The claimant (Mahonia) was a special-purpose vehicle created to take part in Enron financial transactions. Enron requested the London Branch of West LB AG (Westdeutsche LandesBank Girozentrale), a German bank to issue a standby letter of credit (for US\$165 million) in favour of Mahonia. The letter of credit was issued to support a swap transaction between a subsidiary of Enron, Enron North American Corporation (‘ENAC’) and Mahonia.<sup>41</sup> Shortly after the letters of credit had been issued (on 5 October 2001) Enron’s financial difficulties started to become apparent and on 2 December 2001 Enron went into chapter 11 bankruptcy (so did 13 of its direct and indirect subsidiaries, including ENAC). Under the letter of credit Enron’s bankruptcy was an event of default, which entitled Mahonia to make a demand. Therefore, Mahonia made a demand on 5 December 2001 for the amount due under the letter of credit. JP Morgan Chase Bank, on behalf of its customer, Mahonia, presented conforming documents (i.e., a confirming demand). West LB AG refused to pay and argued that although the documents presented for payment conformed with the standby letter of credit, the credit was unenforceable because it was illegal. The illegality alleged was that, in fact, and unknown to it at the time, the purpose of the underlying swap transaction was to provide Enron with a disguised loan so as to enable it improperly to manipulate its account in breach of the United States General Accepted Accounting Practices (‘GAAP’), Financial Accounting Standards, and the United States securities law (Securities Exchange Act, 1934).<sup>42</sup>

Therefore, the bank (West LB AG) declined to pay on the standby letter of credit and pleaded a detailed defence stipulating the respects in which it was claimed that the purpose behind the letter of credit was for Enron to disguise what, in fact, was a loan in violation of United States criminal and civil law, and therefore was unenforceable under English law, as result of illegality under the America law and/or is unenforceable on the grounds of

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<sup>37</sup> See *ABLU 1997 op cit* note 28 at 4 of the article.

<sup>38</sup> See *Enonchong op cit* note 1 in note 33 at 409.

<sup>39</sup> See *Enonchong op cit* note 1 at 409.

<sup>40</sup> [2003] 2 Lloyd’s Rep 911 (QB (Com Ct)). For a full discussion of this case, see J C T Chuah ‘Documentary Credits and Illegality in the Underlying Transaction’ (2003) 9 *Journal of International Maritime Law* 518; C Hugo ‘Documentary Credits and Independent Guarantees’ *ABLU 2004* (a paper delivered at the 2004 Annual Banking Law Update held at the Indaba Hotel, Johannesburg on 21 April 2004) (unpaginated) (hereinafter ‘*ABLU 2004*’) at 5–10 of his article; and P S Turner ‘*Mahonia Ltd. V. J.P. Morgan Chase Bank: The Enron L/C and the Issuing Bank’s Defence of Illegality*’ (2006) 8 *Journal of Payment Systems Law* 733.

<sup>41</sup> See also note 43 below.

<sup>42</sup> See also *Enonchong op cit* note 1 at 409–410.

public policy.<sup>43</sup> Mahonia applied for the illegality defence to be struck out and for summary judgment. The matter came before Justice Colman on a summary basis to decide the point of law which arose, namely whether illegality could amount to a defence.<sup>44</sup>

Colman J first considered the precise nature of the illegality contended. He interpreted the pleadings as asserting that as the procurement of the standby letter of credit was a vital requirement for Chase Bank to set up the cosmetic scheme, it was illegal directly or by way of taint or unenforceable. Colman J then said:<sup>45</sup>

I therefore understand the substance of what the defendant bank alleges to be that not only the three swaps but also the letter of credit had an illegal purpose in as much as both the swaps and the letters of credit were entered into for the purpose of providing the structure upon which Enron's misleading accounts were to be founded. While it is true that the swaps were intended to provide the visible basis of these accounts and so were closer to the ultimate intended illegality, without the letters of credit this basis could not have been created.

As the purpose was illegal by American law and not by the English law, it posed the question as to whether the English courts would refuse to enforce a contract where the purpose was to commit an act illegal in a foreign country.<sup>46</sup> Colman J referred to *Regazzoni v KC Sethia (1944) Ltd*<sup>47</sup> and pointed out that it was clear that where the common purpose of the parties to a contract was to break the law of a foreign country, the contract was unenforceable in English law on the grounds of public policy. However, although in the case before him, Enron had the intention of breaking American law, it was not the common intention of the parties, as West LB AG (the bank) was entirely ignorant of this fact. Therefore, the next question that had to be answered was what the legal position would be if only one of the parties had an unlawful purpose.<sup>48</sup>

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<sup>43</sup> It was argued that this illegal purpose came to light when the swap transaction was seen in conjunction with two other related swap transactions: one between Mahonia and JP Morgan Chase Bank ('Chase Bank'); and the other between ENAC and Chase Bank. The swaps provided for fixed and floating payments in opposite directions. Chase Bank paid an amount of US\$350 million (minus an arrangement fee of US\$1 million) to Mahonia under the Mahonia/Chase Bank swap and Mahonia paid it to ENAC under the Mahonia/ENAC swap. Furthermore, under the ENAC/Chase Bank swap the fixed payment which ENAC agreed to pay Chase Bank was US\$356 million. Therefore, the effect of the three swaps was that US\$350 million was paid by Chase Bank to Mahonia and by Mahonia to Enron and Enron was obliged about six months later to pay around US\$356 million to Chase Bank. As the floating payments were precisely the same in each of the three swaps, the ultimate effect of the transaction was to provide Enron with US\$350 million (less the arrangement fee) for six months, for which it was obliged to pay a figure which compared to the repayment of a loan of US\$350 million with an effective annual interest rate of 3.44% (see Enonchong *op cit* note 1 in note 35 at 410). As a condition of the three-swap transaction Chase Bank required Enron to provide security in the form of standby letters of credit in the amount of US\$315 million in favour of Mahonia. West LG AG's letter of credit in the amount of US\$165 million was one of two such credits (the other was issued by a syndicate of banks led by Chase Bank).

<sup>44</sup> [2003] 2 Lloyd's Rep 911 (QB (Com Ct)). See also Warne and Elliott *op cit* note 27 at 272.

<sup>45</sup> *Mahonia Ltd v JP Morgan Chase Bank* [2003] 2 Lloyd's Rep 911 (QB (Com Ct)) in para 12 at 915.

<sup>46</sup> See *Mahonia Ltd v JP Morgan Chase Bank* [2003] 2 Lloyd's Rep 911 (QB (Com Ct)) in paras 13 and 14 at 916.

<sup>47</sup> [1958] AC 301.

<sup>48</sup> See *Mahonia Ltd v JP Morgan Chase Bank* [2003] 2 Lloyd's Rep 911 (QB (Com Ct)) at 916–917. See also *ABLU 2004 op cit* note 40 at 7 of the article.

After referring to extensive case law, Colman J argued that a plaintiff who had contracted for a purpose that was illegal under English law, could not enforce that contract in English law, because to permit him to do so ‘would be contrary to public policy as offending against the *ex turpi causa* principle’. Colman J also dealt with the issue of whether it made any difference that the purpose was unlawful, not under English law, but under the law of a foreign friendly state.<sup>49</sup> In dealing with this issue he stated in his judgment that it did not matter. He pointed out that it had to be just as contrary to the public policy to enable the claimant to enforce a contract that had been entered into for a foreign illegal purpose known only to himself, than it would be to enable him to enforce such a contract where the purpose is known to both parties to it.<sup>50</sup>

Thereafter, the court considered the potential impact of the autonomy principle of letters of credit on the general law regarding illegal-purpose contracts.<sup>51</sup> Colman J, *inter alia*, referred to the classic cases *R D Harbottle (Mercantile) Ltd v National Westminster Bank Ltd and Others*<sup>52</sup> where the integrity of letters of credit and demand guarantees was likened to ‘the life-blood of international commerce’,<sup>53</sup> and *United City Merchants (Investments) Ltd and Glass Fibres and Equipments Ltd v Royal Bank of Canada (incorporated in Canada), Vitrorefuerzos SA and Banco Continental SA*<sup>54</sup> and *Sztejn v J Henry Schroder Banking Corporation*,<sup>55</sup> in which the one established exception to the autonomy principle – fraud by the beneficiary – arose and was developed. He considered the *United City Merchants v Royal Bank of Canada* as a clear application of the *ex turpi causa* principle and stressed that the English courts would not permit the use of their process by a dishonest person to commit a fraud. Therefore, the House of Lords had in mind ‘that as a matter of public policy a claimant would not be entitled to use the autonomy doctrine to derive a benefit from his own fraud’.<sup>56</sup>

The court therefore had to decide whether illegality as opposed to fraud was also a possible basis upon which the autonomy principle could be infringed. In this regard, Colman J stated that if a beneficiary were as a matter of public policy (*ex turpi causa*) precluded from utilising a letter of credit to benefit from his own fraud, it was hard to see why he had to be permitted to use the courts to enforce part of an underlying transaction that would have been unenforceable on the grounds of illegality if no letter of credit had been involved, however serious the material illegality involved. Furthermore, to prevent him from doing so in an appropriately serious case, for instance, a case involving an international crime, would hardly be seen as a threat to the lifeblood of international commerce.<sup>57</sup>

<sup>49</sup> See *Mahonia Ltd v JP Morgan Chase Bank* [2003] 2 Lloyd’s Rep 911 (QB (Com Ct)) in para 28 at 919.

<sup>50</sup> See *Mahonia Ltd v JP Morgan Chase Bank* [2003] 2 Lloyd’s Rep 911 (QB (Com Ct)) in paras 29–31 at 919.

<sup>51</sup> See *Mahonia Ltd v JP Morgan Chase Bank* [2003] 2 Lloyd’s Rep 911 (QB (Com Ct)) at 919–923.

<sup>52</sup> [1978] 1 QB 146 (CA) ([1977] 2 All ER 862 (CA)).

<sup>53</sup> [1978] 1 QB 146 (CA) at 155G.

<sup>54</sup> [1983] AC 168 (HL) ([1982] 2 Lloyd’s Rep 1 (HL)).

<sup>55</sup> 31 NYS 2d 631 (1941).

<sup>56</sup> See *Mahonia Ltd v JP Morgan Chase Bank* [2003] 2 Lloyd’s Rep 911 (QB (Com Ct)) in para 39 at 921. See also *ABLU 2004 op cit* note 40 at 8 of the article; and *Chuah op cit* note 40 at 519.

<sup>57</sup> See *Mahonia Ltd v JP Morgan Chase Bank* [2003] 2 Lloyd’s Rep 911 (QB (Com Ct)) in para 68 at 927.

Colman J held that on the assumed facts in this case there was at least a strong arguable case that the letter of credit could not be permitted to be enforced against the defendant bank and said:<sup>58</sup>

[T]he conclusion as to whether enforcement is permissible at least arguably depends on the gravity of the illegality alleged. Although on the pleaded case that appears to be considerable, the uncertainty of this area of law is such that this is an issue which ought to be determined by reference to the evidence before the court at trial and not merely on assumptions derived from the pleaded defence. Moreover, I have also concluded, as I have sought to explain, that the fact that the bank did not have clear evidence of such illegality at the date when payment had to be made would not prevent it having a good defence on that basis if such clear evidence were to hand when the Court was called upon to decide the issue. For this purpose I proceed on the basis that it now has sufficiently clear evidence as expressed in the pleading.

Colman J took the view that in certain instances the illegality of the underlying contract can taint the letter of credit and thereby render it unenforceable. Therefore, he dismissed Mahonia's application that the defence be struck and held that 'on the assumed facts there is at least a strongly arguable case that the letter of credit cannot be permitted to be enforced against the defendant bank'.<sup>59</sup> He also held that the decision whether enforcement was permissible at least arguably depended on the gravity of the illegality alleged and that 'the uncertainty of this area of the law is such that this is an issue which ought to be determined by reference to the evidence before the court at trial'.<sup>60</sup>

The matter went on trial before Cooke J in *Mahonia Ltd v West LB AG*<sup>61</sup> and the case was heard on its merits. The West LB AG, the issuing bank, advanced arguments based on (1) an alleged conspiracy to which Chase Bank and Mahonia were party, and (2) an argument based on the illegality of the transactions underlying the standby letter of credit. The court, however, held that the issuer of a letter of credit (West LB AG) was obligated to pay an apparently conforming demand, but only after a lengthy hearing in which the issuing bank failed to prove its allegations of 'illegality' or a conspiracy.<sup>62</sup>

Cooke J found that there was no illegality in the underlying contract, since Enron's accounting was not in breach of United States Securities law and Mahonia, the beneficiary, was not privy to any unlawful purpose and, on the facts, had no knowledge of any element

<sup>58</sup> *Mahonia Ltd v JP Morgan Chase Bank* [2003] 2 Lloyd's Rep 911 (QB (Com Ct)) in para 69 at 927–928.

<sup>59</sup> See *Mahonia Ltd v JP Morgan Chase Bank* [2003] 2 Lloyd's Rep 911 (QB (Com Ct)) in para 69 at 927.

<sup>60</sup> See *Mahonia Ltd v JP Morgan Chase Bank* [2003] 2 Lloyd's Rep 911 (QB (Com Ct)) in para 69 at 928. See also Enonchong *op cit* note 1 at 410.

<sup>61</sup> [2004] EWHC 1938 (Comm). For a full discussion of this case, see C Hugo 'Documentary Credits and Independent Guarantees' *ABLU 2005* (a paper delivered at the 2005 Annual Banking Law Update held at the Indaba Hotel, Johannesburg on 20 April 2005) (unpaginated) (hereinafter '*ABLU 2005*') at 11–16 of his article. For a critical discussion, see J Barnes "'Illegality' as Excusing Dishonour of L/C Obligations' (January–March 2005) 11 *ICC's DCInsight* 7.

<sup>62</sup> However, for a discussion of what the implication of this case was for Chase Bank, see [2004] EWHC 1938 (Comm) in para 223; and see *ABLU 2005 op cit* note 61 at 15–16 of the article.

of wrongful accounting,<sup>63</sup> and therefore Mahonia succeeded on its claim under the letter of credit.<sup>64</sup> West LB AG was successful at the interlocutory stage, but was unsuccessful in all the aspects of its case on the merits. Although, it was unnecessary for the court to decide what would have been the effect of illegality in the swap transaction on the enforceability of the letter of credit, Cooke J, nonetheless, continued and considered this issue and arrived at the same conclusion as Colman J, namely, that the autonomy principle of a letter of credit does not prevent it from being tainted by illegality of the underlying contract. In other words, illegality in the underlying contract could constitute a defence to the enforcement of a letter of credit.

The most interesting and controversial parts of Cooke J's judgment are found in the last few paragraphs:<sup>65</sup>

427. If West [the issuing bank] had established that there was an unlawful underlying purpose for the Three Swaps and in particular the ENAC/Mahonia [letter of credit supported] Swap, inasmuch as the performance of the Three Swaps constituted the provision of a loan for which unlawful accounting was intended, and to which unlawful purpose Mahonia [the beneficiary] was a party, I would have accepted its contention that the L/C was directly tied to the illegal purpose since it was an important part of the scheme which was to give rise to the unlawful accounting albeit that it was not directly connected to the accounting itself, in the manner of the Three Swaps . . .

428. Equally, the doctrine of taint could be seen to apply inasmuch as the L/C is analogous to a form of security for the performance of ENAC's [the applicant's] obligations and there is a stream of authority . . . where the courts have refused to enforce security given for an illegal contract . . .

432. With this reservation, I would have accepted the arguments of West [the issuing bank] as to the unenforceability of the L/C had West been able to make good Mahonia's [the beneficiary's] complicity in an illegal scheme unlawfully to account for the Three Swaps. For the reasons essentially set out by Colman J in July 2003 and those set out in West's closing submissions, I would not have held that the "autonomy" of letters of credit required a different conclusion. If the L/C had played a part in the overall scheme of the magnitude alleged, to deliberately mislead by wrongful accounting, contrary to section 10(b) of the Exchange Act 1934, and Chase and Mahonia [the beneficiary] had been complicit therein, public policy would, in my view have required the court not to lend its aid to the enforcement of the L/C which shared the same unlawful purpose as the Three Swaps, which came into existence solely by virtue of that purpose and which was, in any event so closely connected with them as to be tainted by that purpose.

Cooke J also stated that whether enforcement would be permissible under the letter of credit depended on the gravity of the illegality alleged. By way of example, Colman J, the

<sup>63</sup> This decision is rather interesting and controversial in its finding that Mahonia (Enron) properly accounted for and reported the specific swap obligation supported by the letter of credit, as well as the overall transactions involving three related swap obligations (see Barnes *op cit* note 61 at 7).

<sup>64</sup> See *Mahonia Ltd v West LB AG* [2004] EWHC 1938 (Comm) in para 423. See also Enonchong *op cit* note 1 at 410.

<sup>65</sup> *Mahonia Ltd v West LB AG* [2004] EWHC 1938 (Comm) in paras 427–428 and 432.

justice at the interlocutory hearing,<sup>66</sup> indicated that he would find it incredible that a party to an illegal arms transaction (the example of a type of illegal transaction referred to by Staughton LJ in *Group Josi Re v Walbrook Insurance Co Ltd and Others*)<sup>67</sup> would be permitted to enforce a letter of credit that was a vital part of that transaction. To take an even more extreme example, Colman J said that a court would not enforce a letter of credit that had been issued to secure payment for the sale and purchase of heroin between foreign locations in which such underlying contracts were illegal. Conversely, he considered that the impregnability of letters of credit may not be superseded on public policy grounds where there was an unlawful underlying contract, if the nature of the underlying illegal purpose was relatively trivial.<sup>68</sup>

In addition to the accepted fraud exception, the judgment in *Mahonia Ltd v West LB AG* illustrates that illegality in the underlying contract is a further potential exception to the principle of autonomy of letters of credit. This decision also reinforces the preliminary ruling in the earlier case, namely, *Mahonia Ltd v JP Morgan Chase Bank and Another*,<sup>69</sup> that under the English law, letter of credit obligations are subject to an ‘illegality’ defence. Furthermore, an illegal defence could also be based on a beneficiary’s complicity in the applicant’s procurement of a letter of credit to facilitate, for example, the applicant’s violation of United States securities laws.<sup>70</sup>

Therefore, in *Mahonia Ltd v West LB AG*<sup>71</sup> the English Commercial Court recognised that illegality in the underlying contract to a commercial letter of credit is a defence that a dishonouring issuer may raise against a complicit beneficiary. However, Enonchong points out that although Cooke J’s opinion on the availability is no doubt a strong indication of the direction of the English law, it is still strictly speaking *obiter*. Therefore, as there is currently no English case where the court has refused to enforce a letter of credit specifically because the underlying contract is illegal, it seems that despite the *Mahonia Ltd v West LB AG* case the English law is still not settled in this regard.<sup>72</sup>

The fact that the illegality in the *Mahonia Ltd v West LB AG* case was perpetrated under a foreign law, and not English law, seems to have been immaterial. However, naturally where the foreign law that was involved was contrary to English public policy, the ‘illegality’ would be disregarded and the letter of credit would be enforced.<sup>73</sup>

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<sup>66</sup> See *Mahonia Ltd v JP Morgan Chase Bank and Another* [2003] 2 Lloyd’s Rep 911 (QB (Com Ct)).

<sup>67</sup> [1996] 1 Lloyd’s Rep 345 (CA) ([1996] 1 WLR 1152 (CA); and [1996] 1 All ER 791 (CA)).

<sup>68</sup> See *Mahonia Ltd v JP Morgan Chase Bank and Another* [2003] 2 Lloyd’s Rep 911 (QB (Com Ct)) at 927.

<sup>69</sup> *Mahonia Ltd v JP Morgan Chase Bank and Another* [2003] 2 Lloyd’s Rep 911 (QB (Com Ct)).

<sup>70</sup> See Barnes *op cit* note 61 at 7.

<sup>71</sup> [2004] EWHC 1938 (Comm).

<sup>72</sup> See Enonchong *op cit* note 1 at 410. He also discusses (at 410–413) whether the English law should recognise an illegality exception. Based on various reasons, he submits that the recognition of the illegality exception in the English law is justified.

<sup>73</sup> See J C T Chuah *Law of International Trade* 3 ed (2005) at 492.



### 6.2.2.1 *Established Illegality, Seriousness of the Illegality and the Time at Which Knowledge of Illegality Must be Proved*

If there is evidence of illegality in the underlying transaction to the letter of credit, then presumably the facts proving that defence would have to be clearly established, just as fraud must be.<sup>74</sup> This will, of course, not be easy to do, especially where the illegality is one under some obscure foreign law.<sup>75</sup> However, this issue has not yet been settled authoritatively.<sup>76</sup> In this regard, Staughton LJ in *Group Josi Re v Walbrook Insurance Co Ltd and Others*<sup>77</sup> mentioned that it was his view that before illegality could operate as a defence, or a ground for restraining payment by the bank, it, like fraud, had to be clearly established and known to the bank. He warned that if the legality of the payment was merely doubtful, it might be that the bank would not be restrained. He also pointed out that it was a problematic issue if the illegality was clearly proved at trial, but it was not clear at the time when the documents were presented for payment.<sup>78</sup>

It does, however, appear from the *Group Josi* case<sup>79</sup> that the mere suspicion of illegality will not be enough. If all that can be shown is that the underlying contract is arguably illegal, the court will not grant an injunction restraining payment. Apparently, the consequence of this high standard of proof is that, in practice, the illegality exception will be successful only in very exceptional cases. Therefore, just as with the fraud exception, it will not be easy for banks to use the illegality exception as an excuse not to pay under the letters of credit.<sup>80</sup>

The judgment in *Mahonia Ltd v JP Morgan Chase Bank and Another*<sup>81</sup> is substantially based on public policy, which it has been said can sometimes be a blunt instrument. For instance, it has been asked how a court should deal with the validity and enforceability of a letter of credit where the underlying contract is illegal, but the illegality is purely of a technical nature (e.g., an agreement of sale has contravened a section of a specific statute, but such a contravention carries with it no penalty and does not specify whether the contract is void because of it). This question has not yet been comprehensively answered, but in this regard Colman J in *Mahonia Ltd v JP Morgan Chase Bank and Another* said the following:<sup>82</sup>

[T]here is much to be said for the view that the public policy in superseding the impregnability of letters of credit where there is an unlawful underlying transaction defence may not be engaged where the nature of underlying illegal purpose is relatively trivial, at least where the purpose is to be accomplished in a foreign jurisdiction.

<sup>74</sup> See Enonchong *op cit* note 1 at 412 and 413; and Chuah *op cit* note 40 at 521.

<sup>75</sup> See Chuah *op cit* note 40 at 521.

<sup>76</sup> See Warne and Elliott *op cit* note 27 at 273.

<sup>77</sup> [1996] 1 Lloyd's Rep 345 (CA) ([1996] 1 WLR 1152; and [1996] 1 All ER 791 (CA)).

<sup>78</sup> See [1996] 1 Lloyd's Rep 345 (CA) at 362.

<sup>79</sup> See at 357 and 362.

<sup>80</sup> See Enonchong *op cit* note 1 at 413–414.

<sup>81</sup> [2003] 2 Lloyd's Rep 911 (QB (Com Ct)).

<sup>82</sup> [2003] 2 Lloyd's Rep 911 (QB (Com Ct)) in para 68 at 927.

Cooke J in *Mahonia Ltd v West LB AG*<sup>83</sup> also stated that whether enforcement would be permissible under the letter of credit depended on the gravity of the illegality alleged. So it appears that for the illegality exception to apply, the illegality must be sufficiently serious. However, it is not clear what the test is that must be applied in order to determine whether the illegality was sufficiently serious. Cooke J adopted the test, already familiar in the general law of illegality, of whether the illegality involved deliberate wrongdoing (in which instance the illegality defence applies) or whether the illegality was merely an act of inadvertence (in which case it did not).<sup>84</sup> However, both judgments in the *Mahonia* cases neglected to provide clear guidance on this. Chuah correctly points out that such a qualitative assessment of what is trivial is difficult and he asks whether the triviality should be examined from English eyes or under foreign law or both? He also points out that it is uncertain how such an assessment of gravity is to be approached given the principle of international judicial comity.<sup>85</sup>

From the above, it appears that for the illegality exception to apply, the illegality must be sufficiently serious, but it will often be difficult to decide whether the illegality is, in fact, sufficiently serious.<sup>86</sup> In extreme cases, for example, where the illegality relates to an illegal underlying transaction for the illegal sale of arms and ammunition or illegal drugs (of course illegal refers to illegality as provided for in the relevant country), it will be easy to establish that the illegality is sufficiently serious. In other cases, where, for example, it relates to a transaction concluded without the required licence, it will not be so easily established.

As already mentioned above, for the fraud exception to the autonomy principle to succeed, earlier English cases have consistently required clear evidence of the fraud. Furthermore, this was sometimes expressed to be clear evidence of fraud *at the time of presentation of the documents*.<sup>87</sup> Justice Colman in *Mahonia Ltd v JP Morgan Chase Bank and Another*<sup>88</sup> took the view that these cases did not intend restricting the time by which the evidence of fraud had to be available to the extent of ignoring evidence of fraud that came to light after presentation of the documents, but before hearing the case. The point was rather that the bank would have to reach a decision on whether or not to pay soon after presentation of the documents. Usually it would only refuse payment in the light of compelling evidence available to it at that stage. However, if the bank refused to pay on a suspicion of fraud and is later sued, and before the case is heard, acquired evidence, this evidence should be admissible.<sup>89</sup>

Another unresolved issue is what state of mind the beneficiary and the issuing bank must be in at the time of presentation. For instance, in the situation where neither knew of the illegality, but the issuing bank rejected on the grounds of non-conformity and at the trial it

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<sup>83</sup> [2004] EWHC 1938 (Comm).

<sup>84</sup> See also Enonchong *op cit* note 1 at 417.

<sup>85</sup> See Chuah *op cit* note 40 at 521.

<sup>86</sup> See Enonchong *op cit* note 1 at 416.

<sup>87</sup> See para 5.4.4 in Chapter 5.

<sup>88</sup> [2003] 2 Lloyd's Rep 911 (QB (Com Ct)).

<sup>89</sup> See also *ABLU 2004 op cit* note 40 at 9 the article.

becomes clear to have been wrongful, it then becomes important to establish whether the issuing bank can still defend on the ground of illegality. Knowledge of fraud on the part of the beneficiary is vital for the fraud exception to arise at all, because if the beneficiary is not party to the fraud, then there is no reason to invoke the principle of *ex turpi causa*.<sup>90</sup> It has also been suggested that knowledge of illegality should be treated differently, unless the state of mind of one or both parties is a precondition for illegality to be available as a defence.<sup>91</sup>

The court also did not quite consider the issue that in cases of fraud the fraud is generally practised on the applicant/principal and/or the bank. Whereas in cases where the underlying contract is said to be illegal, the illegality is likely not practised on either the applicant or the bank. From the judgment in *Mahonia Ltd v JP Morgan Chase Bank and Another*<sup>92</sup> it would appear that that was immaterial. As long as an offence (be it under the English or friendly foreign law<sup>93</sup>) is to be committed through the use of the letter of credit, a court must prevent the beneficiary from benefiting from it as long as the beneficiary was a participant in the offence and the bank had no prior notice of the illegality. Chuah says that this reliance on the public policy rule that a dishonest person should not benefit from his crime is to ensure that beneficiaries are suitably deterred. He points out that there is no emphasis on the bank's role in all of this – the bank is not required to make enquiries into the purpose of the application for the letter of credit. Even where the strange nature of the terms of the letter of credit might have put the bank on enquiry that something may not be entirely right, there is nothing to prevent the bank from refusing to pay. Chuah also makes it clear that even where the bank is fully complicit in the illegality, on the basis of *ex turpi causa* the beneficiary need not be paid.<sup>94</sup>

Chuah points out that the analogy made with fraud means that before the defence of illegality can be relied on, it must be shown that the beneficiary was privy to the illegality<sup>95</sup> and that it is not enough for the bank to claim that it has suspicions that the underlying contract was illegal. It must be able to show that the bank had more than plain suspicion and that not only was the underlying contract illegal, but the letter of credit was essential to achieving the illegal purpose or cannot be separated from the illegal purpose.<sup>96</sup>

It follows that there are still many uncertainties regarding the exact application of the illegality exception<sup>97</sup> and it therefore remains to be seen how it will be developed under the English law.

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<sup>90</sup> See Chapter 5.

<sup>91</sup> See Warne and Elliott *op cit* note 27 at 273.

<sup>92</sup> [2003] 2 Lloyd's Rep 911 (QB (Com Ct)).

<sup>93</sup> If the foreign law involved is contrary to English public policy, the 'illegality' will be disregarded and the letter of credit will be enforced (see J C T Chuah *Law of International Trade* 3 ed (2005) at 492). It is likely that the foreign law of certain 'unfriendly' countries, for example, Zimbabwe, might be contrary to the English, American and South African public policy. Therefore, in my view, it is important that reference is made to the law of friendly foreign countries only.

<sup>94</sup> See Chuah *op cit* note 40 at 519.

<sup>95</sup> See Enonchong *op cit* note 1 at 417–418.

<sup>96</sup> See Chuah *op cit* note 40 at 519.

<sup>97</sup> For example, it is still an open question as to whether a clause in a letter of credit that provides that a bank's obligation to pay under it is not affected by illegality of the underlying contract, will have the effect of excluding the availability the illegality defence (in this regard, see Enonchong *op cit* note 1 at 422–424).

### 6.2.2.2 Degree of Connectivity

From the discussions above, it also appears that another requirement that will have to be complied with before the illegality exception will be applicable, is that the letter of credit must be so closely related (connected) to the illegality in the underlying contract that it is tainted by it. At present, it is not certain with what criteria the court is going to determine whether in a particular case there is a sufficiently close connection between the letter of credit and the illegality of the underlying contract. The tests advanced thus far do not seem to be entirely satisfactory.<sup>98</sup> Chuah, however, correctly points out that in many cases of illegality, it is often virtually impossible to claim that the letter of credit is not significant to the underlying illegal transaction.<sup>99</sup>

### 6.2.3 Illegality in the Underlying Contract and Demand Guarantees

From the above it follows that if illegality in the underlying contract is a defence under a commercial and standby letter of credit, then it should follow that illegality is also available as a defence under a demand guarantee, given that the two types of transactions are so closely related. If illegality is a defence under a demand guarantee, this could have important results. In any such transaction where the principal wishes to prevent payment, consideration ought to be given as to whether the underlying contract to the demand guarantee can be shown to be an illegal transaction. If so, then this might provide useful ammunition in an attempt to prevent payment being made when a seemingly unjustified demand is made.<sup>100</sup>

However, it remains to be seen how the defence of illegality in relation to demand guarantees will be developed under the English law.<sup>101</sup>

## 6.3 AMERICAN LAW

### 6.3.1 Introduction

In the United States a few applicants have argued in the past that if a specific letter of credit were to be honoured, it would be unlawful; either because the credit itself was unlawful<sup>102</sup> or because the underlying transaction was unlawful. Usually these types of attempts fail.<sup>103</sup>

<sup>98</sup> See Enonchong *op cit* note 1 at 418, and see in particular, his discussion of the tests that have so far been advanced in this regard at 418–422.

<sup>99</sup> See J C T Chuah *Law of International Trade* 3 ed (2005) at 493.

<sup>100</sup> See Warne and Elliott *op cit* note 27 at 286.

<sup>101</sup> See Warne and Elliott *op cit* note 27 at 273.

<sup>102</sup> The American bankruptcy laws, for example, may apply directly to prohibit honour under a letter of credit, and the Export Administration Act and its regulations (Export Administration Act, 50 app. USCA 2407(a)(1) (1991); 15 CFR 769.2(f)(5) (1995)) also provide a defense to honour any credit that violates the anti-boycott provisions of the legislation (see Turner *op cit* note 40 under the heading ‘Illegality in the Underlying Transaction’).

<sup>103</sup> See J F Dolan *The Law of Letters of Credit: Commercial and Standby Credits* Revised Edition (loose-leaf edition) (1996) (hereinafter ‘Dolan: *The Law of Letters of Credit*’) in paras 7.03[2] and 9.06[1] and the authorities cited. The United States federal laws often compel dishonour of a letter of credit obligation to enemies of the state, and so forth. This kind of prohibition may, for example, be based on the name of the beneficiary appearing in the letter of credit (and a terrorist list) or mention of Cuba in the documents

The Revised United States Uniform Commercial Code ('UCC') article 5 ('Revised UCC article 5') does not make provision for an illegality exception to the autonomy principle of commercial or standby letters of credit. In terms of article 5, the only exceptions to the autonomy principle of commercial and standby letters of credit are fraud and forgery as provided for in section 5-109.<sup>104</sup> There is no explicit provision for a separate illegality exception.<sup>105</sup>

### 6.3.2 Illegality in the Underlying Contract

#### 6.3.2.1 Revised UCC Article 5

Generally, the American courts have refused to allow illegality in the underlying transaction to affect the beneficiary's right to claim payment in terms of the letter of credit.<sup>106</sup>

As already mentioned, before article 5 of the United States UCC was revised in 1995<sup>107</sup> and before the appointment of the drafting committee of Revised UCC article 5, a special Task Force, consisting of eminent letter of credit specialists, was appointed to study the relevant case law, evolving technologies, and changes in customs and practices.<sup>108</sup> The Task Force identified a large number of issues, discussed them and made recommendations for the revision of article 5. They also participated substantially in the amendment of article 5. During the course of the recodification of article 5, the Task Force spelt out the

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presented. (Such action has in the past affected payments to, for example, Iran, Cuba Panama and Libya (see also, C F Hugo *The Law Relating to Documentary Credits from a South African Perspective with Special Reference to the Legal Position of the Issuing and Confirming Banks* (published LLD, University of Stellenbosch (1996)) (1997) (hereinafter '*Hugo: The Law Relating to Documentary Credits*') at 295; and Dolan: *The Law of Letters of Credit op cit* note 103 in paras 9.06[4][b] and 9.06[4][e]).) But, Barnes considers these kinds of prohibitions to raise a sovereign compulsion defence, not illegality. He states that the laws (or implementing regulations), do more than declare payment illegal. They deal specifically with the obligations of the issuer of the letter of credit, that is, they make the decision that illegality in the underlying transaction is such that the independence principle of the letter of credit should not apply. According to Barnes, unlike the UCC article 5 section 5-109 fraud exception, which is based on letter of credit policy limiting independence, these sovereign compulsion defences depend on non-letter of credit policy that specifies how it applies to letter of credit obligations. He thinks it is critical that banks and applicants not be allowed to excuse dishonour on non-letter of credit policy grounds without showing that letter of credit dishonour is compelled by a relevant sovereign compulsion defence. (Information obtained via an e-mail sent by J G Barnes to author of thesis on 17 July 2008; and see also Turner *op cit* note 40 under the heading 'Illegality in the Underlying Transaction').

<sup>104</sup> For a full discussion, see paras 5.5.2.2, 5.5.3, 5.5.4.4 and 5.5.5 in Chapter 5.

<sup>105</sup> See Enonchong *op cit* note 1 at 408.

<sup>106</sup> See A N Oelofse *The Law of Documentary Letters of Credit in Comparative Perspective* (1997) (hereinafter '*Oelofse: The Law of Documentary Letters of Credit*') at 419. For instance, it has been held that a bank that has issued a standby letter of credit may not refuse to pay on the ground that the credit was issued to secure an illegal penalty clause (in contrast to an enforceable pre-estimate of damages) in the underlying contract (see, e.g., *New York Life Assurance Company v Hartford National Bank and Trust Company* 173 Conn 492, 378 A 2d 562 (Sc Conn 1977), and 22 UCC Rep Serv 761 (1977); and *The Prudential Insurance Company of America v Marquette National Bank of Minneapolis* 419 F Supp 734 (1976).

<sup>107</sup> For a full discussion of article 5 of the UCC, see paras 3.4.2 and 3.4.2.2 in Chapter 3 and para 5.5 in Chapter 5.

<sup>108</sup> See the 'Prefatory Note' to Revised UCC article 5.

exception to the autonomy principle of letters of credit (and standby letters of credit) so that the exception applied only where a required document is forged or materially fraudulent or honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or the applicant. They therefore clarified that fraud could be based on the:

- documents (so as to make the beneficiary responsible for documents provided by others); or
- underlying transaction (so as to cover a drawing by a beneficiary that fraudulently induced the applicant to procure the letter of credit).<sup>109</sup>

They did not extend the exception to include ‘illegality’. They limited an issuer’s extraordinary defences (and an applicant’s injunction actions) to drawings that would unduly exploit the independence principle of letters of credit. They focused on letter of credit policy and not on the existence of other public policy grounds. In determining the scope of defences to payment of a letter of credit obligation, they gave no attention to the law applicable to guarantee, suretyship or other security arrangements.<sup>110</sup>

Therefore, Revised UCC article 5 does not make provision for an illegality exception to the autonomy principle of commercial or standby letters of credit. In terms of Revised UCC article 5 the only exceptions to the autonomy principle of commercial and standby letters of credit are fraud and forgery as provided for in article 5 section 5-109.<sup>111</sup> There is no explicit provision for a separate illegality exception. Therefore, in the absence of fraud or forgery, it is no defence for a paying bank (or the applicant) of a letter of credit to prove that the underlying contract is illegal.<sup>112</sup> One commentator disagrees with this and argued that, although there was no explicit statutory provision for an illegality exception, it was still possible to accept an illegality exception, because the UCC did not exclude it as an exception either.<sup>113</sup> McCullough, another commentator<sup>114</sup> also stated that fraud in the

<sup>109</sup> See Barnes *op cit* note 61 at 7 (this author played a leading role in the recodification of article 5 and he was also part of the Task Force).

<sup>110</sup> *Idem*.

<sup>111</sup> For a full discussion, see para 5.5 in Chapter 5.

<sup>112</sup> See also Enonchong *op cit* note 1 at 408. One American court even tried to indicate that illegality in the underlying contract constitutes fraud. Of course, it is possible that in certain circumstances the underlying contract could be illegal as well as fraudulent, but not all illegality would also necessarily constitute fraud. In *Western Security Bank NA v Superior Court* (25 Cal Rptr 2d 908 (Cal Ct App 1993), remanded with directions to vacate, 37 Cal Rptr 2d 840 (Cal 1995)) the California court viewed presumed illegality in the underlying transaction as constituting fraud. The court in the appellate decision sought to promote the California public policy and to support California legislation prohibiting the collection of deficiencies in real estate foreclosures. The beneficiary’s draw under the letter of credit would have allowed the beneficiary to collect the deficiency. As the court viewed the deficiency as ‘illegal’ under the anti-deficiency statute, the court held that the beneficiary’s presentation was fraudulent and that the issuer was entitled to dishonour by reason of the fraud. Turner points out that this decision did violence to the independence principle. The decision was subsequently reversed by the California Supreme Court (see *Western Security Bank v Superior Court* 15 Cal 4th 232, 933 P2d 507, 62 Cal Rptr 2d 243 (1997)) and it brought about clarifying legislation by the California legislature (see Turner *op cit* note 40 under the heading ‘Illegality in the Underlying Transaction’).

<sup>113</sup> See G T McLaughlin ‘Exploring Boundaries: A Legal and Structural Analysis of the Independence Principle of Letter of Credit Law’ (2002) 119 *Banking Law Journal* 501 at 527–528; and G T McLaughlin ‘Letters of Credit and Illegal Contracts: The Limits of the Independence Principle’ (1989) 49 *Ohio State Law Journal* 1197 at 1217–1235. As authority for this view, McLaughlin relies on UCC section 5-103(b) which provides: ‘the statement of a rule in this article does not by itself require, imply, or negate application of the same or a different rule to a situation not provided for, or to a person not specified in the article’.

transaction may not be the only ground in the United States for an exception to the independence principle. He stated that if the underlying contract was illegal, it was perhaps appropriate to suspend the independence principle and enjoin payment on that ground as well.<sup>115</sup> However, the traditional view in the United States is that because illegality is not included in section 5-109, it means that the bank must pay despite the illegality of the underlying contract.<sup>116</sup> Even before Revised UCC article 5 came into effect (i.e., when Prior UCC article 5 section 5-114(2) was still in operation),<sup>117</sup> judicial opinion was that ‘there is nothing in the U.C.C . . . which excuses an issuing bank from paying a letter of credit because of supervening illegality’.<sup>118</sup>

Turner also argues that there is no need for a generally recognised defence to be honoured based on illegality in the underlying contract. But, if such a defence were to be acknowledged, he states that it should be narrowly construed and be available only in the case of criminal or other serious illegality and, analogously to the defence of fraud, be available only when payment to the beneficiary would be obviously pointless or unjust.<sup>119</sup>

However, it has been said that American banks would, of course, abide by a court injunction or other government order that prohibits payment under a letter of credit, but only if the prohibition on the payment of a letter of credit is clear. Declarations that the underlying obligation is illegal and unenforceable will not prevent payment of the commercial or standby letter of credit. In such instances, relief based on illegality must be sought after the bank has paid.<sup>120</sup> In other words, the applicant of a letter of credit will only be allowed to institute actions against, for example, the beneficiary for damages, after the payment under the letter of credit has been made by the bank.

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<sup>114</sup> See B V McCullough *Banking Law* (Vol No 12: International Banking – Letters of Credit) (loose-leaf, 1981–) at 234.04[3][g]; and B V McCullough *Letters of Credit* (loose-leaf, 1987–) at 5.04[3][g].

<sup>115</sup> One court that did this was the district court in Nevada in *Hubbard Business Plaza v Lincoln Liberty Life Insurance Co* 649 F Supp 1310 (D Nev 1986). But cf *Brown v United States National Bank* 371 NW 2d 692, 41 UCC Rep Serv 1765 (Neb 1985); and *New York Life Insurance Company v Hartford National Bank and Trust Company* 173 Conn 492, 378 A 2d 562 (Sc Conn 1977), and 22 UCC Rep Serv 761 (1977) (authorities referred to by B V McCullough *Banking Law* (Vol No 12: International Banking – Letters of Credit) (loose-leaf, 1981–) at 234.04[3][g]); and B V McCullough *Letters of Credit* (loose-leaf, 1987–) at 5.04[3][g].

<sup>116</sup> See, e.g., Barnes *op cit* note 61; J Barnes comments on *Mahonia Ltd v West LB AG* [2004] EWHC 1938 (Comm) in J E Byrne and C S Byrne (eds) 2005 *Annual Survey of Letter of Credit Law and Practice* (2005) (hereinafter ‘2005 Annual Survey’) at 331; and B Wunnicke, D B Wunnicke and P S Turner *Standby and Commercial Letters of Credit* 3 ed (loose-leaf edition) (2000–) where the authors discuss the fraud exception in Chapter 8, but mention nothing of the existence of an illegality exception; R D Aicher, D L Cotton and T K Khan ‘Credit Enhancement: Letters of Credit, Guaranties, Insurance and Swaps (The Clash of Cultures)’ in 2005 *Annual Survey op cit* note 116 at 19-21. See also Enonchong *op cit* note 1 at 408.

<sup>117</sup> See paras 5.5.1, 5.5.2.1, 5.5.3, 5.5.4.2, 5.5.4.3, and 5.5.5 in Chapter 5 for a full discussion of this article.

<sup>118</sup> *KMW International v Chase Manhattan Bank NA* 606 F 2d 10 (2nd Cir 1979) at 16. See also *Centrifugal Casting Mach Co Inc v American Bank and Trust Co* 966 F 2d 1348 (1992) at 1352; and Enonchong *op cit* note 1 at 408.

<sup>119</sup> See Turner *op cit* note 40 at 733.

<sup>120</sup> See Barnes *op cit* note 61 at 7.

### 6.3.2.2 *America's View of the Mahonia cases*<sup>121</sup>

For a number of years, American newspapers contained various reports on improper accounting by Enron of transactions with little or no commercial substance entered into with large banks and surety companies with the aim of increasing Enron's balance sheet. Many surety companies in the United States were reportedly able to avoid paying approximately half of the US\$1 billion they owed to banks as sureties for Enron's performance of buy-and-sell transactions that they alleged were, to the knowledge of Enron and its bankers, disguised loans. The view in the United States was that the issuers of letters of credit (the banks) could not and would not follow suit, because of the vital differences between the law applicable to letters of credit and surety bonds.<sup>122</sup>

Therefore, banks and lawyers in the United States are inclined to think that the *Mahonia Ltd v West LB AG*<sup>123</sup> judgment is incorrect. They also think that the documents presented in the *Mahonia Ltd v West LB AG* case did not qualify as being fraudulent and also that the conduct complained of did not qualify as fraud by the beneficiary on the applicant or on the issuing bank.<sup>124</sup>

The independence principle of letters of credit protects, *inter alia*, the beneficiary's right under a letter of credit that is procured by applicant fraud on the issuing bank. Barnes points out that it should take something like an active conspiracy between an insolvent applicant and a solvent beneficiary to defraud an issuing bank before letter of credit law should allow an applicant's fraud to be converted into an excuse for dishonouring the beneficiary's draw. According to him, the law of letters of credit should not allow an issuer (or the applicant) to convert an applicant's willingness to violate securities law into an excuse for dishonouring an obligation under a letter of credit.<sup>125</sup>

Barnes correctly states that the 'illegality' defence is potentially more problematic than the 'fraud' defence. He also points out that even those who recognise that the 'fraud/abuse' defence is typical of the law of letters of credit and are experienced in applying the fraud exception sometimes disagree on whether a specific drawing crosses the line and constitutes a fraud. Applying an 'illegality' defence (beyond laws applicable to the letter of credit obligation that expressly prohibit payment under the letter of credit) would, according to Barnes, be more challenging than applying the letter of credit fraud defence, because the public policies to be applied are much more varied and unrelated to the purpose of a commercial or standby letter of credit. Therefore, letters of credit's supporting obligations to pay for an investment security, to pay executive compensation on termination, to pay liquidated damages, to pay for a covenant not to compete, and so forth, would appear to be more vulnerable to defences based on illegality than on letter of credit fraud.<sup>126</sup>

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<sup>121</sup> See *Mahonia Ltd v JP Morgan Chase Bank and Another* [2003] 2 Lloyd's Rep 911 (QB (Com Ct)); and *Mahonia Ltd v West LB AG* [2004] EWHC 1938 (Comm); and see the discussions in para 6.2.2 above.

<sup>122</sup> See Barnes *op cit* note 61 at 7.

<sup>123</sup> *Mahonia Ltd v West LB AG* [2004] EWHC 1938 (Comm).

<sup>124</sup> See Barnes *op cit* note 61 at 7.

<sup>125</sup> See Barnes *op cit* note 61 at 7–8.

<sup>126</sup> See Barnes *op cit* note 61 at 8.



