Sensitivity to fraud: demand guarantees & standby letters of credit

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Demand guarantees and standby letters of credit, both of which are used for enhancing credit, are vulnerable to fraud by their beneficiaries. Due to the widespread global use of these instruments, the International Chamber of Commerce (ICC) has developed voluntary uniform rules regulating their use, in part to minimise the risk of fraud.

This article examines strategies for minimising the risk of fraud, including adoption of the ICC’s various uniform rules and general remedies in court.

Demand guarantees

A demand guarantee is a written undertaking by a bank (or a similar institution) to pay a person (the beneficiary) an amount of money upon the presentation of certain specified documents. This is different from a ‘standard’ guarantee which demands actual proof of a failure to perform contractual obligations. Demand guarantees also allow the beneficiary to:

- replace the unknown credit worthiness of the principal with the bank’s known credit worthiness
- gain speedy access to funds if the principal defaults
- ensure that, if there is a dispute as to an event of default, the beneficiary has access to funds until the dispute is resolved.

A beneficiary wishing to call upon a demand guarantee must present the required documents for examination by the guarantor within the time and at the place specified in the guarantee. These documents may range from a simple written demand to, for example, a certificate of default signed by a project engineer or supervising architect. If the documents pass examination by the guarantor, the beneficiary is entitled to payment under the demand guarantee even if there is a dispute over whether or not the principal has breached its obligations under the original underlying contract.

Standby letters of credit

Apart from differences in terminology used in the actual documents, standby letters of credit...
credit work in essentially the same way as demand guarantees. For example, where demand guarantees refer to a principal, beneficiary and guarantor, standby letters of credit refer to an applicant, beneficiary and issuing bank respectively.

**ICC rules**

Professor Roy Goode suggests, in the *Guide to the International Chamber of Commerce Uniform Rules for Demand Guarantees* (an official ICC publication), that from a legal perspective a standby credit is simply another term for a demand guarantee. