

Article

The Independence of Demand Guarantees, Performance Bonds and Standby Letters of Credit

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I. INTRODUCTION

The principle of independence of demand guarantees, independent guarantees, performance bonds and standby credits (hereafter referred to as “documentary guarantees”) means that the payment undertaking contained in a documentary guarantee is separate from, and in the ordinary way independent of, the underlying contract giving birth to it; what the issuer is concerned with is whether the tendered documents, or even a simple demand, comply with the terms and conditions of the undertaking, rather than with the disputes arising from the underlying contract.¹ This principle coexists with the principle that the issuer in documentary credit and documentary guarantee transactions deals with documents rather than goods, services, or performance of the underlying contract,² and it is predicated on the intention of the parties to a documentary guarantee to let the beneficiary have access to prompt and certain payment should the underlying contract go wrong.³

II. THE PURPOSES AND FUNCTIONS OF THE PRINCIPLE OF INDEPENDENCE

The purpose of employing documentary guarantees in international commerce is to let the beneficiary have prompt and certain payment⁴ from a known solvent⁵ issuer in his country, pending resolution of underlying disputes with the funds in his pocket.⁶ It is a *prompt* way of obtaining payment in that the beneficiary can have funds in hand if his demand is apparently conforming. The payment is *certain* partly because the credit of the known solvent issuer is substituted for that of the overseas account party,⁷ and partly because the payment is triggered by a

1. *Richardson v. Polimex* 1 LLOYD'S REP. 161 at 16 (1978) 5; *Bergerco Canada v. Iraqi State Co. for Food Stuff*, 924 F. SUPP. 252, 258 (1996); *Ganz v. Lyons Partnership, L.P.*, 961 F. SUPP. 981, 986-987 (1997); cf. *Turkiye v. Bank of China* 1 Lloyd's Rep. 250 at 25 (1998) 1. As to the fraud exception to the principle of independence, see Chung-hsin Hsu, *The Fraud Exception to the Principle of Independence* 22 FU JEN LAW REVIEW 151 (2002).

2. R. JACK, DOCUMENTARY CREDITS 17, 18 (Rev. 2nd ed. 1996); C. Schmitthoff, *Conflict of Laws Issues Relating to Letters of Credit: An English Perspective*, in CURRENT PROBLEMS OF INTERNATIONAL TRADE FINANCING 103, 104 (Kee & Chan eds., 1990); *Montrud Ltd. v. Grundkoetter Fleischvertriebs GmbH (CA)* 1 W.L.R. 1975, 1985 (2002).

3. *Esal (Commodities) v. O.C.L* 2 LLOYD'S REP. 546 at 549. (1985).

4. *United City Merchants v. Royal Bank of Canada* A.C. 168 at 183 (1983); *Esal (Commodities)* 2 LLOYD'S REP. at 549; *Maurice O'Meara Co. v. National Park Bank*, 146 N.E. 636, 639 (1925); *Re Deloitte & Touche Inc.* 2 BANK. L.R. 307 at 310 (1993); *In Re Graham Square, Inc.*, 126 F. 3d 823, 827 (6th Cir. 1997).

5. *Matter of Compton Corp.*, 831 F. 2d 586, 590 (5th Cir. 1987).

6. *Ross Bicycles, Inc. v. Citibank, N.A.*, 613 N.Y.S. 2d 538, 541 (Sup. 1994).

7. *Banco General Ruminahui, S.A. v. Citibank Intern.*, 97 F. 3d 480, 482 (11th Cir. 1996); *Insurance Co. of North America v. Heritage Bank*, 595 F. 2d 171, 173 (1979); *Continental Nat. Bank v. National City Bank*, 69 F. 2d 312, 316 (1934); *Brown v. United States Nat. Bank of Omaha*, 371 N.W. 2d 692, 697 (Neb. 1985).

demand rather than proof of claim.⁸

In realizing this purpose, a documentary guarantee performs a risk distribution function.⁹ It shifts the burden of litigation¹⁰ in that the beneficiary can rapidly have the funds in hand by way of presenting an apparently conforming demand, and the account party must start proceedings if he wishes to reclaim the money.¹¹ It also shifts the burden of proof¹² and the risk of currency fluctuation; and, most importantly, it shifts the forum of litigation in a transnational transaction.¹³ To exercise these functions, a documentary guarantee has to be independent of the underlying contract, and the payment undertaking contained in it has to have minimal extraneous interference.

III. THE RATIONALES BEHIND THE PRINCIPLE OF INDEPENDENCE

It is a common practice for the employer under a construction contract to request the contractor to furnish a cash deposit or to place funds in an escrow account as security for the proper performance of the underlying obligation. As frozen capital is neither convenient nor economical to the contractor, a documentary guarantee issued by a reliable issuer is used in lieu of a cash deposit. To be a full substitute for the deposit and acceptable to the beneficiary (the employer), a documentary guarantee must be independent of underlying contractual disputes. Although the use of documentary guarantees places the account party (the contractor) at some risk, it is a result of negotiation and, indeed, he benefits from using the documentary guarantee as a substitute for the cash deposit. Thus, having realized the risks involved, if the account party still consents to the use of documentary guarantees, he must accept its consequences.¹⁴

The issuer, who has neither control over the making of the underlying contract nor over the selection of the beneficiary,¹⁵ and who is not

8. *Security Finance Group v. N. KY. Bank and Trust*, 858 F.2d 304, 307 (6th Cir. 1988).

9. M. Coleman, *Performance Guarantees* (1990) *L.M.C.L.Q.* 223 at 238.

10. *Itek Corp. v. First Nat. Bank of Boston*, 730 F. 2d 19, 24 (1984); *CKB & Assoc. v. Moore McCormack Petroleum*, 734 S.W. 2d 653, 655 (Tex. 1987); *Foxboro Co. v. Arabian American Oil Co.*, 805 F. 2d 34, 36 (1st Cir. 1986); *Insurance Co. of North America*, 595 F. 2d at 173.

11. *Urquhart Lindsay & Co. v. Eastern Bank, Ltd.* (1922) 1 K.B. 318 at 323; *Cargill Int. v. Bangladesh Sugar* (1996) 2 LLOYD'S REP. 524 at 528-529, affirmed by the Court of Appeal (1998) 1 W.L.R. 461 at 468, 469; *Comdel v. Siporex* (1997) 1 LLOYD'S REP. 424 at 431; *CKB & Assoc.*, 734 S.W.2d at 655.

12. N. Horn and E. Wymeersch, *Bank-guarantee, Standby Letters of Credit, and Performance Bond in International Trade*, in *THE LAW OF INTERNATIONAL TRADE FINANCE* 455, 529 (N. Horn ed., 1989).

13. J. DOLAN, *THE LAW OF LETTERS OF CREDIT* 3-32, 3-33, 3-34 (REV. ed. 1996).

14. R. GOODE, *COMMERCIAL LAW* 1038 (2d ed., 1995); *United Technologies Corp. v. Citibank, N.A.*, 469 F. Supp.473, 480 (1979).

15. *Ross Bicycles, Inc.*, 613 N.Y.S. 2d at 540; *Brown*, 371 N.W. 2d at 698.

specialized in the subject matter of the underlying contract, is not a suitable party to get involved in underlying disputes. In addition, the issuer, who charges a relatively tiny commission fee for its efforts, is not supposed to spend energy and resources on investigating the justification of the beneficiary's claim.¹⁶ Furthermore, the issuer's right of reimbursement depends on its adherence to the instructions from the account party, which will in turn form the terms of the documentary guarantee. The more uncertain the terms of the documentary guarantee become, the less certain its right of reimbursement becomes.¹⁷ Accordingly, for the protection of the issuer, its payment undertaking has to be independent from underlying disputes.

The integrity of documentary guarantees as a financial instrument is premised on the principle of independence. Documentary guarantees, like documentary credits, are the life blood of international commerce. Thrombosis will occur if, where fraud or illegality is not involved, the courts intervene and thereby disturb the mercantile practice of treating rights thereunder as being the equivalent of cash in hand.¹⁸ Further, as disputes arising from the underlying contract are commonplace, if the account party is free to use these disputes to stop payment, the assurance given to the beneficiary would be severely undermined,¹⁹ with the result that documentary guarantees would become unacceptable.

IV. THE RELATION WITH THE PRINCIPLE OF STRICT COMPLIANCE

In documentary credit and documentary guarantee transactions (hereafter referred to as abstract payment undertaking transactions), "there is no room for documents which are almost the same or which will do just as well."²⁰ The obligation of the issuer is to pay the stated sum on presentation of a demand and other specified documents (if any) which appear on their face to comply strictly with the terms and conditions of the abstract payment undertaking. This is the principle of strict compliance,²¹

16. *I.E. Contractors v. Lloyds* (1990) 2 LLOYD'S REP. 496 at 499; M. Coleman, *supra* note 9, at 230; H. Bennett, *Performance Bonds and the Principle of Autonomy* J.B.L. 574 at 579 (1994).

17. H. Bennett, *Performance Bonds and the Principle of Autonomy* J.B.L. 574, at 579. In the context of documentary credits, see G. McLaughlin, *Letters of Credit and Illegal Contracts: The Limits of the Independence Principle*, 49 OHIO STATE L.J. 1197, 1198 (1989).

18. *The "Bhoja Trader"* 2 LLOYD'S REP. 256 at 257 (1981), per Donaldson, L.J.; *Hongkong and Shanghai Banking Corp. v. Kloeckner* (1990) 2 Q.B. 514 at 523, per Hirst, J.; *Re Deloitte & Touche Inc.* (1993) 2 BANK. L.R. at 310; *Murphy v. F.D.I.C.*, 38 F. d 1490, 1502 (9th Cir. 1994).

19. *Power Curber v. National Bank, Kuwait* (1981) 1 W.L.R. 1233 at 1241; *Ross Bicycles, Inc.*, 613 N.Y.S. 2d at 541; *Brown*, 371 N.W. 2d at 698.

20. *Equitable Trust Co. of New York v. Dawson Partners* 27 LL. L. REP. 49 at 52 (1927).

21. *Glencore v. Bank of China* (1996) 1 LLOYD'S REP. 135 at 150; *English, Scottish and Australian Bank, Ltd. v. The Bank of South Africa* (1922) 2 LL. L. REP. 21 at 24; *N & C Properties v. AmSouth Bank, N.A.*, 558 So. 2d 906, 909 (Ala. 1990); *Lamborn v. Lake Shore Banking & Trust Co.*, 188 N.Y.S. 162, 164 (1921); *Bank of Seoul v. Norwest Bank Minnesota*, 630 N.Y.S. 2d 520,

and the maxim *de minimis non curat lex* (the rule of insignificance) does not apply here.²² This principle requests the issuer to look only at the documents tendered and to disregard any extraneous factors.²³ Therefore, even if the documents tendered are forged, if they appear on their face to comply strictly with the terms and conditions of the abstract payment undertaking, they have passed this threshold test²⁴ and the issuer has to pay, unless the issuer or the account party can clearly establish that fraud is involved.

A. *The Rationales Behind the Principle of Strict Compliance*

The justification for the principle of strict compliance is that it ensures business certainty. First, the issuer, who knows nothing officially of the details of the transaction thus financed, cannot take upon itself to decide what will do well enough and what will not.²⁵ The issuer will be reimbursed if it does as it is told, and it acts at its own risk if it departs from the conditions laid down by the account party.²⁶ Secondly, the prompt and certain payment function of abstract payment undertakings can only be served if the issuer can finish the review quickly, with little expense and with minimal extraneous interference.²⁷ To achieve this goal, the documents tendered should strictly comply with the terms of the payment undertaking and require minimal discretion on the issuer's part.²⁸ Thirdly, the main purpose of the principle is to protect the account party: as the beneficiary is entitled to payment if he has tendered the prescribed documents, the account party can be protected only when the documents

522 (1995).

22. *Moralice (London), Ltd. v. E.D. & F. Man* 2 LL. L. REP. 526 at 532 (1954); *Soproma S.P.A. v. Marine & Animal By-product Corp.* (1966) 1 LL. L. REP. 367 at 390.

23. GUTTERIDGE & MEGRAH, *THE LAW OF BANKERS' COMMERCIAL CREDITS* 123 (7th ed. 1984); *First Nat. Bank, ETC. v. Rosebud H. Authority*, 291 N.W. 2d 41, 45 (1980).

24. *Gian Singh Ltd. v. Banque de L'Indochine* 1 W.L.R. 1234 at 1238-1239 (1974); *United City Merchants A.C.* at 183 (1983); J. DOLAN, *supra* note 13, at 6-39, 6-40; cf. R. Goode, *Abstract Payment Undertakings*, in *ESSAYS FOR PATRICK ATIYAH* 209, 234 (Cane & Stapleton eds., 1991).

25. *Equitable Trust Co. of New York* 27 LL. L. REP. at 52 (1927); J. Dolan, *Letter-Of-Credit Disputes Between The Issuer and Its Customer*, 105 BANK. L.J. 380, 385 (1988).

26. *Equitable Trust Co. of New York* 27 LL. L. REP. at 52 (1927); *Banque Indochine v. J.H. Rayner Ltd.* 1 Q.B. 711 at 730 (1983); *Armac Industries, Ltd. v. Citytrust*, 525 A. 2d 77, 81 (Conn. 1987); *Voest-alpine Intern. Corp. v. Chase Manhattan Bank*, 707 F. 2d 680, 682-683 (1983); *Bisker v. Nationsbank, N.A.*, 686 A. 2d 561, 565 (1996).

27. *Hansson v. Hamel & Horley, Ld.* (1922) 2 A.C. 36 at 46; *Commercial Banking Co. v. Jalsard* (1973) A.C. 279 at 286; M. BRIDGE, *THE SALE OF GOODS* (1997), p. 242; *Armac Industries, Ltd.*, 525 A. 2d at 80.

28. *Toyota Tsusho Corp. v. Comerica Bank*, 929 F. SUPP. 1065, 1071 (1996); *Voest-alpine Intern. Corp.*, 707 F.2d at 682-683; J. Dolan, *Strict Compliance with Letters of Credit: Striking A Fair Balance*, 102 BANK. L.J. 18, 26-27 (1985).

strictly conform to his instruction.²⁹ Fourthly, the beneficiary also benefits from the principle in that the issuer cannot raise additional conditions other than those required by the payment undertaking,³⁰ and the beneficiary can be certain that he will be paid if the terms and conditions are strictly complied with.³¹ Finally, the principle also saves the issuer, who charges a modest fee, the trouble of taking decisions as to whether the documents presented are sufficient,³² thus protecting it from getting involved in underlying disputes between the beneficiary and the account party.

B. *Interaction Between the Principles of Independence and Strict Compliance*

It can be seen from the above that the principle of strict compliance shares similar rationales with the principle of independence. That is because the two principles are derived from the same principle that the parties in abstract payment undertaking transactions deal with documents rather than goods (hereafter “the principle of dealing with documents”), and also because of the common purpose of prompt and certain payment they cooperate to achieve. Notwithstanding these shared origins and aims, the operation of the principle of strict compliance is circumscribed by the principle of dealing with documents and by the principle of independence. Consequently, in deciding whether the documents tendered comply with the terms and conditions of the payment undertaking, extraneous facts cannot be taken into account because of the principle of dealing with documents;³³ nor should the underlying contract,³⁴ the purpose of the documents,³⁵ or relevant trade usage³⁶ be taken into consideration because the principle of independence isolates them from the abstract payment undertaking.

29. R. BERTRAMS, *BANK GUARANTEES IN INTERNATIONAL TRADE* (2nd ed. 1996), p. 115; *I.E. Contractors* (1990) 2 LLOYD’S REP. at 500.

30. J. DOLAN, *supra* note 13, at 6-7, 6-36.

31. *First Nat. Bank, ETC.*, 291 N.W. 2d at 45; *Optopics Laboratories v. Savannah Bank*, 816 F. SUPP. 898, 908 (1993); *Bisker*, 686 A. 2d at 565.

32. *I.E. Contractors* (1990) 2 LLOYD’S REP. at 500; J. Dolan, *Commentary on Legislative Developments in Letter of Credit Law: An Interim Report* (1993) 8 *B.F.L.R.* 53 at 56.

33. *Gian Singh Ltd.* (1974) 1 W.L.R. at 1238.

34. *Westpac v. S.C.N.B.* (1986) 1 Lloyd’s Rep. 311 at 315; *Utica Mut. Ins. Co. v. Walker*, 725 S.W.2d 24, 27 (1987); *American Coleman v. Intrawest Bank of Southglenn*, 887 F.2d 1382, 1386 (10th Cir. 1989); *McReynolds v. Cherokee Ins. Co.*, 896 S.W.2d 137, 141 (1994).

35. *Commercial Banking Co.* (1973) A.C. at 286; *Banque Indochine* (1983) 1 Q.B. at 729; *Glencore* (1996) 1 Lloyd’s Rep. at 150.

36. *J.H. Rayner & Co. v. Hambro’s Bank, Ltd.* 1 K.B. 37 at 41 (1943); *Philadelphia Gear Corp. v. Central Bank*, 717 F. 2d 230, 237 (1983); *Kredietbank Antwerp v. Midland Bank* 1 ALL E.R. (Comm.) 801 at 805 (1999); *BENJAMIN’S SALE OF GOODS* 23–186 (5th ed., 1997). However, if the usage has become a banking usage, it can be taken into consideration, see *Old Colony Trust Co. v. Lawyers’ Title & Trust Co.*, 297 F. 152, 157 (1924); also B. Kozolchik, *The Emerging Law of Standby Letters of Credit and Bank Guarantees*, 24 *ARIZ. L.R.* 319, 323 (1982).

In addition, there is an interaction between the principle of strict compliance and the principle of independence. As the principle of independence places the account party at the risk of a fraudulent demand, the only safeguard for him, except for the remedies based on the fraud and other exceptions, is the principle of strict compliance.³⁷ Hence, these two principles are used to accommodate the interests of the parties to the underlying contract and constitute a counterbalance between themselves.³⁸ As a corollary, the stricter the compliance rule is, the more independent the payment undertaking must become; the less strict the compliance rule is, the less independent the payment undertaking must become, thus, rendering the exception rule wider. Empirical support can be gained from the practice of the United States Court of Appeals for the Sixth Circuit. The Circuit in *Tosco Corp. v. F.D.I.C.*³⁹ favored the substantial compliance rule and, thus, in *Aetna Life and Casualty Co. v. Huntington National Bank*⁴⁰ adopted the intentional fraud standard, rather than the egregious fraud standard, in construing the fraud in the transaction defense.⁴¹ The interaction can be further seen in the American standby credit practice. To constitute a fraud in the transaction defense, the beneficiary's fraud in drawing on a standby credit need only to be an intentional one, which is determined by the "having absolutely no basis in fact formula."⁴² It need not be egregious fraud as required in the context of commercial credits. This distinction reflects the fact that the (strict) compliance rule cannot work well to protect the account party of standby credits.⁴³

C. *The Application of Strict Compliance Rule to Documentary Guarantees*

Compared with the shipping documents usually required under documentary credits, the circumscription of the documents prescribed under documentary guarantees cannot always have the same degree of exactitude. As a result, Professor Bertrams argues that the compliance rule in documentary guarantee transactions is less stringent than the strict

37. *Global Network Technologies v. Regional Airport*, 122 F. 3d 661, 665 (8th Cir. 1997); *O.E.I. v. Citibank, N.A.*, 957 F. Supp. 492, 509 (1997); *Banque Paribas v. Hamilton Industries Intern.*, 767 F. 2d 380, 384 (7th Cir. 1985); C. Debattista, *Performance Bonds and Letters of Credit: a Cracked Mirror Image* (1997) J.B.L. 289, at 301.

38. DOLAN, *supra* note 13, p. 6-7; Ademuni-Odeke, *The Judicial Approach to Injunctions in Letters of Credit and Performance Bond Transactions: the Fraud Exception Re-examined* (1995) DENNING L.J. 35, at 38.

39. 723 F. 2d 1242, 1247 (6th Cir. 1983).

40. 934 F. 2d 695, 702 (6th Cir. 1991).

41. See Chung-hsin Hsu, *The Fraud Exception to the Principle of Independence* 22 FU JEN LAW REVIEW 151, 223-224 (2002).

42. *Id.* at 224-231.

43. See Sec. V.A.3. *post*.

compliance rule in documentary credit transactions.⁴⁴ This is not persuasive and should be avoided. What documents are required and what requirements the document must fulfill is a matter of construction:⁴⁵ “what was the promise which the bank make to the beneficiary—and did the beneficiary avail himself of the promise?”⁴⁶ However, once the terms and conditions have been reasonably construed⁴⁷ as requiring certain documents or requirements, they must be strictly complied with.⁴⁸ This is due to the intrinsic nature of documentary transactions, and is the only way that the account party’s instruction can be carried out completely. Support for this view can be derived from the prevailing application of the strict compliance rule to American standby credits,⁴⁹ which are documentary guarantees by definition.

V. THE LEGAL EFFECTS OF THE PRINCIPLE OF INDEPENDENCE

The legal effects of the principle of independence are premised upon the purposes of this principle.⁵⁰ To serve the purpose of prompt and certain payment and to exercise the risk distribution function, the issuer’s payment undertaking is not only independent of the underlying contract between the beneficiary and the account party, but also independent of the relationship between the issuer and the account party.⁵¹ It is argued by one commentator that the principle of independence should be extended in scope to exclude the possibility of attachment by a third party.⁵² However, given the above stated purposes of the principle of independence, this argument cannot be sustained and is not favored by the courts. When a third party tries to attach a documentary guarantee, his

44. BERTRAMS, *supra* note 29, at 118; *Siporex v. Banque Indosuez* (1986) 2 LLOYD’S REP. 146 at 159.

45. *Esal (Commodities)* 2 LLOYD’S REP. at 550 (1985); *I.E. Contractors* (1990) 2 LLOYD’S REP. at 499.