A few years ago in the United States (before the *Mahonia Ltd v West LB AG* case) there were apparently wide-ranging efforts by so-called Lloyd's names to establish that their underlying obligations to Lloyd's syndicates were unenforceable by reason of violations of securities laws (including violations of securities fraud law that might not have qualified as letter of credit fraud). Their efforts included United States court actions to declare those obligations illegal and, separately, to enjoin American banks from honouring the letters of credit that supported those obligations. For the most part, their United States court actions were frustrated by English law and forum provisions and by the effect of English banks' confirmations of the letters of credit issued by American banks. Today, however, efforts to prevent payment of letters of credit based on allegations that the underlying contracts are illegal seem to be much more promising after the judgment given in the *Mahonia Ltd v West LB AG* case.<sup>127</sup>

For new transactions, the *Mahonia Ltd v West LB AG* judgment will present a challenge. Barnes correctly points out that until such time as the courts in England (and other countries applying English law principles) decide cases raising illegality defences, he believes that the *Mahonia Ltd v West LB AG* precedent will not be vigorously applied and that the demonstrated reluctance of English courts to find letter of credit fraud will carry over to illegality defences. However, he also indicates that this suspicion might not carry the day in new transactions relying on financial standbys that are expected to be bullet proof.<sup>128</sup>

Barnes is of the view that the English courts' treatment of illegality in the *Mahonia Ltd v West LB AG* case is not likely to have any effect on courts in the United States enforcing American law-governed letters of credit, and non-United States courts enforcing letter of credit obligations governed by American law may well be persuaded to apply that law, including the United States uniform statutory provisions on letter of credit independence and the limited fraud exception to independence.<sup>129</sup>

## 6.4 SOUTH AFRICAN LAW

### 6.4.1 Demand Guarantee Itself is Illegal

It is settled law that a contract that is contrary to the law,<sup>130</sup> good morals<sup>131</sup> or public policy<sup>132</sup> is illegal and consequently void.<sup>133</sup> In terms of the maxim *ex turpi causa non*

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<sup>127</sup> *Idem.*

<sup>128</sup> See Barnes *op cit* note 61 at 8.

<sup>129</sup> *Idem.*

<sup>130</sup> A contract will be unlawful or illegal when its conclusion, or the reason or object of its existence, or rights and duties agreed upon is/are forbidden by common (e.g., against public policy or contrary to the good morals) or statutory law (e.g., against an act/regulations of Parliament, a provincial ordinance, or municipal regulation) (see P Havenga *et al General Principles of Commercial Law* 6 ed (2007) at 85 and 90; J P van Niekerk and W G Schulze *The South African Law of International Trade: Selected Topics* 2 ed (2006) at 66; J C de Wet and A H van Wyk *Die Suid-Afrikaanse Kontraktereg en Handelsreg* (Vol No 1) 5 ed (1992) at 89; and for a full discussion see A J Kerr *The Principles of the Law of Contract* 6 ed (2002) in Chapter 8, and R H Christie *The law of Contracts in South Africa* 5 ed (2006)).

<sup>131</sup> A contract will be contrary to the good morals of the community if the contract itself, its purpose or the rights and duties agreed upon, are contrary to the community's perception of what is proper and decent. The convictions of the community with regard to good moral values differ from one community to another, and

*oritur actio* – an illegal contract does not give rise to an action and a court must refuse to give effect to it.<sup>134</sup> It has been said that if the commercial letter of credit is contrary to law, good morals or public policy, it will likewise not be enforceable.<sup>135</sup> By implication, this will also apply to a demand guarantee or standby letter of credit.

Although no such cases have presented themselves yet, the view above makes perfect sense and it is seriously doubted that a South African court will make a decision contrary to this. However, the only issue that remains uncertain here is whether or not the courts will have this view where the demand guarantee or letter of credit itself is contrary to the law, good morals or public policy of a different country. In my view, it should not matter whether the demand guarantee or letter of credit is illegal because of South African law or the law of another country. As long as it can be proven to be contrary to the proper law that applies to the demand guarantee/ letter of credit or the law of the place of performance of the guarantee/credit, the South African courts should not enforce such guarantees/credits.

#### 6.4.2 Illegality in the Underlying Contract

A more difficult situation arises where the demand guarantee is not illegal, contrary to good morals or public policy, but the underlying contract is. In the South African law, it has been stated that as a commercial letter of credit (and by implication also a demand guarantee and standby letter of credit) is independent of, and separate from, the underlying contract, it might be argued that the illegality (or it being contrary to good morals or public policy) of the underlying contract is not relevant to the enforceability of the letter of credit.

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also change within any particular community over time (see Havenga *op cit* note 130 at 86). For a full discussion of when it will be considered that a contract is contrary to good morals, see Havenga *op cit* note 130 at 86; Christie *op cit* note 130; Kerr *op cit* note 130 in Chapter 8; and De Wet and Van Wyk *op cit* note 130 at 89–92.

<sup>132</sup> An agreement will be contrary to public policy if the agreement itself, its effect, or the purpose for its conclusion is harmful to the interests of the public as a whole. When determining whether a contract is contrary to public policy or not, one has to look to the tendency of the proposed transaction, not its actually proven result (see *Citibank NA v Thandroyen Fruit Wholesalers CC and Others* 2007 (6) SA 110 (SCA)). An agreement is generally not contrary to public policy purely because its terms offend an individual's sense of propriety and fairness – it should be unconscionable, immoral or illegal. The South African Supreme Court of Appeal, as well as the Constitutional Court, has stipulated that when deciding whether to invalidate an agreement on the ground of 'public policy' the courts have to take into consideration the founding values of the South African Constitution of 1996 (Act 108 of 1996), namely, those of human dignity, the achievement of equality, the advancement of human rights and freedoms, and non-racialism and non-sexism (see *Napier v Barkhuizen* 2006 (4) SA 1 (SCA); and *Barkhuizen v Napier* 2007 (5) SA 323 (CC) (for a discussion of this case, see Anon 'Unfair Contract Terms: The Constitutional Court's Approach' (2007) 25 *Commercial Law Information Service Bulletin* (Bureau for Mercantile Law) 70 and 'Unfair Clauses in Contracts' 74 at 74–75)). Harm should be substantially irrefutable. Although the concept 'public policy' normally refers to the interest of the society as a whole, it must be kept in mind that a society's interest, may, in certain cases, be served by upholding the interest of a section of the society, or even individual interests. Furthermore, if it is also kept in mind that public policy in general favours utmost freedom of contract, it becomes clear that the determination of public policy is often problematic (see Havenga *op cit* note 130 at 86–87). For a full discussion of when it will be considered that a contract is against the public policy, see Havenga *op cit* note 130 at 86–90; Christie *op cit* note 130; and Kerr *op cit* note 130 in Chapter 8.

<sup>133</sup> For a full discussion of when it will be considered that a contract is contrary to the law, good morals and public policy, see Havenga *op cit* note 130 at 85–92; Christie *op cit* note 130; and Kerr *op cit* note 130 in Chapter 8.

<sup>134</sup> See Havenga *op cit* note 130 at 91.

<sup>135</sup> See Van Niekerk and Schulze *op cit* note 130 at 312.

This argument has the effect that the banks (i.e., guarantor/issuer) will be allowed to ignore the illegality of the underlying contract, and will thereby be aiding and condoning the illegal objectives of the parties to the underlying contract.<sup>136</sup>

The matter gives rise to the important question of whether the bank should, as a matter of policy, be drawn into a dispute concerning the illegal conduct or real motives of the parties to the underlying contract. On the one hand, it has been said that to expect the bank to investigate the legality of the underlying contract, will not only frustrate the autonomy of the letter of credit and demand guarantee, but will also place a time-consuming duty on the bank to investigate the motives and objectives of the parties to the underlying contract. While, on the other hand, it has also been said that it is also undesirable to allow a party to an illegal contract to enforce it merely because the bank may not investigate the legality of the underlying contract.<sup>137</sup>

In the English cases it has not been made clear what the duties and obligations of the banks are in relation to illegality in the underlying contract. In the United States there is also the misconception that if the illegality defence is recognised, banks would be compelled to determine whether payment under the letter of credit will be used for an illegal purpose and this will then place them under additional difficulties in examining the documents.<sup>138</sup> Banks should not be compelled to determine whether payment under the demand guarantee/credit of credit will be used for an illegal purpose, because of the autonomy principle of demand guarantees and letters of credit, and should therefore not have to look beyond the documents at the underlying contract. The duty of banks is only to examine documents with reasonable care. If that examination does not disclose evidence of illegality, the bank is entitled to pay and to be reimbursed by its customer (i.e., the principal/applicant). Therefore, in the absence of clear evidence of illegality, the bank is not only entitled, it is bound to pay. Thus, the availability of the illegality exception will not put banks under any additional difficulty in the examination of documents.<sup>139</sup> However, in South Africa, Van Niekerk and Schulze<sup>140</sup> have given this issue some thought and have made a few workable suggestions as to how the banks should deal with this.

In the instance where the bank is actually aware of the illegality of the underlying contract (e.g., where it is evident from the information supplied by the applicant/principal in the application form for the letter of credit/demand guarantee that certain foreign-exchange regulations will be contravened by the bank if it complies with its payment instruction under the credit/guarantee), Van Niekerk and Schulze<sup>141</sup> suggest that the bank should refuse to honour it. Likewise, when the bank may obtain knowledge of the illegality of the transaction by exercising reasonable care, it should similarly be under an obligation not to pay out on the letter of credit/demand guarantee. However, where the bank is neither actually aware of the illegality of the underlying contract, nor able to become aware by exercising reasonable care, its payment under the letter of credit/demand guarantee cannot

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<sup>136</sup> See Van Niekerk and Schulze *op cit* note 130 at 312.

<sup>137</sup> *Idem.*

<sup>138</sup> See Enonchong *op cit* note 1 at 412.

<sup>139</sup> See Enonchong *op cit* note 1 at 412.

<sup>140</sup> See Van Niekerk and Schulze *op cit* note 130 at 312.

<sup>141</sup> See Van Niekerk and Schulze *op cit* note 130 at 312.

be faulted.<sup>142</sup> Their suggestions as to how banks should deal with the matter of illegality in the underlying contract make sense and cannot be faulted. Placing such a duty (i.e., obtaining knowledge of the illegality of the transaction by exercising reasonable care, for example, by looking at the information applied on the application form) on a bank makes sense and will not, as already mentioned above, necessarily place an additional duty on the bank. Therefore, if a reasonable examination by the bank does not disclose evidence of illegality, the bank should be entitled to pay and to be reimbursed by its customer (i.e., the principal/applicant). However, if the bank fails to fulfil such a duty, the bank should not be allowed to be reimbursed by its customer. Hopefully, South African courts will take the suggestions made by Van Niekerk and Schulze into consideration when they are confronted with cases dealing with the issue of illegality in the underlying contract.

There have been no reported cases in South Africa where the courts have indicated their willingness to accept or even to consider the possibility that illegality could in exceptional cases constitute an exception to the autonomy principle of demand guarantees/letters of credit. South African writers so far have not specifically dealt with this issue, neither have they voiced specific opinions on whether the courts should also follow the English precedents (i.e., accept illegality in the underlying contract as an exception)<sup>143</sup> in this regard. According to Hugo, it is unnecessarily restrictive to limit the exceptions to the independence principle to the defence of fraud. Public policy dictates that a fraudulent beneficiary should not be able to succeed in an action against the bank. Other illegal conduct on the part of the beneficiary, for example, drug or illegal arms trafficking, could be equally or even more reprehensible. He states that the argument put forward in relation to fraud is equally applicable to cases such as these.<sup>144</sup> However, by providing the above-mentioned solutions, it seems by implication that Van Niekerk and Schulze also support the view that illegality in the underlying contract could constitute an exception to the autonomy principle.

The fraud exception requires that the fraud must be clearly established. Having such a high standard keeps the fraud exception within narrow limits. In other words, this strict standard has the effect that not many letters of credit and demand guarantees are influenced, because there are so many stringent conditions that have to be complied with before the fraud exception can apply.<sup>145</sup> Therefore, the standard of proof for illegality should be the same as for fraud – clear evidence of established illegality. If the underlying contract is illegal because it is contrary to the public policy or good morals of a specific country, it will be more difficult and nearly impossible to prove, particularly when dealing with the law of a more unfamiliar country. The concepts ‘public policy’ and ‘good morals’ are also often interchangeable and they also adapt to changing times.<sup>146</sup> Another difficulty is found in the fact that certain illegal contracts are not invalidated by their illegality, but are merely unenforceable. For instance, where an Act does not specifically state that a contract concluded in contravention of the Act will be null and void, it is not always clear what the

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<sup>142</sup> *Idem.*

<sup>143</sup> See *Mahonia Ltd v JP Morgan Chase Bank and Another* [2003] 2 Lloyd’s Rep 911 (QB (Com Ct)); and *Mahonia Ltd v West LB AG* [2004] EWHC 1938 (Comm); and see the discussion in para 6.2.2 above.

<sup>144</sup> See *Hugo: The Law Relating to Documentary Credits op cit* note 103 at 316–317.

<sup>145</sup> For a full discussion of fraud, see Chapter 5.

<sup>146</sup> See *Havenga op cit* note 130 at 85 and 87.

precise effect of the contravention of the Act will be on the agreement.<sup>147</sup> For instance, is such a contract illegal, merely unenforceable, or does it merely render the party liable to prosecution and penalties? Obviously, the effect of statutory illegality has to be determined with reference to the wording of the Act.<sup>148</sup> The answers, however, will not always be evident, even if an Act is read as a whole. Where an Act specifically provides that an agreement in contravention of the Act will be null and void, the position regarding illegality is clear, but unfortunately, not all Acts are that clear.

Therefore, in my view, the exception of illegality in the underlying contract should be limited only to those instances where the underlying contract's illegality carries with it a clear criminal element. The illegality should relate to a *prima facie* criminal offence being committed. If the illegality therefore is not linked to a criminal element, it should be deemed that the illegality is not sufficiently serious, but of a mere technical nature (i.e., that it contravenes a section of a specific Act that carries with it no possibility of a criminal prosecution by the concerned authorities) and it should then not constitute an exception to the autonomy principle and the bank should then have to pay despite the illegality, and the parties should thereafter proceed against each other in terms of the normal principles applicable to the law of contract (if that is allowed). The exception of illegality should not include instances where the underlying contract is illegal (but not also criminal) merely because it is against the public policy or good morals of a country, as this will often be too difficult for the principal to prove. In such instances, it should be left to the principal to sort out with separate proceedings after payment has been made (if allowed by the law of contracts applicable to the underlying contract).

## 6.5 ILLEGALITY AND THE UNCITRAL CONVENTION

The United Nations Convention on Independent Guarantees and Stand-by Letters of Credit ('UNCITRAL Convention')<sup>149</sup> specifically provides for an illegality exception. Article 19(2)(b) of the UNCITRAL Convention clearly provides for an exception to the autonomy principle of demand guarantees and standby letters of credit if the underlying contract is illegal. However, the article specifically states that this illegality exception will only be accepted where the underlying obligation of the principal/applicant has been declared invalid by a court or arbitral tribunal.

Article 20 of the Convention makes specific provision both for measures similar to an injunction (i.e., an interdict under the South African law) preventing payment<sup>150</sup> and for attachment or *Mareva*-type injunctions (freezing orders)<sup>151</sup> to be available to the court where there is a 'high probability' shown by 'immediately available strong evidence';<sup>152</sup>

<sup>147</sup> See Havenga *op cit* note 130 at 91.

<sup>148</sup> *Idem*.

<sup>149</sup> See the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit (1996) (hereinafter 'the Convention' or 'the UNCITRAL Convention' interchangeably). For a full discussion of the Convention, see para 3.3 in Chapter 3 and para 4.4 in Chapter 4. See also the conclusions reached as to whether the UNCITRAL Convention deals sufficiently with the illegality exception in para 8.3.2.1 in Chapter 8.

<sup>150</sup> For a full discussion of injunctions (i.e., interdicts), see Chapter 7.

<sup>151</sup> See the discussion of *Mareva*-type injunctions (freezing orders) and the South African anti-dissipation orders in paras 7.2.5 and 7.4.5 in Chapter 7.

<sup>152</sup> See Hugo: *The Law Relating to Documentary Credits op cit* note 103 at 309.

the court 'may issue a provisional order' or similar. Article 20(3) specifically provides that where the underlying obligation of the principal/applicant has been declared invalid by a court or arbitral tribunal (unless the undertaking indicates that such contingency falls within the risk to be covered by the undertaking) or where the undertaking (demand guarantee/standby letter of credit) is used for a criminal purpose, the court may issue an injunction preventing payment or issue a *Mareva*-type injunction. The only problem with this, in my view, is that the impression is gained that before the court may issue an injunction or payment may be withheld, the underlying contract must first have been declared invalid by a court or arbitral tribunal. Both of this might take a long time to achieve and in the meantime the bank might still pay as there is no injunction preventing it from paying and the beneficiary might also, after receiving payment, utilise and spend the money obtained. Also if the bank pays in the meantime, it will be entitled to be reimbursed by its customer (i.e., principal of the demand guarantee). If this happens, there will clearly be no need to apply for these types of injunctions and the principal's/applicant's best option would be to try and claim damages (if that is allowed in the specific jurisdiction's law of contract, especially when it relates to a contract that has been found to be illegal). It is also not certain whether this declaration of invalidity by a court should be an order dealing specifically with the underlying contract, be final or from a court having jurisdiction over the underlying contract. Many questions without answers arise. For instance, what if the court declaration is ambiguous, or is not final, or comes from a court that has no jurisdiction over the underlying contract?

However, it seems that if the demand guarantee/standby letter of credit is used for a criminal purpose, the court may immediately issue an injunction preventing payment or issue a *Mareva*-type injunction, without a prior court or arbitral tribunal having made a declaration on the matter. It is not clear whether the phrase 'use of the undertaking for a criminal purpose' relates to a case where the payment on the undertaking itself would violate criminal law, or where the payment of the underlying obligation would violate criminal law.

However, at this point it seems that the exact interpretation of the illegality exception as provided for in the UNCITRAL Convention is problematic and consists of mere speculation.

## 6.6 CONCLUSION<sup>153</sup>

It seems to be settled law in England and South Africa that a contract that is contrary to the law, good morals or public policy is illegal, and consequently, void in terms of the general principles of the law of contract in each separate jurisdiction. Therefore, if it is the commercial or standby letter of credit/demand guarantee itself that is contrary to the law, good morals or public policy (i.e., the law of the country which applies to the guarantee/credit or the law of the country where the guarantee/credit is to be performed), it will likewise not be enforceable. Where the demand guarantee/letter of credit itself is illegal (and the underlying contract legal), the principle of autonomy does not come into play and no difficulty arises as a result of that principle.

Recent cases in England are in favour of accepting illegality in the underlying contract as an exception to the principle of autonomy of letters of credit and demand guarantees. Fraud

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<sup>153</sup> See also the further conclusions set out in paras 8.3.2 and 8.3.2.1 in Chapter 8.

as a possible exception to the autonomy principle already received attention during the 1920s and has been in development for nearly a century and still it has not been authoritatively settled in all respects. Illegality as a possible exception received its first real consideration as a possibility during the 1990s, but it was not until 2004 that it was really acknowledged as an exception. Illegality as an accepted exception is still in its infancy stage and there are still too many uncertainties regarding its exact application, the specific types of illegality that would be considered to be sufficient to constitute an exception (i.e., illegality as a concept), and the exact standard of proof that is required. Therefore, it remains to be seen exactly how the defence of illegality will be developed under the English law.<sup>154</sup>

However, at this stage (based on the discussions above), it is possible to identify only a few requirements that will need to be satisfied before the illegality exception will be applicable under the English law. Firstly, the alleged illegality will have to be established clearly. Secondly, the illegality will also have to be sufficiently serious. Thirdly, the beneficiary must have been involved in the illegality. Lastly, the letter of credit/demand guarantee must be sufficiently connected to the illegality in the underlying transaction.<sup>155</sup>

For the fraud exception to the autonomy principle to succeed, earlier English cases<sup>156</sup> have consistently required that banks had to have clear evidence of the fraud at the time of presentation of the documents. Whereas later cases<sup>157</sup> take the view that the earlier cases did not intend restricting the time by which the evidence of fraud had to be available to the extent of ignoring evidence of fraud that came to light after presentation of the documents, but before hearing the case. The point is rather that the bank should reach a decision on whether or not to pay, soon after presentation of the documents. Usually it will only refuse payment in the light of compelling evidence available to it at that stage. However, if the bank refuses to pay on a suspicion of fraud, and is sued, and prior to the hearing of the case acquires evidence, this evidence should be admissible.<sup>158</sup> Therefore, as to the time when the bank should have the evidence on which it relies to establish illegality, the view of the later English cases is to be preferred.

The Revised United States UCC article 5 does not make provision for an illegality exception to the autonomy principle of commercial or standby letters of credit. Revised UCC article 5 has limited the exceptions to the autonomy principle to fraud in the narrow (i.e., regarding fraud in the documents (e.g., forgery)) as well as in the wide sense (i.e., fraud in the underlying contract). Therefore, the American law does not accept that illegality in the underlying contract is an exception to the autonomy principle of

<sup>154</sup> See Warne and Elliott *op cit* note 27 at 273.

<sup>155</sup> See Enonchong *op cit* note 1 at 413.

<sup>156</sup> See, e.g., *Group Josi Re v Walbrook Insurance Co Ltd and Others* [1996] 1 Lloyd's Rep 345 (CA) ([1996] 1 WLR 1152; and [1996] 1 All ER 791); and *United City Merchants (Investments) Ltd and Glass Fibres and Equipments Ltd v Royal Bank of Canada (incorporated in Canada), Vitrorefuerzos SA and Banco Continental SA* [1983] AC 168 (HL) ([1982] 2 Lloyd's Rep 1 (HL)).

<sup>157</sup> See, e.g., *Rafsanjan Pistachio Producers Co-Operative v Bank Leumi (UK) Plc* [1992] 1 Lloyd's Rep 513 (QB); *Balfour Beatty Civil Engineering and Another v Technical and General Guarantee Co Ltd* (2000) 68 Con LR 180 ([2000] CLC 252; and [2000] CILL 1574); *Solo Industries UK Ltd v Canara Bank* [2001] 2 Lloyd's Rep 578 (CA) ([2001] 1 WLR 1800 (CA)); and *Mahonia Ltd v JP Morgan Chase Bank and Another* [2003] 2 Lloyd's Rep 911 (QB (Com Ct)). For a full discussion, see in para 5.4.4 in Chapter 5.

<sup>158</sup> See *Mahonia Ltd v JP Morgan Chase Bank* [2003] 2 Lloyd's Rep 911 (QB (Com Ct)).

commercial or standby letters of credit. The United States banks would, apparently, abide by a court injunction or other government order that clearly prohibits payment under a commercial or standby letter of credit.

Barnes correctly points out that until such time as the courts in England (and other countries applying English law principles) decide cases raising illegality defences, he suspects that the *Mahonia Ltd v West LB AG*<sup>159</sup> precedent will not be vigorously applied, and that the demonstrated reluctance of English courts to find letter of credit fraud will carry over to illegality defences. It also seems that the English court's treatment of illegality in the *Mahonia Ltd v West LB AG* case is not likely to have any effect on United States courts enforcing American law-governed letters of credit.

South Africa currently has no cases where illegality in the underlying contract has been accepted or has even been considered as a possible exception to the autonomy principle of letters of credit and demand guarantees. A few South African writers, however, seem to favour the acceptance of illegality as an exception. Public policy, just as with fraud, clearly requires that a party to an illegal contract should not be able to enforce it. Therefore, in my view, South Africa should accept illegality as an exception to the autonomy principle of letters of credit and demand guarantees, provided it is confined within a narrow scope. If the courts were to accept illegality in the underlying contract as an exception to the autonomy principle, they should also use the requirements that have so far been established by the English courts as a basis for developing the exception further: namely that the

- alleged illegality must be established clearly;
- illegality must be sufficiently serious;
- beneficiary must have been involved in the illegality; and
- letter of credit/demand guarantee must be sufficiently connected to the illegality in the underlying transaction.

As regards the requirement that the illegality must be 'sufficiently serious', I submit that South Africa should also limit the illegality to instances where the illegality carries with it a clear criminal element. The illegality should relate to a *prima facie* criminal offence being committed. If the illegality therefore is not linked to a criminal element, it should be deemed that the illegality is not sufficiently serious, but of a mere technical nature (i.e., that it merely contravenes a section of a specific Act that carries with it no possibility of a criminal prosecution by the authorities concerned) and it should then not constitute an exception to the autonomy principle and the bank should then have to pay despite the illegality. The parties should thereafter proceed against each other in terms of the normal principles applicable to the law of contract (if that is allowed). Therefore, in instances where the underlying contract is tainted by sufficiently serious illegality, it should be possible for the principal to apply for an interdict to restrain the bank from paying and/or the beneficiary from making a demand or receiving payment under a demand guarantee/letter of credit.

In the English cases it has not been made clear what the duties and obligations of the banks are in relation to illegality in the underlying contract. In the United States there is also the misconception that if the illegality defence is recognised, banks would be compelled to determine whether payment under the letter of credit will be used for an illegal purpose

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<sup>159</sup> [2004] EWHC 1938 (Comm).



and this will then place them in additional difficulties in examining the documents.<sup>160</sup> It is true that banks should not be forced to determine whether payment under the guarantee/credit will be used for an illegal purpose, because of the autonomy principle of demand guarantees and letters of credit, and should therefore not have to look beyond the documents at the underlying contract. The duty of banks is only to examine documents with reasonable care. If that examination does not disclose evidence of illegality, the bank is entitled to pay and to be reimbursed by its customer (i.e., the principal/applicant). Therefore, in the absence of clear evidence of illegality, the bank is not only entitled, it is bound to pay. Thus, the availability of the illegality exception will not necessarily put banks under any additional difficulty in the examination of documents.<sup>161</sup> However, in South Africa, Van Niekerk and Schulze<sup>162</sup> have given this issue some thought and have made a few workable suggestions as to how the banks should deal with this.

In the instance where the bank is actually aware of the illegality of the underlying contract (e.g., where it is evident from the information supplied by the applicant/principal in the application form for the letter of credit/demand guarantee that certain foreign-exchange regulations will be contravened by the bank if it complies with its payment instruction under the credit/guarantee), Van Niekerk and Schulze<sup>163</sup> suggest that the bank should refuse to honour it. Likewise, when the bank may obtain knowledge of the illegality of the transaction by exercising reasonable care, it should similarly be under an obligation not to pay out on the letter of credit/demand guarantee. However, where the bank is neither actually aware of the illegality of the underlying contract, nor able to become aware by exercising reasonable care, its payment under the letter of credit/demand guarantee cannot be faulted.<sup>164</sup> Their suggestions as to how banks should deal with the matter of illegality in the underlying contract make sense and cannot be faulted. Placing such a duty (i.e., obtaining knowledge of the illegality of the transaction by exercising reasonable care, e.g., by looking at the information applied on the application form) on a bank makes sense and will not, as already mentioned above, necessarily place an additional duty on the bank. Therefore, if a reasonable examination by the bank does not disclose evidence of illegality, the bank should be entitled to pay and to be reimbursed by its customer (i.e., the principal/applicant). However, if the bank fails to fulfil such a duty, the bank should not be allowed to be reimbursed by its customer. Hopefully the South African courts will take the suggestions made by Van Niekerk and Schulze into consideration when they are confronted with cases dealing with the issue of illegality in the underlying contract. Their suggestions clearly take cognisance of the principle of autonomy and the fact that bank deal purely with documents and should therefore not have to look beyond the documents at the underlying contract.

I agree with Barnes that the 'illegality' defence will be potentially more problematic than the 'fraud' defence.<sup>165</sup> It will often be very difficult (1) to determine whether a specific underlying contract is indeed illegal, especially if it is against, for example, the public policy or good morals of a rather unfamiliar country and (2) if illegality is proven, whether

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<sup>160</sup> See Enonchong *op cit* note 1 at 412.

<sup>161</sup> *Idem.*

<sup>162</sup> See Van Niekerk and Schulze *op cit* note 130 at 312.

<sup>163</sup> See Van Niekerk and Schulze *op cit* note 130 at 312.

<sup>164</sup> *Idem.*

<sup>165</sup> See Barnes *op cit* note 61 at 8.

that illegality is serious enough to justify the infringement of the autonomy principle. It will not be an easy task for a court always to establish whether or not the illegality is serious enough. It is possible that what one country considers to be a serious illegality, another country might view as being an illegality of a pure technical nature. For example, the sale of Cuban cigars might be illegal in the United States, but will not be illegal in South Africa. With fraud, the different jurisdictions often seem to have a more similar view that a specific action is of a fraudulent nature, although they often disagree on the standard of proof that is required for the fraud. It is also possible that in some cases there will be an overlapping of fraud and illegality. Until such time as the English courts continue to have such a stringent approach to the fraud exception, parties will surely try the illegality exception thinking that the courts will be more lenient with it. Looking at the English tradition that was followed with the fraud exception, they are sure to follow a similar stringent approach regarding this exception.

## CHAPTER 7: INTERIM COURT RELIEF

### 7.1 GENERAL INTRODUCTION

When a court is required to make a decision as to whether or not it should intervene and restrain payment following an alleged improper demand, it must first consider how far the bank's duty to pay under the guarantee should take preference over a challenge to the beneficiary's right to claim under the underlying contract. There is no doubt that in an action for damages the principal can ultimately recover a payment made as a result of an improper or fraudulent claim,<sup>1</sup> but, practically, an action for damages against a beneficiary may be of little help, because the beneficiary may be in a foreign country or even insolvent. Furthermore, the transfer of assets from the principal to the beneficiary will strengthen the beneficiary's bargaining position during settlement negotiations. Therefore, the principal's best opportunity to challenge a wrongful claim is at the point of demand before payment.<sup>2</sup>

The principal/applicant may raise the defence of fraud or any another accepted defence<sup>3</sup> in proceedings in which he applies for an injunction<sup>4</sup> (interdict under the South African law)<sup>5</sup> against the bank restraining it from effecting payment under a demand guarantee/letter of credit, and/or against the beneficiary (and/or second issuing bank, in the case of indirect demand guarantees) restraining him (them) from calling on the (counter-) guarantee. Both types of preventative actions will be referred to as applications for 'restraining' or 'stop-payment' orders. These applications are made in proceedings known as 'provisional', 'interim', 'preliminary' or 'interlocutory' proceedings. These are provisional remedies to enable the claimant (i.e., the plaintiff) to protect himself against dissipation of property by the beneficiary (i.e., the defendant), and are temporary in nature; they are not actions in themselves, but are ancillary proceedings available only in connection with a main action.<sup>6</sup>

Therefore, should the principal hear that the beneficiary intends to make a fraudulent/abusive or otherwise unfair call on a demand guarantee, an interim injunction (i.e., an interim interdict)<sup>7</sup> may be sought either against the guarantor (i.e., the bank)

<sup>1</sup> See, e.g., *Hyosung America Inc v Sumagh Textile Co Ltd* 25 F Supp 2d 376 (SDNY 1998).

<sup>2</sup> See M Coleman 'Performance Guarantees' (1990) *Lloyd's Maritime and Commercial Law Quarterly* 223 at 224–225.

<sup>3</sup> See Chapters 5–6 for a discussion of fraud and illegality in the underlying contract as possible grounds upon which payment may be restrained.

<sup>4</sup> An injunction is a judicial process whereby a party is ordered to refrain from doing or ordered to do a particular thing. Injunctions can either be interlocutory or perpetual (see C B Prest *The Law and Practice of Interdicts* (1996) at 82).

<sup>5</sup> See J P van Niekerk and W G Schulze *The South African Law of International Trade: Selected Topics* 2 ed (2006) at 313.

<sup>6</sup> See B V McCullough *Letters of Credit* (loose-leaf edition) (1987–) at 5-2 and in para 5.01.

<sup>7</sup> An interim interdict is a court order preserving or restoring the *status quo* pending the final determination of the right of the parties. It, therefore, does not involve a final determination of these rights and does not affect their final determination (see L T C Harms (revised by LTC Harms) 'Interdict' in WA Joubert (ed) *The Law of South Africa* Vol No 11 (first reissue, 1998) (hereinafter '*Harms: The Law of South Africa*') in para 314 at 290 and the authorities cited; and L T C Harms *Civil Procedure in the Superior Courts: Students' Edition* 3 ed (2003) (hereinafter '*Harms: Civil Procedure in the Superior Courts*') in para A5.6 at 28).

preventing payment, and/or against the beneficiary preventing the making of a demand on the guarantor.<sup>8</sup> However, the first question that a court will have to deal with is whether the facts justify a departure from the independence principle. Only if this is the case, does the possibility of a defence or injunction arise.<sup>9</sup>

Another means of protection available to the principal/applicant of a demand guarantee/letter of credit is the English freezing injunction (previously known as the ‘*Mareva* injunction’)<sup>10</sup> or the South African anti-dissipation interdict (i.e., the South African equivalent of the English’s freezing order)<sup>11</sup> which provides a means whereby a beneficiary may be prevented from removing his money or other assets from the jurisdiction of the court or otherwise dealing with them within or without the jurisdiction before the matter has been finally settled.<sup>12</sup> Attempts to secure injunctions/interdicts through full-length main court proceedings are often futile, since payment will often already have been effected by the time a favourable judgment might be rendered.<sup>13</sup> The advantage of the English freezing injunction (the *Mareva* injunction) and the South African anti-dissipation interdict from the principal’s point of view is that the injunction or interdict does not interfere with the operation of the demand guarantee (or letter of credit). Therefore, the autonomy principle does not come into play.<sup>14</sup>

Court relief in the form of only interim (interlocutory, provisional or preliminary) interdicts/injunctions and anti-dissipation interdicts/freezing injunctions (*Mareva* injunctions) that are available in the English, American and South African law<sup>15</sup> are briefly discussed below.

## 7.2 ENGLISH LAW

### 7.2.1 Introduction

Over the last couple of decades the international business community has become increasingly concerned about abusive calls on demand guarantees by overseas

<sup>8</sup> See Howard N Bennett ‘Performance bonds and the principle of autonomy’ (1994) *Journal of Business Law* 574 at 581–582.

<sup>9</sup> See C F Hugo *The Law Relating to Documentary Credits from a South African Perspective with Special Reference to the Legal Position of the Issuing and Confirming Banks* (published LLD, University of Stellenbosch (1996)) (1997) (hereinafter ‘*Hugo: The Law Relating to Documentary Credits*’) at 271.

<sup>10</sup> See para 7.2.5 below for a full discussion.

<sup>11</sup> See para 7.4.5 below for a full discussion.

<sup>12</sup> See R Jack, A Malek and D Quest *Documentary Credits: The Law and Practice of Documentary Credits Including Standby Credits and Demand guarantees* 3 ed (2001) (hereinafter ‘*Jack*’) in para 9.64 at 296; and *Hugo: The Law Relating to Documentary Credits op cit* note 9 at 282.

<sup>13</sup> See R Bertrams *Bank Guarantees in International Trade: The Law and Practice of Independent (First Demand) Guarantees and Standby Letters of Credit in Civil Law and Common Law Jurisdictions* 3 ed (2004) at 336.

<sup>14</sup> See *Hugo: The Law Relating to Documentary Credits op cit* note 9 at 330; *Bolivinter Oil SA v Chase Manhattan Bank, Commercial Bank of Syria and General Company of Homes Refinery* [1984] 1 Lloyd’s Rep 251 (CA) ([1984] 1 All ER 351 (CA) and [1984] 1 WLR 392 (CA)); *Z Ltd v A-Z and AA-LL* [1982] 1 QB 558 (CA) ([1982] 1 All ER 556) at 574.

<sup>15</sup> See also P O’Brien ‘Letters of Intent and Demand Guarantees’ *ABLU* 1993 (a paper delivered at the 1993 Annual Banking Law Update held at the Indaba Hotel, Johannesburg) 134 at 173–178.

beneficiaries. Injunctions<sup>16</sup> are regularly sought in English courts to prevent the banks from making payment, when the demand is deemed unjustified.<sup>17</sup> However, as seen from the case law mentioned in chapter 5 and below, it is not easy for a principal of a demand guarantee or an applicant of a letter of credit indeed to succeed in obtaining an injunction. The English courts have taken a harsh approach to the enforcement of these instruments and their autonomous nature, and the traditional view is that the only exception to the general rule – that banks must honour them ‘without proof or condition’ – is in the cases where the demand is made fraudulently.<sup>18</sup>

A real difficulty for banks where, for example, the fraud exception alone is relied upon as a ground for rejection, is the very limited period of time available to investigate the matter. Generally, London banks accept or reject a presentation within three banking days and there is a longstop period of five banking days under the UCP 600.<sup>19</sup> So, when there is a suspicion of fraud, three or even five banking days are normally not adequate time in which a bank can decide whether there is sufficient evidence to rely on the fraud exception. Accordingly, a bank faced with a suspicion of fraud often finds itself in a predicament.<sup>20</sup>

If the bank decides to make the payment, then its customer (i.e., principal/applicant) may refuse to indemnify it on the basis that the evidence was sufficient to justify the reliance of the fraud exception. Then by the time that the matter goes to trial, the evidence of fraud may have improved in the customer’s favour and it is difficult to reconstruct the knowledge of fraud as at the relevant time. However, conversely, if the bank refuses to make the payment on the basis of fraud, and it turns out to have been the wrong action, then the bank’s international reputation may be damaged<sup>21</sup> and it may face litigation by the beneficiary. As already mentioned in Chapter 5, there are only a few cases in practice where the documents were apparently in conformity with the guarantee/credit and the bank was willing to reject on the basis of the fraud exception. It does not even seem to help that the bank’s customer is willing to give the bank a full indemnity for the consequences of

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<sup>16</sup> ‘An injunction is a judicial remedy by which a person is ordered to refrain from doing something or ordered to do a particular act or thing’ (see *Halsbury Laws of England* 4 ed reissue (2004) 24 Injunctions para 801). An injunction is defined in the Civil Procedure Rules 1998 Glossary as ‘a court order prohibiting a person from doing something or requiring a person to do something’. An interim injunction (formerly an interlocutory injunction) is an order restraining the defendant from doing something or requiring him to do something pending trial or further order. The procedure for obtaining them is contained in rule 25 of the Civil Procedure Rules (see G Clark ‘As Good as Cash? Injuncting Calls on Letters of Credit and Performance Guarantees’ (a paper delivered at a seminar organised by the Professional Solutions Training and Consultancy held at the Discussion Conference Centre in London on 15 May 2006) (unpublished) in para 28 at 10).

<sup>17</sup> See G Penn ‘On-demand Bonds – Primary or Secondary Obligations?’ [1986] 4 *Journal of International Banking Law* 224 at 228. On injunctions in English law in general, see D B Casson *Odgers on High Court Pleading and Practice* 23 ed (1991) at 78–84; and S Gee *Commercial Injunctions (formerly Mareva Injunctions and Anton Piller Relief)* 5 ed (2004).

<sup>18</sup> See Penn *op cit* note 17 at 228.

<sup>19</sup> See article 14(b) of the UCP 600 (i.e., the 2007 version of the Uniform Customs and Practice for Documentary Credits (*ICC Publication* No 600, Paris (2006))). Article 14(d)(i) of the UCP 500 (i.e., the 1993 version of the Uniform Customs and Practice for Documentary Credits (*ICC Publication* No 500, Paris (1993))) made provision for seven banking days.

<sup>20</sup> See D Warne and N Elliott *Banking Litigation* 2 ed (2005) at 267.

<sup>21</sup> See Penn *op cit* note 17 at 228; and *Tukan Timber Ltd v Barclays Bank Plc* [1987] 1 Lloyd’s Rep 171 (QB) at 174.

rejecting wrongly on the grounds of fraud, as the bank will still be more concerned about its reputation. If the principal/applicant sues the guarantor/issuing bank for making the payment (and for not relying on the fraud exception), then the relevant time for considering whether or not the bank had knowledge of fraud sufficient for it to refuse payment, is before it made the actual payment.<sup>22</sup>

A principal of a demand guarantee may seek an injunction for one of three reasons, namely to<sup>23</sup>

1. restrain payment by the bank to the beneficiary (or by one bank to another);
2. restrain a claim by the beneficiary against the bank (or by one bank against another);  
or
3. freeze funds in the hands of the recipient (beneficiary) following the payment of a claim.

In terms of section 37 of the Supreme Court Act of 1981, the High Court may by order, whether interim or final, grant an injunction in all cases in which it appears to the court to be just and convenient to do so. The County Court's similar power derives from section 38 of the County Courts Act of 1984. The power is discretionary.<sup>24</sup> The principles to be followed by the court in considering applications for interim injunctions were stated by the House of Lords in *American Cyanamid Co v Ethicon Ltd*.<sup>25</sup>

In order to succeed with an injunction, the principal must first show that he has a good arguable claim against the party he is seeking to restrain. This will entail that he must establish a case of fraud to the knowledge of the party to be enjoined (otherwise the court will not intervene with the operation of the demand guarantee), and he must also convince the court that the party he wishes to enjoin owes him a duty not to pay, either in contract or in tort.<sup>26</sup> In the second place, it must also appear that the granting of an injunction is the correct exercise of the court's discretion after considering the balance of convenience.<sup>27</sup> In terms of the 'balance of convenience' test, the court must establish whether more harm will be done by granting or refusing the injunction. If damages would be a sufficient remedy, this would suggest that an injunction would ordinarily not be granted.<sup>28</sup> Therefore, even if a case of clear fraud is established, the case may still fail where, for example, the party

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<sup>22</sup> See *United Trading Corporation SA and Murray Clayton Ltd v Allied Arab Bank Ltd and Others* [1985] 2 Lloyd's Rep 554 (CA) at 560. See also Warne and Elliott *op cit* note 20 at 268. See also para 5.4.4 in Chapter 5.

<sup>23</sup> See Coleman *op cit* note 2 at 238.

<sup>24</sup> See also Clark *op cit* note 16 in para 29 at 10.

<sup>25</sup> [1975] AC 396 (HL) ([1975] 1 All ER 504 (HL)). See the full discussion in para 7.2.4 below.

<sup>26</sup> For more on whether a guarantor/issuer (i.e., bank), beneficiary, or other banks, for example, confirming bank, in a documentary credit context or demand guarantee context owes a principal/applicant a duty not to pay under the credit/guarantee, see *Hugo: The Law Relating to Documentary Credits op cit* note 9 at 280–281; and *United Trading Corporation v Allied Arab Bank* [1985] 2 Lloyd's Rep 554 (CA).

<sup>27</sup> See *Jack op cit* note 12 at 284–285. See also the discussion of the 'balance of convenience' test in para 7.2.4 below.

<sup>28</sup> See *American Cyanamid Co v Ethicon Ltd* [1975] AC 396 (HL) ([1975] 1 All ER 504 (HL)); and cf *Hugo: The Law Relating to Documentary Credits op cit* note 9 at 281; and Casson *op cit* note 17 at 80.

sought to be enjoined is a bank, because if the balance of convenience test is applied,<sup>29</sup> it will be shown that damages will be a sufficient remedy for any breach of duty by the bank.<sup>30</sup>

### 7.2.2 Injunctions Against the Bank: Injunctions to Prevent Payment

If the principal fears that a fraudulent or otherwise abusive demand is going to be made under the demand guarantee, he should immediately inform the bank of the evidence of fraud or the abuse. This also applies to a case where such a demand has been made and the bank has not yet paid. The bank will then need to decide whether the evidence of fraud or abuse is sufficient for it to refuse payment in the event of a demand being made. If the bank refuses to pay, it may damage its own reputation and become the defendant to litigation by the beneficiary to enforce the instrument. However, if the bank rejects the evidence of clear and obvious fraud or even abuse and makes payment, then it would be liable to the principal if it were subsequently held that it should have invoked the fraud exception or another exception on the materials available at the time. The principal would also then be entitled to refuse to indemnify the bank (guarantor).<sup>31</sup>

However, if the principal/applicant obtains an injunction restraining the bank from making a payment then the bank may avoid damage to its reputation, as the bank will not be blamed for complying with a court order. If there is evidence of fraud, a short-term injunction may at least freeze the position for a brief period during which the beneficiary may be forced either to abandon the attempt to obtain payment or to produce evidence countering the allegations of fraud.<sup>32</sup> Often when banks find themselves in the above predicament, they informally invite applications for an injunction from the principal/applicant,<sup>33</sup> because such an injunction in the short term is both in the interest of the bank and its customer.<sup>34</sup>

<sup>29</sup> See, e.g., *Czarnikow-Rionda Sugar Trading Inc v Standard Bank London Ltd and Others* [1999] Lloyd's Rep Bank 197 ([1999] 2 Lloyd's Rep 187).

<sup>30</sup> See *Jack op cit* note 12 at 285.

<sup>31</sup> See *Warne and Elliott op cit* note 20 at 286.

<sup>32</sup> See, e.g., *Edward Owen Engineering Ltd v Barclays Bank International Ltd and Another* [1978] 1 QB 159 (CA) ([1978] 1 Lloyd's Rep 166 (CA) and [1978] 1 All ER 976 (CA)); *United Trading Corporation v Allied Arab Bank* [1985] 2 Lloyd's Rep 554 (CA); and *Bolivinter Oil v Chase Manhattan Bank* [1984] 1 Lloyd's Rep 251 (CA) ([1984] 1 All ER 351 (CA) and [1984] 1 WLR 392 (CA)). All these cases involve unsuccessful attempts by the principal to prevent the bank (guarantor) by injunction from making a payment under the demand guarantee. Similar cases involving letters of credit are, for example, *Discount Records Ltd v Barclays Bank Ltd and Barclays Bank International Ltd* [1975] 1 Lloyd's Rep 444 (Ch D) ([1975] 1 WLR 315 and [1975] 1 All ER 1071); and *Tukan Timber Ltd v Barclays Bank* [1987] 1 Lloyd's Rep 171 (QB).

<sup>33</sup> There is no duty on a bank to inform the principal (its customer) that a demand has been made on the demand guarantee and before it has made the payment (see *Esal (Commodities) Ltd and Reltor Ltd v Oriental Credit Ltd and Wells Fargo Bank NA; Banque du Caire SAE v Wells Fargo Bank NA* [1985] 2 Lloyd's Rep 546 (CA) at 553). However, the position would be different if the bank had expressly agreed to inform its customer before making payment (see also *Penn op cit* note 17 at 229).

