



**FRAUD RULE IN INDEPENDENT GUARANTEES AND  
STAND-BY LETTERS OF CREDIT UNDER THE  
UN CONVENTION**

**BY**

**MR. BOWORNSITH NITIYAVANICH**

**A THESIS SUBMITTED IN PARTIAL FULFILLMENT OF  
THE REQUIREMENTS FOR THE DEGREE OF MASTER OF  
LAWS IN BUSINESS LAW (ENGLISH PROGRAM)**

**FACULTY OF LAW**

**THAMMASAT UNIVERSITY**

**ACADEMIC YEAR 2014**

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THESIS

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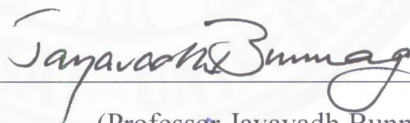
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THE FRAUD RULE IN INDEPENDENT GUARANTEES AND STAND-BY  
LETTERS OF CREDIT UNDER THE UN CONVENTION

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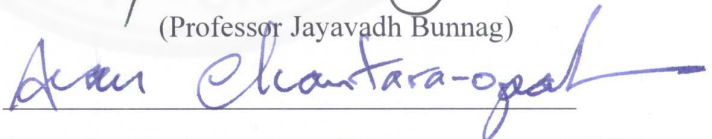
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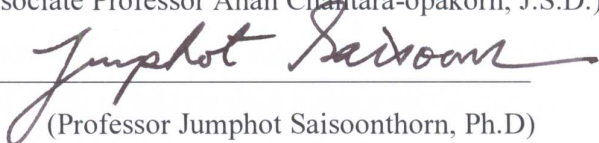
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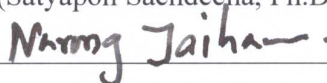
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## ABSTRACT

The United Nations Convention on Independent Guarantees and Stand-by Letters of Credit, 1995 is drafted to accommodate the independent guarantees and stand-by letters of credit used to facilitate international businesses. To overcome the misuse by the beneficiary who makes demand for payment against the guarantor, the Convention contains the provisions on fraud rule in independent guarantees and stand-by letters of credit as an exception to payment. The Convention further to clarifies the situations of fraud as well as the provisional means for principal or applicant to enforce their rights through court injunction in the event that the guarantor or issuer does not comply with its duty to withhold payment under the provisions of the Convention.

Thailand is not a party to the Convention. Thailand therefore has no obligations under the Convention. However, the significance of the independent guarantees and stand-by letters of credit in international trade is well recognized when Thai business entities enter into contracts with their foreign business partners and require independent guarantees and stand-by letters of credit as the financial security to ensure performance of the contract. Thailand and its legislation, therefore, should be more familiar with and able to resolve the issues in the event that the beneficiary has committed fraud on demand of payment. It should be more comfortable if

Thailand is able to accommodate independent guarantees and stand-by letter of credit usages especially on the fraud rule as an exception to payment to protect the applicant and principal from making payment to the beneficiary when the fraud on the part of the beneficiary is established.

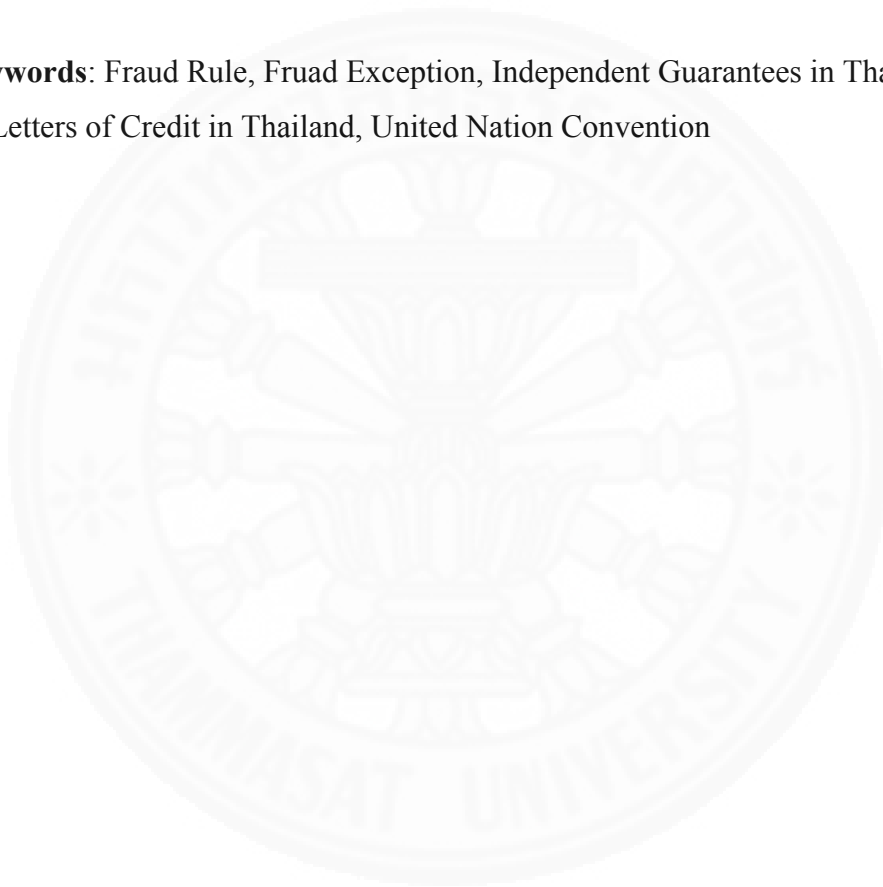
Independent guarantees and stand-by letters of credit are used by banks and financial institutions with no specific law or ordinary usages on the transactions. Furthermore, fraud exception to withhold the payment is still not covered by Thailand's domestic laws. This issue would lead the contractual parties additional difficulties when the principle basis of independent guarantees and stand-by letters of credit on the fraud rule is not recognized by Thai courts which are unable to grant a provisional order to withhold the payment due to the unavailability of applicable law issue. Therefore, Thailand needs to have specific law to deal with this business function of fraud in independent guarantees and stand-by letters of credit whether or not Thailand chooses to become a party to the Convention.

Considering the significance of protection of the applicant or principal from demand for payment with fraud element in independent guarantees and stand-by letters of credit in international level, Thailand needs to develop Thai law on this matter. Thailand may consider becoming a party to the Convention or to adopt the Convention provisions on the fraud exception in Thai law without joining the Convention. This legal implementation will be able to ensure the protection of the parties who are engaged in international business in Thailand in the event that demand for payment involves fraud elements.

The study reveals that currently Thailand does not have any law on the fraud rule as stipulated under the Convention. It would lead the applicant or principal to face with significant difficulty to protect itself from the fraud demand by the beneficiary. However, Thailand has a draft law to deal with commercial documentary credit contracts but its contents are still unable to cover independent guarantees and stand-by letters of credit especially on the fraud rule. It is recommended that Thailand should have its own specific law on this matter. The draft law should be amended by

(1) adding “independent guarantees” as a part of the definition term “commercial documentary credit contract” (2) adding the provisions dealing with the presumption that the beneficiary is deemed to certify that the demand is in good faith and none of fraud elements are presented (3) Clarifying more situations under which the fraud rule can be invoked to withhold payment (4) adding the specific provisions dealing with provisional court measures to stop payment to the beneficiary in case fraud is invoked by the applicant or principal.

**Keywords:** Fraud Rule, Fruad Exception, Independent Guarantees in Thailand, Stand-by Letters of Credit in Thailand, United Nation Convention



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## LIST OF ABBREVIATIONS

<b>Symbols/Abbreviations</b>	<b>Terms</b>
All. E. R.	All England Law Report
ISP	International Standby Practice
UCC	Uniform Commercial Code
UCP	Uniform Customs and Practice for Documentary Credits
CCC	Civil and Commercial Code

## CHAPTER 1

### INTRODUCTION

#### 1.1 Background and Problems

Independent guarantees and stand-by letters of credit have become necessary to when trade between countries make it impossible to simply do business by handshake.<sup>1</sup> Independent guarantees and stand-by letters of credit have been developed recently from the business issues relating to international supply or construction contracts. It was originally formed from American Domestic Market in 1960s and played a significant role in the international banking starting from the 1970s.<sup>2</sup> It seems that the countries in the Middle East, which was increasing their wealth from the oil-producing industry, are able to enter into the huge number of contracts with western countries. The original development of independent guarantees came from the bank activities at an initial process relating to this event.<sup>3</sup> The bank which is normally involved in the contractual line provides an independent guarantee or a stand-by letter of credit to be used as security for default in relation to the main contract between buyer/hirer and seller/contractor as well as to secure debtors' obligations incurred from leases, loans, bonds or even financial transactions. Furthermore, independent guarantees or stand-by letters of credit can provide security to the party who is able to receive the payment and the other party who is looking for receiving agreed specifications of the goods or services<sup>4</sup> In the United States, the term calling this business function is "Stand-by Letter of Credit" due to the limitation of power of the bank under statutes and case law in the U.S. does not allow the bank to provide the guarantee.<sup>5</sup> The term stand-by letters of credit is therefore used to call this method of payment which is identical to the European countries' "Independent

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<sup>1</sup> Eric Bergsten, A New Regime for International Independent Guarantees and Stand-by Letters of Credit, UNCITRAL Draft Convention on Guaranty Letters, 27 **International Law**, 859 (1993).

<sup>2</sup> R Bertrams, Bank Guarantees in international trade, 3<sup>rd</sup> edition, **Kluwer law international**, 1 (2004)

<sup>3</sup> Paatakhotenashvili, 'Some aspects of Independent Guarantees according to national legislation and private international law', 6/2003-2/3, **Georgian law review**, 329

<sup>4</sup> R Bertrams, *supra* note 2, at 2

<sup>5</sup> *Id.*



Guarantees” in its content and function.<sup>6</sup> However, in the late 1980s, the most significant commercial European countries accepted that the promises or guarantees should be applicable and enforced in writing. Since then, independent guarantees must be acknowledged independently and should not be categorized with the normal surety as understood in many countries such as France and Belgium which were confused with the similarity between surety and independent guarantees.<sup>7</sup>

This functional business tool of independent guarantees and stand-by letters of credit use different terminology of their own to call the party who promises to pay to the beneficiary a certain amount on the basis of failure to fulfill the main contract eg. Agreement of Sales, Hire of Work Agreement (collectively called “Underlying Contract) between the main contractual parties or to perform obligations, collectively called “Guarantor” and “Issuer”.<sup>8</sup> The beneficiary is entitled to receive the payment from the issuer or guarantor by making simple demand without justification or by his demand with specified documents<sup>9</sup> The required documents can be beneficiary’s statement stating that the principal / applicant has failed to perform its duties or obligations. Further the third party might be able to provide such statement indicating about the failure.<sup>10</sup>

However, independent guarantees and stand-by letters of credit provide various mechanisms for making payment. The most attractive element is to allow the guarantee payable upon the first demand namely “unconditional guarantee”. The beneficiary shall be entitled to receive payment from the bank, which is guarantor/issuer without proving that the principal/applicant acting as debtor/exporter, committed default of contract.<sup>11</sup> Such first demand for payment can be abused easily due to the fact that the beneficiary does not need to prove that the contract is breached by the principal/applicant or to prove that the beneficiary suffers from the damage or any other risk. The guarantee was to provide protection of this situation. That is why

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<sup>6</sup> *Id.*

<sup>7</sup> Jean Stoufflet, Recent Development in the Law of International Bank Guarantees in France and Belgium, 4 **Arizona Journal of International Comparative Law** (1987), 48

<sup>8</sup> Eric Bergsten, *supra* note 1, at 859

<sup>9</sup> *Id.*

<sup>10</sup> *Id.*

<sup>11</sup> R Bertrams, *supra* note 2, at 3

the guarantor/issuer is liable to make payment to the beneficiary according to such demand with required tendered documents. Nevertheless, The unfair or abusive calling is of considerable important problem in international practice as this could be considered as fraud.<sup>12</sup> Fraud is one of a rigid issue between the beneficiary and bank because it is an exception for the bank to withhold payment although the beneficiary is able to provide the documents according to the credit.<sup>13</sup>

Most commercial states, having their business with the United States or the European Union, normally become the contracting parties to the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit 1995 (“the Convention”) in order to resolve this specific issues.<sup>14</sup> Even though the contracting states have joined the Convention, the problematic fact regarding 1) how to manage or deal with the case that the beneficiary call fraudulently for payment by exploiting independence and strict compliance rules to obtain the payment and 2) how to maintain the balance between (a) the purpose of independent guarantee mechanism that the beneficiary expects certainty in the business and (b) fraud rule which is an exception to payment that can protect the principal/applicant who acts *bona fide*<sup>15</sup> but suffering from the fraudulent act of the beneficiary calling for demand and 3) how do the principal/applicant and the bank (issuer/guarantor) maintain their position or manage its role in relation to beneficiary’s fraudulent calling.

This thesis focuses on the fraud rule under the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit 1995, and possibility of existing business issues relevant to independent guarantees and stand-letters of credit in Thailand, which are significant elements for withholding payment to protect the principal or applicant which has fulfilled its obligations in the underlying contract but

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<sup>12</sup> Grace Kayembe, **The Fraud Exemption in Bank Guarantee**, (2008), 3

<sup>13</sup> Agasha Mugasha, **The Law of Letters of Credit and Bank Guarantees**, **The Federation Press**, 2003. 123

<sup>14</sup> Khemjuta Suwanjinda, *Possibility of Thailand’s Accession to the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit, 1995* (2012), 83

<sup>15</sup> *Bona fide* means “good faith”

suffering loss from losing money because of fraudulent calls of the *mala fide*<sup>16</sup> beneficiary. The thesis also analyses the disadvantage or legal loopholes in the event that Thai courts passing judgment by applying domestic laws without considering fraud rules under the Convention.

## 1.2 Hypothesis

The hypothesis is that the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit, 1995 contains fraud rule as an exception to payment under the independent guarantees or stand-by letters of credit while Thai laws do not have the same exception. Therefore, Thai laws should adopt the fraud rule in order to deal with the situation, where the fraud rule under the Convention can be invoked as an exception to payment.

## 1.3 Scope of Study

This thesis focuses mainly on the fraud rule under the independent guarantees and stand-by letters of credit covered by the Convention. In addition, UCP500 and 600 are mentioned partially for better understanding of the fraud exceptions in the independence and strict compliance principle, which are stipulated in the Convention. Therefore, the scope of this thesis is limited to the following matters:

- a. The definition and nature of an independent guarantee and stand-by letter of credit;
- b. The scope and governing rules for an independent guarantee and stand-by letter of credit under the Convention; and
- c. The fraud rule under the Convention;
- d. Business practice in relation to demand for payment comprising fraud element under the Convention in relation to an independent guarantees and stand-by letter of credit.

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<sup>16</sup> *Mala fide* is the intentional dishonest act by not to fulfill legal or contractual obligation, misleading others or even enter into the agreement without intention to fulfill it.

#### **1.4 Objectives of study**

The objectives of this thesis are to study and analyze:

1. the legal nature and functions of an independent guarantee and stand-by letter of credit under the Convention including their legal implications;
2. the fraud rule under the Convention and the current laws of Thailand regarding fraudulent demand for payment under independent guarantee and stand-by letter of credit.
3. the current attitude or acknowledgement of Thai courts in relation to the fraud exception regarding documentary credits, independent guarantees and stand-by letters of credit.
4. the necessary legal provisions which should be adopted in the event where Thailand is not ready to become a contracting party to the Convention.

#### **1.5 Methodology**

This thesis is conducted and researched by gathering relevant information and materials relating to the United Nations Convention on Independent Guarantees and Stand-by letters of credit, law books, articles, journals, newspapers, and documents of governmental organizations such as the Ministry of Commerce, the Ministry of Foreign Affairs. Additionally, much information is available on website and online media.

#### **1.6 Expected Results**

The benefits to be derived from this thesis are;

1. To consider adopting the fraud rule under independent guarantees and stand by letters of credit under the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit.
2. To use the advantages and disadvantages of adopting fraud rule under the independent guarantees and stand-by letters of credit.
3. To apply the fraud rule under the Convention to stop payment process when fraud element occurs in the demand for payment by the beneficiary under independent guarantee and stand-by letter of credit.

## **CHAPTER 2**

### **INDEPENDENT GUARANTEES AND STAND-BY LETTERS OF CREDIT UNDER THE UNITED NATIONS CONVENTION ON INDEPENDENT GUARANTEES AND STAND- BY LETTERS OF CREDIT 1995**

#### **2.1 Independent Guarantees and Stand-by Letters of Credit under the Convention**

The United Nations Convention on Independent Guarantees and Stand-by Letter of Credit (the Convention) was adopted by the United Nations General Assembly on 12 December 1996. The Convention entered into force on 1 January 2000. The Convention incorporates current understanding and compromise positions on the law and practice of independent guarantees and stand-by letter of credit. It applies to independent (autonomous) and international undertakings issued in a state that become a party to the Convention or where the conflict of laws rules lead to the application of the law of a state party to the Convention. Furthermore, an international letter of credit, which does not exactly fall within the definition of “undertaking”, is governed by the Convention if such letter of credit expressly states that it is subject to the Convention. An undertaking falling within the Convention's scope may, however, exclude the application to the Convention.

The Convention describes an independent guarantee (referred to as, e.g. demand, first demand, simple demand, demand guarantee or bank guarantees)<sup>17</sup> and stand-by letter of credit jointly as “undertaking” ( “Undertaking”). An undertaking is issued by a guarantor, which could be a bank or other institutions or even persons, to pay the beneficiary a certain amount upon simple demand or upon demand accompanied by required documents according to the terms or documentary conditions of the undertaking.<sup>18</sup> The condition may indicate that payment is due because principal/applicant is in default in the performance of obligation, or another

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<sup>17</sup> UNCITRAL Explanatory Note by UNCITRAL Secretariat on the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit, w. 8, U.N. Doc. A/CN. 8/431 (July 4, 1996).

<sup>18</sup> Article 2 of the UN Convention

contingency, or for money borrowed or advanced, or on account of any mature indebtedness undertaken by the principal/applicant of such undertaking.<sup>19</sup>

## **2.1.1 Nature of Undertaking under in the Convention**

### **2.1.1.1 Meaning and Nature of an Independent Guarantee**

According to Article 2<sup>20</sup> of the Convention, stand-by letter of credit and independent guarantee are collectively called the "undertaking" which denotes a commitment provided by bank or any other financial institution or person as an issuer in the case of a stand-by letter of credit or called a guarantor in the case of an independent guarantee to pay to the beneficiary a certain amount of money. The beneficiary can simply demand for payment accompanied by documents which are in conformity with the terms and any documentary conditions of the undertaking indicating that the 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 in the case of an independent guarantee or an applicant in the case of a stand-by letter of credit or another person.

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<sup>19</sup> *Id.*

<sup>20</sup> United Nations Convention on Independent Guarantees and Stand-by Letters of Credit art. 2.

(1) 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.

(2) The undertaking may be given:

(a) At the request or on the instruction of the customer ("principal/applicant") of the guarantor/issuer;

(b) On the instruction of another bank, institution or person ("instructing party") that acts at the request of the customer ("principal/applicant") of that instructing party; or

(c) On behalf of the guarantor/issuer itself.

The Convention also indicates that the undertaking comprises the following

a) Article 6 (a) and (c) of the Convention, “Counter guarantee<sup>21</sup> which is the undertaking given to the guarantor/issuer of another undertaking by its instructing party and providing for payment 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 under that other undertaking has been demanded from, or made by, the person issuing that other undertaking.”<sup>22</sup>

b) Under Article 6 (e) of the Convention, “Confirmation of an undertaking” which means the undertaking added to that of the guarantor/issuer, and authorized by the guarantor/issuer, providing the beneficiary with the option of demanding payment from the confirmer (the person adding a confirmation to an undertaking)<sup>23</sup> instead of from the guarantor/issuer, upon simple demand or upon demand accompanied by other documents, in conformity with the terms and any documentary conditions of the confirmed undertaking.<sup>24</sup>

Independent guarantees also has many other names e.g. first demand guarantee, independent guarantee, performance guarantee, unconditional bond or performance bond<sup>25</sup> They are used in a wide range of transactions e.g. finance, international sales of goods or even construction to provide security and certainty against possibility and risk that some contingency may occur.<sup>26</sup> This financial method involves at least three parties which are (a) the “principal” who applies for an independent guarantees (b) the “guarantor” who is a bank or any other institution issuing an independent guarantee and (c) the “beneficiary” who is entitled to receive

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<sup>21</sup> See further on Indirect Undertaking in counter guarantee structure

<sup>22</sup> Article 6 (a) and (c) of the UN Convention.

<sup>23</sup> Article 6 (f) of the UN Convention

<sup>24</sup> Article 6 (d) of the UN Convention

<sup>25</sup> Boris Kozochyk, *Bank Guarantees and Letters of Credit: Time for a Return to the Fold*, 11 **University of Pennsylvania Journal of International Economic Law** 13-14 (1989)

<sup>26</sup> Xiang Gao, *The Fraud Rule under the UN Convention on Independent Guarantees and Standby Letters of Credit*, 1 **George Mason Journal of International Commercial Law**, at 54 (2010)



payment from the guarantor under an independent guarantee upon the presentation of documents required in the independent guarantee<sup>27</sup> and at least three transactions between the principal and the beneficiary under the underlying transaction, between the principal and the guarantor under the guarantee agreement and between the guarantor and the beneficiary under the independent guarantee.<sup>28</sup> It may further involve more than three parties and three transactions<sup>29</sup> in case of an indirect guarantee that includes such transactions as counter-guarantees between the instructing bank (confirmer) and issuing bank (counter-guarantor).<sup>30</sup>

### 2.1.1.2 Meaning and Nature of a Stand-by Letter of Credit

Like an independent guarantee, a stand-by letter of credit is used in many transactions. John Dolan comments whether "there are virtually no limits to the variety of transactions that the stand-by credit can serve. In principle, stand-by credits can be used in any contract where the performance of one party is executory."<sup>31</sup> The function and mechanism of stand-by letters of credit, which are to furnish security and to be used for the same purposes and contain the same condition of payment as same as independent guarantees. These two financial methods are conceptually and legally the same device<sup>32</sup> Two factors contributed to the necessity of using stand-by letter of credit in America. First, Federal and State banking laws prohibit national chartered banks in United States to act as guarantors or sureties for the obligations of the third parties.<sup>33</sup> Guarantees issuance was considered *ultra vires*<sup>34</sup> because it is believed that this should be the sole area of insurance and bonding companies.<sup>35</sup> The guarantee

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<sup>27</sup> KhemJuta Suwanjinda, *supra* note 14, at 8

<sup>28</sup> *Id.* at 8

<sup>29</sup> Xiang Gao, *supra* note 26, at 55

<sup>30</sup> *See infra* item 2.2.2

<sup>31</sup> John F. Dolan, "The Law of Letters of Credit: Commercial and Stand-by Credits 1", 1-24 (rev. ed. 2003 and 2006 Supplement No.2, A.S. Pratt & Sons 2006 Can Bus L.J) 1984.

<sup>32</sup> R Bertrams, *supra* note 2, at 8

<sup>33</sup> G Penn, *The law and practice of international banking: Banking law*, vol.2, London, Sweet & Maxwell, 1987, at 287.

<sup>34</sup> Ultra Vires means beyond the powers, describing actions taken by government entity or corporation that exceed the scope of power given by laws.

<sup>35</sup> Grace Kayembe, *supra* note 12, at 5



industry was heavily regulated by insurance commissioners in the United States, and consequently has been very conservative in both its underwriting policies and geographical scope.<sup>36</sup> The unavailability to exercise bank guarantees was a significant obstacle for American business that required expansion of international trade volumes, especially after the Second World War. There was a clear necessity of a viable instrument to guarantee performance under international agreements.<sup>37</sup> American banks therefore adapted the traditional letter of credit (which they were allowed to use) to a new use in order to circumvent this prohibition and to meet the need of the market. The stand-by letters of credit came thereby into existence. However, This instrument was initially referred to as “the guaranty letter of credit” but its title was quickly changed due to the word “guaranty” was inappropriate to be used according to the prohibitions placed on the U.S. banks.<sup>38</sup>

Independent guarantees and stand-by letters of credit serve the same purpose and share the same nature to perform the same business function. The differences between them are only laid in their names and origins.<sup>39</sup> The Convention therefore calls independent guarantees and stand-by letters of credit by the single term of undertaking as their definition in the Convention.<sup>40</sup>

### **2.1.2 Difference of Functions between Commercial Letters of Credit and Stand-by Letter of Credit**

Letters of credit are developed from international trade and became “the life blood of international commerce.”<sup>41</sup> Commercial Letter of credit and stand-by letters of credit (undertaking as called in the Convention) are documentary transactions that the presenter, requiring payment under these instruments, need to produce documents complying with the terms and conditions of the instrument.<sup>42</sup> Both of them recognize

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<sup>36</sup> *Id.* at 287

<sup>37</sup> *Id.* at 6

<sup>38</sup> *Id.* at 6

<sup>39</sup> KhemJuta Suwanjinda, *supra* note 14, at 9

<sup>40</sup> Article 2 of the Convention

<sup>41</sup> *R.D.Harbottle (mercantile) Ltd. v. National Westminster Bank Ltd.*, (1978) 1Q.B. 146, 155.

<sup>42</sup> Xiang Gao, *supra* note 26, at 49

the principle of independence, documentary nature and strict compliance<sup>43</sup> whilst the purpose of their business functions and usages are different.<sup>44</sup>

### **2.1.2.1 Commercial Function of Commercial Letters of Credit**

A letter of credit has been developed through custom of international trade as the business instrument to ensure that the seller or contractor will be paid when they fulfill the underlying contract<sup>45</sup>. For example, the seller in Thailand wishes to sell products to the buyer in London. The buyer and the seller in the contract of sales, which is the underlying contract in this transaction, are strangers. The seller is worried that, if it delivers the product to the buyer without advance payment from the buyer, the buyer may refuse to pay or become insolvent upon the arrival of the products. The seller will definitely face the great expenses for suing the buyer in the UK jurisdiction, and may also have to afford the cost of disposing the products or to be liable for demurrage in the UK territory. Under the letter of credit transaction, the buyer is normally required to provide an irrevocable letter of credit from a reputable bank to the seller. If the bank agrees to issue the letter of credit, it will be committed to honor the draft made by the seller upon its proper presentation of the draft accompanied with the specific documents in the letter of credit to evident the seller's performance of the underlying contract. The seller will not be paid unless it produces document indicating that the goods have been shipped properly. The bank will pay the seller for the buyer by taking security (a pledge) over the documents to secure the advance payment made for financing the transaction.<sup>46</sup>

### **2.1.2.2 Commercial Function of Stand-by Letters of Credit**

The commercial function of a stand-by letter of credit is different from that of a commercial letter of credit but still operates in the same basic framework as that of the commercial letters of credit.<sup>47</sup> A commercial letters of credit is designed as

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<sup>43</sup> See *infra* item 2.2.1 – 2.2.4

<sup>44</sup> Xiang Gao, *supra* note 26, at 53

<sup>45</sup> Boris Kozolchyk, *Letters of Credit*, 9 **International Encyclopedia of Comparative Law** 10 (Jacob S. Ziegel ed. (1979))

<sup>46</sup> Xiang Gao, *supra* note 26, at 51

<sup>47</sup> James E. Byrne, ISP98, *supra* note 8, *Preface*

a payment and mechanism for international sales of goods, a stand-by letter of credit is tailored as a financial instrument to provide security to the beneficiary against the seller or contractor (applicant)'s defective performance or non-performance of the underlying contract.<sup>48</sup> Assuming a US construction company contracts with the Thai Ministry of Energy (TME) to build a power plant in Thailand, to guarantee that the US contractor shall provide proper performance of the construction contract, the TME requires the US contractor to provide a stand-by letter of credit in its favor. In case the US contractor defaults on the construction contract (underlying contract), the TME will present the required documents to the bank (issuer) of the stand-by letter of credit for payment. This scenario shows that a simple stand-by letter of credit also involves three parties, which are; (a) the contractor as the applicant, (b) the bank as the issuer and (c) the employer as the beneficiary.<sup>49</sup>

## 2.2 Structure of the Undertaking

### 2.2.1 Direct Independent Guarantees

Guarantee or Independence Guarantee is a contract derived from business relationship between principal debtor and creditor.<sup>50</sup> The primary contract referred to as the “underlying contract” develops another contract to safeguard the employer or buyer against non-performance, delay or any other defective performance from supplier or contractor's part in the underlying contract comprising of international element.<sup>51</sup> The buyer or employer usually incorporates clause that demands the debtor to provide a guarantee in favor of the creditor in order to avoid filing a lawsuit against the supplier or contractor in an unfamiliar territory.<sup>52</sup> This situation usually occurs when it is the first time that contractual parties start their business relationship and the two parties have not yet built a relation of trust.<sup>53</sup> For example, the supplier T in Thailand has entered into a contract with U in the U.K. for the sale of metal sheet to U. But U requires T to provide an independent guarantee in favor of U to cover the

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<sup>48</sup> *Id.* at 53

<sup>49</sup> *Id.*

<sup>50</sup> Grace Kayembe, *supra* note 12, at 13

<sup>51</sup> *Id.*

<sup>52</sup> *Id.* at 14

<sup>53</sup> *Id.*

risk of defective or late performance in the supply of metal sheet. T therefore instructs his guarantor or issuer (bank) to issue an independent guarantee with the terms and conditions specified by the other party whether in the event that T is in breach of his obligations under the contract. U can present a written demand in conformity with the terms and conditions of the independent guarantee to T's bank. Then the bank, as the guarantor, has no option than to make the payment to U. After the payment, T's bank will ask for reimbursement from T for the payment that the bank has paid to U under the independent guarantee.

The diagram to express this situation is as followed;

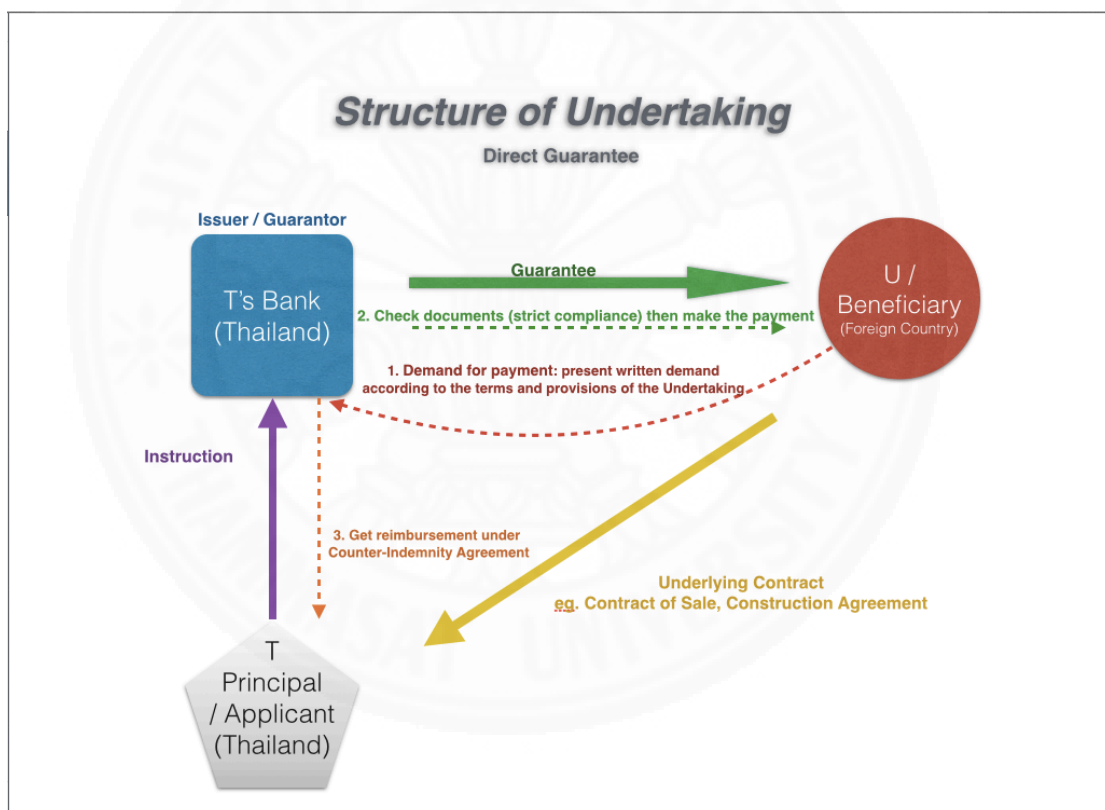


Figure 2.1 Direct Guarantees

### 2.2.2 Indirect Independent Guarantees

The beneficiary may require the independent guarantee or stand-by letter of credit to be issued by a bank of his own country instead of relying on the

principal or applicant's bank.<sup>54</sup> This is a common practice since it provides many advantages to the beneficiary on several counts. First, the risk of currency exchange restriction is limited. Secondly, It would be more inclined to pay under independent guarantee and any problem can be solved more smoothly than if it was with a foreign bank. Thirdly, the national law of the beneficiary will govern the relationship between the beneficiary and the bank.<sup>55</sup>

In this situation, the principal or applicant contacts his bank ("instructing party") to arrange for the issue of the guarantee or stand-by letter of credit by a bank in the country of the beneficiary. Instructions are then given to the local bank in the beneficiary's territory ("confirmer") to issue an independent guarantee or stand-by letter of credit in favor of the beneficiary against a counter guarantee from the instructing party. The instructing bank will be then entitled to obtain reimbursement from the applicant or principal if the beneficiary demands for payment under the independent guarantee or the stand-by letter of credit.

The word "indirect" refers to the structure of two links, mandate and counter-guarantee between the principal and the instructing bank, and instructions, mandate and counter-guarantee between the instructing bank and the issuing bank.<sup>56</sup>

The diagrammatic form of the structure is as follows;

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<sup>54</sup> R Bertrams, *supra* note 2, at 78

<sup>55</sup> *Id.* at 78

<sup>56</sup> *Id.* at 18

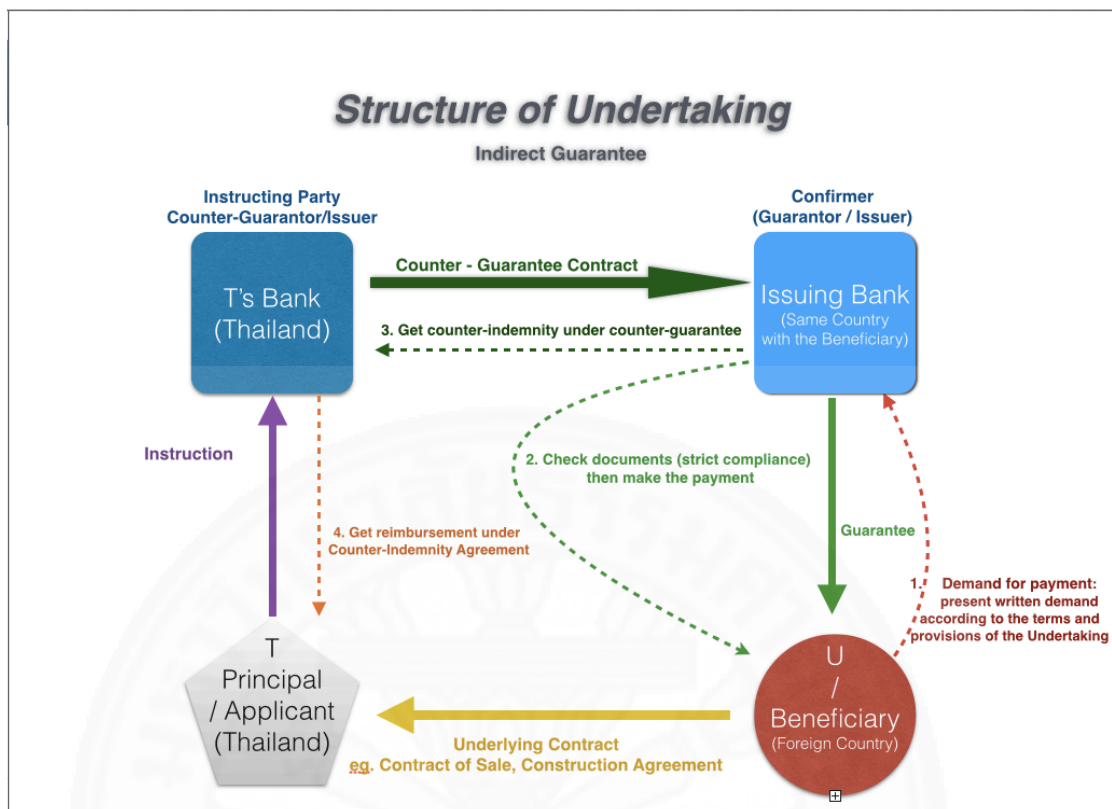


Figure 2.2 Indirect Guarantees

### 2.3 Principles of the Undertaking under the Convention

There are three basic principles for an undertaking under the Convention namely independence, documentary nature and strict compliance, internationality and irrevocability of undertaking.<sup>57</sup> These basic principles are adopted from the same principles found in the rules of commercial letters of credit.

#### 2.3.1 Independence

The independence principle of undertaking means that an undertaking under the Convention exists, operates and is enforced independently and separately from any underlying transaction or any other undertaking. Nor is such undertaking subject to any terms and conditions not appearing in the undertaking nor to any future or uncertain act or event.<sup>58</sup>

<sup>57</sup> Khemjuta Suwanjinda, *supra* note 14, at 21

<sup>58</sup> *Id.*

The principle of independence is an essential element of the structure and operation of an undertaking and constitutes the heart of the Convention.<sup>59</sup> This autonomy principle provides the undertaking's remarkable attraction as the finance method that a bank, financial institution or person can exercise it in international commerce. Article 3 of the Convention formulates the independence principle that the obligation of the guarantor/issuer to the beneficiary does not rely on the existence or validity of the underlying contract. This principle also expands to the indirect undertaking, which is included in the stand-by letters of credit or independent guarantees involving confirmation or counter-guarantees.<sup>60</sup> This principle is also embodied in the Uniform Rules for Demand Guarantees which states that bank guarantees (equivalent to undertaking) are by nature, separate transactions.<sup>61</sup> Therefore, an undertaking shall not be subject to any other terms and conditions aside from those appearing in the undertaking<sup>62</sup> regardless of uncertainty of act or event in the future, except for presentation of documents or such other acts or events within a guarantor/issuer's sphere of operation.<sup>63</sup>

The independence of undertaking is referred to as "basic tool of international commerce" in UNCITRAL Explanatory Note of the Convention.<sup>64</sup> As there has been a lack of international uniformity in the understanding and recognition of the essential characteristic in relation to undertakings under the Convention,<sup>65</sup> Article 3 of the Convention therefore formulates the rule that the undertaking shall be independent from any underlying transaction, counter-guarantees or confirmations. That is the origin of clarification and definition, under the Convention, that counter-guarantees and confirmation are primary undertakings.<sup>66</sup>

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<sup>59</sup> Alan Davidson, *Fraud and the UN Convention on independent Guarantees and Stand-by Letter of Credit*, 1 **George Mason Journal of International Commercial Law**, at 25 (2010)

<sup>60</sup> Article 3 (a) of the UN Convention.

<sup>61</sup> Uniform Rules for Demand Guarantees, article 2

<sup>62</sup> Article 3 (a) of the UN Convention.

<sup>63</sup> Article 3 (b) of the UN Convention.

<sup>64</sup> See 17 Explanatory Note, *supra* note 41, comment 3.

<sup>65</sup> *Id.* comments 17-18.

<sup>66</sup> Article 6 (c) and (e) of the Convention



The underlying rationale behind this principle is to ensure the beneficiary that the payment under an undertaking shall be certainly paid without worrying about other uncontrollable factors such as an underlying transaction including other undertakings as well as future or uncertainty events or actions of relevant parties, which are not stipulated in such undertaking. Unless existence of certain excuse to payment under an undertaking e.g. fraud is established, an independent undertaking shall be subject only to the terms and conditions stipulated in the undertaking.<sup>67</sup> This Article resolves the uniformity issue by stipulate definition of the independence principle as mentioned above. The non-documentary conditions shall be considered irrelevant to the undertaking and must be ignored.<sup>68</sup> Therefore, it is in line with the notion that the role of the guarantor/issuer is the paymaster role, not the investigator.<sup>69</sup>

When the bank is deciding to make payment under the credit to the beneficiary, it may only look at the terms of the credit itself. The bank may not raise any defense of which the applicant avails itself in respect of the underlying agreement of sales.<sup>70</sup> The seller will thus always receive payment from the bank in the event that the seller submits correct documents that comply with the terms of the credit, regardless of any consideration concerning the underlying sales agreement. The guarantor/issuer should not be forced into the position required to resolve the disputes between the debtor (applicant/principal) and creditor (beneficiary) because the bank has no acknowledgment about the fact in underlying contract, which is the matter of the creditor and obligator would dispute each other upon it.<sup>71</sup> If the guarantor/issuer is not prohibited to play offensive role by ignoring the independence principle, this would lead to extensive delays in payment and would make the letter of credit unattractive as a commercial device. If the doctrine of independence is not scrupulously observed, the continuance of the letter of credit system as the primary means of payment in international trade would be jeopardized.

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<sup>67</sup> Khemjuta Suwanjinda, *supra* note 14, at 9

<sup>68</sup> Article 3 of the Convention

<sup>69</sup> See UNCITRAL Explanatory Note, *supra* note 17, comment 18

<sup>70</sup> Sandra M. Rocks, **Provisions of Standard Commercial Guarantee Agreements** (2010)

<sup>71</sup> R Bertrams, *supra* note 2, at 399



### 2.3.2 Documentary Nature and Strict Compliance

#### 2.3.2.1 Documentary Nature

Stand-by letters of credit and independent guarantees under the Convention possess a documentary nature. This means that the guarantor of an independent guarantee or the issuer of a stand-by letter of credit has the duty to examine the demand for payment with all supported documents, proposed by the beneficiary, and to make payment to the beneficiary if the terms of the undertaking are in conformity.<sup>72</sup> The legal effect of the documentary nature in the undertaking is that an undertaking comprising non-documentary conditions shall be out of the scope of the Convention.<sup>73</sup>

The guarantor or issuer is just only required to pay the beneficiary when notified of a demand for payment accompanied by documents complying with the terms and conditions of the undertaking, irrespective of any dispute or claim relating to the underlying transaction between the beneficiary and the principal in the case of an independent guarantee or applicant in the case a stand-by letter of credit. The guarantor or issuer has an obligation to make payment in good faith with full recourse against the applicant unless existence of fraud as stipulated in the Convention is established.<sup>74</sup> The guarantor or issuer's main and only concern is whether the document presented conform on their face to the terms and conditions stipulated in the independent guarantee or stand-by letter of credit.

#### 2.3.2.2 Strict Compliance

Under this strict compliance principle, a beneficiary who wishes to receive payment under an independent guarantee or stand-by letter of credit is required to tender all documents, which are strictly in compliance with those required and stipulated in such undertaking.<sup>75</sup> If the documents so tendered are on their face in strict compliance with the terms and conditions of the guarantee or stand-by letter of credit, the guarantor or issuer must perform the obligations under the terms and

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<sup>72</sup> Khemjuta Suwanjinda, *supra* note 14, at 22

<sup>73</sup> See UNCITRAL Explanatory Note, *supra* note 17, comment 19

<sup>74</sup> Section 19 of the Convention

<sup>75</sup> INCE & CO, "Letters of credit – strict compliance and the use of banking shorthand", <http://incelaw.com/en/knowledge-bank/publications/letters-of-credit-strict-compliance-and-the-use-of-banking-shorthand>. (last visited May 1, 2015)

conditions of such independent guarantee or stand-by letter of credit. On the contrary, if the documents so tendered are not in strict compliance with the terms and conditions of such guarantee or stand-by letter of credit, the beneficiary will not be entitled to payment thereunder even though the beneficiary has fully performed the underlying transaction. This was first formulated in a 1927 decision handed down by an English court, in which Lord Sumner stated that:

*'[T]here is no room for documents which are almost the same, or which will do just as well ... the bank which knows nothing officially of the details of the transactions financed cannot take 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>76</sup>

Strict compliance in an undertaking is incorporated in Article 15 of the Convention which requires compliance of a demand for payment by the beneficiary. This Article requires that a demand for payment must be made in the form in a complete record of context of the undertaking. Further, the beneficiary must provide authentication of undertaking source by generally accepted means or by procedure agreed upon by the guarantor/issuer and the beneficiary.<sup>77</sup> More importantly, the demand for payment under the undertaking must conform to the undertaking's terms and conditions. Article 15 (2) of the Convention rules that a demand and any certification or other documents required by the undertaking, unless otherwise stipulated in the undertaking, must be presented to the guarantor/issuer within the time that the demand for payment is made at the place of undertaking issuance.<sup>78</sup> However, the Convention significantly reflects the strict compliance of undertaking beyond the terms and conditions or time and place stipulated in the undertaking. This matter is provided in Article 15(3) of the Convention that the beneficiary, when demanding the payment from the issuer/guarantor, is deemed to certify that the

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<sup>76</sup> *Equitable Trust Co. v. Dawson Partners Ltd.*, 27 **Lloyds' List L.R.** 49, 52 (H.L. 1927).

<sup>77</sup> Khemjuta Suwanjinda, *supra* note 14, at 23

<sup>78</sup> *Id.*

demand is not in bad faith and none of fraud elements which are stipulated in Article 19 subparagraph (a), (b) and (c) of the Convention, are present.<sup>79</sup>

### 2.3.3 Internationality

The Convention clearly indicates, in Article 1(1), that the Convention applies to international undertaking.<sup>80</sup> The Convention does not apply to domestic letters of credit due to lack of international character under Article 2 of the Convention<sup>81</sup> Thus, Article 4 of the Convention recognizes the internationality and international nature of undertaking if the places of business specified in undertaking, of any guarantor/issuer, beneficiary, applicant/principal, instructing party or confirmer are in the different states.<sup>82</sup> Further, if the undertaking lists more than one place of business that the one which has the closest relationship with the undertaking<sup>83</sup> or in case that the undertaking does not specify a place of business for a given person but specifying the “habitual residence”, such residence shall be relevant place for determining the international character of the undertaking.<sup>84</sup>

As mentioned earlier that Articles 1 and 4 of the Convention cannot be applied to the purely domestic letters of credit,<sup>85</sup> but the demand of letter of credit usage for domestic transactions is minimal, that is the reason why the Article 4 of the Convention is focused to accommodate international undertaking due to the high demand of international undertaking usage.<sup>86</sup> The Convention defines international undertaking in two methods. The first one is the location of the place of business of the guarantor/issuer in a state of the Convention in accordance with Article 1 (1) (1) of the Convention. The other is to apply when the rules of private international law

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<sup>79</sup> *Id.*

<sup>80</sup> Alan Davidson, *supra* note 46, at 30

<sup>81</sup> *Id.* at 31

<sup>82</sup> Khemjuta Suwanjinda, *supra* note 14, at 23

<sup>83</sup> Article 4 paragraph 2(a) of the Convention

<sup>84</sup> Article 4 paragraph 2(b) of the Convention, *See also* Alan Davidson, *supra* note 46, at 31

<sup>85</sup> Khemjuta Suwanjinda, *supra* note 14, at 24

<sup>86</sup> Alan Davidson, *supra* note 46, at 31

lead to the application of the law of the state party according to Article 1(1)(b) of the Convention.<sup>87</sup>

Additional layer of harmonization of law in this matter is also provided in Articles 21 and 22, Chapter VI, of the Convention. They focus on conflict of laws to formulate the rule for the court of the contracting parties to identify cases subject to an independent guarantee or stand-by letters of credit.<sup>88</sup> The rule apply regardless of the event that applicable substantive law for the independent guarantees or stand-by letter of credit could be the Convention.<sup>89</sup> It means that the undertaking has no revocable clause in its context. Therefore, such undertaking shall be deemed irrevocable.<sup>90</sup>

### **2.3.4 Irrevocability**

This element is related to the principle of independence in the sense that the undertaking is a transaction independent from the underlying contract as long as the guarantor/issuer revokes it. The Convention therefore sets out as one of a fundamental principle of undertaking that the undertaking shall be irrevocable unless such undertaking stipulates that it is revocable.<sup>91</sup>

## **2.4 Payment under the Undertaking**

### **2.4.1 Demand for Payment by the Beneficiary**

The demand for payment under the undertaking may be made in any form which preserves a complete record of the text of the undertaking and provides authentication of its sources by generally accepted means or by a procedure agreed upon by the guarantor or issuer and the beneficiary and in conformity with the terms and conditions of the undertaking.<sup>92</sup> Presentation of such demand and any certification or other documents required by the undertaking must be made within the time that a

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<sup>87</sup> Khemjuta Suwanjinda, *supra* note 14, at 24

<sup>88</sup> 24UNCITRAL Explanatory Note, *supra* note 14, comment 21.

<sup>89</sup> *Id.*

<sup>90</sup> Khemjuta Suwanjinda, *supra* note 14, at 25

<sup>91</sup> Article 7 of the Convention

<sup>92</sup> Article 15 paragraph 1 of the Convention

demand for payment may be made to the guarantor or issuer at the place where the undertaking was issued unless otherwise stipulated in the undertaking.<sup>93</sup>

When demanding payment, the beneficiary is deemed to certify that the demand is not in bad faith and that none of the elements of fraud in subparagraph (a), (b) and (c) of paragraph (1) of Article 19 of the Convention are present, which allows the guarantor or issuer to withhold payment.<sup>94</sup>

#### **2.4.2 Payment by the Guarantor or Issuer**

According to Article 19 of the Convention, the guarantor or issuer upon determination that the demand for payment conforms thereto unless the undertaking stipulates payment on a deferred basis in which case payment must be made at the stipulated time must promptly make payment against the demand made in accordance with Article 15 of the Convention.<sup>95</sup> However, any payment against the demand that is not in accordance with Article 15 does not prejudice the rights of the principal or applicant<sup>96</sup> particularly with the guarantor or issuer who has made such payment.

Article 18 of the Convention allows the guarantor or issuer to discharge the payment obligation under the undertaking by availing itself of a right of set-off unless otherwise stipulated in the undertaking or elsewhere agreed upon by the guarantor or issuer and the beneficiary.<sup>97</sup> However, set-off is not applicable to the claim assigned to the guarantor or issuer by the principal or applicant or the instructing party.<sup>98</sup>

### **2.5 Applicable Law**

#### **2.5.1 Choice of Applicable Law**

Like other international contracts, the parties to an undertaking may stipulate the law applicable to the undertaking. In this respect, Article 21 of the Convention allows an undertaking to be governed by the law the choice of which is (a) stipulated

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<sup>93</sup> Article 15 paragraph 2 of the UN Convention

<sup>94</sup> Article 15 paragraph 3 of the UN Convention

<sup>95</sup> Article 17 paragraph 1 of the UN Convention

<sup>96</sup> Article 17 paragraph 2 of the UN Convention

<sup>97</sup> Article 18 of the UN Convention

<sup>98</sup> *Id.*

in the undertaking or demonstrated by the terms and conditions of the undertaking or (b) agreed elsewhere by the guarantor/issuer and the beneficiary.<sup>99</sup>

It thus follows that the law stipulated in the undertaking or agreed elsewhere may or may not be that of the states which are parties to the Convention. If the said law is that of a state party to the Convention, then the provisions of the Convention apply to the undertaking. If, on the other hand, the said law is that of a state not a party to the Convention, the law of that state applies to the undertaking just because the Convention allows such law to be applicable to the undertaking.<sup>100</sup>

### **2.5.2 Determination of Applicable Law**

In the absence of such choice of law, Articles 21 and 22 of the Convention provide that the law of the state where the guarantor/issuer has that place of business at which the undertaking was issued governs the undertaking. According to Article 1(3) of the Convention, Articles 21 and 22 apply to international undertakings independently of Article 1(1) of the Convention. This simply means that even if the parties to an international undertaking choose to apply a legal regime other than that of the Convention, The court can still apply Articles 21 and 22 of the Convention as the governing choice of law mechanism.<sup>101</sup>

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<sup>99</sup> Khemjuta Suwanjinda, *supra* note 14, at 34

<sup>100</sup> *Id.*

<sup>101</sup> See UNCITRAL Explanatory Note, *supra* note 14, comment 52.

### CHAPTER 3

#### FRAUD RULE IN INDEPENDENT GUARANTEES AND STAND-BY LETTERS OF CREDIT

#### 3.1 Concept of the Fraud Rule

An undertaking is a device providing certainty to the beneficiary that he will receive payment. It means that there is a balance between certainty of payment for the beneficiary and risk of losing payment by the principal if the transaction is committed by fraud<sup>102</sup>

Fraud harms the basic principles of equity, business and justice. Protecting the bank's obligation of payment under an undertaking without exception, when documents fulfill the terms and conditions, would therefore lead to protection of fraud. To prevent unlawful outcome that may result on fraudulent action from the part of the beneficiary, courts have attempted to form a balance between the commercial utility of bank guarantees and needs of preventing the fraud transaction. Such balance has been achieved through the fraud exception.<sup>103</sup> The only exception to the principle of independence is fraud committed by the beneficiary when tendering the documents. As De Rooy has stated: 'No system can be effective if it is blind to something which is manifestly unreasonable.'<sup>104</sup> If the guarantor or issuer discovers the fraud under the Convention that was tendered by the beneficiary, it is entitled to refuse to make payment to the beneficiary. This situation conduces that the beneficiary would have tendered documents that did not strictly comply with the terms of the undertaking if he had been truthful in his representations. However, the fraud which enabling the guarantor/issuer to stop payment must be obvious and evident to the guarantor or issuer without the need of further proof or any investigation on the actual circumstances surrounding the underlying contract. It reflects a balance between all deference of interest in a particular country involving undertaking. In the event that standard is too low, an applicant, who is not willing to make the payment, will easily

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<sup>102</sup> J Browne, *The fraud exception to standby letters of credit in Australia : Does it embrace statutory unconscionability?*, vol.11, **Bond Law Review**. 101 (1996)

<sup>103</sup> Xiang Gao and Buckley, *A comparative analysis of the standard of fraud required under the fraud rule in letter of credit law*, vol 13, 293, (2003)

<sup>104</sup> F.P. de Rooy, *Documentary Credits*, Deventer: Kluwer, 116 (1984).



commit the fraud. It will affect commercial function of an undertaking definitely. On the other hand, if the standard is too strict, this would encourage fraudulent maneuvers on the part of the beneficiary. Therefore, extreme standards of fraud should be avoided as they represent only the interests of the beneficiary or the principal.<sup>105</sup>

### 3.1.1 Meaning of the Fraud Rule

Fraud instigates significant controversy and constitutes a confusing area of law governing an undertaking. The inconsistency between the legal interpretation and applicability of courts in different countries shows the important issues that the lawyers have to formulate appropriate standard of fraud.<sup>106</sup> It must be understood that the "fraud rule" as used herein is the term used and commonly known among the courts and lawyers in the Common Law countries. The term specifically applies to the exercise of the rights or performance of the duties of the parties involved in the performance guarantee and letter of credit transaction. The consequence of the fraud rule is that if a fraud is established, payment under such guarantee or letter of credit transaction can be withheld. Therefore, the fraud rule should be distinguished from "fraud" induced by one person to engage the other to enter into a contract with the former.<sup>107</sup> In such a case, the fraud is committed at the stage of formation of a contract and the said contract thereby become voidable. Thus, the term "fraud" which makes a contract voidable is equally well understood and recognized as a ground to avoid the contract in the Civil Law countries. However, the "fraud rule" which emphasizes the situations or circumstances in the stage of performance rather than that of formation of a contract is not the term used in the Civil Law countries but is encompassed by the term "good faith" in the exercise of the rights or performance of the duties under the contract.

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<sup>105</sup> *Id.*

<sup>106</sup> Xiang Gao and Buckley, *supra* note 14, at 334

<sup>107</sup> United Nation, Recognizing and Preventing Commercial Fraud 3 (2013)



### 3.1.2 Fraud Rule to Stop the Payment

It is generally known that fraud is a major factor for any bank dealing with letters of credit and demand guarantees. Therefore, any attempt to reduce a fraud should be supported. Fraud is a matter that cannot be dealt with by the rules of practice but by necessity should be left to the law because government and public policy issues are involved.<sup>108</sup> By introducing the provisions on the exception to payment obligation based on fraud, the Convention is able to redress the inadequacies of the rules of practice found in UCP600, ISP98 and URDG758.<sup>109</sup>

It is clear that along the evolution of the customs and practice of letter of credit, fraud exception has been ignored. The UCP 600, ISP 98 and URDG758 fail to define predetermined fraud standard whereby the guarantor in the case of independent guarantees or the issuer in the case of stand-by letters of credit is entitled to withhold payment to the beneficiary. The UCP600 makes no attempt to deal with the fraud exception at all and leaves the matter to the courts. The ICC Banking Commission has discussed the fraud issue on several occasions and finally reached the conclusion that the fraud issue should be left to the courts. The ISP98 expressly provides that it does not define nor otherwise provide the defenses based on fraud, abuse or similar matters and that these matters are left to the applicable law. The Convention, on the other hand, has for the first time on international level introduced a fraud rule as the ground for withholding payment under independent guarantees and stand-by letters of credit to the beneficiary. Fraud rule under domestic laws, however, has existed long before the introduction of the same by the Convention.

### 3.1.3 Fraud Rule under the Convention

Exception to payment for a demand is generally known as "fraud". Although the word "fraud" is not expressly used in the Convention, it is clear that the exception to payment obligation provided for in Article 19 of the Convention reflects the "fraud" concept. Fraud is considered as an innovative step taken by the Convention since the issue of fraud is not clearly addressed and provided for in other rules of independent guarantees and stand-by letters of credit.

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<sup>108</sup> Alan Davidson, *supra* note 56, at 34

<sup>109</sup> Khemjuta Suwanjinda, *supra* note 14, at 35

There are three Articles related to the fraud exception under the Convention namely Articles 15, 19 and 20. Article 15(3) assumes that the beneficiary, when demanding payment under an undertaking, is deemed to certify that the demand is not in bad faith and that none of the elements referred to in subparagraph (a),(b) and (c) of paragraph (1) of Article 19 are present. Article 15(3) of the Convention does not only require the beneficiary to be "not in bad faith" when making a demand for payment but also imply that payment has the potential to be disrupted if the elements provided for in Article 19 exist in the demand. Article 19 articulates the conditions and situations under which payment to the beneficiary by the guarantor or issuer can be withheld. Article 20 allows the court to issue a provisional order to the effect that the beneficiary will not receive payment and that the guarantor/issuer hold the amount of the undertaking or that the proceeds of the undertaking paid to the beneficiary will be blocked

### **3.2 Elements of the Fraud Rule under the Convention**

Article 19 of the Convention provides three major elements of the fraud rule as the exception to payment as follows;

“(1) If it is manifest and clear that:

- (a) any document is not genuine or has been falsified;
- (b) no payment is due on the basis asserted in the demand and the supporting documents; or

(c) judging by the type and purpose of the undertaking, the demand has no conceivable basis, the guarantor/issuer, acting in good faith, has a right, as against the beneficiary, to withhold payment.

(2) For the purposes of subparagraph (c) of paragraph (1) of this article, 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) Fulfillment of the underlying obligation has clearly been prevented by willful 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.

(3) 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>110</sup>

Based on Article 19 above, there are three circumstances under which payment to the beneficiary can be withheld by the guarantor or issuer.

### **3.2.1 Any Document Is Not Genuine or Has Been Falsified.**

In the event that the document required to support the payment under an independent guarantees or stand-by letters of credit is not genuine or has been falsified, it shall be the ground for the guarantor or issuer for holding with payment to the beneficiary .<sup>111</sup> Article 19(1)(a) focuses mainly on the documentary nature of an undertaking that document presentation by beneficiary must not with identity of the fraudulent party.<sup>112</sup> In the event that the presented document is not genuine or has been falsified regardless of the identity of the person committing the fraud,<sup>113</sup> the Convention focuses on the nature of misconduct, not the fraudulent party’s intention, by requiring the “manifest and clear evidence” leading to the fraud to invoke the fraud exception.<sup>114</sup> However, the guarantor or issuer would not be able to withhold the payment when it is found with the manifest and clear evidence that the document is not genuine or has been falsified because the guarantor has passive role. Therefore, an

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<sup>110</sup> United Nations Convention on Independent Guarantees and Stand by Letter of Credit, 1995 art. 19.

<sup>111</sup> Article 19 subparagraph (a) of paragraph (1) of the Convention

<sup>112</sup> Michelle Kelly-Louw, *International Measures to Prohibit Fraudulent Calls on Demand Guarantees and Stand-by Letters of Credit*, 1 **George Mason Journal of International Commercial Law**, at 74 (2010)

<sup>113</sup> Xiang Gao, *supra* note 26, at 69.

<sup>114</sup> *Id.*

allegation that any such document is not genuine or has been falsified must be accompanied by some kinds of proof particularly from the principal or applicant.<sup>115</sup> In the event that the guarantor or issuer is able to verify the proof of non-genuineness or forgery of the document itself, the guarantor or issuer shall exercise its right to stop payment otherwise such proof may be raised against the guarantor or issuer, by the principal or applicant, when reimbursement is sought by the guarantor or issuer against the principal or applicant.<sup>116</sup>

Article 20 of the Convention provides procedure for the principal or applicant to follow in order to prove that any document, involved in the stand-by letter of credit and independent guarantee, is not genuine or has been falsified. The principal or applicant is required to file an application under Article 20 with the competent court having jurisdiction over the dispute in order to prove that the required document relevant to the undertaking is not genuine and has been falsified according to Article 19(a) of the Convention.<sup>117</sup> This allegation must comprise the basis of availability to provide strong evidence. The court may (a) issue a provisional order to the effect that the beneficiary does not receive payment including and a provisional order to the effect that the proceeds of the undertaking paid to the guarantor or issuer are withheld<sup>118</sup> or (b) issue a provisional order to effect that the proceeds of the undertaking which to be paid to the beneficiary are blocked taking into the account that the absence of the order may cause the principal or applicant to be likely to suffer the serious harm.<sup>119</sup>

### **3.2.2 No Payment is Due on the Basis Asserted in the Demand and the Supporting Documents**

The circumstances that the payment to the beneficiary may to be withheld by the guarantor or issuer is not clarified in the Explanatory Note to the Convention.<sup>120</sup> The demand, regardless of due consideration, therefore shall be considered on a case

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<sup>115</sup> Khemjuta Suwanjinda, *supra* note 14, at 40.

<sup>116</sup> *Id.*

<sup>117</sup> Article 20 of the UN Convention.

<sup>118</sup> Article 20 subparagraph (a) of paragraph (1) of the UN Convention

<sup>119</sup> Article 20 subparagraph (b) of paragraph (1) of the UN Convention

<sup>120</sup> Khumjuta Suwanjinda, *supra* note 14, at 40

by case basis because the payment under stand-by letters of credit or independent guarantees is due on multiple basis, such as, on the basis of the fixed date in the demand relating to documents or on the basis of a contingency event e.g. the failure to make payment under the loan by the principal or applicant or defective/non-performance of certain conditions in construction contracts by the principal or applicant as the contractor or on the simple basis of the breach of the underlying contract.<sup>121</sup> This matter reflects difficulties to determine immediately whether the payment under the demand of payment is due or not. Significant burden of proof lies on the applicant or principal party in relation to the issue of the due payment which is required to stop the payment. Moreover, such proof must also be the strong evidence leading to the establishment that no payment is due. A simple email correspondence between the principal or applicant and the guarantor or issuer, which is normally the considered a communication between bank and a customer, is not enough to stop the payment. The best solution to allow the applicant or principal to stop to payment proceedings is to file an application with the court of competent jurisdiction in order to request a provisional order to block such payment according to Article 20 (1) of the Convention.

In the event that the principal or applicant files an application with the court of competent jurisdiction and such applicant, accompanied by a high possibility of existence of the circumstances referred to in subparagraph (a) of paragraph (1) of Article 19 of the Convention that no payment is due on the basis asserted in the demand with availability of strong evidence, the court may (a) issue a provisional order to the effect that the beneficiary does not receive payment including an order that the guarantor or 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 that in the absence of such an order, the principal or applicant would be likely to suffer serious harm.<sup>122</sup>

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<sup>121</sup> *Id.* at 41.

<sup>122</sup> Article 20 subparagraph (b) of paragraph (1) of the Convention, *see also* Khemjuta Suwanjinda *supra* note 14, at 41

### 3.2.3 The Demand has no Conceivable Basis Judging by the Type and Purpose of the Undertaking.

Article 19 (2) of the Convention especially focuses on the kind of situations under which the demand will be considered as having no conceivable basis. Comparing to the specific grounds for withholding payment stipulated in Article 19 (1) (a) and (b) of the Convention, the ground under Article 10 (1) (c) is much more general in terminology since the Convention does not provide definition or meaning of the term “no conceivable basis”.<sup>123</sup> Nevertheless, Article 19 (2) of the Convention articulates the situation in which a demand has no conceivable basis by providing the purposes of paragraph (1) subparagraph (c) of Article 19. The guarantor or issuer of the undertaking becomes the offensive party to look into the underlying transaction for good cause prior to make such payment in relation to the grounds for withholding payment to the beneficiary under Article 19 (2) (a), (b), (c) and (d) whilst subparagraph (e) of paragraph (2) of the Article 19 gather the role of the beneficiary and the guarantor or issuer on the notice that payment needs to be justifiably made by good course.<sup>124</sup>

#### 3.2.3.1 Grounds Constituting “No Conceivable Basis”

##### (1) Article 19 Paragraph (2) Subparagraph (a)

This subparagraph stipulates that “*The contingency or risk against which the undertaking was designed to secure the beneficiary has undoubtedly not materialized.*”<sup>125</sup>, which is an example to illustrate that the payment under stand-by letter of credit or independent guarantee is called by demand of payment by the beneficiary on the ground of breach of the underlying contract e.g. hire of work agreement by the applicant or principal but the breach can be proved clearly that there is no existence of such breach because the applicant or principal has duly performed the obligations under such underlying contract. Further, there is no actual breach occurring in such circumstance. Any demand for payment by the

<sup>123</sup> Michelle Kelly-Louw, *supra* note 95, at 109.

<sup>124</sup> Charles Debattista, *Performance Bonds and Letters of Credit: A Cracked Mirror Image*, **Journal Business Law**, 298 (1997).

<sup>125</sup> Article 19 subparagraph (a) of paragraph (2) of the UN Convention



beneficiary ( eg. the employer under the construction agreement or seller in an international sale of goods contract shall be considered as “no conceivable basis” judging by the purpose and type of such stand-by letter of credit or independent guarantee.

### **(2) Article 19 Paragraph (2) Subparagraph (b)**

This subparagraph stipulates that “*The underlying obligation of the principal or 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>126</sup> which is obvious that the underlying contract is invalid by judgment of the court or award of the arbitral tribunal. A stand-by letter of credit or independent guarantee having origin from particular underlying contract will become invalid like the underlying contract. Therefore, the demand for payment by the beneficiary shall be considered to have no conceivable basis. However, an independent guarantee or stand-by letter of credit comprising the context illustrating that the validity of such independent guarantee and stand-by letter of credit is not affected by the invalidity of the relevant underlying contract shall remain the obligations of guarantor or issuer to make payment to the beneficiary whenever the demand from the beneficiary occurs. This kind of independent guarantees and stand-by letters of credit is likely to be immortal even though the underlying contract, which is the creator of the undertaking, is invalid.<sup>127</sup>

### **(3) Article 19 Paragraph (2) Subparagraph (c)**

This subparagraph stipulates that “*The underlying obligation has undoubtedly been fulfilled to the satisfaction of the beneficiary*”<sup>128</sup>. This means that the fulfillment of perform obligations to the satisfaction of the beneficiary, by the principal or applicant shall be the ground for withholding payment to the beneficiary. The beneficiary will not be able to call or to demand for payment under an independent guarantee or stand-by letter of credit due to the original purpose for

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<sup>126</sup> Article 19 subparagraph (b) of paragraph (2) of the UN Convention

<sup>127</sup> Khemjuta Suwanjinda *supra* note 14, at 42

<sup>128</sup> Article 19 subparagraph (c) of paragraph (2) of the UN Convention

creating the particular independent guarantee or stand-by letter of credit no longer exists. The result of this matter renders the demand to have a no conceivable basis.

**(4) Article 19 Paragraph (2) Subparagraph (d)**

This subparagraph stipulates that *“Fulfillment of the underlying obligation has clearly been prevented by willful misconduct of the beneficiary.”*<sup>129</sup> It reflects the ground to withhold payment to the beneficiary in case of willful misconduct, that is, the beneficiary has prevented the way to fulfill the obligations by the principal or applicant according to the underlying contract. However, such willful misconduct of the beneficiary must be proven and requires strong evidence to support this ground. It is not easy for the applicant or principal to prove this ground because the beneficiary usually does not admit its willful misconduct even if the beneficiary has prevented the situation of the fulfillment of the underlying obligation willfully. The allegation from the principal or applicant, whether the beneficiary has committed the prevention just only to aim for the demand of payment, is not enough to request the guarantor or issuer to withhold payment. Thus, the suitable resolution for the principal and applicant to withhold payment is to seek a provisional order of the court to stop payment by the guarantor or issuer to the beneficiary.<sup>130</sup>

**(5) Article 19 Paragraph (2) Subparagraph (e)**

This subparagraph stipulates, *“In the case of a demand under a counter-guarantee, the beneficiary of the counter-guarantee has made payment in bad faith as guarantor or issuer of the undertaking to which the counter-guarantee relates.”*<sup>131</sup> This means that if the undertaking is an indirect guarantee having counter-guarantee involved in the underlying contract, and the counter-guarantor who acts as the guarantor or issuer has been involved in the conspiracy with the beneficiary in bad faith the demand shall therefore be deemed as having no conceivable basis. Nevertheless, as the guarantor or issuer is the counter guarantor who has committed the act action in bad faith, it is merely impossible for the applicant or principal to request the counter guarantor to withhold payment. Seeking court provisional order in an inevitable option for the applicant or principal to stop payment because it is the

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<sup>129</sup> Article 19 subparagraph (d) of paragraph (2) of the UN Convention

<sup>130</sup> Article 20 of the UN Convention

<sup>131</sup> Article 19 subparagraph (d) of paragraph (2) of the UN Convention



only way to force the issuer or guarantor (counter-guarantor), who has conspired with the beneficiary to stop payment.<sup>132</sup>

### 3.3 Filing Application with the Court to Stop Payment

Whenever the guarantor or issuer itself found the fraud element under Article 19 of the Convention itself, it is entitled to withhold payment to the beneficiary. This situation will become more difficult, for the principal or applicant, if such guarantor or issuer ignores to exercise this right to withhold payment or freeze the payment procedure. The Convention therefore provides a measure to stop payment on the basis of fraud by the principal or applicant itself by seeking the court provisional order. Such means is stipulated in Article 20 of the Convention as follows.

*“(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 therefor 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*

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<sup>132</sup> Khumjuta Suwanjinda, *supra* note 14, at 43.

*referred to in subparagraphs (a), (b) and (c) of paragraph (1) of article 19, or use of the undertaking for a criminal purpose.”*<sup>133</sup>

Court measures provided in Article 20 of the Convention, clearly establishes an important judicial mechanism to stop payment to the beneficiary in case where fraud under an independent guarantee or a stand-by letter of credit is established by the guarantor or issuer. The right to seek such provisional court measures is conferred by Article 20 of the Convention upon the principal or applicant or instructing party in the case of counter-guarantee.<sup>134</sup> While the guarantor or issuer has the right to withhold payment to the beneficiary in the event where guarantor or issuer found the identity of fraud element in an undertaking<sup>135</sup>, Article 20 provides an ultimate solution to stop or to freeze payment under the undertaking, through provisional court order, against the guarantor or issuer who ignores to exercise the right to withhold payment to the beneficiary. This Article allows the principal or applicant to obtain a court order to block or freeze the payment proceedings under the independent guarantees and stand-by letters of credit if any of them are in with Article 19 of the Convention.<sup>136</sup> Furthermore, Article 19 also creates a standard of proof upon the evidence presented to the court in order to obtain such provisional measures. The standard provided by Article 19 are on the basis that the principal or applicant must be able to present strong evidence immediately leading to the high possibility of fraudulent or abusive circumstance, committed by the beneficiary.<sup>137</sup> In addition, the principal or applicant is further required to convince the court that it would be likely to suffer serious harm in the absence of such provisional measures and the possibility of the court to require a security from the principal or applicant in certain amount to ensure that the beneficiary shall not be suffering from the provisional court measures granted to the principal or applicant claiming false allegation or acting in *mala fide*.<sup>138</sup> However, Article 20 of the Convention limits judicial procedure usage by the principal or applicant to prevent the principal or applicant intervene operation of the undertaking,

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<sup>133</sup> Article 20 of the UN Convention

<sup>134</sup> *Id.*

<sup>135</sup> Article 19 of the UN Convention

<sup>136</sup> Khumjuta Suwanjinda, *supra* note 14, at 44

<sup>137</sup> *Id.*

<sup>138</sup> UNCTRAL Explanatory Note, *supra* note 17, comment 50.

by granting the provisional court measures only in the cases provided for under Article 19 of the Convention. In addition, the Article also allows the court to grant provisional court order to the principal or applicant to withhold payment or freeze its procedure if the relevant undertaking is used for criminal purpose.<sup>139</sup>

### **3.3.1 Provisional Court Measures under Article 20**

#### **3.3.1.1 Limitation for Seeking Provisional Court Measures**

According to Article 20 (1) of the Convention, upon application by the principal or applicant or instructing party, if 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 10 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 or issuer hold the amount of the undertaking or (b) issue a provisional order to effect that the proceeds of the undertaking paid to the beneficiary are blocked taking into account whether the absence of such order, the principal or applicant would be likely to suffer serious harm.

In order for the court to issue a provisional order, the principal or applicant or instructing party as the case may be must (1) prove to the court that there is a high probability that one of the circumstances referred to in subparagraphs (a), (b) and (c) of paragraph (1) of Article 19 is present (2) submit the available strong evidence to the court in support of such high probability and (3) prove to the court that in the absence of such provisional order, the principal or applicant or instructing party would be likely to suffer serious harm. Certainly, it is up to the court in particular jurisdiction to decide whether such “high probability” of fraud is established, “available evidence” is strong and such principal or applicant or instructing party would be “likely to suffer serious harm” in the absence of such provisional order.

#### **3.3.1.2 Security Requirement**

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<sup>139</sup> *Id.* comment 51.

According to Article 20 (2) of the Convention, the court may require security from the principal or applicant or instructing party to be placed as collateral property prior to issuance of a provisional order under Article 20 (1). The value of collateral property or amount of money is left to the discretion of the court. This security may or may not be required depending on the discretion of the court. In cases where payment under the undertaking is clearly proved to be unduly made to the beneficiary, the court would not require the principal or applicant or instructing party to furnish such security for securitizing the possible damages incurred from false allegation of the principal, applicant or instructing party.<sup>140</sup> The procedural provisions in any jurisdiction are normally common on the basis that the court is allowed to exercise its discretion as to whether or not the security is required to be placed by the principal, applicant (in case of direct undertaking) or instructing party (in case of indirect undertaking).<sup>141</sup>

### **3.3.1.3 Criminal Purpose in the Usage of Undertaking**

The Court might not be able to issue a provisional order referred to in Article 20 paragraph (1) of the Convention if the demand under the undertaking is not in accordance with Article 19 subparagraph (a), (b) and (c) of paragraph (1) or if such independent guarantee or stand-by letter of credit is not used criminally.<sup>142</sup> Such criminal usage of independent guarantees and stand-by letters of credit may occur in money laundering transactions or other illegal acts. If the applicant or principal or instructing party can immediately present some reliable evidence for such proof, the court would issue a provisional order in order to block the payment or to freeze the payment procedure to the beneficiary of the undertaking.<sup>143</sup>

## **3.4 Comparative Study on Fraud Rule in Selected Jurisdictions**

When fraud occurs, a question arises whether the bank is or would have been obliged to pay or not. Such question is likely to occur in the following situation:

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<sup>140</sup> Khemjuta Suwanjinda, *supra* note 14, at 45

<sup>141</sup> *Id.*

<sup>142</sup> Article 20 paragraph (3) of the UN Convention

<sup>143</sup> UNCITRAL Explanatory Note, *supra* note 17, comment 50.

- (a) where the applicant wishes to stop the paying bank from making payment to the beneficiary on the ground that the beneficiary has acted fraudulently and turns to court for injunction<sup>144</sup>
- (b) where the paying bank has refused to pay on the ground of fraud and the beneficiary is suing the bank for wrongful dishonor of the presentation of documents<sup>145</sup>
- (c) where fraud is alleged after the bank has made payment to the beneficiary and the bank wishes to have recovery<sup>146</sup>
- (d) where the bank invoking the fraud exception refuses to pay to a third party, who obtained the beneficiary's right after the bank had accepted the documents tendered by the beneficiary<sup>147</sup>

National courts in particular countries have approached the fraud rule in different ways and have required different standards of fraud in order to justify the disruption of the normal course of the documentary credit operation.<sup>148</sup>

### 3.4.1 Fraud Rule Practice in United States of America

Historically, the fraud rule in the United States was first formulated in *Sztejn v. Henry Schroder Banking Corporation*<sup>149</sup> which is regarded as the catalyst case with regard to the development of the fraud exception to the autonomy or independence principle of a letter of credit.<sup>150</sup> In this case, Chester Charles Sztejn was a buyer who was based in United States. He contracted to buy bristles from an Indian company namely Transea Traders Ltd. that was based in Lucknow in India and asked Henry Schroder Bank to issue an irrevocable letter of credit in favor of the seller. The

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<sup>144</sup> Zsuzsanna Toth, *Documentary Credits in International Commercial Transactions Special Focus on the Fraud Rule* (2006), at 122.

<sup>145</sup> *Id.*

<sup>146</sup> *Id.*

<sup>147</sup> *Id.*

<sup>148</sup> *Id.*

<sup>149</sup> 31 N.Y.S2d 631 (N.Y. App. Div. 1941).

<sup>150</sup> See E.P. Ellinger, *Documentary Letters of Credit – A Comparative Study* (1970), pp. 190-196; John F. Dolan, *supra* note 31; Juleit May, *Letters of Credit – The Fraud Exception*, 3 Verulum Building Law Newsletter (2000); Adam Johnson and Daniel Ahoroni, *Fraud and Discounted Deferred Payment Documentary Credits: The Banco Santander Case*, 15 *Journal International Business Law*, 22

seller shipped fifty cases of “cowhair and other worthless material an rubbish,”<sup>151</sup> procured the document required under the letter of credit and drew draft to the order of Chartered Bank, which presented to Schroder for payment. Before payment was made, Szejn filed a lawsuit to stop the issuer from paying the draft. Szejn also claimed that the presenting bank was merely a collecting bank, not an innocent holder of the draft for value. The presenting bank moved to dismiss the complaint on the ground that it failed to state a cause of action 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>152</sup>

After restating the significance of the autonomy or independence principle of a letter of credit, Justice Shientag of the New York Supreme Court distinguished the case before him as the case involving fraud by the beneficiary and noted that the case was not a mere breach of warranty. He ruled the fraud of the seller has been called to the bank’s attention before the drafts and documents have been presented, the principle of independence or the autonomy principle should not be extended to protect an unscrupulous seller<sup>153</sup>, and claimed that

*“...although our courts have used broad language to the effect that a letter of credit is independent of the primary contract between the buyer and seller, that language was used in cases concerting alleged breaches of warranty; no case has been brought to my attention on this point involving an international 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 this account. The distinction between a breach of warranty and active fraud on the part of the seller is supported by authority and reason.”*<sup>154</sup> Judge Shientag also assumed that all allegations in the complaint were true, rejected the Chartered Bank’s motion and ruled for the plaintiff. In reaching his discretion, Justice Shientag stated:

*“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*

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<sup>151</sup> See *supra* note 149, at 633

<sup>152</sup> *Id.* 634-635

<sup>153</sup> Alan Davidson, *supra* note 56, at 36

<sup>154</sup> Szejn, *supra* note 129, at 634-635; Alan Davidson, *Id.* at 37.



*independence of the bank's obligation under the letter of credit should not be extended to protect the unscrupulous seller. ... On this motion only the complaint is before me and I am bound by its allegation that the Chartered Bank is not a holder in due course but is a mere agent for collection for the account of the seller charged with fraud. Therefore, the Chartered Bank's motion to dismiss the complaint must be denied. If it had appeared from the face of the complaint that the bank presenting the draft for payment was a holder in due course, its claim against the bank issuing the letter of credit would not be defeated even though the primary transaction was tainted with fraud.*<sup>155</sup>

Sztejn case has established three crucial elements of the fraud rule that (a) payment under a letter of credit can be stopped in a case of fraud, (b) payment under a letter of credit can only be stopped when fraud is established and (c) payment should be made, notwithstanding the existence of proven fraud, if the demand for payment is made by a holder in due course.<sup>156</sup> Since then, many courts in many jurisdiction other than the US have cited Sztejn case and the fraud rule eventually have been recognized worldwide.<sup>157</sup>

The fraud rule manifested in the Sztejn case has been codified as Article 5 of the UCC in the United States in the 1950's and eventually fine-tuned in 1995.<sup>158</sup> In particular, Section 5 – 109 of Article 5 of the UCC provides 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

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<sup>155</sup> Xiang Gao, *supra* note 26, at 57

<sup>156</sup> Xiang Gao, *supra* note 26, at 57

<sup>157</sup> R. Bertrams, *supra* note 2, at 335-447

<sup>158</sup> Xiang Gao, *supra* note 26, at 58

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 honour or dishonor the presentation in any other case.