46. *J.H. Rayner & Co.* (1943) K.B. at 43.

47. Since the beneficiary must comply strictly with the requirements of the documentary guarantee, he must know precisely and unequivocally what those requirements are. Consequently, the requirements must be explicit and all ambiguities are construed against the issuer, see *Bouzo v. Citibank N.A.*, 6 BANK. L.R. 230 at 235 (1997); *Marino Industries v. Chase Manhattan Bank, N.A.*, 686 F. 2d 112, 115 (1982); *United States v. Sun Bank of Miami*, 609 F. 2d 832, 833 (1980).

48. L. Sealy & R. Hooley, *Text and Materials in Commercial Law* (1994), p. 687; C. Debattista, *supra* note 37, at 300-01; H. Bennett, *The Formal Validity of Demands under Performance Bonds* 5 J.I.B.L. 207, at 209-10 (1991); *Star-Trans Far East Pte Ltd. v. Norske-Tech Ltd.*, 3 S.L.R. 631 at 640 (1995); cf. C. SCHMITTHOFF, *THE LAW AND PRACTICE OF INTERNATIONAL TRADE* 218 (10th ed., 2000).

49. *Hellenic Republic v. Standard Chartered Bank*, 631 N.Y.S. 2d 320, 321 (1995); *Chase Manhattan Bank v. Equibank*, 550 F. 2d 882, 885-86 (1977); *Insurance Co. of North America*, 595 F.2d at 174.

50. See Sec. II. *ante*.

51. *Canadian Imperial Bank v. Pamukbank Tas*, 632 N.Y.S. 2d 918, 923 (1994).

52. See McLaughlin, *supra* note 17, at 1214-216.

action usually fails on the ground that there are no assets to be attached when the documentary guarantee is still executory, rather than on the ground that the principle of independence prevents him from doing so.⁵³

A. *Independent of the Contract Between the Beneficiary and the Account Party*

On account of the above stated purposes and rationales, documentary guarantees are independent of the underlying contract they secure, and the obligation of the issuer is predicated on the terms and conditions of the documentary guarantee only.⁵⁴ Thus, the courts should not resort to the underlying contract when interpreting a documentary guarantee.⁵⁵ The beneficiary's breach of the underlying contract, absent clear fraud or illegality, is not a ground to stop payment,⁵⁶ nor is it a reason for the account party to attach the documentary guarantee.⁵⁷

1. *The Issue of Set-Off by the Account Party*

The account party sometimes alleges a cross-claim arising from the underlying contract and tries to offset it against the beneficiary's claim under a documentary guarantee. In *Steinmeyer v. Warner Consolidated Corp.*,⁵⁸ Steinmeyer executed and delivered various promissory notes to the defendants, Warner, to pay for a purchase of capital stock, and procured a standby credit to secure honor of the promissory notes. One of the promissory notes authorized Steinmeyer to offset "[t]he amount of any loss, liability or damage suffered by or in connection with the provision of the agreement." Alleging that Warner had failed to disclose facts affecting the value of the stock, Steinmeyer exercised his right of set-off, and sought an interim injunction to restrain Warner from claiming under the standby credit. The Court of Appeal of California, in confirming the injunction, articulated that the injunction only restrained the beneficiary from tendering the required statement, rather than forbid the issuer to pay; that as between Steinmeyer and Warner the standby credit could not be construed in isolation with the underlying agreement and the notes because they formed part of the sale arrangement; and that it would be anomalous to empower Warner to circumvent Steinmeyer's rights of

53. *Studwell Inc. v. Korean Exchange Bank*, 64 Cal. Rptr. 2d 538, 542-543 (1997).

54. *Turkiye v. Bank of China* 1 LLOYD'S REP. 132 at 135(1993); *Universal Sec. Ins. Co. v. Ring*, 769 S.W. 2d 750, at 752-53 (Ark. 1989).

55. *Pringle-Assoc. Mortg. Corp. v. Southern Nat. Bank*, 571 F. 2d 872, 874 (1978).

56. *Jupiter Orrington Corp. v. Zweifel*, 469 N.E. 2d 590, 593 (1984).

57. *Power Curber* (1981) 1 W.L.R. at 1239, 1241; *Hohenberg Co. Inc. v. Comitex Knitters Ltd.*, 428 N.Y.S. 2d 156, 157-158; BERTRAMS, *supra* note 29, at 335, 336.

58. 116 CAL. RPTR. 57 (1974).

set-off simply by seeking payment under the credit.⁵⁹

This decision overlooks the principle of independence, and has been strongly criticized by various American commentators.⁶⁰ Documentary guarantees, like documentary credits, are important in international trade. It is vital that every issuer must honor its obligation under a documentary guarantee, and the account party cannot stop the issuer from honoring its obligation by reason of the fact that he has a cross-claim against the beneficiary. By the same token, the account party cannot allege set-off or a counterclaim, no matter whether it arises from the underlying transaction or not, to enjoin *the beneficiary* from making a demand. That is because, unlike a bill of exchange given directly between the buyer and the seller, a documentary guarantee is given by a third party issuer to the beneficiary with the very intention of avoiding anything in the nature of set-off or counterclaim; furthermore, by procuring a documentary guarantee in favor of the beneficiary, the account party has implicitly agreed that he will not raise any set-off or counterclaim to prevent the beneficiary from being paid.⁶¹

Sometimes the account party assigns his claim to the issuer, and tries to get around this obstacle. It should be noted that the assignee stands in the shoes of the assignor and, hence, its right should not be greater than that of the assignor according to the maxim *nemo dat qui non habet* (he who has not cannot give). The account party cannot raise a set-off defense against the beneficiary's claim before assignment⁶² because of the principle of independence. It is submitted that this restriction should be brought forward with the assignment, and the issuer should be under the same restriction.

2. *The Issues of Liquidated Damages and Penalty*

As a documentary guarantee is independent of the underlying contract, and its function is to provide a near foolproof method of placing money in the beneficiary's hand pending resolution of any underlying disputes,⁶³ the account party cannot complain that the amount drawn under a documentary guarantee exceeds the sum due under the underlying contract.⁶⁴ By the same token, the issuer cannot resort to the underlying contract to examine whether the amount of the beneficiary's claim is

59. *Id.* at 59, 60.

60. DOLAN, *supra* note 13, at 2-53; S. Farrar et al., *An Examination of U.C.C. Article 5 (Letters of Credit)*, 45 BUS. LAW. 1521, 1616-1617 (1990).

61. *Power Curber* (1981) 1 W.L.R. at 1241.

62. *Id.*

63. *Itek Corp.*, 730 F. 2d at 24; *Emery-Waterhouse Co. v. R.I. Hosp. Trust Nat. Bank*, 757 F.2d 399,404 (1985).

64. *Brown*, 371 N.W.2d at 701.

justified according to the underlying contract.⁶⁵ If the demand is apparently conforming, all the issuer has to do is to make payment. After the beneficiary is in possession of the funds, if he is not entitled, according to the underlying contract, to retain the money, the account party can claim it back in a separate action against the beneficiary.⁶⁶ The basis for the account party's claim is a term, either express or implied, of the underlying contract.⁶⁷ Consequently, if the underlying contract provides that the amount claimed under the documentary guarantee is liquidated damages for the account party's default,⁶⁸ the account party cannot reclaim the money on the ground that the beneficiary has not suffered any loss, unless the sum is not a genuine and reasonable pre-estimate of damage at the time of concluding the underlying contract and, hence, is a penalty.⁶⁹ If the proceeds drawn under the documentary guarantee (similar to a prepaid deposit) should constitute a penalty, the account party is entitled to reclaim the amount exceeding the beneficiary's actual loss.⁷⁰ Nevertheless, as between the beneficiary and the issuer, the sum specified in the documentary guarantee is anything but a penalty. That is because the issuer, owing to the independence principle, cannot look at the underlying contract to check whether it is liquidated damages, let alone whether it is a reasonable pre-estimate or not.⁷¹ That is also because, unless it is intended to be liquidated damages, the sum can be reclaimed by the account party in the future.

65. *San Diego Gas & Elec. Co. v. Bank Leumi*, 50 CAL. RPTR. 2d 20, 25-27 (1996); *Bank of N.C. v. Rock Island Bank*, 630 F.2d 1243, 1254 (1980); *Colorado Nat. Bank, ETC. v. Bd. of County Com'rs*, 634 P. 2d 32, 39 (1981); *East Girard Sav. Ass'n v. Citizens Nat. Bank, ETC.*, 593 F. 2d 598, 603 (1979).

66. *Cargill Int.* (1996) 2 LLOYD'S REP. at 528-529, affirmed by the Court of Appeal (1998) 1 W.L.R. at 468-469; *Comdel* (1997) 1 LLOYD'S REP. at 431; *Wood Hall Ltd. v. Pipeline Authority* (1979) 141 C.L.R. 443 at 454; *CKB & Assoc.*, 734 S.W. 2d at 655; cf. *Australian Conference Assoc. Ltd. v. Mainline Constructions Ltd.* (1978) 141 C.L.R. 335 at 352-353.

67. *G. McMeel, Pay now, argue later* (1999) 1 L.M.C.L.Q. 5 at 6; *Cargill Int.* 2 LLOYD'S REP. at 530 (1996), which discarded the restitutionary approach. This decision is acceptable partly because there is a contractual relationship between the parties, and partly because if the action has to be framed upon an unjust enrichment, it may face the beneficiary's defence of change of position, see *Lipkin Gorman v. Karpnale Ltd* 2 A.C. 548 at 574. (1991), 577 *et. seq.*

68. *Cargill Int.* (1996) 2 LLOYD'S REP. at 528-529, affirmed by the Court of Appeal (1998) 1 W.L.R. 461; *New York Life Ins. Co. v. Hartford Nat. Bank & Trust Co.*, 378 A.2d 562, 564 (1977); *Shel-al Corp. v. American National Insurance Co.*, 492 F.2d 87, 93 (1974).

69. *Dunlop Pneumatic Tyre Co. Ltd. v. New Garage and Motor Co. Ltd.* (1915) A.C. 79 at 86, 87; *Public Works Commissioner v. Hills* (1906) A.C. 368 at 375-376; *Hubbard Business Plaza v. Lincoln Liberty Life Ins.*, 649 F. Supp. 1310, 1314-1316 (1986); *In Re Graham Square, Inc.*, 126 F.3d 823, 828-829 (6th Cir. 1997).

70. *Workers Trust Bank Ltd. v. Dojap Ltd.* A.C. 573 at 582. (1993); *McGregor on Damages* (16th ed. 1997), par. 557; *Telenois, Inc. v. Village of Schaumburg*, 628 N.E.2d 581, 584-86 (1993), confirmed in 633 N.E. 2d 16 (1994).

71. *New York Life Ins. Co.*, 378 A. 2d at 567; cf. *Hubbard Business Plaza*, 649 F. SUPP. at 1314-316; *Birdwell v. Ferrell*, 746 S.W. 2d 338, 341 (1988).

3. *Lesser Independence of Documentary Guarantees*

Compared with documentary credit transactions,⁷² where the documents required are a manifestation of the beneficiary's performance of the underlying contract and have commercial value, the demand and documents, if any, required under documentary guarantees are nothing of commercial value and have nothing to do with the beneficiary's own performance of the underlying contract. As a consequence, the beneficiary's honesty or fraud in drawing on a documentary guarantee cannot be decided without reference being made to the underlying contract;⁷³ and the issuer of documentary guarantees, who has no security in the documents to rely on, is much more concerned about the underlying performance than the issuer of documentary credits.

In addition, the documents required under documentary guarantees usually originate from the beneficiary himself. As a result, although the principle of strict compliance, as has been submitted,⁷⁴ applies to documentary guarantees, it cannot work well to protect the account party's interest. Thus, the equilibrium of protection present in documentary credit transactions cannot be achieved in documentary guarantee transactions without making documentary guarantees less independent of the underlying contract than documentary credits. In other words, only when the scope of the exception rule to the principle of independence becomes wider can the account party have the same protection as enjoyed by the buyer in the context of documentary credits, thus restoring the equilibrium and striking a fair balance between interests of the beneficiary and the account party.⁷⁵

B. *Independent of the Relationship Between the Issuer and the Account Party*

Documentary guarantees are not only independent of the underlying contract between the beneficiary and the account party they secure, but are also independent of the relationship between the issuer and the account party.⁷⁶ Consequently, neither a repudiation of the mandate from the account party, nor a failure of the account party to put the issuer in funds can be an excuse for the issuer to dishonor its own independent undertaking. By the same reasoning, the validity of any modification to a documentary guarantee does not need the consent of the account party

72. *Potton Homes v. Coleman Contractors* 28 B.L.R. 24 at 29 (1984).

73. See Chung-hsin Hsu, *loc.cit.*, at 176.

74. See Sec. IV. *ante*.

75. For a similar opinion, see C. Debattista, *supra* note 37, at 301 et seq.

76. *North American MFRS. Export Asso. v. Chase Nat. Bank*, 77 F. Supp. 55, 55 (1948); *Kingdom Sweden v. New York Trust Co.*, 96 N.Y.S. 2d 779, 791 (1949); *Pringle-Assoc. Mortg. Corp.*, 571 F. 2d at 874; *Naugatuck Sav. Bank v. Fiorenzi*, 654 A. 2d 729, 734 (Conn. 1995).

(although it does require the beneficiary's consent), and the fact that the issuer may as a result lose its right of reimbursement from the account party does not bar the beneficiary from drawing on the documentary guarantee as altered.⁷⁷ And, most importantly, the insolvency of the account party is generally accepted as having no effect on a documentary guarantee because of the independent nature of documentary guarantees and also because of their risk allocation function:⁷⁸ the risk of the account party's insolvency has been shifted to the issuer by the use of documentary guarantees.⁷⁹

As far as the U.S. insolvency law is concerned, the independence of standby credits is respected by the insolvency courts when the position of the issuer is not secured by any property of the bankrupt account party.⁸⁰ In the case of secured standby credits, however, the strong anti-preferential transfer policy of U.S. bankruptcy regulations has, on one occasion, caused the independence of standby credits to come under attack when the account party goes bankrupt. *In re Twist Cap, Inc.*,⁸¹ the bankruptcy Court held that when a standby credit was secured by a property of the account party, an indirect preference would occur to the benefit of the unsecured beneficiary if the issuer was not enjoined from honoring the credit. It is submitted that this decision overlooks the independent nature, and risk allocation function, of standby credits,⁸² and errs in concluding that the beneficiary was unsecured.⁸³ On the contrary, the beneficiary was completely secured by the standby credit. For these reasons, in subsequent insolvency cases the Federal Courts of the United States have striven to abide by the independence principle of standby credits and to protect them from preference attacks.⁸⁴ Only where a standby credit has been used to secure an unsecured antecedent debt, and in reality has been used as a device to achieve a preferential transfer before the account party goes bankrupt, can the trustee in bankruptcy be

77. *Chase Manhattan Bank*, 550 F. 2d at 886-887.

78. *Re Deloitte & Touche Inc.* (1993) 2 Bank. L.R. at 310-311; B. Wunnicke, *Under U.S. Law, what happens to the parties to an L/C when one of them goes bankrupt?* 2 (No. 3) *D.C.I.* 13 at 13 (1996); R. JACK, *supra* note 2, at 112; R. BERTRAMS, *supra* note 29, at 95.

79. *Insurance Co. of N.A.*, 595 F. 2d at 173.

80. *In Matter of Marine Distributors, Inc.*, 522 F.2d 791, 795 (1975); J.A. Rodenberg, *Letters of Credit in Bankruptcy: Can the Independence Doctrine Survive Preference Attacks?* 96 *COMM. L.J.* 431, 452 (1991).

81. 1 Bankr. 284 (Bankr. D. Fla. 1979), cited by J.A. Rodenberg, *supra* note 80, at 440.

82. G.T. McLaughlin, *Letters of Credit as Preferential Transfers in Bankruptcy*, 50 *FORDHAM L.R.* 1033, 1034, 1035, 1076 (1982); D.G. Baird, *Standby Letters of Credit in Bankruptcy*, 49 *UNIV. CHI. L.R.* 130, 132 (1982); J. A. Rodenberg, *supra* note 80, at 441, 450.

83. DOLAN, *supra* note 13, p. 7-14.

84. *Matter of Compton Corp.*, 831 F.2d at 590-591; *In Re Air Conditioning, Inc. of Stuart*, 845 F.2d 293, 296 (11th Cir. 1988); *Pine Top Ins. Co. v. Century Indem. Co.*, 716 F. Supp. 311, 313 (N.D. Ill. 1989); *In Re Graham Square, Inc.*, 126 F.3d at 828, *Berman v. Le Beau Inter-America, Inc.*, 509 F. Supp. 156, 160, 161 (1981).

allowed to recover from the preferred beneficiary; but the standby credit itself is left intact.⁸⁵

C. *The Independence of the Counter-Guarantee from the Primary Guarantee*

In a four-party documentary guarantee transaction, the account party requests its bank (called the counter guarantor) to instruct another bank (called the primary guarantor) in the beneficiary's country to issue a primary guarantee in the beneficiary's favor. The counter guarantor in turn issues a counter-guarantee to reinforce the reimbursement duty owed by it to the primary guarantor. In practice, the reimbursement duty may be reinforced by an indemnity contract rather than by a counter-guarantee. If the counter guarantor's undertaking to reimburse the primary guarantor takes a documentary form, the counter-guarantor's undertaking is a counter-guarantee.⁸⁶ If the counter guarantor undertakes to indemnify the primary guarantor against any loss incurred by acting on its instruction, but does not prescribe the documents required to trigger the obligation, the undertaking is a contract of indemnity. Thus, between the primary guarantor and the counter guarantor there are two related but distinct relationships: one arising from the agency contract,⁸⁷ the other arising from the counter-guarantee or the contract of indemnity, as the case may be. In issuing the primary guarantee on the counter guarantor's instruction, the primary guarantor acts in a dual capacity: as between itself and the beneficiary it acts as a principal; as between itself and the counter guarantor, however, it acts as the counter guarantor's agent. An analogy can be drawn from the situation where an advising bank adds its confirmation to a documentary credit. The confirming bank acts as a principal as against the beneficiary, but acts as an agent for the issuing bank in such respects⁸⁸ as adding the confirmation, examining the documents, and making payment if the documents tendered are conforming.

Like the primary guarantee, the counter-guarantee is also documentary in nature and the obligation under it has to take effect according its own terms.⁸⁹ The counter-guarantee is not only independent

85. *Matter of Compton Corp.*, 831 F. 2d at 594; *In Re Air Conditioning, Inc. of Stuart*, 845 F. 2d at 296-299; *Pine Top Ins. Co.*, 716 F. Supp. at 313-315.

86. *I.E. Contractors* (1990) 2 LLOYD'S REP. at 500, 502.

87. Professors Goode and Bertrams use "mandate" to denote this relationship, see R. GOODE, *GUIDE TO THE ICC UNIFORM RULES FOR DEMAND GUARANTEES* 20 (1992); R. BERTRAMS, *supra* note 29, p. 141. As for "mandate" in English law, see R. CRANSTON, *PRINCIPLES OF BANKING LAW* 149-151 (1997).

88. *Bowstead & Reynolds on Agency* (16th ed. 1996), par. 2-033; *Bank Melli Iran v. Barclays Bank* 2 LL. L. REP. 367 at 376(1951), per McNair, J.

89. *Gulf Bank v. Mitsubishi* (1994) 2 LLOYD'S REP. 145 at 150-151.

of the underlying contract between the beneficiary and the account party,⁹⁰ and of the relationship between the counter guarantor and the account party, it is also independent of the primary guarantee.⁹¹ However, the independence of the counter-guarantee from the primary guarantee has been recently questioned by English courts on two separate occasions when called upon to decide the proper law issue of a counter-guarantee. In *Turkiye v. Bank of China*⁹² and *Wahda Bank v. Arab Bank*,⁹³ although Phillips, J., in the former case, and the Court of Appeal, in the latter case, acknowledged that the counter-guarantee was an autonomous contract in the sense that it could be operated by a demand on its own without regard to anything extraneous, both Courts nevertheless held that the counter-guarantee was so intimately connected with the primary guarantee (just as an accessory guarantee is connected with the underlying contract) that it should be governed by the same law as the primary guarantee.⁹⁴ It is submitted that these two decisions distort the principle of independence in order to let the counter-guarantee be governed by the same law as the primary guarantee, which can be achieved by other means without tampering with that principle.⁹⁵ Admittedly, the counter-guarantee is related in certain respects to the primary guarantee it generates; they are, nevertheless, independent of each other.

Another related issue is whether the counter-guarantee is independent of the mandate received from the counter guarantor. Professor Goode suggests that the counter-guarantee, being an abstract payment undertaking, is also independent of the mandate received from the counter guarantor, and that a breach of that mandate is not in itself a ground for refusal to honor the primary guarantor's demand under the counter-guarantee.⁹⁶ This stringent approach is accepted by some German courts, but is not favored by French and Dutch courts according to Professor Bertrams' research. In the French and Dutch cases explored by Professor Bertrams, the French and Dutch courts in deciding whether to allow the primary guarantor's claim under the counter-guarantee examined whether the primary guarantor had breached its mandate, such as making payment against non-conforming documents or allowing the beneficiary's claim under the primary

90. *Turkiye* (1998) 1 LLOYD'S REP. at 251, C.A.

91. *Gulf Bank* (1994) 2 LLOYD'S REP. at 150-151; *Mitsubishi v. Gulf Bank* (1996) 1 Lloyd's Rep. 499 at 502; R. Bertrams, 'Counter-guarantees in an Indirect, Independent (first Demand) Guarantee Structure' (1997) 8 *B.J.I.B. & F.L.* 373 at 376.

92. (1993) 1 LLOYD'S REP. 132.

93. (1996) 1 LLOYD'S REP. 470.