<sup>34</sup> See *Warne and Elliott op cit* note 20 at 268. It is important to bear in mind that although the bank is not a party to the fraud, the injunction is issued against the bank restraining it from paying. The reason why it is necessary for the injunction to be issued against the bank is because the bank has a primary obligation towards the beneficiary to pay; it cannot refuse to pay without there being compelling reasons. Therefore, should a beneficiary make a proper demand in terms of the demand guarantee, the bank is obliged to pay. However, if the bank refuses payment, for example, because of alleged fraud on the part of the beneficiary, the beneficiary might sue the bank for not paying in terms of the demand guarantee. So, when the principal

From case law<sup>35</sup> it is apparent that a principal invoking the fraud exception for injunctive relief against payment by a bank must overcome the following obstacles (hurdles) (1) knowledge that the fraudulent call has been made or will be made;<sup>36</sup> (2) proving that there is indeed clear (obvious) evidence of fraud;<sup>37</sup> and (3) proving that the bank has knowledge of the fraud.<sup>38</sup>

Case law has shown how difficult it is for a principal to overcome all these obstacles and an injunction against a bank is seldom likely to succeed.<sup>39</sup> Donaldson MR in *Bolivinter Oil SA v Chase Manhattan Bank, Commercial Bank of Syria and General Company of Homes Refinery*<sup>40</sup> stated that in a documentary credit and demand guarantee context an injunction would only be granted against the bank in a ‘wholly exceptional case’. Where a principal does succeed in establishing fraud, an injunction will not be granted unless the principal can also satisfy the ‘balance of convenience test’.<sup>41</sup> This test is part of the general requirement for an application for an interim injunction.<sup>42</sup>

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obtains an injunction restraining a bank from paying, it prevents the bank from getting involved or being faulted for not honouring its primary obligation towards the beneficiary. This will, of course, also allow the bank to step back and to wait for the matter to be resolved by the courts and the relevant parties to the demand guarantee.

<sup>35</sup> See the case law referred to in para 5.4 in Chapter 5.

<sup>36</sup> As an obvious precondition of any steps to obtain the injunction, the principal needs to know either that a call is impending or that a claim has been made, but before the bank has met it. Under English law a bank is, unless specifically provided for in the contract, under no duty to inform a principal that a call has been made or is imminent (see *Esal (Commodities) Ltd v Oriental Credit Ltd supra* note 33; and I Ndekugri ‘Performance Bonds and Guarantees: Construction Owners and Professionals Beware’ (November/December 1999) 125 *Journal of Construction Engineering and Management* 428 at 433).

<sup>37</sup> It has been questioned in other jurisdictions whether, considering that the injunction normally sought is only interlocutory (provisional or temporarily), clear fraud is not demanding a higher standard of proof more appropriate to instances where courts have to make final determinations. For instance, *CDN Research and Development Ltd v Bank of Nova Scotia and Others* (1982) 136 DLR (3d) 656, the Divisional Court of the Ontario High Court (Canada) preferred a strong *prima facie* case of fraud (see Ndekugri *op cit* note 36 at 433).

<sup>38</sup> A bank is not required to investigate whether or not the claim is made fraudulently. A bank will rarely be in a position to know whether the claim is honest or not (see *Edward Owen Engineering Ltd v Barclays Bank International Ltd* [1978] 1 QB 159 (CA) ([1978] 1 Lloyd’s Rep 166 (CA) and [1978] 1 All ER 976 (CA))). However, from case law, it is evident that if a bank is not aware of the fraud, an injunction may still be granted on the ground that the circumstances of the demand are of such a nature that the only realistic inference is that the demand is fraudulent (see *United Trading Corporation v Allied Arab Bank Ltd* [1985] 2 Lloyd’s Rep 554 (CA); and see also Ndekugri *op cit* note 36 at 432–433).

<sup>39</sup> See, e.g., *Bolivinter Oil SA v Chase Manhattan Bank* [1984] 1 Lloyd’s Rep 251 (CA) ([1984] 1 All ER 351 (CA) and [1984] 1 WLR 392 (CA)).

<sup>40</sup> [1984] 1 Lloyd’s Rep 251 (CA) at 257.

<sup>41</sup> See *Tukan Timber Ltd v Barclays Bank Plc* [1987] 1 Lloyd’s Rep 171 (QB) at 177.

<sup>42</sup> See *American Cyanamid Co v Ethicon Ltd* [1975] AC 396 (HL) ([1975] 1 All ER 504 (HL)). For a full discussion see para 7.2.4 below.



### 7.2.3 Injunctions Against the Beneficiary: Injunctions to Prevent Demand or Receipt of Payment

As soon as a principal becomes aware that a fraudulent or abusive call is impending, he can also apply for an injunction against the beneficiary restraining him from making a demand on the guarantee.<sup>43</sup> A few cases, such as *Themehelp Ltd v West and Others*<sup>44</sup> and *Kvaerner John Brown v Midlands Bank Plc*<sup>45</sup> concerned successful attempts made by the principal to obtain an injunction to prevent the beneficiary from making a fraudulent demand. Where a principal becomes aware that the beneficiary has made a fraudulent or abusive call on the demand guarantee, the principal may also choose to seek an injunction restraining the beneficiary from receiving payment.<sup>46</sup>

When a principal applies for injunctions in these circumstances, it does not carry any risk that the bank's reputation will be damaged. However, so far there have been no relevant reported cases where a principal has applied for an injunction preventing a beneficiary from receiving payment.<sup>47</sup> *Themehelp Ltd v West and Others*<sup>48</sup> and *Kvaerner John Brown v*

<sup>43</sup> *Hamzeh Malas and Sons v British Imex Industries Ltd* [1958] 2 QB 127 (QB) ([1958] 1 All ER 262 (QB) and [1958] 2 WLR 100 (QB)); and *Deutsche Ruckversicherung AG v Walbrook Insurance Co Ltd and Others; Group Josi Re (formerly known as Group Josi Reassurance SA) v Walbrook Insurance Co Ltd and Others* [1994] 4 All ER 181 (QBD) are examples where applicants of letters of credit were unsuccessful in obtaining injunctions against the beneficiaries.

<sup>44</sup> [1996] QB 84 (CA) ([1995] All ER 215 (CA) and [1995] 3 WLR 751 (CA)). An earlier case dealing with a similar issue was *Elian and Rabbath (trading as Elian & Rabbath) v Matsas and Matsas; JD McLaren and Co Ltd; and Midland Bank Ltd* [1966] 2 Lloyd's Rep 495 (CA). Here the principal of a (ordinary bank) guarantee also attempted to only restrain the beneficiary or their agents from making a demand under the guarantee. Here the validity of the guarantee was disputed, though not apparently on grounds of fraud. The court of first instance granted an interlocutory injunction. The beneficiaries and their agents appealed, but the Court of Appeal dismissed their appeal and confirmed the injunction. The injunction had been granted on the ground that the beneficiary/shipowner had refused to release the goods, which he had promised to do in consideration of the principal/shipper putting up the guarantee. The Court of Appeal indicated that this was a special case in which an injunction should have been granted (see at 497).

<sup>45</sup> [1998] CLC 446.

<sup>46</sup> See Ndekugri *op cit* note 36 at 433.

<sup>47</sup> However, such applications were instituted in other common law jurisdictions, like Singapore and Malaysia. In *Kvaerner Singapore Pte Ltd v UDL Shipbuilding (Singapore) Pte Ltd* (1993) 3 SLR 350, the Singapore High Court granted an injunction restraining the beneficiaries of a demand guarantee (i.e., performance guarantee), who had failed to perform a condition precedent of the underlying contract, from calling on the guarantee. In *Esso Petroleum Malaysia Inc v Kago Petroleum Sdn Bhd* (1995) 1 MLJ 149 (Supreme Court (Kuala Lumpur)), a Malaysian case, the availability of an injunction to restrain the beneficiary from receiving any money under the demand guarantee (i.e., performance guarantees) was also considered. In this case, the principal obtained an *ex parte* injunction restraining the beneficiary from receiving payment under the guarantee. The principal alleged a breach of the underlying contract by the beneficiary. The High Court of Kuala Lumpur confirmed the injunction, but it was later set aside by the Supreme Court of Kuala Lumpur on the grounds that such an injunction based on the allegation of breach of the underlying contract would subvert the commercial value of demand guarantees. See also Ndekugri *op cit* note 36 at 433; and I Ndekugri 'Performance Bonds and Guarantees in Construction Contracts: A Review of Some Recurring Problems' (1999) 16 *International Construction Law Review* 294 at 307–308.

<sup>48</sup> [1996] QB 84 (CA) ([1995] All ER 215 (CA) and [1995] 3 WLR 751 (CA)) (for a discussion of this case, see paras 5.4.1, 5.4.2, and 5.4.5 in Chapter 5). There are also earlier cases suggesting the availability of injunctions to restrain beneficiaries from making a demand under a demand guarantee, they include: *Elian and Rabbath v Matsas and Matsas supra* note 44; *Howe Richardson Scale Co Ltd v Polimex-Cekop and National Westminster Bank Ltd* [1978] 1 Lloyd's Rep 161 (CA); and *Intraco Ltd v Notis Shipping Corporation (The 'Bhoja Trader')* [1981] 2 Lloyd's Rep 256 (CA). In *Elian and Rabbath v Matsas and*

*Midlands Bank Plc*<sup>49</sup> concern successful attempts made by the principal to obtain an injunction to prevent the beneficiary from making a demand.

In *Themehelp Ltd v West and Others* the Court of Appeal decided that in appropriate circumstances the court may issue an interim injunction against the calling of a demand guarantee by a beneficiary.<sup>50</sup> It was contended on behalf of the beneficiary of the guarantee that the remedy was incompetent – that in the context of the fraud exception the only possible injunction is against both the guarantor and the beneficiary *after* presentation of the notice of default (i.e., the required demand document). Therefore, to allow an injunction against the beneficiary alone prior to presentation of the notice ‘would be to deprive the guarantor of the right which the law accords to it of appraising the element of fraud for itself’ and would be an ‘unwarranted invasion of the integrity of a performance guarantee’.<sup>51</sup> Evans LJ, who delivered the minority judgment, supported this argument,<sup>52</sup> but it was rejected by the majority and in this regard Waite LJ stated:<sup>53</sup>

The assumption upon which this argument proceeds is that the autonomy of a performance guarantee is threatened if the beneficiary is placed under a temporary restraint from enforcing it. That is not an assumption, however, which appears to me to have any validity. In a case where fraud is raised between the parties to the main transaction at an early stage, before any question of the enforcement of the guarantee, as between the beneficiary and the guarantor, has yet arisen at all, it does not seem to me that the slightest threat is involved to the autonomy of the performance guarantee if the beneficiary is enjoined from enforcing it in proceedings to which the guarantor is not a party.

From case law and legal writing it might appear that English courts have taken a different approach in letter of credit cases where the applicant takes an action against the issuer (bank) for an injunction preventing it from honouring a letter of credit from cases where the beneficiary takes an action against the issuer for wrongful dishonour or cases where the applicant takes an action against the beneficiary to prevent him from demanding payment.<sup>54</sup>

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*Matsas* the principal of a (ordinary bank) guarantee also attempted to only restrain the beneficiary or their agents from making a demand under the guarantee. Here the validity of the guarantee was disputed, though not apparently on grounds of fraud. The court of first instance granted an interlocutory injunction. The beneficiaries and their agents appealed, but the Court of Appeal dismissed their appeal and confirmed the injunction. The injunction had been granted on the ground that the beneficiary/shipowner had refused to release the goods, which he had promised to do in consideration of the principal/shipper putting up the guarantee. The Court of Appeal indicated that this was a special case in which an injunction should have been granted (see at 497). In *State Trading Corpn of India Ltd v ED and F Man (Sugar) Ltd and ANR* [1981] Com LR 235 (CA), the Court of Appeal refused to maintain an injunction to restrain the beneficiary of a performance guarantee from giving notice of default to the bank, despite the default being in dispute.

<sup>49</sup> [1998] CLC 446.

<sup>50</sup> See also Ndekugri *op cit* note 36 at 434.

<sup>51</sup> [1996] QB 84 (CA) at 98F.

<sup>52</sup> See at 98.

<sup>53</sup> At 98 H–99A. See also *Hugo: The Law Relating to Documentary Credits op cit* note 9 at 279.

<sup>54</sup> This seems to have been implied in *Discount Records Ltd v Barclays Bank Ltd* [1975] 1 Lloyd’s Rep 444 (Ch D) ([1975] 1 WLR 315 and [1975] 1 All ER 1071) at 447, a case where the applicant applied for an injunction preventing the issuer (bank) from paying under a letter of credit. It also seems that Goode supports this view (see R M Goode ‘Reflections on Letters of Credit – I’ [1980] *Journal of Business Law* 291 at 294; and see also Xiang Gao *The Fraud Rule in the Law of Letters of Credit: A Comparative Study* (2002) at 51).

In *Group Josi Re v Walbrook Insurance Co Ltd and Others*<sup>55</sup> the applicant applied for an injunction to restrain the beneficiary from presenting documents under a letter of credit. Here it was argued that different principles applied where the injunction sought would merely prevent presentation (i.e., demand payment) and would not interfere with the obligation of a bank to make payment. The Court of Appeal rejected this argument, and referred to *Dong Jin Metal Co Ltd v Raymet Ltd*, an unreported case, where the Court of Appeal found that there was therefore no distinction to be drawn between cases where it was sought to restrain the beneficiary and cases where it was sought to restrain the bank.<sup>56</sup>

When dealing with demand guarantees, the opinion was expressed that different principles apply to demand guarantees, because there was an important distinction between an injunction preventing the beneficiary thereof making a demand in the requisite form and an injunction preventing the bank from paying where a demand was made.<sup>57</sup> *Themehelp v West* involved such an action by the principal against the beneficiary's demand for payment under a demand guarantee.<sup>58</sup> However, Rix J in *Czarnikow-Rionda Sugar Trading Inc v Standard Bank London Ltd and Others*<sup>59</sup> doubted that such a distinction existed. He held that the judgment of *Themehelp v West* was based either on a genuine distinction that the claim was made against the beneficiary alone at an early stage, well before the question of enforcement of the demand guarantee arose, or on the basis of a wrong concession made that a claim against the beneficiary, as opposed to against the bank, was not covered by prior authority (case law).<sup>60</sup>

However, as the number of cases in which the fraud exception (or even other exceptions) has been applied is very limited, it is too soon to draw such conclusions.<sup>61</sup> There also appears to be conflicting views on whether or not a distinction should be made in the different situations and therefore it still remains a debatable issue.

#### 7.2.4 Interim Injunctions and the Balance of Convenience

A major factor that limits the availability of, for example, the fraud exception is the high standard of proof that is required.<sup>62</sup> For the exception to apply, the evidence of fraud must

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For a full discussion of this issue, see para 5.4.5 in Chapter 5. However, it appears that no such distinction has been made in the United States (see also Xiang Gao *op cit* note 54 at 51). For a discussion of what the position in the United States is, see para 5.5.6 in Chapter 5.

<sup>55</sup> [1996] 1 Lloyd's Rep 345 (CA) ([1996] 1 WLR 1152 and [1996] 1 All ER 791).

<sup>56</sup> See *Group Josi Re v Walbrook Insurance Co Ltd and Others* [1996] 1 Lloyd's Rep 345 (CA) at 351 and the full reference to *Dong Jin Metal Co Ltd v Raymet Ltd*. See also Warne and Elliott *op cit* note 20 at 268–269. Other commentators have also said that the distinction is an impossible one (see Warne and Elliott *op cit* note 20 at 269).

<sup>57</sup> Such a distinction was also implied in *Royal Design Studio Pte Ltd v Chang Development Pte Ltd* (1991) 2 MLJ 229, an earlier Singaporean case.

<sup>58</sup> This view that different principles apply depending on the circumstances has been supported by Lords Justices Balcombe and Waite in the *Themehelp v West* [1996] QB 84 (CA) ([1995] All ER 215 (CA) and [1995] 3 WLR 751 (CA)), and to a very limited extent also by Lord Justice Evans.

<sup>59</sup> [1999] Lloyd's Rep Bank 197 ([1999] 2 Lloyd's Rep 187) at 202.

<sup>60</sup> See also Warne and Elliott *op cit* note 20 at 269.

<sup>61</sup> See Xiang Gao *op cit* note 54 at 51.

<sup>62</sup> See Penn *op cit* note 17 at 228.

be clear or obvious.<sup>63</sup> This requires that at an interim (pre-trial) stage the claimant must show that there is a real prospect of establishing that on the material available the ‘only realistic inference to draw is that of fraud’.<sup>64</sup> A mere allegation of fraud is not enough, nor is it enough to show that there is good reason to suspect fraud. Proving established fraud under the English law is extremely difficult to do.<sup>65</sup> As the burden of establishing fraud is so high and the reluctance of the court to issue injunctions in such cases is so great, it is in practice nearly impossible for a principal to prevent payment on the ground of fraud.<sup>66</sup>

In deciding whether or not to grant an interim injunction, the courts also apply the ‘balance of convenience test’.<sup>67</sup> This test was formulated in detail by the House of Lords in *American Cyanamid Co v Ethicon Ltd*.<sup>68</sup> The House of Lords stated that unless the material available to the court at the hearing of the application for an interim 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 favour of granting or refusing the interim (interlocutory) relief that is sought. In this regard the governing principle is that the court should in the first place 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 the trial. If damages in the measure recoverable at the English common law would be an adequate remedy and the defendant would be in a financial position to pay them, no interim injunction should generally be granted, however strong the claimant’s claim appeared to be at that stage. Conversely, if damages would not provide an adequate remedy for the claimant in the event of him succeeding at the trial, then the court should 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

<sup>63</sup> See paras 5.4.1 and 5.4.3 in Chapter 5.

<sup>64</sup> See *United Trading Corporation v Allied Arab Bank* [1985] 2 Lloyd’s Rep 554 (CA) at 561.

<sup>65</sup> See *Penn op cit* note 17 at 228; and *Coleman op cit* note 2 at 234.

<sup>66</sup> See *Coleman op cit* note 2 at 234.

<sup>67</sup> In *R D Harbottle (Mercantile) Ltd v National Westminster Bank Ltd and Others* [1978] 1 QB 146 (CA) ([1977] 2 All ER 862 (CA)), the court clearly illustrated how difficult it was to obtain an interim injunction against a bank (at 155A–D):

The plaintiffs then still face what seems to me to be an insuperable difficulty. They are seeking to prevent the bank from paying and debiting their account. It must then follow that if the bank pays and debits the plaintiffs’ account, it is either entitled to do so or not entitled to do so. To do so would either be in accordance with the bank’s contract with the plaintiffs or a breach of it. If it is in accordance with the contract, then the plaintiffs have no cause of action against the bank and, as it seems to me, no possible basis for an injunction against it. Alternatively, if the threatened payment is in breach of the contract, which the plaintiff’s writs do not even allege and as to which they claim no declaratory relief, then the plaintiffs would have good claims for damages against the bank. In that event the injunctions would be inappropriate, because they interfere with the bank’s obligations to the Egyptian banks, because they might cause greater damage to the bank than the plaintiffs could pay on their undertaking as to damages, and because the plaintiffs would then have an adequate remedy in damages. The balance of convenience would in that event be hopelessly weighted against the plaintiffs.

<sup>68</sup> [1975] AC 396 (HL) ([1975] 1 All ER 504 (HL)). For a detailed discussion of this case, see *Prest op cit* note 4 at 81–102.

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. Therefore, 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 interim injunction.<sup>69</sup>

Before the *American Cyanamid Co v Ethicon Ltd* case, the view was that when dealing with an interim injunction, the applicant first had to satisfied the 'threshold' test – proof of at least a *prima facie* right, before the court would apply its mind to the balance of convenience.<sup>70</sup> However, in *American Cyanamid Co v Ethicon Ltd* the House of Lords stated what the principles are that should govern the granting of interim injunctions. Lord Diplock discarded the requirement of a *prima facie* right as threshold for applying the balance of convenience. The only threshold recognised in Lord Diplock's speech is that the claim must not be frivolous or vexatious, in other words, that there must be a serious question to be tried.<sup>71</sup> Instead, the House of Lords stressed the requirement that the balance of convenience should favour the plaintiff. In other words, the fundamental question is whether more harm would be done by refusing or granting the injunction. If the refusal of the injunction would be more harmful, the injunction will be granted.<sup>72</sup> Therefore, under the English law, it must firstly be established that there is a threatened or an apprehended injury; then, that there is a serious question to be tried; and lastly, where the balance of convenience then lies. The requirement of a serious question to be tried is not the same as that of *prima facie* right, although the court must be satisfied that the claim is not frivolous or vexatious.<sup>73</sup>

From this it follows that, in principle, the principal (i.e. applicant) needs to show that<sup>74</sup>

- there is a serious issue to be tried between the parties which means that his case on the merits has reasonable prospects of success;
- damages would not be an adequate remedy; and
- the balance of convenience favours the granting of the injunction.

An instant problem for any principal/applicant seeking to restrain the guarantying/issuing bank from making a payment under a demand guarantee/letter of credit is that the balance of convenience will almost always favour a refusal of the injunction. The bank will have been informed of all the facts on which the beneficiary/applicant relies in order to bring the fraud exception into effect, and *ex hypothesis*, will have refused to apply the fraud exception, because otherwise the beneficiary/applicant would not need to apply to the court for an injunction. In such circumstances the beneficiary/applicant will only incur a financial loss if payment is made by the guarantying/issuing bank, and it subsequently turns out at trial that such payment was wrongful. Such a loss can clearly be compensated for in damages and there will seldom be any doubt regarding the solvency of the bank.<sup>75</sup>

<sup>69</sup> See [1975] AC 396 (HL) at 408A–E; and cf Warne and Elliott *op cit* note 20 at 270–271.

<sup>70</sup> See Hugo: *The Law Relating to Documentary Credits op cit* note 9 at 319; and Prest *op cit* note 4 at 57.

<sup>71</sup> [1975] AC 396 (HL) at 407 F–G.

<sup>72</sup> See also Hugo: *The Law Relating to Documentary Credits op cit* note 9 in note 156 at 278.

<sup>73</sup> See Harms: *The Law of South Africa op cit* note 7 in para 316 at 292 and the *authorities* cited.

<sup>74</sup> See Clark *op cit* note 16 in para 30 at 10.

<sup>75</sup> See Warne and Elliott *op cit* note 20 at 271.

However, Lord Diplock stated in *American Cyanamid Co v Ethicon Ltd*<sup>76</sup> that there may be many other special factors that one should take into consideration in the particular circumstances of each case. Demand guarantees and letters of credit may well be an example of exceptional cases that fall outside the ordinary balance of convenience test. However, in the unreported case of *Dong Jin Metal Co Ltd v Raymet Ltd*,<sup>77</sup> which was cited with approval in *Group Josi Re v Walbrook Insurance Co Ltd and Others*,<sup>78</sup> the court said that it preferred the view that the letter of credit cases were special cases within the *American Cyanamid* guidelines, because of the special factors that applied in such cases.

## 7.2.5 Freezing Injunctions (*Mareva* Injunctions)

### 7.2.5.1 Introduction

The discussions in earlier chapters<sup>79</sup> have shown how difficult it is for a principal/applicant of a demand guarantee/letter of credit to prevent the beneficiary of the guarantee/credit successfully from making a fraudulent or otherwise abusive demand. In terms of the independence principle, if there are disputes between the principal and the beneficiary regarding the underlying contract, they should sort that out in separate proceedings based on their underlying contract and in terms of the law of contract. Although this course of action is available in theory, there is always the risk that the beneficiary may frustrate execution of the judgment under the separate proceedings, even if the court decides for the principal. A beneficiary can do this by either dissipating his assets that are in the jurisdiction of the court or by removing them from the jurisdiction.<sup>80</sup>

A freezing injunction (previously known as a *Mareva* injunction)<sup>81</sup> is an interim (i.e., provisional) order of the court that prevents a defendant (often the beneficiary of the demand guarantee/letter of credit) from dealing with, disposing of, or diminishing, the value of either the whole or a particular part of his assets or money pending the resolution of the substantive court process.<sup>82</sup> A freezing order normally also compels the defendant to

<sup>76</sup> [1975] AC 396 (HL) at 409C.

<sup>77</sup> Unreported, 13 July 1993 (CA) (LEXIS), as quoted in Warne and Elliott *op cit* note 20 at 271.

<sup>78</sup> [1996] 1 Lloyd's Rep 345 (CA) at 361.

<sup>79</sup> See also para 5.4 in Chapter 5 and para 6.2 in Chapter 6.

<sup>80</sup> See Ndekugri *op cit* note 36 at 434.

<sup>81</sup> After the case of *Mareva Compania Naviera SA v International Bulkcarriers SA* [1975] 2 Lloyd's Rep 509 (CA) ([1980] 1 All ER 213 (CA)) these injunctions became known as *Mareva* injunctions (for a full discussion, see W Faul and F R Malan 'The Mareva Injunction' (1990) 2 *South African Mercantile Law Journal* 305). However, when the Civil Procedure Rules of 1998 came into force *Mareva* injunctions became known as 'freezing injunctions' (see rule 25.1(1)(f) of the Civil Procedure Rules of 1998). Therefore, the juridical basis for the freezing order is now provided for by legislation. For a full discussion of the development and early workings of the *Mareva* injunction, see Faul and Malan *op cit* note 81. See also C Schulze *On Jurisdiction and the Recognition and Enforcement of Foreign Money Judgments* (2005) in note 80 at 85.

<sup>82</sup> See Gee *op cit* note 17 in para 3.001 at 77; Jack *op cit* note 12 in para 9.64 at 296; and Schulze *op cit* note 81 in note 80 at 85. A freezing order was first recognised in England in 1975 (see *Nippon Yusen Kaisha v Karageorgis and Another* [1975] 2 Lloyd's Rep 137 (CA) ([1975] 3 All ER 82 and [1975] WLR 1093); and *Mareva Compania Naviera SA v International Bulkcarriers SA* [1975] 2 Lloyd's Rep 509 (CA) ([1980] 1 All ER 213 (CA)); and for a historical discussion, see Faul and Malan *op cit* note 81). For a full discussion of freezing injunctions, see Warne and Elliott *op cit* note 20 at 81–92; Gee *op cit* note 17; L Katz 'Asset

provide documents and information about his assets.<sup>83</sup> A freezing injunction can be granted either before or after a judgment has been given by a court; in the latter case to assist in the enforcement of that judgment. A freezing injunction is intended to maintain the *status quo* between the parties and to make sure that a subsequent or existing order of the court is not rendered nugatory. Its aim is not to incorporate any final view of the court as to the ultimate merit of the claimant's claim (except to the extent that the claimant must have satisfied the court that it has a good arguable case, see discussion below). Furthermore, it is apparent from case law that the aim of such an injunction is not to place the claimant in the position of a secured creditor,<sup>84</sup> nor does it provide the claimant with any pre-action security, nor is it to be used to put pressure on the defendant to secure the claimant's claim once proceedings are taking place.<sup>85</sup> The freezing injunction merely aims to prevent the defendant from disposing of his assets, otherwise than allowed for by the order, pending the final outcome of the claim.<sup>86</sup> The main sanction against failure to comply with a freezing order is contempt of court proceedings leading to monetary fines and/or even imprisonment.<sup>87</sup>

The claimants see the freezing order as a highly effective offensive weapon to put pressure on the defendants, whereas most defendants see it as an unjustified and premature interference with their personal affairs before the claimant has succeeded in his claim by obtaining judgment and, if an injunction has been obtained without notice, before the defendant has even had an opportunity to put his side of the case regarding the claimant's claim.<sup>88</sup>

Banks dealing with freezing orders granted against their customers need to be aware of the sensitivities, as far as possible, when dealing with such orders. In addition to this, banks will also wish to protect themselves against the possibility of exposure to proceedings for contempt of court, or to liability in negligence for damages.<sup>89</sup>

### 7.2.5.2 *General Principles of Freezing Injunctions*

A freezing injunction can apply to the defendant's assets that are within the court's jurisdiction and, occasionally in exceptional circumstances also to those that are outside

Tracing: Getting Evidence and Injunctive Relief' (March 2008) *Newsletter of the Association of Insolvency Practitioners of Southern Africa* 10; and Prest *op cit* note 4 at 105–120.

<sup>83</sup> See D A Crerar 'Mareva Freezing Orders and Non-party Financial Institutions: A Practical Guide' (2006) 21 *Banking and Finance Law Review* 169 at 169.

<sup>84</sup> See *Derby v Weldon (Nos 3 & 4)* (1990) Ch 65 ((1989) WLR 412). See also Gee *op cit* note 17 in para 3.001 at 77.

<sup>85</sup> See *Cretanor Maritime Co Ltd v Irish Marine Management Ltd (The Cretan Harmony)* [1978] 3 All ER 164.

<sup>86</sup> See Ndekugri *op cit* note 36 at 434; Warne and Elliott *op cit* note 20 at 82; and Gee *op cit* note 17 in para 3.001 at 78.

<sup>87</sup> See also Ndekugri *op cit* note 36 at 434; and I Ndekugri 'Performance Bonds and Guarantees in Construction Contracts: A Review of Some Recurring Problems' (1999) 16 *International Construction Law Review* 294 at 310.

<sup>88</sup> See Warne and Elliott *op cit* note 20 at 82. See also Gee *op cit* note 17 in para 3.001 at 78.

<sup>89</sup> See Warne and Elliott *op cit* note 20 at 82; and Crerar *op cit* note 83 at 171–172.

it.<sup>90</sup> The availability of the alleged ‘worldwide’ freezing injunction is recognised in rule 25.1(1)(f) of England’s Civil Procedure Rules, which provides that the court may grant an order (1) restraining a party from removing from the jurisdiction assets located there; or (2) restraining a party from disposing of, dealing with, or diminishing the value of any assets, whether located within the jurisdiction or not.<sup>91</sup> However, the courts are extremely reluctant to grant such a freezing order in respect of the proceeds of a demand guarantee/letter of credit payable abroad.<sup>92</sup>

However, a freezing order will normally not prevent a third party (e.g., the bank of the defendant) from complying with what it reasonably believes to be its obligations, contractual or otherwise, under the laws and obligations of a country or a state in which those assets are situated. The English Court of Appeal has expressed the view that an express provision to this effect (known as the ‘Baltic provision’) should be included in a freezing order, unless inappropriate.<sup>93</sup> Therefore, if a freezing order does not contain such a provision and a third-party bank receiving notice of it is likely to be so affected, it should apply to the court to change the order.<sup>94</sup>

A freezing injunction is normally expressed to apply to all of the defendant’s assets, whether they are solely or jointly owned. It will also normally specify categories of assets of which the claimant is aware. For the purpose of the order, the defendant’s assets may be defined in extremely wide terms, so as to include any asset that the defendant has the power, directly or indirectly, to dispose of or deal with as if it were his own, including assets held by a third party in accordance with the defendant’s direct or indirect instructions.<sup>95</sup> However, such an order will not have an effect on assets to which the defendant is not beneficially entitled, whether or not these are held in the defendant’s name.<sup>96</sup>

The freezing order will most often also cover the assets held by banks for the defendant. In such cases, it is standard practice for a claimant to serve a copy of the injunction on a bank at which the claimant knows the defendant has an account. He may also serve the order on a bank at which he only suspects the defendant to hold an account, or which he suspects

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<sup>90</sup> See *Z Ltd v A-Z and AA-LL* [1982] 1 QB 558 (CA) ([1982] 1 All ER 556); *Babanaft International Co SA v Bassatine* [1990] Ch 13 and *Derby v Weldon (Nos 3 & 4)* *supra* note 84. See also *Jack op cit* note 12 in paras 9.64–9.65 at 296–297.

<sup>91</sup> The standard order annexed to Practice Direction 25 contains alternative paragraphs for domestic and worldwide injunctions.

<sup>92</sup> See *Intraco Ltd v Notis Shipping Corporation* [1981] 2 Lloyd’s Rep 256 (CA); *Potton Homes Ltd v Coleman Contractors Ltd* (1984) 28 BLR 19 (CA); and *Derby v Weldon (Nos 3 & 4)* *supra* note 84. In *Intraco Ltd v Notis Shipping Corporation* it was established that the proceeds of a documentary credit/demand guarantee could not be frozen by way of a freezing order if the obligation to pay of the bank was not to pay in England but overseas. See also N Enonchong ‘The Problem of Abusive Calls on Demand Guarantees’ (2007) *Lloyd’s Maritime and Commercial Law Quarterly* 83 at 88; and *Jack op cit* note 12 in para 9.65 at 297.

<sup>93</sup> See *Bank of China v NBM LLC* [2002] 1 WLR 844 ([2002] 1 All ER 717). As a result of this Court of Appeal judgment, the standard form of order has been amended to include the Baltic provision (derived from the case of *Baltic Shipping Company v Translink Shipping Limited* [1995] 1 Lloyd’s Rep 673).

<sup>94</sup> See *Warne and Elliott op cit* note 20 at 83; and *Gee op cit* note 17 in paras 3.003–3.004 at 80.

<sup>95</sup> A provision which has this effect is included in the standard form of order.

<sup>96</sup> See *Warne and Elliott op cit* note 20 at 83; and *Gee op cit* note 17 at 83–90.



may hold assets falling within the wide definition of assets (as referred to above), together with a request that the bank carries out a search for assets that may fall in the injunction.<sup>97</sup>

In order to obtain a freezing injunction, a claimant will need to prove to the court the following:<sup>98</sup>

1. an accrued cause of action against the defendant;<sup>99</sup> and that he has a ‘good arguable case’ in the proposed action against the defendant (obviously not applicable to applications made after judgment);<sup>100</sup>
2. a real risk that any judgment of the court will go unsatisfied by reason of the defendant dissipating or disposing of his assets, thereby frustrating execution of judgment;<sup>101</sup> and
3. that it will be just and convenient in all circumstances for the court to grant the injunction.<sup>102</sup>

Most freezing injunctions are granted at a very early stage in a possible action, often even before service of the Claim Form or Particulars of Claim. However, they can be granted at any time, even, as mentioned above, after judgment, or on registration of a foreign judgment or arbitration award, in support of enforcement, where a party has grounds for suspecting the probable dissipation of assets by the defendant.<sup>103</sup>

### **7.2.5.3 Freezing Injunctions Granted Against a Bank’s Customer in the Context of a Civil Claim Against that Customer**

As most defendants have bank accounts that will be covered by freezing injunctions, specific attention is given to the common situations in which banks are served with, or become involved in, these injunctions and the specific points that banks should be aware of and the actions they can and should take in such situations.<sup>104</sup>

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<sup>97</sup> See Warne and Elliott *op cit* note 20 at 83.

<sup>98</sup> It would seem that the standard of proof is likely to be lower than that required for an injunction restraining an initial claim or payment by the bank. However, in practice a freezing order will still be rather tricky to enforce if it involves an overseas beneficiary claiming under a demand guarantee issued by a bank outside the jurisdiction (see Coleman *op cit* note 2 at 241.)

<sup>99</sup> See *Siskina (Owners of Cargo Lately Laden on Board) and Others v Distos Compania Naviera SA* [1979] AC 210 (HL) at 256; and *Veracruz Transportation Inc v VC Shipping Co Inc and Den Norske Bank A/S, The Veracruz* [1992] 1 Lloyd’s Rep 353.

<sup>100</sup> See *Ninemia Maritime Corp v Trave Schiffahrtsgesellschaft mbH, KG (The Niedersachsen)* (1983) 1 WLR 1412.

<sup>101</sup> See *Third Chandris Shipping Corporation v Unimarine SA* [1979] 1 QB 645 (QB).

<sup>102</sup> See section 37(1) of the United Kingdom Supreme Court Act of 1981. See also Warne and Elliott *op cit* note 20 at 84; Ndekugri *op cit* note 36 at 434; and I Ndekugri ‘Performance Bonds and Guarantees in Construction Contracts: A Review of Some Recurring Problems’ (1999) 16 *International Construction Law Review* 294 at 310.

<sup>103</sup> See also D Warne and N Elliott *Banking Litigation* 2 ed (2005) at 84; and Gee *op cit* note 17 at 77 and 95–96.

<sup>104</sup> See *Z Ltd v A-Z and AA-LL* [1982] 1 QB 558 (CA) ([1982] 1 All ER 556) where the Court of Appeal fully considered the problems that are caused for banks by freezing injunctions. For a full discussion of this, see also Crerar *op cit* note 83.

In practice, a copy of the freezing injunction is served on the bank in England. If an asset is covered by the terms of the injunction, a third party who holds the assets and knows of the injunction (e.g., the bank of the defendant) must do what it reasonably can to preserve the asset and must not assist in any way in the disposal thereof. It should rather keep the asset pending a further order.<sup>105</sup>

This is to make sure that the order of court is complied with and to provide a practical way to prevent the defendant, who will often be accused of dishonesty in the substantive proceedings, from merely disregarding the court order and disposing of his assets. In fact, the receipt by a bank of notice of a freezing order affecting a customer's account automatically revokes the mandate with regard to the amount that is frozen in that customer's account: such receipt may therefore revoke the customer's instructions in relation to that account. Therefore, a bank must be careful to avoid honouring payment instructions from the defendant where that would amount to a breach of the order. The bank's defence to a claim by the customer for dishonouring a cheque will either be that the freezing order makes honouring illegal (and a contract authorising such conduct is unenforceable); or alternatively that the customer has only authorised the bank to do what it is lawful for the bank to do and the injunction makes it unlawful.<sup>106</sup>

The freezing injunction should provide as much detail as possible as to the assets that it is intended to cover. If the claimant knows of the existence of specific assets (e.g., bank accounts) the order should refer to them with as much clarity as possible. The aim is to make the meaning of the order clear to all who are affected by the order, including third parties who may be required to comply with the order, and to make it more difficult for the defendant to avoid contempt of court proceedings, if he intends to breach the order.<sup>107</sup>

Therefore, when a bank is faced with a freezing injunction, it is important that it should establish with clarity how it intends to proceed in connection with the injunction and should do this if necessary by clarifying matters either with the claimant or with the court. Until such clarification is obtained, the bank should obviously take care to make sure that it complies fully with the injunction in the meantime. Generally, problems arise because of a lack of clarity in the terms of the injunction that has been applied for, and obtained. In particular, severe problems can arise in circumstances where a general prohibition is made against the defendant, but where it is wholly impractical or even impossible for a third-party bank to know whether a particular request of its customer regarding a particular asset held with that bank constitutes a breach of the general prohibition. This is why the bank should in such circumstances clarify the matter either with the claimant or the court.<sup>108</sup>

Banks are well aware of the possibility of contempt proceedings that may be instituted against them (as a third party) if they knowingly assist a defendant in breaching a freezing injunction. The aim of such proceedings would not be to compensate any particular party

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<sup>105</sup> See *Z Ltd v A-Z and AA-LL* [1982] 1 QB 558 (CA) ([1982] 1 All ER 556) at 572H and 574F. See also Warne and Elliott *op cit* note 20 at 84–85; and Gee *op cit* note 17 at 80–81.

<sup>106</sup> See *Z Ltd v A-Z and AA-LL* [1982] 1 QB 558 (CA) ([1982] 1 All ER 556) at 574A–C. See also Warne and Elliott *op cit* note 20 at 85; and Crerar *op cit* note 83 at 171–173.

<sup>107</sup> See Warne and Elliott *op cit* note 20 at 85; and Gee *op cit* note 17 in para 4.001 at 111 and para 4.006 at 115.

<sup>108</sup> See Warne and Elliott *op cit* note 20 at 85–86.

for loss suffered as a result, but to impose sanctions on the guilty third party for its role in a failure to comply with a court order.<sup>109</sup>

Until recently there has been no authority on whether a bank could be held liable in tort to a claimant if the bank failed to take reasonable care that funds of a person whose account has been frozen pursuant to a freezing injunction were not dissipated in breach of that order. In *Commissioners of Customs and Excise v Barclays Bank Plc*<sup>110</sup> the Court of Appeal held, as a preliminary issue, that as soon as the bank was served with a freezing injunction it has the duty to take reasonable care that the funds of the person whose account has been frozen in terms of the injunction were not dissipated in breach of this order. However, the House of Lords gave the bank (i.e., Barclays Bank) permission to appeal. The House of Lords<sup>111</sup> then unanimously held that the bank was not obliged to take reasonable care to comply with two freezing orders that had been issued and did not owe a duty to the beneficiary of those orders (i.e., claimant). So far this is the only decision delivered by the House of Lords on the issue of a bank's separate duty in tort to beneficiaries of freezing orders.<sup>112</sup>

The standard form of freezing order will generally cover joint bank accounts held in the name of the defendant and other people (usually a spouse). The injunction attaches to the joint account and will normally prohibit dealing with it. The non-defendant will obviously be able to apply to a court to enable him or her (depending on which spouse) to continue to use the joint account for other purposes or alternatively to apply for his or her share of the account to be paid over to him or her free from the injunction. It often happens that joint bank accounts are used by spouses to pay ordinary living expenses. In such situations, there should normally be an express exception in the injunction allowing such expenses.<sup>113</sup>

Normally, the freezing order will specify an amount that is to be allowed for the ordinary living expenses and an account from which they should be paid. Furthermore, the order may also specify a figure below which dealings and disposals by the defendant do not constitute a breach of the order. These two types of provisions in orders can considerably alleviate the positions of the defendant and the bank in terms of compliance with and monitoring compliance with the order.<sup>114</sup>

A defendant will be entitled to settle legal and other related expenses incurred in defending the substantive claim. Therefore, a defendant will not be restrained from incurring *bona*

<sup>109</sup> See Warne and Elliott *op cit* note 20 at 87. See also Crerar *op cit* note 83 at 172.

<sup>110</sup> [2005] 1 Lloyd's Rep 165 (CA) ([2004] EWCA Civ 1555). For a discussion of this judgment by the Court of Appeal, see Crerar *op cit* note 83 at 184–188.

<sup>111</sup> See *Customs and Excise Commissioners v Barclays Bank Plc* [2006] 2 Lloyd's Rep 327 (HL) ([2006] 4 All ER 256 (HL)). For a full discussion of this case, see R Huang 'The House of Lords Concludes that Bank Owes No Duty of Care to the Beneficiary of Freezing Orders: *Customs and Excise Commissioners v Barclays Bank plc*' (2007) 22 *Banking and Finance Law Review* 449.

<sup>112</sup> See also Warne and Elliott *op cit* note 20 at 87; and Huang *op cit* note 111.

<sup>113</sup> See Warne and Elliott *op cit* note 20 at 88–89; and Gee *op cit* note 17 in paras 3.043–3.046 at 108–110 and para 4.006 at 115.

<sup>114</sup> See Gee *op cit* note 17 in para 4.006 at 115 and para 4.009 at 116–117; and Warne and Elliott *op cit* note 20 at 89.

*fide* legal expenses regarding an action that has a reasonable prospect of success and which was under way when the injunction was granted.<sup>115</sup>

The purpose of the freezing injunction is not to prevent the defendant from carrying out his ordinary *bona fide* business dealings. It is also common practice for a maximum sum to be inserted into a freezing order to ensure that a defendant is not unnecessarily prevented from dealing with his assets over and above a sum which equates to the value of the claimant's claims.<sup>116</sup>

The standard form of a freezing order also provides that the injunction does not prevent any bank from exercising the normal right of set-off it may have regarding any credit facility that it gave to the defendant before it was notified of the order.<sup>117</sup>

Generally, there is no obligation on the part of the bank served with a freezing injunction, to inform the claimant what assets, if any, are held by it and are covered by the injunction. This would constitute a breach of the bank's duty of confidentiality and the bank will be allowed to provide such information if there is a specific order for such disclosure that will override the general duty of confidentiality.<sup>118</sup>

#### **7.2.5.4 Protection for the Bank in the Context of Freezing Injunctions Issued Against its Customers**

To the extent that the defendant's bank is asked to take some form of positive action, the bank's costs should be paid and in so far as such actions expose the bank to liability, the bank is entitled to be indemnified by the claimant.<sup>119</sup> However, courts often require that this protection should be expressed in the order in the form of an undertaking given by the claimant (which is then usually secured in one way or another).<sup>120</sup>

As mentioned above, the standard form of freezing order also allows the bank to exercise such right of set-off as it has.<sup>121</sup>

#### **7.2.5.5 Freezing Injunctions: The Bank as the Defendant**

A freezing injunction will only be granted against a bank in the role of defendant under very exceptional circumstances. In cases where the bank is the defendant, two specific problems in the context of freezing orders arise. In the first place, the fact that a bank's stock-in-trade is money borrowed from depositors means that a freezing order against the bank (except insofar as it permitted dealings with assets in the ordinary course of its

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<sup>115</sup> See Warne and Elliott *op cit* note 20 at 90; and *Jack op cit* note 12 in para 9.64 at 296.

<sup>116</sup> *Idem*.

<sup>117</sup> See Civil Procedure Rules, Pt 25, Practice Direction 13 in para 17. See also Warne and Elliott *op cit* note 20 at 90–91.

<sup>118</sup> See rule 25.1(1)(g) of the Civil Procedure Rules of 1998; and also Warne and Elliott *op cit* note 20 at 91.

<sup>119</sup> It was made clear in *Z Ltd v A-Z and AA-LL* [1982] 1 QB 558 (CA) ([1982] 1 All ER 556) that such protection for the bank is implied by the claimant's request for a freezing injunction affecting the defendant's bank accounts.

<sup>120</sup> See also Warne and Elliott *op cit* note 20 at 91.

<sup>121</sup> *Idem*.

business) would prevent the bank from carrying on its business in the ordinary way. Such an order would prevent the bank from repaying its depositors, create a run on the bank and inhibit the bank from depositing its funds in another country for investment purposes. That is not the aim of a freezing order. In the second place, the other problem is that a bank is fundamentally dependent on the maintenance of the confidence of the bank's customers. Thus, the possibility of a run on the bank would seriously harm such confidence.<sup>122</sup>

Based on the above, the court is reluctant to grant freezing orders against defendant banks. However, that does not mean that such an order would never be granted against a defendant bank.<sup>123</sup>

#### **7.2.5.6 Application of the Freezing Injunction to Demand Guarantees and Letters of Credit**

The application of the freezing injunction in the documentary credit context is explained by Jack as follows:<sup>124</sup>

A buyer who suspects his seller of fraud or simply providing goods which do not fully accord with the contract of sale, may not fancy his chances of enforcing his claim against the seller if the credit is operated and the seller receives the price and is free to do what he likes with it. For the seller may be in a jurisdiction where proceedings against him will be difficult, or he may become insolvent, or disappear. Instead of trying to prevent the bank paying, which even in the case of fraud will face the great difficulties already discussed, the buyer may consider an application for a freezing Mareva injunction. Because the order does not interfere with the operation of the credit, but restrains the use of the proceeds of its operation, the buyer does not have to bring himself within the fraud exception to the autonomy rule to claim a Mareva order. The claim for a Mareva order may be supported by a simple claim by the buyer against the seller for breach of contract.

From the above it is clear that a freezing injunction is an order of the court that has the effect of freezing assets in the hands of the defendant (e.g., beneficiary) or third party (e.g., bank of the defendant) until trial or further order. Wherever a principal of a demand guarantee/applicant of a letter of credit considers using injunctive relief to prevent payment being made under the guarantee/credit, by invoking, for instance, the fraud exception, the question of a freezing order should be considered. *Prima facie* if there is evidence that the presentation/demand under the guarantee/credit is being made fraudulently, then there is likely to be sufficient evidence of a dissipation of assets. In many situations the applicant/principal should make an application for a freezing order as part of an application to restrain payment, or instead of such an application. There are more conceptual difficulties involved in obtaining an injunction to restrain payment than with a freezing order. When applying for a freezing order, the principal/applicant can rely in the context of such proceedings on the underlying contract between himself and the beneficiary. However, a freezing order is not intended to give the claimant security in the event of the insolvency of the defendant (i.e., the beneficiary). So for this reason, there may be

<sup>122</sup> See also Warne and Elliott *op cit* note at 91–92.

<sup>123</sup> See for instance, *Polly Peck International Plc v Nadir (No 2)* [1992] 4 All ER 769, in particular at 786. See also Warne and Elliott *op cit* note 20 at 92.

<sup>124</sup> See Jack *op cit* note 12 in para 9.65 at 296–297.

instances where the principal/applicant is substantially less well protected by obtaining a freezing order than he would be if he could prevent payment being made at all to the beneficiary.<sup>125</sup>

If there is no fraud or other accepted ground to enjoin beneficiary from claiming or receiving payment under a demand guarantee, a freezing order will be the only remedy available to the principal, if he wishes to secure the availability of assets of the beneficiary against which an eventual claim for breach of the underlying contract between him and the beneficiary can be satisfied. It is, of course, also available where fraud is, in fact, involved.<sup>126</sup>

### 7.2.6 Conclusion

As the burden of establishing fraud is so high under English Law and the reluctance of the English courts to issue injunctions in such cases is so great, it is, in practice, nearly impossible for a principal to prevent payment on the basis of fraud. In deciding whether or not to grant an interim injunction, the courts also apply the ‘balance of convenience test’ as it was formulated by the House of Lords in *American Cyanamid Co v Ethicon Ltd.*<sup>127</sup> An instant problem for any principal/applicant seeking to restrain the guarantying/issuing bank from making a payment under a demand guarantee/letter of credit is that the balance of convenience will almost always favour a refusal of the injunction.

Bertrams finds the great reluctance of English courts to allow injunctions against the bank, because they deem that it would interfere with the bank’s independent obligation towards the beneficiary to be rather unconvincing. He points out that it is a well-established rule, also in English case law, that the principle of autonomy allows for an exception in the case of established fraud.<sup>128</sup> Therefore, according to him, English courts should not be so reluctant to issue injunctions in appropriate circumstances.

## 7.3 AMERICAN LAW<sup>129</sup>

A temporary restraining order prohibits the acts complained of until a hearing on whether the claimant (i.e., plaintiff) is entitled to a preliminary injunction. A temporary restraining order may be issued *ex parte*. Such orders are of short duration, generally expiring at the time of the hearing on the preliminary injunction. A preliminary injunction (also called an *injunction pendente lite*) is also temporary in purpose and effect. Whether or not the main action seeks the remedy of permanent injunction, the granting of a preliminary injunction does not mean that the claimant will be entitled to a permanent injunction after a trial on

<sup>125</sup> See Warne and Elliott *op cit* note 20 at 269–270. In *Z Ltd v A-Z and AA-LL* [1982] 1 QB 558 (CA) ([1982] 1 All ER 556) at 574, Lord Denning MR stated that a *Mareva* injunction does not prevent payment under a letter of credit, but may apply to the proceeds as and when they are received by or for the beneficiary.

<sup>126</sup> See A N Oelofse ‘Developments in the Law of Documentary Letters of Credit’ *ABLU* 1996 (a paper delivered at the 1996 Annual Banking Law Update held at the Indaba Hotel, Johannesburg) (unpaginated) (hereinafter ‘*ABLU 1996*’) in note 65 at 11 of the article.

<sup>127</sup> [1975] AC 396 (HL). For a detailed discussion of this case, see Prest *op cit* note 4 at 81–102. See also para 7.2.4 above.

<sup>128</sup> See Bertrams *op cit* note 13 at 418.

<sup>129</sup> See also the discussions in paras 5.5.4 and 5.5.6 in Chapter 5.

the merits. Therefore, the preliminary injunction is merely a provisional remedy to preserve the *status quo* until final judgment. It is based on the claimant's showing that no other remedy will compensate without such immediate, if temporary, relief. Upon final judgment, if a permanent injunction is sought, either a permanent injunction is granted and the preliminary injunction is amalgamated therein, or a permanent injunction is denied and the preliminary injunction stops having any effect.<sup>130</sup>

The possibility of injunctions<sup>131</sup> against the bank in the case of established fraud relating to letters of credit (commercial and standby) has always been recognised in American case law and legal writing.<sup>132</sup>

In the case where a document presented under a letter of credit was forged or fraudulent, or where there was 'fraud in the transaction' the issuing bank could in terms of Prior UCC (i.e., United States Uniform Commercial Code of 1962) article 5 section 5-114(2)<sup>133</sup> dishonour the credit or be enjoined from honouring a letter of credit.<sup>134</sup> Section 5-114(2)(b) spoke only of injunctions against issuers and did not address the case where the applicant of the letter of credit (i.e., customer of the bank also the claimant) sought not to enjoin the issuer from payment, but to enjoin the beneficiary from presenting the documents with a demand for payment. But, apparently, the same principles applied if the applicant sought an injunction against the beneficiary preventing him from receiving payment.<sup>135</sup>

Whenever a court is asked to issue injunctive relief, various factors are examined to determine whether the remedy should be employed. Some of those factors, but not all of them, are applicable to letter of credit transactions.<sup>136</sup> The specific requirements for injunctive relief were not set out in Prior UCC article 5 section 5-114(2)(b). Therefore, it

<sup>130</sup> See B V McCullough *Letters of Credit* (loose-leaf edition) (1987-) in para 5.04[1][c] and the authorities cited.

<sup>131</sup> An injunction is a court order either preventing (prohibitory injunction) or compelling an act (mandatory injunction) (see McCullough *op cit* note 130 at 5-2 and in para 5.04 at 5-16). For a full discussion of the provisional remedies that are available in relation to letters of credit, see McCullough *op cit* note 130 in Chapter 5.

<sup>132</sup> See Bertrams *op cit* note 13 at 415; and J F Dolan *The Law of Letters of Credit: Commercial and Standby Credits* Revised Edition (loose-leaf revised edition) (1996) (hereinafter '*Dolan: The Law of Letters of Credit*') in para 7.04.

<sup>133</sup> For a full discussion of Prior UCC article 5 section 5-114(2), see para 3.4.2 (particularly 3.4.2.2) in Chapter 3 and para 5.5.2.1 in Chapter 5.

<sup>134</sup> However, when California and Nevada incorporated this section into their respective statutes, they omitted that portion which provided that: 'a court of appropriate jurisdiction may enjoin such honor'. Therefore, in those two states, courts could not issue injunctions in the instances of fraud set out by the section (also called the 'California Fraud-Injunction Rule') (for a full discussion of this see McCullough *op cit* note 130 in para 5.04[3][d]; and for an illustration of what the result of this was, see *Agnew v Federal Deposit Insurance Corporation* 548 F Supp 1235 (ND Cal 1983)). However, both California and Nevada have adopted Revised UCC article 5, and neither state has omitted the provision regarding injunctions (see B V McCullough *Banking Law* (Vol No 12: International Banking – Letters of Credit) (loose-leaf edition) (1981-) in para 230.06[1][b][iii] at 230-120).

<sup>135</sup> See the full discussion in *Dolan: The Law of Letters of Credit op cit* note 132 in para 7.04[4][f]; and cf A N Oelofse *The Law of Documentary Letters of Credit in Comparative Perspective* (1997) (hereinafter '*Oelofse: The Law of Documentary Letters of Credit*') in note 238 at 420.

<sup>136</sup> See McCullough *op cit* note 130 in para 5.04[2][a] at 5-17.

appeared that the applicant had to satisfy the traditional rules for injunctive relief.<sup>137</sup> This has always been part of the case law and is specifically stated in Revised UCC (i.e., United States Uniform Commercial Code of 1995) article 5 section 5-109(b)(3): ‘a court of competent jurisdiction may temporarily or permanently enjoin the issuer from honouring a presentation or grant similar relief against the issuer . . . only if the court finds that . . . all of the conditions to entitle a person to the relief under the law of this State have been met’ (see discussion below).<sup>138</sup> Therefore, apart from satisfying the criteria for material fraud and the evidence thereof,<sup>139</sup> in order to obtain a preliminary injunction, the following, for example, also has to be shown by the applicant (obviously this will vary from state to state).<sup>140</sup>

1. irreparable injury or harm (i.e., the injury the claimant (applicant of letter of credit) would suffer if a preliminary injunction is denied on account of the fact that he would be unable to effectively recover his loss from the beneficiary);<sup>141</sup> and
2. either probable success on the merits or sufficiently serious questions going to the merits to make them a fair ground for litigation; and
3. a balance of convenience/a balance of hardships weighing decidedly in favour of the applicant (i.e., establishing whether the injury to the claimant (applicant), if the application for preliminary relief were dismissed would outweigh the harm which granting the injunction would inflict on the defendant).<sup>142</sup>

<sup>137</sup> See *Hugo: The Law Relating to Documentary Credits op cit* note 9 at 290; and *McCullough op cit* note 130 in para 5.04[2][a] at 5-17. See also *Harris Corporation v National Iranian Radio and Television* 691 F 2d 1344 (11th Cir 1982).

<sup>138</sup> See *Oelofse: The Law of Documentary Letters of Credit op cit* note 135 in note 258 at 426.

<sup>139</sup> See para 5.5.4 in Chapter 5.

<sup>140</sup> See, e.g., *American Bell International Inc v The Islamic Republic of Iran* 474 F Supp 420 (SDNY 1979) at 422; *United Technologies Corporation v Citibank NA* 469 F Supp 473 (1979) at 477; *Rockwell International Systems Inc v Citibank NA and Bank Tejarat* 719 F 2d 583 (USCA 2nd Cir 1983) at 586. The requirements were put differently in other cases such as: *Harris Corporation v National Iranian Radio and Television supra* note 137 at 1353; and *Enterprise International Inc v Corporacion Estatal Petrolera Ecuatoriana* 762 F 2d 464 (1985) at 471. See also *Hugo: The Law Relating to Documentary Credits op cit* note 9 at 290; *Oelofse: The Law of Documentary Letters of Credit op cit* note 135 at 426; *Dolan: The Law of Letters of Credit op cit* note 132 in para 7.04[1]; and *Bertrams op cit* note 13 at 415. *McCullough* (see *McCullough op cit* note 130 in para 5.04[2][a] at 5-17–5-18 and the authorities cited), for instance, indicates that the major factors determining the right to an injunction can be listed as follows:

- Statutory enumeration. (Most states have statutes providing for injunctive relief.)
- Inadequacy of other remedies.
- Irreparable Injury
- Multiplicity of suits. (Fairly often the reason for injunctive relief is the likelihood that a multiplicity of actions may result if an injunction is not granted.)

<sup>141</sup> See *Bertrams op cit* note 13 at 415.

<sup>142</sup> For example, in *Jeri-Jo Knitwear Inc v Gulf Garments Industry WLL* 685 NYS 2d 724 (1999) the court held that equitable relief was appropriately denied since the claimant had an adequate remedy at law and since the claimant had shown a likelihood of success upon the merits. The result came about because the claimant had not demonstrated actual, intentional fraud in the underlying transaction independent of any claim regarding non-conforming goods (see also see *McCullough op cit* note 130 in para 5.04[2][a] at 5-18). However, for an example of a case where the court found that the necessary proof had been furnished and an injunction was granted, see *Takeo Company Ltd v Mead Paper Inc* 611 NYS 2d 543 (1994). The facts on which the alleged fraud was based, had to be established by evidence that was ‘clear, direct, precise and convincing’ (see also *Roman Ceramics Corporation v Peoples National Bank* 714 F 2d 1207 (3d Cir 1983). See also *Oelofse: The Law of Documentary Letters of Credit op cit* note 135 in note 240 at 421.



The criteria for an injunction mentioned are rather flexible and elusive, and could therefore be applied by the courts with quite different results. This was clearly illustrated by the Iranian cases which led to an increase in the use of the fraud exception to the independence of letters of credit.<sup>143</sup> The requirement of irreparable harm in the absence of an injunction is clearly illustrated by the cases resulting from the political revolution in Iran in late 1979.<sup>144</sup> The Iranian cases<sup>145</sup> generally involved standby credits in the form of repayment or performance guarantees issued in favour of the Iranian government or one of its agencies. As a consequence of the Islamic revolution in Iran, the performance of many contracts by American businesses in Iran was disrupted. The American contracting parties (applicants of the standby credits) feared that the new Iranian government would make punitive and unwarranted calls on these standby credits issued on application of the American contract parties. Accordingly, they sought injunctions against payment.<sup>146</sup>

As regards the ‘irreparable harm’ requirement,<sup>147</sup> there is a striking difference in approach between those cases decided before the taking of American hostages in Iran<sup>148</sup> and those cases decided afterwards.<sup>149</sup> The earlier group of cases (i.e., those before the hostages were taken) show an unrealistic strict approach to the ‘irreparable harm’ requirement. In a few of these cases it was held that this requirement was not met and that an injunction was not competent even if the ‘fraud exception’ had been proved, because the American applicant could always recover his money from the Iranian beneficiary afterwards in an Iranian court.<sup>150</sup> Oelofse submitted that such an approach took insufficient account of the factual risks of non-recovery of what had been paid, and of the costs and effort involved in undoing the effects of payment. It largely emasculated the recognition of a ‘fraud exception’ to the autonomy principle.<sup>151</sup> In the later group of cases (i.e., those after the

<sup>143</sup> See Bertrams *op cit* note 13 at 415; and McCullough *op cit* note 130 at 5-2. See also the discussion of the Iranian crisis in paras 5.5.4.3, and 5.5.6 in Chapter 5. However, for a full discussion of the Iranian crisis and the relevant cases, see McCullough *op cit* note 130 in para 5.04[3][b][i]–[ii] at 5-35–5-52.

<sup>144</sup> See also Oelofse: *The Law of Documentary Letters of Credit op cit* note 135 at 426. For a full list of the US cases, see H A Getz ‘Enjoining the International Standby Letter of Credit: The Iranian Letter of Credit Cases’ (1980) 21 *Harvard International Law Journal* 189 at 248–252.

<sup>145</sup> For the background to these cases, see Anon ‘“Fraud in the Transaction”: Enjoining Letters of Credit During the Iranian Revolution’ (1980) 93 *Harvard Law Review* 992 at 992–995; and McCullough *op cit* note 130 in para 5.04[3][b].

<sup>146</sup> See Oelofse: *The Law of Documentary Letters of Credit op cit* note 135 at 426–427. See also Xiang Gao *op cit* note 54 at 78.

<sup>147</sup> For a general discussion regarding the ‘irreparable harm’ requirement and its practical application see Dolan: *The Law of Letters of Credit op cit* note 132 in para 11.05[2].

<sup>148</sup> And subsequent administrative measures taken by the US government against the Iranian government. See also Xiang Gao *op cit* note 54 in note 51 at 78–79, for a discussion of the orders (federal regulations) that were issued by the US President in this regard.

<sup>149</sup> See McCullough *op cit* note 130 in para 5.04[3][b]; and Oelofse: *The Law of Documentary Letters of Credit op cit* note 135 at 427. For examples of ‘non-Iranian’ cases where an injunction was refused on the ground of absence of ‘irreparable harm’, see *Enterprise International Inc v Corporacion Estatal Petrolera Ecuatoriana* 762 F 2d 464 (1985); and *Magar Inc v National Westminster Bank USA* 592 NYS 2d 37 (1993).

<sup>150</sup> See, e.g., *American Bell International Inc v The Islamic Republic of Iran* 474 F Supp 420 (SDNY 1979) at 422; *KMW International v Chase Manhattan Bank NA* 606 F 2d 10 (2nd Cir 1979); and *United Technologies Corporation v Citibank NA* 469 F Supp 473 (1979). See also Oelofse: *The Law of Documentary Letters of Credit op cit* note 135 at 427.

<sup>151</sup> See Oelofse: *The Law of Documentary Letters of Credit op cit* note 135 at 427.

American hostages had been taken) the courts were much more lenient with regard to the ‘irreparable harm’ requirement, adopting the approach that there was a real danger of American litigants not obtaining any satisfaction in Iranian courts and that this danger satisfied the ‘irreparable harm’ requirement.<sup>152</sup> As regards this aspect, Oelofse correctly submitted that an injunction should not merely be refused, because it will be possible to obtain a judgment for repayment in a foreign court. He said that it followed from *Sztejn v J Henry Schroder Banking Corporation*<sup>153</sup> that a fraudulent beneficiary should not be allowed to obtain the money in the first place, and a strict approach to the ‘irreparable harm’ requirement allows just that.<sup>154</sup>

Prior UCC article 5 section 5-114(2) evidently allowed the issuing bank (within its relationship with the applicant) to pay in good faith despite the applicant’s claims of fraud on the part of the beneficiary. It was up to the applicant to obtain an injunction before payment was made. If the applicant himself did not initiate proceedings for an injunction, but merely provided evidence of fraud to the issuing bank, the bank were often uncertain about the weight of the evidence and then often decided to stay out of the issue between the two parties to the underlying contract. The question that arose was whether the bank could initiate interpleader proceedings, leaving it to the applicant and the beneficiary to prove or disapprove the applicability of the ‘fraud exception’ to the court. Although the availability of interpleader proceedings in this situation had been denied or at least doubted,<sup>155</sup> there was also authority accepting that the bank could initiate interpleader proceedings.<sup>156</sup>

The applicant’s right to injunctive relief is currently set out in Revised UCC article 5 section 5-109(b),<sup>157</sup> which reads as follows:

- (b) If an applicant claims that a required document is forged or materially fraudulent or that honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant, a court of competent jurisdiction may temporarily or permanently enjoin the issuer from honouring a presentation or grant similar relief against the issuer or other persons only if the court finds that:
- (1) the relief is not prohibited under the law applicable to an accepted draft or deferred obligation incurred by the issuer;
  - (2) a beneficiary, issuer, or nominated person who may be adversely affected is adequately protected against loss that it may suffer because the relief is granted;
  - (3) all of the conditions to entitle a person to the relief under the law of this State have been met,<sup>158</sup> and

<sup>152</sup> See, e.g., *Harris Corporation v National Iranian Radio and Television Television* 691 F 2d 1344 (11th Cir 1982); *Rockwell International Systems Inc v Citibank* 719 F 2d 583 (USCA 2nd Cir 1983); and *Itek Corporation v First National Bank of Boston* 730 F 2d 19 (1984).

<sup>153</sup> 31 NYS 2d 631 (1941). For a full discussion of this case, see para 5.3.3 in Chapter 5.

<sup>154</sup> See Oelofse: *The Law of Documentary Letters of Credit* op cit note 135 at 428.

<sup>155</sup> See *Dallas Bank and Trust v Commonwealth Development Corporation* 686 SW 2d 226 (1984); and *Citizens and Peoples National Bank of Pensacola v Futch* 650 So 2d 1008 (1994) at 1014.

<sup>156</sup> See Oelofse: *The Law of Documentary Letters of Credit* op cit note 135 at 427; and for a full discussion of this issue, see Dolan: *The Law of Letters of Credit* op cit note 132 at 7-91 and in para 11.07.

<sup>157</sup> For a full discussion of Revised UCC article 5 section 5-109, see para 3.4.2 (particularly 3.4.2.2) in Chapter 3 and para 5.5.2.2 in Chapter 5.

- (4) on the basis of the information submitted to the court, the applicant is more likely than not to succeed under its claim of forgery or material fraud and the person demanding honor does not qualify for protection under subsection (a)(1). (Footnote added.)

Unlike its predecessor (i.e., Prior UCC article 5 section 5-114(2)), Revised UCC article 5 section 5-109 specifies the requirements to be met for injunctive relief.<sup>159</sup> Furthermore, it is stated in the Official Comment that the standard for injunctive relief is high and that the burden remains on the applicant ‘to show by evidence and not by mere allegation’ that the relief is warranted.<sup>160</sup> It must also be noted that section 5-109(b) does not restrict itself to injunctions against honour, but refers also to ‘similar relief’.<sup>161</sup> The Official Comment to this section provides that although the section deals mainly with injunctions against honour, it also cautions against granting ‘similar relief’ and the same principles apply when the applicant or issuer attempts to achieve the same legal outcome by injunction against presentation, interpleader, declaratory judgment, or attachment. Therefore, all these attempts should face the same obstacles that face efforts to enjoin the issuer from paying. In the Official Comment it is also warned that expanded use of any of these devices could threaten the independence principle just as much as injunctions against honour do. Therefore, the courts should have the same hostility to them and place the same restrictions on their use as they would to injunctions against honour.<sup>162</sup>

Although there are many difficult requirements that a claimant (normally the applicant of the letter of credit) has to comply with in order to obtain injunctive relief, it has been said that it is still safe to conclude, based on the many successful suits that there have been, that injunctive relief has generally been substantially easier to obtain in the United States than in England.<sup>163</sup>

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<sup>158</sup> For instance, in *Mid-America Tire Inc v PTZ Trading Ltd Import and Export Agents* 95 Ohio St 3d 367 (2002 Ohio – 2427) in para 78 the court held that in order for a court of competent jurisdiction to enjoin the issuer of a letter of credit from honouring a presentation, the court must find that the claimant has no adequate remedy at law.

<sup>159</sup> See *Hugo: The Law Relating to Documentary Credits op cit* note 9 at 292–293.

<sup>160</sup> See Official Comment 4 to section 5-109. Reference is specifically made to the case of *Griffen Cos v First National Bank* 374 NW 2d 768 (Minn App 1985), where the court enjoined payment under a standby letter of credit, basing its decision on plaintiff’s allegation, rather than competent evidence of fraud. Therefore, with section 5-109, it is aimed that these type of cases are avoided.

<sup>161</sup> *Network Alliance Group LLC v Cable and Wireless USA Inc* 2002 US Dis (Lexis 10161) (D Minn), is a case where the applicant of a standby letter was unsuccessful in trying to enjoin the beneficiary from drawing on the letter of credit. The court did not find that there was adequate evidence of fraud in the transaction to justify issuing an injunction. The applicant could also not satisfy the requirement for obtaining a preliminary injunction. He *inter alia* failed to show irreparable harm and that the balance of harm favoured him. See also *SouthTrust Bank of Alabama NA v Webb-Stiles Co Inc* 58 UCC Rep Serv 2d (West) 60 (Ala 2005) where the claimant also failed to show irreparable injury.

<sup>162</sup> See Official Comment 5 to section 5-109.

<sup>163</sup> See *Hugo: The Law Relating to Documentary Credits op cit* note 9 at 290. *Brenntag International Chemicals Inc v Bank of India* 175 F 3d 245 (2nd Cir 1999) involves a case where the applicant of a standby letter was successful in obtaining an injunction against payment where fraudulent documents were presented. In this case, the court found that the applicant had proved that he would suffer irreparable harm if the injunction were not granted, and that there was a likelihood of success on the merits of the applicant (for a full discussion of this case, see McCullough *op cit* note 130 in para 5.04[3][f] at 5-68–5-69). Other cases where injunctive relief was granted is: *Mid-America Tire Inc v PTZ Trading Ltd Import and Export Agents* 95 Ohio St 3d 367 (2002-Ohio-2427); *Hendricks v Bank of America NA* 408 F 3d 1127 (9th Cir 2005) (for a

### 7.3.1 Conclusion

Courts in the United States have always accepted the possibility of injunctions against banks in the event of established fraud and they are more than willing to put this principle into practice if an appropriate case presents itself. This possibility is also recognised in Revised UCC article 5 section 5-109(b). It also seems that American courts recognise that an injunction against the bank in the event of established fraud is the most effective means of preventing fraud by the beneficiary. It seems that English courts do not have the same view in this regard.<sup>164</sup>

It also seems that obtaining injunctive relief in the United States has generally been substantially easier to obtain than in England. Under the English law, an injunction will not be granted unless the claimant (e.g., applicant of a letter of credit/principal of a demand guarantee) can in addition to proving fraud, also satisfy the ‘balance of convenience’ test. The balance of convenience test is similar to the United States ‘balance of hardships’ test.<sup>165</sup> However, contrary to the position in England, in the United States it is not that

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discussion of this case, see J G Barnes and J E Byrne ‘Letters of Credit’ (2006) 61 *Business Lawyer* 1591 at 1593–1594; and for criticism of this case, see J F Dolan ‘Tethering the Fraud Inquiry in Letter of Credit Law’ (2006) 21 *Banking and Finance Law Review* 479 at 494–502); *Lakeside at Pole Creek LLC v Tabernash Meadows LLC (In re Tabernash Meadows LLC)* 56 UCC Rep Serv 2d (West) 622 (Bankr D Colo 2005) (here the bankruptcy court entered a permanent injunction against the beneficiary’s draw and the issuer’s honour of a standby letter of credit (see also J G Barnes and J E Byrne ‘Letters of Credit’ (2006) 61 *Business Lawyer* 1591 at 1594); and *Langley v Prudential Mortgage Capital Co LLC* No 07-cv-404-JMH; 2007 US Dist LEXIS 92224 (ED Ky 12 December 2007) (see the summary in J E Byrne and C S Byrnes (eds) 2008 *Annual Survey of Letter of Credit Law and Practice* (2008) (hereinafter ‘2008 Annual Survey’) at 288–290). For cases where the claimant (applicant) failed to show material fraud, see e.g., *All Star Advertising Agency Inc v Reliance Insurance Co* 898 So 2d 369 (La 2005); and *McIngvale v AGM LLC* No G-07-0228, 2007 US Dist LEXIS 54581 (SD Tex 27 July 2007) (see the summary in 2008 *Annual Survey of Letter op cit* 163 at 293). See also *Intrinsic Values Corporation v Superintendencia De Administracion Tributaria* 2002 WL 181133, 46 UCC Rep Serv 2d 1092 (Fla App 2002) where the Court of Appeal for Florida denied the beneficiary’s motion to dissolve a temporary injunction to prevent the confirming bank from honouring which was issued by the Circuit Court of Miami-Dade County. For other cases where applications were made for injunctions, see e.g., *Drago v Holiday Isle* No 07-0430-KD-B; 2007 WL 2683675 (SD Ala 2007) (here the court dealt with the irreparable harm requirement, but neglected to deal with the issue of material fraud, before dealing with the irreparable harm requirement (see the summary of this case in 2008 *Annual Survey op cit* note 163 at 253–255); *Jameson v Pine Hill Dev LLC* No 07-0111-WS-B, 2007 US Dist LEXIS 13212 (SD Ala 23 Feb 2007) (see the summary of this case in 2008 *Annual Survey op cit* note 163 at 282–284); and *Astec Inc v SA Toffolutti (In re: Irrevocable Standby Letter of Credit No SE444393W)* 336 F Supp 2d 578 (MDNC 2004) (claimant was unsuccessful in his attempt to obtain a temporary and preliminary injunction) (for a discussion, see J E Byrne ‘Litigation Digest’ (Nov/Dec 2004) 8 *Documentary Credit World* 22 at 22–24); and see the detailed list of other cases mentioned in McCullough *op cit* note 130 in note 166 at 5-69. In the United States it sometimes may even be possible to get an injunction on something less than fraud or forgery (see, e.g., *Seguin Savings Association v Vista Verde Plaza Joint Venture* 7 UCC Rep Serv 2 d 862 (Tex Ct App 1988) where the court held that there could be circumstances in which an obvious breach of contract, but not amounting to fraud, could be so pervasive in its effect as to undermine the parties’ contract to such an extent that it could vitiate the legitimate purpose for the independence of the letter of credit from the underlying contract (for a discussion of *Seguin Savings Association*, see McCullough *op cit* note 130 in para 5.04[2][c][v] at 5-27–5-28.).

<sup>164</sup> See Bertrams *op cit* note 13 at 416–417. See the discussion in paras 7.2.1–7.2.4 above.

<sup>165</sup> See *Caulfield v Board of Education* 583 F 2d 605 (2nd Cir 1978) as applied in *American Bell International Inc v The Islamic Republic of Iran* 474 F Supp 420 (SDNY 1979) at 425–426; and *KMW International v Chase Manhattan Bank NA* 606 F 2d 10 (2nd Cir 1979).

difficult for a principal to satisfy the test and the American courts have been able to grant injunctions in many cases despite this test.<sup>166</sup>

## 7.4 SOUTH AFRICAN LAW

### 7.4.1 Introduction

In *Loomcraft Fabrics CC v Nedbank Ltd and Another*<sup>167</sup> the South African Appellate Division (as it then was) said that an interdict<sup>168</sup> restraining a bank from paying under a documentary credit would only be granted in exceptional circumstances.<sup>169</sup> It also stated that it was well established that a court would grant an interdict restraining the bank from paying a beneficiary under a documentary credit in the event of it being established that the beneficiary was a party to the fraud in relation to the documents presented to the bank for payment.<sup>170</sup> The court also made the following important comment:<sup>171</sup>

Whether Nedbank [i.e., the issuing bank] would be prepared to honour the credit or not would depend, therefore, on whether it considers that, even in the absence of the notation, the bills conform with the requirements of the credit. If on this basis it considers itself obliged to honour the credit, it is difficult to see on what grounds the appellant could obtain an interdict against the bank restraining it from doing so. If Nedbank [issuing bank] is wrong, the appellant [i.e., Loomcraft and the applicant of the letter of credit] would have its ordinary contractual remedy against it. No case was made out that the appellant [applicant of the letter of credit] would be unable to obtain relief from Nedbank [the issuing bank] in the event of the latter acting in breach of its contract with the appellant. It is trite law that an applicant for a final interdict must establish that there is no other satisfactory remedy available to him . . . Nor was any other reason advanced why, in the absence of fraud, the Court *a quo* should have been required to interfere with the freedom of the bank to decide for itself whether to honour its credit or not.

The obligation of the issuing bank against its customer (i.e., the applicant of a letter of credit/ principal of a demand guarantee) is to pay only against conforming documents. Therefore, if the bank were to pay against non-conforming documents, the applicant's/principal's remedy would be an ordinary contractual one against the bank. The Appellate Division in *Loomcraft Fabrics v Nedbank* found it 'difficult to see' on what

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<sup>166</sup> See, e.g., *Itek Corporation v First National Bank of Boston* *supra* note 152; *Harris Corporation v National Iranian Radio and Television* *supra* note 152 at 1357; and *Rockwell International Systems Inc v Citibank* *supra* note 152. See also *Enonchong op cit* note 92 at 86–87.

<sup>167</sup> 1996 (1) SA 812 (A) at 816C–D and 824A. For a full discussion of this case, see para 5.6.1 in Chapter 5.

<sup>168</sup> An interdict is an order of court. It is a judicial process whereby a person (in a documentary credit and demand guarantee context often the beneficiary and/or the bank/issuer) is ordered to refrain from doing something, or ordered to do something (see note 16 above; *Harms: The Law of South Africa op cit* note 7 in para 303 at 286; and see also *Jafta v Minister of Law and Order* 1991 (2) SA 286 (A) at 295).

<sup>169</sup> See also *Union Carriage and Wagon Company Ltd v Nedcor Bank Ltd* 1996 CLR 724 (W) at 732 where the court said the same regarding an application for an interdict restraining a beneficiary from receiving payment.

<sup>170</sup> See 1996 (1) SA 812 (A) at 816–817.

<sup>171</sup> At 823G–824A.

grounds the applicant could obtain an interdict to restrain the bank from paying against non-conforming documents (see the quote above).<sup>172</sup>

#### 7.4.2 Interim Interdicts

The South African law draws a basic distinction between interim and final interdicts.<sup>173</sup> However, as the focus of this chapter is on interim relief given by courts in a documentary credit and demand guarantee context, the focus will be on interim interdicts.

Of course, in addition to proving that there is established fraud<sup>174</sup> or any other acceptable ground<sup>175</sup> to prevent payment under a letter of credit/demand guarantee, an applicant/principal applying for an interim interdict against the bank and/or the beneficiary will also have to satisfy all the other traditional requirements in relation to interdicts before an interim interdict will be granted.<sup>176</sup> The rules regarding the prerequisites for the granting of an interdict are founded upon Roman-Dutch law.<sup>177</sup> However, the practical application of those rules has been affected by English judgments dealing with injunctions.<sup>178</sup> The formalities relating to interdicts are governed by the provisions regulating civil proceedings in the different courts in South Africa.<sup>179</sup> In order to be successful in obtaining an interim interdict, a person will also have to prove all of the following requirements:<sup>180</sup>

<sup>172</sup> See *Hugo: The Law Relating to Documentary Credits op cit* note 9 at 326.

<sup>173</sup> See *Hugo: The Law Relating to Documentary Credits op cit* note 9 at 317.

<sup>174</sup> See paras 5.6.1 and 5.6.3 in Chapter 5.

<sup>175</sup> See Chapter 6 for a full discussion.

<sup>176</sup> In the light of the theme and scope of this study (see paras 1.3.1–1.3.2 in Chapter 1), a full discussion of the South African law in relation to interdicts is not required here, but it is, however, necessary to comment briefly on certain aspects in order to evaluate the South African cases dealing with interdicts in the documentary credit and demand guarantee context. However, a full discussion of interdicts can be found in: *Harms: The Law of South Africa op cit* note 7 in paras 302–344 at 285–306; J Meyer *Interdicts and Related Orders* (1993); *Harms: Civil Procedure in the Superior Courts op cit* note 7 at 26–33; and *Prest op cit* note 4.

<sup>177</sup> See *Setlogelo v Setlogelo* 1914 AD 221.

<sup>178</sup> See *Harms: The Law of South Africa op cit* note 7 in para 304 at 286 and the authorities cited.

<sup>179</sup> See *Harms: The Law of South Africa op cit* note 7 in para 304 at 287.

<sup>180</sup> See, e.g., *Z Z Enterprises v Standard Bank of South Africa Ltd* 1995 CLD 769 (W) at 783–784; and for a full discussion of these requirements, see *Harms: The Law of South Africa op cit* note 7 in paras 316–321 at 291–295 and the authorities cited). For cases not dealing specifically with documentary credits or demand guarantees, but dealing with the requirements in general that need to be proved before an interim interdict will be granted, see *Setlogelo v Setlogelo supra* note 177; *Olympic Passenger Service (Pty) Ltd v Ramlagan* 1957 (2) SA 382 (D); *L F Boshoff Investments (Pty) Ltd v Cape Town Municipality* 1969 (2) SA 256 (C) at 267B–F; *Eriksen Motors (Welkom) Ltd v Protea Motors, Warrenton and Another* 1973 (3) SA 685 (A); *Beecham Group Ltd v B-M Group (Pty) Ltd* 1977 (1) SA 50 (T); *Tshabalala and Others v Minister of Health and Others* 1987 (1) SA 513 (W); *Masuku v Minister van Justisie* 1990 (1) SA 832 (A); *Knox D’Arcy Ltd and Others v Jamieson and Others* 1995 (2) SA 579 (W); *Dorbyl Vehicle Trading and Finance Co (Pty) Ltd v Klopper* 1996 (2) SA 237 (N); *Sanachem (Pty) Ltd v Farmers Agri-Care (Pty) Ltd and Others* 1995 (2) SA 781 (A); *Ferreira v Levin NO and Others; Vryenhoek and Others v Powell NO and Others* 1995 (2) SA 813 (W); *Hix Networking Technologies v System Publishers (Pty) Ltd and Another* 1997 (1) SA 391 (A) at 398I–J; *Thabani Wines (Pty) Ltd and Another v Darling Cellars (Pty) Ltd and Others* [2005] JOL 15378 (C); *Simon NO v Air Operations of Europe AB and Others* 1999 (1) SA 217 (SCA); *Fedsure Life Assurance Co Ltd v Worldwide African Investment Holdings (Pty) Ltd and Another* 2003 (3) SA 268 (W); and *Uncedo Service Taxi Association v Nelson Mandela Bay Municipality and Another* (unreported, case no: 929/08, 12 May 2008, South Eastern Cape Local Division).

1. that he has a *prima facie* right;<sup>181</sup>
2. a well-grounded apprehension of irreparable harm if the interim relief is not granted and the ultimate relief is eventually granted;<sup>182</sup>
3. a balance of convenience in favour of the granting of the interim interdict;<sup>183</sup> and
4. the absence of any other satisfactory remedy.<sup>184</sup>

<sup>181</sup> Corbett J, as he then was, in *LF Boshoff Investments (Pty) Ltd v Cape Town Municipality* 1969 (2) SA 256 (C) (while referring to *Gool v Minister of Justice and Another* 1955 (2) SA 682 (C) at 687–688 and *Pietermaritzburg City Council v Local Road Transportation Board* 1959 (2) SA 758 (N) at 772) said that before an applicant could obtain an interim interdict he had to show that (see at 267B–F):

- the right that was the subject matter of the main action and which he sought to protect by means of interim relief was clear or, if not clear, was *prima facie* established, though it may be open to some doubt;
- if the right was only established *prima facie*, there was a well-grounded apprehension of irreparable harm to the applicant if the interim relief was not granted and he ultimately succeeded in establishing his right;
- the balance of convenience favoured the granting of interim relief; and
- he has no other satisfactory remedy.

While referring to the *Gool* case *supra*, Corbett J also said that where the applicant could not show a clear right, and more particularly where there were disputes of fact, a court's approach in determining whether the applicant's right was established *prima facie*, although it could be open to some doubt, was to take the facts as set out by the applicant into consideration together with any facts set out by the respondent that the applicant could not dispute, and to then consider whether, having regard to the inherent probabilities, the applicant must on those facts obtain final relief at the trial of the main action.

Smalberger JA in *Simon NO v Air Operations of Europe* 1999 (1) SA 217 (SCA) at 228G–H expressed a similar view and also relied on the *Gool* case *supra*. He also stipulated that an applicant who applied for an interim interdict must prove that he has a *prima facie* right, although it may be open to some doubt. He confirmed that the accepted test for a *prima facie* right in the context of an interim interdict was to take into consideration the facts presented by the applicant, together with the facts provided by the defendant that were not or could not be disputed and to then consider whether, having regard to the inherent probabilities, the applicant should on those facts obtain final relief at the trial. Furthermore, the facts supplied in contradiction by the defendant must then be considered and, if serious doubt was thrown upon the case of the applicant, he should not be able to succeed with his application for an interim interdict.

<sup>182</sup> The test is objective and the question is whether a reasonable man, confronted by the facts, would apprehend the probability of harm. Actual harm need not be proved upon a balance of probabilities (see *Mcilongo v Minister of Law and Order* 1990 (4) SA 181 (E); *Minister of Law and Order v Nordien* 1987 (2) SA 894 (A)). However, if it has been established that a clear right exists then this apprehension of irreparable harm does not need to be established (see *Setlogelo v Setlogelo* 1914 AD 221; *L F Boshoff Investments (Pty) Ltd v Cape Town Municipality* 1969 (2) SA 256 (C) at 267). See also further *Harms: The Law of South Africa op cit* note 7 in para 318 at 293.

<sup>183</sup> The court must weigh the prejudice the applicant will suffer if the interim interdict is not granted against the prejudice the respondent will suffer if it is. The exercise of the court's discretion normally resolves itself into a consideration of the prospects of success and the balance of convenience: the stronger the prospects of success, the less the need for such balance to favour the applicant; and the weaker the prospects of success the greater the need for it to favour him (see *Harms: The Law of South Africa op cit* note 7 in para 319 at 293–294 and the authorities cited).

<sup>184</sup> Generally, an applicant will not obtain an interdict if he can obtain adequate redress through an award of damages (see *Fourie v Uys* 1957 (2) SA 125 (C); *Candid Electronics (Pty) Ltd v Merchandise Buying Syndicate (Pty) Ltd* 1992 (2) SA 459 (C); *Croatia Meat CC v Millennium Properties (Pty) Ltd* 1998 (4) SA 980 (W); *Nampesca (SA) Products (Pty) Ltd v Zaderes* 1999 (1) SA 886 (C) at 901; and cf *Harms: The Law of South Africa op cit* note 7 in para 312 at 289–290; and *Harms: Civil Procedure in the Superior Courts op cit* note 7 in para A5.5 at 28). The requirements for the right to claim a final interdict are

- a clear or definite right;

The court always views all the requirements as a whole and do not judge any of them in isolation. The court, however, always has a wide discretion to refuse an interim interdict despite the fact that all the requirements have been met.<sup>185</sup>

The English law relating to injunctions is very similar to the South African law of interdicts, but there are some important, although discrete, differences.<sup>186</sup> The traditional approach of the South African courts to interim interdicts has been that before a court will apply its mind to the balance of convenience, the applicant must have satisfied the ‘threshold’ test – proof of at least a *prima facie* right.<sup>187</sup> Initially, this was also the case in England.<sup>188</sup> In *American Cyanamid Co v Ethicon Ltd*<sup>189</sup> the House of Lords stated what the principles that should govern the granting of interim injunctions should be. Lord Diplock discarded the requirement of a *prima facie* right as threshold for applying the balance of convenience. The only threshold recognised in Lord Diplock’s speech is that the claim must not be frivolous or vexatious, in other words, that there must be a serious question to be tried.<sup>190</sup> Instead, the House of Lords stressed the requirement that the balance of convenience should favour the plaintiff. In other words, the fundamental question is whether more harm would be done by refusing or granting the injunction. Therefore, if the refusal of the injunction would be more harmful, the injunction will be granted.<sup>191</sup> Under the English law, it must be established that there is a threatened or an apprehended injury, that there is a serious question to be tried and where the balance of convenience then lies.

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- an injury actually committed or reasonably apprehended; and
  - the absence of similar protection by any other remedy.

The requirements for an interim interdict differ in three important respects from those set for final interdicts. First, irreparable injury, though relevant for interim injunctions, is not a condition precedent to or a requirement for the granting of a final interdict. Secondly, for a final interdict the applicant must establish a clear right whilst a *prima facie* right will suffice for an interim interdict. Lastly, the balance of convenience is only relevant in the case of interim interdicts (see also *Hugo: The Law Relating to Documentary Credits op cit* note 9 at 319). For a full discussion of the requirements for a final interdict, see *Harms: The Law of South Africa op cit* note 7 in paras 309–313 at 288–290 and the authorities cited; and *Harms: Civil Procedure in the Superior Courts op cit* note 7 at 27–28 and authorities cited). For cases dealing with the requirements for a final interdict, see, e.g., *Nienaber v Stuckey* 1946 AD 1049 at 1053–1054; *Hydro Holdings (Edms) Bpk v Minister of Public Works* 1977 (2) SA 778 (T); *Bankorp Trust Bpk v Pienaar* 1993 (4) SA 98 (A); *Sanachem (Pty) Ltd v Farmers Agri-care (Pty) Ltd and Others* 1995 (2) SA 781 (A) at 789B–C; *V & A Waterfront Properties (Pty) Ltd and Another v Helicopter & Marine Services (Pty) Ltd and Others* [2006] 3 All SA 523 (SCA); *Oasis Group Holdings (Pty) Ltd and Another v Bray* [2006] 4 All SA 183 (C); *North Safety Products (Africa) v Nicolay and Others* [2007] 3 All SA 647 (C); *Crystal Holdings (Pty) Ltd and Others v The Regional Land Claims Commissioner and Others* [2008] All SA 243 (N); and *Chevron South Africa (Pty) Ltd v Awaiz at 110 Drakensburg CC* [2008] All SA 557 (T).

<sup>185</sup> See *Harms: The Law of South Africa op cit* note 7 in paras 316 at 292 and in para 321 at 294 and the authorities cited.

<sup>186</sup> See *Harms: The Law of South Africa op cit* note 7 in para 304 at 286–287; *Beecham Group Ltd v B-M Group (Pty) Ltd* 1977 (1) SA 50 (T). For a full discussion of the differences between the South African law and the English law in relation to interdicts/injunctions, see *Prest op cit* note 4.

<sup>187</sup> See *Hugo: The Law Relating to Documentary Credits op cit* note 9 at 319; and *Prest op cit* note 4 at 57.

<sup>188</sup> See also para 7.2.4 above.

<sup>189</sup> [1975] AC 396 (HL) ([1975] 1 All ER 504 (HL)) and see the discussion of this case in para 7.2.4 above. For a full discussion of this case, see *Prest op cit* note 4 at 81–102.

<sup>190</sup> [1975] AC 396 (HL) at 407 F–G.

<sup>191</sup> See *Hugo: The Law Relating to Documentary Credits op cit* note 9 in note 156 at 278.



The requirement of a serious question to be tried is not the same as that of *prima facie* right, although the court must be satisfied that the claim is not frivolous or vexatious.<sup>192</sup> Therefore, the approach in the English law is different from the South African approach. Prest<sup>193</sup> suggested that South Africa also adopt these English principles laid down in *American Cyanamid Co v Ethicon Ltd*,<sup>194</sup> which constitute a more flexible approach than that of South African. From the aforesaid, it thus appears that it might be more difficult to obtain an interdict in the South Africa law than in the English law.<sup>195</sup>

It has already been indicated in an earlier chapter<sup>196</sup> that in the context of interdicts (both interim and final) in the field of letters of credit/demand guarantees based on fraud on the part of the beneficiary, a degree of proof that is clearly stricter than that which generally applies in civil cases, will be required. However, precisely how much more convincing the evidence must be, still remains uncertain in South African law.<sup>197</sup>

### 7.4.3 Interdicts Against the Bank Preventing Payment

From the case law discussed it is clear that although it is possible, in principle, for a principal/applicant to obtain an interdict against the bank prohibiting it from paying the beneficiary, such an application will seldom succeed. It was expressly stated in *Loomcraft Fabrics CC v Nedbank Ltd and Another*<sup>198</sup> that an interdict of this nature would not be granted, except in the most exceptional cases. Fraud as an ‘established exception’ was recognised in *Phillips and Another v Standard Bank of South Africa Ltd and Others*;<sup>199</sup> *Loomcraft Fabrics v Nedbank* and *Ex parte Sapan Trading (Pty) Ltd*.<sup>200</sup>

So far, there have been only two cases dealing with the situation where an applicant has tried to interdict the bank from paying under a letter of credit. In *Phillips and Another v Standard Bank of South Africa Ltd and Others*<sup>201</sup> and *Loomcraft Fabrics CC v Nedbank Ltd and Another*<sup>202</sup> all the applicants tried unsuccessfully to restrain the banks from paying.

<sup>192</sup> See Harms: *The Law of South Africa op cit* note 7 in para 316 at 292 and the authorities cited.

<sup>193</sup> See Prest *op cit* note 4 at 101–102.

<sup>194</sup> In *Beecham Group Ltd v B-M Group (Pty) Ltd* 1977 (1) SA 50 (T) the court found that this approach was not in line with our law and ought not be followed. However, a change of direction towards, the *American Cyanamid Co v Ethicon Ltd supra* note 189 approach is found in a few cases (see, e.g., *Tshabalala and Others v Minister of Health and Others* 1987 (1) SA 513 (W); and *Ferreira v Levin NO and Others; Vryenhoek and Others v Powell NO and Others* 1995 (2) SA 813 (W). It also appears that Prest’s view has found some favour in the context of constitutional law (see also Harms *The Law of South Africa op cit* note 7 in para 316 in note 6 at 292.

<sup>195</sup> See Hugo: *The Law Relating to Documentary Credits op cit* note 9 at 320.

<sup>196</sup> See para 5.6.3 in Chapter 5; and see also *Loomcraft Fabrics CC v Nedbank Ltd and Another* 1996 (1) SA 812 (A) at 817F–G.

<sup>197</sup> See Oelofse: *The Law of Documentary Letters of Credit op cit* note 135 at 480.

<sup>198</sup> 1996 (1) SA 812 (A) at 816D.

<sup>199</sup> 1985 (3) SA 301 (W).

<sup>200</sup> 1995 (1) SA 218 (W).

<sup>201</sup> 1985 (3) SA 301 (W).

<sup>202</sup> 1996 (1) SA 812 (A).

In the *Phillips* case the applicant of a letter of credit approached the court to issue an interim interdict against the bank to prevent it from paying on the letter of credit.<sup>203</sup> The court dismissed the application for an interdict.<sup>204</sup> The court found that no fraud on the part of the beneficiary had been alleged by the applicant. It also held that the facts of this case were quite consistent with an ‘innocent breach of contract’.<sup>205</sup> Therefore, the court specifically refrained from commenting on the extent to which and the circumstances under which it would consider the fraud exception.<sup>206</sup> The *Phillips* case serves as an illustration that mere breach of the underlying contract by the beneficiary of a letter of credit/demand guarantee will not necessarily entitle the applicant/principal to block payment by acquiring an interdict against the bank.<sup>207</sup>

Hugo has indicated that although the court in the *Phillips* case in reaching its decision did not specifically apply the principles of South African law regarding interim interdicts, its result was clearly in line with those principles. He states that the fact that the bank’s obligation to pay was independent of the contract of sale meant that the applicant could not meet the ‘threshold test’ of *prima facie* right. He even went as far as saying that even if one were to adopt the lower threshold of the *American Cyanamid case*<sup>208</sup> discussed above, it

<sup>203</sup> See 1985 SA (3) 301 (W) at 302A–D. For a full discussion of this case, see para 5.6.1 in Chapter 5.

<sup>204</sup> See at 304.

<sup>205</sup> See at 303I–304A.

<sup>206</sup> See Van Niekerk and Schulze *op cit* note 5 at 314.

<sup>207</sup> See also Hugo: *The Law Relating to Documentary Credits op cit* note 9 at 322. However, for a case where the applicant of a letter of credit tried to circumvent the *Phillips* case by trying to block the payment in a completely different manner (i.e., by way of an *ex parte* order for the attachment of the beneficiary’ claims to the proceeds of four letters of credit against the bank), see *Ex parte Sapan Trading (Pty) Ltd* 3 CLD 200 (W) (court *a quo*) and 1995 (1) SA 218 (W) (for a full discussion of the decisions of the respective courts, see F R Malan ‘Letters of Credit and Attachment *ad Fundandam Jurisdictionem*’ 1994 *TSAR* 150; A N Oelofse ‘Developments in the Law of Documentary Letters of Credit’ (1996) 8 *South African Mercantile Law Journal* 56 at 65–68; Oelofse: *The Law of Documentary Letters of Credit op cit* note 135 at 465–470; A J Itzikowitz ‘Financial Institutions and Stock Exchange: Case Law – Letters of Credit’ (1995) *Annual Survey of South African Law* at 476–479; G F Lubbe ‘Law of Purchase and Sale: Case Law – Duties of the Purchaser’ (1995) *Annual Survey of South African Law* at 190–194; C F Hugo ‘Letters of Credit: Reflections on Recent Developments *ABLU* 1994 (a paper delivered at the 1994 Annual Banking Law Update held at the Indaba Hotel, Johannesburg) (unpaginated) at 3–8 of his article; A van Wyk ‘Letters of Credit and Attachment Proceedings’ (September 1995) *De Rebus* 575 at 575; W G Schulze ‘Attachment *Ad Fundandam Jurisdictionem* of the Rights Under a Documentary Letter of Credit – Some Questions Answered, Some Questions Raised’ (2000) 63 *Tydskrif vir Hedendaagse Romeins-Hollandse Reg* 672 at 675–678; and Hugo: *The Law Relating to Documentary Credits op cit* note 9 at 331–339). In *Ex parte Sapan Trading* the court was asked whether the South African applicant of an irrevocable the letter of credit issued by a South African bank could in effect stop payment of the letter of credit to the German beneficiary by obtaining an attachment of the beneficiary’s claim against the issuing bank in order to found or confirm jurisdiction in an action which the applicant intended to institute against the beneficiary. The court rejected the applicant’s application on various grounds (see also Van Niekerk and Schulze *op cit* note 5 at 307–308). This case clearly shows the extent to which South African courts are prepared to go in order to honour the principle of independence of letters of credit (and by implication also demand guarantees). This was also showed in another case, similar to the *Ex parte Sapan Trading* case, namely, *Transcontinental Procurement Services CC v ZVL and ZKL International AS* 2000 CLR 67 (W) (for a full discussion of this case, see W G Schulze ‘Attachment *Ad Fundandam Jurisdictionem* of the Rights Under a Documentary Letter of Credit – Some Questions Answered, Some Questions Raised’ (2000) 63 *Tydskrif vir Hedendaagse Romeins-Hollandse Reg* 672; and for a brief discussion, see Van Niekerk and Schulze *op cit* note 5 at 308–309). This case was concerned with the attachment of the beneficiary of a letter of credit’s claim under the credit in a foreign country. However, here the party that had applied for the attachment order was not the letter of credit applicant, but a third party.

<sup>208</sup> [1975] AC 396 (HL) ([1975] 1 All ER 504 (HL)).

would still be doubtful whether there was a serious question to be tried in the *Phillips* case. He also points out that the applicant also clearly had another remedy – an action against the seller-beneficiary for breach of the contract of sale. This, in turn, would then also imply that the requirement of irreparable harm could not be met. In addition to this, he said that not even the balance of convenience test would have favoured the applicant in this case.<sup>209</sup>

Using the *Loomcraft Fabrics v Nedbank* case, it is now well established that a court will grant an interdict restraining a bank from paying the beneficiary under a letter of credit and a demand guarantee in the event of it being established that the beneficiary was a party to the fraud in relation to the documents presented to the bank for payment.<sup>210</sup> In *Loomcraft Fabrics v Nedbank* the court stated that the fraud on the part of the beneficiary had to be clearly established before an interdict could be issued. In this case, fraud was not clearly established. Although the court has expressed that it would be willing to issue interdicts in appropriate circumstances (i.e., where fraud is clearly established), it is too early to say whether they will also follow such a stringent approach similar to the English courts. A deduction will only be possible where a case of clear fraud is established by an applicant/principal and he applies for an interdict restraining the bank from paying under the letter of credit/demand guarantee.

In *Loomcraft Fabrics v Nedbank* Scott AJA stated that on the presentation of conforming documents the bank can escape liability ‘only upon proof of fraud on the part of the beneficiary’.<sup>211</sup> If this is used as a basis, it would appear that fraud by the beneficiary is the one established, if not the only, basis for an interdict against the bank. This can clearly not be correct, as such a view would overlook other established defences, such as illegality in the underlying contract<sup>212</sup> of the credit/guarantee.<sup>213</sup>

It has been said that in cases where the principal/applicant of a demand guarantee/letter of credit seeks to obtain an interim interdict against a bank, the biggest obstacle would be to prove a *prima facie* right. Thereafter, another obstacle that will face him, will be to convince the court that the balance of convenience favours him – in other words, that the refusal of the interdict will be more harmful than the granting of it.<sup>214</sup> However, in cases where a principal/applicant of a demand guarantee/letter of credit seeks to obtain a final interdict against the bank to restrain it from paying under the instrument, the biggest obstacle is to prove that the bank has a duty towards the principal/applicant not to pay.<sup>215</sup>

#### 7.4.4 Interdicts Against Beneficiaries

To date there has been only one case dealing with the situation where an application for an interdict has been made against a beneficiary restraining him from receiving payment

<sup>209</sup> See also *Hugo: The Law Relating to Documentary Credits op cit* note 9 at 322.

<sup>210</sup> See 1996 (1) SA 812 (A) at 816–817.

<sup>211</sup> At 815I–J.

<sup>212</sup> See Chapter 6 for a full discussion.

<sup>213</sup> See also *Hugo: The Law Relating to Documentary Credits op cit* note 9 in note 412 at 327.

<sup>214</sup> For a full discussion of this and the problems experienced with proving this requirement, see *Hugo: The Law Relating to Documentary Credits op cit* note 9 at 328.

<sup>215</sup> For a full discussion of this and the problems experienced with proving that such a duty exists, see *Hugo: The Law Relating to Documentary Credits op cit* note 9 at 327–328.

under a standby letter of credit/demand guarantee. In *Union Carriage and Wagon Company Ltd v Nedcor Bank Ltd*<sup>216</sup> the application for an interdict against the beneficiary was unsuccessful. This case illustrates that South African courts are willing to grant such interdicts in appropriate circumstances, but only in the most exceptional circumstances.<sup>217</sup> In England, however, interdicts of this nature have been relatively more successful than interdicts against banks.<sup>218</sup>

*Z Z Enterprises v Standard Bank of South Africa Ltd*<sup>219</sup> concerned a case dealing with a dispute between a bank and its customer in connection with a documentary collection that was subject to the 1978 version of the ICC Uniform Rules for Collections.<sup>220</sup> In this case, the applicant applied for an interdict and relied on the fraud of the seller (beneficiary) to prevent the bank (i.e., Standard Bank) from making payment to the Indian remitting bank. The court found that although fraud was alleged, the facts alleged in support of it were equally consistent with a mere breach of contract not amounting to fraud. Therefore, the application for an interdict was dismissed because there was no proof of at least a *prima facie* case of fraud. The court stated:<sup>221</sup>

In my view the applicant has not shown a *prima facie* right. That is, it has not shown that the fraud exception is applicable to this case. It has further not shown that it may suffer irreparable harm or that it does not have another remedy. It may be that it will have difficulty in suing Choice International, but it may very well recover the moneys which it seeks to if it proves its case that there were material breaches of contract. It therefore also has another remedy.

The requisite of the balance of convenience has to be seen against the inconvenience and prejudice to the respondent if the interdict is granted. Although the interdict would be part of the court order and the bank would obviously inform the Indian bank of such, a bank's reputation in international trade is its greatest asset.

From this it follows, that in *Z Z Enterprises v Standard Bank of South Africa Ltd* the application for the interdict also failed because an apprehension of irreparable harm and the absence of another satisfactory remedy had not been shown and, since the applicant could very well have recovered the moneys that he sought to from its foreign contract partner. Oelofse has correctly said that if the courts take such a strict view of these two requirements for an interim interdict, it is difficult to picture any case in which payment can be interdicted on the ground of established fraud, seeing as there is always the unattractive possibility of trying to recover something from the other party in his home country.<sup>222</sup> He has suggested that the mere fact of having to try and recover the amount paid in a foreign country should be sufficient to satisfy the 'irreparable harm' requirement.

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<sup>216</sup> 1996 CLR 724 (W).

<sup>217</sup> See at 732.

<sup>218</sup> See the full discussion in para 7.2.3 above and para 5.4.5 in Chapter 5.

<sup>219</sup> 1995 CLD 769 (W).

<sup>220</sup> ICC Publication No 322, Paris (1978).

<sup>221</sup> 1995 CLD 769 (W) at 783–784.

<sup>222</sup> See *ABLU 1996 op cit* note 126 at 14 of the article.

He further also correctly submitted that the availability of a claim for damages ‘after the fact’ should not be regarded as a ‘satisfactory’ alternative to an interdict.<sup>223</sup>

The *Z Z Enterprises v Standard Bank of South Africa Ltd* case illustrates that a court might often refuse an interdict for failure to comply with requirements (2)–(4)<sup>224</sup> in the case of an interim interdict. This will be so, because an applicant/principal will commonly have a sufficient remedy in damages against the fraudulent beneficiary after payment under the letter of credit/demand guarantee, and he will often not suffer irreparable harm because he will be able to recover such damages afterwards. Therefore, the balance of convenience will not frequently favour the granting of an interdict.<sup>225</sup>

However, it has been indicated that at the interim stage the balance of convenience is more likely to favour the principal where he applies for an interdict against the beneficiary, than where he applies for an interdict against the bank. In this regard an important factor in the principal’s favour is that the beneficiary’s financial standing is not likely to be as good as that of the bank. Thus, an action for damages against the beneficiary for breach of contract will not be such a secure alternative than an action for damages against the bank will be.<sup>226</sup>

From the above it follows that should an applicant/principal of a letter of credit/demand guarantee ever succeed in proving established fraud on the side of the beneficiary, he will also have to comply with all the other requirements for obtaining an interim interdict. Practically, this seems rather difficult to do. It would be interesting to see how the South African courts will deal with a matter where the fraud has been established and an application for an interdict against the bank and/or beneficiary is made. From the little case law that there is in this area it seems that the South African courts will also take a stringent approach just like the English courts and will not easily grant interdicts.

#### 7.4.5 Anti-Dissipation Interdicts

The South African anti-dissipation interdict<sup>227</sup> is similar to the freezing injunction (*Mareva* injunction)<sup>228</sup> in England and is available only in exceptional circumstances.<sup>229</sup> In

<sup>223</sup> See *Oelofse: The Law of Documentary Letters of Credit op cit* note 135 at 481.

<sup>224</sup> As set out in para 7.4.2 above.

<sup>225</sup> See *Oelofse: The Law of Documentary Letters of Credit op cit* note 135 at 481.

<sup>226</sup> See *Hugo: The Law Relating to Documentary Credits op cit* note 9 at 329.

<sup>227</sup> In *Knox D’Arcy Ltd and Others v Jamieson and Others* 1994 (3) SA 700 (W) Stegmann J pointed out that an interdict of the *Mareva* nature has long been part of our law and is based on civilian sources. He did, however, stress that the adoption of the English terminology in this regard was best avoided as it was likely only to ‘invite confusion’ (see at 706A). Regarding the proper name of the interdict he said (at 706A–E):

Best of all we should adopt a name which aptly describes in a word what the interdict aims to achieve . . .

The measure is in substance an interdict *in securitatem debiti*; but if the need is felt for a more descriptive name, it could appropriately be called, say, an “anti-dissipation interdict”. That name emphasises its purpose of forestalling a *prima facie* intention to defeat due execution of an anticipated judgment by the dissipation of assets.

Today, this type of interdict is commonly referred to as an anti-dissipation interdict (see H J Erasmus and A M Breitenbach (consulting ed D E Van Loggerenberg) *Superior Court Practice* (1994) (loose-leaf ed) at E8-5.

<sup>228</sup> See para 7.2.5 above.

English law this special species of interim injunctions was developed in order to prevent a respondent from disposing of his assets in order to defeat a judgment the applicant believes he will obtain in due course.<sup>230</sup>

The anti-dissipation order is particularly structured so as to prevent a respondent (i.e., in the context of this thesis, the beneficiary of a letter of credit/demand guarantee) from placing its assets beyond the reach of the applicant.<sup>231</sup> The dissipation prohibited by the court must relate to property within the jurisdiction of the court.<sup>232</sup>

The legal requirements for an anti-dissipation interdict were held to be no different from the legal requirements for any other interim interdict.<sup>233</sup> Apart from a *prima facie* claim against the respondent (i.e., beneficiary), a well-grounded apprehension of irreparable injury and a balance of convenience in favour of the applicant (i.e., in the context of this thesis the principal/applicant of a demand guarantee/letter of credit), the applicant in order to succeed in obtaining an order preventing the respondent from dealing freely with his assets, the applicant must also prove (at least *prima facie*) that the respondent is wasting or secreting assets with the intention of defeating the claims of creditors.<sup>234</sup> The applicant does not have to show that he has no other satisfactory remedy, as there cannot be any substitute for such a ‘blocking order’. Neither does he have to show that the respondent has no *bona fide* defence against the intended claim.<sup>235</sup> It should be borne in mind that the anti-dissipation order does not create a preference for the applicant to the property interdicted.<sup>236</sup>

Unlike the English law, there are in South Africa no statutory measures governing the jurisdiction of the court to grant anti-dissipation interdicts, or even interdicts of any other

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<sup>229</sup> See *Knox D’Arcy Ltd and Others v Jamieson and Others* 1994 (3) SA 700 (W) and 1995(2) SA 579 (W); and *Knox D’Arcy Ltd and Others v Jamieson and Others* 1996 (4) SA 348 (A) at 372 (for a full discussion of this case, see A N Oelofse ‘South Africa: Litigation: “Mareva” Injunction’ (1997) 12 *Journal of International Banking Law* N-29–N-30 (at the News Section)). See also *ABLU 1996 op cit* note 126 in note 65 at 11 of the article. For a full comparison between the English freezing (*Mareva*) injunction and the South African anti-dissipation interdict, see *Prest op cit* note 4 at 160–172.

<sup>230</sup> See *Mareva Compania Naviera SA v International Bulkcarriers SA* [1975] 2 Lloyd’s Rep 509 (CA) ([1980] 1 All ER 213 (CA)); and for a full discussion, see para 7.2.5 above. See also *Harms: The Law of South Africa op cit* note 7 in para 335 at 301.

<sup>231</sup> See also *Director of Public Prosecutions v Mohamed NO* 2003 (4) SA 1 (CC); *Fey NO v Van der Westhuizen* [2003] All SA 679 (C). See also *Harms: The Law of South Africa op cit* note 7 in para 335 at 301.

<sup>232</sup> See *Hugo: The Law Relating to Documentary Credits op cit* note 9 at 330; and *Prest op cit* note 4 at 164.

<sup>233</sup> See *Knox D’Arcy Ltd and Others v Jamieson and Others* 1995(2) SA 579 (W) at 600B; and *Knox D’Arcy Ltd and Others v Jamieson and Others* 1996 (4) SA 348 (A) ([1996] 3 All SA 669 (A)) at 371–373.

<sup>234</sup> See *Knox D’Arcy Ltd and Others v Jamieson and Others* 1996 (4) SA 348 (A) ([1996] 3 All SA 669 (A)) at 372; and *Mcitiki v Maweni* 1913 CPD 684 at 687; *Nieuwoudt v Maswabi* 2002 (6) SA 96 (O); *Metlika Trading Ltd v Commissioner South African Revenue Service* 2005 (3) SA 1 (SCA) ([2004] 4 All SA 410) in para 35 at 15C–D; and *Carmel Trading Co Ltd v Commissioner South African Revenue Service and Others* 2008 (2) SA 433 (SCA) in para 3 at 435C–D. See also *Harms: The Law of South Africa op cit* note 7 in para 335 at 301.

<sup>235</sup> See *Oelofse: The Law of Documentary Letters of Credit op cit* note 135 in note 443 at 469.

<sup>236</sup> See *Carmel Trading Co Ltd v Commissioner, South African Revenue Service and Others supra* note 234 in para 3 at 435D.

type. More specifically, there are no statutory measures in South Africa that compare with the provisions of section 37(3) of England's Supreme Court Act of 1981.<sup>237</sup>

It has been pointed out that the anti-dissipation interdicts are open for considerable potential abuse and should not be granted lightly,<sup>238</sup> particularly because of the devastating effect they may have on the affairs of the respondent (in this context, often the beneficiary of the letter of credit/demand guarantee).<sup>239</sup> It has been said that South African courts should therefore consider the balance of convenience with great circumspection before granting this interdict. Stegmann J in *Knox D'Arcy Ltd and Others v Jamieson and Others*<sup>240</sup> referred to the anti-dissipation order that he had ordered against the parties in an earlier case between them as 'a Draconian interlocutory interdict'. Courts should also draft such orders with sufficient safeguards.<sup>241</sup>

However, anti-dissipation interdicts have not yet been considered by the South African courts, specifically in the context of letters of credit/demand guarantees.

#### 7.4.6 Conclusion<sup>242</sup>

The South African courts have shown that they are prepared, in cases where the fraud exception applies and, of course, where fraud has been established not only to interdict the beneficiary from receiving payment or making a demand, but also to interdict the bank from paying. However, they have also indicated<sup>243</sup> that they are willing to go to great lengths to protect the integrity of letters of credit (and probably also demand guarantees).

From the handful of cases that there are in this area it seems that the South African courts will also take a stringent approach just like the English courts and will probably also be reluctant to grant interdicts. As already mentioned in an earlier chapter<sup>244</sup> the obligation of the bank to pay under a letter of credit/demand guarantee can also be compared to the payment obligation of a bank that has guaranteed the payment of a cheque (i.e., a bank-guaranteed cheque). Therefore, cases where the drawer of a bank-guaranteed cheque applies for an interdict to prevent the bank from paying where a fraudulent demand is made, may also be comparable to similar cases dealing with demand guarantees/letters of credit and may provide important guidance in such cases.<sup>245</sup> It is imperative that the courts bear this in mind in future, especially in view of the fact that South Africa currently

<sup>237</sup> See *Prest op cit* note 4 at 164.

<sup>238</sup> See *Knox D'Arcy Ltd and Others v Jamieson and Others* 1994 (3) SA 700 (W).

<sup>239</sup> See also *Hugo: The Law Relating to Documentary Credits op cit* note 9 at 320; and *Knox D'Arcy Ltd and Others v Jamieson and Others* 1994 (3) SA 700 (W) at 707I–708E.

<sup>240</sup> See 1995(2) SA 579 (W) at 582D.

<sup>241</sup> See *Harms: The Law of South Africa op cit* note 7 in para 335 at 301.

<sup>242</sup> See also the conclusions reached and set out in para 8.4 in Chapter 8.

<sup>243</sup> See, e.g., *Ex parte Sapan Trading (Pty) Ltd* 1995 (1) SA 218 (W).

<sup>244</sup> See notes 10, 548 and 619 in Chapter 5.

<sup>245</sup> See e.g., *Wavecrest Enterprises v Cema Africa (Pty) Ltd (In Liquidation) and Others* (1991) 2 *Commercial Law Digest* 266 (C) ((CPD A1163/88), November 1988) (for a discussion of this case, see J T Pretorius 'Countermanding Payment of a Certified Cheque' (1992) 4 *South African Mercantile Law Journal* 210; and A N Oelofse 'Onlangse Ontwikkelings in die Tjekreg' (1991) 3 *South African Mercantile Law Journal* 364 at 369))

has limited demand guarantee and letters of credit cases dealing specifically with instances where the fraud exception has been raised and where applications for interdicts have been made trying to prevent the payment of fraudulent demands.

The discussion above has illustrated that the English law relating to injunctions is very similar to the South African law of interdicts, but there are some important, although discrete, differences. From the discussion above it appears that it might be even more difficult to obtain an interdict in the South Africa law than in the English law. If that is true, then it will practically mean that it will be nearly impossible for a principal to prevent payment on the basis of fraud or any other established ground in South Africa. If this is so, then Prest<sup>246</sup> is probably correct in suggesting that South Africa should also adopt the more flexible approach of the English courts to granting interdicts. However, even if South Africa were to adopt the English approach, it would by no means result in the courts having a flexible approach, as the English courts have a very stringent approach to the granting of interdicts. Adopting the English approach will merely have the effect of bringing the South African law in this regard on par with the English position.

Instead of applying for an interim injunction, the principal of a demand guarantee or an applicant of a letter of credit can in proper circumstances rather apply for a *Mareva* injunction under English law, which will restrain the beneficiary from moving the proceeds of the credit or guarantee from the jurisdiction of the court. The advantage of this procedure from the applicant's/principal's point of view is that the *Mareva* injunction does not interfere with the operation of the credit/guarantee, and therefore their autonomy principle is not influenced. This will also be the position with the South African anti-dissipation interdict. Although anti-dissipation interdicts have not yet been considered by the South African courts in the context of demand guarantees/letters of credit, the possibility exists that it will be used in future.

## 7.5 UNCITRAL CONVENTION

Article 20 of the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit ('UNCITRAL Convention')<sup>247</sup> clearly recognises the possibility of restraining orders in the event of established fraud. Article 20 specifically recognises the possibility of restraining orders against the beneficiary and/or bank on the basis of immediately available strong evidence that the beneficiary's demand for payment has no conceivable basis, as further described in article 19. When a court considers an application for a restraining order, it must also take into account whether in the absence of such order the principal would be likely to suffer serious harm. Furthermore, in such an application, the bank's knowledge of the beneficiary's fraud is not a relevant issue.<sup>248</sup> Therefore, if the

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<sup>246</sup> See Prest *op cit* note 4 at 101–102.

<sup>247</sup> See the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit (1996) (hereinafter 'the UNCITRAL Convention' or 'the Convention'). For a full discussion of the UNCITRAL Convention see para 3.3 in Chapter 3 and para 4.4 in Chapter 4.

<sup>248</sup> See Bertrams *op cit* note 13 at 416.



UNCITRAL Convention is applicable, the principal will have to comply with the specific requirements set out in articles 19 and 20 of the Convention.<sup>249</sup>

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<sup>249</sup> For a full discussion see para 4.4 in Chapter 4. See also the conclusions reached and set out in para 8.5 in Chapter 8. Although this part has been discussed fully in para 4.4 of Chapter 4, this part is included in this chapter merely for the sake of completeness and to also remind the reader that if the UNCITRAL Convention applies to a demand guarantee that the relevant provisions of the Conventions must be followed in order to obtain an interdict/injunction.



## CHAPTER 8: SUMMARIES, CONCLUSIONS AND RECOMMENDATIONS

### 8.1 BRIEF OVERVIEW

A bank demand guarantee can be described<sup>1</sup> as a personal security (undertaking) under which a bank promises payment to a beneficiary if a principal (the bank's client) defaults in the performance of his obligation in terms of the underlying contract (e.g., construction contract). The bank has to pay if the documents presented with the demand for payment comply with the documents that are mentioned in the text of the demand guarantee. For this reason, the bank's obligations are autonomous from the underlying contract between the beneficiary and the principal, which means that, in principle, the bank must pay if proper complying documents are presented, even if the beneficiary and the principal have not stipulated that there is a default under the original underlying contract.<sup>2</sup> In this regard, demand guarantees differ from surety guarantees/bonds, in which the security lender (i.e., surety) is only involved if the principal party defaults in the performance of an obligation.<sup>3</sup>

Demand guarantees and standby letters of credit issued by banks are still fairly new bank products compared to commercial letters of credit. Their use, particularly internationally, has grown dramatically since the 1960s.<sup>4</sup> Bank demand guarantees have become an established part of international trade, particularly in overseas construction and engineering projects, and international sale of goods contracts.<sup>5</sup> They are also often used locally. For example, when a supplier tenders for the supply of goods or services to the South African Government he must comply with the government's general conditions of contract, which often require that potential suppliers must provide tender guarantees (a type of demand guarantee).<sup>6</sup>

Demand guarantees, standby letters of credit and commercial letters of credit are all treated as autonomous contracts.<sup>7</sup> This means that the payment undertaking embodied in the demand guarantee/letter of credit is independent from both the performance of the underlying contract between the principal/applicant of the guarantee/credit and the beneficiary, and from the relationship between the principal/applicant and the bank (guarantor/issuing bank). Although the issue of the demand guarantee/letter of credit follows from the underlying contract between the principal/applicant and the beneficiary, the demand guarantee/letter of credit is separate from that underlying contract and the

<sup>1</sup> For a full discussion of the definition of a demand guarantee, see para 2.1 in Chapter 2.

<sup>2</sup> See F De Ly 'The UN Convention on Independent Guarantees and Stand-by Letters of Credit' (Fall 1999) 33 *International Lawyer* 831 at 832; and cf M Brindle and R Cox (eds) *Law of Bank Payments* 3 ed (2004) in para 8-026 at 672–673; and D Dinnie 'A Pound of Flesh' (2007) 15 *Juta's Business Law* 127 at 127.

<sup>3</sup> See De Ly *op cit* note 2 in note 5 at 832. See also para 2.5.1.1 in Chapter 2 for a full discussion of how demand guarantees differ from suretyship guarantees/traditional guarantees.

<sup>4</sup> See De Ly *op cit* note 2 at 832–833.

<sup>5</sup> For a discussion of the purpose and uses of a demand guarantee, see para 2.2 in Chapter 2.

<sup>6</sup> See para 1.1.2 in Chapter 1 and para 2.4.2.1 in Chapter 2.

<sup>7</sup> For a full discussion of the autonomy principle of demand guarantees and letters of credit, see para 2.5.2.2 in Chapter 2.

rights and obligations created by the guarantee/credit are independent of those arising under the underlying contract, with which the guarantor/issuing bank is generally not concerned. In practice, most demand guarantees are payable 'on demand' or 'on first demand' that imply that such guarantees create a binding obligation to pay against the simplest of demands by the beneficiary without any proof of any default by the principal on the underlying contract. Therefore, a bank that issues a demand guarantee must honour that guarantee according to its terms. The bank is not concerned in the least with relationships between the principal and the beneficiary; nor with the question of whether or not the principal has performed in terms of the underlying contract; and nor with the question of whether or not the principal is in default. The bank providing the demand guarantee undertakes an absolute obligation to pay the beneficiary according to the direction of the guarantee. Courts will also not interfere with the operation of a demand guarantee/letter of credit on grounds immaterial to the guarantee/credit itself. The idea in the demand guarantee/documentary credit transaction is that if the demand/documents presented comply with the terms of the credit/guarantee the bank has to pay and, if the documents do not correspond with the requirements, the bank must not pay.<sup>8</sup>

If the beneficiary calls on a demand guarantee, he will not have to establish proof of breach of the underlying contract by the principal and the bank will normally be obliged to pay in such circumstances. The applicability of the principle of autonomy to demand guarantees therefore clearly puts the principal at the mercy of an unscrupulous beneficiary. The complete detachment of the demand guarantee from the underlying contract generally denies any right to prevent performance in the event of an unjustified or fraudulent call upon the guarantee. A case of unjustified calling arises if the beneficiary draws the demand guarantee and demands payment, although he knows or can easily ascertain that the risk covered by the guarantee has not materialised.

The autonomy of the standby and commercial letter of credit, and demand guarantee have limits and are not absolute. All jurisdictions acknowledge certain exceptions to the autonomy principle.<sup>9</sup> Over the years a limited number of exceptions to the autonomy principle have come to be acknowledged and accepted in practice. In certain circumstances, the autonomy of demand guarantees/letters of credit may be ignored by the bank and regard may be had to the terms and conditions of the underlying contract. For instance, established fraud on the part of the beneficiary or his agent (e.g., where the beneficiary or his agent makes a demand knowing that the principal has fully performed his obligations under the underlying contract) disentitles him to payment, and the bank is entitled to refuse payment (i.e., the beneficiary's fraud is a valid defence to an action brought on the demand guarantee). It is a well-established exception to the principle of autonomy that the courts will intervene where they conclude that payment should be refused on the ground of fraud on part of the beneficiary.<sup>10</sup> The two main exceptions to the autonomy principle relate to fraud<sup>11</sup> and illegality in the underlying contract<sup>12</sup> and therefore

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<sup>8</sup> For a full discussion of the legal nature, characteristics and fundamental principles of demand guarantees, see para 2.5 in Chapter 2.

<sup>9</sup> For a full discussion see para 2.5.2.2 in Chapter 2, Chapter 5, and Chapter 6.

<sup>10</sup> For a full discussion of fraud as a ground upon which payment of a demand guarantee may be restrained, see Chapter 5.

<sup>11</sup> For a full discussion, see Chapter 5.

<sup>12</sup> For a full discussion, see Chapter 6. See also J P van Niekerk and W G Schulze *The South African Law of International Trade: Selected Topics* 2 ed (2006) at 311–312.

they were looked at in more detail in this thesis.<sup>13</sup> However, over the last few years a number of other possible grounds have also been acknowledged in various different jurisdictions.<sup>14</sup> But a further discussion of these possible exceptions falls beyond the scope of this thesis and attention was only given to the main exceptions, namely fraud and illegality.

The courts, progressively, take the view that it is for the guarantor of the demand guarantee or the issuer of the letter of credit, to make up his own mind as to whether he should refuse payment on the grounds of fraud or forgery. In practice, it has proved difficult to persuade banks that the beneficiaries' demands are fraudulent or otherwise unfair, and guarantors have generally been reluctant in the exercise of their own discretion to refuse payment.<sup>15</sup> If the evidence of fraud is unconvincing, the guarantor/issuer will normally pay. However, independent of the right of the guarantor/issuer to refuse payment, a principal/applicant may apply for an injunction/interdict to restrain enforcement of a demand guarantee/letter of credit by the beneficiary if he can prove fraud on the part of the beneficiary of which the guarantor/issuer has knowledge.<sup>16</sup> That is not easy to do – and it has, accordingly, been extremely difficult in practice to prevent fraudulent, and in some cases even illegal, demands for payment being made by beneficiaries on guarantors/issuers.<sup>17</sup> From the case law discussed in this thesis, it became clear that the calling of a demand guarantee does not preclude the principal from going to court if compelling merits, for example clearly established fraud or illegality in the underlying contract, exist.<sup>18</sup> It was also shown that the prospect of success depends on the law applicable to the demand guarantee/letter of credit and the approach a court in a specific jurisdiction takes.

The problem of unfair and abusive calls on demand guarantees is well known internationally. The International Chamber of Commerce ('ICC')<sup>19</sup> and the United Nations Commission on International Trade Law ('UNCITRAL')<sup>20</sup> have both been active in seeking a solution to the problems caused by unfair and fraudulent calls on demand guarantees and standby letters of credit. Their efforts to deal with this problem were fully discussed in this thesis, but they have proven not to be too successful.<sup>21</sup>

South Africa has limited literature on demand guarantees and standby letters of credit, and its case law, particularly regarding the grounds upon which payment under a guarantee and standby letter of credit might be prevented is scarce and often non-existent. During the

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<sup>13</sup> See Chapters 5–6.

<sup>14</sup> For brief discussions of other possible grounds, see note 33 in Chapter 1, notes 162 and 357 in Chapter 2, and note 8 in Chapter 5.

<sup>15</sup> See Chapters 5–7.

<sup>16</sup> For a discussion of the interlocutory relief that courts can give, see paras 5.4.5, 5.5.6, 5.6.5 in Chapter 5, and Chapter 7.

<sup>17</sup> For a full discussion of fraud, see Chapter 5; for a discussion of illegality, see Chapter 6; and for a discussion of injunctions/interdicts see Chapter 7.

<sup>18</sup> See Chapters 5–7.

<sup>19</sup> For a full discussion of the International Chamber of Commerce (hereinafter the 'ICC'), see para 3.2.1 in Chapter 3.

<sup>20</sup> For a discussion of the United Nations Commission on International Trade Law (hereinafter the 'UNCITRAL'), see para 3.3.1 in Chapter 3.

<sup>21</sup> For a full discussion, see Chapter 4 and para 8.5 below.

course of writing this thesis, it also became apparent that South Africa still has a lack of proper case law dealing with various issues relating to letters of credit. What the exact reasons are for having so few cases dealing with letters of credit and demand guarantees are still uncertain. It has been said that there tends to be considerably more litigation regarding letters of credit and demand guarantees in developed countries, than in less developed countries. This is so, because in less developed countries, such as South Africa, the scale of international trade is very slow, resulting in little litigation.<sup>22</sup> However, a contrary view for the lack of case law in this area of the law has also been expressed. Others have said that the fact that only a few South African cases on letters of credit (and by implication also demand guarantees) have reached the law reports over the years serves perhaps as proof of the reliability and the safeguards inherent in the letter of credit as a trusted and fair method of payment in international trade.<sup>23</sup> While others, at a totally other end, have indicated that the main reason for the limited attention granted to letters of credit (and by implication also demand guarantees) probably lies in the relatively informal manner in which international trade is conducted. It has also been said that South Africa's past isolation from international trade due to its apartheid laws and the sanctions that were introduced have also undoubtedly had a negative influence on the flow of the business between South Africa and the international community. It has also been indicated that participants know what is expected of them in fulfilling their obligations, since the greatest sanction for default would be to become a pariah in the international business community.<sup>24</sup> Of course, the possibility also exists that there is a practice in South Africa that if disputes between parties to the underlying contract do arise, that they are sorted out informally between the parties themselves, without involving the courts. Therefore, the exact reasons for the lack of case law seem to be legion.

In South Africa one often finds guidance by looking at similar cases dealing with commercial letters of credit and applying those similar principles to demand guarantees. The South African courts also further find guidance by looking at how other jurisdictions, in particular the English courts, deal with these issues.<sup>25</sup> Therefore, how the South African courts currently deal with or should be dealing or probably will be dealing with the unfair and fraudulent calling of demand guarantees/standby letters of credit was discussed in earlier chapters.<sup>26</sup>

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<sup>22</sup> See B Maripe 'The Legal Aspects of Documentary Credits in International Trade: The Case for Botswana' (1997) 30 *Comparative and International Law Journal of Southern Africa* 199 at 199.

<sup>23</sup> See H Schulze 'Letters of Credit' (July 2002) *De Rebus* 40 at 40.

<sup>24</sup> See A van Wyk 'Letters of Credit and Attachment Proceedings' (September 1995) *De Rebus* 575 at 575.

<sup>25</sup> See e.g., *Phillips and Another v Standard Bank of South Africa Ltd and Others* 1985 (3) SA 301 (W); *Ex parte Sapan Trading (Pty) Ltd* 1995 (1) SA 218 (W); *Loomcraft Fabrics CC v Nedbank Ltd and Another* 1996 (1) SA 812 (A); *Union Carriage and Wagon Company Ltd v Nedcor Bank Ltd* 1996 CLR 724 (W); and *Koumantarakis Group CC v Mystic River Investments 45 (Pty) Ltd and Another* [2007] JOL 19699 (D). See also C F Hugo *The Law Relating to Documentary Credits from a South African Perspective with Special Reference to the Legal Position of the Issuing and Confirming Banks* (published LLD, University of Stellenbosch (1996)) (1997) (hereinafter '*Hugo: The Law Relating to Documentary Credits*') at 314.

<sup>26</sup> See Chapters 2, and 5–7.

## 8.2 DEFENCES THAT ARE NOT CONCERNED WITH THE AUTONOMY PRINCIPLE

A few of the defences available to the guarantor (bank) of a demand guarantee that are in no way concerned with the autonomy principle of demand guarantees were also briefly examined in this thesis. This included the defence where there was a late presentation of documents or where there was a defective demand.<sup>27</sup> It also included the defence where the demand guarantee itself was illegal.<sup>28</sup>

### 8.2.1 Non-Compliance of Documents/Demands and Late Presentations

The obligation of the bank (guarantor/issuing bank) against its customer (i.e., principal of a demand guarantee/the applicant of a letter of credit) is to pay only against a proper conforming demand and/or documents. In other words, the bank has to pay if the documents presented with the demand for payment comply with the documents that are mentioned in the text of the demand guarantee, and if they do not the bank is not allowed to pay. Therefore, if the bank were to pay against non-conforming documents (without the express consent of the principal/applicant), the applicant's/principal's remedy would be an ordinary contractual one against the bank. International rules also recognise that the presentation of non-conforming documents is a valid defence available to a bank against a beneficiary.<sup>29</sup>

The late presentation and the presentation of non-conforming documents and/or defective demands are clearly valid defences against non-payment under English and American law.<sup>30</sup> Whether or not documents presented will be regarded as complying, will obviously depend on the standard of compliance that is required and how it is interpreted in the different jurisdictions.<sup>31</sup> In some jurisdictions, such as England and the United States, there must be strict compliance, so that even very slight deviations might disentitle the beneficiary to receive payment.<sup>32</sup> As already mentioned in Chapter 2, the doctrine of strict compliance has not been fully established in South Africa for commercial letters of credit.<sup>33</sup> The standard of compliance applicable to demand guarantees in South Africa has also not been settled yet, mainly due to a lack of case law and legal writings dealing with this issue. Based on the fact that South Africa presumably already follows a standard of strict documentary compliance in relation to commercial letters of credit and that its courts

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<sup>27</sup> See para 2.11 in Chapter 2.

<sup>28</sup> See paras 6.1, 6.2.1, 6.4.1 and 6.6 in Chapter 6.

<sup>29</sup> See, e.g., articles 2 (definition of 'complying presentation'), 5, 7, 8, 14(a), 15 and 16, particularly article 16(a), of the Uniform Customs and Practice for Documentary Credits (2007 version) (*ICC Publication* No 600, Paris (2006) (hereinafter the 'UCP 600'), and articles 9(a) and (b), 13(a) and 14(b) of its predecessor, Uniform Customs and Practice for Documentary Credits (1993 version) (*ICC Publication* No 500, Paris (1993)) (hereinafter the 'UCP 500'). See also rules 1.06(d), 2.01 and 4.01 of the International Standby Practices (*ICC Publication* No 590, Paris (October 1998)) (hereinafter the 'ISP98'); articles 2(b), 19 and 20 of the ICC Uniform Rules for Demand Guarantees (*ICC Publication* No 458, Paris (April 1992)) (hereinafter the 'URDG'); and article 15(1) read with article 17 of the UNCITRAL Convention.

<sup>30</sup> See para 2.11.1 in Chapter 2.

<sup>31</sup> For a full discussion see para 2.5.2.5 in Chapter 2.

<sup>32</sup> See also paras 2.5.2.5.1, 2.5.2.5.4, and 2.5.2.5.6 in Chapter 2.

<sup>33</sup> See paras 2.5.2.5.1, and 2.5.2.5.6 in Chapter 2.

often follow the English judgments in this area of law, it is assumed that the courts will also apply the same standard of strict documentary compliance to demand guarantees.<sup>34</sup> There are, of course, also other jurisdictions where the requirement is less stringent and where only substantial compliance is required.

Whether or not the demand guarantee is subject to any specific rules (such as the UCP,<sup>35</sup> URDG,<sup>36</sup> or ISP98<sup>37</sup>) or is subject to the UNCITRAL Convention,<sup>38</sup> will also play a role in establishing what the standard of compliance for the documents and/or demands is and whether the presented documents or demand are compliant.<sup>39</sup>

There has been no South African case dealing with the matter directly where the bank has refused to pay under a demand guarantee/letter of credit, because the demand was defective or where the documents presented under a demand guarantee/letter of credit was not compliant.<sup>40</sup> However, some guidance is found in two cases dealing with letters of credit, namely *Loomcraft Fabrics CC v Nedbank Ltd and Another*<sup>41</sup> and *OK Bazaars (1929) Ltd v Standard Bank of South Africa Ltd*.<sup>42</sup> In *Loomcraft Fabrics v Nedbank* the Appellate Division (as it then was) made an important observation. It said that if the documents were not conforming as stipulated, but the bank nevertheless decided to pay, there was nothing that the applicant could do to prevent the bank from paying, but the bank would then not be able to reimburse itself from the funds of the applicant. In those circumstances the bank would, in effect, be paying from its own funds. In the *OK Bazaars v Standard Bank* case the Supreme Court of Appeal reiterated some of the basic principles of letters of credit<sup>43</sup> and specifically said ‘[i]f the presented documents do not conform with the terms of the letter of credit the issuing bank is neither obliged nor entitled to pay the beneficiary without its customer’s consent’.<sup>44</sup> From these two cases it is clear that banks are not obliged to pay under letters of credit (and by implication also demand guarantees), unless the documents presented conform with the terms of the credit (or guarantee).

From various statements made in the *OK Bazaars v Standard Bank* case<sup>45</sup> the deduction can also be made that the presentation of non-conforming documents and/or demands under a letter of credit/demand guarantee will most likely also be viewed by the South African courts as a successful defence here. This assumption is also strengthened by the fact that the South African courts have in the past been guided basically exclusively by

<sup>34</sup> See paras 2.5.2.5.1, 2.5.2.5.4, and 2.5.2.5.6 in Chapter 2.

<sup>35</sup> See para 2.5.2.5.2 in Chapter 2.

<sup>36</sup> See para 2.5.2.5.4 in Chapter 2.

<sup>37</sup> See para 2.5.2.5.3 in Chapter 2.

<sup>38</sup> See para 2.5.2.5.5 in Chapter 2.

<sup>39</sup> See para 2.11.3 in Chapter 2.

<sup>40</sup> For a full discussion see para 2.11.2 in Chapter 2.

<sup>41</sup> 1996 (1) SA 812 (A).

<sup>42</sup> 2002 (3) SA 688 (SCA).

<sup>43</sup> See in paras 25–26 at 697G–698D.

<sup>44</sup> At 697J–698A.

<sup>45</sup> 2002 (3) SA 688 (SCA) in paras 25–26 at 697G–698D (and quoted in para 2.11.2 in Chapter 2).



English judgments in documentary credit issues, and therefore, the English approach is also likely to prevail here.<sup>46</sup> As a result, since South Africa apparently also follows a strict standard of compliance,<sup>47</sup> it is also quite possible that it will follow suit here in holding that non-compliance is a proper defence that can be invoked. Of course, the success of such a defence will also depend on how strictly the South African courts will apply the doctrine of strict compliance regarding demand guarantees.<sup>48</sup>

### 8.2.2 Demand Guarantee Itself is Illegal (and the Underlying Contract Legal)

It seems to be settled law in England and South Africa that a contract that is contrary to the law, good morals or public policy is illegal and, consequently, void in terms of the general principles of the law of contract in each separate jurisdiction. Therefore, if it is the commercial or standby letter of credit or demand guarantee itself that is contrary to the law, good morals or public policy (i.e., the law of the country which applies to the guarantee/credit or the law of the country where the guarantee/credit is to be performed), it will likewise not be enforceable. A demand guarantee/letter of credit itself may be illegal where, for instance, the issue of the guarantee/credit is prohibited.<sup>49</sup> This will, for instance, be the case where it would be against a specific statute to issue a demand guarantee in favour of beneficiaries from certain countries (e.g., those that have been black-listed or are considered to be terrorists). A demand guarantee/letter of credit itself may also be illegal because of a supervening prohibition.<sup>50</sup> A supervening prohibition may take place where at the time of issue the issuing of the guarantee or credit was lawful, but by the time of payment it has become illegal for the bank to pay by reason of a government or judicial order.<sup>51</sup> The position will also be the same where the order against payment is that of a foreign government or court, provided it is the government or court in the country where the bank's payment obligation is to be performed or the country whose law is the proper law of the credit/guarantee.<sup>52</sup> Where the demand guarantee/letter of credit itself is illegal (and the underlying contract legal), the principle of autonomy does not come into play and no difficulty arises as a result of that principle.<sup>53</sup>

### 8.3 EXCEPTIONS TO THE AUTONOMY PRINCIPLE

Over the years a handful of exceptions to the autonomy principle of demand guarantees and letters of credit have come to be acknowledged and accepted in practice.<sup>54</sup> In certain circumstances, the autonomy of demand guarantees and letters of credit may be ignored by

<sup>46</sup> See *Hugo: The Law Relating to Documentary Credits op cit* note 25 at 314.

