# The UN Convention on Independent Guarantees and Stand-by Letters of Credit

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## I. Introduction

In this contribution, brief attention will be given to the recent UN Convention on Independent Guarantees and Stand-by Letters of Credit (Convention),[1] which was adopted

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1. U.N. CONVENTION ON INDEPENDENT GUARANTEES AND STAND-BY LETTERS OF CREDIT, UNITED NATIONS, 1995, at 10. For further literature concerning the Convention see Bertrams, R.I.V.F., UNCITRAL CONVENTION ON INDEPENDENT GUARANTEES AND STAND-BY LETTERS OF CREDIT, WPNR 1996, at 590–595; *see also* Bertrams, R.I.V.F., BANK GUARANTEES IN INTERNATIONAL TRADE (2nd ed.——); *The Hague*, KLUWER LAW INTERNATIONAL, 428, 1996 (with references in particular parts to articles of the Convention); J. Stoufflet Int'l, La Convention des Nations Unies sur les garanties independantes et les lettres de credit stand-by, Revue de droit bancaire et de la bourse, 132–139 (1995); R. Fayers, The latest UNCITRAL text raises some intriguing questions about the relationship of the Convention/Model Law with the UCP, *Documentary Credits Insight*, Spring 1995, at 22–23; E. Bergsten, *A New Regime for International Independent Guarantees and Stand-By Letters of Credit: The UNCITRAL Draft Convention on Guaranty Letters*, 27 INT'L LAW, 859–879 (1993); H. Harfield, *Guaranties, Stand-by Letters of Credit and Ugly Ducklings*, 26 UCCLJ 195–203 (1994); G.W. Jones, *UNCITRAL Draft Convention on International Guaranty Letters*, INT'L BUS.LAWYER 28–34 (1994); J.E. Byrne & H. Burman, Introductory Note, *United Nations Convention on Independent Guarantees and Stand-by Letters of Credit*, 35 I.L.M. 735–738 (1996); L. Gorton, *Draft UNCITRAL Convention on Independent Guarantees*, LLOYDS' MAR.COM.L.Q. 175–191 (1996), J. BUS. L. 240–253 (1997); G. Herrmann, THE UNCITRAL DRAFT CONVENTION ON INDEPENDENT GUARANTEES AND STAND-BY LETTERS OF CREDIT, 323–331, Twenty-First International Trade Law Conference (Attorney-General's Department and Law Council of Australia) (Canberra, Australia, 1994); M. Sneddon, *Letters of Credit* 331–341, in Twenty-First International Trade Law Conference (Attorney-General's Department and Law Council of Australia) (Canberra, Australia, 1994); A. Markus, UNO-Konvention über unabhängige Garantien und stand-by letters of credit, 72 (Zurich, Schulthess 1997); N. Horn, *The United Nations Convention on Independent Guarantees and the Lex Mercatoria*, Centro di studi e ricerche di diritto comparato e straniero (Saggi, Conferenze e Seminari, No. 30, Roma) (1997); N. Horn, *Die UN-Konvention über unabbüngige Garantien: ein Beitrag zur lex mercatoria*, 717–723 RIW (1997) ; A. Giampieri, *La Convenzione Uncitral sulle garanzie autonome e le stand-by letters of credit, Prime considerazione, Diritto del commercio internazionale* 807–828 (1995); J. Dolan, *The UN Convention on International Independent Undertakings: Do States with Mature Letter-of-Credit Regimes Need It?*, 13 Banking & Finance L. Rev.1–23 (1998); J. Dolan, *The Law of Letters of Credit*, 7–14 (Rev. ed., A.S. Pratt & Sons, 1999).

The convention was also discussed in two unpublished dissertations, *see* B.G. Affaki, L'unification internationale du droit des garanties indépendantes, 783 (1995) Paris II;. and G. Bögl, Internationale Garantieverträge: Probleme und Reformbestrebungen, (1993) [unpublished dissertation, Regenburg, 167].

by the General Assembly of the United Nations on December 11, 1995. In 1988,[2] the *United Nations Commission on International Trade Law* (UNCITRAL), a UN organization specializing in codifying and unifying international trade law, began preparing for the Convention. Once the preparatory work for the Convention was concluded in 1995, the draft convention was presented to the General Assembly.[3] States have been given a two year period to sign the Convention. Thereafter, they should accede to it. As of the date of writing, Belarus and the United States of America have signed the Convention and Ecuador, El Salvador, Kuwait, Panama, and Tunisia have ratified it.[4] In accordance with Article 28, the Convention will enter into force on the first day of the month following the expiration of one year from the deposit of the fifth instrument of ratification. Because Tunisia, the fifth state, deposited its ratification on December 8, 1998, the Convention will thus enter into force on January 1, 2000.

The aim of this article is to determine whether other countries should consider acceding to and ratifying the Convention. In addition, the possible influences of the Convention on the practice of bank guarantees and stand-by letters of credit will be discussed.

## II. Bank Guarantees and Stand-by Letters of Credit: Development and Sources

### A. Definitions

Bank guarantees and stand-by letters of credit are fairly recent bank products. A bank guarantee can be described as a personal security under which a bank promises payment to a beneficiary if an account party (often the bank's client) defaults in the performance of its obligation. Then, the bank pays if the documents presented with the demand for payment comply with the documents that are mentioned in the text of the bank guarantee. For this reason the bank's obligations are autonomous from the underlying agreement between the beneficiary and the account party,[5] which means that in principle the bank must pay if proper complying documents are presented even if the beneficiary and the account party have not stipulated that there is a default under the original agreement.

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2. The first relevant UNCITRAL document was dated 21 March 1988 (A/CN.9/301). A review of the preparatory UNCITRAL documents can be found in UNCITRAL Doc. A/CN/.9/WG.II/WP.84 (1994). These documents comprise the *Travaux Préparatoires* of the Convention, and are essential for its interpretation and application. All these documents may also be found in the UNCITRAL Yearbooks.

Of further interest, the Secretariat of UNCITRAL has published an explanatory report on the convention, which is an unofficial commentary and intended to be purely informative. (*Explanatory Note by the UNCITRAL Secretariat on the United Nations Convention on Independent Guarantees and Stand-By Letters of Credit*, U.N. Doc. A/CN.9/431 (1996).