94. *Wahda Bank v. Arab Bank* (1996) 1 LLOYD'S REP. 470 at 473, per Staughton, L.J.; *Turkiye v. Bank of China* (1993) 1 LLOYD'S REP. at 135-136.

95. See Sec. II.E.2. *post*.

96. R. GOODE, *supra* note 87, at 20; also *Abstract Payment Undertaking and the Rules of the International Chamber of Commerce*, 39 SAINT LOUIS U. L. J. 725, 734-735 (1995).

guarantee even after the expiry date.⁹⁷ As far as English law is concerned, the Court of Appeal in *Esal (Commodities) v. O.C.L.*,⁹⁸ and in *I.E. Contractors v. Lloyds*⁹⁹ also examined whether the primary guarantor had breached the instruction received from the counter guarantor when deciding the validity of the primary guarantor's claim under the counter-guarantee.¹⁰⁰ It is submitted that Professor Bertrams' approach is preferable. First, the counter-guarantee is utilized to perform or reinforce the counter guarantor's reimbursement obligation arising from the primary guarantor's strict adherence to the mandate. It is, thus, difficult to infer from the circumstances an intention of the parties that the counter-guarantee should be independent of the mandate and that the counter-guarantee is payable even if the primary guarantor has breached the mandate. Secondly, the purposes of the principle of independence (*e.g.*, pay first, argue later) cannot, or are inappropriate to, justify the independence of the counter-guarantee from the mandate.

Admittedly, the suggestion that the counter-guarantee is not independent of the mandate will narrow the independence of the counter-guarantee from the primary guarantee. That is destined to be so because of the reimbursement nature of counter-guarantees. Nevertheless, the counter-guarantee is, in principle, independent of the primary guarantee. Thus, even if the primary guarantee is unenforceable or otherwise devoid of legal effects, the counter-guarantee is not affected.¹⁰¹ And, even if the beneficiary of the primary guarantee is guilty of fraud, the primary guarantor's claim under the counter-guarantee is not necessarily fraudulent.¹⁰² However, where the primary guarantor has breached the mandate, such as making payment against a non-conforming demand or making payment after the expiry date, if the counter guarantor can clearly substantiate that conduct, it is entitled to refuse payment despite the fact that the terms of the counter-guarantee have been complied with. To sum up, the counter-guarantee can be said to be independent of the primary guarantee to the extent that the primary guarantor does not breach the mandate received from the counter guarantor.

97. R. BERTRAMS, *supra* note 29, at 146-49; also *supra* note 91, at 377-78.

98. 2 LLOYD'S REP. 546 (1985).

99. 2 LLOYD'S REP. 496 (1990).

100. *Esal* 2 LLOYD'S REP. at 550, 551, 553 (1985); *I.E. Contractors* 2 LLOYD'S REP. at 502 (1990).

101. *Gulf Bank* (1994) 2 LLOYD'S REP. at 150-151.

102. See Chung-hsin Hsu, *loc. cit.* pp. 193-194.

D. *The Issue of Set-Off by the Issuer*

Where the issuer for some reason has a cross claim against the beneficiary, is it entitled to exercise set-off against the beneficiary's claim under a documentary guarantee? If the issuer is entitled to do so, does such set-off constitute an exception to the principle of independence? It is sometimes loosely stated that set-off is an exception. The principle of independence, however, is best defined as the principle that the issuer's payment undertaking is independent of the underlying contract and of the relationship between the issuer and the account party. It is, therefore, conceptually inappropriate to recognize set-off by the issuer as an exception to the principle of independence.

Set-off, as defined by Professor Goode, is the right of a debtor who is owed money by his creditor on another account or dealing to secure payment for what is owed to him by setting this off in reduction of his own liability.¹⁰³ As far as English law is concerned, there are five types of set-off: statutory (independent) set-off, equitable (transaction) set-off, current-account set-off, contractual set-off, and insolvency set-off. Among them, only statutory set-off and equitable set-off are important in the context of documentary guarantees and, hence, other types of set-off are not discussed here.

1. *Statutory Set-Off*

Statutory set-off is set-off under the rules carried over from the former Statutes of Set-off. It allows claims and cross claims which are legal, mutual, liquidated, and due debts to be set off against each other in proceedings. It is, thus, a purely procedural defense, which does not operate to extinguish or reduce the creditor's claim until judgment for the balance has been given. In other words, it does not affect the substantive rights of the parties against each other until both causes of action have been merged in judgment.¹⁰⁴ It is confined to debts which, at the time when the defense of set-off is pleaded, are due, payable, and either liquidated or in sums capable of ascertainment without estimation.¹⁰⁵ Although it is not necessary that the claim and cross claim should be connected with each other, they must be mutual¹⁰⁶ in the sense that the two claims must be between the same parties in the same right. Thus, a

103. R. GOODE, PRINCIPLE OF CORPORATE INSOLVENCY LAW 172 (2nd ed. 1997).

104. *Stein v. Blake* (1996) 1 A.C. 243 at 251, per Lord Hoffmann; R. Goode, *id.* at 175.

105. *Stein* (1996) 1 A.C. at 251; *Stooke v. Taylor* (1880) 5 Q.B.D. 569 at 575, per C.J. Cockburn; *Axel Johnson A.B. v. Mineral Group A.G.* (1992) 1 W.L.R. 270 at 272, C.A.

106. *Axel Johnson A.B.* (1992) 1 W.L.R. at 272; GOODE, *supra* note 103, at 175.

joint debt cannot be set off against a separate debt at law.¹⁰⁷

Although documentary guarantees are abstract payment undertakings, the issuer is entitled to plead statutory set-off where a liquidated sum is due to the issuer from the beneficiary under a separate account.¹⁰⁸ That is because, when judgment for the balance has been given, statutory set-off operates in *pro tanto* satisfaction of the beneficiary's claim and constitutes payment of the debt.¹⁰⁹ However, it should be noted that statutory set-off is only a procedural defence, and the issuer cannot effectively raise statutory set-off outside legal proceedings. In addition, a paying bank, which is an agent of the issuing bank, transmits the funds merely as a conduit. A paying bank cannot, as a matter of law, exercise any right of set-off against the beneficiary's claim under a documentary guarantee advised by it to satisfy its own claim.¹¹⁰ By the same token, the issuing bank cannot set off a debt owed to it by a collecting bank personally against the claim made by the collecting bank on behalf of the beneficiary under a documentary guarantee.¹¹¹

2. *Equitable Set-Off*

Equitable set-off arises where the claim and cross claim, even if not arising from the same transaction, are so closely connected with each other that it would be inequitable for one claim to be enforced without credit being given for the other. For equitable set-off to be operative, the claim must be for money or for relief based on non-payment of money. As the essence of equitable set-off is that equity considers it unjust that a claimant should seek to enforce a claim without giving credit for a related cross claim, equitable set-off is equally applicable whatever form of relief the claimant is claiming, provided that the relief depends on non-payment of a money claim to which equitable set-off is a complete defence.¹¹²

Furthermore, the claim and cross claim must be mutual, that is, must be due from the same parties in the same right.¹¹³ Thus, a debt due to a

107. *Vulliamy v. Noble* (1817), 3 Mer. 613, 618 36 E.R. 228, 237, per Lord Eldon; R. GOODE, *LEGAL PROBLEMS OF CREDIT AND SECURITY* 154 (2nd ed. 1988).

108. R. Goode, *supra* note 107, at 162; cf. P. Wood, *English and International Set-off* 700-01 (1989); A. Mugasha, *Set-off against a letter of credit claim*, in *DIMENSIONS IN BANKING AND FOREIGN EXCHANGE LAW* 45 (J. Prebble ed., 1992).

109. *High Street Services v. B.C.C.I. S.A2 BANK*, L.R. 247 at 250. (1993), per L.J. Dillon. (in the insolvency set-off context); *Callander v. Howard* (1850) 19 L.J.C.P. 312 at 315, per Talfourd, J. (in the context of accounting between the creditor and debtor); R. GOODE, *supra* note 107, at 147; also R. GOODE, *PAYMENT OBLIGATIONS IN COMMERCIAL AND FINANCIAL TRANSACTION* 13 (1983); S. DERHAM, *SET-OFF* 131 (2nd ed. 1996).

110. *Bamberger Polymers Intern. Corp. v. Citibank*, 477 N.Y.S. 2d 931, 932-933 (Sup. 1983).

111. *Banco Nacional De Cuba v. Chase Manhattan Bank* (1980), 505 F. Supp. 412, 427.

112. *B.I.C.C. Plc. v. Burndy Corp.* (1985) 1 ALL E.R. 417 at 427, per Dillon, L.J.

113. *Middleton v. Pollock* (1875) L.R. 20 Eq. 29 at 34, per Sir G. Jessel, M.R.

trustee in that capacity cannot be set off against a cross claim due from him personally.¹¹⁴ Equity, however, being more concerned with beneficial interests rather than bare legal titles, construes the requirement of mutuality differently from that at law,¹¹⁵ so that where an action is brought by a claimant as a trustee for a third party and the defendant has a cross claim against that third party, the defendant is entitled to set up his claim as an equitable defense to the action.¹¹⁶ That is because a person, by creating a trustee to sue for him, cannot be entitled to any greater rights than he would be if he sued in his own name.¹¹⁷

The rationale behind equitable set-off is that it is inequitable to allow the claim without giving credit for the cross claim.¹¹⁸ It is a process of discretion in equity. It follows that equitable set-off may nevertheless be denied, notwithstanding that the cross claim is otherwise closely connected with the claim, if in the circumstances it would be unjust that set-off occurs.¹¹⁹ As a corollary, to justify equitable set-off, according to the orthodox view, the cross claim must be closely connected with the claim so that the claim is impeached.¹²⁰ The concept of impeachment, however, is vague and was explained by Lord Denning in *Federal Commerce Ltd. v. Molena Alpha Inc.*¹²¹ as such: the cross claim is “so closely connected with his demands that it would be manifestly unjust to allow him to enforce payment without taking into account the cross-claim.”¹²² The test is rigorous and, as a result, a derivative test has emerged which is mechanical and short of discretionary elements. In *Bank of Boston v. European Grain Ltd.*,¹²³ Lord Brandon of Oakbrook articulated that the concept of a cross claim being such as to impeach the title to the legal claim was no longer a familiar one, and his Lordship preferred a new test that equitable set-off is allowed whenever a cross claim flows out of, and is inseparably connected with, the dealing and transactions which also give rise to the claim.¹²⁴ Given that equitable set-off in its very nature is an equitable defense and, hence, the judges’ discretion is inherent in its operation, it is submitted that Lord Denning’s

114. *Id.*

115. GOODE, *supra* note 107, p. 158; DERHAM, *supra* note 109, at 68.

116. *Bankes v. Jarvis* (1903) 1 K.B. 549 at 552, per Lord Alverstone; *Bhogal v. Punjab National Bank* (1988) 2 ALL E.R. 296 at 307.

117. *Bankes* (1903) 1 K.B. at 553.

118. *Hanak v. Green* (1958) 2 ALL E.R. 141 at 147.