(b) If an applicant claims that a required document is forged or materially fraudulent or that honour 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 courts find 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 honour does not qualify for protection under subsection (a)(1).

Section 5-109 of Article 5 of the UCC has restated the three basic elements of the fraud rule established by Sztejn whether; (a) the payment can be stopped if fraud is involved in a letter of credit transaction; (b) payment under a letter of credit can only be stopped when fraud is established; and (c) payment should be made if demand is made by an innocent party such as a holder in due course. Moreover, Section 5-109 of Article 5 of the CCC has improved the fraud rule in a number of respects. First, it clearly provides when fraud is found, then the payment under a letter of credit may be stopped by two ways: by the issuer's dishonor of the



presentation<sup>159</sup> or by a court order to prevent payment by the issuer.<sup>160</sup> Secondly, it provides that the fraud rule can only be applied when “material” fraud is established,<sup>161</sup> setting up a clear standard of fraud that can be invoked under the fraud rule.<sup>162</sup> Thirdly, it has listed four types of persons that may be immune from the fraud rule under Section 5-109(a)(1) rather than one as indicated in *Sztejn*. Finally Section 5-109 has stipulated four procedural conditions that must be met when a court considers an injunction under Section 5-109(b)<sup>163</sup>

### 3.4.2 Fraud Rule Practice in China

Like the United States, China has formulated legal provisions in order to ultimately cover the rules in the letters of credit as well as the fraud rule in relation to the letters of credit.<sup>164</sup> There are altogether eighteen articles in the letter of credit rules of China, eight of which are devoted to the fraud rule.<sup>165</sup> Having studied from the court practices and decisions of other countries, the provisions of Article 5 of the UCC of the United States, the provisions of the Convention and the practice and decisions of the Chinese courts, the drafters of the Chinese letter of credit rules have attempted to make the rules as detailed and comprehensive as possible, covering both substantive and procedural matters of the law.<sup>166</sup>

With respect to the fraud rule, Article 8 of the rules, Article 8 of the Chinese letter of credit rules provides for the types or standards of fraud under which the fraud rule can be invoked by introducing the concept of fraud in the letters of credit to indicate that the fraud rule under the law of letters of credit is entirely the same as that found under general civil and commercial cases.<sup>167</sup> Taken into consideration the provisions of Article 19 of the Convention, Article 8 of the Chinese letter of credit rules categorizes four types of situations under which the fraud rule can be invoked.

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<sup>159</sup> U.C.C. Section 5-109 (a)(2)

<sup>160</sup> *Id.* 5-109 (b).

<sup>161</sup> *Id.* 5-109 (a)-(b).

<sup>162</sup> U.C.C. Section 5-109 (a)(1)

<sup>163</sup> Xiang Gao, *supra* note 26, at 60

<sup>164</sup> *Id.* at 60.

<sup>165</sup> *Id.*

<sup>166</sup> Khemjuta Suwanjinda, *supra* note 14, at 58

<sup>167</sup> Xiang Gao, *supra* note 26, at 60

1. the beneficiary has forged the documents or presented the documents containing fraudulent information;
2. the beneficiary has intentionally failed to deliver the goods or delivered the goods with no value;
3. the beneficiary has conspired with the applicant or a third party and presented the fraudulent documents whereas there is no actual underlying transaction; or
4. other circumstances that constitute letter of credit fraud.<sup>168</sup>

Similar to Section 5-109(a)(1) of Article 5 of the UCC, Article 10 of the Chinese letter of credit rules identifies four types of situations under which the fraud rule cannot be invoked even though fraud is established in a letter of credit transaction as follows.

1. The nominated person or the person authorized by the issuing bank has paid in good faith in accordance with the instructions of the issuing bank;
2. The issuing bank or its nominated or authorized person has accepted the draft under the letter of credit in good faith;
3. The confirming bank has paid in good faith; or
4. The negotiating bank has negotiated in good faith.<sup>169</sup>

The other six Articles of the Chinese letter of credit rules are all related to procedural matters of which Articles 9 and 11 are the most important. Article 9 identifies the persons who are entitled to bring a court action to prevent payment under the letter of credit. Under Article 9, the applicant, the issuing bank or any other interested party may file an application with a competent people's court for a ruling to suspend payment.<sup>170</sup> Likewise, similar to Section 5-109(b) of Article 5 of the UCC and Article 20 of the Convention, Article 11 of the Chinese letter of credit rules sets forth the procedural conditions that must be met when a court considers the measures to stop payment under the letter of credit. The said procedural conditions are as follows.

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<sup>168</sup> *Id.* at 60-61

<sup>169</sup> *Id.* at 61.

<sup>170</sup> *Id.*

1. The people's court receiving the application has the competent jurisdiction to hear the case.
2. The evidence submitted by the applicant has established the existence of the circumstances set out in Article 8.
3. The applicant will suffer irreparable damage if a ruling to suspend the payment is not issued.
4. The applicant has provided effective and adequate security, and
5. The circumstances set out in Article 10 do not exist.<sup>171</sup>

Based on the history of the aforementioned Chinese letter of credit rules, the Chinese letter of credit rules appear to be compatible with the court practices of other countries, the UCC of the United States and most importantly the Convention. However, China has neither signed nor ratified the Convention and therefore is under no obligation to implement the Convention. Should China choose to become a party of the Convention, the Chinese letter of credit rules will well accommodate the provisions of the Convention particularly with respect to the application of the fraud rule.<sup>172</sup>

### 3.4.3 Fraud Rule Practice in United Kingdom

Like the fraud rule in the United States, the fraud rule in the United Kingdom was first recognized and formulated in a case law but, unlike that of the United States, it has not been reduced to legislation in the United Kingdom. The most well-known case in the United Kingdom on the fraud rule is *United City Merchants (Investments) Ltd. v. Royal Bank of Canada*.<sup>173</sup> In this case, payment under a letter of credit was refused when the bill of lading presented had been fraudulently pre-dated by a third party. The beneficiary filed an action for wrongful refusal to honor the letter of credit. Before considering the issue of fraud committed by a third party, Lord Diplock stated that

*“to this general statement of principle [of independence]... there is an established exception: that is, where the seller, for the purpose of drawing on the*

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<sup>171</sup> *Id.* at 61-62.

<sup>172</sup> Khemjuta Suwanjinda, *supra* note 14, at 59

<sup>173</sup> 1 Lloyd's Rep. 267 (Q.B. 1979).

*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. Henry Schoder Banking Corporation.*<sup>174</sup>

From the above quotation, it is clear in the English case law with respect to the fraud rule in the letters of credit that *Sztejn* is the "foundation stone of English law in this area"<sup>175</sup> Although the fraud rule is recognized in the United Kingdom, it has not often been applied.<sup>176</sup> The English courts have traditionally been very reluctant to interfere with the operation of a letter of credit and have adopted a relatively inflexible and narrow approach towards the application of the fraud rule.<sup>177</sup> This approach has been expressed by Lord justice Jenkins in *Hamzeh Malas & Son v. British Imex Industries Ltd.*<sup>178</sup> that

*"it seems to be plain enough that the opening of a confirmed letter of credit constitutes a bargain between the bank and the vender 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 upon the footing that banker's confirmed credit 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... would breakdown 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 open."*<sup>179</sup>

By attaching to the non-interference approach, English courts have imposed the heavy burden of proof upon the plaintiffs who are required to established the existence of "clear" and "obvious" fraud known to the issuer in order to invoke the

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<sup>174</sup> 1983 A.C. 168, 183 (H.L. 1982) (Lord Diplock).

<sup>175</sup> Raymond Jack et al., *Documentary Credits*, (3<sup>rd</sup> ed. 2001), p. 260.

<sup>176</sup> Ross P. Buckley & Xiang Gao, *The Development of Fraud Rule in Letter of Credit Law: The Journey so far and the Road Ahead*, **University of Pennsylvania Journal of International Economic Law**, 687 (2002).

<sup>177</sup> *Id.*

<sup>178</sup> 2 Q.B. 127 (1958).

<sup>179</sup> *Id.* at 129.

fraud rule. In *R D Harbottle (Mercantile) Ltd. v. National Westminster Bank Ltd.*<sup>180</sup> Justice Kerr said that

*“it is only in exceptional cases that the court will interfere with the machinery of irrevocable obligations assumed by banks. They are the life-blood of international commerce. Such obligations are regarded as collateral to the underlying rights and obligations between the merchants at either end of the banking chain. Except possibly in clear cases of fraud of which disputes under the contracts by litigation or arbitration as available to them or stipulated in the contracts... Otherwise, trust in international commerce could be irreparably damaged.”*<sup>181</sup>

The difficulty to meet this high standard of proof of fraud in the English courts is well illustrated by the first English case citing *Sztejn* with approval, that is, *Discount Records Ltd. v. Barclays Bank Ltd.*<sup>182</sup> In this case, the plaintiff, an English buyer, entered into a contract with a French company, Promodisc, to purchase 8,625 discs and 825 cassettes. The purchaser instructed the defendant, Barclays Bank Ltd., to issue a documentary letter of credit in favor of the seller. The seller shipped the goods purporting to be those ordered, and presented the draft with documents regular on their face to the confirming bank in Paris who accepted such draft.<sup>183</sup> When the goods arrived, the purchaser inspected the goods in the presence of a representative of the issuer. The inspection revealed that

*“there were 94 cartons, but of these two were empty, five were filled with rubbish or packing, twenty-five of the records boxes and three of the cassette boxes were only partly filled, and two boxes labeled as cassettes were filled with records; instead of 825 cassettes, as ordered, there were only 518 cassettes and 25 cartridges. Out of the 518 cassettes delivered, 75 percent were not as order..., out of the 8625 records ordered only 275 were delivered as per order. The rest were not as ordered and were either rejected or unsalable.”*<sup>184</sup>

Relying upon *Sztejn* case, the buyer attempted to enjoin the issuer from honoring the seller's draft drawn up on the letter of credit, alleging that the seller was

<sup>180</sup> 2 All E.R. 862 (Q.B. 1977).

<sup>181</sup> *Id.* at 870

<sup>182</sup> 1 All E.R. 1071 (ch. 1974).

<sup>183</sup> *Id.* at 1072-73.

<sup>184</sup> *Id.* at 1073

guilty of fraud. Justice Magarry of the Chancery Division rejected the buyer's claim, distinguished the case from *Sztejn* and said that

*"it is important to notice 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. That being so, the court had to assume that the facts stated in the complaint were true. The complaint alleged fraud, and so the court was dealing with a case of established fraud. In the present case there is, of course, no established fraud, but merely an allegation of fraud. In the present case there is, of course, no established fraud, but merely an allegation of fraud. The defendants, who were not concerned with that matter, have understandably adduced no evidence on the issue of fraud. Indeed, it seems unlikely that any action to which Promodisc was not a party would contain the evidence required to resolve this issue. Accordingly, the matter has to be dealt with on the footing that this is a case in which fraud is alleged but has not been established."*<sup>185</sup>

A comment on the above mentioned case is that the purchaser obtained its evidence in the presence of a third party, the issuer, demonstrating that a great portion of the goods which had been shipped was wither rubbish or empty cartons.<sup>186</sup> It is therefore quite a surprise to hear that the court found there was "no established fraud, but merely an allegation of fraud." Based on the approach, obtaining an injunction to stop payment under a letter of credit is practically impossible in most cases in the United Kingdom despite English court's claims that they "will not allow their process to be used by a dishonest person to carry out a fraud."<sup>187</sup>

However, some of the more recent decisions have indicated that the courts in the United Kingdom might have started to depart from this strict non-interference approach. In *Themehelp Ltd. v. West*,<sup>188</sup> the plaintiffs agreed to purchase the defendants' share capital in a company which owned the trading assets of Shinecrest, 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

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<sup>185</sup> *Id.* at 1704

<sup>186</sup> Xiang Gao and Buckley, *supra* note 180, at 22.

<sup>187</sup> *United City Merchants (Investmetn) Ltd. v. Royal Bank of Canada*, 1983 A.C. 168, 184 (1982).

<sup>188</sup> 4 All E.R.215 (C.A. 1995).



assumption that demand from a major customer of the business, Sony, would continue. Part of the purchase price was payable upon completion of the contract and the balance by subsequent installments at stipulated dates. The third and the largest installment was secured by a performance guarantee which is a legal equivalent of a letter of credit.<sup>189</sup>

After the first two installment had been paid, the plaintiffs “started proceedings for rescission of the contract and damages on the ground of alleged fraudulent misrepresentation by” the defendants.<sup>190</sup> The buyers claimed that the sellers had concealed important information about the business, having “become aware by the date of execution of the agreement that there was no longer any basis” for the assumption used for calculating the purchase price, because Sony “had decided to order all future supplies.... From a competitor of the sellers.”<sup>191</sup> In the proceedings, the buyers applied for an injunction “to restrain the sellers from giving notice to the guarantors (to enforce the guarantee) until the trial...”<sup>192</sup> The injunction was granted on the ground that “the evidence was sufficient to raise a seriously arguable case at trial that the only reasonable interference which could be drawn from the circumstances was that the sellers were fraudulent.”<sup>193</sup> The Court of Appeals affirmed the sellers’ appeal. This affirmation was given by two to one: Lord Justice Waite delivered the judgment, Lord Justice Balcombe agreed and Lord Justice Evans dissented.<sup>194</sup>

It is noteworthy that none of the limited number of English cases where the fraud rule has been applied involves actions brought by the applicant against the bank. They are cases involving either actions against the bank’s refusal to honor a letter of

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<sup>189</sup> Xiang Gao and Buckley, *supra* note 180, at 22.

<sup>190</sup> 4 All E.R.218 (C.A. 1995).

<sup>191</sup> *Id.*

<sup>192</sup> *Id.*

<sup>193</sup> *Id.* It was also stated that this case was exceptional in that the relief in this case was sought at an earlier stage, that is, a restraint against the beneficiary alone in proceedings to which the guarantor is not a party, to prevent the exercise by the beneficiary of his power to enforce the guarantee. *Id.* at 225.

<sup>194</sup> Anthony Pugh-Thomas, *Letter of Credit Injunction – The Purist and the Pragmatist: Can a Buyer Bypass the Guarantor and Stop the Seller from Demanding Payment for the Guarantor?* 11 **Journal of International Banking Law** 210 (1996).

credit such as *Banco Santander SA v. Bayfern Ltd.*<sup>195</sup> or action against the beneficiary's demand for payment such as *Themehelp Ltd. v. West.*<sup>196</sup> It thus appears that English courts have taken different approach in cases where the applicant takes an action against the issuer for an injunction enjoining the issuer to honor a letter of credit from cases where the beneficiary takes an action against the issuer for wrongful refusal to honor a letter of credit or from cases where the applicant takes an action against the beneficiary to prevent the beneficiary from demanding payment.<sup>197</sup> Such distinction seems to have been implied by Judge Megarry in *Discount Record Ltd. v. Barclays Bank Ltd.* when he observed that

*"the defendants [the issuers], who were not concerned with that matter, have understandably adduced no evidence on the issuer of fraud. Indeed, it seems unlikely that any action to which Promodisc [the beneficiary] was not a party would contain the evidence required to resolve this issue."*<sup>198</sup>

The distinction is also supported by one commentator who has commented that *"a distinction must be drawn between the evidence required to obtain an interlocutory injunction and the evidence necessary to entitle a bank that has refused to pay to justify its refusal in proceedings against it. In the latter case ... all that the bank has to show at the trial is that on a balance of probabilities the beneficiary was guilty of fraud. In proceedings against the bank for an injunction, either the fraud must be established or the evidence of it must be compelling."*<sup>199</sup> It should be noted that no such distinction has been made in the United States by inferring from Official Comment 5 on the Revised UCC 1995 Article 5, Section 5-109 that *"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."*<sup>200</sup>

<sup>195</sup> 2 All E. R. 18 (1999 Q.B.), affd, 1 All E. R. 776 (C.A. 2000).

<sup>196</sup> 4 All E. R. 215 (C.A. 1995).

<sup>197</sup> Xiang Gao and Buckley, *supra* note 180, at 23.

<sup>198</sup> 1 All E. R. 1071 (gh. 1974).

<sup>199</sup> Roy Goode, *Reflections on Letters of Credit- I*, 1980 **Journal of Business Law** 291, 294.

<sup>200</sup> U.C.C., Section 5-109, official comment 5 (1952) (revised 1995).



### 3.4.4 Fraud Rule Practice in Canada

Canada accepted fraud rule concept in letters of credit from the *Sztejn* case. It was reflected in the leading fraud rule case, *Bank of Nova Scotia v. Angelica-Whiteware Ltd.* whether Judge Le Dain of the Canadian Supreme Court said that it is preferable to gain benefit of the uniformity that is very significant in this law area, Canada should follow the fraud rule that was affirmed in *Sztejn* case law.<sup>201</sup> In applying the fraud rule, the earlier Canadian cases also followed the English precedent of *Edward Owen Eng'g Ltd. v. Barclays Bank International Ltd.*<sup>202</sup> in requiring a clear and obvious fraud to invoke the fraud rule. In *Aspen Planners Ltd. v. Commerce Masonry & Forming Ltd.*,<sup>203</sup> the plaintiff and the defendant entered into a contract under which the defendant agreed to construct a building for the plaintiff. Payment under the contract was to be made by installments through a stand-by letter of credit on the account of the plaintiff against certificates of entitlement presented by the defendant. The building collapsed after it had been partially completed. The plaintiff then claimed damages for breach of the said contract by the defendant and sought a declaration that the defendant was “*not entitled to deliver further certificate to obtain payment..., under the letter of credit and should be enjoined from doing so, and that the bank should be enjoined from making further payments to the defendant.*”<sup>204</sup>

No fraud was alleged in the case. However, in dismissing the plaintiff's request for injunction, Judge Henry of the Ontario High Court of Justice stated at the outset of his judgment that

“*the law respecting.....letters of credit has been developed principally in the United Kingdom and is well settled.*”<sup>205</sup> He cited *Edward Owen* and finally decided that only “*what is called established or obvious fraud to the knowledge of the*

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<sup>201</sup> *Bank of Nova Scotia v. Angelica-Whitewear Ltd.* [1987] D.L.R. 4th at 161, 177

<sup>202</sup> 1 All E. R. 976, 981 (C.A. 1977).

<sup>203</sup> [1979] D.L.R. 3d 546 (1979).

<sup>204</sup> *Id.* at 546-547.

<sup>205</sup> *Id.* at 549

bank”<sup>206</sup> in the transaction could justify an injunction for the payment of a letter of credit.”<sup>207</sup>

Despite the aforementioned trend, many of the Canadian courts have been less hesitant to apply the fraud rule. They “*have on the whole adopted the test of a strong prima facie case of fraud*” as applied by Justice Galligan in *C.D.N. Research & Developments Ltd. v. Bank of Nova Scotia*.<sup>208</sup> In this case, the plaintiff contracted to sell five firefighting vehicles to the Ministry of War of Iran. The defendant in favor of the Ministry of War issued two letters of credit. One of the letters of credit was made long after the delivery of the vehicles. The plaintiff later requested the court to enjoin the defendant as the issuer from making payments under the said letter of credit on the ground that a call upon such letter of credit would be fraudulent. Although Justice Galligan of the Ontario High Court also quoted Lord Denning’s remark in *Edward Owen* as it appeared in *Aspen Planners*, he granted the injunction by stating that

“*a good deal of argument was addressed to the issue of whether or not fraud has been established by the plaintiff in this case... It seems, on the material before me, that there can be no doubt that the five firefighting vehicles were delivered... it is my opinion, in this case, an injunction ought to be granted. In my view, ... the plaintiff has made out a strong prima facie case that the demand made by the agent of the Ministry of War is fraudulent. Delivery has clearly been made an claim for a payment of a delivery guarantee necessarily implying that delivery was not made is clearly untrue and false.*”<sup>209</sup>

In *Bank of Nova Scotia v. Angelica-Whitewear Ltd.*,<sup>210</sup> the plaintiff issued an irrevocable letter of credit at the request of Whitewear Manufacturing Co., Ltd. in favor of Protective Clothing Company to cover the purchase price of garments. Before the payment of one of the invoices, Whitewear Manufacturing Co., Ltd. as the applicant notified the plaintiff that the signature on the inspection certificate was forged and payment under the letter of credit should be withheld. Despite such notification, payment under the letter of credit was finally made upon repeated

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<sup>206</sup> *Id.*

<sup>207</sup> Xiang Gao and Buckley, *supra* note 180, at 25.

<sup>208</sup> 18 C.P.C. 62 (1980).

<sup>209</sup> *Id.* at 65.

<sup>210</sup> *See supra* note 201, at 177

demands by the negotiating bank and the applicant's account was debited. The plaintiff claimed that the plaintiff was not entitled to debit its account as it was obliged to pay because of prior knowledge of fraud by the beneficiary. The applicant also alleged that the plaintiff had been notified before payment was made that the prices in the invoice were fraudulently inflated. The trial court ruled in favor of the plaintiff. The appeal was made and allowed and the Court of Appeals upheld the contention for dismissal of the case on the ground of the application of the strict compliance rule.<sup>211</sup> Judge Le Dain, however, in distinguishing from disputes between the issuer and the applicant after the issuer has made payment to the beneficiary, stated that

*"I would draw a distinction between what must be shown on an application for an interlocutory injunction to restrain payment under a letter of credit on the ground of fraud by the beneficiary of the credit and what must be shown in a case such as this one, to establish that a draft was improperly paid by the issuing bank after notice of alleged fraud by the beneficiary. A strong prima facie case of fraud would appear to be a sufficient test on an application for an interlocutory injunction. Where, however, no such application was made and the issuing bank had to exercise its own judgment as to whether or not to honour a draft, the test in my opinion should be the one laid down in Edward Owen Engineering-whether fraud was so established to the knowledge of the issuing bank before payment of the draft as to make the fraud clear or obvious to the bank."*<sup>212</sup>

The Canadian Supreme Court held that the judgment of the Court of Appeal allowing Whitewear's appeal could not be supported on the ground of fraud.<sup>213</sup>

It is observed that the Canadian Supreme Court's approach is similar to that taken by the courts in the United Kingdom in the sense that such English courts take different approaches to actions against different parties while the courts in the United States have generally not observed the distinction between cases involving interlocutory injunctions and those arising after the fact of payment.<sup>214</sup>

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<sup>211</sup> Xiang Gao and Buckley, *supra* note 180, at 26.

<sup>212</sup> *See supra* note 210, at 177

<sup>213</sup> *Id.* at 184.

<sup>214</sup> Xiang Gao and Buckley, *supra* note 180, at 26.

The Canadian Supreme Court in this case also considered the issues with respect to the application of the fraud rule whether the application of the fraud rule “*should be confined to cases of forged or false documents or whether it should extend to fraud in the underlying [sale of goods] transaction;*” or “*should be confined to fraud by the beneficiary..., or whether it should include fraud by a third party which affects the letter of credit transaction but of which the beneficiary of the credit is innocent;*” and whether “*a holder in due course of a draft*” should be immune from the application of the fraud rule.<sup>215</sup>

After referring to *Sztejn* case, relevant provisions of the previous version of the UCC, Article 5, Section 5-144 (2), the French position towards the fraud rule and many cases decided in the United States, the United Kingdom and Canada, the Court observed as follows.

*The fraud exception to the autonomy of documentary letters of credit should not be confined to cases of fraud in the tendered documents but should include fraud in the underlying transaction of such a character as to make the demand for payment under the credit a fraudulent one.... The fraud exception to the autonomy of of which would be to permit the beneficiary to obtain the benefit of the credit as a result of fraud. The fraud exception should not be opposable to the holder in due course of a draft on a letter of credit.*”<sup>216</sup>

It is said that may aspects of the fraud rule were thoroughly considered in the case, which has been appraised as “*a scholarly decision,*”<sup>217</sup> and “*a lucid and comprehensive judgment setting out the Canadian position to the exception.*”<sup>218</sup> Nevertheless, the Court barely addresses one of the most important issues with regard to the application of the fraud rule, that is, the kind of fraud that the fraud rule can be invoked.<sup>219</sup>

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<sup>215</sup> See *supra* note 210, at 168

<sup>216</sup> *Id.* at 176-177

<sup>217</sup> John F. Dolan, *supra* note 31, at 122

<sup>218</sup> Greg Fellingner, *Letter of Credit: The Autonomy Principle and the Fraud Exception*, 1 **Journal of Banking and Financial Law and Practice** 4, 21 (1990).

<sup>219</sup> Xiang Gao and Buckley, *supra* note 180, at 27.

### 3.5 Possible Types of Fraud

#### 3.5.1 Fraud on Contract Completion

In the event that the contract reached its completion by the principal/applicant and the beneficiary exploits undertaking mechanism and insists on payment, this event shall be construed as a fraud committed by the beneficiary.<sup>220</sup> The hurdle in this case of fraud is for the principal to prove that he has perfectly performed his obligations under the underlying contract. The judgment in *United Trading Corp. v. Allied Arab Bank*<sup>221</sup> illustrates which kind of evidence the principal will have to produce in order to successfully present his case before the court. Indeed, in this case Ackner LJ requires strong corroborative evidence of the allegation usually in the form of contemporary documents particularly those emanating from the buyer. However, in a construction contract, the principal can produce additionally engineers' certificates issued in the course of the construction projects.

Other factors that bear on the matter of evidence concern the existence of genuine different points of view between the principal and the beneficiary, and the conduct of beneficiary. Therefore, an absence of serious complaints on the part of the beneficiary can help establish fraud.<sup>222</sup>

However, the fact that the contractual warranty period has elapsed does not forfeit the beneficiary's right to hold the principal liable because of certain provisions in the main contract. Nor does it relieve the principal of his burden of proof. On the other hand, protracted silence on the part of the beneficiary could suggest that his complaints are spurious.<sup>223</sup> It is therefore wise to decide each case on the basis of its own facts. The principal may have a valuable plea in case of non-completion of the underlying contract when a *force majeure* occurs. Consequently, when there is a situation of force majeure, and demand made by the beneficiary will be considered fraudulent. In this case, the principal will have to establish that the supervening events have occurred and that these events made the performance of the contract impossible. Impossibility must be established not just mere difficulties in the performance.

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<sup>220</sup> Grace Kayembe, *supra* note at 46

<sup>221</sup> [1985] 2 Lloyd's Rep. 554.

<sup>222</sup> R Bertrams, *supra* note 2, at 282

<sup>223</sup> *Id.*

Consequently, if the principal could have prevented non-completion of the contract by adopting other means than those planned at the beginning of the contract, his plea will not be effective. A case decided on the basis of force majeure is *Dynamics Corp. of America v. Citizens & Southern National Bank*.<sup>224</sup> The facts of the case were that Dynamics the plaintiff contracted a contract of sale with the Indian government for defense-related equipment. In accordance with the terms of the contract, Dynamics requested his bank to issue a stand-by letter of credit in favor of the Indian government. A short time after, war broke out between India and Pakistan rendering the execution of the contract impossible because of an embargo on military supplies to the region. The Indian government presented a draft in order to obtain payment under the letter of credit; subsequently the plaintiff filed a complaint for a stop to payment injunction alleging that he had perfectly performed the contract. The court acknowledged the fact that the demand of payment was indeed fraudulent because the occurrence of force majeure, in this case the U.S. embargo, discharges the principal from liabilities under the contract.<sup>225</sup>

### **3.5.2 Fraud on the Breach of Fundamental Obligation on the Part of the Beneficiary**

International contracts require the issuance of a letter of credit for the benefit of the principal prior the formation of contract. If the breach of this requirement committed by the hirer, the principal who is a contractor or seller shall suspend his obligations without incurred liability. A call for demand by this event is therefore considered as a fraud on the ground of “no conceivable basis” as there is no contract technically.<sup>226</sup> In *Garcia v. Page & Co. Ltd.*<sup>227</sup> it was held that the buyer’s duty to open a letter of credit in time is usually a condition precedent to the seller’s duty to ship the goods. Justice Porter stated in his judgment in favor of the seller, where a date for the opening of the credit is stipulated in the contract, the buyer must comply

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<sup>224</sup> 356 F. Supp. 991 (N.D. Ga. 1973)

<sup>225</sup> Kayembe, *supra* note 12, at 47.

<sup>226</sup> *Id.* at 48.

<sup>227</sup> [1936] 55 L1. 391.



with that date. Failure to do so is tantamount to a repudiatory breach that allows the seller to consider the contract as having been discharged.<sup>228</sup>

A demand for payment could be considered as fraud if performance of the contract by the principal has been made impossible due principally to the non-performance of the beneficiary of his obligations under the contract. For instance, failure to provide the necessary licenses for the completion of the work, failure to provide the labor if required by the contract, failure to provide down payment if agreed by party. In these cases, the burden on the principal will be to prove that otherwise for his obligations that have been delayed because of the beneficiary, he has performed correctly the rest of his obligations.<sup>229</sup>

### 3.5.3 Fraud on Violation of Public Order and Illegality

The beneficiary cannot claim payment under the underlying contract from the guarantor or issuer when it violates public order.<sup>230</sup> For example, when the underlying contract relates to drug trafficking. However, the notion of public order must be construed narrowly as because a particular country has its own notion of public policy. Allowing a broad concept of public policy will have the effect to infringe the utility and desirability of the undertaking. It will be absurd to expect of the beneficiary to be familiar with all that constitutes violation of public order in the principal's country. Therefore, public order must be understood as "international public order"<sup>231</sup>

Any demand for payment by the beneficiary made in circumstances of illegality is also considered as fraud. As opposed to the case of public order, the notion of illegality must be measured by international standards. The first example is that the situation where the undertaking itself is illegal and where it is the underlying contract itself that is illegal. In this situation, there are no difficulties that the payment must not be made to the beneficiary. An example of the second situation is provided

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<sup>228</sup> Kayembe, *supra* note 12, at 48.

<sup>229</sup> R Bertrams, *supra* note 2, at 290.

<sup>230</sup> R Bertrams, *supra* note 2, at 296.

<sup>231</sup> N Enonchong, *The autonomy principle in letter of credit: an illegality exception*, (2006) 289-446

in *Mohania Ltd v. JP Morgan Chase Bank*<sup>232</sup> where Cooke J took the view of Colman J according to which illegality in the underlying contract can taint the letter of credit and thereby render it unenforceable. It is submitted that the claim for payment should be dismissed only if the principal contract is illegal under the applicable law and if the law governing the guarantee considers the kind of transaction manifestly illegal as measured by international standard.<sup>233</sup>

### **3.5.4 Fraud on the Call Does not Relate to the Underlying Contract or by Improper Motives**

Independent guarantees copes particular risk within one of the contract. A demand for payment needs to relate to the risk within a particular contract, not others. If a demand for payment in view of losses originating from other contracts, not the underlying contract, a demand for payment or its attempts to call shall be one of a fraudulent call for payment.<sup>234</sup> When a demand for payment is inspired by improper motives, the call will be treated as fraud. The guarantor or issuer will not be able to make payment to the beneficiary when the beneficiary commits a manifest “abuse of law”. This is for the case when the beneficiary demands for payment with the clear intention to put the principal or applicant under pressure to change the underlying contract condition. *Samwoh v. Sum Cheong Piling Ptd. Ltd.*<sup>235</sup> illustrated this concept as *Samwoh*, the plaintiff, entered into a contract with *Piling*, the defendant, for the performance of some work on the site. The parties agreed that, upon *Samwoh* moving their equipment on the site, *Piling* would ensure the existence of proper drainage and fitness of the area for paving. *Samwoh* moved a paving team as agreed and carried out some work but complained *Piling* that *Piling* had failed to perform his part of the contract so that it would be unreasonable for *Samwoh* to accept that area was fit for them to carry out their work. After that, *Samwoh* stopped working, as *Piling* did not intend to perform his duty in the contract. *Piling* therefore made a claim under the guarantee for non-performance of the contract by *Samwoh*. As a result of the demand

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<sup>232</sup> [2003] EWHC 1927.

<sup>233</sup> R Bertrams, *supra* note 2, at 296.

<sup>234</sup> *Id.* at 298.

<sup>235</sup> [2002] BLR 459 (Sing CA)



for payment, Samwoh sought an injunction in order to prevent Piling from drawing under the guarantee. The judge found that in the light of all circumstances of the case, Piling had acted unconscionably and in bad faith. The demand under the guarantee was therefore abusive used by the defendant, Piling, mainly as a means of forcing Samwoh to accept the terms under the underlying contract in order to avoid his performance for area preparation. The judgment was therefore in favor of Samwoh as the plaintiff.<sup>236</sup>

### 3.6 Duties of the Guarantor/Issuer Under the Convention

Based on the principle of independence, the guarantor/issuer of an undertaking is bound to pay the beneficiary once occurrence of demand arises regardless of the situation in the underlying contract. However, the guarantor/issuer has a duty to the principal/applicant to stop payment on such demand if the fraud on the part of the beneficiary is evident to the guarantor/issuer at the time of the payment. The guarantor/issuer will be liable toward the principal/applicant in the event that the guarantor/issuer ignores his duty to refrain the payment on fraud basis. Such liability can be implied as the forfeit under the contract of indemnity which enjoins the guarantor/issuer to obtain reimbursement from the principal/applicant.<sup>237</sup>

According to Article 14 (1) of the Convention, in discharging the guarantor or issuer's obligations under the undertaking, the guarantor or issuer must perform its obligations 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. The guarantor or issuer may contract for lower standards<sup>238</sup> but may not be exempted from liability for its failure to act in good faith or for any grossly negligent conduct.<sup>239</sup>

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<sup>236</sup> Grace Kayembe, *supra* note 12, at 50-51.

<sup>237</sup> D Warne and N Elliott, *Banking litigation*, Sweet & Maxwell, *supra* note 237, at 397 (2005)

<sup>238</sup> See UNCITRAL Explanatory Note, *supra* note 14, comment 38.

<sup>239</sup> Article 14 paragraph 2 of the Convention.

The term “good faith” is neither defined in the Convention nor in international practice.<sup>240</sup> It, however, may be found in a domestic law such as Section 5-102 (a)(7) of the Uniform Commercial Code, hereinafter referred to as the UCC, as revised in 1995 of the United States where the term “good faith” is defined as “honesty in fact and in the conduct of transaction concerned.” It is said that an “honesty in fact” as a definition of good faith accommodates the purposes of independent guarantees and stand-by letters of credit since “honest in fact” requires the guarantor or issuer to take facts at face value without further investigation.<sup>241</sup> It is further argued that a broad definition of “good faith” is undesirable because the definition should be limited within the context of independent guarantees and stand-by letters of credit.<sup>242</sup> An expansion of the definition of “good faith” beyond the “honest in fact” standard would contradict the substantive decision that compliance should be “strict” instead of “reasonable”.<sup>243</sup> Such a limitation, therefore, is justified in order to preserve the principle of independence of undertaking.<sup>244</sup> For example, in a case where there are allegations of fraud, the guarantor or issuer is not required to investigate the underlying transaction.<sup>245</sup>

“Reasonable care” mentioned in Article 14(1) of the Convention, on the other hand, does not have much bearing on the undertakings because it is usually cited out of habit and has no true definition or function.<sup>246</sup> No real definition of “reasonable care” is found in international practice of independent guarantees or stand-by letters of credit.<sup>247</sup>

Upon demand of payment, the guarantor or issuer is required to examine the demand and accompanying documents in good faith with reasonable care having due regards to other generally accepted standards of international practice of

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<sup>240</sup> Ramsey Saleeby, *Contracting out of the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit*, 1 **George Mason Journal of International Commercial Law**, 150 (2010).

<sup>241</sup> *Id.*

<sup>242</sup> James G. Barnes, *Defining Good Faith Letter of Credit Practices*, 28 **Loyola of Los Angeles Law Review** 101, 109 (1994).

<sup>243</sup> *Id.*

<sup>244</sup> Ramsey Saleeby, *supra* note 94, at 150.

<sup>245</sup> *Id.*

<sup>246</sup> *Id.*

<sup>247</sup> *Id.*

independence guarantees of stand-by letters of credit. In determining whether documents are on their face in strict conformity with the terms and conditions of the undertaking and consistent with one another, the guarantor or issuer must have due regard to the applicable international standard of independent guarantees or stand-by letters of credit which can be found in e.g. the URDG758 and ISP98.<sup>248</sup>

In making payment under a demand to the beneficiary under an independent guarantee or a stand-by letter of credit, the guarantor or issuer has a reasonable time but not more than seven business days following the date of receipt of the demand and any accompanying documents to (a) examine the demand and any accompanying documents (b) decide whether or not to pay and (c) if the decision is not to pay, issue a notice thereof to the beneficiary unless otherwise stipulated in the undertaking or elsewhere agreed upon by the guarantor or issuer and the beneficiary. Such notice not to pay must be made by expeditious means such as teletransmission and indicate the reason for the decision not to pay.<sup>249</sup>

### **3.6.1 Strict Compliance with the Documentary Terms and Conditions of the Undertaking**

Strict compliance principle is universally applied, as well as the Convention, when the documents in relation to the undertaking are presented to the guarantor/issuer to be examined.<sup>250</sup> The guarantor/issuer therefore has the duty to make payment only against documents that are in facial conformity with the terms of the undertaking.<sup>251</sup> The guarantor/issuer will always have to ascertain whether the demand has been made in correct form and by the proper person and whether the beneficiary has submitted the statement of default required by the undertaking. Additionally, the guarantor or issuer needs to verify if the demand for payment has been made on or before the expiry date.<sup>252</sup> Any discrepancy of the documents shall be

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<sup>248</sup> Article 16 paragraph 1 of the UN Convention

<sup>249</sup> Article 16 paragraph 2 of the UN Convention

<sup>250</sup> Jens Nielsen and Nicolai Nielsen, 'Standby Letter of Credit and the ISP98: A European perspective', *Banking & Finance Law Review*, 206

<sup>251</sup> See UNCITRAL Explanatory Note, *supra* note 17, comment 41

<sup>252</sup> See in detail Khemjuta Suwanjinda, *supra* note 14, item 3.5.2 Expiry of Undertaking, at 30.

a motion for the guarantor/issuer to reject the demand of the payment even though the beneficiary can prove outside the documents whether the underlying contract has been breached.<sup>253</sup> Failure by the bank to comply with these requirements will unravel its right of reimbursement under the counter indemnity and may expose it to a claim of damage from the principal/applicant party. In *Equitable Trust Co. of New York v. Dawson Partners, Ltd.*<sup>254</sup> Justice Sumner has appropriately summarized the essence of examination in his statement:

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

However, a mere visual inspection of the documents by the guarantor/issuer should suffice to determine that the documents are acceptable. The guarantor/issuer is neither required to look beyond the documents to ascertain their compliance nor to check their authenticity.<sup>255</sup>

According to the provisions of Article 14 (1) of the Convention, the guarantor/issuer must perform its obligations in good faith and exercise reasonable care according to generally accepted standards of international practice of the undertaking. Parties can agreed to use lower standards for document examination<sup>256</sup> but the guarantor/issuer is still liable to the principal/applicant if the guarantor/issuer fails to act in good faith or for any grossly negligent conduct.<sup>257</sup> All the guarantor/issuer is to do is to determine, based on the documents only, whether the accompanying document appear on their face to comply with the terms and conditions of the undertakings. In determining whether the documents comply with the terms of the undertaking, the guarantor/issuer will have no regard to trade custom because it will distract the guarantor/issuer involving with the underlying contract, which would sabotage strict compliance, documentary nature and independence doctrine on the duty of the guarantor or issuer. The reason to narrowly bind the guarantor/issuer to the

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<sup>253</sup> Jens Nielsen and Nicolai Nielsen, *supra* note 250, at 207

<sup>254</sup> [1927] 27 Ll. L. Rep.49,52.

<sup>255</sup> Article 16 subparagraph (1) of the Convention.

<sup>256</sup> Article 14 paragraph 2 of the Convention.

<sup>257</sup> Ramsey Saleeby, *supra* note 94, at 150

terms of the guarantee is based on the fact that the guarantor/issuer has no visibility of the relation between the parties in the underlying contract and, due to lack of specific industry experience, cannot foresee what the results of a deviation to the order will occur.<sup>258</sup>

### **3.6.2 Examining Accompanying Document within a Reasonable Time**

The guarantor/issuer must examine the document as within a reasonable time. The length of the reasonable time depends on case-by-case basis e.g. urgency, complexity and language of the document.<sup>259</sup> Normally, it should take two or three business days to examine the documents submitted under the undertaking. Exceeding this period, Article 16 of the Convention sets out that the guarantor or issuer must not examine the documents beyond the time limit of seven business days. Although the Convention does not stipulate any sanction or legal implication for punishing guarantor/issuer in the event of the inappropriate delay, the guarantor/issuer would be liable for the damages if there is no fraud allegation from the principal or applicant and the beneficiary filing a lawsuit to claim compensation or damages incurred from such delay against the guarantor or issuer according to wrongful act under domestic statutory law.

### **3.6.3 Notifications of the Demand for Payment**

The main purpose of the notification is the announcement of the guarantor/issuer to the principal/applicant that the beneficiary has placed a demand for payment under the undertaking and that consequently the claim for reimbursement of the undertaking now becomes due. So, the applicant/principal shall have the time to attune to the imminent debit to his account or advise the guarantor/issuer that the demand for payment comprises fraud exception or not. In a case of plausible fraud, the importance of notification has a side effect. It is a common ground that the only possibility for the principal/application to obtain a preliminary stop-payment order is to establish fraud on the part of beneficiary.<sup>260</sup>

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<sup>258</sup> Jen Nielsen and Neil Nielson, *supra* note 250, at 14.

<sup>259</sup> Grace Kayembe, *supra* note 12, at 56.

<sup>260</sup> Grace Kayembe, *supra* note 12, at 56.

## CHAPTER 4

### THAILAND AND THE FRAUD RULE UNDER THE CONVENTION

This part of the thesis focuses on the analysis and consideration of the laws of Kingdom of Thailand as to whether Thailand can derive significant benefits to have the law on the undertaking. Regarding this matter, Thailand does not have any direct law or specific provisions on independent guarantees nor letter of credit. In the event of any dispute in relation to documentary credit, focusing on fraud issue of undertakings, is brought before Thai courts whilst Thailand's Civil Procedural Code states that the Judge shall not deny to pass judgment by claiming that no specific law has been enacted to deal with the issue.

It should be observed that, as discussed earlier, many states such as the United States and China which are not parties to the Convention have the law containing the fraud rule relating to commercial letters of credit including independent guarantees and stand-by letters of credit. The same situation will occur to Thailand if Thailand chooses not to become a party to the Convention but perceives the usefulness and significance of certain provisions of the Convention such as the fraud rule under Article 19 and provisional court measures under Article 20 of the Convention and thereby adopts such provisions into Thai law.

However, autonomy principle in relation to entry into a juristic act would be one of important methods that Thai courts can apply in the process of passing the judgment. Undertaking is a kind of lawful juristic act, namely a kind of contract made by the parties. Such contract, in the event it is not contrary to law and public order, therefore is recognized by law with full legally binding force<sup>261</sup> The laws concerning undertaking is the international business practice that has been used between merchant one of different countries to ensure that the creditor will be able to obtain certain money from the bank in case that creditor is in breach of the underlying contract. This business practice is part of '*Lex Mercatoria*'<sup>262</sup> which has been recognized and reflected as the term "ordinary usage" in Section 368 of the Thai

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<sup>261</sup> Section 150 of the CCC

<sup>262</sup> *Lex Mercatoria* means rules and principles laid down by merchants to regulate their dealings.



CCC<sup>263</sup> that the contract between parties shall be interpreted by applying such rules as URDG759, ISP 98 to the case before the court. However, this ordinary usage under Section 368 of the CCC, which could be such non-mandatory rules as URDG759 or ISP 98 or such mandatory law as the Convention, must be incorporated in the contract. This alternative solution can initially resolve the unavailability of the applicable laws to apply in the dispute in relation to the undertaking. It will be the dead end if there is no rule in the undertaking incorporated in the contract. Lack of any ordinary usage specified in the contract shall force the court to resort to the applicable law. This matter will lead to a significant problem if one of the parties in the undertaking has its place of business in Thailand and the applicable law is Thai law, which has no direct application to this matter. This shall form a significant issue that this chapter will be focusing on.

#### **4.1 Thailand's Position with Respect to the Convention**

Thailand is not a party to the Convention. Therefore, Thailand has no obligation to comply with the Convention. However, the significance and business function of the independent guarantees and stand-by letters of credit in international trade in goods and services including finance facilities are impossible to ignore. That is why Thailand should be more adoptable to go along with the Convention particularly when Thailand's trading partners such as the United States, European Union, Japan and other ASEAN countries choose to become the parties to the Convention. In such a situation, it is inevitable that those trading partners will be more comfortable to see that Thailand is ready to accommodate independent guarantees and stand-by letters of credit internationally and also nationally through its legal support in order to enforce those undertakings.

In Thailand, independent guarantees and stand-by letters of credit are currently used by private sector particularly banks and financial institutions on a contractual basis. There is no specific law nor established custom/practice on the transactions while the only existing provisions concerning suretyship under the Thai CCC may be viewed as unsuitable for Thailand to apply to the undertaking yet due to their

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<sup>263</sup> CCC Section 368 Contract shall be interpreted according to the requirement of good faith, ordinary usage being taken into consideration.



particular nature and purposes. The specific laws dealing with such undertaking are therefore required whether or not Thailand chooses to become a contracting party to the Convention. Regardless of the convention, the use of the undertaking of remains to be very important business tool or method providing advantage to promote and to generate businesses of international nature. However, the existence of the Convention indicates that national legislation dealing with such undertaking should be introduced to support a uniform practice of independent guarantees and stand-by letters of credit both internationally and domestically.

## **4.2 Positive and Negative Factors for Thailand to Become a Party to the Convention**

Positive and negative factors for consideration by Thailand before becoming a party to the Convention is very important because Article 27 of the Convention does not allow any contracting party to make any reservation against the context of the Convention. This crucial point persuades Thailand to make its decision between becoming a party of the Convention and staying out of the Convention but adopting useful contents of the Convention.<sup>264</sup>

### **4.2.1 Positive Factors to Become a Party to the Convention**

1. One of the advantages for Thailand in becoming a party to the Convention is that Thailand will have a specific law dealing with independent guarantees and stand-by letters of credit separately from the existing suretyship provisions under the Civil and Commercial Code. Since the nature and purpose of a suretyship transaction and an independent guarantees and stand-by letters of credit transaction are different, having a specific law on the independent guarantees and stand-by letters of credit will provide specific legal rules and mechanism for such transactions involving international trade.

2. Adoption of a specific law on independent guarantees and stand-by letters of credit will allow Thailand's practices on the matter to be welcome on an international level particularly by those states which are also the parties to the

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<sup>264</sup> Khemjuta Suwanjinda, *supra* note 14, at 61

Convention and the trading partners with Thailand. This recognition cannot be achieved effectively by applying other commercial rules dealing with independent guarantees and stand-by letters of credit such as URDG 758 and ISP98 because such rules do not possess the status of law and are applicable only by incorporation into a contract on a basis of mutual agreement by the parties. In the absence of such incorporation, Thailand has no specific law applicable to such transactions. Nor does Thailand have any established commercial custom or usage on the matter. This situation creates uncertainty and insecurity for Thailand's trading partners involving in such transactions.<sup>265</sup>

3. As practices with respect to independent guarantees and stand-by letters of credit in Thailand are limited to the banks and financial institutions, introduction of a specific law on the issues will not only enhance the use of independent guarantees and stand-by letters of credit beyond the banks and financial institution to the entire private sector as well as individuals who may take advantage of this kind of transactions but also encourage legal jurisprudence development on the issues surrounding or relating to these transactions.<sup>266</sup>

#### **4.2.2 Negative Factors to Become a Party to of the Convention**

1. One disadvantage with respect to Thailand's accession to the Convention is perhaps the fact that the Convention is considered too specific in terms of the limited subject matters covered by the Convention e.g. independent guarantees and stand-by letters of credit and therefore too narrow in terms of its application. This disadvantage, however, may be vindicated by the fact that the practices of independent guarantees and stand-by letters of credit are recognized both on international and domestic levels as an effective means to secure payment in case where a principal in the case of independent guarantees or applicant in the case of stand-by letters of credit fails to perform any of its obligations through presentation of the required documents only. These practices will facilitate a payment process by limiting its complication to only a presentation of the required documents. Payment to the beneficiary by the guarantor or issuer is therefore documentary in nature

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<sup>265</sup> *Id.* at 61

<sup>266</sup> *Id.* at 62

conditional upon strict compliance with the requirements under an independent guarantee or stand-by letter of credit as a case may be.<sup>267</sup>

Accordingly, no matter how specific the scope of the Convention may be, its significance for and contribution to the essential part of international trade is undeniable. The Convention, if adopted, will serve as the only applicable law on independent guarantees and stand-by letters of credit at least for those states, which are the parties to it. The question for Thailand is whether or not, Thailand is ready to introduce the law to cover all concepts of independent guarantees and stand-by letters of credit. Perhaps, it may be only a matter of time for Thailand to become a party to the Convention. Moreover, the Convention will serve as the rules on independent guarantees and stand-by letters of credit to be taken into consideration if Thailand perceives the need to have its laws on this matter.<sup>268</sup>

2. Another disadvantage can be seen in the limited application of the Convention to only international independent guarantees and stand-by letters of credit. Should Thailand adopts the law on these matters, it may be considered too narrow for such law to apply only to international independent guarantees and stand-by letters of credit without taking into consideration its application to domestic independent guarantees and stand-by letters of credit. This disadvantage may be overcome by extending the application of Thai law on these matters to domestic independent guarantees and stand-by letters of credit in order to accord equal treatment to both international and domestic independent guarantees and stand-by letters of credit.

3. The last disadvantage may be the reluctance of the banks and financial institutions in Thailand particularly to accept the fraud exception to payment under the undertaking to the beneficiary as spelt out in Article 19 of the Convention. These banks and financial institutions generally serve as the guarantors or issuers under the commercial letters of credit, independent guarantees and stand-by letters of credit i.e. UCP600, URDG758 and ISP98 respectively none of which contains a provision on the fraud rule. As discussed earlier, the UCP600, URDG759 and ISP98 are silent on the fraud rule because the fraud rule is intended to be left to the applicable law. The

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<sup>267</sup> Khemjuta Suwanjinda, *supra* note 14, at 62.

<sup>268</sup> *Id.* at 62

absence of inclusion of the fraud rule in the UCP600, URDG759 and ISP98 is not peculiar because there are also other issues that are not or cannot be included in the said rules such as court jurisdiction and prescription, which should be clearly provided for, in the applicable law. In this respect, the fraud rule is another issue, which should be provided for, in the applicable law.

In light of the above discussion, concern of the banks and financial institutions in Thailand with respect to the fraud rule might be minimized by the fact that such fraud rule will not appear in the undertaking but rather in the applicable law. As the said banks and financial institutions are parties to an undertaking, they may agree upon the applicable law of a state which has no law on the fraud rule in the undertaking if they are really unhappy with Thai law which contains the fraud rule in the undertaking.

It should be observed that, as discussed earlier, many countries such as the United States and China which are not parties to the Convention have the law containing the fraud rule relating to commercial letter of credit including independent guarantees and stand-by letters of credit. The same situation will occur to Thailand if Thailand chooses not to become a party to the Convention but perceives the usefulness and significance of certain provisions of the Convention such as the fraud rule under Article 19 and provisional court measures under Article 20 of the Convention and thereby adopts such provisions into Thai law. As discussed and analyzed below, the draft Commercial Documentary Credit Contract Act of Thailand does contain the provisions similar to the fraud rule under Article 19 of the Convention despite that fact that such draft Commercial Documentary Credit Contract Act is based principally on the UCP600 and ISP98 and not on the Convention. Based on the above analysis, concern of the banks and financial institutions about the fraud rule under the Convention if Thailand chooses to become a party to the Convention is legally and practically irrelevant.

Thus, it can be seen that the disadvantages for Thailand to become a party to the Convention as discussed above are either overshadowed by the advantages or vindicated by the fact that the fraud rule is irrelevant to the concern of the banks and financial institutions in Thailand but rather relevant to the concern of Thai courts and must be left to the domain of applicable law.

### 4.3 Alternative Solution

Despite the advantages of becoming a party to the Convention, in so doing Thailand must be sure first that Thailand is ready to engage in this kind of international rules and practices and secondly that the domestic laws of Thailand are readily available to implement the provisions of the Convention once Thailand decides to become a party to the Convention. In preparation for the application of such rules and practices on an international level, it is also suggested that Thailand might as well adopt certain rules provided for in the Convention in its domestic law. Pending such decision, Thailand will have the provisions on independent guarantees and stand-by letters of credit which are compatible with those recognized on an international level while Thailand has no international obligations with respect to the implementation of the Convention. In addition, Thailand should consider extending the application of the law on this matter to cover not only international independent guarantees and stand-by letters of credit but also domestic ones and to cover other forms of commercial letters of credit.