3. For a while, it was unclear whether the unifying text would become a model law or a convention. Except for the contentions that a convention is capable of achieving greater unity, while a model law leaves greater freedom and flexibility to states regarding implementation, the essential arguments on which the final choice rested were not discussed.

4. Information obtained from the UNCITRAL-Secretariat on March 1, 1999. The status of the convention is as follows: Belarus signed on Dec. 3, 1996; Ecuador ratified on June 18, 1997; El Salvador ratified on July 31, 1998; Kuwait ratified on Oct. 28, 1998; Panama ratified on May 21, 1998; Tunisia ratified on Dec. 8, 1998; United States signed on Dec. 11, 1997.

5. In this regard, guarantees and stand-by letters of credit differ from "contract bonds" or "surety bonds," in which the security lender is only involved if the principal party defaults in the performance of an obligation. The International Chamber of Commerce (ICC) has established rules for contract bonds in its publication *ICC Uniform Rules for Contract Bonds* (ICC Publ. no. 524, Paris, ICC Publishing, 1993, 20 pp.).

Stand-by letters of credit are similar products that were developed in the United States. The main difference between bank guarantees and letters of credit is that stand-by letters of credit are usually drafted in the form of a letter of credit. Stand-by letters of credit are highly similar to bank guarantees regarding their function and legal *régime* although they differ regarding their form, in that stand-by letters of credit involve documentary credits.[6] However, the most important difference between bank guarantees and stand-by letters of credit is to be found in the fact that in the United States, unlike in other countries, stand-by letters of credit are used much more to guarantee money obligations (as opposed to performance obligations) incurred in transactions on the capital markets. This has caused difficulty in international unification because liquidity of stand-by letters of credit is even more important than under bank guarantees.

### B. Development

The use of bank guarantees and stand-by letters of credit has grown spectacularly since the 1960s. As the result of the Iranian revolution of 1979 and the resulting political tension which arose between Iran and the United States, both bank guarantees and stand-by letters of credit led to a multitude of procedures involving the key question whether payment by a Western bank to an Iranian beneficiary (often through an Iranian bank) could be obstructed by petitioning judges or arbitrators for provisional and conservatory measures to prevent payment. The grounds for the request for such measures were often the allegation of fraud committed by the Iranian beneficiary. However, since the mid-eighties, litigation surrounding guarantees and stand-by letters of credit has diminished and in some countries practically dried up. This situation didn't change in relation to the Iraqi attack on Kuwait in 1990 which did not lead to many disputes involving guarantees and stand-by letters of credit,[7] partially as the result of international sanctions against Iraq which made payments under guarantees and stand-by letters of credit illegal. However, one cannot exclude that in the future new diplomatic tensions or adverse economic circumstances might change the present picture drastically.

As a result of the Iranian litigation of the 1980s, the law on guarantees and stand-by letters of credit was strongly tested but its cornerstones remained by and large intact. Thus, bank guarantees and stand-by letters of credit managed to survive fairly well.

### C. Sources

In most countries both of common and civil law origins, there are no explicit statutory rules for guarantees and stand-by letters of credit. Disputes must, therefore, be primarily tackled under explicit contractual provisions, unwritten rules, principles of contract and commercial law, and case law. The most important exception to this is the United States. In the United States, stand-by letters of credit developed for bank regulatory reasons. As a result, disputes could be decided under Article 5 of the Uniform Commercial Code (UCC), which governs letters of credit.[8] However, a number of problems regarding documentary

6. For a further discussion, *see* F. De Ly, *Garanties en standby letters of credit*, Revue de droit commercial belge,172–174 (1986); M. Richter, *Standby letter of credit*, Eine systematische Darstellung unter besonderer Berucksichtingung des US-amerikanischen Rechts, Zurich, Schulthess 338 1990.

7. For an exception, see the Italian case of Tribunale Livorno, June 4, 1996, Diritto del Commercio Internazionale 1997, 191, case note M. Roli.

credits are not addressed in Article 5 of the UCC, such as the requirements for temporary and conservative measures. On crucial points regarding letters of credit, the UCC is characterized by open standards, such as fraud as an exception to the bank's obligation to pay. For these reasons, the UCC, in many respects, does not provide the United States with greater legal certainty in comparison to other countries in which no specific regulations exist. The absence of regulations in most countries and the number of disputes raised the necessity of developing guidelines or rules for guarantees and stand-by letters of credit. In general, one can distinguish between two points of view.[9] On one side of the spectrum, in certain commercial and industrial sectors (such as the construction world) it was argued that guarantees and stand-by letters of credit were biased in favor of the beneficiary and extended too much protection to the banks. As a result, the risks from fraud could be shifted far too easily to the account party.[10] On the other side of the spectrum, arguments of market economics prevailed. The bargaining positions of the parties should control, implying that the beneficiaries dictate the terms of guarantees and stand-by letters of credit in a buyer's market while account parties do so in a seller's market. In a buyer's market, account parties have a choice either to take the risk and grant beneficiaries strong guarantees or not to engage in a contract with the beneficiary.

### D. Self-Regulation

Considering the highly international character of the market for guarantees and stand-by letters of credit and the possibility of regulatory competition between various countries, there have been few initiatives at the national level to design regulations. Thus, initiatives have primarily been developed at the international level where a distinction should be made between self-regulation and official regulation. Concerning the former, one should focus on the work of the International Chamber of Commerce (ICC). As early as 1978, the ICC published *Uniform Rules for Contract Guarantees* (UCG).[11] These rules were intended to serve as a means of balancing the interests of account parties, beneficiaries, and banks, and were only relevant for guarantees for which proof was provided of the account party's default in the performance of his obligation. Consequently, the UCG were not appropriate for the

8. Article 5 was recently revised by the National Conference of Commissioners on Uniform State Laws. The revised Article 5 is being presented to the various state legislatures for approval and is gradually becoming law in the various states. As far as can be speculated, the revised text of Article 5 does not affect any essential elements regarding stand-by letters of credit.

The recent revision of the law on stand-by letters of credit in the United States, poses the question of whether there will be an interest in ratifying the UNCITRAL Convention (which, by the way, was expressly mentioned in the commentary on the revised Section 5–101), also because bank guarantees are used infrequently. At the moment, different views seem to exist as to the answers to this question (*see* Dolan, *supra* note 1, at 4) but the recent signature by the United States of the convention as well as the adoption of ISP98 (see hereafter) to meet U.S. concerns may indicate that the U.S. is on its way to ratify the convention.

For a recognition of the convention from the bank regulatory perspective, see the U.S. Comptroller of the Currency Interpretive Ruling at 12 C.F.R. § 7.1016.

9. *See also* regarding this discussion with respect to the right balancing of the interests involved, G. Schrans, *Eenvormige regels voor autonome garanties, in Liber amoricum Paul De Vroede, Antwerp, Kluwer* 1168–1169 and 1178–1179 (Part II) (1994) and Horn, *supra* note 1, at 8.

10. For an example of this argument, *see* Th. De Galard, *Les Nouvelles Règles Uniformes de la Chambre de Commerce Internationale relatives aux Garanties sur Demande*, 759–764 RDAI/IBLJ (1993).

11. ICC Pub. No. 325, Paris; *see also Model Forms For Issuing Contract Guarantees*, 16 ICC Pub. No. 406, Paris.

regulation of demand guarantees where a mere request for payment triggers payment. Since at that time there was a buyers' market in relation to the oil crises and the recycling of petrodollars from the Arab world where demand guarantees were required, the UCG were seldom used. In response, the ICC attempted to formulate a code for demand guarantees, which was abandoned before completion.[12] As a result of the revision in 1983 of the Uniform Customs and Practice for Documentary Credits (UCP),[13] it was decided to specifically include stand-by letters of credit under the scope of the UCP,[14] through which the regulation of stand-by letters of credit was achieved. However, the incorporation of stand-by letters of credit into the UCP did not result in specific rules for this form of letters of credit and thus, the application of the UCP merely implied that the UCP's general letter of credit principles were expressly made applicable to stand-by letters of credit.

Bank guarantees were also codified. Using the model of the British Bankers Association as a basis, negotiations began for uniform rules for demand guarantees. This led in 1992 to ICC approval and the publication of *Uniform Rules on Demand Guarantees* (URDG).[15] The prevention of fraud is central to the URDG. The demand for payment must state the reasons for calling on the guarantee in order to meet the URDG's clear preference for reasoned demand guarantees.[16] The hope is that the requirement of providing reasons will prevent fraud. Von Westphalen, correctly in my eyes, doubts the effectiveness of reasoned demand guarantees.[17] Furthermore, in order to stop fraud it is imperative that the account party is informed about the demand for payment. Article 17 of the URDG obliges banks to do so but does not require[18] a bank to hold payment until the account party has been made aware of the demand and its reasons.[19] Banks at their discretion may wait with payment or may proceed with payment as long as the account party is informed. In case of fraud, the account party will then have the possibility of requesting provisional and/or conservatory measures from a competent court. However, since no requirement for withholding payment is imposed, the fraud prevention provided in Article 17 is without much

12. *See* further, F. De Ly, *International Business Law and Lex Mercatoria*, 185 Amsterdam, North Holland (1992).

13. ICC Pub. No. 400, Paris (1983).

14. Afterwards, no changes were brought about by the approval of the last revision of the UCP in 1993 (see Art. 1 UCP 500, 60 Paris, ICC Publishing, 1993). The use of the UCP 500 was—just as for the earlier versions of 1962, 1974, and 1983—recommended by UNCITRAL (see UNCITRAL Doc. A/CN.9/395 of April 29, 1994 and XXV UNCITRAL Y.B., 1994, 28).

15. ICC Pub. No. 45820, April 1992. The URDG were provided with an ICC commentary prepared by Professor R. Goode (*see Guide to the ICC Uniform Rules for Demand Guarantees*, 139, ICC Pub. No. 510 (ICC Publishing, Paris 1992). For a commentary, see F. De Ly, *Recente ontwikkelingen inzake bankgaranties*, 1418–1421 (NJB 1992); H.J. Pabbruwe, *Uniforme regels voor bankgaranties van de Internationale Kamer van Koophandel*, 921–925 (WPNR 1993); Bertrams, R.I.V.F., *Uniforme regels voor bankgaranties van de Internationale Kamer van Koophandel*, 95–100 (TVVS 1993); Bannier, F.A.W., *ICC Uniform Rules for Demand Guarantees*, 23–24 (Feb. 5, 1992); C. Martin & M. Delierneux, *Les nouvelles règles uniformes de la C.C.I. relatives aux garanties sur demande, Revue de droit commercial belge*, 288–328 (1993); M. Vasseur, *Les nouvelles règles de la Chambre de Commerce Internationale pour les garanties sur demande*, 239–296 (RDAI/IBLJ 1992); S. Piedelièvre, *Remarques sur les règles uniformes de la CCI relatives aux garanties sur demande*, Rev.trim.dr.com. 615–630 (1993).

16. M. Vasseur, *supra* note 15 at 248, 250.

17. F. Von Westphalen, Die neuen einheitlichen Richtlinien fur "Demand Guarantees," 2021 (DB 1992).

18. *See* R. Goode, *Guide to the ICC Uniform Rules for Demand Guarantees*, 86–87, ICC Pub. No. 510, Paris, ICC Publishing, 1992.

19. F. De Ly, *supra* note 15, at 1421; K.P. Berger, *Internationale Bankgarantien*, Deutsche Zeitschift fur Wirtschaftsrecht, 10 (1993); *compare* H.J. Pabbruwe, Bankgarantie, 20 (2nd ed., Deventer, Kluwer, 1995).

force if a bank decides to pay before the account party has been able to obtain interim relief. The URDG aim, however incompletely, is to achieve a more even distribution of risk between account parties and beneficiaries than was previously the case. From the side of the account parties, the rules have been applauded.[20] Also banks seem to approve of the URDG.[21] However, the success of the URDG will probably be varied. Since the URDG are not formulated custom or usage, they are contract terms to which parties must agree. In a buyers' market the beneficiary will frequently refuse to accept the URDG, which would worsen their position. The URDG seems to be preferable for markets in which the bargaining positions of account party and beneficiary are not clearly skewed. Since the URDG do not replace the UCG, both rules will remain in force at the same time.

In the aftermath of the Convention's negotiations (1988–1994) and as a result of U.S. concerns about the application of the Convention to the U.S. financial stand-by letter of credit market,[22] the Maryland based Institute of International Banking Law & Practice, with the support of the U.S. Council on International Banking (USCIB, now the International Financial Services Association) embarked on a project to formulate self-regulatory rules for the U.S. stand-by letter of credit market. This International Standby Practices Project (ISP Project) was aimed at providing self-regulatory rules that were more appropriate than the UCP to address stand-by letter of credit problems. Because the ICC did not initiate rules regarding stand-by letters of credit, the project started in the United States and not at the ICC level. The ISP Project led to *International Standby Practices* (ISP98) which were adopted by USCIB.[23] ISP98 were subsequently submitted to the ICC for approval and the ICC Banking Commission on April 6, 1998, endorsed the rules and they took effect as of January 1, 1999.[24] Also, the ISP project was intended to draft self-regulatory rules complimentary to the Convention in order to address the above-mentioned U.S. concerns. A consequence of specific U.S.-initiated self-regulation for stand-by letters of credit may be that the United States may now proceed with ratification of the Convention. Contrary to URDG, ISP98 do not attempt to police fraud. Under Rules 4.16 and 4.17 of ISP98, a demand for payment under a stand-by letter of credit subject to ISP98 should not indicate a default or other event under the underlying transaction if that is not required under the terms of the stand-by letter of credit. Furthermore, the issuer under Rule 3.10, unlike under Article 17 URDG, is not required to notify the account party of receipt of a demand for payment under the stand-by.

From the foregoing, it appears that regarding guarantees and stand-by letters of credit, four instruments for self-regulation are available:[25] 1) the UCP for stand-by letters of credit;

20. De Galard, *supra* note 10, at 764.

21. *See* H.J. Pabbruwe, *supra* note 15, at 921–925.

22. These concerns were already raised in 1992 by the U.S. delegation to the UNCITRAL working sessions and led to the ultimately unsuccessful U.S. proposals to incorporate into the convention specific rules on stand-by letters of credit (*see* UNCITRAL Doc. A/CN.9/WG.II/WP.77 (1992).

23. International Standby Practices (ISP98) ICC Pub. No. 590, 76 (ICC Publishing, Paris Oct. 1998). For a commentary, *see* J. Byrne, *The Official Commentary on the International Standby Practices* 353, J. Barnes, Montgomery Village, Institute of International Banking Law & Practice (ed. 1998).

24. For further discussions *see* J. Byrne, Standby Rulemaking: A Glimpse at the Elements of Standardization and Harmonization of Banking Practice, *in* NEW DEVELOPMENTS IN INTERNATIONAL COMMERCIAL AND CONSUMER LAW, PROCEEDINGS OF THE 8TH BIENNIAL CONFERENCE OF THE INTERNATIONAL ACADEMY OF COMMERCIAL AND CONSUMER LAW, 135–160, (J. Ziegel, ed., Oxford, Hart 1998); J. Dolan, THE LAW OF LETTERS OF CREDIT, REVISED EDITION, Chapter 4 at 94–113 (1999); J. Dolan, *Analyzing Bank Drafted Standby Letter of Credit Rules, The International Standby Practices (ISP98)*, WAYNE L.REV. 1999 (forthcoming).

2) the ISP98 for stand-by letters of credit; 3) the UCG for conditional guarantees;[26] and 4) the URDG for reasoned demand guarantees.

Parallel to the ICC's activities regarding bank guarantees and stand-by letters of credit, UNCITRAL has been working on a convention regarding guarantees and stand-by letters of credit, which culminated in the Convention of December 11, 1995 and will be discussed below in greater detail. Also, the relationship between the four previously mentioned forms of self-regulation and the need for a convention in addition to self-regulation, will be addressed.

## III. Summary of the Convention

### A. Closing Articles

The UN Convention on Independent Guarantees and Stand-By Letters of Credit is a relatively short convention consisting of merely seven chapters and twenty-nine articles. The last chapter contains the traditional closing articles of conventions regarding signature, ratification and accession, deposition of ratification instruments, implementation, denunciation, reservations, and implementation for states with more than one legal system. From the perspective of substantive law, these aspects are not very relevant.

However, two particular provisions deserve more attention. First, the Convention will be entering into force after only five ratifications or accessions. Considering the worldwide character of UNCITRAL harmonization attempts, the Convention can enter in force with the ratification by only five countries. However, the success of the Convention will not be determined by the speed of its entry into force, but rather by the particular countries which ratify it. The latter will be determined, among others, by the merits of the Convention. A second closing article that deserves further examination is the one regarding the prohibition of reservations to the Convention. The unifying model of the Convention is presented on a take-it- or-leave-it basis, which will strengthen the harmonization if the Convention becomes a success. On the other hand, it also puts the entire Convention at risk if a few articles meet with resistance to which no reservation is possible. Essential to this is the fraud exception.

### B. Contents of the Convention

The remaining chapters of the Convention consist of twenty-two articles and relate to the scope of application of the Convention, its interpretation, the form and content of the guarantee and stand-by letter of credit, the rights, obligations, and defenses of the parties involved, the provisional and conservatory measures available to prevent or block payment under the guarantee or stand-by letter of credit, and the applicable law. These articles will be dealt with briefly in light of their relevance to the central questions posed in this article:

25. One may deplore that UCP and ISP98 exist at the same time and that the next revision of the UCP did not incorporate specific rules for stand-by letters of credit. If ISP98 is not successful, this option may still be available. If ISP98 becomes a success, one might consider excluding stand-by letters of credit from the UCP. In that scenario, UCP would apply to commercial letters of credit and ISP98 to stand-by letters of credit. In any event, one may anticipate that some novel provisions in ISP98 may influence the next revision of the UCP.

26. Hereafter, URG will no longer be discussed because these rules are hardly used in practice.

the desirability of the ratification of the Convention and the importance of the Convention in practice.

### C. Conflict Rules

The Convention is innovative in its method of unification. Traditionally, unification of substantive law and private international law were seen as separate endeavors undertaken mainly by different harmonizing organizations. However, the Convention has chosen a combined method; Articles 1 through 20 contain substantive law rules while Articles 21 and 22 contain private international law rules. The latter aim merely to solve the problem of the applicable law. Initially the aim was also to include rules on international jurisdiction; however, this goal was later abandoned. Article 21 honors the choice of law clause as bank and beneficiary may agree which law is applicable to the guarantee or stand-by letter of credit. In the absence of a choice of law, the guarantee is governed by the law of the place where the bank has its business. These rules are separate from those governing the unification of substantive law, which have their own rules regarding the scope of application of the Convention (see below). This means that the conflict rules in the Convention apply even if the substantive rules of the Convention are not applicable. The conflict rules in the Convention are thus universally applicable for courts in a contracting state; that means that no link to contracting states is required.

### D. Territorial Scope of Application

The territorial scope of application of the substantive law articles of the Convention depends on two criteria. In the first place, the guarantee or stand-by letter of credit must be international. The Convention follows the dualistic method, which means that a difference is made between national and international guarantees and stand-by letters of credit. This was done for political reasons. UNCITRAL was afraid that overly ambitious unification would meet with too much resistance when it comes to ratification and as a result would damage the success of a unifying text. Therefore, the unification effort is limited to international guarantees and stand-by letters of credit. For instance, the United States may maintain Article 5 UCC upon an eventual ratification of the Convention in relation to domestic stand-by letters of credit which is particularly relevant for the U.S. capital markets.

In Article 4 of the Convention, the definition of an international guarantee and stand-by letter of credit is given. Generally, an undertaking is considered international if two of the parties involved (the account party, the beneficiary, the first and second bank) have their places of business or residence in two different countries. In international trade, this frequently will be the case.

Furthermore, independent guarantees and stand-by letters of credit must pass a second requirement to fall under the scope of the Convention. The Convention is applicable in two cases: 1) if the bank which issued the guarantee or stand-by letter of credit[27] has its place of business in a contracting state (direct applicability); or 2) if private international law rules determine that the law of a contracting state is applicable (indirect applicability).[28]

27. This is also valid for the extension of a counter-guarantee or the confirmation of a stand- by letter of credit (Article 6 sub (b) Convention).

28. In contrast to, for example, Article 1, 1 (b) of the Convention on the International Sales of Goods (CISG), no reservation is possible against this provision.

Once the Convention enters into force, a state's ratification of the Convention results in the international guarantees and stand-by letters of credit issued by banks in that country to fall under the rules of the Convention. Thus, the Convention will directly apply as of January 1, 2000 to international undertakings of banks having their places of business in Ecuador, El Salvador, Kuwait, Panama, and Tunisia. The Convention will also apply indirectly if courts in these countries under conflict rules determine that the law of any of these countries is applicable. Finally, courts in non-contracting states may also apply the Convention if their conflict rule leads to the application of the law of any of these countries although they are not under an international obligation to do so.

Contracting parties may exclude the direct or indirect application of the Convention by opting out. Whether this should be recommended depends partly on the quality of the substantive articles of the Convention (*see infra* Section IV and the Conclusion, *infra* Section V). Regarding opting out, the question most often raised is whether a reference in the guarantee to the URDG or a reference in the stand-by letter of credit to the UCP or ISP98 should be interpreted as an implicit exclusion of the entire Convention. This interesting point essentially is a question of contract construction but also involves the relationship between existing self-regulation and the Convention. Proponents of self-regulation will prefer to interpret a reference to URDG, UCP, or ISP98 as completely excluding the Convention, while proponents of official unification will argue that the URDG, UCP, and ISP98 are contractual provisions which must yield to the Convention in cases of conflict between the two. However this conflict should not occur frequently considering that during the preparation of the Convention, the URDG and UCP were taken into account. Also, in drafting ISP98, the Convention was taken into account. Finally, the Convention contains a few articles presenting optional and not mandatory rules. In practice, it should be possible to interpret the Convention and self-regulation primarily as parallel regulations with a complementary rather than conflicting purpose.

The absence of a general rule for the possibility of parties to partially exclude the Convention, should be seen in the context of the Convention as partially mandatory law, especially with regard to the exception of fraud and the provisional and conservatory measures available to prevent fraud. The Convention contains, therefore, not only optional rules. This means that parties have four options: 1) they completely exclude the Convention, including the Convention's rules on fraud, in which case national law rules are applicable in case of fraud; 2) they completely exclude the Convention and incorporate self-regulatory rules; 3) they do not completely exclude the Convention, and instead choose indirectly for the Convention, including mandatory rules in case of fraud; or 4) they do not exclude the Convention, and fall therefore under the Convention, including the rules in case of fraud, but are permitted, where the Convention allows, to deviate from optional rules (*e.g.*, by incorporating UCP, URDG or ISP98). This complex arrangement seeks to achieve a compromise between freedom of choice and mandatory unifying regulations for the prevention of fraud. The Convention does not place parties under mandatory rules, since they are free to exclude the Convention. Instead by exercising subtle pressure, it aims to create and harmonize mandatory law.

If the above-mentioned criteria regarding the scope of application of the Convention are not met, then the applicable conflict rules will determine which national law is to be applied to guarantees and stand-by letters of credit. This raises the question whether it still would be possible for parties to elect to fall under the Convention (opting in)? The Convention does not expressly provide for this. If parties would want this option, they would do best

to do this indirectly by choosing the law of a contracting state (see Article 1 (b) of the Convention). The benefit of this type of choice of law is, of course, partially dependent on the final judgment regarding the quality of the Convention (*see infra* Section IV)

### E. Substantive Scope of Application

The substantive scope of application of the Convention is determined in Articles 2 and 3. Influenced by Anglo-American legislative techniques, these articles present in a descriptive and empirical way the definition of independent guarantees and stand-by letters of credit. These are obligations to pay a specific amount in return for receiving a request for payment or other documents which indicate the default of the account party. From these articles emerge the security characteristics of the guarantee/stand-by letter of credit and their documentary nature. In addition, Article 3 defines their autonomous character: payment may not be dependent on elements outside of the text of the guarantee/stand-by letter of credit or have links with rights or obligations of an underlying transaction. This last reference covers non-autonomous obligations, such as those stemming from ancillary undertakings (e.g., suretyship) which were especially excluded from the Convention.