<sup>47</sup> As mentioned earlier (see paras 2.5.2.5.1, 2.5.2.5.4 and 2.5.2.5.6 in Chapter 2), the South African law regarding the doctrine of strict compliance has not been authoritatively settled yet (see also *Hugo: The Law Relating to Documentary Credits op cit* note 25 at 314).

<sup>48</sup> See para 2.11.2 in Chapter 2.

<sup>49</sup> See, e.g., *International Dairy Queen Inc v Bank of Wadley* 407 F Supp 1270 (MD Ala 1976).

<sup>50</sup> See N Enonchong 'The Autonomy Principle of Letters of Credit: An Illegality Exception?' (2006) *Lloyd's Maritime and Commercial Law Quarterly* 404 at 406.

<sup>51</sup> *Idem*.

<sup>52</sup> See Enonchong *op cit* note 50 at 406–407.

<sup>53</sup> For a full discussion, see paras 6.2.1, 6.4.1 and 6.6 in Chapter 6.

<sup>54</sup> See Chapters 5 and 6.

the bank and regard may be had to the terms and conditions of the underlying contract. The main exceptions concern fraud<sup>55</sup> and illegality in the underlying contract.<sup>56</sup> In this thesis a great deal of attention has been given to fraud and illegality as possible grounds on which payment under demand guarantees and letters of credit have been attacked (and sometimes even prevented) in the courts in England, the United States and South Africa. It was shown that the prospect of success often depends on the law applicable to the demand guarantee and letter of credit, and the approach a court in a specific jurisdiction takes.

### 8.3.1 Fraud as an Exception to the Autonomy Principle<sup>57</sup>

The fraud exception is an integral part of the law governing letters of credit and it has developed to fill a gap in that law. The objective of the fraud exception is to prevent unscrupulous beneficiaries from abusing the letter of credit system/demand guarantee system and defrauding the applicant/principal and the issuer.<sup>58</sup> The fraud rule is an extraordinary rule in the law of letters of credit (and by implication also the law of demand guarantees), because it is in conflict with the fundamental principle of autonomy of letters of credit (and demand guarantees). It has correctly been said that the fraud exception should be applied cautiously and confined strictly to its purpose. It has also been cautioned that any deviation from its original purpose could destroy the independence of the letter of credit (and by implication also the demand guarantee) and undermine the commercial utility of the letter of credit (and the demand guarantee).<sup>59</sup>

All three jurisdictions (i.e., England,<sup>60</sup> the United States<sup>61</sup> and South Africa<sup>62</sup>) discussed in this thesis appear to regard fraud perpetrated by the beneficiary as a valid exception to the autonomy principle of demand guarantees and letters of credit. It is the most common ground upon which the bank may be entitled to refuse or withhold payment under a letter of credit and demand guarantee.<sup>63</sup> Fraud in relation to documentary credits and demand guarantees can exist at two levels. It may be fraud in relation to the autonomous letter of credit/demand guarantee itself, for example, forgery in the documents in which the parties deal (i.e., fraud in the narrow sense) or it may relate to the underlying contract in terms of which the letter of credit/demand guarantee was issued (i.e., fraud in the wide sense).<sup>64</sup> The majority of cases in all three jurisdictions deal with the former, and the impression may have been created in England and South Africa that only fraud in the narrow sense (i.e., fraud in the documents, e.g., forgeries) may entitle the bank to withhold payment

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<sup>55</sup> See Chapter 5.

<sup>56</sup> See Chapter 6.

<sup>57</sup> See Chapter 5.

<sup>58</sup> See Xiang Gao *The Fraud Rule in the Law of Letters of Credit: A Comparative Study* (2002) at 63. For a full discussion of the meaning and rationale of the fraud exception, see para 5.2 in Chapter 5.

<sup>59</sup> See also Xiang Gao *op cit* note 58 at 63.

<sup>60</sup> For a full discussion of the fraud exception in England, see para 5.4 in Chapter 5.

<sup>61</sup> For a full discussion of the fraud exception in the United States, see para 5.5 in Chapter 5.

<sup>62</sup> For a full discussion of the fraud exception in South Africa, see para 5.6 in Chapter 5.

<sup>63</sup> See para 5.1 in Chapter 5.

<sup>64</sup> See para 5.1 in Chapter 5.

where no payment has been made or restrain the beneficiary from accessing the credit/guarantee in instances where the bank may have already paid.<sup>65</sup>

The principle of autonomy is a cornerstone of the law of demand guarantees and letters of credit.<sup>66</sup> The whole rationale of these instruments is that the bank must pay against conforming demands and documents, leaving it to the parties to the underlying contract to settle their disputes afterwards.<sup>67</sup> The accepted exception to the principle of autonomy is the case where the beneficiary knowingly tenders fraudulent documents containing misrepresentations. In such an instance the bank has a defence, but only if the fraud can be shown with a relatively high degree of probability.

English courts have saddled plaintiffs (i.e., principals of demand guarantees/applicants of letters of credit) with a great burden of proof, requiring them to establish the existence of 'clear' or 'obvious' fraud also known to the issuer in order to invoke the fraud rule. Undoubtedly, the beneficiary must also know of the fraud at the time of the presentation, because in the absence of such knowledge the beneficiary cannot be party to the fraud. The ordinary standard of proof in civil cases is that of the balance of probabilities. This standard also applies in a fraud case, but the court will weigh the evidence with due regard to the gravity of the particular allegation. It has become the generally accepted formula for the evidence, which is required in order to establish fraud, that it should be the only realistic inference to draw that the demand was fraudulent. The proof must also be immediately available without the need for lengthy and in-depth investigation into the underlying contract. Therefore, the only exception where a bank does not have to pay under a demand guarantee is where there is clear fraud of which the bank has notice and to which the beneficiary was a party. In the English law the accepted test is that on the material before it the court must consider fraud to be the 'only realistic inference'.<sup>68</sup>

In English law the leading House of Lords decision in *United City Merchants (Investments) Ltd and Glass Fibres and Equipments Ltd v Royal Bank of Canada (incorporated in Canada), Vitrorefuerzos SA and Banco Continental SA*<sup>69</sup> confined the fraud exception in relation to commercial letters of credit to fraud in the narrow sense (i.e., fraud committed in the documents). However, more recent English judgments contain indications that the earlier formulation of the fraud exception should not be read too literally. The cases dealing specifically with demand guarantees indicate an acceptance of fraud in the wide sense (i.e., fraud not in relation to the documents, but in relation to the conduct by the beneficiary in relation to the underlying contract). However, the precise limits of the fraud exception under the English law are far from settled.<sup>70</sup>

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<sup>65</sup> See Chapter 5 and Maripe *op cit* note 22 at 204–205.

<sup>66</sup> For a full discussion of the autonomy principle of demand guarantees/demand guarantees, see para 2.5.2.2 in Chapter 2.

<sup>67</sup> For a full discussion of the documentary nature of demand guarantees and letters of credit, see para 2.5.2.4 in Chapter 2 and for a discussion of the principle of strict compliance, see para 2.5.2.5 in Chapter 2.

<sup>68</sup> See paras 5.4.1–5.4.4 in Chapter 5.

<sup>69</sup> [1983] AC 168 (HL) ([1982] 2 Lloyd's Rep 1 (HL)).

<sup>70</sup> See para 5.4.2 in Chapter 5. See also Van Niekerk and Schulze *op cit* note 12 at 316.

In South Africa the first time the courts briefly referred to the fraud exception was in 1985 in *Phillips and Another v Standard Bank of South Africa Ltd and Others*.<sup>71</sup> However, it was not until the *Loomcraft Fabrics CC v Nedbank Ltd and Another*<sup>72</sup> case in 1995 that the South African courts really acknowledged and dealt with the fraud exception. The Appellate Division (as it then was) in *Loomcraft Fabrics v Nedbank* provided merely a basis for the fraud rule and has left us with many uncertainties regarding, specifically, the concept of fraud and the standard of proof that is required. However, the Appellate Division did make it clear that South African courts were willing to intervene and issue interdicts restraining payment, in cases where the fraud was clearly established; and they were also willing to enforce the fraud exception where the forgery or falsification concerned the documents (i.e., where there was fraud in the narrow sense). Since 1995, there have been no other cases specifically dealing with the fraud exception. The fraud rule in South Africa has thus remained stagnant for more than a decade and it is unclear how its courts would apply the fraud rule today. For instance, the courts have not yet indicated that they will not be prepared to interdict a bank from paying in the case of fraud concerning the performance by the beneficiary in terms of the underlying contract (i.e., in cases of fraud in the wide sense). But, if one takes into consideration the *obiter dictum* made in *Union Carriage and Wagon Company Ltd v Nedcor Bank Ltd*,<sup>73</sup> there is strong reason to believe that the courts will acknowledge fraud in the wide sense as a valid exception to the autonomy principle of the letter of credit and demand guarantee. The South African law regarding the fraud exception is far from being settled.

As the obligation of the bank to pay under a letter of credit/demand guarantee can also be compared to the payment obligation of an acceptor of a bill of exchange or that of a bank of a bank-guaranteed cheque, it is possible that decisions where the fraud exception has been raised against the payment obligation of the acceptor of a bill of exchange or bank can also be of assistance in similar cases dealing with demand guarantees or letters of credit.<sup>74</sup> Therefore, it is recommended that the South African courts bear this in mind in future, especially in view of the fact that South Africa currently has very few cases specifically dealing with the fraud exception regarding demand guarantees/letters of credit.

From the very few (and old) case law that is available in South Africa one can see strong correlations with the English law in the South African courts' application of the fraud exception.<sup>75</sup> For instance, both jurisdictions require that the fraud on the part of the beneficiary must be clearly established for the fraud exception to apply. Both require that the burden of proof required is the ordinary civil one which has to be discharged on a balance of probabilities. In the English law it has been said that although this is the standard that applies in a fraud case, the court also 'weighs the evidence with due regard to the gravity of the particular allegation'.<sup>76</sup> Therefore, the degree of probabilities depends upon the subject matter and it is clear that a very high degree of probability is required in

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<sup>71</sup> 1985 (3) SA 301 (W).

<sup>72</sup> 1996 (1) SA 812 (A).

<sup>73</sup> 1996 CLR 724 (W). See the discussion of the *obiter dictum* in para 5.6.1 in Chapter 5.

<sup>74</sup> See notes 10, 548 and 619 in Chapter 5

<sup>75</sup> See paras 5.6.1–5.6.3 and 5.6.6 in Chapter 5.

<sup>76</sup> See *Themehelp Ltd v West and Others* [1996] QB 84 (CA) ([1995] All ER 215 (CA) and [1995] 3 WLR 751 (CA)) at 99. See also D Warne and N Elliott *Banking Litigation* 2 ed (2005) at 261.

this context.<sup>77</sup> In *Rafsanjan Pistachio Producers Co-Operative v Bank Leumi (UK) Plc*<sup>78</sup> Hirst J said that ‘a very heavy burden of proof rests upon the defendants to establish their case to the highest level of probability’.<sup>79</sup> In the South African law it is stressed that although it is the ordinary civil burden of proof that is required, it will not be inferred lightly and it seems that a little more than the mere civil burden is required.<sup>80</sup> However, precisely how much more convincing the evidence must be remains uncertain in South African law.<sup>81</sup>

The few South African cases, discussed in Chapter 5, where the fraud exception was referred to or acknowledged did not deal with the question of at which exact time the fraud had to be clear to the bank. Therefore, there is no authority on this issue. Initially, the English law required that clear evidence of fraud had to be known to the bank at the time of presentation of the documents. Therefore, the bank was obliged to pay against a demand that complied with the terms of the letter of credit/demand guarantee unless, at the time of presentation, the bank had clear evidence from which the only inference to draw was that it was fraudulent. However, it now seems, as a result of more recent decisions,<sup>82</sup> that a bank may also be entitled to rely on knowledge it obtained between the demand and the hearing that (1) the demand was fraudulent; or (2) that the letter of credit/demand guarantee was voidable for fraudulent misrepresentation when the demand was made, as grounds for refusing to pay the beneficiary. Unlike the position in England,<sup>83</sup> the question of whether the bank was aware of the beneficiary’s fraud has never been regarded as a relevant issue in the United States, particularly when an application has been made for an injunction against the bank preventing payment.<sup>84</sup> As already mentioned, in the light of the fact that South African courts have a long tradition of following decisions made by the English courts, it is likely that they will also follow the English decisions in this regard. Although the South African law regarding letters of credit and demand guarantees is similar to the English law, and despite its tradition of following English decisions, it is submitted that in this specific regard the position of the United States is to be preferred to the English position and should rather be followed by South African courts. As it has been said that, ‘fraud unravels all’ and therefore it should not matter at what time the bank has knowledge, just as long as the required standard of fraud is proved. If fraud is proved to the standard required and all other requirements for an interdict are proved, an interdict preventing payment should be granted irrespective of the time at which the bank obtained knowledge of the fraud.

<sup>77</sup> See *Hugo: The Law Relating to Documentary op cit* note 25 at 278.

<sup>78</sup> [1992] 1 Lloyd’s Rep 513 (QB) at 525. See also the discussion of the case in para 5.4.4 in Chapter 5.

<sup>79</sup> See para 5.4.3 in Chapter 5.

<sup>80</sup> See paras 5.6.1 and 5.6.3 in Chapter 5.

<sup>81</sup> See A N Oelofse *The Law of Documentary Letters of Credit in Comparative Perspective* (1997) (hereinafter ‘*Oelofse: The Law of Documentary Letters of Credit*’) at 480.

<sup>82</sup> See, e.g., *Balfour Beatty Civil Engineering and Another v Technical and General Guarantee Co Ltd* (2000) 68 Con LR 180 ([2000] CLC 252 and [2000] CILL 1574); *Safa Ltd v Banque du Caire* [2000] 2 Lloyd’s Rep 600 (CA); *Solo Industries UK Ltd v Canara Bank* [2001] 2 Lloyd’s Rep 578 (CA) ([2001] 1 WLR 1800 (CA)); and *Standard Bank (London) Ltd v Canara Bank* [2002] All ER (D) 340 (May) ([2002] EWHC 1032 (Comm) (QB)).

<sup>83</sup> For a full discussion, see para 5.4.4 in Chapter 5.

<sup>84</sup> See R Bertrams *Bank Guarantees in International Trade: The Law and Practice of Independent (First Demand) Guarantees and Standby Letters of Credit in Civil Law and Common Law Jurisdictions* 3 ed (2004) at 416–417.

As already mentioned, more recent cases in England also seem to accept that fraud in the underlying contract (i.e., fraud in wide sense), especially when it concerns a demand guarantee, will be a valid exception to the autonomy principle.<sup>85</sup> In South Africa the Appellant Division seemed to have restricted the fraud exception to fraud in the documents, but from comments made in other cases, it seems that the South African courts would also be willing to accept fraud in the wide sense as valid exception.<sup>86</sup> However, in both jurisdictions, there has been no specific indication of the exact kind of fraud, as between the principal and beneficiary, that would legally create a restraint on the beneficiary in operating the demand guarantee or credit. It is submitted that there should not be any limitations placed on only accepting certain types of fraud as valid exceptions. To list the kinds of fraud that would be acceptable seems to be of academic interest only. It would make more sense if courts and banks were to judge each case on its own merits – if fraud is established clearly of whatever nature (i.e., irrespective of whether it relates to forged documents or to fraud in the underlying contract) payment should be refused or restrained.

In the United States the fraud rule manifested by *Sztejn v J Henry Schroder Banking Corporation*<sup>87</sup> was codified for the first time in Prior UCC article 5 section 5-114(2) (i.e., United States Uniform Commercial Code of 1962).<sup>88</sup> Section 5-114 specifically provided for the fraud exception to the independence principle of commercial and standby letters of credit.<sup>89</sup> However, the section failed to mention what constituted fraud under the fraud rule and therefore vastly different standards of fraud were subsequently applied in different American cases. This caused confusion and it had the effect that there were vastly different opinions as to the standard of fraud required. There was much support for the view that only ‘egregious fraud’, that is ‘fraud which taints the entire transaction’, would suffice. However, there was also support for the standard of ‘ordinary’ or ‘intentional fraud’ (i.e., fraud ‘in the sense of common law deceit requiring scienter’ (i.e., one requires knowledge as a condition of fraud)), as well as for the even broader, more flexible ‘constructive fraud’ standard. Unfortunately, the cases applying section 5-114(2) did not provide a consistent answer to the question of concept or standard of fraud.<sup>90</sup>

Section 5-114 provided that the fraud rule should be applied ‘when . . . a required document . . . is forged or fraudulent’ or ‘there is fraud in the transaction’. The phrase ‘fraud in the transaction’ was particularly problematic due to a diversity of opinion as to the exact meaning of the phrase. It was not apparent whether the ‘transaction’ referred to the relationship between the beneficiary and the issuer or to the underlying contract between the beneficiary and the applicant or to both. There was thus uncertainty as to

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<sup>85</sup> See para 5.4.2 in Chapter 5.

<sup>86</sup> See para 5.6.2 in Chapter 5.

<sup>87</sup> 31 NYS 2d 631 (1941). For a discussion of this case, see para 5.3.3 in Chapter 5.

<sup>88</sup> See para 5.5.1 in Chapter 5. For a discussion of the background to article 5 of the United States Uniform Commercial Code (hereinafter the ‘UCC’), see paras 3.4.2 and 3.4.2.2 in Chapter 3, and for a full discussion of how the current revised article 5 of the UCC (i.e., the 1995 version) deals with fraud and how its predecessor, Prior UCC article 5 (i.e., the 1962 version) dealt with fraud, see para 5.5 in Chapter 5.

<sup>89</sup> For a full discussion of Prior UCC article 5 section 5-114(2), see para 5.5.2.1, 5.5.3, 5.5.4.2, and 5.5.4.3 in Chapter 5.

<sup>90</sup> See the full discussion in paras 5.5.2.1 and 5.5.4.2–5.5.4.3 in Chapter 5.

whether fraud related to fraud committed by the beneficiary on the documents ('fraud in the narrow sense'), or whether it also referred to fraud committed by the beneficiary which does not relate to documents, but relates to the underlying contract, for example, where a beneficiary intentionally dispatched goods of an inferior quality ('fraud in the wide sense').<sup>91</sup>

Most of the uncertainty that might have existed regarding the concept and standard of the fraud exception set out in Prior UCC article 5 section 5-114(2) was eliminated when the Revised UCC (i.e., United States Uniform Commercial Code of 1995) article 5 section 5-109 came into operation.<sup>92</sup> This section now stands as the most comprehensive code of the fraud rule in the law of letters of credit in the common law world. Section 5-109 has addressed two of the most controversial issues raised in the application of the fraud rule since the promulgation of Prior UCC article 5 section 5-114(2), namely the standard of fraud and the concept of fraud. As regards the former, section 5-109 provides that to invoke the fraud rule, the fraud involved has to be 'material'. From the most recent American cases, discussed in Chapter 5, it follows that the American courts in applying the standard of 'material fraud' as set out in section 5-109 seem generally to have taken a similar approach to the old cases that applied Prior UCC article 5 section 5-114(2) and preferred the standard of 'egregious' fraud. They have taken the position that the fraud exception may only be applied in limited situations where the demand for payment under the letter of credit 'has absolutely no basis in fact'.<sup>93</sup> However, in the minority judgment in *Mid-America Tire Inc v PTZ Trading Ltd Import and Export Agents*<sup>94</sup> Valen J has indicated that the standard of 'material fraud' is equivalent to a violation of the beneficiary's obligation of 'good faith, diligence, reasonableness, and care'. This type of view is similar to the standard of 'constructive fraud' (as mentioned above). The aforesaid indicates that different views as to the standard of fraud may still appear in future in the United States, although a uniform and appropriate standard of 'material fraud' has been stipulated in Revised UCC article 5 section 5-109.<sup>95</sup> This clearly illustrates that although a standard of fraud is codified, it could still cause interpretational problems for courts. It also demonstrates the difficulty that there is to firstly, identify an appropriate standard, and then, to correctly apply it to the different circumstances where fraud arises.

As far as the concept of fraud is concerned, section 5-109 indicates that the fraud can relate to forgeries or to fraud in the underlying transaction. Therefore, it is now clear that American law accepts that the fraud exception relates to fraud committed by the beneficiary on the documents ('fraud in the narrow sense'), and fraud committed by the beneficiary that does not relate to documents, but relates to the underlying transaction ('fraud in the wide sense').<sup>96</sup>

What is clear from Chapter 5 is that the fraud exception to the principle of independence of demand guarantees and letters of credit (commercial and standby) is clearly acknowledged

<sup>91</sup> See the full discussion in paras 5.5.2.1 and 5.5.3 in Chapter 5.

<sup>92</sup> See the full discussion in paras 5.5.2.2, 5.5.3, and 5.5.4.4 in Chapter 5.

<sup>93</sup> See also Xiang Gao *op cit* note 58 at 88.

<sup>94</sup> 43 UCC Rep Serv 2d 964 (2000) ((2000) Ohio App LEXIS 5402). See note 514 in Chapter 5.

<sup>95</sup> See also Xiang Gao *op cit* note 58 at 88.

<sup>96</sup> See para 5.5.3 in Chapter 5.

under English, American and South African law. All three jurisdictions seem to accept that both ‘fraud in the narrow sense’ (i.e., fraud committed by the beneficiary on the documents) and ‘fraud in the wide sense’ (i.e., fraud committed by the beneficiary that does not relate to documents but the underlying contract, for example, by intentionally dispatching goods of an inferior quality) will constitute a valid exception to the autonomy principle.

However, it does seem that the English and South African courts tend to use the fraud exception more narrowly as opposed to the more flexible criteria found in American jurisprudence where the exception first found expression. For instance, the American courts would grant interim restraining orders on the basis of strong suspicion of fraud, and they also do not require proof that the beneficiary was involved in the fraud. Therefore, it seems that in America it would be possible for an applicant of a letter of credit to obtain an injunction preventing payment where fraud was committed by a party other than the beneficiary.<sup>97</sup> English courts and South African courts, in turn, correctly require that fraud on the part of the beneficiary must be proved for the fraud exception to apply. If fraud was committed by a third party without the knowledge of the beneficiary, the fraud exception will and correctly should not find application.

English courts and legal writing have consistently required that fraud must be established clearly and beyond doubt, but at times, American lower court case law has occasionally been somewhat diffused and conflicting in this regard. Mere allegations, testimony or documentation from the principal is considered insufficient. He must, at least, produce, for example, documents from independent third parties that clearly confirm the facts alleged by the principal or documents, statements or acknowledgements from the beneficiary or undisputed facts. Ackner LJ in *United Trading Corporation SA and Murray Clayton Ltd v Allied Arab Bank Ltd and Others*<sup>98</sup> stated that the correct test to use to establish whether there is clear evidence of fraud is, if based on the material before the court, the only realistic inference to draw is that of fraud (i.e., the ‘sole realistic inference’ test).<sup>99</sup> This standard laid down in *United Trading Corporation v Allied Arab Bank* has become the generally accepted formula in England for the evidence that is required in order to establish fraud. This test is commendable due to its preciseness and simplicity, and it is recommended that South Africa also use this test in order to establish whether fraud has been clearly established. The problems experience in the United States with the American courts’ different interpretations of the standard of ‘material fraud’, lead to the recommendation that South Africa should continue to follow the English law in this regard – requiring that the correct standard for fraud is that of clearly established fraud.

From the discussion of the cases and legal writing in Chapter 5, it is clear that the fraud rule in the law governing letters of credit and demand guarantees is still a developing area in all three jurisdictions discussed, and it is not possible to state some aspects of the law with certainty.

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<sup>97</sup> See notes 323 and 401 in Chapter 5.

<sup>98</sup> [1985] 2 Lloyd’s Rep 554 (CA).

<sup>99</sup> See at 561. For a full discussion, see para 5.4.3 in Chapter 5.



### 8.3.2 Illegality as an Exception to the Autonomy Principle<sup>100</sup>

Recent cases<sup>101</sup> in England are in favour of accepting illegality in the underlying contract as an exception to the principle of autonomy of letters of credit and demand guarantees.<sup>102</sup> Fraud as a possible exception to the autonomy principle already received attention during the 1920s and has been in development for nearly a century and still it has not been authoritatively settled in all respects.<sup>103</sup> Illegality as a possible exception received its first real consideration as a possibility during the 1990s, but it was not until 2004 that it was really acknowledged as an exception. Illegality as an accepted exception is still in its infancy stage, and there are still too many uncertainties regarding its exact application, the specific types of illegality that would be considered to be sufficient to constitute an exception (i.e., illegality as a concept) and the exact standard of proof that is required. Therefore, it remains to be seen exactly how the defence of illegality will be developed under the English law.<sup>104</sup>

However, at this stage (based on earlier discussions),<sup>105</sup> it is possible to identify only a few requirements that will need to be satisfied before the illegality exception will be applicable under the English law. Firstly, the alleged illegality will have to be established clearly. Secondly, the illegality will also have to be sufficiently serious. Thirdly, the beneficiary must have been involved in the illegality. Fourthly, the letter of credit/demand guarantee must be sufficiently connected to the illegality in the underlying transaction.<sup>106</sup>

For the fraud exception to the autonomy principle to succeed, earlier English cases have consistently required that banks had to have clear evidence of the fraud at the time of presentation of the documents. Later cases took the view that these earlier cases did not intend restricting the time by which the evidence of fraud had to be available to the extent of ignoring evidence of fraud that came to light after presentation of the documents, but before hearing the case.<sup>107</sup> The point was rather that the bank would have to reach a decision on whether to pay or not, soon after presentation of the documents. Usually, it will only refuse payment in the light of compelling evidence available to it at that stage. However, if the bank refuses to pay on a suspicion of fraud and is sued, and acquires evidence prior to the hearing of the case, this evidence should be admissible.<sup>108</sup> Therefore, as to the time when the bank should have the evidence on which it relies to establish illegality, the view of the later English cases, are to be preferred.<sup>109</sup>

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<sup>100</sup> See Chapter 6.

<sup>101</sup> See, e.g., *Mahonia Ltd v JP Morgan Chase Bank and Another* [2003] 2 Lloyd's Rep 911 (QB (Com Ct)); and *Mahonia Ltd v West LB AG* [2004] EWHC 1938 (Comm) (see the full discussion of these cases in para 6.2.2 in Chapter 6).

<sup>102</sup> See para 6.2.2 in Chapter 6.

<sup>103</sup> See paras 5.3.2 and 5.4.6 in Chapter 5.

<sup>104</sup> See Warne and Elliott *op cit* note 76 at 273. See also the full discussion in para 6.2.2 in Chapter 6.

<sup>105</sup> See para 6.2.2 in Chapter 6.

<sup>106</sup> See Enonchong *op cit* note 50 at 413. See also the full discussion in paras 6.2.2.1–6.2.2.2 in Chapter 6.

<sup>107</sup> For a full discussion, see in para 5.4.4 in Chapter 5.

<sup>108</sup> See *Mahonia Ltd v JP Morgan Chase Bank and Another* [2003] 2 Lloyd's Rep 911 (QB (Com Ct)).

<sup>109</sup> See para 6.2.2.1 in Chapter 6.

Generally, the American courts have refused to allow illegality in the underlying transaction to affect the beneficiary's right to claim payment in terms of the letter of credit.<sup>110</sup> The Revised UCC article 5 also does not make provision for an illegality exception to the autonomy principle of commercial or standby letters of credit. As already mentioned, before article 5 of the UCC was revised in 1995 and before the appointment of the drafting committee of Revised UCC article 5, a special Task Force, consisting of eminent letter of credit specialists, was appointed to study the relevant case law, evolving technologies and changes in customs and practices.<sup>111</sup> The Task Force identified a large number of issues, discussed them and made recommendations for the revision of article 5. They also participated substantially in the amendment of article 5. During the course of the recodification of article 5, the Task Force spelt out the exception to the autonomy principle of letters of credit (and standby letters of credit) so that the exception applied only where 'a required document is forged or materially fraudulent or honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or the applicant.' They did not extend the exception to include 'illegality'. They limited an issuer's extraordinary defences (and an applicant's injunction actions) to drawings that would unduly exploit the independence principle of letters of credit. They focused specifically on letter of credit policy and not on the existence of other public policy grounds. In determining the scope of defences to payment of a letter of credit obligation, they gave no attention to the law applicable to guarantee, suretyship or other security arrangements.<sup>112</sup> Therefore, the Revised UCC article 5 has limited the exceptions to the autonomy principle to fraud in the narrow (i.e., regarding fraud in the documents (e.g., forgery)) as well as in the wide sense (i.e., fraud in the underlying contract).<sup>113</sup> The American law does not accept that illegality in the underlying contract is an exception to the autonomy principle of commercial or standby letters of credit. However, it has been said that the American banks would apparently abide by a court injunction or other government order that clearly prohibits payment under a commercial/standby letter of credit.<sup>114</sup>

It has been correctly pointed out that until such time as the courts in England (and other countries applying English law principles) decide cases raising illegality defences, it is suspected that the *Mahonia Ltd v West LB AG*<sup>115</sup> precedent will not be vigorously applied, and that the demonstrated reluctance of English courts to find letter of credit fraud will carry over to illegality defences.<sup>116</sup> It also seems that the English court's treatment of illegality in the *Mahonia Ltd v West LB AG* case is not likely to have any effect on United States courts enforcing American law-governed letters of credit.<sup>117</sup>

South Africa currently has no cases where illegality in the underlying contract has been accepted or has even been considered as a possible exception to the autonomy principle of

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<sup>110</sup> See para 6.3.2.1 in Chapter 6.

<sup>111</sup> See the 'Prefatory Note' to Revised UCC article 5. For a full discussion, see para 6.3.2.1 in Chapter 6.

<sup>112</sup> See the 'Prefatory Note' to Revised UCC article 5. For a full discussion, see para 6.3.2.1 in Chapter 6.

<sup>113</sup> See Revised UCC article 5 section 5-109(a).

<sup>114</sup> See para 6.3 in Chapter 6.

<sup>115</sup> [2004] EWHC 1938 (Comm).

<sup>116</sup> See J Barnes "'Illegality' as Excusing Dishonour of L/C Obligations' (January–March 2005) 11 *ICC's DCInsight* 7 at 8.

<sup>117</sup> See para 6.3.2.2 in Chapter 6.

letters of credit and demand guarantees.<sup>118</sup> According to Hugo, it is unnecessarily restrictive to limit the exceptions to the independence principle to the defence of fraud. Public policy dictates that a fraudulent beneficiary should not be able to succeed in an action against the bank. Other illegal conduct on the part of the beneficiary, for example, drug or illegal arms trafficking, could be equally or even more reprehensible. He states that the argument put forward in relation to fraud is equally applicable to cases such as these.<sup>119</sup>

It is submitted that South Africa should also accept established and sufficiently serious illegality as an exception to the autonomy principle of letters of credit and demand guarantees, provided it is confined within a narrow scope. Public policy, just as with fraud, clearly requires that a party to an illegal contract should not be able to enforce such an illegal contract. It has correctly been argued that, because the illegality exception has the same juristic basis as the fraud exception, it should have a similar effect on the autonomy principle. It is settled that the illegality defence is based on the well-established Latin maxim *ex turpi causa non oritur actio* (i.e., no action arises from an unworthy cause). The unworthy cause can either be fraud or illegality. It is trite law that if the unworthy cause is fraud, that the principle of *ex turpi causa* will apply.<sup>120</sup> In other words, the fraud exception to the principle of autonomy is a clear application of the maxim *ex turpi causa non oritur actio*. Therefore, it has correctly been said that if the maxim can breach the autonomy principle where the unworthy cause is fraud, it should be capable of producing the same effect where the unworthy cause is illegality.<sup>121</sup> Some have even argued that in the case of illegality the public policy in favour of the application of the *ex turpi causa* principle is stronger. Where fraud is involved the wrongdoing is against a private party, such as the bank and/or principal/applicant, but where illegality is involved the mischief is against a wider public interest. From this, it follows that if fraud against the private interest of the bank and/or principal/applicant is strong enough to disrupt the principle of autonomy, then illegality against the wider public interest must surely also have the same powerful effect.<sup>122</sup> Such reasoning cannot be faulted, and provide ample reasons for why appropriately serious illegality in the underlying contract should in addition to fraud be accepted as an exception to the autonomy principle.

However, if South Africa were to accept illegality in the underlying contract as an exception to the autonomy principle, one should also use the requirements that have so far been established by the English courts as a basis for developing the exception further, namely that the<sup>123</sup>

- alleged illegality must be established clearly;
- illegality must be sufficiently serious;
- beneficiary must have been involved in the illegality; and
- letter of credit/demand guarantee must be sufficiently connected to the illegality in the underlying transaction.<sup>124</sup>

<sup>118</sup> See para 6.4.2 in Chapter 6.

<sup>119</sup> See *Hugo: The Law Relating to Documentary op cit* note 25 at 316–317.

<sup>120</sup> See Chapter 5 for a full discussion of fraud, and see also para 8.3.1 above.

<sup>121</sup> See Enonchong *op cit* note 50 at 411.

<sup>122</sup> See Enonchong *op cit* note 50 at 411–412.

<sup>123</sup> See para 6.4.2 in Chapter 6.

<sup>124</sup> See para 6.2.2 in Chapter 6.

As regards the requirement that the illegality must be ‘sufficiently serious’, it is suggested that the illegality exception be limited to those instances where the underlying contract’s illegality carries with it a clear criminal element. The illegality should relate to a *prima facie* criminal offence being committed. If the illegality therefore is not linked to a criminal element, it should be deemed that the illegality is not sufficiently serious, but of a mere technical nature (i.e., that it contravenes a section of a specific Act that carries with it no possibility of a criminal prosecution by the authorities concerned) and it should then not constitute an exception to the autonomy principle and the bank should then have to pay despite the illegality and the parties should thereafter proceed against each other in terms of the normal principles applicable to the law of contract (if that is allowed). Therefore, in instances where the underlying contract is tainted by sufficiently serious illegality, it should be possible for the principal to apply for an interdict to restrain the bank from paying and/or the beneficiary from making a demand or receiving payment under a demand guarantee/letter of credit.<sup>125</sup>

In the English cases it has not been made clear what the duties and obligations of the banks are in relation to illegality in the underlying contract. In the United States there is also the misconception that if the illegality defence is recognised, banks would be compelled to determine whether payment under the letter of credit will be used for an illegal purpose and this will then place them under additional difficulties in examining the documents.<sup>126</sup> It is true that banks should not be forced to determine whether payment under the guarantee/credit will be used for an illegal purpose, because of the autonomy principle of demand guarantees and letters of credit, and should therefore not have to look beyond the documents at the underlying contract. The duty of banks is only to examine documents with reasonable care. If that examination does not disclose evidence of illegality, the bank is entitled to pay and to be reimbursed by its customer (i.e., the principal/applicant). Therefore, in the absence of clear evidence of illegality, the bank is not only entitled, it is bound to pay. Thus, the availability of the illegality exception will not necessarily put banks under any additional difficulty in the examination of documents.<sup>127</sup> However, in South Africa, Van Niekerk and Schulze<sup>128</sup> have given this issue some thought and have made a few workable suggestions as to how the banks should deal with it.

In the instance where the bank is actually aware of the illegality of the underlying contract (e.g., where it is evident from the information supplied by the applicant/principal in the application form for the letter of credit/demand guarantee that certain foreign-exchange regulations will be contravened by the bank if it complies with its payment instruction under the credit/guarantee), Van Niekerk and Schulze<sup>129</sup> suggest that the bank should refuse to honour it. Likewise, when the bank may obtain knowledge of the illegality of the transaction by exercising reasonable care, it should similarly be under an obligation not to pay out on the letter of credit/demand guarantee. However, where the bank is neither actually aware of the illegality of the underlying contract, nor able to become aware by exercising reasonable care, its payment under the letter of credit/demand guarantee cannot

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<sup>125</sup> See para 6.4.2 in Chapter 6.

<sup>126</sup> See Enonchong *op cit* note 50 at 412.

<sup>127</sup> *Idem*.

<sup>128</sup> See Van Niekerk and Schulze *op cit* note 12 at 312.

<sup>129</sup> See Van Niekerk and Schulze *op cit* note 12 at 312.

be faulted.<sup>130</sup> Their suggestions as to how banks should deal with the matter of illegality in the underlying contract make sense and cannot be faulted. Placing such a duty (i.e., obtaining knowledge of the illegality of the transaction by exercising reasonable care, e.g., by looking at the information applied on the application form) on a bank makes sense and will not, as already mentioned above, necessarily place an additional duty on the bank. Therefore, if a reasonable examination by the bank does not disclose evidence of illegality, the bank should be entitled to pay and to be reimbursed by its customer (i.e., the principal/applicant). However, if the bank fails to fulfil such a duty, the bank should not be allowed to be reimbursed by its customer. Hopefully, the South African courts will take the suggestions made by Van Niekerk and Schulze into consideration when they are confronted with cases dealing with the issue of illegality in the underlying contract. Their suggestions clearly take cognisance of the principle of autonomy and the fact that bank deal purely with documents and should therefore not have to look beyond the documents at the underlying contract.<sup>131</sup>

I agree with the submission that has been made that the ‘illegality’ defence will be potentially more problematic than the ‘fraud’ defence.<sup>132</sup> It will often be very difficult (1) to determine whether a specific underlying contract is indeed illegal, especially if it is against, for example, the public policy or good morals of a rather unfamiliar country, and, (2) if illegality is proven, whether that illegality is serious enough to justify the infringement of the autonomy principle. It will not be an easy task for a court always to establish that the illegality is serious enough. It is possible that what one country considers to be a serious illegality, another country might view as being an illegality of a pure technical nature. With fraud, the different jurisdictions often seem to have a more similar view that a specific action is of a fraudulent nature, although they often disagree on the standard of proof that is required for the fraud. It is also possible that in some cases there will be an overlapping of fraud and illegality. Until such time as the English courts continue to have such a stringent approach to the fraud exception, parties will surely try the illegality exception thinking that the courts will be more lenient with the illegality exception. By looking at the English decisions that were made regarding the fraud exception, the deduction is made that the English courts are sure to also follow a similar stringent approach regarding the illegality exception.<sup>133</sup>

### 8.3.2.1 *Illegality and the UNCITRAL Convention*

The UNCITRAL Convention<sup>134</sup> specifically provides for an illegality exception.<sup>135</sup> Article 19(2)(b) of this Convention clearly provides for an exception to the autonomy principle of demand guarantees and standby letters of credit if the underlying contract is illegal (unless the undertaking indicates that such contingency falls within the risk to be covered by the undertaking). It specifically states that the illegality exception will only be accepted where the underlying obligation of the principal/applicant has been declared invalid by a court or arbitral tribunal. Article 20(3) then specifically provides that where

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<sup>130</sup> *Idem.*

<sup>131</sup> See paras 6.4.2 and 6.6 in Chapter 6.

<sup>132</sup> See Barnes *op cit* note 116 at 8. See also para 6.3.2.2 in Chapter 6.

<sup>133</sup> See also para 6.6 in Chapter 6.

<sup>134</sup> For a full discussion of the UNCITRAL Convention, see para 3.3 in Chapter 3 and para 4.4 in Chapter 4.

<sup>135</sup> See para 6.5 in Chapter 6.

the underlying obligation of the principal/applicant has been declared invalid by a court or arbitral tribunal, or where the undertaking is used for a criminal purpose, the court may issue an injunction preventing payment or issue a *Mareva*-type injunction.<sup>136</sup> These provisions are problematic as they create the impression that before the court may issue an injunction or payment may be withheld, the underlying contract must first have been declared invalid by a court or arbitral tribunal. Both of these provisions might take a long time to achieve and in the meantime the bank might still pay as there is no injunction preventing it from paying and the beneficiary might also after receiving payment utilise and spend the money obtained. Furthermore, if the bank pays in the meantime, it will be entitled to be reimbursed by its customer (i.e., principal of the demand guarantee). If this happens, there will clearly be no need to apply for these types of injunctions and the principal's/applicant's best option would be to try and claim damages (if that is allowed in the specific jurisdiction's law of contract, especially when it relates to a contract that has been found to be illegal).

However, it seems that if the demand guarantee or standby letter of credit is used for a criminal purpose, the court may immediately issue an injunction preventing payment or issue a *Mareva*-type injunction, without a prior court or arbitral tribunal having made a declaration on the matter. It is not clear whether the phrase 'use of the undertaking for a criminal purpose' relates to a case where the payment on the undertaking itself would violate criminal law, or where the payment of the underlying obligation would violate criminal law.<sup>137</sup> It seems to be settled law in England and South Africa that a contract that is contrary to the law, good morals or public policy is illegal and, consequently, void in terms of the general principles of the law of contract in each separate jurisdiction. Therefore, if it is the standby letter of credit/demand guarantee itself that is contrary to the law, good morals or public policy (i.e., the law of the country that applies to the guarantee or credit or the law of the country where the guarantee or credit is to be performed), it will likewise not be enforceable. Where the demand guarantee/letter of credit itself is illegal (and the underlying contract legal), the principle of autonomy does not come into play and no difficulty arises as a result of that principle.<sup>138</sup> Therefore, seen from the perspective of the English and South African law, it would seem to me that this phrase in the Convention refers to the situation where the payment of the underlying obligation would violate criminal law, because if it relates to a case where the payment on the undertaking itself would violate criminal law, no injunction would be necessary as the undertaking would merely be unenforceable.

The illegality exception is not adequately dealt with in the UNCITRAL Convention. It does not provide for a workable illegality exception. The exact interpretation of the illegality exception is fraught with uncertainties and its application seems to be problematic.

### **8.3.3 Limit the Exceptions to the Autonomy Principle**

The problem of unfair and abusive calls on demand guarantees is well known internationally. However, efforts to deal with this problem by international organisations,

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<sup>136</sup> See Chapter 7 for a full discussion of injunctions/interdicts.

<sup>137</sup> See para 6.5 in Chapter 6.

<sup>138</sup> See paras 6.2.1, 6.4.1, 6.6 in Chapter 6 and para 8.2.2 above.

such as the ICC and the UNCITRAL, have proven not to be too successful.<sup>139</sup> As a result, in many jurisdictions, for example, England, the United States and South Africa the problem is dealt with through their respective domestic law.<sup>140</sup> This thesis examined the response of mainly English, American and South African law to the problem. It followed that the principal tool used by the English and American jurisdictions to protect against unfair and abusive calls is the fraud exception to the autonomy principle. Whereas courts in Australia and Singapore have also adopted extra measures besides the fraud exception, namely by creating additional exceptions to the principle of independence.<sup>141</sup> In recent years it seems that the English courts have also started to follow suit. However, the position under the South African law is far from being settled and it seems that at this point they only accept the fraud exception to the autonomy principle. This is so mainly because of a lack of proper case law and legal writing on the topic, and also because South Africa has no specific legislation governing demand guarantees and letters of credit. The question whether and to what extent the South African law should also recognise further exceptions to the principle of autonomy as devices with which to prevent abusive and unfair calls were not specifically addressed in this thesis.

In this thesis only two accepted and recognised grounds were examined, namely (1) fraud and forgery, and (2) illegality in the underlying contract. It is by no means an indication that these are the only possible grounds upon which payment of a demand guarantee may be restrained. Other jurisdictions, like Singapore and Australia, also acknowledge other exceptions to the autonomy principle, and it is therefore possible that the jurisdictions covered here (i.e., England, the United States and South Africa) might also be willing to accept similar additional exceptions. However, this thesis merely attempted to deal with some of the more familiar and accepted exceptions to the independence principle. It should therefore by no means be seen as a comprehensive discussion of all the possible exceptions to the autonomy principle, but rather as basis for further investigation into this interesting and complex topic.

When it comes to accepting wide-ranging exceptions to the autonomy principle, it should be borne in mind that if courts in a particular country provide for wide-ranging exceptions, beneficiaries will demand that their demand guarantees and letters of credit be paid by banks located in other jurisdictions.<sup>142</sup> In *Power Curber International Ltd v National Bank of Kuwait SAK*<sup>143</sup> it was said:

If the court of any of the countries should interfere with one of the obligations of its banks (by ordering it not to pay under a letter of credit), it would strike at the very heart of that country's trade. No foreign seller would supply goods to that country on letters of credit because he could no longer be confident of being paid. No trader would accept a letter of credit issued by a bank of that country if it might be ordered by its courts not to pay. So it is part of the law of

<sup>139</sup> See Chapter 4 and para 8.5 below.

<sup>140</sup> See also, N Enonchong 'The Problem of Abusive Calls on Demand Guarantees' (2007) *Lloyd's Maritime and Commercial Law Quarterly* 83 at 84.

<sup>141</sup> See also note 33 in Chapter 1, notes 162 and 357 in Chapter 2, and note 8 in Chapter 5.

<sup>142</sup> See J Ulph 'The UCP600: Documentary Credits in the Twenty-first Century' (2007) *Journal of Business Law* 355 at 372; and J F Dolan 'Letters of Credit: A Comparison of UCP500 and the New U.S. Article 5' (1999) *Journal of Business Law* 521 at 533-534.

<sup>143</sup> [1981] 3 All ER 607 (CA) ([1981] 1 WLR 1233 (CA)) at 613.

international trade that letters of credit should be honoured and not nullified by an attachment order at the suit of the buyer.

It is accepted that the principle of autonomy of demand guarantees should be jealously guarded, because it is imperative for the preservation of the unique quality of the demand guarantee and letter of credit as an attractive instrument for international transactions. However, public policy considerations in favour of the fraud and illegality defence require that in certain cases the principle of autonomy should give way to the wider purpose of making sure that parties who engage in illegal or fraudulent transactions should not (mis)use the judicial process in furtherance of their unlawful or fraudulent purpose.<sup>144</sup>

However, in instances, where no fraud or illegality is involved, but where it relates to, for example, a breach of the underlying contract or where a demand would constitute conduct that would be unconscionable or unreasonable, it should not be possible for a principal to obtain an interdict against the banks. If the ground for obtaining an interdict is one of these, the principal should be forced to try and obtain an interdict against only the beneficiary to prevent a demand being made or receiving payment, and even here interdicts should only be granted in highly exceptional circumstances or better yet be totally denied. As the demand guarantee is separate and independent of the underlying contract, and the bank is only concerned with documents and not even a party to the underlying contract, it follows that in the absence of established fraud and illegality, the bank should in all other instances pay, despite any disputes regarding the underlying contract. Even where the underlying contract is a nullity (i.e., it does not exist), the bank should still pay and it should not be possible to obtain an interdict against the bank to prevent payment in such a case. If all these types of exceptions are allowed, it would mean that the clear distinction of demand guarantees from traditional guarantees (i.e., accessory/secondary undertakings) would be diminished, and the original purpose why demand guarantees were created – to be similar to cash deposits – would become meaningless.