119. Derham, *supra* note 109, at 43 and 66.

120. *Rawson v. Samuel* (1841) Cr. & Ph. 161 at 179, 41 E.R. 451 at 458.

121. 1 Q.B. 927 (1978).

122. *Ibid.*, at 975; *see also The Teno* (1977) 2 LLOYD’S REP. 289 at 297; *Hanak* (1958) 2 ALL E.R. at 150; *cf. Box v. Midland Bank* (1981) 1 LLOYD’S REP. 434 at 437, where Lord Denning allowed equitable set-off because “(t)he claim and counterclaim arose out of a whole series of transactions in regard to the obtaining of the loan.”

123. 1 A.C. 1056(1989).

124. *Id.* at 1103.

Molena formula is more acceptable.¹²⁵ Thus, it is not necessary for equitable set-off to be operative that the claim and cross claim should have originated from the same contract;¹²⁶ at the same time it is not sufficient that they arise from the same contract.¹²⁷ What matters is that they arise from related transactions and are closely connected with each other so that the claim is impeached by the cross claim, and that it would be manifestly unjust if the claim is allowed without giving credit for the cross claim.¹²⁸

a. *Equitable Set-Off against the Claim on a Bill of Exchange*

In the context of equitable set-off and documentary guarantees, an analogy is often drawn by English courts between documentary guarantees and bills of exchange. English courts have long treated a bill of exchange as cash and as a separate contract within a wider transaction in pursuance of which the bill is executed.¹²⁹ Thus, a buyer who has accepted a bill of exchange, but complains about the quality of the goods, has to satisfy the bill first and then proceeds upon a breach of warranty.¹³⁰ And, non-liquidated damages cannot be relied upon by way of equitable set-off against the claim on the bill of exchange.¹³¹ Only where there is a total failure of consideration between the immediate parties to the bill,¹³² or where there is a partial failure of consideration between the immediate parties and its amount is ascertained and liquidated,¹³³ may equitable set-off be utilized as a pro tanto defense.

The extra requirement that the quantum of the claim must be definite and liquidated for a partial failure of consideration is, however, unusual for equitable set-off. This extra requirement can only be justified by the analogy drawn between bills of exchange and cash,¹³⁴ and by the

125. *The "Aditya Vaibhav"* 1 LLOYD'S REP. 573 at 574 (1991); *Esso Petroleum Co. v. Milton* (1997) 1 W.L.R. 938 at 950.

126. *Hanak* 2 ALL E.R. at 155 (1958).

127. *Rawson* (1840) Cr. & Ph. at 178, 41 E.R. at 458; *The Teno* 2 LLOYD'S REP. at 297 (1977); *Esso Petroleum Co* 1 W.L.R. at 951 (1997).

128. *The "Raven"* 2 LLOYD'S REP. 266 at 272 (1980); *Guinness Plc. v. Saunders* (1988) 1 W.L.R. 863 at 870; *Zemco Ltd. v. Jerrom-Pugh* (1993) B.C.C. 275 at 281.

129. *James Lamont & Co. v. Hyland Ltd.* (1950) 1 K.B. 585 at 591.

130. *Warwick v. Nairn* (1855) 10 Ex. 762 at 764, 156 E.R. 648 at 649, per Pollock, C.B.; *Montebianco v. Carlyle Mills* (1981) 1 LLOYD'S REP. 509 at 511-512.

131. *Anglo-Italian Bank v. Davies* (1878) 38 L.T. 197 at 199, per Jessel, M.R.; *Agra and Masterman's Bank v. Leighton* (1866) L.R. 2 Ex. 56 at 65; *Nova (Jersey) Knit v. Kammgarn Spinnerei* (1977) 1 W.L.R. 713 at 720-721; *Montecchi v. Shimco Ltd.* (1979) 1 W.L.R. 1180 at 1183.

132. *James Lamont & Co.* 1 K.B. at 592 (1950); *Agra and Masterman's Bank* L.R. 2 Ex. at 64 (1866).

133. *Agra and Masterman's Bank* L.R. 2 Ex. at 64, 65 (1866); *Nova (Jersey) Knit* 1 W.L.R. at 720-721 (1977).

134. *Nova (Jersey) Knit* 1 W.L.R. at 721 (1977); *The Brede* 1 Q.B. 233 at 249-250 (1974).

discretionary nature of equitable set-off.¹³⁵ The cash analogy and the discretionary nature of equitable set-off also explain why it is very rare that the defendant successfully pleads his cross claim arising from a breach of other related contracts, or from tortious wrongdoing in the transaction, although in theory they are eligible to be raised as equitable set-off if these cross claims are closely connected with the claim on the bill of exchange.¹³⁶

b. *The Equitable Set-Off Issue in the Context of Documentary Guarantees*

In *Etablissement Esefka Intern. Anstalt v. Central Bank of Nigeria*,¹³⁷ the claimant, Etablissement, agreed to sell 240,000 tons of cement c.i.f. Lagos to the Nigerian Ministry of Defense. The defendant, Central Bank, opened a number of irrevocable, transferable, and divisible documentary credits advised by the Midland Bank (which also acted as the paying bank) to pay for the price. According to a special provision in the credits, if demurrage was incurred, that demurrage also came under the credits. A great deal of cement was shipped, many of the ships were held up, and a large amount of demurrage became payable. Eight shipments were tainted with fraud: the tendered documents were forged. Out of these eight shipments, three were made by Etablissement and the other five by its supplier. The Midland Bank paid out huge sums of money for these shipments in ignorance of the fraud. Having later discovered the fraud, the defendant refused to pay any demurrage outstanding on the documentary credits for other shipments, and the claimant started an action to claim demurrage. Lord Denning held that all the documentary credits covering the 240,000 tons of cement constituted one transaction and the documents tendered ought to be correct and valid in respect of each parcel. His Lordship further held that if the documents in respect of one parcel were forged or fraudulent, the defendant was entitled to recover money paid before discovery of the forgery or fraud as money paid under a mistake of fact; and that the claimant's claim for demurrage for other shipments (which had been made) was so closely connected with the cross claim in respect of these forged or fraudulent documents that it would be manifestly unjust to allow him to enforce the payment of demurrage without taking into account this cross claim.¹³⁸

In *The Hongkong and Shanghai Banking Corp. v. Kloeckner & Co.*

135. *Anglo-Italian Bank* (1878) 38 L.T. at 199, per Jessel, M.R.

136. *Ibid.*; *James Lamont & Co.* (1950) 1 K.B. at 592-593; *Brown, Shipley & Co. v. Alicia Hosier, Ltd.* (1966) 1 Ll. L. R. 668 at 669, per Lord Denning, M.R.

137. (1979) 1 LLOYD'S REP. 445.

138. *Id.* at 447-48.

A.G.,¹³⁹ the claimants (HKSBC) provided certain facilities to Gatoil in connection with crude oil trading dealings between Gatoil and the defendants (Kloeckner), under which Kloeckner would “front” Gatoil’s contracts with the general market under an umbrella arrangement by means of back-to-back contracts. The crude oil dealings included forward contract transactions (the dry cargoes arrangements), under which HKSBC advanced money to Gatoil against assignments by Gatoil of the proceeds of matched pairs of forward contracts in dry cargoes together with *undertakings* by Kloeckner to pay the difference in debt to HKSBC. HKSBC, in addition, provided a standby credit in favour of Kloeckner in respect of the liabilities of Gatoil on dry cargo transactions. By their cross summons Kloeckner sought summary judgment on their counterclaim under the standby credit. HKSBC did not dispute the liability but asserted set-off in the approximate sum under Kloeckner’s *undertakings* relating to the dry cargo contracts. Kloeckner conceded that the dry cargo claims which HKSBC sought to set off were arguable, but contended that the Court could not as a matter of law entertain set-off against a claim under a letter of credit. Hirst, J., held that HKSBC was entitled to set it off. His reasoning was as follows. First, the standby credit was opened for the specific purpose of financing Gatoil’s liabilities on the dry cargoes transactions, so that it would seem very unjust if HKSBC were precluded from enforcing set-off in relation to the present claims which arose directly out of the selfsame transactions. Secondly, the set-off was of a liquidated amount, and it would be anomalous that such set-off should be unavailable in letters of credit cases but available in bills of exchange cases. Thirdly, the principle of independence only precluded *the account party* from raising set-off against the beneficiary and did not restrain *the issuer* in appropriate, but rare, situations from setting off its own money claim owed by the beneficiary.¹⁴⁰

In these two decisions, which both allowed equitable set-off against the beneficiary’s claim, the Courts adopted the impeachment test as construed in the *Molena* formula, *i.e.*, the issuing bank’s cross claim was so closely connected with the beneficiary’s claim that it would be manifestly unjust to allow the beneficiary to enforce payment without taking into account the cross claim. In the *Hongkong and Shanghai Banking Corp.* case, the decision can be justified on the ground that the issuing bank was provided with irrevocable undertakings by the beneficiary to keep the issuer harmless.¹⁴¹ Thus, the beneficiary’s claim

139. 2 Q.B. 514 (1990).

140. *Id.* at 525, 526. But it should be noted that if the issuer’s claim is assigned from the account party, the issuer will be under the same restriction as the account party, *see* Sec. V.A.1. *ante.*

141. *Id.* at 519.

under the standby credit was impeached by the issuing bank's cross claim because of the irrevocable undertakings given by the beneficiary himself.

Mugasha strongly objects to allowing equitable set-off in this context on the ground that the very essence of employing a bank in the transaction is to let the beneficiary have prompt unqualified payment; that as the beneficiary frequently uses a credit as security in the form of back to back credits or transferable credits, if the set-off is allowed, it will affect a third party's reliance on the credit; that allowing a set-off defense is contrary to the intention of the parties to the underlying contract; and that the principle of independence stops the issuer from asserting a set-off defense.¹⁴²

It is submitted that this objection goes too far. Although the beneficiary's rights under a documentary credit are unique, the resulting proceeds are to be treated in the same manner as his other assets. Thus, when the issuer has decided to honor the demand, it is entitled to use equitable set-off to effect payment. Furthermore, the principle of independence has no effect, as has been stated above, on an equitable set-off defense raised by the issuer. Finally, given the discretionary nature of equitable set-off, the courts can reject an equitable set-off defense where the credit has been used as security for other credits and where injustice will occur if set-off is allowed.

In *Security Finance Group, Inc. v. North Kentucky Bank & Trust, Inc.*,¹⁴³ the defendant's president, acting without authority, issued various standby credits in favor of the claimant, who on the faith of the credits lent sums of money to Rhein. In an action brought by the claimant to enforce its right under the credits, the defendant alleged that the beneficiary (claimant) was in league with its president and Rhein in a fraudulent scheme to defraud it and, hence, counterclaimed damages for the fraud. The United States Court of Appeals, Sixth Circuit, in reversing the district court's summary judgment articulated in the remand that if the counterclaim was successful, damages should not be awarded to the claimant until the defendant's right to set-off was determined.¹⁴⁴

E. *The Law Governing Documentary Guarantees*

According to the governing law rules at common law, the proper law of a contract with foreign elements is decided by the parties' choice of law if there is an express or implied choice, otherwise the proper law is the law of the country with which the contract has the closest and most real

142. A. Mugasha, *supra* note 108, at 36, 43, 46, 47; also A. Mugasha, *Set-off and Letters of Credit* (1992) 7 B.F.L.R. 307 at 315-318.