### F. Definitions and Construction

Chapter II of the Convention contains various definitions and principles of interpretation. It is sufficient to state that the Convention articles also apply—*mutatis mutandis*—to counter-guarantees and confirmations of stand-by letters of credit. In addition, the Convention must be interpreted according to its international character and the necessity of uniform application. Furthermore, the interpretation should take into account the need for promoting good faith in the international practice of bank guarantees and stand-by letters of credit.[29] Additionally, Article 13 (1) from Chapter IV provides that the rights and obligations of parties are determined by the articles in the Convention and the provisions in the guarantee/stand-by letter of credit, including its general conditions, and usages and rules to which it refers. This raises the questions as to where UCP, URDG, and ISP98 fit into Article 13 (1). This article does not expressly provide the hierarchy between contract terms, convention, and self-regulation. Considering the partially mandatory nature of the Convention, mandatory rules in the Convention will preempt other conflicting rules. However, questions concerning hierarchy shall not occur frequently since UCP, URDG, and ISP98 on the one hand and the Convention on the other hand complement each other well.[30]

Also, Article 13 (2) of the Convention states that for the interpretation of guarantee/stand-by letters of credit and for filling in the gaps in the Convention regard should be given for generally accepted international rules and usages in this area. Here, construction and gap-filling are addressed by a mere reference to international rules and usages and no reference is made to the role of the law applicable to the undertaking. A better means of

29. This article was inspired by Article 7 (1) CISG, which was also prepared by UNCITRAL.

30. *See in this regard* R. Illescas-Ortiz, International Demand Guarantees: The interaction of the Uncitral Convention and the URDG Rules of the ICC, in New developments in international commercial and consumer law, Proceedings of the 8th biennial conference of the International Academy of Commercial and Consumer Law, 161–169, (J. Ziegel, ed., Oxford, Hart 1998).

filling the gaps in the Convention could have been found, perhaps along the lines of Articles 7 (2) and 9 of CISG. In this regard, it is regrettable that the Convention could not better settle this question and more precisely the function that private international law has to play in the gap filling process. It is now unclear whether one must immediately fall back on applicable law or instead, as in CISG, look first for solutions within the Convention. This question is not without importance since, especially in the United States, a reference will frequently be made to Article 5 UCC when these gaps arise. For this reason, it is already argued in the United States that the Convention will not change very much, and that, therefore, ratification should take place. For most of the other legal systems without comprehensive regulations for documentary credit and guarantees, the case is different. However, the question remains how far unification of guarantee law reaches and when resort to the applicable law should occur. It is submitted that Article 5 of the Convention should control this debate and that its obligation to interpret in accordance with the international character of the Convention and the need to promote uniformity in its application finds its counterpart in the obligation for domestic courts not to fall back automatically on provisions of the law applicable to the undertaking.

### G. Extend or Pay and Expiry

Chapter III the Convention deals with the form and contents of the guarantee and stand-by letter of credit. These articles concern the issuance, amendment, cessation, and expiry of guarantees and stand-by letters of credit. A comprehensive discussion of these articles falls, partially considering their limited relevancy, outside of the scope of this article. However, two elements with regard to the expiry of guarantees and stand-by letters of credit deserve a short explanation. First, UNCITRAL has rejected its original desire to regulate the practice of *extend or pay* requests, under which the beneficiary before the expiry date of the guarantee requests an extension of the guarantee, or in the absence of an extension, payment. Usually the bank decides to extend. Article 26 of the URDG contains a few principles regarding extend or pay requests which do not bring into question the validity of these agreements and under which the payment obligation of the bank is suspended until the account party and the beneficiary have agreed with the extension. Absent such an agreement, the bank is obliged to pay. UNCITRAL on the other hand has not been successful in providing a code for these practices to prevent possible misuse.[31] In the absence of a regulation in the Convention, Article 26 of URDG remains worthwhile, which illustrates the possible complimentary nature of both rules. Similarly as in the Convention, ISP98 have not addressed nor attempted to solve the extend or pay dilemma (Rule 3.09 of ISP98).

A second element concerns the legal relevance of legislation and usages that determine that the guarantee/stand-by letter of credit can only expire if the beneficiary returns it to the bank. This practice involves the risk of blackmail by the beneficiary. Inspired by Articles 18, 22, 23, and 24 of URDG, Article 11 (2) of the Convention determines that the beneficiary cannot reserve his rights by not returning the guarantee/stand-by letter of credit to the bank if the bank has paid and the expiry date has passed. Similarly, Rule 9.05 of ISP98 provides that the retention of a stand-by does not preserve any rights after the right to demand payment has ceased. Thus, one notes an identical solution to this problem in URDG, ISP98, and in the Convention.

31. *See also*, Stoufflet, *supra* note 1, at 135–136.

## H. Payment, Fraud and Provisional Measures

The most important articles of the Convention are found in Chapters IV and V, which concern the bank's payment obligation and the exceptions to this obligation. The latter is primarily essential for gauging the soundness of the Convention. These are the achilles tendons of the entire regulation, its *pièce de résistance*. If these articles prove to be difficult for all parties on the market to accept, then the Convention will die a quick and silent death. If, however, they prove acceptable to certain parties on the market, then the Convention's entry into force will be a real option. In that case, it will depend on the negotiation skills of the parties and their respective bargaining positions whether the Convention will be contracted away or not.

With regard to the payment obligation, Articles 13 through 17 of the Convention determine that the bank must honor a payment demand if it meets the requirements in the guarantee/stand-by letter of credit.[32] The bank is given a reasonable amount of time to examine the demand (a maximum of seven working days). Article 19 of the Convention codifies the exception of fraud, primarily the cases in which the bank does not have to pay (payment is however permitted).[33] This article is immediately attached to the right of the account party to petition the court in the case of fraud, and to invoke his rights which are set out in Article 20 (for attachment proceedings see Article 19 (3) of the Convention). Accordingly, Articles 19 and 20 of the Convention provide respectively for the definition and description of the fraud exception and the measures available to the account party in such case. The Convention describes the exceptions to the autonomy of the guarantee/stand-by letter of credit as follows:

1. Any document is not genuine or has been falsified;
2. No payment is due on the basis asserted in the demand and the supporting documents; or
3. Judging by the type and purpose of the undertaking, the demand has no conceivable basis.