As the demand guarantee is a separate and independent contract from the underlying contract, it would clearly make sense that any basis for an interdict based on the underlying contract, except for fraud and illegality, cannot be valid when it comes to the bank. Therefore, the basis for an interdict against the bank cannot be contractual. If one were to look at the intentions of the parties when it was decided to create a demand guarantee, it is clear that it was not their intention to permit an enquiry into the actual breach of contract.

Before demand guarantees were developed, a principal would have been required to pay a deposit to the beneficiary, or make a payment of cash to a relevant interested party. In both cases, he would have given his money away. Demand guarantees assist him and make it cheaper as he does not have to make the initial money outlay. Even if there is an abusive call and the demand guarantee is paid out, he would still have saved the interest. There is therefore no commercial purpose for allowing principals to obtain interdicts preventing payment, except in clear cases of established fraud and serious illegality in the underlying contract.

There has been no reported South African case in which a bank has raised any defence (not even fraud) against the beneficiary's demand for payment. All the South African cases have concerned attempts by the buyers (i.e., applicants of letters of credit) to block

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<sup>144</sup> See Enonchong *op cit* note 50 at 418.



payment by either preventing the beneficiary from receiving payment or making a demand. Therefore, South Africa can find valuable guidance on the issue of defences from other jurisdictions, such as England and the United States.<sup>145</sup>

#### 8.4 INTERIM INJUNCTIONS AND INTERDICTS

The courts, progressively, take the view that it is for the guarantor of the demand guarantee or the issuer of the letter of credit, to make up his own mind on whether he should refuse payment on the grounds of fraud or forgery. However, independent of the right of the guarantor/issuer to refuse payment, a performing party (principal/applicant) may apply for an interdict (injunction) to restrain enforcement of a demand guarantee/letter of credit by the beneficiary if he can prove fraud on the part of the beneficiary of which the guarantor/issuer has knowledge. That is not simple to do – and it has, accordingly, been extremely difficult to prevent fraudulent, and in some cases even illegal, demands for payment being made by beneficiaries on guarantors/issuers.

The principal/applicant of a demand guarantee/letter of credit may raise the defence of fraud<sup>146</sup> or any other accepted defence<sup>147</sup> in proceedings in which he applies for an injunction/interdict against the bank restraining it from effecting payment under a demand guarantee/letter of credit, and/or against the beneficiary (and/or second issuing bank, in the case of indirect demand guarantees) restraining him (them) from calling on the (counter-) guarantee. These are provisional remedies to enable the claimant (i.e., plaintiff and usually the principal/applicant of a demand guarantee/letter of credit) to protect himself against dissipation of property by the beneficiary (i.e., the defendant), and are temporary in nature; they are not actions in themselves, but are ancillary proceedings available only in connection with a main action.<sup>148</sup>

Another means of protection available to the principal/applicant of a demand guarantee/letter of credit is the freezing injunction (previously known as the *Mareva* injunction) in England<sup>149</sup> or the South African anti-dissipation interdict (i.e., the South African equivalent),<sup>150</sup> which provides a means whereby a beneficiary may be prevented from removing his money or other assets from the jurisdiction of the court or otherwise dealing with them within or without the jurisdiction before the matter has been finally settled. Attempts to secure injunctions/interdicts through full-length main court proceedings are often futile, since payment will often already have been effected by the time a favourable judgment might be rendered. The advantage of these types of injunctions/interdicts from the principal's point of view is that the injunction/interdict does not interfere with the operation of the demand guarantee/letter of credit. Therefore, the autonomy principle does not come into play.<sup>151</sup>

<sup>145</sup> See Hugo: *The Law Relating to Documentary Credits op cit* note 25 at 310–311.

<sup>146</sup> See Chapter 5 for a full discussion.

<sup>147</sup> See Chapter 6 for a discussion of illegality in the underlying contract as a possible ground upon which payment may be restrained.

<sup>148</sup> For a full discussion, see Chapter 7.

<sup>149</sup> For a full discussion, see para 7.2.5 in Chapter 7.

<sup>150</sup> For a full discussion, see para 7.4.5 in Chapter 7.

<sup>151</sup> See para 7.1 in Chapter 7.

These types of injunctions/interdicts that are available in the English, American and South African law were discussed in Chapter 7.<sup>152</sup>

Injunctions are often sought in English courts to prevent the banks from making payment, when the demand is deemed unjustified. However, as seen from the case law mentioned in Chapters 5 and 7, it is not easy for a principal of a demand guarantee or an applicant of a letter of credit to indeed succeed in obtaining an injunction. The English courts have taken a harsh approach to the enforcement of these instruments and their autonomous nature, and the traditional view is that the only exception to the general rule – that banks must honour them ‘without proof or condition’ – is in the cases where the demand is made fraudulently.<sup>153</sup>

As the burden of establishing fraud is so high under English law and the reluctance of the English courts to issue injunctions in such cases is so great, it is in practice nearly impossible for a principal to prevent payment on the ground of fraud.<sup>154</sup> In deciding whether or not to grant an interim injunction, the courts also apply the ‘balance of convenience test’ as it was formulated by the House of Lords in *American Cyanamid Co v Ethicon Ltd.*<sup>155</sup> An instant problem for any principal/applicant seeking to restrain the guarantying/issuing bank from making a payment under a demand guarantee/letter of credit is that the balance of convenience will almost always favour a refusal of the injunction.<sup>156</sup>

The possibility of injunctions against the bank in the case of established fraud relating to letters of credit (commercial and standby) has always been recognised in American case law and legal writing.<sup>157</sup> Courts in the United States have always accepted the possibility of injunctions against banks in the event of established fraud and they are more than willing to put this principle into practice if an appropriate case presents itself. This possibility is also recognised in Revised UCC article 5 section 5-109(b). It also seems that American courts recognise that an injunction against the bank in the event of established fraud is the most effective means of preventing fraud by the beneficiary. It seems that English courts do not have the same view in this regard.<sup>158</sup>

The more relaxed approach of the American courts is preferred to the more stringent approach taken by the English courts. One commentator has correctly said that he finds the great reluctance of English courts to allow injunctions against the bank, because they deem that it would interfere with the bank’s independent obligation towards the beneficiary, to be rather unconvincing. The commentator points out that it is a well-established rule, also in English case law that the principle of autonomy allows for an exception in the case of

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<sup>152</sup> See para 7.1 in Chapter 7.

<sup>153</sup> See para 7.2.1 in Chapter 7.

<sup>154</sup> See the discussion of the fraud exception under the English law in para 5.4 in Chapter 5, and a full discussion of injunctions under the English law, see para 7.2 in Chapter 7.

<sup>155</sup> [1975] AC 396 (HL).

<sup>156</sup> For a full discussion of the balance of convenience test, see para 7.2.4 in Chapter 7.

<sup>157</sup> See the discussion of the fraud exception under the American law in para 5.5 in Chapter 5, and the full discussion of injunctions under the American law in para 7.3 in Chapter 7.

<sup>158</sup> See para 7.3.1 in Chapter 7.

established fraud.<sup>159</sup> Therefore, the English courts should not be so reluctant to issue injunctions in appropriate circumstances. It would serve no purpose to accept established fraud as an exception to the autonomy principle, but to then make it nearly impossible for parties actually to prevent the fraud from taking place in the first place. The issuance of an injunction is the most effective and the only way in which fraud can be prevented and the American courts clearly understand this. If a beneficiary has been a party to the fraud, it is also likely that the principal/applicant will have great difficulty in obtaining damages from the fraudulent beneficiary in a separate legal action later. There is always a possibility that such a beneficiary was not merely fraudulent in that one transaction and it is also possible that he has a habit of conducting his business in a fraudulent matter. If that is so, he might easily have himself declared bankrupt after receiving payment under the demand guarantee/ letter of credit or he might even be hiding some of his assets, and these are all factors that limit the chances of instituting a successful action for damages afterwards. Therefore, the aforementioned again stresses the importance that when it comes to fraud, prevention is better than cure.

Obtaining injunctive relief in the United States has generally been substantially easier to obtain than in England. Under the English law, an injunction will not be granted unless the claimant (e.g., applicant of a letter of credit/principal of a demand guarantee) can in addition to proving fraud, also satisfy the ‘balance of convenience’ test. The balance of convenience test is similar to the United States ‘balance of hardships’ test. However, contrary to the position in England, in the United States it is not very difficult for a principal to satisfy the test and the American courts have been able to grant injunctions in many cases despite this test.<sup>160</sup>

The decision of the Appellate Division in *Loomcraft Fabrics CC v Nedbank Ltd and Another*<sup>161</sup> led to the now well-established notion that a South African court may grant an interdict restraining a bank from paying the beneficiary under a letter of credit/demand guarantee in the event of it being established that the beneficiary was a party to the fraud<sup>162</sup> in relation to the documents presented to the bank for payment.<sup>163</sup> In this case the Appellate Division stated that the fraud on part of the beneficiary had to be clearly established before an interdict could be issued.<sup>164</sup> In the context of interdicts (both interim and final) in the field of letters of credit/demand guarantees based on fraud on the part of the beneficiary, a degree of proof which is clearly stricter than that which generally applies in civil cases, will be required.<sup>165</sup> Precisely how much more convincing the evidence must be still remains to be uncertain in the South African law.<sup>166</sup> In England Ackner LJ in

<sup>159</sup> See Bertrams *op cit* note 84 at 418. See also para 7.2.6 in Chapter 7.

<sup>160</sup> See para 7.3.1 in Chapter 7.

<sup>161</sup> 1996 (1) SA 812 (A) at 816D.

<sup>162</sup> Fraud as an ‘established exception’ to the autonomy principle of letters of credit (and by implication also to the autonomy principle of demand guarantees) was recognised in *Phillips and Another v Standard Bank of South Africa Ltd and Others* 1985 (3) SA 301 (W); and *Loomcraft Fabrics v Nedbank and Ex parte Sapan Trading (Pty) Ltd* 1995 (1) SA 218 (W). See the full discussion of the fraud exception in the South African law in para 5.6 in Chapter 5.

<sup>163</sup> See 1996 (1) SA 812 (A) at 816–817.

<sup>164</sup> See para 7.4.1 in Chapter 7.

<sup>165</sup> See para 5.6.3 in Chapter 5; and see also *Loomcraft Fabrics v Nedbank* 1996 (1) SA 812 (A) at 817F–G.

<sup>166</sup> See *Oelofse: The Law of Documentary Letters of Credit op cit* note 81 at 480.

*United Trading Corporation SA and Murray Clayton Ltd v Allied Arab Bank Ltd and Others*<sup>167</sup> stated that the correct test to use to establish whether there is clear evidence of fraud is, if based on the material before the court, the only realistic inference to draw is that of fraud (i.e., the ‘sole realistic inference’ test).<sup>168</sup> This has since become the generally accepted formula in England for the evidence that is required in order to establish fraud. This test is commendable due to its preciseness and simplicity and it is recommended that South Africa should also use this test in order to establish whether fraud has been clearly established.

As already mentioned,<sup>169</sup> the leading House of Lords decision in *United City Merchants (Investments) Ltd and Glass Fibres and Equipments Ltd v Royal Bank of Canada (incorporated in Canada), Vitrorefuerzos SA and Banco Continental SA*<sup>170</sup> confined the fraud exception in relation to commercial letters of credit under the English law to fraud in the narrow sense (i.e., fraud committed in the documents). However, more recent English judgments indicate an acceptance of fraud in the wide sense (i.e., fraud not in relation to the documents, but in relation to the conduct by the beneficiary in relation to the underlying contract).<sup>171</sup> In *Loomcraft Fabrics v Nedbank* it seems that the South African Appellate Division followed the same narrow view of the fraud exception as formulated in *United City Merchants (Investments) Ltd and Glass Fibres and Equipments Ltd v Royal Bank of Canada*. The *Loomcraft Fabrics v Nedbank* case clearly demonstrated that South African courts are willing to enforce the fraud exception where the forgery or falsification relates to the documents. But, it is still uncertain whether the South African courts will also acknowledge fraud in the wide sense (i.e., fraud in the underlying contract) as a valid exception to the autonomy principle of the letter of credit and demand guarantee. There are indications that the courts will acknowledge fraud in the wide sense as a valid exception to the autonomy principle of the letter of credit/demand guarantee. South African courts will apparently be less likely to interdict the bank from paying when fraud concerns the performance rendered by the beneficiary in terms of the underlying contract. However, there is currently no case law supporting this deduction and it seems to be mere speculation.<sup>172</sup> As already submitted, it should not make a difference whether the fraud relates purely to the documents or whether it relates to the underlying contract. No limitations should be placed on accepting certain types of fraud as valid exceptions. To list the kinds of fraud that would be acceptable seems to be of academic interest only. It would make more sense if courts and banks were to judge each case on its own merits – if fraud is established clearly of whatever nature (i.e., irrespective of whether it relates to forged documents or to fraud in the underlying contract), payment should be refused or restrained.

In addition to proving that there is established fraud<sup>173</sup> or any other acceptable ground (e.g., illegality in the underlying contract)<sup>174</sup> to prevent payment under a letter of

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<sup>167</sup> [1985] 2 Lloyd’s Rep 554 (CA).

<sup>168</sup> See at 561. For a full discussion, see para 5.4.3 in Chapter 5.

<sup>169</sup> See para 5.4.2 in Chapter 5.

<sup>170</sup> [1983] AC 168 (HL) ([1982] 2 Lloyd’s Rep 1 (HL)).

<sup>171</sup> See para 5.4.2 in Chapter 5 for a full discussion.

<sup>172</sup> See para 5.6.2 in Chapter 5 for a full discussion.

<sup>173</sup> See paras 5.6.2 and 5.6.5 in Chapter 5.

<sup>174</sup> See para 6.4 in Chapter 6 for a full discussion.

credit/demand guarantee, an applicant/principal applying for an interim interdict against the bank and/or the beneficiary will also have to satisfy all the other South African requirements for an interim injunction before it will be granted. In order to be successful in obtaining an interim interdict, a claimant will, therefore, also have to prove all of the following requirements:

1. that he has a *prima facie* right;
2. a well-grounded apprehension of irreparable harm if the interim relief is not granted and the ultimate relief is eventually granted;
3. a balance of convenience in favour of the granting of the interim interdict; and
4. the absence of any other satisfactory remedy.<sup>175</sup>

From the case law discussed it is clear that although it is possible, in principle, for a principal/applicant of a demand guarantee/letter of credit to obtain an interdict against the bank prohibiting it from paying the beneficiary, such an application will seldom succeed. It was expressly stated in *Loomcraft Fabrics v Nedbank* that an interdict of this nature will not be granted, except in the most exceptional cases. This is similar to the unnecessarily strict approach of the English courts and it is submitted that South African courts should rather follow a more relaxed approach similar the American courts. If South Africa were also to follow the strict approach as the English courts, acknowledging the fraud exception as in the case with the English position will serve no purpose, unless clearly established cases of fraud can also be prevented.

So far there have been only two South African cases dealing with the situation where an applicant has tried to interdict the bank from paying under a letter of credit. In both cases the applicants tried unsuccessfully to restrain the banks from paying.<sup>176</sup> In the first case, *Phillips v Standard Bank*,<sup>177</sup> the court found that no fraud on the part of the beneficiary had been alleged by the applicant. It also held that the facts of this case were quite consistent with an ‘innocent breach of contract’.<sup>178</sup> The *Phillips* case serves as an illustration that mere breach of the underlying contract by the beneficiary of a letter of credit/demand guarantee will not necessarily entitle the applicant/principal to block payment by acquiring an interdict against the bank. In the second case, *Loomcraft Fabrics v Nedbank* the Appellate Division stated that the fraud on the part of the beneficiary had to be clearly established before an interdict could be issued. However, in this case, fraud was not clearly established. Although the courts have expressed that they would be willing to issue interdicts in appropriate circumstances (i.e., where fraud is clearly established), it is too early to say whether they will also follow a stringent approach similar to the English courts. A deduction will only be possible where a case of clear fraud is established by an applicant/principal and he applies for an interdict restraining the bank from paying under the letter of credit/demand guarantee.<sup>179</sup>

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<sup>175</sup> See the full discussion in para 7.4.2 in Chapter 7.

<sup>176</sup> See *Phillips and Another v Standard Bank of South Africa Ltd and Others* 1985 (3) SA 301 (W); and *Loomcraft Fabrics CC v Nedbank Ltd and Another* 1996 (1) SA 812 (A); and see also the discussion in para 7.4.3 in Chapter 7.

<sup>177</sup> 1985 (3) SA 301 (W).

<sup>178</sup> 1985 (3) SA 301 (W) at 303I–304A.

<sup>179</sup> See the full discussion in para 7.4.3 in Chapter 7; and see also para 5.6.5 in Chapter 5.

To date there have been no cases dealing specifically with demand guarantees in relation to applications for injunctions against banks. It is true that it should not be too easy for a principal to obtain an injunction to prevent payment. If the law allows for interdicts to be issued too easily, it will seriously undermine the sanctity and commercial utility for which demand guarantees were created. If the international community finds that a certain country's law is not adequate to protect the sanctity and commercial utility of the demand guarantee, it will merely request that demand guarantees not be governed by that specific law. If the law is too strict in allowing for interdicts in situations where fraud has been clearly established, it will again allow unscrupulous beneficiaries to commit fraud. It is a complicated balance to get right. It is clear that the English approach is too strict. It also seems that South African courts are following in their footsteps. It is submitted that the South African courts should rather follow an approach between the stringent approach followed by the English courts and the more flexible approach followed by the American courts.

To date there has been only one case dealing with the situation where an application for an interdict has been made against a beneficiary restraining him from receiving payment under a standby letter of credit/demand guarantee. Although the applicant (claimant) in *Union Carriage and Wagon Company Ltd v Nedcor Bank Ltd*<sup>180</sup> was unsuccessful with his application for an interdict against the beneficiary, the case did illustrate that South African courts are willing to grant such interdicts in appropriate circumstances, but only in the most exceptional circumstances.<sup>181</sup> In England, however, interdicts of this nature have been relatively more successful than interdicts against banks.<sup>182</sup>

Both the South African law and the American law require that in addition to any other requirements that a claimant for an interim interdict/injunction must comply with, he must also show that he will suffer 'irreparable harm',<sup>183</sup> in the event of the injunction not being granted. Traditionally, the American courts have been fairly strict as far as this requirement is concerned (except during the time of the Iranian crisis in 1979 after the Americans were taken hostage)<sup>184</sup> – if adequate monetary compensation can be recovered 'after the fact', then it is deemed that the 'irreparable harm' requirement has not been met. Even in the American cases where the claimant was able to get past the 'irreparable harm' requirement, the cases nevertheless again illustrate the difficulty that this requirement presents for claimants for injunctions in the context of letters of credit. From the limited case law that South Africa has dealing with interdicts in relation to letters of credit and demand guarantees, it is still uncertain how strictly the courts will adhere to this requirement. Oelofse suggested that this requirement should not be applied too strictly when an interdict against payment is sought under a letter of credit/demand guarantee on the basis of fraud. He specifically suggested that the unattractive possibility to the applicant/principal of attempting to recover from a fraudulent beneficiary in a foreign country should not be

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<sup>180</sup> 1996 CLR 724 (W).

<sup>181</sup> See at 732. For a full discussion, see para 7.4.4 in Chapter 7; and see also para 5.6.5 in Chapter 5.

<sup>182</sup> See the full discussion in para 5.4.5 in Chapter 5 and para 7.2.3 in Chapter 7.

<sup>183</sup> See paras 7.4.2 and 7.3 in Chapter 7.

<sup>184</sup> For a discussion of the Iranian crises and how courts then dealt with the irreparable harm requirement, see paras 5.5.2.1, 5.5.4.3, and 5.5.6 in Chapter 5, and para 7.3 in Chapter 7.

regarded as indicating an absence of ‘irreparable harm’.<sup>185</sup> The suggestions made by Oelofse have some merit, but they will not be true in all situations and will still depend on the merits of each specific situation and the law of the foreign country that is involved. For example, it will be easier for a principal to recover from the fraudulent beneficiary using the English or American courts than what it would be using courts in Iran. Even more important than considering the law that would apply for recovering damages, is for the courts to determine whether the principal/applicant will suffer ‘irreparable harm’ if the injunction is not granted by taking into consideration the financial position of the fraudulent beneficiary. Therefore, courts should not only take into consideration the difficulty an applicant will have to deal with instituting legal action in a foreign court, but they will also have to consider which foreign court is involved and then consider what the financial position of the fraudulent beneficiary is.

The discussion in Chapter 7 has also illustrated that the English law relating to injunctions is very similar to the South African law of interdicts, but there are some important, although discrete, differences. From the discussion in Chapter 7 it appears that it might be even more difficult to obtain an interdict in the South African law than in the English law.<sup>186</sup> If that is true, then it will practically mean that it will be nearly impossible for a principal to prevent payment on the ground of fraud or any other established ground in South Africa. If this is so, then Prest<sup>187</sup> is probably correct in suggesting that South Africa should adopt the more flexible approach of the English courts to granting interdicts. However, even if South Africa were to adopt the English approach, it would by no means result in the South African courts having a flexible approach, as the English court have a very stringent approach to the granting of interdicts. Adopting the English approach will merely have the effect of bringing our law in this regard on par with the English position.<sup>188</sup> The English approach is too strict, and as already mentioned, the preferred approach is that South Africa should follow an approach that lies between the stringent approach of the English courts and the more relaxed approach of the American courts. This will create the necessary balance between protecting the sanctity and commercial utility of demand guarantees/letters of credit and preventing fraudulent beneficiaries from abusing the autonomy of these instruments.

The South African courts have shown that they are prepared, in cases where the fraud exception applies and, of course, where fraud has been established, not only to interdict the beneficiary from receiving payment or making a demand, but also to interdict the bank from paying. However, they have also indicated<sup>189</sup> that they are willing to go to great lengths to protect the integrity of letters of credit (and probably also demand guarantees).<sup>190</sup>

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<sup>185</sup> See A N Oelofse ‘Developments in the Law of Documentary Letters of Credit’ *ABLU* 2000 (a paper delivered at the 2000 Annual Banking Law Update held at the Indaba Hotel, Johannesburg) (unpaginated) at 4 of his article; and *Oelofse: The Law of Documentary Letters of Credit op cit* note 81 at 481. See also the discussion in para 7.4.4 in Chapter 7.

<sup>186</sup> See also the full discussion in para 7.4.2 in Chapter 7.

<sup>187</sup> See C B Prest *The Law and Practice of Interdicts* (1996) at 101–102.

<sup>188</sup> See also para 7.4.6 in Chapter 7.

<sup>189</sup> See, e.g. *Ex parte Sapan Trading (Pty) Ltd* 1995 (1) SA 218 (W).

<sup>190</sup> See para 7.4.6 in Chapter 7.

In *Loomcraft Fabrics v Nedbank* the Appellate Division stated that on the presentation of conforming documents the bank can escape liability ‘only upon proof of fraud on the part of the beneficiary’.<sup>191</sup> It would thus appear that fraud by the beneficiary is the one established basis, if not the only one, for an interdict against the bank. This can clearly not be correct, as such a view would overlook other established defences, such as illegality in the underlying contract<sup>192</sup> of the letter of credit/demand guarantee.<sup>193</sup> The reasons mentioned above<sup>194</sup> are enough to make it possible to obtain an interdict in cases where there is serious illegality in the underlying contract.<sup>195</sup>

As already mentioned in an earlier chapter<sup>196</sup> the obligation of the bank to pay under a letter of credit/demand guarantee can also be compared to the payment obligation of a bank that has guaranteed the payment of a cheque (i.e., a bank-guaranteed cheque). Therefore, cases where the drawer of a bank-guaranteed cheque applies for an interdict to prevent the bank from paying where a fraudulent demand is made, may also be comparable to similar cases dealing with demand guarantees/letters of credit and may provide important guidance in such cases. Therefore, it is imperative that the courts bear this in mind in future, especially in view of the fact that South Africa currently has limited demand guarantee and letters of credit cases dealing specifically with instances where the fraud exception has been raised and where applications for interdicts have been made trying to prevent the payment of fraudulent demands.

Instead of applying for an interim injunction, the principal of a demand guarantee/applicant of a letter of credit can in proper circumstances rather apply for the freezing injunction (previously known as the *Mareva* injunction) in terms of the English law<sup>197</sup> or the South African anti-dissipation interdict (i.e., the South African equivalent of England’s freezing order),<sup>198</sup> which provides a means whereby a beneficiary may be prevented from removing his money or other assets from the jurisdiction of the court or otherwise dealing with them within or without the jurisdiction before the matter has been finally settled.<sup>199</sup> Attempts to secure injunctions/interdicts through full-length main court proceedings are often futile, since payment will often already have been effected by the time a favourable judgment might be rendered.<sup>200</sup>

The advantage of England’s freezing injunction and the South African anti-dissipation interdict from the principal’s point of view is that the injunction or interdict does not interfere with the operation of the demand guarantee (or letter of credit). Therefore, the

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<sup>191</sup> 1996 (1) SA 812 (A) at 815I–J.

<sup>192</sup> See Chapter 6 for a full discussion.

<sup>193</sup> See para 7.4.3 in Chapter 7 for a full discussion.

<sup>194</sup> See para 8.3.2 above.

<sup>195</sup> See the full discussion in Chapter 6.

<sup>196</sup> See notes 10, 548 and 619 in Chapter 5 and para 7.4.6 in Chapter 7.

<sup>197</sup> See para 7.2.5 in Chapter 7 for a full discussion.

<sup>198</sup> See para 7.4.5 in Chapter 7 for a full discussion.

<sup>199</sup> See R Jack, A Malek and D Quest *Documentary Credits: The Law and Practice of Documentary Credits Including Standby Credits and Demand guarantees* 3 ed (2001) in para 9.64 at 296; and Hugo: *The Law Relating to Documentary Credits op cit* note 25 at 282.

<sup>200</sup> See Bertrams *op cit* note 84 at 336.



autonomy principle does not come into play.<sup>201</sup> Although anti-dissipation interdicts have not yet been considered by the South African courts in the context of demand guarantees/letters of credit, the possibility exist that it will be used in future.<sup>202</sup>

## 8.5 INTERNATIONAL RULES AND INITIATIVES TO PREVENT FRAUDULENT OR UNFAIR CALLS

The ICC and the UNCITRAL have both been active in seeking a solution to the problems caused by unfair and fraudulent calls on demand guarantees and standby letters of credit. The ICC created various instruments (international rules) to serve as sources of law for demand guarantees and letters of credit. These ICC instruments are, in effect, standard-term contract rules available for incorporation into demand guarantees/standby letters of credit by the parties if they so choose.<sup>203</sup> The instrument issued by the UNCITRAL as a source of law for demand guarantees and standby letters of credit, and which deals extensively with the fraud exception is the UNCITRAL Convention. The adoption of the UNCITRAL Convention by a state has the effect of making it law in that state.<sup>204</sup> These various ICC instruments and the UNCITRAL Convention were discussed in Chapter 4 to see whether or not their attempts have assisted in preventing unfair and fraudulent calls. From the discussion in Chapter 4 it follows that none of these instruments or the UNCITRAL Convention has really succeeded in preventing fraudulent and unfair calls being made.

The ICC instruments that are particularly relevant are: the URCG;<sup>205</sup> the URDG;<sup>206</sup> and the ISP98.<sup>207</sup> Attention was also given the ICC's UCP 600<sup>208</sup> and their predecessor, the UCP 500<sup>209</sup> none of which contain provisions attempting to prevent unfair or fraudulent demand being made on commercial/standby letters of credit.

The UCP 600 contain no provisions attempting to prevent unfair or fraudulent calls on commercial or standby letters of credit. Neither did their predecessor, the UCP 500.<sup>210</sup> The UCP do not deal with the problems that arise where documents presented under a credit are forged or otherwise fraudulent. Article 34 of the UCP 600 goes as far as stating that a

<sup>201</sup> See *Hugo: The Law Relating to Documentary Credits op cit* note 25 at 330; *Bolivinter Oil SA v Chase Manhattan Bank, Commercial Bank of Syria and General Company of Homes Refinery* [1984] 1 Lloyd's Rep 251 (CA) ([1984] 1 All ER 351 (CA)); and [1984] 1 WLR 392 (CA)); and *Z Ltd v A-Z and AA-LL* [1982] 1 QB 558 (CA) ([1982] 1 All ER 556) at 574.

<sup>202</sup> See also para 7.4.6 in Chapter 7.

<sup>203</sup> For a full discussion of the ICC instruments as sources of the law relating to demand guarantees and standby letters of credit, see para 3.2 in Chapter 3.

<sup>204</sup> See C Debattista 'Performance Bonds and Letters of Credit: A Cracked Mirror Image' (1997) *Journal of Business Law* 289 at 295. For a full discussion of the UNCITRAL Convention, see para 3.3 in Chapter 3, para 4.4 in Chapter 4, and para 6.5 in Chapter 6.

<sup>205</sup> See the Uniform Rules for Contract Guarantees, *ICC Publication No 325*, Paris (1978) (hereinafter 'the URCG'). For a full discussion of the URCG, see para 3.2.4 in Chapter 3 and para 4.2.2 in Chapter 4.

<sup>206</sup> For a full discussion of the URDG, see para 3.2.5 in Chapter 3 and para 4.2.3 in Chapter 4.

<sup>207</sup> For a full discussion of the ISP98, see para 3.2.6 in Chapter 3 and para 4.3 in Chapter 4.

<sup>208</sup> See also the full discussion of UCP 600 in para 3.2.2 in Chapter 3 and para 4.2.1 in Chapter 4.

<sup>209</sup> See also the full discussion of UCP 500 in para 3.2.2 in Chapter 3 and para 4.2.1 in Chapter 4.

<sup>210</sup> For a full discussion, see para 4.2.1 in Chapter 4.

'bank assumes no liability or responsibility for the form, sufficiency, accuracy, genuineness, falsification or legal effect of any document'.<sup>211</sup> In fact, the UCP is completely silent with regard to the issue of fraud and the fraud rule. The drafters of the UCP 500 and UCP 600 respectively deliberately decided to leave out the fraud issue. Accordingly, the lack of a fraud provision in the UCP clearly indicates that the intention of the drafters was that the issue of fraud should be determined by the applicable national law.

Opinion on whether or not the UCP should deal with the fraud issue is divided.<sup>212</sup> It is regretted that the UCP, which have become such an important universal set of rules (source of law particularly for letters of credit) are silent on the issue of unfair or fraudulent calling of letters of credit and standby letters of credit. What is even more regrettable is the fact that the UCP do not contain any provision on the issuing bank's right to refuse payment.

One of the objectives of the URCG was to limit the possibilities of unfair demands of guarantees issued under it. In terms of article 9 of the URCG, if the guarantee did not specify the documentation to be produced in support of a claim or merely specified the submission of a statement of claim, the beneficiary was required to submit (1) in the case of a tender guarantee, the beneficiary's declaration that the guarantee was due and an agreement to have any dispute with the principal submitted to litigation or arbitration, and (2) in the case of a performance guarantee or of a repayment guarantee, either a court decision or an arbitral award justifying the claim, or the approval of the principal in writing to the claim and to the amount to be paid. Furthermore, article 8(3)(b) also specifically specified that a claim under a guarantee could only be honoured if it was supported by the documents as specified in the guarantee or in the rules of the URCG. The effect of article 8(3)(b) and article 9 was to make all demand guarantees conditional and, furthermore, to make the conditions to which calls were subject particularly onerous on the beneficiary. If payment under the demand guarantee was subject to justification under the underlying contract or the agreement of the principal, then the guarantee was not truly independent of the underlying contract: for payment to be justified, the veil of the guarantee had to be lifted and justification found in the underlying contract. In addition to limiting the possibility of improper demand, the requirements of article 8(3)(b) read with article 9 also effectively eliminate the simple demand guarantee. Therefore, one of the major problems with respect to the URCG is that they did not take into consideration the increasing use and importance of on-demand (simple or first demand) guarantees. This also had the effect that the URCG were not popular and accordingly it were seldom used.

Article 20 of the URDG does not go as far as article 9 of the URCG.<sup>213</sup> The article has gone some small way to placing restrictions on the beneficiary's right of payment. This article only requires that the demand be in writing and supported by a written statement that the principal is in breach of the underlying contract and in what respect the principal is in breach. The simple demand guarantee is thereby transformed into a documentary guarantee, with a required minimum content of the document. However, the wording used in article 20 here is not a very effective safety device, but at least it places on the beneficiary a certain obligation to show his hand. The requirement that the beneficiary has to state in writing both that there is some kind of breach of the underlying contract and the

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<sup>211</sup> The UCP 500 contained a similar provision (see section 15).

<sup>212</sup> For a full discussion of the different views, see para 4.2.1 in Chapter 4.

<sup>213</sup> For a full discussion, see para 4.2.3 in Chapter 4.

type of breach that is involved gives the principal limited protection.<sup>214</sup> However, the URDG do not contain any provision on the guarantor's right to refuse payment.

Therefore, although the URCG and the URDG have both attempted to prevent unfair calls on demand guarantees, in conclusion, it can be said that neither the URCG nor the URDG seem quite sufficient. In fact, the URDG have not only failed to win the support of all groups but have also been strongly opposed by some.

In the UNCITRAL Convention, neither the approach of the URCG nor that of the URDG was taken. Contrary to the ICC rules, the UNCITRAL Convention made an attempt to address the issue of fraud and to prevent fraudulent or unfair calling of standby letters of credit and demand guarantees. From the viewpoint of unfair calls and the principle of autonomy, the vital articles of the UNCITRAL Convention are articles 15(3), 19 and 20. These articles work together to make it more difficult for an unfair call to succeed and they do so by seeking a justification for the call in the underlying contract. The UNCITRAL Convention specifically recognises exceptions to the absolute and independent nature of demand guarantees and standby letters of credit. Article 19 with the heading 'Exception to Payment Obligation' stipulates the circumstances under which the issuer/guarantor may dishonour the beneficiary's demand for payment.<sup>215</sup> Article 19(1) provides that if it is manifest and clear that (1) any document is not genuine or has been falsified; (2) no payment is due on the basis asserted in the demand and the supporting documents; or (3) judging by the type and purpose of the undertaking, the demand has no conceivable basis, the guarantor/issuer, acting in good faith, has a right, as against the beneficiary, to withhold payment. Article 19(2) then proceeds to listing the circumstances in which it will be considered that the demand has no conceivable basis. It provides that in the following five circumstances it will be deemed that the demand has no conceivable basis:

1. The contingency or risk against which the undertaking was designed to secure the beneficiary has undoubtedly not materialised;
2. The underlying obligation of the principal/applicant has been declared invalid by a court or arbitral tribunal, unless the undertaking indicates that such contingency falls within the risk to be covered by the undertaking;<sup>216</sup>
3. The underlying obligation has undoubtedly been fulfilled to the satisfaction of the beneficiary;
4. Fulfilment of the underlying obligation has clearly been prevented by wilful misconduct of the beneficiary; and
5. In the case of a demand under a counter-guarantee, the beneficiary of the counter-guarantee has made payment in bad faith as guarantor/issuer of the undertaking to which the counter-guarantee relates.

The Convention for the first time contains a codification of the different situations where fraud is present, and it too requires strong evidence as to this situation. This list may not be exhaustive, but it is a remarkable and encouraging way in which to define the kind of

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<sup>214</sup> For a full discussion of the very limited protection that article 20 offers a principal, see para 4.2.3 in Chapter 4.

<sup>215</sup> For a full discussion of the UNCITRAL Convention and how it deals with fraud and the problems that arise in this regard, see para 4.4.2 in Chapter 4.

<sup>216</sup> For a full discussion of the illegality defence in the UNCITRAL Convention, see para 6.5 in Chapter 6, and see the concluding comments in para 8.3.2.1 above.

misconduct that may provoke the fraud exception. Article 19 provides that as far as the degree of proof is concerned, the fraud must be ‘manifest and clear’ and ‘immediately available’. It clearly provides that appropriate fraud in the narrow as well as wide sense will be sufficient to constitute an exception to the autonomy principle. In my view, it defines the concept of fraud a little too widely in article 19(2). However, it unquestionably stands as the most detailed provision so far with regard to the clarification of the type of misconduct that may bring the fraud exception into operation.<sup>217</sup>

The Convention is mainly concerned with the nature of the documents presented. It does not mention, and is not concerned with the identity of the fraudulent party. Therefore, the fraud exception applies under the Convention, if ‘any document is not genuine or has been falsified’, regardless of the identity of the fraudster. Furthermore, although the Convention requires ‘manifest and clear’ evidence to invoke the fraud exception, it does not mention that the wrongdoer’s intention should be proven. From reading the provisions of the Convention, it seems that the Convention, like the United States Revised UCC article 5 section 109,<sup>218</sup> focuses rather on the nature of misconduct than the fraudster’s state of mind or the identity of the fraudster.<sup>219</sup>

Article 20 of the UNCITRAL Convention recognises the possibility of restraining orders against the beneficiary and/or bank on the basis of immediately available strong evidence that the beneficiary’s demand for payment has no conceivable basis, as further described in article 19(2). In addition, the court should take into account whether in the absence of such order the principal would be likely to suffer serious harm. The bank’s knowledge of the beneficiary’s fraud is not a relevant issue.<sup>220</sup>

However, it does seem that article 19 departs quite clearly from the principle of autonomy. For instance, in determining whether a call is justified, most of the sub-articles of article 19<sup>221</sup> require the guarantor/issuer of the demand guarantee or standby letter of credit to look to the underlying contract for good cause to pay. Article 19 does not place an express duty on the guarantor to refuse payment under certain circumstances, but only a right to do so. The article seems to allow the guarantor/issuer certain discretion when payment is demanded, but it also implies a certain duty on him to make a judgment whether the requirements are met or not. Therefore, there now appears to be a certain duty on the guarantor to make a judgment whether payment should be made. Banks understandably want to keep their involvement to a minimum when dealing with the question of whether or not to pay under a demand guarantee (and letter of credit), particularly when there are allegations of fraud. It has been said that banks are objecting to the ratification of the UNCITRAL Convention, because of their perception that articles 15(3) and 19 will bring about their greater involvement.<sup>222</sup>

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<sup>217</sup> For a full discussion, see para 4.4.2 in Chapter 4.

<sup>218</sup> See paras 5.5.2 and 5.5.3 in Chapter 5.

<sup>219</sup> For a full discussion, see para 4.4.2 in Chapter 4, and also notes 323 and 401 in Chapter 5.

<sup>220</sup> For a full discussion of articles 19 and 20 of the UNCITRAL Convention see para 4.4 in Chapter 4. See also para 7.5 in Chapter 7.

<sup>221</sup> See articles 19(1)(b) and (c) and 19(2)(a)–(d).

<sup>222</sup> See R Fayers ‘Developments Concerning the “Accounting Principle”’ (October–December 2006) 12 *ICC’s DCInsight* 18 at 20.

Articles 19 and 20 provide respectively for the definition and description of the fraud exception, and the measures available to the principal in such a case. The attempts made by the UNCITRAL Convention by way of articles 19 and 20 are commendable, especially since it is the first real international attempt to prevent unfair calls and to codify the fraud rule, but, the true effectiveness of the Convention is seriously doubted.

The ISP98 take a similar approach to the UCP and expressly leave the issue of fraudulent or unfair calling of standby letters of credit to be determined by the applicable jurisdictional law. As with the UCP, it is also regretted that the ISP98 is silent on this issue. However, Dolan states that it was a wise decision of the drafters of the ISP98 to leave questions regarding the troublesome subject of fraud in the transaction to local law. He further indicated that a major failing of the UNCITRAL Convention lay in the Convention's attempt to codify rules dealing with that subject.<sup>223</sup> According to him, fraud rules are best left to local law, because fraud questions are inextricably entwined with matters of local procedural law and because the notion of fraud itself varies from jurisdiction to jurisdiction. It is the market that will sort out the problem. Jurisdictions that do not fashion efficient rules, procedurally and otherwise, for resolving fraud questions, will find credits issued by their banks unacceptable in world markets. Dolan is of the view that the ISP98, like the UCP, correctly eschew the fraud question.<sup>224</sup>

It follows that if market participants want strong protection against fraud, they should incorporate the URCG; if they desire moderate protection they should incorporate the UNCITRAL Convention; and if they only want minimal protection, they should incorporate the URDG.

From the above, it seems that we are back to square one. Banks need a simple device whereby they will have to pay without having to make difficult considerations and to take hard decisions based on unclear evidence. Beneficiaries need a device whereby they get paid against a simple demand or against a simple document without risking various obscure objections. Principals, however, are interested in having some safety mechanism in the system so as to prevent unfair callings. Although the international initiatives, discussed above, are laudable, they are unlikely to bring about a clear and practical solution to the problem of unfair calls, given the opposing nature of commercial and political interests and motives. The problem with all of these international initiatives, however, is that their effectiveness is limited to the extent to which the international community is prepared to adopt them in practice.

## 8.6 USE OF INTERNATIONAL RULES LOCALLY

In Chapter 3 attention was given to all the sources of law for demand guarantees and standby letters of credit. Specific attention was also given to all the international rules that are available for incorporation into demand guarantees, standby letters of credit and even commercial letters of credit by the parties to these instruments.<sup>225</sup>

<sup>223</sup> See J F Dolan 'The UN Convention on International Independent Undertakings: Do States with Mature Letter-of-Credit Regimes Need It?' (1998) 13 *Banking and Finance Law Review* 1.

<sup>224</sup> See J F Dolan 'Analysing Bank Drafted Standby Letter of Credit Rules, the International Standby Practice (ISP98)' (2000) 14 *Wayne Law Review* 1865 in note 129 at 1901. See para 4.3.1 in Chapter 4 for a full discussion.

<sup>225</sup> For a full discussion, see Chapter 3.

### 8.6.1 Use of the UCP

South African banks are already issuing commercial letters of credit subject to UPC 500.<sup>226</sup> It is expected that they will also use the latest version, UCP 600. It is submitted that this is a good practice and banks should continue to do so. Owing to the lack of legislative regulation for commercial letters of credit, South Africa should also consider following the approach used in the United States, to make the UCP part of our local law.

### 8.6.2 Use of the URDG and/or the UNCITRAL Convention

There is a lack of legislative regulation for demand guarantees in South Africa, and because of their highly international nature, the available international rules, such as the URDG, make it a natural choice for the local banks to use. It has even been accepted by the World Bank as the rules for its standard guarantees. At present South African banks are not generally issuing demand guarantees subject to the URDG. It is recommended that banks investigate the possibility of making the URDG part of their current practice. As the ICC is currently in the process of reviewing the existing URDG, banks should also start appointing appropriate teams so that they can study the revised URDG once they become available. This will enable banks to determine whether or not they should issue demand guarantees subject to them. It will also place them in a position to advise their customers adequately on whether they should issue or accept demand guarantees that are made subject to the URDG.

The UNCITRAL Convention is aimed at providing a harmonised set of rules for the demand guarantee and the standby letter of credit and to provide greater legal certainty in their use for daily commercial transactions. In addition to being consistent with the UCP and the URDG and working *in tandem* with them, the Convention supplements their operation by dealing with issues beyond the scope of those rules, in particular regarding the question of fraudulent or abusive demands for payment and judicial remedies in such circumstances. There is also a difference in emphasis; only a Government can adopt the Convention for its country. The ICC rules will apply only if expressly stated in the guarantee or standby letter of credit, whereas the Convention automatically applies to such documents issued from a country that has adopted the Convention, unless expressly excluded from the document.<sup>227</sup> There is also a need for more information to be made generally available about the UNCITRAL Convention so that interested parties can consider it in detail.<sup>228</sup>

### 8.6.3 Use of the ISP98

The URDG govern demand guarantees and the ISP98 govern standby letters of credit. Although the demand guarantee and the standby letter of credit are essentially the same in character,<sup>229</sup> they are still different products, and therefore they need different rules to

<sup>226</sup> See para 3.2.2.1 and notes 48 and 57 in Chapter 3.

<sup>227</sup> See SITPRO's *Report on the Use of Demand Guarantees in the UK* (July 2003) at 6 (www.sitpro.org.uk accessed 3 June 2008).

<sup>228</sup> See SITPRO's *Report on the Use of Demand Guarantees in the UK* (July 2003) at 4 (www.sitpro.org.uk accessed 3 June 2008). See the full discussion of whether South Africa should ratify the UNCITRAL Convention or create their own legislation in para 8.7 below.

<sup>229</sup> See para 2.9.5 in Chapter 2.

apply to them. Therefore, South African banks should issue these instruments, subject to the respective international rules that apply.

It is recommended that the banks should use the international rules of the ICC. By incorporating them into the demand guarantees and standby letters of credit, it will be easier for banks, lawyers and courts to interpret them, and to learn about their exact use, as this would provide them with some form of international standard of comparison.

## 8.7 CODIFICATION OF THE LAW VERSUS THE ADOPTION OF THE UNCITRAL CONVENTION

### 8.7.1 Advantages of Codifying the South African Law

As pointed out above<sup>230</sup> and in earlier chapters, the lack of proper case law has led to many issues relating to letters of credit and demand guarantees not being authoritatively settled as yet. However, the few issues that have been settled by the limited case law that South Africa does have, and that have been dealt with here, seem to be very sound in their reasoning. In a comprehensive study conducted by Hugo in 1996 that focused on nearly all aspects of commercial letters of credit, he reached the following conclusion:<sup>231</sup>

The South African courts have in the few opportunities given them clearly manifested an intention of protecting the integrity of the system of documentary credits. This is to be welcomed. In so doing they have ably demonstrated the ability of the South African law to give effect to the international consensus regarding these instruments, as well as to the commercial expectations of the parties involved. Although some questions still need to be resolved it would be fair to conclude that our law regarding documentary credits is on a sound footing.

Although this conclusion cannot be faulted, it does beg the question of whether South Africa should possibly codify its law regarding letters of credit and demand guarantees? South Africa and England have not codified their fraud exception as the United States has, nor have they made any attempts to do so. This also brings to mind the question whether South Africa should attempt to codify its fraud exception to the principle of independence? The advantage of having legislation is that it will bring certainty to certain identified problem areas, particularly to those issues that have not been authoritatively settled as yet. For instance, it could bring certainty to the following areas of the law in South Africa regarding demand guarantees and letters of credit that have been fully discussed in earlier chapters, namely

- the exact standard of compliance that should be followed (it could bring certainty to whether South Africa, in fact, apply a strict standard of compliance),<sup>232</sup>
- acceptance of fraud in the wide as well as in the broad sense, as an exception to the autonomy principle of letters of credit (i.e., it could bring certainty to the concept of fraud),<sup>233</sup>

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<sup>230</sup> See para 8.1 above.

