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INTRODUCTION

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I. THE LIFEBLOOD OF INTERNATIONAL COMMERCE

An exporter who is unsure about the importer's ability to pay the contract price for goods shipped will require the importer to arrange for the price to be paid by a letter of credit. A letter of credit is an undertaking by a bank to pay an exporter the price of goods shipped by the exporter to the importer. The letter of credit allows the exporter to reduce the risk of the importer failing to pay the contract price by substituting the importer's promise to pay for the promise of a more reliable and solvent paymaster, often a bank in the exporter's country. Under a letter of credit arrangement the exporter will ship the goods to the importer and demand payment from the bank in his country, rather than from the importer in a distant country. Conversely, an importer who requires some security in respect of the exporter's performance of the contract of sale may require the exporter to arrange for a bank to issue a demand guarantee for the benefit of the importer.¹ In such a case, the demand guarantee is an undertaking by the bank to make payment to the importer upon demand. The purpose of the payment is to give the importer immediate access to cash to remedy any damage caused by the exporter's default in performing the contract of sale, pending resolution of any disputes as to whether the exporter has committed a breach of contract and, if so, the extent of his liability in damages. **1.01**

In the case of both letters of credit and the demand guarantees, if the specified documents are presented the issuer must pay without question. Under both instruments there is an assurance of payment. This assurance of payment has led to the two instruments being described as the equivalent of cash in hand.² Whereas a letter of credit secures the obligation of the importer to pay the price of the goods, a demand guarantee secures the **1.02**

¹ See, e.g. the performance bond issued on behalf of the seller in *Tradigrain v. State Trading Corp. of India* [2006] 1 Lloyd's Rep. 216.

² e.g. *Power Curber International Ltd v. National Bank of Kuwait SAK* [1981] 1 WLR 1233 at 1241; [1981] 3 All ER 607 at 612.

exporter's obligation to deliver the contract goods. In this respect, letters of credit and demand guarantees are like two sides of the same coin that performs a vital function in the financing of international trade. And it is because both instruments play such an important role in the financing of international trade that they have famously been described as the 'life-blood of international commerce'.³

II. BALANCING TWO CONFLICTING INTERESTS

- 1.03** There are two conflicting interests in relation to letters of credit and demand guarantees that the law is always attempting to balance. The first is the general interest in promoting international trade by maintaining the flow of the lifeblood of international commerce. This interest is advanced by the principle of independence of letters of credit and demand guarantees. The principle is to the effect that the obligation of the issuer to make payment is independent of any disputes between the exporter and the importer arising from the underlying contract of sale. If the beneficiary of the relevant instrument presents documents that appear on their face to comply with the requirements of the instrument the issuer must pay. In the case of a letter of credit, for example, the bank is not entitled to refuse to pay because the importer says that the goods shipped are not of satisfactory quality or are less than the contract quantity. The bank must pay and the importer can sue the exporter for breach of contract if there is a basis for such a claim. The position is the same with a demand guarantee. If the importer makes a demand for payment which complies with the terms of the guarantee, the bank must pay even though the exporter claims that he has fully performed the contract of sale or that the importer has failed to perform his part of the contract of sale. The bank must honour its undertaking to pay and the parties can argue the rights and wrongs later. By providing an assurance of payment to beneficiaries of letters of credit and demand guarantees, the principle of independence serves the wider public interest of promoting international trade, financed by means of these instruments.
- 1.04** On the other hand, the assurance of payment provided to the beneficiary exposes the bank and ultimately the account party, who is liable to reimburse the bank, to the risk of abusive demands for payment. For example, in the case of a letter of credit, the exporter may present to the bank a document, such as a bill of lading, which appears to comply with the requirements of the credit because it states that the contract goods have been shipped whereas in fact the document is false to the knowledge of the exporter and no goods have been shipped. If the principle of independence is adhered to strictly the bank would have to pay the exporter even though no goods have been shipped. But such a strict application of the principle of independence would leave the importer without protection against fraud or abuse by the exporter and would conflict with the wider public interest in discouraging commercial fraud. Yet to allow the bank to refuse to pay because of the beneficiary's fraud, the evidence of which would normally lie outside the document presented and would involve looking into the underlying contract will be a breach of the principle of independence. There is therefore a conflict between the need to preserve the independence of letters of credit and demand

³ *R.D. Harbottle v. National Westminster Bank Ltd* [1978] QB 146 at 155.

guarantees and the need to protect the account party from fraud or abuse and the wider public interest in favour of discouraging reprehensible conduct such as fraud and illegality.