The second exception includes the so-called literal defenses—the defenses available which stem from the text of the guarantee/stand-by letter of credit and which the bank can use against the beneficiary. With the third exception, the Convention has formulated a general definition of the fraud exception. Considering that in different countries various descriptions are given for the circumstances under which it is possible to reject payment under a guarantee/stand-by letter of credit (fraud, abuse of right, manifestly unreasonable demand), it was decided to use a general formula for the fraud exception.[34] The disadvantage of this open formulation is that judges from various contracting states could interpret this provision in different directions. This risk has been reduced to some degree by the examples given in Article 19 (2) of the Convention of grounds for denying payment: 1) the risk which was covered by the guarantee/stand-by letter of credit has undoubtedly not materialized;

32. For recent Dutch case law, see Dutch Supreme Court, June 9, 1995, NJ 639, note PvS and the commentary of Bertrams in NTBR 1996, 27–30.

33. *See also* Stoufflet, *supra* note 1, at 138.

34. Nevertheless, it is difficult to deny that the new definition is inspired by American case law, *see e.g.*, Dynamics Corp. v. Citizens and Southern Nat'l Bank, 356 F. Supp. 991 (N.D. Ga. 1973) discussed in F. De Ly, *supra* note 6, at 186–187.

2) the underlying obligation was declared invalid under the applicable law;[35] 3) the underlying obligation was undoubtedly fulfilled in a way satisfactorily to the beneficiary; 4) the beneficiary willfully prevented the fulfilment of the underlying obligation; and 5) the counter-guarantor paid out the counter-guarantee in bad faith.

The regulation of the fraud exception in Article 19 is a success both politically and technically. Politically, a uniform and mandatory concept of fraud avoids regulatory competition between various legal systems and thus between the banking industries of different countries concentrating competition on the terms and prices of the banking products and not on regulatory issues.[36] Technically, the somewhat open-ended formulation of the fraud exception has avoided the unholy exercise of reaching a consensus regarding the notion of fraud of various national legal systems. Furthermore, the description of fraud is strong enough so that payment as a rule remains while refusal of payment is an exception. The examples in Article 19 (2) of the Convention make the rule sufficiently clear. Of course, an open uniform description has the disadvantage that judges in contracting states will interpret this concept differently. This risk is typical of unifying texts that do not provide for an international court to decide in a binding way how uniform law is to be interpreted. However, this risk can be controlled if there is sufficient information available in other countries regarding the interpretation of the unifying text. A few years ago, UNCITRAL developed a databank that contains court decisions on unifying texts (CLOUT—Case Law on UNCITRAL Texts). It also publishes summaries of recent decisions.

In Article 20 of the Convention, the legal remedies are provided which account parties can employ to prevent payment under the guarantee/stand-by letter of credit. In all probability, the text of Article 20 suggests that provisional rather than conservatory measures are intended. In many countries, summary proceedings (such as injunctive relief) could be interpreted as a provisional measure, although it is doubtful that conservatory attachments would fall under Article 20.[37] Under the Convention, the account party can request provisional measures under which the beneficiary will not receive payment (including the bank putting the funds into an escrow account) or in which the beneficiary's funds are blocked. This is only possible under the exceptions listed in Article 19 and if the guarantee/stand-by letter of credit is used for criminal purposes. Under procedural law, provisional measures have been given extra guarantees to prevent them from being accepted too often. Above all, the account party must present the circumstances set out in Article 19 in a way in which prima facie evidence is insufficient[38] ("immediately available strong evidence" is required[39]). The judge may only allow provisional measures if there is a "high probability" that the circumstances listed in Article 19 exist and it may be taken into account that the account party is "likely to suffer serious harm" if no provisional measure is taken.[40] With regard to

35. Exceptions to this are cases in which the guarantee/stand-by letter of credit would have covered this risk.

36. *Contra* DOLAN, supra note 1, at 16–21, who prefers that fraud be left to be governed by the domestic law of mature letter of credit and bank guarantee jurisdictions.

37. The text of Article 20, the requirements for provisional measures, and the cases in which provisional measures can be employed are arguments for keeping "conservatory attachments" and similar conservatory measures outside of the convention.

38. Regarding problems of evidence, *see* F. De Ly, *Indirecte garanties, betalingsverbod en bewijs, case note President Commercial Court Brussels*, May 26, 1988, REVUE DE LA BANQUE, 1990, at 171–172.

39. Stoufflet, *supra* note 1, at 138, assesses this requirement positively on the grounds that article 20 is not an open invitation for the judge to interfere.

provisional measures, the Convention is strict enough with account parties while still being flexible enough to permit the application of provisional measures in exceptional cases.

## IV. Assessment of the Convention

The following presents a list of the benefits of the Convention:

1. The Convention contains a uniform regulation in the area of guarantees and stand-by letters of credit under which the law of these international personal securities has become more transparent, the transaction costs for international commerce are reduced and the competition among international regulations and national legal systems has been diminished. Fifteen years ago, these uniform regulations would have been premature. In the meantime, however, security law has developed enough to warrant unification.[41]
2. The Convention contains mandatory law among others important in practice regarding fraud,[42] thereby achieving important unifying results.
3. Limiting unification to international guarantees and stand-by letters of credit could perhaps be regarded as a disappointment. From a more realistic political viewpoint, it is still necessary to consider that the United States has extensive rules which were recently revised, which codify both international and national stand-by letters of credit, and which in all likelihood it does not want to abandon for an international unifying instrument which also would extend to domestic transactions. However, countries which do not face a similar problem may decide to expand the convention rules to include internal domestic law (in civil law countries, for example, through incorporation in Civil Codes or in special statutes).
4. The combination of private international law and the unification of substantive law in one unifying instrument is a fortuitous choice and heightens the transparency at the international level of relevant rules.
5. The Convention concerns not only guarantees, but also stand-by letters of credit (in contrast to self-regulation, in which four forms of regulation exist side-by-side) so that the rules of the Convention—conforming with the UNCITRAL mandate—are available worldwide. In addition, similar rules are applicable to functionally equivalent bank products, which prevents competitive distortions between these different products eventually offered in different countries.
6. The Convention complements the existing self-regulation provided for in URDG, UCG, UCP, and ISP98. Parties on the market can choose between five types of instruments or a combination thereof: bank guarantees governed by the URDG; bank guarantees governed by the UCG; stand-by letters of credit governed by the UCP; stand-by letters of credit governed by ISP98; and instruments governed by the Convention. The Convention does not provide the account party with the highest amount

40. Also here there is an obvious influence of American law concerning the procedural requirements for injunctive relief. *See* De Ly, *supra* note 6, at 189.