143. 858 F. 2d 304 (1989), supplemented in 875 F.2d 529 (6th Cir. 1989).

144. 875 F. 2d at 531.

connection.¹⁴⁵ The choice of law can be expressed, or it can be implied from the circumstances which show the intention of the parties. However, with the implementation of the Rome Convention on the Law Applicable to Contractual Obligations 1980 within the United Kingdom in 1990,¹⁴⁶ the provisions of the Rome Convention apply to contracts entered into after 1 April 1991.

According to the Rome Convention, a documentary guarantee¹⁴⁷ is governed by the system of law chosen by the parties to it, and the choice can be either an express one, or an implied one¹⁴⁸ demonstrated with certainty by the terms of the payment undertaking or by the circumstances.¹⁴⁹ If the parties have not chosen a proper law, the undertaking is governed by the law of the country with which it is most closely connected:¹⁵⁰ that country is presumed to be the country in which the principal place of business of the party who is to effect the characteristic performance of the undertaking is situated; or, if that performance is to be effected through a place of business other than the principal place of business, the country in which that other place of business is situated.¹⁵¹ However, this presumption will be rebutted if it appears from the circumstances as a whole that the undertaking is more closely connected with another country.¹⁵²

It is a feature of documentary guarantees that they do not regularly contain any express choice of law. Presumably that is because the issuer prefers its payment undertaking to be governed by the law of the country where it is situated, but this is not acceptable to the beneficiary. As long as this banking practice stands, unless there are general conditions of business, previous course of dealings, or other circumstances pointing to an implied choice of law,¹⁵³ it is inappropriate to infer the parties' intention from the choice of law clause in the underlying contract,¹⁵⁴ for

145. *John Lavington Bonython v. Commonwealth of Australia* (1951) A.C. 201 at 219; *Re United Railways of Havana and Regla Warehouse Ltd.* (1961) A.C. 1007 at 1068, per Lord Denning; *Cie. v. Tunisienne v. Cie. d'Armement* (1971) A.C. 572 at 583.

146. The Contracts (Applicable Law) Act 1990.

147. Although the legal nature of documentary guarantees is argued to be a unilateral abstract payment undertaking in this essay, it is, like a promise under seal, still subject to the Rome Convention, see DICEY & MORRIS, *THE CONFLICT OF LAWS* (12th ed. 1993), p. 1234.

148. The English concept of implied choice is still appropriate in the operation of the Rome Convention, see BENJAMIN'S *SALE OF GOODS* (5th ed. 1997), par. 25-029 *LAW OF BANK PAYMENT* 460 (Brindle & Cox eds., 1996).

149. Art. 3 (1).

150. Art. 4 (1).

151. Art. 4 (2).

152. Art. 4 (5).

153. BENJAMIN'S *SALE OF GOODS* (5th ed. 1997), par. 25-070; *Attock Cement v. Romanian Bank* (1989) 1 W.L.R. 1147 at 1158.

154. *Wahda Bank v. Arab Bank* (1996) 1 LLOYD'S REP. 470 at 473; *Turkiye v. Bank of China* (1993) 1 LLOYD'S REP. 132 at 135.

the principle of independence severs this inference.¹⁵⁵ *A fortiori*, a documentary guarantee is not necessarily closely connected with the country whose law is the governing law of the underlying contract. Instead, the governing law of a documentary guarantee is the system of law that has the most and real connection with the issuer's undertaking or, in the parlance of the Rome Convention, that is closely connected with the undertaking. This, in turn, is premised upon what is the performance that is characteristic of the documentary guarantee transaction.

In deciding what is the characteristic performance of a documentary guarantee and of other contracts involved in a documentary guarantee transaction, the manner of operation in practice of this transaction is crucial. In particular, although standby credits share with demand guarantees the same legal nature, their operation in practice is different, and this difference affects the determination of governing law. Therefore, in the following discussion a distinction is drawn between standby credits and demand guarantees.

1. *The Governing Law of Standby Credits*

In a standby credit transaction there may be five relationships involved, apart from the underlying contract. These are the relationship between: (a) the issuer and the account party, (b) the issuer and the confirming bank, (c) the issuer and the advising (or paying) bank, (d) the confirming bank and the beneficiary, and (e) the issuer and the beneficiary. The relationship between the issuer and the account party¹⁵⁶ is presumed to be governed by the law of the issuer (*i.e.*, the law of the country where the issuer's principal place of business, or its issuing branch, is situated), either because the provision of the banking facility by the issuer is the characteristic performance of the contract between the issuer and the account party,¹⁵⁷ or because it is the law of the place of performance of the instructions from the account party.¹⁵⁸

As between the issuer and the confirming bank, the relationship is one of agency, although as against the beneficiary the confirming bank acts as a principal.¹⁵⁹ Under this contract of agency, the characteristic

155. *Attock Cement* (1989) 1 W.L.R. at 1159; *Wahda Bank* (1996) 1 LLOYD'S REP. at 473; N. Moloney, *Choice of Law Rules and Trade Finance Contracts* (1997) L.M.C.L.Q. 344 at 350.

156. The issuer acts as a principal, not as an agent for the applicant, see *Agri Export Co-op. v. Universal Sav. Ass'n*, 767 F. Supp. 824, 829 (1991); *cf. Midland Bank, Ltd. v. Seymour*. (1955) 2 Ll. L. Rep. 147 at 153.

157. BENJAMIN'S SALE OF GOODS (5th ed. 1997), par. 25-070; C. Morse, *Letters of Credit and the Rome Convention* (1994) L.M.C.L.Q. 560 at 570; B. Davenport & M. Smith, *The Governing Law of Letters of Credit Transactions* (1994) 1 B.J.I.B. & F.L. 3 at 5.

158. C.M. Schmitthoff, *supra* note 2, at 111.

159. *Bank Melli Iran v. Barclays Bank* (1951) 2 Ll. L. REP. 367 at 376, per McNair, J.; *Bank of Baroda v. Vysya Bank* (1994) 2 LLOYD'S REP. 87 at 90, 91; BOWSTEAD & REYNOLDS ON

performance is the addition of confirmation by the confirming bank and its honouring of the obligation incurred thereby in its relationship with the beneficiary. The liability of the issuer to reimburse the confirming bank is only consequential to the character of the contract and does not itself characterize the agency contract.¹⁶⁰ Accordingly, the country where the confirming bank is situated is presumed to be the country that is closely connected with the contract of agency and, hence, the law of that country governs this relationship.

As between the issuer and the advising (or paying) bank, the relationship is also one of agency.¹⁶¹ The paying bank's examination of documents and its making payment on behalf of the issuing bank is the characteristic performance of the agency contract and,¹⁶² hence, the law of the country where the paying bank is situated governs the relationship.¹⁶³ If the advising bank does not act as a paying bank, it is more difficult to decide which bank's performance is characteristic. Nevertheless, given, first, that the law of the advising bank is the law of place of performance of the agency contract, and, secondly, that the advice in the Giuliano-Lagard report points out that the characteristic performance of an agency contract is that of the agent,¹⁶⁴ the presumption for the law of the advising bank is stronger.¹⁶⁵

As between the confirming bank and the beneficiary, the standby credit is presumed to be governed by the law of the confirming bank if there is no other paying bank involved in between. The confirming bank undertakes, by adding its confirmation, to pay the beneficiary,¹⁶⁶ and the prescribed documents are tendered to the confirming bank for determination, with payment made thereafter if the documents are conforming. These make the confirming bank's performance qualified as the characteristic performance of the relationship as to the beneficiary.¹⁶⁷ By the same reasoning, the same result will be reached as to the

AGENCY par. 2-033 (16th ed. 1996); cf. *Kingdom of Sweden*, 96 N.Y.S. 2d at 791.

160. *B.C.C.H.K. v. Sonali* (1995) 1 LLOYD'S REP. 227 at 237; BENJAMIN'S SALE OF GOODS par. 25-070 (5th ed. 1997).

161. *Bank of Baroda* 2 LLOYD'S REP. at 91-92 (1994).

162. *Bank Melli Iran* 2 LL. L. REP. (1951) at 376, per Mcnair, J.; *Gian Singh Ltd.* (1974) 1 W.L.R. at 1238; *Bamberger Polymers Intern. Corp. v. Citibank*, 477 N.Y.S. 931, 932 (1983); *Sound of Market Street v. Continental Bank Intern.*, 819 F. 2d 384, 388 (1987); Gutteridge & Megrah, *supra* note 23, 77-78; BENJAMIN'S SALE OF GOODS (5th ed. 1997), par. 25-070.

163. BENJAMIN'S SALE OF GOODS par. 25-070 (5th ed. 1997); M. Gopal, *English Courts and Choice of Law in Irrevocable Documentary Letters of Credit*, in CURRENT PROBLEMS OF INTERNATIONAL TRADE FINANCING 115, 135 (Kee & Chan eds., 1990).

164. C. Morse, *supra* note 157, at 564-565.

165. C. Schmitthoff, *supra* note 48, at 190.

166. *Newport Industries v. Berliner Und Frankfurter Bank*, 923 F. Supp. 31, 34 (1996).

167. *European Bank v. Punjab Bank* (1981) 2 LLOYD'S REP. 651 at 656-657; *Bank of Baroda* 2 LLOYD'S REP. at 92 (1994), per Mance, J.; C. Morse, *supra* note 157, at 567; R. JACK, *supra* note 2, at 295.

relationship between the issuing bank and the beneficiary when there is no intermediary bank involved. The situation, however, is different when the issuing bank employs a correspondent bank to effect the credit. Where a confirming bank is employed, the relationship as between the issuer and the beneficiary is subject to the law of the confirming bank.¹⁶⁸ First, although according to Article 4(2) of the Rome Convention the direct relationship between the beneficiary and the issuer is presumed to be governed by the law of the issuer, whose undertaking to pay is characteristic performance of the standby credit, the fact that the credit is confirmed and effected by an intermediary bank makes the credit more closely connected with the country where the confirming bank is situated, and thus brings Article 4(5) of the Rome Convention into operation rebutting the preceding presumption. Secondly, the place of performance of the credit constituted by the confirmation is the country where the confirming bank is situated and is different from the place of principal business of the issuer; and this difference further justifies that rebuttal. Thirdly, sustaining that presumption will bring forward a wholly undesirable multiplicity of proper laws in one standby credit transaction: one system of law governs the relationship between the beneficiary and the confirming bank, and another governs the relationship between the beneficiary and the issuer.¹⁶⁹

Where a nominated bank rather than a confirming bank is utilized to effect the credit, the same result will be reached by similar reasoning.¹⁷⁰ That is also because, by nominating an intermediary bank to examine the prescribed documents and to make payment on behalf of the issuer, the place of performance of the credit has been transferred to the country where the nominated bank is situated. To hold otherwise, the nominated bank would have constantly to be seeking to apply a whole variety of foreign laws, *e.g.*, the exchange control regulations of the issuer's country,¹⁷¹ and this would cause very great inconvenience.¹⁷²

2. *The Governing Law of Demand Guarantees*

In a four-party demand guarantee transaction there are three relationships involved, apart from the underlying contract. These are the relationships between: (1) the account party and the counter guarantor, (2)

168. *Bank of Baroda* 2 LLOYD'S REP. at 92-93 (1994); *Offshore v. Banco Central* (1976) 2 Lloyd's Rep. 402 at 404.