In order to provide a better balance between, on the one hand, the need to maintain the international commercial value of letters of credit and demand guarantees which is based on the independence principle and, on the other hand, to protect the interests of the account party and the wider public interest in discouraging wrongdoing, the courts have recognized a number of exceptions to the principle of independence. The fraud exception has long been recognized. There are indications that the English courts may now be prepared to accept further exceptions including, an illegality exception, an unconscionable conduct or bad faith exception, an exception where a demand is made in breach of a promise in the underlying contract and perhaps even a recklessness exception. The English courts have rejected a nullity exception which has been recognized in Singapore. Whether the courts have achieved the right balance between the principle of independence and the exceptions to it will always be difficult to determine. **1.05**

III. THE STRUCTURE AND SCOPE OF THE BOOK

This book is concerned with two instruments used in the financing of international trade: letters of credit and demand guarantees. It is concerned with the fundamentally important feature of the instruments which give them their international commercial value, namely, their independence from the underlying transaction in respect of which they are issued. It considers the extent to which the need to protect the account party and to advance the public interest has resulted in exceptions to the independence principle. In the following account four main areas are covered. **1.06**

By way of background, the legal nature of letters of credit and demand guarantees is considered in Chapters 2 and 3 respectively. In Chapter 2 the main features of a letter of credit transaction and the principal functions of a letter of credit are considered. There is also a brief discussion of the use of bills of exchange in letters of credit, the types of letters of credit and the main contractual relationships arising in a letter of credit transaction. **1.07**

Chapter 3 seeks to provide a brief explanation of the key features of a demand guarantee transaction, including the functions and types of demand guarantee. It also considers the main contractual relationships arising in a demand guarantee transaction. In order to highlight the legal nature of a demand guarantee, this chapter identifies the main differences between a demand guarantee and a true (suretyship) guarantee. These differences flow from the chief distinction between the two, namely, that in the case of a demand guarantee the issuer's obligation to pay is independent of the account party's obligation under the underlying contract whereas in the case of a suretyship guarantee the surety's liability is dependent on the liability of the principal obligor. In spite of the differences, problems of characterization have surfaced in recent years as courts endeavour to answer the question whether a particular instrument takes effect as a suretyship guarantee or as a demand guarantee.⁴ **1.08**

⁴ e.g. *Vossloh Aktiengesellschaft v. Alpha Trains (UK) Ltd* [2010] EWHC 2443 (Ch); *Carey Value Added SL (Formerly Losan Hotels World Value Added I SL) v. Grupo Urvasco SA* [2010] EWHC 1905 (Comm); *IIG Capital*

Chapter 3 also considers this issue and attempts to identify some factors that may serve as indicators.