41. *See* L. Gorton, *supra* note 1, at 48–49, and Bertrams, *supra* note 1, at 590–595, who doubt the timeliness of the convention in light of existing self-regulation. Official regulation and self-regulation are, however, complementary.

42. *See* UNCITRAL Doc. A/CN.9/301, 20–21.

of protection from fraud. In the UCG, the account party is protected by the requirement that a document is provided which proves default, while Article 17 of URDG requires that a demand for payment state the reasons. Under Article 15 (3) of the Convention none of this is required; the Convention limits itself to the statement that the beneficiary is considered to have judged whether or not the demand is made in good faith and whether the exceptions listed in Article 19 (1) apply. The weakness contained in the article concerning the beneficiary's examination of his own conscience shall in practice in cases of fraud prove to be meaningless and ineffective in countering fraud.[43] However the practical difference between URDG and the Convention in this perspective is not to be exaggerated; also the reasoned demand of payment by the beneficiary in many cases will not prevent fraud.

7. The majority of Convention articles prove to be acceptable considering they codify law in many countries and resolve controversial points in a defensible manner (see for example, Articles 9 and 10 with regard to assignment[44] or Article 18 with regard to set- off).

The following can be considered the drawbacks of the Convention:

1. The Convention does not provide a clear method for filling its gaps and in particular does not define the role of private international law in this endeavor.
2. The style of the Convention text is cumbersome in places and rather dominated by common law drafting techniques (as opposed to civil law rule making). However, this is fairly typical of attempts at unification in which political and legal cultural compromises must be made, rather than a true argument against unification.
3. Article 13 of the Convention does not contain rules for the extend or pay problem as in Article 26 of URDG.
4. The Convention does not contain sufficiently detailed rules for counter-guarantees or confirmation of stand-by letters of credit.[45]
5. The Convention fraud rules are defensible from the perspective of banks and beneficiaries. However, the account party is left in the cold if a demand for payment is made and the bank makes payment without notifying the account party. The Convention does not place an obligation on the bank to provide information[46] and to wait a few days before payment is made so that in cases of fraud the account party is not in a legal position to take immediate action. The Convention would have achieved a better balance by including an obligation to provide information and to delay payment.[47] Only then would market participants have been able to choose between strong

43. This solution is deplored by Stoufflet, *supra* note 1, at 135.

44. *See* H. J. Pabbruwe, *Nogmaals: overdracht van de rechten uit een abstracte bankgarantie*, WPNR 1995, 6194, at 605–606.

45. *See also*, Stoufflet, *supra* note 1, at 138.

46. For this discussion in the UNCITRAL Working Group and the divergent opinions and arguments, *see* UNCITRAL Doc. A./CN.9/345, 6–7; A/CN.9/361, par 24–29; A/CN.9/374, 18–19, A/CN.9/391, 29. From this last document it appears that an obligation to provide information was finally abandoned since it would be counter to the practice for stand-by letters of credit (including, in that case, the applicable UCP); in this context see the resistance of the U.S. in UNCITRAL Doc. A/CN.9/WP.II/WP.77 (Proposal of the United States of America) at 15. Wringing guarantees and stand-by letters of credit into one unifying instrument took its toll; a successful unification was considered more important than saving the obligation to provide information.

47. *See also* R.I.V.F. Bertrams, *Omtrent de waarschuwingsplicht van de bank bij de bankgarantie*, WPNR 1987, 5843, at 515–519; De Ly, *supra* note 6, at 176–179.

protection against fraud under URG documentary guarantees, moderate protection under the Convention and minimal protection under the URDG. In this instance the Convention is not innovative, and is too closely alligned with the self-regulation of URDG and UCP, by which it has missed an important chance. In practice, regarding fraud prevention, a choice will have to be made between URG on the one hand, and URDG, UCP, ISP98, or the Convention on the other.

6. There is a risk that the success and practical importance of the Convention may be reduced if ISP98 proved to become banking practice or to be used frequently in the United States particularly regarding financial stand-by letters of credit. Ratification of the Convention by the U.S. would force the U.S. banking industry to formulate its position regarding the relationship between the Convention and existing self-regulation. If that choice were to opt out of the Convention and to incorporate ISP98, the Convention would lose a lot of practical importance in relation to stand-by letters of credit issued by U.S. banks. Thus, the U.S. resistance against the Convention's attempts to harmonize both bank guarantee and stand-by letter of credit law in the end might succeed. Also, if this situation were to occur, one would see that the Convention's objective to function as a complement to self-regulation frustrated by ISP98, which in practice may work as a competitor to the Convention rules. On the other hand, this would offer market participants, particularly in relation to financial stand-by letters of credit, the choice between self-regulation of UCP and URDG as complemented by the Convention on the one hand and ISP98 on the other hand. This choice ultimately is to be determined by the respective bargaining positions of account parties, beneficiaries, and banks, but traditions and attitudes may also influence the decision process.

## V. Conclusion

In practice the Convention will not bring about tremendous change. The Convention rules barely attack the existing self-regulation, are mostly codifying, and are hardly innovative. One author has for that reason characterized the Convention as an expresssion of the *lex mercatoria*.[48]

For private practice, a systematic opting out at the expense of the Convention seems thus unnecessary, particularly since the application of the Convention does not exclude the incorporation of self-regulatory rules. As to the desirability of ratification of the Convention by countries, there often is a feeling of conservatism and shyness towards new rules. However, taking into account the analysis of this article, it might be better if cold water fear is overcome as it is obvious that the Convention's advantages outweigh the disadvantages. Primarily the fraud prevention could have been codified better in the Convention, but this was seemingly politically impossible. However, the economic advantages and the legal merits of the Convention imply that countries seriously should consider ratification of the Convention, and their position should not solely be determined by the stance of other states.

48. *See* Horn, *supra* note 1, at 1, 19.