<sup>231</sup> See Hugo: *The Law Relating to Documentary Credits* op cit note 25 at 339.

<sup>232</sup> See paras 2.5.2.5.1, 2.5.2.5.4, and 2.5.2.5.6 in Chapter 2.

<sup>233</sup> See paras 5.6.1, 5.6.2, and 5.6.6 in Chapter 5; and paras 8.3.1 and 8.4 above.

- the standard of fraud that South Africa should apply;<sup>234</sup>
- the exact level of proof of fraud that is required for the fraud rule to apply;<sup>235</sup>
- whether it should be proved that the bank had knowledge of fraud in order to be successful with an application for an injunction to prevent payment;<sup>236</sup>
- what the identity of the fraudster should be, for the fraud exception to find application;<sup>237</sup>
- whether South Africa also accepts other exceptions to the autonomy principle, such as illegality in the underlying contract;<sup>238</sup> and
- whether the normal requirements for interdicts should apply when a principal applies for an interdict to prevent the bank from paying and/or the beneficiary from making a demand or receiving payment, or whether there should be special requirements that should apply in such circumstances.

Another advantage of having legislation in a country such as South Africa where case law is slow and often non-existent, is that it will not have to wait for proper case law to appear to sort out certain issues. Having legislation has the added benefit that the parties will, for instance, know what their rights are, what to expect from using demand guarantees and letters of credit, and when it will be possible to prevent a payment being made and/or a demand being made or payment being received in cases involving appropriate fraud or illegality in the underlying contract.

There have been two earlier comprehensive South African studies dealing with nearly all issues, particularly the shortcoming in the law of regarding commercial letters of credit.<sup>239</sup> Both studies include extensive comparative research with various countries, including England and the United States. Together with these two studies and this thesis dealing exclusively with demand guarantees, it would be possible for South Africa to draft appropriate legislation that would provide certainty to those areas that have been identified as being problematic and lacking in some way.

### 8.7.2 Disadvantages of Codifying the South African Law

However, having said all of this and pointing out the various advantages that there are in codifying the law, it also needs to be pointed out that there are also serious disadvantages to creating a statute for South Africa. For example, if a statute is not favoured by the international business community, they will merely not accept instruments that have been issued subject to it. Owing to the highly international character of demand guarantees, standby letters of credit and commercial letters of credit only a few individual countries in the world have introduced special legislation governing these instruments.<sup>240</sup> England, just

<sup>234</sup> See paras 5.6.1, 5.6.3 and 5.6.6 in Chapter 5; and para 8.3.1 above.

<sup>235</sup> See paras 5.6.1, 5.6.3 and 5.6.6 in Chapter 5; and paras 8.3.1 and 8.4 above.

<sup>236</sup> See paras 5.6.1 and 5.6.4 in Chapter 5; and paras 8.3.1 and 8.4 above.

<sup>237</sup> See para 5.6.1 in Chapter 5; and para 8.3.1 above.

<sup>238</sup> See paras 6.4 and 6.6 in Chapter 6; and para 8.3.2 above.

<sup>239</sup> See *Hugo: The Law Relating to Documentary Credits* op cit note 25; and *Oelofse: The Law of Documentary Letters of Credit* op cit note 81.

<sup>240</sup> For a discussion of a few countries that have statutory provisions regarding documentary credits see R A Schütze and G Fontane *Documentary Credit Law Throughout the World: Annotated Legislation from More than 35 Countries* (2001) ICC Publication No 633 at 43–140. For a discussion of a few countries that have



like South Africa, also has no specific national legislation governing commercial letters of credit, standby letters of credit or demand guarantees. Normally where a country has any legislation governing demand guarantees, commercial letters of credit or standby letters of credit, it tends to consist of only a few provisions; often of a general nature.<sup>241</sup>

However, one such an exception is article 5 of the United States UCC. Article 5 of the UCC deals with letters of credit and it encompasses both the commercial letter of credit and the standby letter of credit. Therefore, disputes relating to an American standby letters of credit or commercial letter of credit are decided under article 5 of the UCC.<sup>242</sup> Although article 5 of the UCC seems to be working fairly well, there are still uncertainties with regard to its exact application. This was, for example, seen with the application of the fraud rule as was set out in Prior UCC article 5.<sup>243</sup> Even with the revised article 5 of the UCC (i.e., Revised UCC article 5), there still seem to be interpretational problems, particularly regarding the exact interpretation of the standard of fraud that has been indicated as being 'material fraud'.<sup>244</sup> Despite these minor problems with the interpretation of article 5 of the UCC, it is a remarkable example of a workable codification of the law regarding commercial and standby letters of credit. However, the law regarding demand guarantees is not codified in the United States, but there is a United States Comptroller of the Currency Interpretative Ruling providing very basic guidelines regarding the issuing of demand guarantees by American banks.<sup>245</sup> America still prefers to issue standby letters of credit and does not seem to be really issuing demand guarantees. Many books that discuss demand guarantees merely provide a discussion of the UNCITRAL Convention or the URDG.<sup>246</sup> This may be an indication of their view that those are the appropriate rules that should be governing demand guarantees. It therefore seems that the United States prefers that these international rules should be used when dealing with demand guarantees.

### 8.7.3 Adopting the UNCITRAL Convention

The UNCITRAL Convention applies to an international undertaking such as a demand guarantee/standby letter of credit, (1) where the place of business of the guarantor/issuer at which the undertaking is issued is in a contracting state<sup>247</sup> or (2) the rules of private law lead to the application of the law of a contracting state,<sup>248</sup> unless the undertaking excludes

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statutory provisions regarding demand guarantees see Bertrams *op cit* note 84 at 35–36 and also notes 41–42 at 35.

<sup>241</sup> See Xiang Gao *op cit* note 58 at 15.

<sup>242</sup> See para 3.4.2 in Chapter 3.

<sup>243</sup> See paras 5.5.2.1, 5.5.3, 5.5.4.2, and 5.5.4.3 in Chapter 5; and para 8.3.1 above.

<sup>244</sup> See paras 5.5.2.2, 5.5.3, and 5.5.4.4 in Chapter 5; and para 8.3.1 above.

<sup>245</sup> For a full discussion, see paras 3.4.2 and 3.4.2.1, particularly note 222, in Chapter 3.

<sup>246</sup> See, e.g., B V McCullough *Banking Law* (Vol No 12: International Banking – Letters of Credit) (loose-leaf edition) (1981–) in Chapter 239; and B V McCullough *Letters of Credit* (loose-leaf edition) (1987–) in Chapter 10.

<sup>247</sup> See article 1(1)(a) of the UNCITRAL Convention. The Convention will apply to international undertakings (demand guarantees or standby letters of credit) issued by banks in Ecuador, El Salvador, Kuwait, Panama, Belarus, Tunisia, Gabon and also in Liberia (from 1 October 2006).

<sup>248</sup> See article 1(1)(b) of the UNCITRAL Convention. For instance, the Convention will apply to international undertakings (demand guarantees or standby letters of credit) if the courts in Ecuador, El Salvador, Kuwait, Panama, Belarus, Tunisia, Gabon and Liberia (from 1 October 2006) under conflict rules determine that the law of any of these countries is applicable.

its application. The Convention can also apply to commercial letters of credit if the parties expressly state that their credit is subject to it.<sup>249</sup> It was decided that the application of the UNCITRAL Convention should be limited to international undertakings (demand guarantees or standby letters of credit), in particular, since it was felt that the inclusion of domestic instruments would adversely affect the global acceptability of the Convention.<sup>250</sup>

The Convention is shaped round both the UCP and the URDG, but it is distinctive in that both the UCP and the URDG are drafted by the ICC, a private organisation, as voluntary rules or self-regulation, whereas the Convention is drafted by the UNCITRAL, as a uniform law or official regulation for those countries who adopt it. Therefore, the adoption of the Convention by a state has the effect of making it law in that state, in contrast to the URDG and other ICC Rules, which take their force from incorporation into the contract of the parties.<sup>251</sup> The Convention, in addition to being essentially consistent with the solutions found in the rules of practice, supplements their operation by dealing with issues beyond the scope of such rules. It does so especially regarding the question of fraudulent or unfair demands for payment and judicial remedies available in such instances. In other words, because the legal status of the Convention is distinctive from the ICC rules, the Convention includes provisions relating to the fraud rule.<sup>252</sup>

Since the adoption of the UNCITRAL Convention (it became effective as from 1 January 2000), no major trading nation has acceded to it, although the ICC<sup>253</sup> and World Bank have indicated their approval. As of 1 July 2006, the Convention was ratified (acceded to) by Ecuador, El Salvador, Kuwait, Panama, Belarus, Tunisia, Gabon and most recently (on 16 September 2005) by Liberia. Although the United States signed the Convention on 11 December 1997, it has not yet acceded to it. In order for the United States to ratify the Convention, the advice and consent of the United States Senate are required. After many years of inaction, there are now signs that the United States might possibly ratify the Convention soon. Recently, a delegation from the Uniform Law Conference of Canada met with a delegation from Mexico and delegates invited by the National Conference of Commissioners on Uniform State Laws ('NCCUSL'), the organisation that oversaw the drafting of the article 5 of the United States UCC, to discuss the implementation of the Convention in North America. NCCUSL, Mexico and Canada all expressed interest in adopting the Convention.<sup>254</sup> The UNCITRAL has also announced that it will maintain on its website a record of court rulings applying the Convention.<sup>255</sup> This has the added benefit for courts to find guidance internationally and it will bring some

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<sup>249</sup> See article 1(2) of the UNCITRAL Convention.

<sup>250</sup> See E E Bergsten 'A New Regime for International Independent Guarantees and Stand-by Letters of Credit: The UNCITRAL Draft Convention on Guaranty Letters' (1993) 27 *International Lawyer* 859 at 863; and see also De Ly *op cit* note 2 at 838. See also para 3.3.2 in Chapter 3.

<sup>251</sup> See Goode *Guide to the ICC Uniform Rules for Demand Guarantees* (1992) ICC Publication No 510 at 7.

<sup>252</sup> See Xiang Gao *op cit* note 58 at 21; and for a full discussion, see para 3.3.2 in Chapter 3. For a full discussion of the fraud provisions, see para 4.4.2 in Chapter 4, and para 8.5 above.

<sup>253</sup> The ICC endorsed the UNCITRAL Convention on 21 June 1999. In this regard, see *ICC Publication* No 500/2, Paris (2002) at 69.

<sup>254</sup> See J E Byrne and C S Byrnes (eds) *2008 Annual Survey of Letter of Credit Law and Practice* (2008) at 13.

<sup>255</sup> See <http://www.un.or.at/uncitral/clout/index.htm> (accessed 1 July 2007). For a full discussion, see para 3.3.1 in Chapter 3.

form of harmonisation to dealing with demand guarantees. Of course, there is still a risk that different domestic courts will interpret and apply the provisions of the Convention differently, but it will still bring the different jurisdictions closer to one another and will make trade and international dealing in this area easier and will provide for some form of international consistency. Therefore, seeing that major trading nations, such as the United States and Canada, might soon be ratifying the Convention, it would at this point make no sense for South Africa to start creating legislation dealing with demand guarantees and therefore it is rather recommended that South Africa should start considering the option of also ratifying the Convention. From an international viewpoint it would make sense to simplify international trade and dealings, and to bring harmony to this area of the law.

So far, it seems that neither the South African Government nor the South African Law Reform Commission has considered the UNCITRAL Convention for ratification and accession.<sup>256</sup> Although this thesis did not deal with all aspects of the Convention – the main focus was on the provisions dealing with the autonomy principle,<sup>257</sup> standard of compliance,<sup>258</sup> fraud exception<sup>259</sup> and the illegality exception<sup>260</sup> – most of the provisions that were referred to, or dealt with, in this thesis seem to be workable and well drafted. The only criticism that can be pointed out is found in articles 19(2)(b) and 20(3) of the UNCITRAL Convention, which specifically provide for, and deal with, the illegality exception. These specific articles seem to be a little ambiguous and problematic.<sup>261</sup> For instance, they do not seem to provide for a workable illegality defence, but the uncertainties and interpretational problems could probably be clarified by appropriate case law, and therefore these articles should not be a reason not to ratify the Convention. However, the fraud exception, as dealt with in articles 19 and 20, seems to be workable and less problematic and it is submitted that by accepting the Convention, many uncertainties regarding the current fraud exception in South Africa could be resolved.<sup>262</sup> From this viewpoint, it is recommended that South Africa should ratify the Convention.

South African jurisprudence creates very few opportunities for a principal of a demand guarantee to make applications to court in order to prevent payment of the guarantee in unjustifiable or fraudulent circumstances. This is similar to the position in England. In both jurisdictions it is still uncertain as to whether fraud in the narrow as well as in the broad sense will be sufficient to provide an exception to the autonomy principle. Article 19 of the UNCITRAL Convention has a more flexible approach to fraud and specifically provides that fraud in the narrow as well as broad sense will be able to suffice as sufficient fraud as to provide an exception. Therefore, if South Africa were to adopt the Convention, at least that uncertainty would be resolved. The way in which the UNCITRAL Convention deals with the fraud exception and the appropriate relief a court may give in a case involving adequate fraud seems to be useful and it is recommended that government should immediately create a working group consisting of all possible stakeholders and legal

<sup>256</sup> For a full discussion of the UNCITRAL Convention, see para 3.3 in Chapter 3 and para 4.4 in Chapter 4.

<sup>257</sup> See para 2.5.2.2 in Chapter 2.

<sup>258</sup> See para 2.5.2.5.5 in Chapter 2.

<sup>259</sup> See para 4.4.2 in Chapter 4.

<sup>260</sup> See para 6.5 in Chapter 6.

<sup>261</sup> See the full discussion in para 6.5 in Chapter 6 and see para 8.3.2.1 above.

<sup>262</sup> For a full discussion of the fraud exception in South Africa, see para 5.6 in Chapter 5 and para 8.3.1 above.

experts to start examining the possibility of accepting the Convention. So far the South African Government has given no attention to this matter, and when recent enquiries were made to the government department concerned it seemed that it was totally ignorant of the fact that this important Convention even existed. If South Africa does not want to be left out of the international business community, it should start taking the appropriate steps now. The South African authorities concerned are strongly encouraged to familiarise themselves with the UNCITRAL Convention and to issue the necessary consultation document on the Convention among all stakeholders, so that an informed decision can be taken as to whether or not the Convention should be ratified.

## 8.8 RECOMMENDATIONS

What follows is a summary of some of the main recommendations that have been made throughout this thesis. Full details on these recommendations can be found in the respective chapters.

### 8.8.1 Recommendations Regarding the Fraud Exception

- The South African Appellate Division<sup>263</sup> made it clear that the courts were willing to intervene and issue interdicts restraining payment in cases where the fraud was clearly established; and they were also willing to enforce the fraud exception where the forgery or falsification concerned the documents (i.e., where there was fraud in the narrow sense). The impression has therefore been created that only fraud in the narrow sense may entitle the bank to withhold payment or restrain the beneficiary from accessing the letter of credit/demand guarantee where the bank may already have paid. But the courts have not yet indicated that they will not be prepared to interdict a bank from paying in the case of fraud concerning the performance by the beneficiary in terms of the underlying contract (i.e., in cases of fraud in the wide sense). However, from comments made in other cases, it seems that the courts would also be willing to accept fraud in the wide sense as valid exception. There has been no specific indication of the exact kind of fraud, as between the principal and beneficiary that would legally create a restraint on the beneficiary in operating the demand guarantee/letter of credit. It is submitted that no limitations should be placed on only accepting certain types of fraud as valid exceptions. To list the kinds of fraud that would be acceptable seems to be of academic interest only. It would make more sense if courts and banks were to judge each case on its own merits – if fraud of whatever nature is clearly established (i.e., irrespective of whether it relates to forged documents or to fraud in the underlying contract) payment should be refused or restrained.
- English courts have saddled principals/applicants with a great burden of proof, requiring them to establish the existence of ‘clear’ or ‘obvious’ fraud also known to the issuer in order to invoke the fraud rule. Undoubtedly, the beneficiary must also know of the fraud at the time of the presentation, because in the absence of such knowledge the beneficiary cannot be party to the fraud. The ordinary standard of proof in civil cases is that of the balance of probabilities. This standard also applies in a fraud case, but the court will weigh the evidence with due regard to the gravity of the particular allegation. Ackner LJ in *United Trading Corporation SA and*

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<sup>263</sup> See *Loomcraft Fabrics CC v Nedbank Ltd and Another* 1996 (1) SA 812 (A).

*Murray Clayton Ltd v Allied Arab Bank Ltd and Others*<sup>264</sup> stated that the correct test to use to establish whether there is clear evidence of fraud is, if based on the material before the court, the only realistic inference to draw is that of fraud (i.e., the ‘sole realistic inference’ test). This test has become the generally accepted formula in England for the evidence that is required in order to establish fraud. This test is commendable due to its preciseness and simplicity, and it is recommended that South Africa also use this test in order to establish whether fraud has been clearly established.

- The few South African cases where the fraud exception was referred to or acknowledged did not deal with at which exact time the fraud had to be clear to the bank. Therefore, there is no authority on this issue. Initially, the English law required that clear evidence of fraud had to be known to the bank at the time when the documents were presented. Therefore, the bank was obliged to pay against a demand that complied with the terms of the letter of credit/demand guarantee unless, at the time of presentation, the bank had clear evidence from which the only inference could be drawn that it was fraudulent. However, it now seems, as a result of more recent English decisions, that a bank may also be entitled to rely on knowledge it obtained between the demand and the hearing that (1) the demand was fraudulent; or (2) that the letter of credit/demand guarantee was voidable for fraudulent misrepresentation when the demand was made, as grounds for refusing to pay the beneficiary. Unlike the position in England, the question of whether the bank was aware of the beneficiary’s fraud has never been regarded as a relevant issue in the United States, particularly when an application has been made for an injunction against the bank preventing payment. Although the South African law regarding letters of credit and demand guarantees is similar to the English law, and despite its tradition of following English decisions, it is submitted that in this specific regard the position of the United States is to be preferred to the English position, and should rather be followed by South African courts. If fraud is proved to the standard required and all other requirements for an interdict is proved, an interdict preventing payment should be granted irrespective of the time at which the bank obtained knowledge of the fraud.
- It seems that the English and South African courts tend to use the fraud exception more narrowly as opposed to the more flexible criteria found in American jurisprudence. For instance, the American courts would grant interim restraining orders on the basis of strong suspicion of fraud, and they also do not require proof that the beneficiary was involved in the fraud. Therefore, it seems that in America it would be possible for an applicant of a letter of credit to obtain an injunction preventing payment where fraud was committed by a party other than the beneficiary. Both English and South African courts correctly require that fraud on the part of the beneficiary must be proved for the fraud exception to apply. It is recommended that if fraud was committed by a third party without the knowledge of the beneficiary, the fraud exception should not find application.
- South Africa has limited cases dealing with the fraud exception and there are still many uncertainties regarding the limits of the fraud rule and much speculation as to how it will be applied by the South African courts. As the obligation of the bank to

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<sup>264</sup> [1985] 2 Lloyd’s Rep 554 (CA).

pay under a letter of credit/demand guarantee can also be compared to the payment obligation of an acceptor of a bill of exchange or that of a bank of a bank-guaranteed cheque, it is possible that decisions where the fraud exception has been raised against the payment obligation of the acceptor or bank can also be of some assistance in similar cases dealing with demand guarantees/letters of credit. Therefore, it is recommended that the South African courts bear this in mind in future, especially in view of the fact that South Africa currently has very few cases dealing specifically with the fraud exception regarding demand guarantees/letters of credit.

### 8.8.2 Recommendations Regarding the Illegality Exception

- Recent cases in England are in favour of accepting established illegality in the underlying contract as an exception to the principle of autonomy of letters of credit and demand guarantees. South Africa currently has no cases where illegality in the underlying contract has been accepted or has even been considered as a possible exception to the autonomy principle of letters of credit and demand guarantees. So far, South African writers have not specifically dealt with this issue, neither have they voiced specific opinions on whether the courts should also follow the English precedents (i.e., accept illegality in the underlying contract as an exception) in this regard. It is submitted that South Africa should accept established and sufficiently serious illegality as an exception to the autonomy principle of letters of credit and demand guarantees, provided such acceptance is confined within a narrow scope. Public policy clearly requires that a party to an illegal contract should not be able to enforce such an illegal contract. However, if South Africa were to accept illegality in the underlying contract as an exception to the autonomy principle, one should also use the requirements that have so far been established by the English courts as a basis for developing the exception further, namely that the
  - alleged illegality must be established clearly;
  - illegality must be sufficiently serious;
  - beneficiary must have been involved in the illegality; and
  - letter of credit/demand guarantee must be sufficiently connected to the illegality in the underlying transaction.
- As regards the requirement that the illegality must be ‘sufficiently serious’, it is suggested that the illegality exception be limited to those instances where the illegality in the underlying contract carries with it a clear criminal element. The illegality should relate to a *prima facie* criminal offence being committed. If the illegality therefore is not linked to a criminal element, it should be deemed that the illegality is not sufficiently serious, but of a mere technical nature (i.e., that it contravenes a section of a specific Act that carries with it no possibility of a criminal prosecution by the authorities concerned) and it should then not constitute an exception to the autonomy principle and the bank should then have to pay despite the illegality.
- In the English cases it has not been made clear what the duties and obligations of the banks are in relation to illegality in the underlying contract. It is true that banks should not be forced to determine whether payment under the guarantee/credit will be used for an illegal purpose, because of the autonomy principle of demand guarantees/letters of credit, and should therefore not have to look beyond the documents at the underlying contract. The duty of banks is only to examine

documents with reasonable care. If that examination does not disclose evidence of illegality, the bank is entitled to pay and to be reimbursed by its customer (i.e., the principal/applicant). Therefore, in the absence of clear evidence of illegality, the bank is not only entitled, but also bound to pay. Thus, the availability of the illegality exception will not necessarily put banks under any additional difficulty in the examination of documents.

However, in South Africa, Van Niekerk and Schulze<sup>265</sup> have given this issue some thought and have made a few workable suggestions as to how the banks should deal with this situation. In the instance where the bank is actually aware of the illegality of the underlying contract (e.g., where it is evident from the information supplied by the applicant/principal in the application form for the letter of credit/demand guarantee that certain foreign-exchange regulations will be contravened by the bank if it complies with its payment instruction under the credit/guarantee), Van Niekerk and Schulze suggest that the bank should refuse to honour it. Likewise, when the bank may obtain knowledge of the illegality of the transaction by exercising reasonable care, it should similarly be under an obligation not to pay out on the letter of credit/demand guarantee. However, where the bank is neither actually aware of the illegality of the underlying contract, nor able to become aware by exercising reasonable care, its payment under the letter of credit/demand guarantee cannot be faulted. Their suggestions as to how banks should deal with the matter of illegality in the underlying contract make sense and, in my view, cannot be faulted. Placing such a duty (i.e., obtaining knowledge of the illegality of the transaction by exercising reasonable care, for example by looking at the information applied on the application form) on a bank makes sense and will not necessarily place an additional duty on the bank. Therefore, if a reasonable examination by the bank does not disclose evidence of illegality, the bank should be entitled to pay and to be reimbursed by its customer (i.e., the principal/applicant). However, if the bank fails to fulfil such a duty, the bank should not be allowed to be reimbursed by its customer. It is recommended that the South African courts take these suggestions into consideration when dealing with cases where the underlying contract is tainted by illegality.

### 8.8.3 Illegality and the UNCITRAL Convention

- The illegality exception as provided for in articles 19(2)(b) and 20 of the UNCITRAL Convention is inadequate. It does not provide for a workable illegality exception. The exact interpretation of the illegality exception is fraught with uncertainties and its application seems to be problematic. It is recommended that the UNCITRAL and the member states readdress this issue.

### 8.8.4 Limit the Exceptions to the Autonomy Principle

- The principle of autonomy of demand guarantees should, in principle, be jealously guarded, because it is essential for the preservation of the unique quality of the demand guarantee and letter of credit as an attractive instrument for international transactions. However, public policy considerations in favour of the fraud and illegality exception require that in certain cases the principle of autonomy should give way to the broader purpose of making sure that parties who engage in illegal or

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<sup>265</sup> See Van Niekerk and Schulze *op cit* note 12 at 312.

fraudulent transactions should not use the judicial process in furtherance of their unlawful/fraudulent purpose. However, in instances, where no fraud or illegality is involved, but where it relates by way of example to a breach of the underlying contract, or where a demand would constitute conduct that would be unconscionable or unreasonable, it should not be possible for a principal to obtain an interdict against a bank. If the ground for obtaining an interdict is one of these, the principal should be forced to try and obtain an interdict against only the beneficiary to prevent a demand being made or receiving payment, and even here interdicts should only be granted in highly exceptional circumstances or better yet be totally denied. As the demand guarantee is separate and independent of the underlying contract, and the bank is only concerned with documents and not even a party to the underlying contract, it follows that in the absence of established fraud and illegality, the bank should in all other instances pay, despite any disputes regarding the underlying contract. Even where the underlying contract is a nullity (i.e., it does not exist), the bank should still pay and it should not be possible to obtain an interdict against the bank to prevent payment in such a case. If all these types of exceptions are allowed, it would mean that the clear distinction of demand guarantees from traditional guarantees (i.e., accessory/secondary undertakings) would be diminished, and the original purpose why demand guarantees were created – to be similar to cash deposits – would become meaningless.

### **8.8.5 Interim Injunctions and Interdicts**

- The South African courts have shown that they are prepared, in cases where the fraud exception applies and, of course, where fraud has been established, not only to interdict the beneficiary from receiving payment or making a demand, but also to interdict the bank from paying. Although it is possible, in principle, for a principal/applicant of a demand guarantee/letter of credit to obtain an interdict against the bank prohibiting it from paying the beneficiary, such an application will seldom succeed. The South African courts have expressly stated that an interdict of this nature will not be granted, except in the most exceptional cases. It is true that it should not be too easy for a principal to obtain an injunction to prevent payment. If the law allows for interdicts to be issued too easily, it will seriously undermine the sanctity and commercial utility for which demand guarantees were created. If the international community finds that a certain country's law is not adequate to protect the sanctity and commercial utility of the demand guarantee, it will merely request that demand guarantees not be governed by that specific law. If the law is too strict in allowing for interdicts in situations where fraud has been clearly established, it will again allow unscrupulous beneficiaries to commit fraud. It is a complicated balance to get right. It is clear that the English approach is too strict. It also seems that South African courts are following in their footsteps. It is submitted that the South African courts should rather follow an approach between the stringent approach followed by the English courts and the more flexible one followed by the American courts. This will create the necessary balance between protecting the sanctity and commercial utility of demand guarantees/letters of credit and preventing fraudulent beneficiaries from abusing the autonomy of these instruments.
- Both the South African law and the American law require that in addition to any other requirements that a claimant for an interim interdict/injunction must comply with, he must also show that he will suffer 'irreparable harm' in the event of the



injunction not being granted. Traditionally, the American courts have been fairly strict as far as this requirement is concerned – if adequate monetary compensation can be recovered ‘after the fact’, then it is deemed that the ‘irreparable harm’ requirement has not been met. From the limited case law that South Africa has dealing with interdicts in relation to letters of credit and demand guarantees, it is still uncertain how strictly the courts will adhere to this requirement. Oelofse suggested that this requirement should not be applied too strictly when an interdict against payment is sought under a letter of credit/demand guarantee on the basis of fraud. He specifically suggested that the unattractive possibility to the applicant/principal of attempting to recover from a fraudulent beneficiary in a foreign country should not be regarded as indicating an absence of ‘irreparable harm’. The suggestions made by Oelofse have some merit, but they will not be true in all situations and will still depend on the merits of each specific situation and the law of the foreign country that is involved. For example, it will be easier for a principal to recover from the fraudulent beneficiary using the English or American courts than what it would be using courts in Iran. Even more important than considering the law that would apply for recovering damages, is for the courts to determine whether the principal/applicant will suffer ‘irreparable harm’ if the injunction is not granted by taking into consideration the financial position of the fraudulent beneficiary. Therefore, courts should not only take into consideration the difficulty an applicant will have to institute legal action in a foreign court, but they will also have to consider which foreign court is involved and then consider what the financial position of the fraudulent beneficiary is.

- The obligation of the bank to pay under a letter of credit/demand guarantee can also be compared to the payment obligation of a bank that has guaranteed the payment of a cheque (i.e., a bank-guaranteed cheque). Therefore, it is possible that the cases where the drawer of a bank-guaranteed cheque applies for an interdict to prevent the bank from paying where a fraudulent demand is made, may also be comparable to similar cases dealing with demand guarantees/letters of credit and may provide importance guidance in such cases. It is imperative that the courts bear this in mind in future, especially in view of the fact that South Africa currently has limited demand guarantee/letters of credit cases dealing specifically with instances where the fraud exception has been raised and where applications for interdicts have been made trying to prevent the payment of fraudulent demands.

#### **8.8.6 Recommendations Addressed Specifically to Banks**

- In line with the suggestions made by Van Niekerk and Schulze, it is recommended that banks should deal with a demand guarantee where the underlying contract is illegal in the following manner. Where the bank is actually aware of the illegality of the underlying contract (e.g., where it is evident from the information supplied by the applicant/principal in the application form for the letter of credit/demand guarantee that certain foreign-exchange regulations will be contravened by the bank if it complies with its payment instruction under the credit/guarantee) the bank should refuse to honour it. Likewise, when the bank may obtain knowledge of the illegality of the transaction by exercising reasonable care, it should not pay out on the letter of credit/demand guarantee. It would also be a good idea if the bank were to inform its customer of the situation, so that he might apply for an interdict restraining payment. In doing so, it will allow the bank to stay out of the matter until it is properly

resolved by the courts. However, where the bank is neither actually aware of the illegality of the underlying contract, nor able to become aware by exercising reasonable care, it must honour its payment where a proper complying demand was made.

- Since there is a lack of legislative regulation for demand guarantees in South Africa, and because of their highly international nature, the available international rules, such as the URDG, make it a natural choice for local banks to use. It has even been accepted by the World Bank as the rules for its standard guarantees. At present South African banks are not generally issuing demand guarantees subject to the URDG. It is recommended that banks investigate the possibility of making the URDG part of their current practice. As the ICC is currently in the process of reviewing the existing URDG, banks should also start to appoint the appropriate teams so that they can study the revised URDG when it becomes available. This will enable banks to determine whether or not they should issue demand guarantees subject to it. It will also place them in a position to adequately advise their customers on whether they should issue or accept demand guarantees that are made subject to it.<sup>266</sup>
- The URDG govern demand guarantees and the ISP98 govern standby letters of credit. Although the demand guarantee and the standby letter of credit are essentially the same in character, they are still different products, and therefore they need different rules to apply to them. It is recommended that the banks use the international rules of the ICC. By incorporating the URDG into the demand guarantees and the ISP98 into standby letters of credit, it will be easier for banks, lawyers and courts to interpret them and to learn about their exact use, as they will provide them with some form of international standard to which they can be compared.

### **8.8.7 Recommendations Addressed to the Relevant South African Authorities**

- There are various advantages to having legislation governing demand guarantees. For instance, one important advantage is that it will bring certainty to various identified problem areas, specifically to those issues that have not been settled authoritatively as yet. Conversely, there are also numerous disadvantages to codifying this area of the law. Based on the above-mentioned reasons, I recommend that the South African law governing demand guarantees (and letters of credit) should not be codified.
- Major trading nations, such as the United States and Canada, might soon be ratifying the UNCITRAL Convention. Therefore, at this point it would make no sense for South Africa to start creating legislation dealing with demand guarantees and it is rather recommended that South Africa should start considering the option of also ratifying the Convention. From an international viewpoint it would make sense to simplify international trade and dealings, and to bring harmony to this area of the law. As pointed out above there are numerous advantages if South Africa were to ratify the Convention. So far the government has given no attention to this matter, and when recent enquires were made to the government department concerned it seemed that it was totally ignorant of the fact that this important Convention even

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<sup>266</sup> See paras 3.2.5.2 and 3.2.5.3 in Chapter 3 and paras 8.6.1 and 8.6.2 above. For a full discussion of the URDG, see para 3.2.5 in Chapter 3 and para 4.2.3 in Chapter 4.

existed. If South Africa does not want to be left out of the international business community, it should start taking the appropriate steps now. The South African authorities concerned are strongly encouraged to familiarise themselves with the UNCITRAL Convention and to issue the necessary consultation document on the Convention among all stakeholders, so that an informed decision can be taken as to whether or not the Convention should be ratified.

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## **AUSTRALIA**

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## **SINGAPORE**

*GHL Pte Ltd v Unitrack Building Construction Pte Ltd and Anor* (1999) 4 SLR 604 (Sing CA)

*Kvaerner Singapore Pte Ltd v UDL Shipbuilding (Singapore) Pte Ltd* (1993) 3 SLR 350

*McConnell Dowell Constructors (Aus) Pty Ltd v Sembcorp Engineers and Constructors Pte Ltd* [2002] 1 SLR 199 (Sing HC); and [2002] Build LR 450 (Sing HC)

*Royal Design Studio Pte Ltd v Chang Development Pte Ltd* (1991) 2 MLJ 229

*Samwoh Asphalt Premix Pte Ltd v Sum Cheong Piling Pte Ltd and Anor* (2001) 3 SLR 447; (2002) 1 SLR 1; and [2002] Build LR 459 (Sing CA)

## **MALAYSIA**

*Esso Petroleum Malaysia Inc v Kago Petroleum Sdn Bhd* (1995) 1 MLJ 149  
(Supreme Court (Kuala Lumpur))

## **CANADA**

*Bank of Nova Scotia v Angelica-Whitewear Ltd* (1987) 36 DLR (4th) 161 (SCC)  
(Supreme Court of Canada)

*BC Ltd v KPMG Inc* [2004] 238 DLR (4th) 13 (BC Ct App)

*CDN Research and Development Ltd v Bank of Nova Scotia and Others* (1982) 136 DLR  
(3d) 656 (Divisional Court of the Ontario High Court)

## INDEX

*References are to paragraph numbers*

<b>ABSTRACT PAYMENT UNDERTAKING</b> .....	1.1.1, 2.5, 2.5.2.1, 2.5.2.9, 2.8.1, 2.8.2
<b>ACCESSORY (UNDERTAKING)</b> .....	2.5.1, 2.5.1.1, 2.5.2.4.1, 3.2.4.2, 3.2.5.2, 3.2.7, 8.3.3, 8.8.4
<b>ANTI-DISSIPATION INTERDICT</b> .....	1.3.2, 1.3.3, 5.1, 5.6.5, 7.4.5, 7.4.6, 8.4
<b>ARTICLE 5 OF THE UNITED STATES</b>	
<b>UNIFORM COMMERCIAL CODE ('UCC')</b> .....	3.1, 3.4.2, 3.4.2.2, 5.5, 7.3, 8.3.1, 8.3.2, 8.4, 8.5, 8.7, 8.8.1
Fraud.....	5.5, 7.3, 8.3.1, 8.4, 8.7, 8.8.1
Illegality.....	6.3.2, 6.3.2.1, 6.6, 8.3.2, 8.7
<b>AUTONOMY PRINCIPLE/DOCTRINE</b> .....	1.3.1, 1.3.2, 1.3.3, 2.5.1.3, 2.5.2.2, 2.5.2.3, 2.5.2.4, 2.5.2.4.1, 2.10.2, 2.11.1, 2.11.3, 3.2.2.1, 3.2.4.2, 3.2.5.2, 3.3.2, 4.1, 4.2.2, 4.2.3, 4.4.1, 4.4.1, 5.1, 5.2.1, 5.4.1, 5.4.2, 5.5.2.1, 5.6.1, 5.6.3, 5.6.6, 6.1, 6.2.1, 6.2.2, 6.2.2.1, 6.3.1, 6.3.2, 6.3.2.1, 6.4.2, 6.5, 6.6, 7.1, 7.2.6, 7.3, 7.4.6, 8.1, 8.2, 8.2.2, 8.3, 8.3.1, 8.3.2, 8.3.2.1, 8.3.3, 8.4, 8.5, 8.7, 8.8.4
<b>DEPOSIT (CASH)</b> .....	1.1.1, 2.1, 8.3.3, 8.8.4
<b>DOCUMENTARY CHARACTER</b> .....	2.5.2.4
Non-documentary conditions.....	2.5.2.4.1
<b>DEFAULT UNDERTAKINGS – SEE DEMAND GUARANTEES</b>	
<b>DEMAND (BANK) GUARANTEE</b>	
Characteristics/fundamental principles.....	2.5.2
Compared to a standby letter of credit.....	2.9.5
Definition.....	2.1
Differences between commercial letters of credit and demand guarantees.....	2.8.2
Direct (three-party) demand guarantee.....	2.3.2.1
Historical development.....	1.1.1
Indirect (four-party) demand guarantee.....	2.3.2.2
Main types.....	2.4.1, 2.4.2, 2.4.2.1–2.4.2.5
Parties.....	2.3.1, 2.3.1.1–2.3.1.4
Relationships created by.....	2.3.3
Role and purpose.....	1.1.1, 2.2
Similarities to a commercial letter of credit.....	2.8.1
Terminology.....	1.1.1, 1.2
<b>DUTY OF GOOD FAITH/REASONABLE CARE</b> .....	2.5.2.7, 8.3.2, 8.5

*References are to paragraph numbers*

## **FRAUD**

American law.....	5.5, 8.3.1, 8.8.1
Effort made by the Institute of International Banking Law and Practice and IFSA (indorsed by the ICC) to prevent fraudulent calls.....	4.3, 8.5
Effort made by the UNCITRAL to prevent fraudulent calls.....	4.4, 4.4.1, 4.4.2, 8.5, 8.7
Efforts made by the ICC to prevent fraudulent calls.....	4.2, 8.5
English law.....	5.4, 5.6.6, 8.3.1, 8.8.1
Historical development.....	5.3.1–5.3.4
Meaning and rationale.....	5.2.1–5.2.3
Problem of fraudulent demands.....	1.3.1, 1.3.3, 2.10.4, 8.1, 8.3.3
Risk of fraudulent calls.....	1.1.3
South African law.....	5.6, 8.3.1, 8.3.3, 8.8.1

## **FIRST DEMAND GUARANTEE – SEE DEMAND GUARANTEE**

## **ILLEGALITY**

American law.....	6.3, 6.6, 8.3.2
Illegality in the underlying contract.....	6.3.1, 6.3.2, 6.6, 8.3.2
Illegality and the UNCITRAL Convention.....	6.5, 8.3.2.1, 8.7, 8.8.3
English law.....	6.2, 6.6, 8.3.2, 8.8.2
Demand guarantee/letter of credit is itself illegal.....	6.2.1, 6.6, 8.2, 8.2.2
Illegality in the underlying contract.....	6.2.2, 6.2.2.1, 6.2.2.2, 6.2.3, 6.6, 8.3.2, 8.8.2
South African law.....	6.4, 6.6, 8.3.2, 8.8.2
Demand guarantee/letter of credit is itself illegal.....	6.4.1, 6.6, 8.2, 8.2.2
Illegality in the underlying contract.....	6.4.2, 6.6, 8.3.2, 8.7, 8.8.2, 8.8.6

## **INDEPENDENT (BANK) GUARANTEES – SEE DEMAND GUARANTEE**

## **INDEPENDENCE PRINCIPLE – SEE AUTONOMY PRINCIPLE**

## **INDEPENDENT UNDERTAKING – SEE DEMAND GUARANTEE**

## **INJUNCTIONS**

American law.....	7.1, 5.5.6, 7.3, 8.4, 8.8.5
English law.....	7.1, 7.2, 5.4.5, 8.4, 8.8.5
Injunctions to prevent payment.....	7.2.2, 5.4.5, 8.4
Injunctions to prevent demand or receipt o payment.....	7.2.3, 5.4.5, 8.4
Interim injunctions and the balance of convenience.....	7.2.4, 5.4.5, 8.4
Introduction.....	7.1, 7.2.1, 5.4.5, 8.4
Freezing injunctions ( <i>Mareva</i> injunctions).....	6.5, 7.2.5, 8.4
Injunctions and the UNCITRAL Convention.....	4.4.2, 6.5, 7.5, 8.5, 8.7

## **INSURANCE.....2.12**

*References are to paragraph numbers*

<b>INTERDICTS IN THE SOUTH AFRICAN LAW</b> .....	7.1, 7.4, 8.4, 8.7, 8.8.5
Anti-dissipation interdicts.....	7.4.5, 7.4.6, 8.4
Interdicts against beneficiaries.....	5.6.5, 7.4.4, 7.4.6, 8.4, 8.8.5
Interdicts against the bank.....	5.6.5, 7.4.3, 7.4.6, 8.4, 8.8.5
Interim interdicts.....	5.6.5, 7.4.2, 7.4.6, 8.4, 8.8.5
Introduction.....	7.1, 7.4.1
<b>INTERNATIONAL CHAMBER OF COMMERCE ('ICC')</b> .....	1.3.1, 3.1, 3.2.1, 4.1, 8.1, 8.5
Efforts to prevent unfair and fraudulent calls.....	4.2, 8.5
ICC rules.....	3.2, 4.2, 8.5, 8.6
<b>INTERNATIONAL STANDBY PRACTICES ('ISP98')</b> .....	3.1, 3.2.6, 3.6, 4.3.1, 4.5, 8.5, 8.6.3
ISP98 and fraud.....	4.3.1, 4.5, 8.5
Non-documentary rules.....	2.5.2.4.1
Strict compliance.....	2.5.2.5.3
Use in South Africa .....	8.6.3
<b>INTERNATIONAL STANDARD BANKING PRACTICE FOR THE EXAMINATION OF DOCUMENTS UNDER DOCUMENTARY CREDITS ('ISBP')</b> .....	3.2.8
The Original ISBP.....	3.2.8.1
ISBP (2007 Revision).....	3.2.8.2
<b>LATE PRESENTATIONS OF DEMANDS/DOCUMENTS</b>	
As a defence.....	2.11.1–2.11.3, 8.2.1
Position in South Africa.....	2.11.2, 2.11.3, 8.2.1
<b>MAREVA INJUNCTIONS – SEE INJUNCTIONS</b>	
<b>NON-COMPLIANCE OF DOCUMENTS/DEFECTIVE DEMANDS</b>	
As a defence.....	2.11.1–2.11.3, 8.2.1
Position in South Africa.....	2.11.2, 2.11.3, 8.2.1
<b>'PAY OR EXTEND'/'EXTEND OR PAY' DEMANDS</b> .....	2.10.3
<b>PERFORMANCE SECURITY</b> .....	1.1.2
<b>SET-OFF</b> .....	4.4.1, 7.2.5.3
<b>STANDBY LETTERS OF CREDIT</b>	
An independent undertaking.....	2.9.2
Compared to commercial letters of credit.....	2.9.4
Compared to demand guarantees.....	2.9.5
History/development.....	1.1.1, 2.9.1
Types.....	2.9.3

*References are to paragraph numbers*

<b>STRICT COMPLIANCE</b> .....	2.5.2.5, 2.5.2.5.1, 2.5.2.5.2, 2.5.2.5.2.1, 2.5.2.5.2.2, 2.5.2.5.3, 2.5.2.5.4, 2.5.2.5.5, 2.5.2.5.6, 2.11.1, 2.11.2, 2.11.3, 4.2.3, 5.1, 5.2, 5.2.1, 5.4.1, 8.2.1, 8.7
<b>SUPPLEMENT TO THE UNIFORM CUSTOMS AND PRACTICE FOR DOCUMENTARY CREDITS FOR ELECTRONIC PRESENTATION (‘EUCP’)</b> .....	3.2.3
<b>SURETY BOND</b> .....	2.1, 2.5.1.1, 3.2.4.2, 3.2.7, 8.1
<b>SURETYSHIP GUARANTEE</b> .....	1.2, 2.5.1, 2.5.1.2, 2.5.1.3, 3.2.5.2, 3.2.7
<b>TRADITIONAL GUARANTEE – SEE SURETYSHIP GUARANTEE AND ACCESSORY (UNDERTAKING)</b>	
<b>UNCITRAL CONVENTION</b> .....	1.3.1, 3.1, 3.3, 3.5, 4.4, 4.5, 8.1, 8.5, 8.6.2, 8.7
Illegality.....	6.5, 8.3.2.1, 8.7, 8.8.3
Injunctions.....	4.4.2, 7.5, 8.5
Fraud.....	4.4, 4.4.1, 4.4.2, 8.5, 8.7
Member countries.....	3.3.1, 4.4.2, 8.7
Ratification/acceding and South Africa.....	3.3.2, 8.6.2, 8.7.1–8.7.3, 8.8.7
Set-off.....	4.4.1
Strict compliance.....	2.5.2.5.5, 8.2.1
<b>UNIFORM CUSTOMS AND PRACTICE FOR DOCUMENTARY CREDITS (‘UCP’)</b>	
UCP 500.....	2.5.2.5.2, 2.5.2.5.2.1, 3.1, 3.2.2.1, 4.2.1, 4.5, 8.5, 8.6.1
UCP 600.....	2.5.2.5.2, 2.5.2.5.2.2, 3.1, 3.2.2.1, 4.2.1, 4.5, 8.5, 8.6.1
UCP and fraud.....	4.2.1, 4.5, 8.5
UCP and standby letters of credit.....	3.2.2.2
UCP and strict compliance.....	2.5.2.5.2, 8.2.1
Use of UCP in South Africa.....	3.2.2.1, 8.6.1
<b>UNIFORM RULES FOR CONTRACT BONDS (‘URCB’)</b> .....	2.5.1.1, 3.2.7
<b>UNIFORM RULES FOR CONTRACT GUARANTEES (‘URCG’)</b> .....	3.1, 3.2.4, 3.6, 4.2.2, 4.5, 8.5
URCG and fraud.....	4.2.2, 4.5, 8.5
<b>UNIFORM RULES FOR DEMAND GUARANTEES (‘URDG’)</b> .....	2.1, 3.1, 3.2.5, 4.2.3, 8.5, 8.6.2
Revision.....	3.2.5.3, 4.2.3, 8.8.6
Strict compliance.....	2.5.2.5.4, 8.2.1
Use in South Africa.....	8.6.2, 8.8.6
URDG and fraud.....	4.2.3, 4.5, 8.5



*References are to paragraph numbers*

**UNITED STATES COMPTROLLER OF THE  
CURRENCY INTERPRETIVE RULING.....3.4.2, 3.4.2.1, 8.7**