169. *Bank of Baroda* 2 LLOYD'S REP. at 92-93 (1994); *Offshore* 2 LLOYD'S REP. at 404 (1976).

170. *Bank of Baroda* 2 LLOYD'S REP. at 93 (1994); *Offshore* 2 LLOYD'S REP. at 404 (1976); *Power Curber* 1 W.L.R. at 1240 (1981); *J. Zeevi & Sons v. Grindlays Bank*, 371 N.Y.S. 2d 892, 898 (1975); *cf.* B. Davenport & M. Smith, *supra* note 157, at 5.

171. M. Schmitthoff, *supra* note 2, at 113.

172. *Offshore* 2 LLOYD'S REP. at 404 (1976).

the beneficiary and the primary guarantor; (3) the primary guarantor and the counter guarantor. It should be noted that there is no direct relationship between the beneficiary and the counter guarantor. The relationship between the account party and the counter guarantor is identical with that between the applicant for a standby credit and the issuer; thus, the conclusion drawn there can be applied here. The relationship between the beneficiary and the primary guarantor is similar to that between the beneficiary of a confirmed credit and the confirming bank and, hence, the conclusion drawn there is also applicable here.

The governing law of the relationship between the primary guarantor and the counter guarantor caused some disputes and was recently decided in *Turkiye Is Bankasi A.S. v. Bank of China*¹⁷³ and *Wahda Bank v. Arab Bank Plc.*¹⁷⁴ In these two cases, it was commonly held that the counter-guarantee was governed by the same system of law as that of the primary guarantee,¹⁷⁵ either by the implied choice of law rule¹⁷⁶ or through the “closest and most real connection” test.¹⁷⁷ The grounds of these two decisions can be summarized as follows. First, although it was generally accepted that the proper law of a demand guarantee was not influenced by the proper law of the underlying contract, the situation here was different in that the counter-guarantee was intimately connected with the primary guarantee.¹⁷⁸ Secondly, according to the so-called doctrine of infection the legal or commercial connection between one contract and another might enable the court to say that the parties (not necessarily the same match of parties) must have implicitly¹⁷⁹ submitted both contracts to the same law. And, the doctrine of infection as applied in *The Broken Hill Proprietary Co. Ltd. v. Xenakis*¹⁸⁰ (holding that the proper law of an accessory guarantee was affected by the proper law of the principal contract) was also applicable in the present cases, these cases being analogous to the *Broken Hill* case.¹⁸¹ Thirdly, the primary guarantor who issued a demand guarantee for a tiny commission would expect to ensure that it took no greater risk than the solvency of the counter guarantor and that its right of reimbursement was back-to-back the same as his liability. And, the counter guarantor would readily agree to that expectation. Thus, it could be inferred without any doubt that the parties intended the

173. 1 LLOYD'S REP. 132 (1993).

174. 1 LLOYD'S REP. 470, C.A. (1996).

175. *Cf. I.E. Contractors* 2 LLOYD'S REP. at 499 (1990).

176. R. CRANSTON, *supra* note 87, at 431; M. BRINDLE & R. COX (eds.), *supra* note 148, at 460.

177. *Turkiye* 1 LLOYD'S REP. at 136 (1993); *Wahda Bank* 1 LLOYD'S REP. at 473 (1996).

178. *Turkiye* (1993) 1 LLOYD'S REP. at 135; *Wahda Bank* (1996) 1 Lloyd's Rep. at 473.

179. In *Attock Cement* (1989) 1 W.L.R. at 1158, Staughton, L.J., articulated that the doctrine of infection could also operate through “the closest and most real connection” test.

180. 2 LLOYD'S REP. 304 at 306 (1982).

181. *Turkiye* 1 LLOYD'S REP. at 135 (1993); *Wahda Bank* 1 LLOYD'S REP. at 473 (1996).

counter-guarantee to be governed by the same law as the primary guarantee.¹⁸² Fourthly, the ruling in *Bank of Baroda v. Vysya Bank*¹⁸³ to the effect that it would be wholly anomalous if the same system of law were not to govern the contract between the issuing bank and the confirming bank and the contract between the confirming bank and the beneficiary, was also persuasive in this setting.

Admittedly, the counter-guarantee is in a sense connected with the primary guarantee in that the latter is backed by the former. Nevertheless, as we have seen,¹⁸⁴ they are still independent of each other. Thus, these two decisions cannot derive any support from the so called doctrine of infection as applied in the *Broken Hill* case, which dealt with the proper law issue in the context of an accessory guarantee. Furthermore, the primary guarantor's need for its right of reimbursement to be identical in amount with its liability under the primary guarantee, and the counter guarantor's acknowledgement of this need, do not necessarily support the parties' implied intention that the counter-guarantee should be subject to the same law as that of the primary guarantee. That is because the principle of independence severs this implication or inference. And, if this reasoning is sustainable, every relationship in a documentary guarantee transaction would be subject to one and the same proper law, because this kind of transaction is invariably conducted on the basis that the relationships involved are all back-to-back: any party who makes payment will be reimbursed by a subsequent party.¹⁸⁵ Finally, the decision in *Bank of Baroda* that the relationship between the beneficiary of a confirmed credit and the confirming bank and the relationship between the confirming bank and the issuer should be governed by the same law, is not a result of application of the so called doctrine of infection, hence it cannot grant any support here.

Notwithstanding the flawed reasoning in these two cases, the conclusion that the counter-guarantee and the primary guarantee should be governed by the same law, is acceptable, although it must be supported by different reasoning. First of all, as we have seen,¹⁸⁶ there are two relationships between the primary guarantor and the counter guarantor, one deriving from the counter-guarantee itself, the other constituted by the contract of agency between them. In opening the primary guarantee on the counter guarantor's instruction, the primary guarantor acts as an agent for the counter guarantor as far as the internal relation between these two guarantors is concerned. In this connection an analogy can be drawn from

182. *Wahda Bank* 1 LLOYD'S REP. at 473 (1996).

183. 2 LLOYD'S REP. 87 at 94 (1994); see also Sec. V.E.1. *ante*.

184. See Sec. V.C. *ante*.

185. Davenport & Smith, *supra* note 157, at 3, 5.

186. See Sec. V.C. *ante*.

the confirmation of a standby credit by a confirming bank,¹⁸⁷ which has long been held to be acting as an agent for the issuing bank as far as the internal relation between these two banks is concerned.¹⁸⁸ As the characteristic performance of this agency is the issuance of the primary guarantee rather than the subsequent reimbursement by the counter guarantor, the proper law of this contract of agency is presumed to be the law of the primary guarantor. Furthermore, the so-called doctrine of infection wins its name from the situation where a charterparty incorporated into a bill of lading carries its proper law with it into the bill of lading¹⁸⁹ because they are closely connected. As the counter-guarantee is more closely connected with the contract of agency than with the primary guarantee, the proper law of the counter-guarantee is infected by the proper law of the contract of agency rather than by that of the primary guarantee. As a result, the proper law of the counter-guarantee is the law of the primary guarantor, which is also the proper law of the primary guarantee. This submission arrives at the same conclusion as reached in *Turkiye Is Bankasi A.S. v. Bank of China* and *Wahda Bank v. Arab Bank Plc*, but still keeps the principle of independence of the counter-guarantee from the primary guarantee intact.

VI. CONCLUSION

The use of documentary guarantees in transnational commerce lets the beneficiary have an inexpensive way of prompt and certain payment from a known solvent issuer in his own country, pending resolution of disputes as to the underlying contract.¹⁹⁰ Thus, the beneficiary's breach of the underlying contract is not a ground to enjoin the issuer from making payment, nor is it a reason for the account party to attach the documentary guarantee.¹⁹¹ By the same reasoning, the account party cannot complain that the amount drawn under the documentary guarantee exceeds the sum due under the underlying contract. After the beneficiary is in possession of the funds, if he is not entitled, according to the underlying contract, to retain the money, the account party can claim it back in a separate action against him.¹⁹²

Although the independence principle stops the account party from

187. *Wahda Bank* (1996) 1 LLOYD'S REP. at 473.

188. *Bank Melli Iran* 2 LL. L. REP. at 376 (1951); *Bank of Baroda* 2 Lloyd's Rep. at 90, 91 (1994); BOWSTEAD & REYNOLDS ON AGENCY par. 2-033 (16th ed. 1996); cf. *Kingdom of Sweden*, 96 N.Y.S. 2d at 791.

189. *The "Njegos*. 53 Ll. L. Rep. 286 at 298" (1936); "*The Elli 2*" 1 LLOYD'S REP. 107 at 112 (1985), per Ackner, L.J.

190. See Sec. II. *ante*.

191. See Sec. V.A. *ante*.

192. See Sec. V.A.2. *ante*.

raising a set-off defense against the beneficiary's claim under a documentary guarantee, the principle cannot restrain the issuer from raising statutory set-off against the beneficiary's claim;¹⁹³ nor can it be used to prevent the issuer from alleging equitable set-off against the beneficiary's claim, provided that the issuer's cross claim is so closely connected with the beneficiary's claim that it would be manifestly unjust to allow the beneficiary to enforce payment without taking into account the issuer's cross claim.¹⁹⁴

Furthermore, if there is no express choice of law in a documentary guarantee, it is inappropriate to infer the parties' intention from the choice of law clause in the underlying contract, for the principle of independence severs this inference. Because of the principle of independence, a documentary guarantee cannot fairly be said to be closely connected with the country whose law is the governing law of the underlying contract.¹⁹⁵ By the same reasoning, it is also not suitable to say that the parties to a counter-guarantee intend the counter-guarantee to be governed by the same law as that of the primary guarantee.¹⁹⁶

Finally, compared with the shipping documents usually required under documentary credits, the demand and documents, if any, required under documentary guarantees have nothing to do with the beneficiary's own performance of the underlying contract. Thus, the beneficiary's honesty or fraud in claiming under the documentary guarantee can only be decided with reference being made to the underlying contract. Furthermore, the documents required under documentary guarantees often emanate from the beneficiary himself. Hence, even if the principle of strict compliance applies to documentary guarantees, it cannot serve the account party's interests well. As a corollary, the equilibrium of protection between the seller and the buyer in documentary credit transactions cannot be achieved in documentary guarantee transactions without making documentary guarantees less independent of the underlying contract than documentary credits.¹⁹⁷

193. See Sec. V.D.1. *ante*.

194. See Sec. V.D.2. *ante*.

195. See Sec. V.E. *ante*.

196. See Sec. V.E.2. *ante*.

197. See Sec. V.A.3. *ante*.