In the event of any necessity to ascertain legal binding of the transaction involving the independent guarantees and stand-by letters of credit, the parties can initially resolve the uncertainty issues arising from the lack of statutory laws in Thailand by incorporating the Convention or other international rules e.g. URDG759 and ISP98 into a contract in order to enforce the undertaking properly. The judge can apply these rules or the Convention as the “ordinary usage” to interpret the contract concerning the undertaking as well as its related exception or process specified in such incorporated rules or the Convention.<sup>269</sup>

### 4.4 Constitutional Implication for Becoming a Party to the Convention

Should Thailand decide to accede to the Convention, the cabinet or executive must meet the requirements and follow the procedure provided in the Constitution of the Kingdom of Thailand (Interim), B.E. 2557, which requires that the consent of National Legislative Assembly for the conclusion of any treaty which alters Thailand’s territory or area beyond such territory over which Thailand has sovereign

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<sup>269</sup> CCC Section 368.

rights or jurisdiction under the treaties or under international law or the implementation of which shall require enactment of an act or which widely affects the economic or social security of the country. Since accession by Thailand to the Convention require enactment of the act to implement the Convention, the National Reform Council is required to obtain consent of the National Legislative Assembly in accordance with Section 23 of the said Interim Constitution<sup>270</sup>

#### **4.5 Rules Applicable to an Undertaking under the Convention**

##### **4.5.1 Contract between Parties to an Undertaking**

Independent guarantees and stand-by letters of credit are a kind of the contract starting from the point that the parties reach mutual agreement in different scenarios. An applicant or principal contacts the bank (guarantor or issuer) to provide a guarantee or stand-by letters of credit in favor of beneficiary. The guarantor or issuer will make payment to the beneficiary upon presentation of the required documents under certain conditions of the undertaking. It is clear that every stage of the transactions comprises mutual agreements between parties complying with the autonomy doctrine. However, The term of the contract are therefore legally binding upon the parties to individual contract. Therefore, the parties to an undertaking are able to incorporate the provisions of the Convention as part of the contract to allow the court to interpret the contract in accordance with the terms of the contract. If such incorporation is made in the, the fraud rule under the Convention will be considered to enforce the contracts between the principal/applicant, guarantor/issuer and beneficiary. Without such incorporation of the Convention in the contract, Thai courts may not be able to apply the Convention or other rules relating the undertaking (URDG759 and ISP98) unless it is proved that such fraud rule constitutes ordinary usage under Section 368 of the CCC

##### **4.5.2 Suretyship under the Thai CCC and Undertaking under the Convention**

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<sup>270</sup> Section 23 Paragraph two of the Constitution (Interim) B.E. 2557

While the concept of independent guarantees and stand-by letters of credit comprises primarily independence of the undertaking from the underlying contract and strict compliance with the instructions required in the undertaking, the concept of suretyship under the CCC is not based on independence of the suretyship transaction from the principal transaction but very much dependent on the principal transaction. As a result, the concept of strict compliance in a suretyship transaction is therefore not applicable.<sup>271</sup>

The purpose of independent guarantees and stand-by letters of credit is to secure payment to the beneficiary by a guarantor or issuer as a case may be without requiring the beneficiary to demand payment first from the principal or applicant as the case may be while under the suretyship transaction, the surety is not liable to make payment to the creditor unless the debtor is in default.<sup>272</sup> In addition, when a creditor demands performance of the obligations from the surety, the surety may require that the debtor be first called upon to perform such obligations unless the debtor has been adjudged bankrupt or his whereabouts in the Kingdom is unknown.<sup>273</sup> These requirements under the suretyship transaction are not applicable to the independent guarantees and stand-by letters of credit.<sup>274</sup>

Moreover, the operation of independent guarantees and stand-by letters of credit under the Convention is international in nature while the suretyship transaction is mainly domestic even though the suretyship provisions under the CCC may serve as the applicable law that may affect international transactions involving suretyship. Such international transactions are therefore subject to defenses that may be raised by the surety when demand of payment is made against the surety.<sup>275</sup>

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<sup>271</sup> Khemjuta Suwanjinda, *supra* note 14, at 65.

<sup>272</sup> Section 686 of the CCC

As soon as the debtor is in default, the creditor is entitled to demand performance of the obligation from the surety

<sup>273</sup> Section 688 of the CCC

When the creditor demands performance of the obligation from the surety, the latter may require that the debtor be first called upon to perform, unless the debtor has been adjudged bankrupt or his whereabouts in the Kingdom is unknown.

<sup>274</sup> Khemjuta Suwanjinda, *supra* note 14, at 65.

<sup>275</sup> *Id.* at 66



It is importance to consider the latest amendment to the CCC, Section 685/1<sup>276</sup> whether it affects the essential elements of the undertaking or not. This Section is enacted to cover “The Corporate Stand-by Guarantee” to facilitate the transaction that the Surety, which is a parent company has provided a guarantee to the creditor which is its subsidiary company (debtor) to comply with its obligations under the transaction owed to the creditor. The surety will be jointly liable to the creditor for certain amount of payment, as a joint debtor, in the event of the subsidiary company’s failure to comply with the contract by the debtor. This Section prohibits the surety to raise its defenses under Sections 688<sup>277</sup>, 689<sup>278</sup> and 690<sup>279</sup> of the CCC against the creditor the Surety.

However, in light of the essential elements of an undertaking under the Convention, comprising independence, documentary nature, strict compliance, internationality and irrevocability, the suretyship under the CCC does not have independence in its nature because the surety can raise any defense points, that the debtor may have, against the creditor whilst the independence principle does not rely on any defect of creditor’s rights in the underlying contract. Documentary nature and strict compliance are also not found in the CCC and its latest amendments in relation to the suretyship as well because suretyship does not require these specific elements. The creditor can simply demand the payment under the suretyship contract by

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<sup>276</sup> Section 685/1 of the CCC

In the event of any agreed condition setting out that the surety is bound jointly with the debtor or as a joint debtor, such condition shall be void.

Paragraph one shall not be applicable if the surety is a juristic person and it makes itself surety for the same obligation as joint debtor. The surety who is a juristic person shall not have any right stipulated in Section 688, 689 and 690

<sup>277</sup> Section 688 of the CCC

When the creditor demands performance of the obligation from the surety, the surety may require that the debtor be first called upon to perform unless the debtor has been adjudged bankrupt, or his whereabouts in Thailand is unknown.

<sup>278</sup> Section 689 of the CCC

Even after the debtor has been called upon as provided in the foregoing section, if the surety can prove that the debtor has the means to perform and that execution would not be difficult, the creditor must first make execution against the property of the debtor.

<sup>279</sup> Section 690 of the CCC

If the creditor holds real security belonging to the debtor, he must, on request of the surety, have the obligation performed first out of the real security.

claiming that the debtor fails to comply with its obligation without presentation of any required document and the surety and the creditor do not need to stick to the documentation as in case of an undertaking under the Convention. Furthermore, in the event that suretyship is made domestically, the internationality principle is required in suretyship according to the CCC.

For the above reasons, it is quite clear that Thailand has neither statutory law nor established custom on independent guarantees and stand-by letters of credit as in the case of suretyship. Sections 680 – 701 plus amendments to the Civil and Commercial Code Amendment Act (No. 21) B.E. 2558, in several aspects, cannot be applied to independent guarantees and stand-by letters of credit under the Convention.<sup>280</sup>

#### **4.5.3 Draft Commercial Documentary Credit Act**

To overcome the advantage of limited subject matter of the Convention, the Thai law dealing with this subject matter may consider extending its application to commercial letters of credit, which share common characteristics with such independent guarantees and stand-by letters of credit. This extension of application is reflected in the draft Commercial Documentary Credit Contract Act B.E.... to be discussed below.

It appears that Thailand is trying to adopt a law involving documentary credit transactions.<sup>281</sup> The Draft Commercial Documentary Credit Contract Act (the “Draft”) is prepared based on UCP500, UCP600 and ISP98 as the main guidelines. Nevertheless, there are outstanding comments that the Draft still fails to cover many matters under the ISP98, UCP500 and UCP600. Furthermore, many provisions of the Draft do not correspond to nor align with the ISP98, UCP500 and UCP600.<sup>282</sup>

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<sup>280</sup> Khemjuta Suwanjinda, *supra* note 14 at 66

<sup>281</sup> Kamchai Jongjakapan, *Analysis of Principles and Provisions of the Draft Commercial Documentary Credit Contract Act*, Academic Symposium of the Faculty of Laws, Thammasat University, (2008), 350

<sup>282</sup> *Id.*

#### 4.6 Meaning of Undertaking

While the term “undertaking” as defined in Article 2(1) of the Convention covers both independent guarantees and stand-by letters of credit, no definition of such term can be found in any of the Thai laws. This is because the existing domestic law of Thailand namely the CCC does not cover the undertaking as defined in the Convention. As examined earlier, suretyship under the CCC has different nature from the undertaking and therefore cannot be applied to the undertaking either as a direct applicable law or by analogy.<sup>283</sup>

#### 4.7 Principles of Undertaking under Thai laws

The principles of undertaking namely independence, documentary nature, strict compliance, internationality and irrevocability of independent guarantees and stand-by letters of credit established under the Convention are not found in any existing law of Thailand. However, the Draft has adopted these principles in Section 14 and 15 of Chapter 2 on letter of credit contract. Such principles in Section 14 and 15 apply *mutatis mutandis*<sup>284</sup> to stand-by letters of credit under Chapter 4 on stand-by letters of credit by virtue of Section 31 of the Draft.<sup>285</sup>

##### 4.7.1 Independence Principle under Thai Laws

Independence of an undertaking is not found in the Thai CCC nor covered by in any other statutory law in Thailand. However, Section 14 of the Draft, which provides that the letter of credit contract and documents are binding upon the parties independently of the sale contract or juristic act or transaction, which forms the basis of such letter of credit contract and documents.<sup>286</sup> The bank is obliged to make payment or performs other obligations stipulated in the letter of credit regardless of the existence of the sales contract or other juristic acts or transactions even though reference is made thereto in the letter of credit.

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<sup>283</sup> See Item 4.5.2

<sup>284</sup> *Mutatis Mutandis* is a phrase of frequent practical occurrence, meaning that matters or things are generally the same, but to be altered, when necessary, as to names, offices, and the like.

<sup>285</sup> Khemjuta Suwanjinda, *supra* note 14, at 69.

<sup>286</sup> *Id.* at 69

The applicant for a letter of credit may not invoke the rights nor raise the defenses arising from the legal relationship between the applicant and the beneficiary or between the applicant and the bank issuing the letter of credit against the bank that has a duty to make payment or to perform other obligations under the letter of credit.<sup>287</sup>

The beneficiary under a letter of credit has the right only to receive payment or to obtain performance of other obligations as specified in the letter of credit and is not entitled to invoke or claim other rights and benefits under the contract between the bank themselves.<sup>288</sup>

In performing a letter of credit, all parties thereto must primarily rely on and take into consideration all documents specified in the letter of credit regardless of the goods or services or other performances of obligations even though reference thereto is made in such documents.

Thai Supreme Court Case no. 775/2525 recognizes the independence of a letter of credit. In this case, before the plaintiff made payment under a letter of credit to the seller, the defendant purchaser had notified the plaintiff to stop payment under such letter of credit alleging that the goods which had been shipped failed to conform to the conditions specified in the letter of credit. The plaintiff, nevertheless, made payment to the seller under the letter of credit and brought this action against the defendant claiming the amount, which had been paid to the seller by the plaintiff. The defendant refused reimbursement of the said amount to the plaintiff. The Supreme Court held that the letter of credit, which had been issued by the plaintiff at the request of the defendant contained the statement that, upon presentation of the documents required by the letter of credit, the plaintiff was not responsible for the damage, deficiency or other shortcomings of the goods shipped. The facts indicated that the documents namely the bill of lading and invoices conformed to those required by the letter of credit but failed to conform to what was specified in the letter of credit, the defendant was required to be liable to the plaintiff as had been agreed upon. In addition, the Uniform Customs and Practice on Documentary Credit as amended in 1962 which had been incorporated as part of the contract between the defendant and

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<sup>287</sup> *Id.* at 69

<sup>288</sup> *Id.* at 70

the plaintiff placed emphasis on the presentation of documents required under the letter of credit rather than the actual performance of the underlying transaction. As a result, the defendant was held responsible to reimburse the amount which had been paid by the plaintiff to the seller.<sup>289</sup>

#### **4.7.2 Documentary Nature and Strict Compliance under Thai laws**

Documentary nature of an undertaking is found in Section 16 of the Draft by virtue of Section 31 of the Draft. Section 16 provides that the banks involving in a letter of credit are required to examine such documents as submitted to them only as appearing on the face of such documents. Such banks are not required to examine nor responsible for the legal validity, authenticity or correctness of such documents. Neither are such banks required to examine nor responsible for the acts, omissions, frauds or insolvency of any person except in the case of forgery, false documents or frauds committed by the act or collusion of the employees or agents of such banks. Applying the provisions of Section 16 to independent guarantees and stand-by letters of credit, the guarantor or issuer is required to deal with the documents submitted to it only on the face of such documents. The exceptions to this rule are forgery, false documents or fraud committed by the act or collusion of the employees or agents of the guarantor/issuer.

The said Supreme Court case recognizes the documentary nature of a letter of credit. In this case the plaintiff bank made payment under a letter of credit to the seller who had duly furnished the draft, a full set of bills of lading, invoices and insurance policy required by the letter of credit. The defendant, upon receipt of all such document was required to pay to the plaintiff the amount which had been paid by the plaintiff to the seller. The Supreme Court held that the plaintiff duly performed its obligations under the letter of credit by making payment to the seller upon surrender of the documents required by such letter of credit. The plaintiff had no duty to examine whether the goods had actually been loaded onto the ship.<sup>290</sup>

Strict compliance of undertaking is found in Section 15 of the Draft which provides that the beneficiary under a letter of credit shall strictly and accurately

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<sup>289</sup> *Id.* at 70

<sup>290</sup> Supreme Court no. 1561/2529

comply with the conditions specified in the letter of credit and the bank shall not make payment unless the beneficiary has complied with such conditions and delivered all documents corresponding to those specified in the letter of credit.

The bank has the duty to exercise a reasonable care in examining all documents presented to it whether they have the nature and contents corresponding to those specified in the letter of credit. Such examination shall be in accordance with international standard of banking practice including the following.

- (1) Documents not required by a letter of credit to be presented are not the responsibility of the bank to examine. The bank may return such documents to the presenter or forward the same to the persons concerned.
- (2) In case where the documents presented have the nature or contents that appear on their face to be in conflict, such documents shall be deemed to be incorrect documents as specified in the letter of credit.
- (3) In case where the documents presented contain the subject matters corresponding to those specified in the letter of credit, although there exist minor typing errors, the bank may not raise such discrepancy as the ground for rejection of payment.
- (4) In case where a letter of credit sets any condition without requiring presentation of documents to fulfill such condition, the bank may deem such condition as non-existing and disregard such condition.

The issuing or advising or confirming banks as the case may be shall complete the examination of such documents as to whether they are accepted or rejected and notify the result thereof to the presenter of such documents within a reasonable period of time but not later than seven banking days as from the date of receipt of such document.

Thai Supreme Court recognized the doctrine of strict compliance of a letter of credit. In this case, the defendant bank refused to make payment to the plaintiff beneficiary who had failed to furnish the documents required by the letter of credit. The Supreme Court held that the defendant was not required to make payment to the

plaintiff unless the plaintiff had duly submitted all documents required by the letter of credit.<sup>291</sup>

#### **4.7.3 Internationality under Thai laws**

Nowhere in the Draft is there any provision expressly spelling out the internality of undertaking because of its domestic status in nature. This does not necessarily mean that the Draft once becoming the law will not be able to apply to an undertaking of international nature. Such application is possible through the mechanism of the principles of conflict of laws. For example, if Thailand becomes a party to the Convention and is there stand-by letter of credit bound to adopt and implement the Convention, Thailand is thus required to have a credit of international nature in accordance with the Convention, which directly applies to independences and stand-by letters of credit of international nature.<sup>292</sup>

#### **4.7.4 Irrevocability under Thai laws**

Irrevocability of undertaking is provided for in Section 24 of the Draft which provides that the stand-by credit issued by the financial institution under Section 23 is binding upon such issuing financial institution on an unchangeable or irrevocable basis regardless of any statement to that effect. Neither amendment nor revocation may be allowed unless expressly specified in such stand-by letter of credit or consent is obtained from a person whose interest is affected by such amendment or revocation. The irrevocable nature of undertaking under the said Section 24 is different from a case of commercial letters of credit under Section 10 of the Draft which provides that a letter of credit issued by a bank under Section 10 may be either revocable or irrevocable.<sup>293</sup>

### **4.8 Payment**

#### **4.8.1 Demand for Payment**

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<sup>291</sup> Supreme Court Case n. 207/2511

<sup>292</sup> Khemjuta Suwanjinda, *supra* note 14, at 72

<sup>293</sup> *Id.* at 72.



While Section 15 of the Draft requires the beneficiary to perform strictly in accordance with the conditions and requirements specified in the stand-by letter of credit, the presumption under Article 15 (3) of the Convention that the 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 of the Convention on exception to payment obligation are present is not found in the Draft. The presumption under Article 15 (3) of the Convention covers both mental and physical elements namely bad faith of the beneficiary and any element of subparagraphs (a), (b) or (c) of paragraph (1) of Article 19 of the Convention respectively. Such presumption is useful to allow the guarantor or issuer to invoke the bad faith of the beneficiary and any element referred to in subparagraphs (a), (b) or (c) of paragraph (1) of Article 19 of the Convention to withhold payment to the beneficiary under Article 19 of the Convention.<sup>294</sup>

In order to implement the provision of the Convention if Thailand chooses to become a party to the Convention, the same presumption should be adopted in Thai law relating to independent guarantees and stand-by letters of credit in order to provide a clear nexus between the principle of strict compliance provided for in Section 15 of the Draft and the invocation of fraud as a ground for withholding payment to the beneficiary.

#### **4.8.2 Payment**

Under the Draft, payment of the amount specified in a stand-by letter of credit must be made by the issuing financial institution or confirmer or authorized or nominated person to the beneficiary upon presentation of documents in accordance with the terms and conditions, time and manner required under the stand-by letter of credit as provided for in Section 12 by virtue of Section 21 of the draft Documentary Credit Act e.g. at sight when the stand-by letter of credit stipulates for sight payment<sup>295</sup> or on the date specified for payment when the stand-by letter of credit stipulates that payment shall be made on a specified date after presentation of the documents required by the stand-by letter of credit.

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<sup>294</sup> Article 15 of the UN Convention.

<sup>295</sup> Section 12 of the draft Documentary Credit Act subparagraph (1) of paragraph 1

While Article 17 of the Convention provides in general that following a determination that a demand for payment conforms to the provisions of Article 15 of the Convention, payment shall be made promptly unless the undertaking stipulates payment on a deferred basis, in which case payment shall be made at the stipulated time, Section 12 of the Draft specifically articulates the situations under which payment will be made. In this respect, it appears that Section 12 of the Draft is clearer and more specific than Article 17 of the Convention and can be said to be in line with Article 17 of the Convention.<sup>296</sup>

In addition, according to Section 15 of the Draft, the issuing financial institution or confirmer or authorized or nominated person is not required to make payment to the beneficiary unless the beneficiary has accurately and strictly complied with the conditions and presented all documents specified in the stand-by letter of credit.

Under Section 28 of the Draft,<sup>297</sup> examination of the documents presented by the beneficiary whether they are in conformity with those required by the stand-by letter of credit must be carried out in accordance with the standard of practice of stand-by letters of credit including (1) any document not required by the stand-by letter of credit to be submitted is not within the responsibility of the person designated to receive such document and may be returned or forwarded to the person concerned and (2) the person receiving the documents shall examine any discrepancy of such documents submitted by the beneficiary only to the extent specified in the stand-by letters of credit referred to in Section 12 of the Draft is also required by Article 14 (1) of the Convention. In this respect, the rules set out in the ISP98 and URDG758 must be taken into consideration. It can be concluded here that the requirements under

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<sup>296</sup> Article 17 of the UN Convention.

<sup>297</sup> Section 28 paragraph two of the draft Documentary Credit Act

In examining the documents under this Section, the issuing financial institution, confirmer or authorized or nominated person shall complete the examination and notify the result thereof to the presenter within a reasonable time. Notification of the result within three working days of the notifier as from the date of presentation of the documents shall be deemed to be beyond a reasonable time and prevent the invocation of inaccuracy of the documents against the beneficiary.

Section 28 of the Draft are in compliance with those of Article 14 (1) of the Convention.<sup>298</sup>

In examining such documents, Section 28 paragraph two of the Draft requires the issuing financial institution or confirmer or authorized or nominated person to complete such examination and give a notice thereof to the beneficiary within a reasonable period of time. In any case, a notice to the beneficiary after seven days as from the date of presentation of the documents is deemed to be that beyond a reasonable period of time and will not constitute a defense against demand to payment by the beneficiary with accompanying documents. The bank has to decide whether or not to make payment under the undertaking by issuing a notice thereof to the beneficiary in the event that the decision of the bank is not to pay. It is required \ by Article 16 (2) of the Convention. In light of Article 16 (2) of the Convention, Section 28 of the Draft appears to provide a clearer result for notification after seven days than does Article 16 (2) of the Convention, which is silent as to the consequence of a notice given to the beneficiary beyond seven days period.<sup>299</sup>

## **4.9 Fraud Rule in Undertaking under Thai Laws**

### **4.9.1 Terminology of “Fraud” under Thai Laws and the Convention**

Section 159 of Civil and Commercial Code<sup>300</sup> comprises the word “fraud” in term of fraudulent transaction that induce a person to enter into a contract and the result of such fraudulent transaction entitles the other party to avoid the contract because such contract becomes voidable as a result of fraud. The word “fraud” does mean the act of inducing a person that lure another party to enter into a contact or the transaction containing conspiracy between third party and the other party. Further, the term fraud is not similar to the fraud stipulated in Article 19 of the Convention.

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<sup>298</sup> Khemjuta Suwanjinda, *supra* note 14, at 80.

<sup>299</sup> *Id.*

<sup>300</sup> CCC Section 159 A declaration of intention procured by fraud is voidable.

An act under paragraph one is voidable on account of fraud only when it is such that without which such juristic act would not have been made.

When a party has made a declaration of intention owing to a fraud committed by a third person, the act is voidable only if the other party knew or ought to have known of the fraud.

“Fraud” in a criminal sense is found in the Section 341<sup>301</sup> of the Criminal Code on the charge of cheating and fraud. The elements of this offense comprise the dishonesty of the person who committed the fraud by 1) deception or 2) concealment of the facts that should be revealed, which leads to the result of 3) obtaining a property from the deceived person. It is important to consider that “fraud” under the Criminal Code has similarity with the fraud under the Convention as the beneficiary is required to manifest the untrue words to convince the guarantor or issuer to release the payment under certain conditions of the undertaking or even committed forgery of the documents concerning the undertaking.

In conclusion, the word “fraud” in the Criminal Code contains the nature of the abuse of right with *mala fide* similarly to the fraud rule under the Convention rather than the fraud under the Civil and Commercial Code.

#### **4.9.2 Fraud as the Exception to Payment**

The exception to payment obligation can be found in Section 16 paragraph two of the Draft which provides that in case there is a reasonable ground for believing that any of the documents required under the stand-by letter of credit is faked, false or there is a fraud committed by the act or knowledge of the beneficiary or employees or agents of the beneficiary and the issuing financial institution or confirmer and authorized or nominated person has known or been notified thereof, such institution or person has a duty to examine the same and suspend payment under the stand-by letter of credit until the fact thereof is otherwise established or security is placed against any damage which may be caused by such payment.<sup>302</sup>

If the fraud exception found in Section 16 of the Draft above is adopted as law, it will allow Thai courts to use such fraud exception to stop payment under a letter of credit. Currently, Thai courts rely principally on the doctrine of independence of a letter of credit from the actual performance under the underlying transaction. As

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<sup>301</sup> Criminal Code Section 324 Whoever, on the ground that oneself having the duty, professing to call the trust, having known or acquired the secret according to industry, discovery or scientific invention, disclosing or using such secret for the benefit of oneself or other person, shall be imprisoned not out of six months or fined not out of one thousand baht, or both.

<sup>302</sup> Khemjuta Suwanjinda, *supra* note 14, at 80

illustrated in the Supreme Court Case no. 775/2525 as mentioned earlier, the Supreme Court held that the defendant was required to reimburse the plaintiff bank the amount which had been paid by the plaintiff bank to the seller as the beneficiary who had submitted all documents required by the letter of credit despite the fact that the goods which had been shipped to the defendant failed to conform to the invoices under the letter of credit. It appears, however, that in this case the defendant did not invoke the act of fraud on the part of the seller beneficiary before he notified the plaintiff bank.<sup>303</sup>

The situations constituting fraud as the exception to payment is found in Article 19 of the Convention that allows the guarantor or issuer to withhold the payment to the beneficiary in case where the guarantor or issuer found the fraud in demand of payment, accompanied with the clear evidence on their face, and withhold the payment in good faith. As Thailand has no applicable law covering fraud in independent guarantees or stand-by letters of credit, the fraud rule therefore is not recognized by Thai courts. The current applicable statutory laws applying to the undertaking is the autonomy of contract reflected in Section 151 of the CCC, which is allow the principal or applicant to be bound with the guarantor under the terms of the contract for issuing the undertaking whilst the guarantor or issuer is bound with the beneficiary under the contract. The concept of the undertaking is the payment method and the assurance to the creditor (beneficiary) that the bank will make payment for debtor's (principal or issuer) breach of the contract. The purpose of the contract to issue the undertaking, made between the applicant or principal and the issuer or guarantor, is not void because such agreement does not violate public order or good moral under Section 151 of the CCC.<sup>304</sup> Nevertheless, as this financial method is a special tool used in international business, it shall be definitely confusing and uncertain to apply the laws in case the dispute in relation to the undertaking arises, which would require specific law to resolve the dispute.

Then this issue needs to be reconsidered in Section 151 of the CCC especially when fraud occurred and the bank has been notified by the principal that the documents submitted by the beneficiary are forged or falsified, thus the guarantor or

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<sup>303</sup> *Id.*

<sup>304</sup> Section 151 of the CCC An act is not void on account of its difference from a provision of any law if such law does not relate to public order or good morals.

issuer cannot withhold the payment by invoking the fraud rule due to nowhere in Thai laws designates the fraud rule under the undertaking =. The guarantor/issuer, therefore, has to comply with the contractual duty under the agreement between the guarantor or issuer and the beneficiary by making payment under the undertaking. It would be different if the fraud situation were obvious enough at the presence of guarantor or issuer as the parties incorporated fraud rule condition as exception to payment into the contract or included Convention into the agreement, which will entitle guarantor or issuer to be able to exercise their contractual right in relation to fraud rule.

However, Section 16 paragraph two of the Draft simply provides for general situations under which payment under a stand-by letter of credit may be suspended until proved otherwise or security against damage is placed. It appears from the wordings used in Section 16 paragraph two that the provisions of Section 16 paragraph two confer broader discretion upon the issuing financial institution or confirmer or authorized or nominated person to suspend payment under the stand-by letter of credit than that allowed under Article 19 of the Convention because Section 16 paragraph two uses the phrase “in case there is a reasonable ground for believing that...” while Article 19 of the Convention uses the phrase “if it is manifest and clear that”, it thus can be said that Section 16 of the Draft appears of be more flexible than Article 19 of the Convention in the sense that fraud does not need to be “manifest and clear” as required by Article 19 (1) of the Convention but is merely based on a “reasonable ground for believing that” This flexibility therefore allows broader discretion for the issuing financial institution or confirmer or authorized or nominated person to refuse payment under the stand-by letter of credit. However, in terms of the situations under which the fraud rule can be invoked to withhold payment to the beneficiary, it appears that the situations under Article 19 of the Convention is broader than those specified in Section 16 of the Draft Act. In addition, Article 19 of the Convention does not specify the persons involved in the fraud while Section 16 of the Draft specifies the persons involved in the fraud, who are the beneficiary or employees or agents of the beneficiary and the bank has been aware or notified thereof. By comparison, it appears that in terms of the persons involved in the fraud, which can be interpreted to include persons other than the beneficiary, employees or



agents of the beneficiary as specified in Section 16 of the Draft. It can therefore be concluded that Section 16 of the Draft is more flexible than Article 19 of the Convention in terms of the situations under which the fraud rule can be invoked and of persons involved in the fraud.<sup>305</sup>

#### 4.9.3 Liability of the Guarantor or Issuer

Article 14 of the Convention requires the guarantor or issuer to act in good faith and to exercise reasonable care having due regard to generally accepted standards of international practice of independent guarantees or stand-by letters of credit. However, Section 5 of the Thai CCC<sup>306</sup> can be said to be sufficient to accommodate the “good faith” standard as required under Article 14 of the Convention. The standard of reasonable care appears in Section 659 of the CCC in particular situations. Paragraph 3 of Section 659<sup>307</sup> of the CCC provides that “if the depositary professes a particular trade, business or calling, he is bound to exercise the degree of care and skill usual and requisite in such trade”. This can be used as an analogy to the duty of care of the guarantor for checking the required documents under certain conditions of the undertaking in order to deal with the fraud issues.