- 1.09** The nature, rationale and scope of the independence principle is considered in Chapter 4. The chapter also contains a discussion of the doctrine of strict compliance, seen as a measure of protection for the account party which does not require a departure from the principle of independence.
- 1.10** Following the discussion of the principle of independence, the five main exceptions to the principle are considered. The fraud exception is examined in Chapter 5. This includes a discussion of the meaning of fraud in the context of the fraud exception, the standard of proof and the limits of the fraud exception in relation to innocent third parties. Prevention of fraud by stipulating for specific documents to be presented with a demand for payment is also considered in this chapter. As the fraud exception does not extend to a case where the presenter of a document is not aware that the document is false or contains a false statement, the question has arisen whether there should be a separate exception where a document presented is a nullity because, for example, it is forged. This very controversial issue is discussed in Chapter 6. A nullity exception has been recognized in Singapore although it has been rejected in England. But in rejecting a nullity exception the English Court of Appeal left open the possibility of a recklessness exception, which may apply where a document is a nullity and the conduct of the beneficiary in the preparation or presentation of the document, although not amounting to fraud, was reckless.⁵ The unconscionable conduct or bad faith exception is considered in Chapter 7. This exception, which has been recognized in Singapore and Australia, received a warm welcome in England in *TTI Team Telecommunications International Ltd v. Hutchison 3 G UK Ltd*.⁶ Chapter 8 deals with the exception based on the illegality of the underlying contract. Recognition of this exception in England received a major boost in *Mahonia Ltd v. JP Morgan Chase Bank*.⁷ In Chapter 9 the exception based on a demand made in breach of the underlying contract is discussed. This exception, which has been recognized by courts in Australia, appears to be gaining ground in England.⁸
- 1.11** In some cases, where a recognized exception applies, the bank would rely on the exception as a ground to refuse payment. However, in certain cases, the bank may be willing to make payment even though the account party is claiming that payment should not be made on the ground of a recognized exception. In such a case, the account party may be left with no option but to seek an interim injunction either to prevent the beneficiary from demanding or receiving payment under the instrument or, if it is too late, to prevent the bank from making payment to the beneficiary, pending resolution of the claim that the beneficiary is not entitled to payment because of a recognized exception. In certain cases, it may be more appropriate for the account party not to attempt to prevent payment under the instrument but rather to seek a freezing injunction preventing the beneficiary from removing the

LLC v. Van Der Merwe [2008] EWCA Civ 542; *Marubeni Hong Kong v. Government of Mongolia* [2005] 2 All ER (Comm) 289.

⁵ *Montrod Ltd v. Grundkötter Fleischvertriebs GmbH* [2002] 1 WLR 1975.

⁶ [2003] 1 All ER (Comm) 914.

⁷ [2004] EWHC 1938 (Comm); [2003] 2 Lloyd's Rep. 911.

⁸ *Sirius International Insurance Corp v. FAI General Insurance Co Ltd* [2003] 1 All ER (Comm) 865; *TTI Team Telecommunications International Ltd v. Hutchison 3G UK Ltd* [2003] 1 All ER (Comm) 914.

proceeds of the letter of credit or demand guarantee from the jurisdiction. The account party's entitlement to injunctions is dealt with in Chapter 10.

In some cases it is only after payment has been made to the beneficiary that it will be discovered that the beneficiary's demand for payment was wrongful, for example, on the ground that it was fraudulent. In such a case the bank may be entitled to sue the beneficiary to recover the money paid. Chapter 11 considers such claims against the beneficiary for a wrongful demand. **1.12**

Since the independence principle requires that the bank must pay on presentation of complying documents, a consequence is that, in the case of demand guarantees, the amount paid to the beneficiary following a non-wrongful demand may exceed the amount of the beneficiary's actual loss. In such a case, the beneficiary is left with a surplus or overpayment. The question that arises is whether the beneficiary is liable to repay the surplus and, if so, to which party. Chapter 12 provides an account of the circumstances when the beneficiary is liable to repay any overpayment and the bases of such liability. **1.13**

The independence principle means that the various contracts arising in a letter of credit or demand guarantee transaction are independent of each other. The implications in the context of conflict of laws, both in terms of jurisdiction and the governing law, are considered in Chapter 13. **1.14**

This book is about the law relating to the principle of independence of letters of credit and demand guarantees in England and Wales. However, to some extent it adopts a comparative approach as it draws from some foreign systems for examples which may assist in the evaluation of the English approach to particular problems. Thus, without attempting to offer a comprehensive account of the law of foreign jurisdictions on the topic, it has been possible to discuss authorities from other Commonwealth countries, such as Australia, Canada, Scotland and Singapore. Some authorities from the United States have also been considered and reference has been made to the Uniform Commercial Code of the United States. There is also some reference to the UN Convention on Independent Guarantees and Standby Letters of Credit and to international practice as reflected in publications by the International Chamber of Commerce, notably, the *Uniform Customs and Practice for Documentary Credits* (UCP 600), the *International Standard Banking Practice* (ISBP) and the *Uniform Rules for Demand Guarantees* (URDG 758), which entered into effect on 1 July 2010. **1.15**

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