However, the purpose of clarity for both “reasonable care” and “good faith” standards should be clearly provided for specifically in the case of undertaking in avoid misinterpretation as Thai law does not have any applicable law specifying in this matter with respect to the undertaking. The issue regarding liability of the guarantor or issuer arises when the beneficiary demands for payment accompanied with the required documents whilst the guarantor or issuer, upon receiving the documents, notifying that the documents presented by the beneficiary might be forged or falsified. As Thailand has no specific laws concerning fraud rule in the undertaking to allow the guarantor, issuer or confirmer to withhold payment to protect the interest of the principal, applicant or instructing party, the guarantor or issuer which normally

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<sup>305</sup> Khemjuta Suwanjinda, *supra* note 14, at 81

<sup>306</sup> Section 5 of CCC Every person must, in the exercise of his rights and in the performance of his obligations, acts in good faith.

<sup>307</sup> Section 369 of CCC paragraph three ... If the depositary professes a particular trade, business or calling, he is bound to exercise the degree of care and skill where such skill is required.



are banks or financial institutions. It is very important for the bank to make the decision to release the fund under the undertaking or to withhold payment in order to wait for court injunction requested by the applicant or principal or instructing party. The crucial legal point to be considered is whether there will be liability imposed upon the principal or applicant or not if the guarantor or issuer chooses to release the fund or if there is no fraud rule anywhere in Thai laws, the bank therefore is required to follow its duty of care as the person who has such profession to perform his duty in good faith. In case where it is clear that the documents are not obvious enough for the guarantor or issuer to conclude there is forgery, the bank has to follow its duty of care to check the discrepancy of the documents and focus primarily on documentary matters only. If it is just the curiosity of the guarantor or issuer without any supporting evidence and the guarantor or issuer has checked the documents thoroughly, the guarantor or issuer shall not be liable to the principal or applicant in case that the fraud can be proven after payment has been made to the beneficiary because guarantor has conducted the transaction in good faith with duty of care in accordance with professional standard. The guarantor or issuer does not have to wait for the court injunction to be requested by the applicant or issuer such as required by Sections 19 plus 20 of the Convention.

#### **4.9.4 Right of the Principal/Applicant to Commence Lawsuit to Stop Payment or Withhold its Process in Thailand**

The procedural mechanism to stop payment though provisional court measures as provided for in Article 20 of the Convention to strengthen the enforcement of the fraud committed under Article 19 of the Convention is not found in neither Thai statutory laws nor the Draft ct. Combining such procedural mechanism in Thai law on independent guarantees and stand-by letters of credit is quite crucial because such mechanism involves the issue of court jurisdiction, which must be clearly provided for in the law. Without such procedural mechanism, effective enforcement of the fraud rule to stop payment by a court order is not possible especially when the guarantor or issuer fails to exercise the right to withhold payment under Section 16 of the Draft. Even though the Civil Procedural Code of Thailand authorizes the court to order an injunction, it remains unclear as to whether such injunction covers what is

provided for in Article 20 of the Convention. In the case where the guarantor or issuer refuses to withhold payment to the beneficiary under the undertaking, when fraud has been invoked by the applicant or principal, no unilateral application for injunction under Section 254 (2) of the Civil Procedural Code can be filed with the court because there is no right of the principal or applicant being disputed from the consequences of the guarantor or issuer's refusal to withhold payment. Besides, there is no specific statutory law allowing the principal or applicant to pursue his right through the competent court according to Section 55 of the Civil Procedural Code. The provisions of Section 55 cannot to be applied to this matter because the money from the guarantor or issuer does not belong to the applicant or principal. No right of the principal or applicant is affected by the beneficiary's demand for payment accompanied with fraud elements because such is a contractual right between the beneficiary and the guarantor or issuer. Indemnity agreement between the applicant/principal and guarantor/issuer is a separate matter from the consequences of fraudulent demand of the beneficiary. Further, there is no statutory law allowing the principal or applicant on the right under the fraud rule in an undertaking under Thai laws. In conclusion, no provisional court measures as provided for in Article 20 of the Convention can be assumed by Thai laws. The method in the Convention should therefore be adopted in Thai law to ensure the effective enforcement of Section 16 of the draft Documentary Credit Act.

## **CHAPTER 5**

### **CONCLUSION AND RECOMMENDATIONS**

#### **5.1 Conclusion**

Thailand still has no specific statutory legal provisions in relation to fraud rule as an exception to stop payment and even the independent guarantees and stand-by letters of credit under the Convention. The unavoidable necessity and importance of independent guarantees and stand-by letters of credit are the key factor because Thailand has a numerous of foreign business partners having their places of business outside Thailand. Furthermore, independent guarantees and stand-by letters of credit have their own legal particularities differently from other typical contracts. However, Thai courts recognize the UCP as the ordinary usage on documentary credit. Parties can incorporate Convention or other non-mandatory rules e.g. URDG758 and ISP98 in relation to the independence guarantees and stand-by letters of credit in the contract to accommodate as the application of “ordinary usage” under Section 368 of the CCC. Thus, the deviation of agreed conditions between parties could be the significant factors for the inconsistency of judgments if the parties fail to incorporate the Convention or other rules properly. For the above reasons, Thailand therefore rigidly limits its legal development on this subject matter. Considering this matter, the advantages for Thailand to become a party to the Convention are clearly indisputable due to international trade activities in Thailand widely involve the undertaking especially in the event of Thai entrepreneurs entering into transactions with foreign business partners who has business places in the contracting parties to the Convention.

However, considering the disadvantage for becoming the party to the Convention, Thailand can choose not to become the party to the Convention but should consider the needs to formulate its own comprehensive laws on independent guarantees and stand-by letters of credit. For such legal formulation, the concept and legal mechanism of the Convention including other non-mandatory rules, which are recognized and used widely in international business practices e.g. URDG758 and ISP98, should be taken into consideration by Thailand when drafting Thai law dealing with the undertaking. The recognition of undertaking nature as well as its legal

implications for the parties to the undertaking, especially fraud rule as exception to payment plus the procedural rules under the Convention is indispensable, to allow the principal or applicant to exercise its right through the court to obtain a provisional order or interim injunction to enforce the fraud exception to stop payment to its beneficiary.

Thailand is trying to move forward to accommodate generally the commercial letters of credit as reflected in the Draft. Nevertheless, certain improvements to cover the undertaking matter especially fraud rule are still required prior to the enactment of law on this matter because such draft does not cover or deal with the issue of independent guarantees and stand-by letters of credit. Although there are fraud rule provisions in the Draft to deal with the fraud exception to payment in part of commercial letters of credit, such provisions are merely close to fraud rule in independent guarantees and stand-by letter of credit. It is yet required to be improved to attain equivalent standard of the fraud rule under the Convention. The following issues in the Draft can be considered as incompatible with the Convention and therefore need to be revised.

1. Section 3 of the Draft does not clearly define independent guarantees as the “commercial documentary credit contract” as specified in Article 2(1) of the Convention whilst stand-by letters of credit can be construed to be included as a part of the definition of the term “commercial documentary credit contract” shown in Section 3 of the Draft.

2. The fraud rule on the presumption of abusive demand for payment specified in Article 19 of the Convention does not appear in Section 15 (3) of the Draft.

3. The situations under which the fraud rule can be invoked as well as the persons involved in the fraud as provided for in Article 19 of the Convention are not found in the Draft at all.

No availability of procedural mechanisms to allow the principal or applicant to request an the interim injunction from the court in order to stop payment to the beneficiary where the guarantor or issuer ignores to exercise its right to withhold the payment in case of fraud invocation or to cease the payment

process, which are stipulated in the Article 20 of the Convention, are found in the Draft.

From the above problems, the following recommendations should be considered.

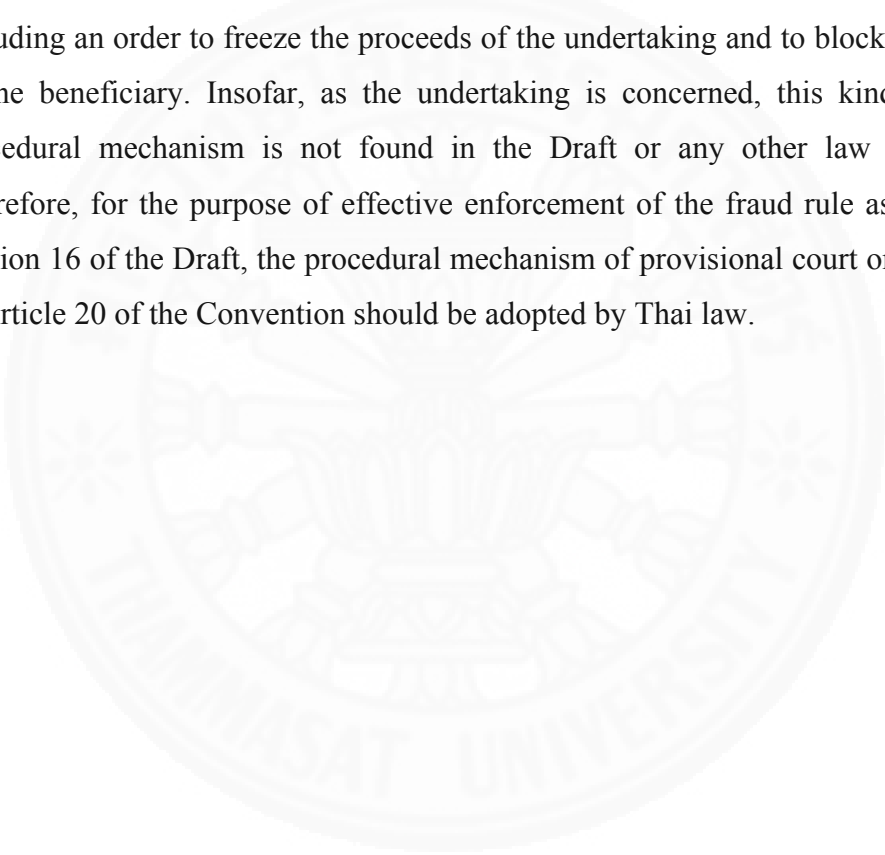
## **5.2 Recommendations**

Thailand must ensure that the law deals with independent guarantees and stand-by letters of credit as well as its exception of fraud rule and the relevant procedural matters. Furthermore, it needs to formulate the laws or to improve its existing Draft to accommodate commercial functions of the undertaking and fraud rule concept reflected in the Convention. Both the concept of the Convention and of existing non-mandatory rules and practices such as UCP600, ISP98 and URDG758 should be incorporated in the Draft in order to cover and to improve the legal clarity in relation to fraud rule in the undertaking under Convention. The Draft should be considered to improve its contents to be in line with the Convention as follows.

1. The Draft should clearly cover “independent guarantees” as a part of the definition of the term “commercial documentary credit contract” to ensure that the Draft can covers the independent guarantees under the Convention.
2. The Draft should contains provisions dealing with the presumption under Article 15 (3) of the Convention that the beneficiary shall be deemed to certify that his demand for payment is not in bad faith and none of the fraud elements, stipulated in Article 19 subparagraphs (a), (b) and (c) of paragraph (1) of the Convention, are presented by the beneficiary.
3. Although the existing contents in relation to the fraud rule in the Draft i.e. Section 16 is more flexible that those under Article 19 of the Convention with respect to conditions to invoke the fraud rule, the Draft still should consider to describe the situations under which the fraud rule can be invoked in order to withhold the payment to the beneficiary as stipulated under Article 19 of the Convention. The situations of fraudulent demand for payment in Article 19 are broader than those

provided for in Section 16 of the Draft. In addition, Section 16 of the Draft should be amended to identify the persons involved in the fraud under the Convention.

4. The Draft should consider the provisions of Article 20 of the Convention with respect to provisional court measures to stop payment to the beneficiary in case where fraud under Article 19 of the Convention has been invoked. This procedural mechanism is quite important because it empowers the court of competent jurisdiction to issue a provisional order to the effect that the beneficiary does not receive payment or an order that the guarantor or issuer hold the amount under the undertaking including an order to freeze the proceeds of the undertaking and to block the payment to the beneficiary. Insofar, as the undertaking is concerned, this kind of specific procedural mechanism is not found in the Draft or any other law in Thailand. Therefore, for the purpose of effective enforcement of the fraud rule as reflected in Section 16 of the Draft, the procedural mechanism of provisional court order spelt out in Article 20 of the Convention should be adopted by Thai law.



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**APPENDIX A**  
**UNITED NATIONS CONVENTION ON INDEPENDENT**  
**GUARANTEES AND STAND-BY LETTERS OF CREDIT**





# **UNITED NATIONS CONVENTION ON INDEPENDENT GUARANTEES AND STAND-BY LETTERS OF CREDIT**

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EXPLANATORY NOTE BY THE UNCITRAL SECRETARIAT ON THE UNITED NATIONS  
CONVENTION ON INDEPENDENT GUARANTEES AND STAND-BY LETTERS OF CREDIT



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# **UNITED NATIONS CONVENTION ON INDEPENDENT GUARANTEES AND STAND-BY LETTERS OF CREDIT**

## **CHAPTER I. SCOPE OF APPLICATION**

### *Article 1. Scope of application*

(1) This Convention applies to an international undertaking referred to in article 2:

- (a) If the place of business of the guarantor/issuer at which the undertaking is issued is in a Contracting State, or
- (b) If the rules of private international law lead to the application of the law of a Contracting State,

unless the undertaking excludes the application of the Convention.

(2) This Convention applies also to an international letter of credit not falling within article 2 if it expressly states that it is subject to this Convention.

(3) The provisions of articles 21 and 22 apply to international undertakings referred to in article 2 independently of paragraph (1) of this article.

### *Article 2. Undertaking*

(1) 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.

(2) The undertaking may be given:

- (a) At the request or on the instruction of the customer ("principal/applicant") of the guarantor/issuer;
- (b) On the instruction of another bank, institution or person ("instructing party") that acts at the request of the customer ("principal/applicant") of that instructing party; or

(c) On behalf of the guarantor/issuer itself.

(3) Payment may be stipulated in the undertaking to be made in any form, including:

- (a) Payment in a specified currency or unit of account;
- (b) Acceptance of a bill of exchange (draft);
- (c) Payment on a deferred basis;
- (d) Supply of a specified item of value.

(4) The undertaking may stipulate that the guarantor/issuer itself is the beneficiary when acting in favour of another person.

#### *Article 3. Independence of undertaking*

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.

#### *Article 4. Internationality of undertaking*

(1) An undertaking is international if the places of business, as specified in the undertaking, of any two of the following persons are in different States: guarantor/issuer, beneficiary, principal/applicant, instructing party, confirmer.

(2) For the purposes of the preceding paragraph:

- (a) If the undertaking lists more than one place of business for a given person, the relevant place of business is that which has the closest relationship to the undertaking;

(b) If the undertaking does not specify a place of business for a given person but specifies its habitual residence, that residence is relevant for determining the international character of the undertaking.

## CHAPTER II. INTERPRETATION

### *Article 5. Principles of interpretation*

In the interpretation of this Convention, regard is to be had to its international character and to the need to promote uniformity in its application and the observance of good faith in the international practice of independent guarantees and stand-by letters of credit.

### *Article 6. Definitions*

For the purposes of this Convention and unless otherwise indicated in a provision of this Convention or required by the context:

- (a) "Undertaking" includes "counter-guarantee" and "confirmation of an undertaking";
- (b) "Guarantor/issuer" includes "counter-guarantor" and "confirmer";
- (c) "Counter-guarantee" means an undertaking given to the guarantor/issuer of another undertaking by its instructing party and providing for payment 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 under that other undertaking has been demanded from, or made by, the person issuing that other undertaking;
- (d) "Counter-guarantor" means the person issuing a counter-guarantee;
- (e) "Confirmation" of an undertaking means an undertaking added to that of the guarantor/issuer, and authorized by the guarantor/issuer, providing the beneficiary with the option of demanding payment from the confirmer instead of from the guarantor/issuer, upon simple demand or upon demand accompanied by other documents, in conformity with the terms and any documentary conditions of the confirmed undertaking, without prejudice to the beneficiary's right to demand payment from the guarantor/issuer;
- (f) "Confirmer" means the person adding a confirmation to an undertaking;
- (g) "Document" means a communication made in a form that provides a complete record thereof.

### CHAPTER III. FORM AND CONTENT OF UNDERTAKING

#### *Article 7. Issuance, form and irrevocability of undertaking*

- (1) Issuance of an undertaking occurs when and where the undertaking leaves the sphere of control of the guarantor/issuer concerned.
- (2) An undertaking may be issued in any form which preserves a complete record of the text of the undertaking and provides authentication of its source by generally accepted means or by a procedure agreed upon by the guarantor/issuer and the beneficiary.
- (3) From the time of issuance of an undertaking, a demand for payment may be made in accordance with the terms and conditions of the undertaking, unless the undertaking stipulates a different time.
- (4) An undertaking is irrevocable upon issuance, unless it stipulates that it is revocable.

#### *Article 8. Amendment*

- (1) An undertaking may not be amended except in the form stipulated in the undertaking or, failing such stipulation, in a form referred to in paragraph (2) of article 7.
- (2) Unless otherwise stipulated in the undertaking or elsewhere agreed by the guarantor/issuer and the beneficiary, an undertaking is amended upon issuance of the amendment if the amendment has previously been authorized by the beneficiary.
- (3) Unless otherwise stipulated in the undertaking or elsewhere agreed by the guarantor/issuer and the beneficiary, where any amendment has not previously been authorized by the beneficiary, the undertaking is amended only when the guarantor/issuer receives a notice of acceptance of the amendment by the beneficiary in a form referred to in paragraph (2) of article 7.
- (4) An amendment of an undertaking has no effect on the rights and obligations of the principal/applicant (or an instructing party) or of a confirmer of the undertaking unless such person consents to the amendment.

#### *Article 9. Transfer of beneficiary's right to demand payment*

- (1) The beneficiary's right to demand payment may be transferred only if authorized in the undertaking, and only to the extent and in the manner authorized in the undertaking.



(2) If an undertaking is designated as transferable without specifying whether or not the consent of the guarantor/issuer or another authorized person is required for the actual transfer, neither the guarantor/issuer nor any other authorized person is obliged to effect the transfer except to the extent and in the manner expressly consented to by it.

#### *Article 10. Assignment of proceeds*

(1) Unless otherwise stipulated in the undertaking or elsewhere agreed by the guarantor/issuer and the beneficiary, the beneficiary may assign to another person any proceeds to which it may be, or may become, entitled under the undertaking.

(2) If the guarantor/issuer or another person obliged to effect payment has received a notice originating from the beneficiary, in a form referred to in paragraph (2) of article 7, of the beneficiary's irrevocable assignment, payment to the assignee discharges the obligor, to the extent of its payment, from its liability under the undertaking.

#### *Article 11. Cessation of right to demand payment*

(1) The right of the beneficiary to demand payment under the undertaking ceases when:

- (a) The guarantor/issuer has received a statement by the beneficiary of release from liability in a form referred to in paragraph (2) of article 7;
- (b) The beneficiary and the guarantor/issuer have agreed on the termination of the undertaking in the form stipulated in the undertaking or, failing such stipulation, in a form referred to in paragraph (2) of article 7;
- (c) The amount available under the undertaking has been paid, unless the undertaking provides for the automatic renewal or for an automatic increase of the amount available or otherwise provides for continuation of the undertaking;
- (d) The validity period of the undertaking expires in accordance with the provisions of article 12.

(2) The undertaking may stipulate, or the guarantor/issuer and the beneficiary may agree elsewhere, that return of the document embodying the undertaking to the guarantor/issuer, or a procedure functionally equivalent to the return of the document in the case of the issuance of the undertaking in non-paper form, is required for the cessation of the right to demand payment, either alone or in conjunction with one of the events referred to in subparagraphs (a) and (b) of paragraph (1) of this article. However, in no case shall retention of any such document by the beneficiary after the right to demand payment ceases in accordance with subparagraph (c) or (d) of paragraph (1) of this article preserve any rights of the beneficiary under the undertaking.

#### *Article 12. Expiry*

The validity period of the undertaking expires:

(a) At the expiry date, which may be a specified calendar date or the last day of a fixed period of time stipulated in the undertaking, provided that, if the expiry date is not a business day at the place of business of the guarantor/issuer at which the undertaking is issued, or of another person or at another place stipulated in the undertaking for presentation of the demand for payment, expiry occurs on the first business day which follows;

(b) If expiry depends according to the undertaking on the occurrence of an act or event not within the guarantor/issuer's sphere of operations, when the guarantor/issuer is advised that the act or event has occurred by presentation of the document specified for that purpose in the undertaking or, if no such document is specified, of a certification by the beneficiary of the occurrence of the act or event;

(c) If the undertaking does not state an expiry date, or if the act or event on which expiry is stated to depend has not yet been established by presentation of the required document and an expiry date has not been stated in addition, when six years have elapsed from the date of issuance of the undertaking.

### CHAPTER IV. RIGHTS, OBLIGATIONS AND DEFENCES

#### *Article 13. Determination of rights and obligations*

(1) The rights and obligations of the guarantor/issuer and the beneficiary arising from the undertaking are determined by the terms and conditions set forth in the undertaking, including any rules, general conditions or usages specifically referred to therein, and by the provisions of this Convention.

(2) In 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.

#### *Article 14. Standard of conduct and liability of guarantor/issuer*

(1) In discharging its obligations under the undertaking and this Convention, 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.



(2) A guarantor/issuer may not be exempted from liability for its failure to act in good faith or for any grossly negligent conduct.

#### *Article 15. Demand*

(1) Any demand for payment under the undertaking shall be made in a form referred to in paragraph (2) of article 7 and in conformity with the terms and conditions of the undertaking.

(2) Unless otherwise stipulated in the undertaking, the demand and any certification or other document required by the undertaking shall be presented, within the time that a demand for payment may be made, to the guarantor/issuer at the place where the undertaking was issued.

(3) The 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.

#### *Article 16. Examination of demand and accompanying documents*

(1) The 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.

(2) Unless otherwise stipulated in the undertaking or elsewhere agreed by the guarantor/issuer and the beneficiary, the guarantor/issuer shall have reasonable time, but not more than seven business days following the day of receipt of the demand and any accompanying documents, in which to:

- (a) Examine the demand and any accompanying documents;
- (b) Decide whether or not to pay;
- (c) If the decision is not to pay, issue notice thereof to the beneficiary.

The notice referred to in subparagraph (c) above shall, unless otherwise stipulated in the undertaking or elsewhere agreed by the guarantor/issuer and the beneficiary, be made by teletransmission or, if that is not possible, by other expeditious means and indicate the reason for the decision not to pay.

#### *Article 17. Payment*

(1) Subject to article 19, the guarantor/issuer shall pay against a demand made in accordance with the

provisions of article 15. Following a determination that a demand for payment so conforms, payment shall be made promptly, unless the undertaking stipulates payment on a deferred basis, in which case payment shall be made at the stipulated time.

(2) Any payment against a demand that is not in accordance with the provisions of article 15 does not prejudice the rights of the principal/applicant.

#### *Article 18. Set-off*

Unless otherwise stipulated in the undertaking or elsewhere agreed by the guarantor/issuer and the beneficiary, the guarantor/issuer 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.

#### *Article 19. Exception to payment obligation*

(1) If it is manifest and clear that:

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

the guarantor/issuer, acting in good faith, has a right, as against the beneficiary, to withhold payment.

(2) For the purposes of subparagraph (c) of paragraph (1) of this article, 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.

(3) 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.

## CHAPTER V. PROVISIONAL COURT MEASURES

### *Article 20. Provisional court measures*

(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 therefor 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.

## CHAPTER VI. CONFLICT OF LAWS

### *Article 21. Choice of applicable law*

The undertaking is governed by the law the choice of which is:

(a) Stipulated in the undertaking or demonstrated by the terms and conditions of the undertaking; or

(b) Agreed elsewhere by the guarantor/issuer and the beneficiary.

#### *Article 22. Determination of applicable law*

Failing a choice of law in accordance with article 21, the undertaking is governed by the law of the State where the guarantor/issuer has that place of business at which the undertaking was issued.

### CHAPTER VII. FINAL CLAUSES

#### *Article 23. Depositary*

The Secretary-General of the United Nations is the depositary of this Convention.

#### *Article 24. Signature, ratification, acceptance, approval, accession*

(1) This Convention is open for signature by all States at the Headquarters of the United Nations, New York, until 11 December 1997.

(2) This Convention is subject to ratification, acceptance or approval by the signatory States.

(3) This Convention is open to accession by all States which are not signatory States as from the date it is open for signature.

(4) Instruments of ratification, acceptance, approval and accession are to be deposited with the Secretary-General of the United Nations.

#### *Article 25. Application to territorial units*

(1) If a State has two or more territorial units in which different systems of law are applicable in relation to the matters dealt with in this Convention, it may, at the time of signature, ratification, acceptance, approval or accession, declare that this Convention is to extend to all its territorial units or only one or more of them, and may at any time substitute another declaration for its earlier declaration.

(2) These declarations are to state expressly the territorial units to which the Convention extends.

(3) If, by virtue of a declaration under this article, this Convention does not extend to all territorial units of a State and the place of business of the guarantor/issuer or of the beneficiary is located in a territorial unit to which the Convention does not extend, this place of business is considered not to be in a

Contracting State.

(4) If a State makes no declaration under paragraph (1) of this article, the Convention is to extend to all territorial units of that State.

#### *Article 26. Effect of declaration*

(1) Declarations made under article 25 at the time of signature are subject to confirmation upon ratification, acceptance or approval.

(2) Declarations and confirmations of declarations are to be in writing and to be formally notified to the depositary.

(3) A declaration takes effect simultaneously with the entry into force of this Convention in respect of the State concerned. However, a declaration of which the depositary receives formal notification after such entry into force takes effect on the first day of the month following the expiration of six months after the date of its receipt by the depositary.

(4) Any State which makes a declaration under article 25 may withdraw it at any time by a formal notification in writing addressed to the depositary. Such withdrawal takes effect on the first day of the month following the expiration of six months after the date of the receipt of the notification of the depositary.

#### *Article 27. Reservations*

No reservations may be made to this Convention.

#### *Article 28. Entry into force*

(1) This Convention enters into force on the first day of the month following the expiration of one year from the date of the deposit of the fifth instrument of ratification, acceptance, approval or accession.

(2) For each State which becomes a Contracting State to this Convention after the date of the deposit of the fifth instrument of ratification, acceptance, approval or accession, this Convention enters into force on the first day of the month following the expiration of one year after the date of the deposit of the appropriate instrument on behalf of that State.

(3) This Convention applies only to undertakings issued on or after the date when the Convention enters into force in respect of the Contracting State referred to in subparagraph (a) or the Contracting State referred to in subparagraph (b) of paragraph (1) of article 1.



### *Article 29. Denunciation*

(1) A Contracting State may denounce this Convention at any time by means of a notification in writing addressed to the depositary.

(2) The denunciation takes effect on the first day of the month following the expiration of one year after the notification is received by the depositary. Where a longer period is specified in the notification, the denunciation takes effect upon the expiration of such longer period after the notification is received by the depositary.

DONE at New York, this eleventh day of December one thousand nine hundred and ninety-five, in a single original, of which the Arabic, Chinese, English, French, Russian and Spanish texts are equally authentic.

IN WITNESS WHEREOF the undersigned plenipotentiaries, being duly authorized by their respective Governments, have signed the present Convention.

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### **Explanatory note by the UNCITRAL secretariat on the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit\***

#### Introduction

1. The United Nations Convention on Independent Guarantees and Stand-by Letters of Credit was adopted and opened for signature by the General Assembly by its resolution 50/48 of 11 December 1995.<sup>1</sup> The Convention was prepared by the United Nations Commission on International Trade Law (UNCITRAL).<sup>2</sup>

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\* This note has been prepared by the secretariat of the United Nations Commission on International Trade Law (UNCITRAL) for informational purposes. It is not an official commentary on the Convention.

<sup>1</sup> The draft Convention was prepared by the Working Group on International Contract Practices at its thirteenth to twenty-third sessions. (For the reports of those sessions, see the following volumes of the UNCITRAL *Yearbook: Yearbook, Volume XXI: 1990* (United Nations publication, Sales No. E.91.V.6), document A/CN.9/330; *Yearbook, Volume XXII: 1991* (United Nations publication, Sales No. E.93.V.2), documents A/CN.9/342 and A/CN.9/345; *Yearbook, Volume XXIII: 1992* (United Nations publication, Sales No. E.94.V.7), documents A/CN.9/358 and A/CN.9/361; *Yearbook, Volume XXIV:*

1993 (United Nations publication, Sales No. E.94.V.16), document A/CN.9/374 and Corr.1; *Yearbook, Volume XXV: 1994* (United Nations publication, Sales No. E.95.V.20), documents A/CN.9/388 and A/CN.9/391; and "Yearbook, volume XXVI: 1995" (to be issued subsequently as a United Nations sales publication), documents A/CN.9/405 and A/CN.9/408.) The deliberations of UNCITRAL on the draft Convention are reflected in the report on the work of its twenty-eighth session (1995) (*Official Records of the General Assembly, Fiftieth Session, Supplement No. 17 (A/50/17)*, paras. 11-201), annex I of which contains the draft Convention as submitted by the Commission to the General Assembly.

<sup>2</sup> UNCITRAL is an intergovernmental body of the General Assembly that prepares international commercial law instruments designed to assist the international community in modernizing and harmonizing laws dealing with international trade. Other legal instruments prepared by UNCITRAL include the following: United Nations Convention on Contracts for the International Sale of Goods (*Official Records of the United Nations Conference on Contracts for the International Sale of Goods, Vienna, 10 March-11 April 1980* (United Nations publication, Sales No. E.82.V.5), part I); Convention on the Limitation Period in the International Sale of Goods, 1974 (New York) (*Official Records of the United Nations Conference on Prescription (Limitation) in the International Sale of Goods, New York, 20 May-14 June 1974* (United Nations publication, Sales No. E.74.V.8), part I); United Nations Convention on the Carriage of Goods by Sea, 1978 (Hamburg) (*Official Records of the United Nations Conference on the Carriage of Goods by Sea, Hamburg, 6-31 March 1978* (United Nations publication, Sales No. E.80.VIII.1), document A/CONF.89/13, annex I); United Nations Convention on the Liability of Operators of Transport Terminals in International Trade (A/CONF.152/13, annex); UNCITRAL Arbitration Rules (*Official Records of the General Assembly, Thirty-first Session, Supplement No. 17 (A/31/17)*, para. 57); UNCITRAL Notes on Organizing Arbitral Proceedings ("Yearbook, volume XXVIII: 1996" (to be issued subsequently as a United Nations sales publication), document A/CN.9/423); UNCITRAL Conciliation Rules (*Official Records of the General Assembly, Thirty-fifth Session, Supplement No. 17 (A/35/17)*, para. 106); Model Law on International Commercial Arbitration (1985) (*Official Records of the General Assembly, Fortieth Session, Supplement No. 17 (A/40/17)*, annex I); United Nations Convention on International Bills of Exchange and International Promissory Notes (General Assembly resolution 43/165, annex, of 9 December 1988); Model Law on International Credit Transfers (1992) (*Official Records of the General Assembly, Forty-seventh Session, Supplement No. 17 (A/47/17)*; annex I); UNCITRAL Model Law on Procurement of Goods, Construction and Services (1994) (*Official Records of the General Assembly, Forty-ninth Session, Supplement No. 17 and corrigendum (A/49/17 and Corr.1)*, annex I); and UNCITRAL Model Law on Electronic Commerce (*Official Records of the General Assembly, Fifty-first Session, Supplement No. 17 (A/51/17)*, annex I).

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2. The Convention is particularly designed to facilitate the use of independent guarantees and stand-by letters of credit where only one or the other of those instruments is traditionally in use. The Convention also solidifies recognition of common basic principles and characteristics shared by the independent guarantee and the stand-by letter of credit. In order to emphasize the common umbrella of rules provided for both independent guarantees and stand-by letters of credit and to overcome divergences that may exist in terminology, the Convention uses the neutral term "undertaking" to refer to both types of

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instruments.

3. Independent undertakings covered by the Convention are basic tools of international commerce. They are used in a variety of situations. For example, they are used to secure performance of contractual obligations including construction, supply and commercial payment obligations; to secure repayment of an advance payment in the event that such repayment is required; to secure a winning bidder's obligation to enter into a procurement contract; to ensure reimbursement of payment under another undertaking; to support issuance of commercial letters of credit and insurance coverage; and to enhance creditworthiness of public and private borrowers. Yet familiarity with one or the other instrument covered by the Convention is not universal; there is an absence of legislative provisions dealing with them, practices concerning the two types of instruments have differed in certain respects, and important questions confronting users, practitioners and courts in the daily life of these instruments are beyond the power of the parties to settle contractually.

4. By establishing a harmonized set of rules for the two types of instruments covered, the Convention will provide greater legal certainty in their use for day-to-day commercial transactions, as well as marshal credit for public borrowers. Also, by making a single legal regime available to both independent guarantees and stand-by letters of credit, the Convention will facilitate the issuance of both instruments in combination with each other, for example, the issuance of a stand-by letter of credit to support the issuance of a guarantee, or the reverse case. The Convention will further facilitate "syndications" of lenders, by allowing them to combine more easily both types of instruments. Lenders participating in a syndication can spread credit risk among themselves, which enables them to extend larger volumes of credit.

5. The Convention gives legislative support to the autonomy of the parties to apply agreed rules of practice such as the Uniform Customs and Practice for Documentary Credits (UCP), formulated by the International Chamber of Commerce (ICC), or other rules that may evolve to deal specifically with stand-by letters of credit, and the Uniform Rules for Demand Guarantees (URDG, also formulated by ICC). In addition to being essentially consistent with the solutions found in rules of practice, the Convention supplements their operation by dealing with issues beyond the scope of such rules. It does so in particular regarding the question of fraudulent or abusive demands for payment and judicial remedies in such instances. Furthermore, the deference of the Convention to the specific terms of independent guarantees and stand-by letters of credit, including any rules of practice incorporated therein, enables the Convention to work in tandem with rules of practice such as UCP and URDG.

6. It should be noted that, strictly speaking, an independent guarantee or stand-by letter of credit is an undertaking given to a beneficiary. Accordingly, the focus of the Convention is on the relationship between the guarantor (in the case of an independent guarantee) or the issuer (in the case of a stand-by letter of credit) (hereinafter referred to as "guarantor/issuer") and the beneficiary. The relationship between the guarantor/issuer and its customer (the principal, in the case of an independent guarantee, or the applicant, in the case of a stand-by letter of credit, hereinafter referred to as "principal/applicant") largely falls outside the scope of the Convention. The same may be said of the relationship between a guarantor/issuer and its instructing party (the instructing party being, for example, a bank, requesting, on

behalf of its customer, the guarantor/issuer to issue an independent guarantee).

7. Provided below is a summary of the main features and provisions of the Convention.

## **I. SCOPE OF APPLICATION**

### **A. Types of instruments covered**

8. The scope of application of the Convention is confined to instruments of the type understood in practice as independent guarantees (referred to as, e.g. "demand", "first demand", "simple demand" or "bank" guarantees) or stand-by letters of credit (article 2(1)). Those instruments can be covered by the umbrella of the Convention because they share a wide area of common use. Both types of instruments, which are payable upon presentation of any stipulated documents, are used to secure against the possibility that some contingency may occur (e.g. a breach of a contract). It may be noted that another major use in particular of stand-by letters of credit is as an instrument to effectuate payment of mature indebtedness ("financial" or "direct pay" stand-by letters of credit).

9. In the undertakings covered by the Convention the guarantor/issuer promises to pay the beneficiary upon a demand for payment. The demand may, depending upon the terms of the undertaking, be either a "simple" demand or one having to be accompanied by the other documents called for in the guarantee or stand-by letter of credit. The guarantor/issuer's obligation to pay is triggered by the presentation of a demand for payment in the form, and with any supporting documents, as may be required by the independent guarantee or stand-by letter of credit. The guarantor/issuer is not called on to investigate the underlying transaction, but is merely to determine whether the documentary demand for payment conforms on its face to the terms of the guarantee or stand-by letter of credit. Because of this characteristic the instruments covered by the Convention are referred to commonly as being "independent" and "documentary" in nature.

10. Reflecting practice, various types of scenarios are envisaged in which an undertaking may be given, including at the request of the customer ("principal/applicant"), on the instruction of another entity or person ("instructing party") acting at the request of the customer of the instructing party, or on behalf of the guarantor/issuer itself (article 2(2)).

11. Full freedom is given to the parties to exclude completely the coverage of the Convention (article 1), with the result that another law becomes applicable. Since the Convention, if it is applicable, is to a large extent suppletive rather than mandatory, wide breadth is given to exclude or alter the rules of the Convention in any given case.

### **B. Coverage of counter-guarantees and confirmations**

12. The Convention is designed to include coverage of the "counter-guarantee". A counter-guarantee is defined in the Convention (article 6(c)) in the same essential terms as the basic notion of "undertaking",

namely, as an undertaking given to the guarantor/issuer of another undertaking by its instructing party and providing for payment upon simple demand or upon demand accompanied by other documents, in conformity with the terms and any documentary conditions of the undertaking (counter-guarantee).

13. Apart from this general treatment of counter-guarantees as "undertakings", the Convention provides a specific provision on counter-guarantees in the context of fraudulent or abusive demands for payment; in that context counter-guarantees may raise questions distinct from those raised by other undertakings covered by the Convention (see paragraph 48, below).

14. The Convention also includes in its scope confirmations of undertakings, i.e. an undertaking added to that of, and authorized by, the guarantor/issuer. A confirmation gives the beneficiary an option of demanding payment from the confirmer as an alternative to demanding payment from the guarantor/issuer. By requiring authorization of the guarantor/issuer, the Convention does not recognize as confirmations "silent" confirmations, i.e. confirmations added without the assent of the guarantor/issuer.

### **C. Instruments outside scope of Convention**

15. The Convention does not apply to "accessory" or "conditional" guarantees, i.e. guarantees in which the payment obligation of the guarantor involves more than the mere examination of a documentary demand for payment. Thus, the Convention does not annul or affect such other instruments in any way, nor does it regulate or discourage their use in any way. Whether it would be preferable to use in any given case an independent undertaking of the type covered by the Convention, or another type of instrument, would depend on the commercial circumstances at play and the particular interests of the parties involved.

16. Letters of credit other than stand-by letters of credit are not covered by the Convention. However, the Convention does recognize a right of parties to international letters of credit other than stand-by letters of credit to "opt into" the Convention (article 1(2)). That provision has been included in particular because the Convention provides a set of rules that parties to commercial letters of credit may wish in their own judgement to take advantage of, in view of the broad common ground between commercial and stand-by letters of credit, and in view of the occasional difficulties in determining whether a letter of credit is of a stand-by or commercial variety.

### **D. Definition of "independence"**

17. While it is widely recognized that undertakings of the type covered by the Convention are "independent", there has been a lack of uniformity internationally in the understanding and recognition of that essential characteristic. The Convention will promote such uniformity by providing a definition of "independence" (article 3). That definition is phrased in terms of the undertaking not being dependent upon the existence or validity of the underlying transaction, or upon any other undertaking. The latter reference, to other undertakings, clarifies the independent nature of a counter-guarantee from the guarantee that it relates to and of a confirmation from the stand-by letter of credit or independent



guarantee that it confirms.

18. In addition, to fall within the scope of the Convention, an undertaking must not be subject to any terms or conditions not appearing in the undertaking. It is specified that, to fall within the Convention, an undertaking should not be subject to any future, uncertain act or event, with the exception of presentation of a demand and other documents by the beneficiary or of any other such act or event that falls within the "sphere of operations" of the guarantor/issuer. That is in line with the notion that the role of the guarantor/issuer in the case of independent undertakings is one of paymaster rather than investigator.

#### **E. "Documentary" character of undertakings covered**

19. As an adjunct to being "independent" from the underlying transaction, the undertakings covered by the Convention possess a "documentary" character. This means that the duties of the guarantor/issuer when faced with a demand for payment are limited to examining the demand for payment and any supporting documents to ascertain whether the demand and other documents submitted conform "facially" with what is called for under the terms of the independent guarantee or stand-by letter of credit. The effect of this rule is that undertakings possessing "non-documentary conditions" are outside the scope of the Convention. The only conditions which would not have to be documentary in nature would relate to acts or events within the sphere of operations of the guarantor/issuer. A simple example of the latter would be a determination by the guarantor/issuer as to whether a required monetary deposit had been made in a designated account maintained with that guarantor/issuer.

#### **F. Definition of internationality**

20. The Convention limits its application to undertakings that are international. Internationality is determined on the basis of the places of business, as specified in the undertaking, of any two of the following being in different States: guarantor/issuer, beneficiary, principal/applicant, instructing party, confirmer (article 4(1)). Special rules are provided for the case of an undertaking listing more than one place of business for a party, as well as for the case of a party not having a "place of business" as such, but only a habitual residence (article 4(2)).

#### **G. Connecting factors for application of the Convention**

21. The Convention applies to international undertakings in either one of two ways. The first way is linked to the location of the guarantor/issuer in a State party to the Convention ("Contracting State") (article 1(1)(a)). The second way in which the Convention applies is if the rules of private international law lead to the application of the law of a Contracting State (article 1(1)(b)).

22. The Convention provides an additional layer of harmonization of law in this field, in that its chapter VI (Conflict of laws, articles 21 and 22) supplies the rules to be followed by courts of Contracting States in identifying in any given case the law applicable to an independent guarantee or a stand-by letter of

credit. Those rules apply whether or not in a particular case it turns out that the Convention is the applicable substantive law for the independent guarantee or stand-by letter of credit in question (see paragraphs 52 and 53, below).

## **II. INTERPRETATION**

23. The Convention contains a general rule that interpretation of the Convention should be with a view to its international character and the need to promote uniformity in its application (article 5). In addition, interpretation is to have regard for the observance of good faith in international practice. Abstracts of any court decisions or arbitral awards applying and interpreting a provision of the Convention will be included in the case collection system called case law on UNCITRAL texts (CLOUT).

## **III. FORM AND CONTENT OF UNDERTAKING**

24. The Convention provides rules on several aspects of the form and content of undertakings, as summarized below.

### **A. Issuance**

25. On the question of the point of time and place of issuance (i.e. when and where the obligations of the guarantor/issuer to the beneficiary become operative), the Convention promotes certainty in an area traditionally of some uncertainty owing to the existence of differing notions. The Convention rule is that issuance occurs when and where the undertaking leaves the sphere of control of the guarantor/issuer (e.g. when it is sent to the beneficiary)(article 7(1)). In addition, the Convention defines issuance in terms of its practical effect. Once issued, the undertaking is available for payment in accordance with its terms and is irrevocable.

26. As is customary in legal texts of UNCITRAL, the Convention establishes a flexible and forward-looking form requirement for issuance. By requiring a form that preserves a complete record of the text of the undertaking, rather than referring to "written" form, the Convention accommodates issuance in a non-paper-based medium (e.g. by means of electronic data interchange). It does so by referring to issuance in any form that preserves a complete record of the text of the undertaking and provides a generally acceptable or specifically agreed means of authentication (article 7(2)).

27. The Convention does not deal with the question of capacity to issue undertakings (i.e. who is permitted to be a guarantor/issuer). That question, which raises regulatory or other legal implications that differ from country to country, is left to national law.

### **B. Amendment**

28. Legislative recognition is given by the Convention to the rule of practice that amendment of an undertaking requires acceptance by the beneficiary in order to take effect, unless it is otherwise

stipulated (article 8(3)). The Convention takes cognizance of the possibility that an amendment might be authorized in advance by the beneficiary. In such cases, the amendment takes effect upon issuance (article 8(2)).

29. In one of the few provisions of the Convention that directly addresses the relationship between the principal/applicant and the guarantor/issuer, it is made clear that an amendment has no effect on the rights and obligations of the principal/applicant, or for that matter of an instructing party or of a confirmer, unless such other person consents to the amendment (article 8(4)).

### **C. Transfer and assignment**

30. The Convention reflects the distinction drawn in practice between, on the one hand, transfer to another person of the original beneficiary's right to demand payment and, on the other hand, assignment of the proceeds of the undertaking, if payment is made. In the case of assignment of proceeds, as contrasted with transfer, the right to demand payment remains with the original beneficiary, the assignee being given only the right to receive the proceeds of payment if such payment occurs.

31. Regarding transfer, the Convention endorses the dual requirement, found in UCP, that the undertaking itself must state that it is transferable, and that, in addition, any actual transfer must be consented to by the guarantor/issuer (article 9). The rationale is that a change in the person who is to present the demand for payment and any accompanying documents may increase the risk assumed by the guarantor/issuer (e.g. if the guarantor/issuer would feel that the proposed transferee was less reliable or familiar than the originally designated beneficiary). For that reason guarantor/issuers are given the opportunity to consent to any given transfer.

32. Regarding assignment of proceeds, the beneficiary of the undertaking may, unless otherwise stipulated in the undertaking or elsewhere agreed, assign the proceeds (article 10(1)). If the beneficiary assigns the proceeds and if the guarantor/issuer or another person obliged to effect payment has received a notice originating from the beneficiary, payment to the assignee discharges the obligor, to the extent of its payment, from liability under the undertaking (article 10(2)).

### **D. Cessation of right to demand payment**

33. The Convention gives legislative effect to notions of cessation of the right to demand payment that are widely followed in practice, though not yet universally recognized in national laws or judicial precedents. Under the Convention (article 11), the events that trigger cessation include: a statement by the beneficiary releasing the guarantor/issuer; a termination of the undertaking agreed by the guarantor/issuer; full payment of the amount stipulated in the undertaking, unless the undertaking provided for automatic renewal or increase of the amount available; expiry of the validity period of the undertaking. By affirming that the presentation of the demand for payment has to occur prior to the expiry of the undertaking, the Convention will help to overcome any remaining uncertainty as to that question.



34. A degree of uncertainty still surrounds, in some jurisdictions, the question of the effect of retention of the instrument embodying the undertaking as regards definitive cessation of the right to demand payment. The Convention, in line with what is regarded widely as the best practice, provides that in no case does retention of the instrument prolong the right to demand payment if the amount available has already been paid or if the undertaking has expired (article 11(2)). Apart from those two contexts, the parties remain free to stipulate a requirement of return of the undertaking in order to terminate the right to demand payment.

### **E. Expiry**

35. The Convention provides (article 12) that the validity period of an undertaking expires in the following ways: at the expiry date, which may be a fixed date or the last day of a fixed period stipulated in the undertaking; if expiry is linked to the occurrence of an act or event, upon presentation of the document called for in the undertaking to indicate the occurrence of the act or event, or, if no such document is called for, by presentation by the beneficiary of certification for that purpose; or after six years from issuance, if no expiry date has been stipulated or if a stipulated expiry act or event has not occurred.

## **IV. RIGHTS, OBLIGATIONS AND DEFENCES**

### **A. Determination of rights and obligations**

36. The rights and obligations of the guarantor/issuer and the beneficiary are determined by the terms and conditions of the undertaking (article 13(1)). Express reference is made in the Convention to rules of practice, general conditions or usages (e.g. UCP, URDG) to which the undertaking is specifically made subject. This is in line with a main purpose of the Convention, to give legislative support to the right of commercial parties to incorporate such rules of practice, conditions or usages. That approach ensures that the Convention will remain a living instrument, sensitive to developments in practice, including future revisions of rules of practice such as UCP and URDG and the development of other international rules of practice.

37. The flexible linking of the Convention to the needs and evolving usages and standards of commercial practice is also referred to elsewhere in the Convention. For example, in the interpretation of the terms and conditions of an undertaking and in settling questions not addressed by the Convention, regard is to be had to generally accepted international rules and usages of independent guarantee or stand-by letter of credit practice (article 13(2)).

38. Similarly, the standard of conduct of the guarantor/issuer, based on good faith and the exercise of reasonable care, is to be defined by reference to generally accepted standards of international practice of independent guarantees and stand-by letters of credit (article 14(1)). While the Convention leaves open the possibility of stipulating a standard somewhat lower than the generally applicable standard of care, it clearly prohibits any exemption of the guarantor from liability for lack of good faith or gross negligence.



## **B. Demand by beneficiary**

39. As regards the beneficiary, the process of demanding and obtaining payment involves presenting a demand for payment and any accompanying documents in accordance with the terms of the undertaking. In view of the documentary character of the demand, the form requirements of the Convention applicable to the undertaking itself (see paragraph 27, above) apply to the demand (article 15(1)). The place of presentation is at the counters of the guarantor/issuer at the place of issuance, unless some other place or person is stipulated for payment purposes (article 15(2)).

40. In addition, the Convention provides (article 15(3)) that by virtue of making a demand the beneficiary implicitly certifies that the demand is not made in bad faith and that none of the circumstances exist that would justify non-payment in accordance with the provisions of the Convention on fraudulent or abusive demands for payment (see paragraphs 47 and 48, below).

## **C. Examination of demand and payment**

41. The duty of the guarantor/issuer is to examine the demand and any accompanying documents to determine whether they are in facial conformity with the terms and conditions of the undertaking and consistent with one another (article 16(1)). That determination is to have due regard to the applicable standard of international practice, a formulation that ensures that the Convention takes account of developments in practice as regards the notion of facial conformity.

42. In a provision expressly subject to variation by the terms of the undertaking, the guarantor/issuer is given a "reasonable time", up to a maximum of seven days, to examine the demand and to decide whether to pay (article 16(2)). Thus, what is deemed a "reasonable time" may well be less than seven days, but in no case more than seven days, unless some different period is stipulated. This takes into account that the time needed for examination of the demand would depend upon the nature of each case (e.g. volume and complexity of documents to be examined).

43. If a decision is taken not to pay, the guarantor/issuer is required to promptly so notify the beneficiary, indicating the grounds therefor (article 16(2)). If the demand is determined to be conforming, payment is to be made promptly, or at any later time stipulated in the undertaking.

44. The Convention recognizes that the guarantor/issuer may, unless the undertaking provides otherwise, discharge the payment obligation by exercising a right of set-off that is generally available under the applicable law (article 18). However, the Convention does not recognize any such right of set-off with respect to claims assigned by the principal/applicant or instructing party, as such a possibility would risk undermining the purpose of the undertaking.

## **D. Fraudulent or abusive demands for payment**

45. A main purpose of the Convention is to establish greater uniformity internationally in the manner in which guarantor/issuers and courts respond to allegations of fraud or abuse in demands for payment under independent guarantees and stand-by letters of credit. That has been a particularly troublesome and disruptive area in practice because allegations of fraud have a tendency to arise when there is a dispute as to the performance of an underlying contractual obligation. That difficulty and the resulting uncertainty have been compounded further because of the divergent notions and ways with which such allegations have been treated both by guarantor/issuers and by courts approached for provisional measures to block payment.

46. The Convention helps to ameliorate the problem by providing an internationally agreed general definition of the types of situations in which an exception to the obligation to pay against a facially compliant demand would be justified (article 19(1)). The definition encompasses fact patterns covered in different legal systems by notions such as "fraud" or "abuse of right". The definition refers to situations in which it is manifest and clear that any document is not genuine or has been falsified, that no payment is due on the basis asserted in the demand or that the demand has no conceivable basis.

47. For additional precision, the Convention provides illustrative examples of cases in which a demand would be deemed to have no conceivable basis (article 19(2); e.g. the underlying obligation has been undoubtedly fulfilled to the satisfaction of beneficiary; the fulfilment of the underlying obligation clearly has been prevented by wilful misconduct of beneficiary; 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).

48. The Convention, by entitling but not imposing a duty on the guarantor/issuer, as against the beneficiary, to refuse payment when confronted with fraud or abuse (article 19(1)), strikes a balance between different interests and considerations at play. By allowing discretion to the guarantor/issuer acting in good faith, the Convention is sensitive to the concern of guarantor/issuers over preserving the commercial reliability of undertakings as promises that are independent from underlying transactions.

49. At the same time, the Convention affirms that the principal/applicant, in the situations referred to, is entitled to provisional court measures to block payment (article 19(3)). This recognizes that it is the proper role of courts, and not of guarantors/issuers, to investigate the facts of underlying transactions. Furthermore, the Convention does not annul any rights that the principal/applicant may have in accordance with its contractual relationship with the guarantor/issuer to avoid reimbursement of payment made in contravention of the terms of that contractual relationship.

## **V. PROVISIONAL COURT MEASURES**

50. Apart from entitling a principal/applicant or an instructing party to provisional court measures blocking payment or freezing proceeds of an undertaking in the types of cases referred to above, the Convention establishes a standard of proof to be met in order to obtain such provisional measures (article 20(1)). That standard refers to ordering of provisional measures on the basis of immediately

available strong evidence of a high probability that the fraudulent or abusive circumstances are present. Reference is also made to consideration of whether the principal/applicant would be likely to suffer serious harm in the absence of the provisional measures and to the possibility of the court requiring security to be posted.

51. While authorizing provisional court measures in the cases concerned, the Convention minimizes the use of judicial procedures to interfere in undertakings by limiting the granting of provisional court measures to those types of cases, with one additional type of case. Provisional court orders blocking payment or freezing proceeds are also authorized in the case of use of an undertaking for a criminal purpose (article 20(3)).

## **VI. CONFLICT OF LAWS**

52. As noted above (paragraph 22), the Convention contains in chapter VI conflict of law rules to be applied by the courts of Contracting States in order to identify the law applicable to international undertakings as defined in article 2, regardless of whether in any given case the Convention itself would prove to be the applicable law. Those conflict of laws rules recognize a choice of law stipulated in the undertaking or demonstrated by its terms or conditions, or agreed elsewhere by the guarantor/issuer and the beneficiary (article 21).

53. In the absence of a choice of law as described above, the Convention provides for application to the undertaking of the law of the State where the guarantor/issuer has that place of business at which the undertaking was issued (article 22).

## **VII. FINAL CLAUSES**

54. The final clauses (articles 23-29) contain the usual provisions relating to the Secretary-General of the United Nations as depositary and providing that the Convention is subject to ratification, acceptance or approval by those States that have signed it by 11 December 1997, that it is open to accession by all States that are not signatory States and that the text is equally authentic in Arabic, Chinese, English, French, Russian and Spanish.

55. In view of its largely suppletive character, as well as of the right of parties to exclude the Convention in its entirety, no reservations are permitted. The Convention enters into force one year from the date of deposit of the fifth instrument of ratification, acceptance, approval or accession.

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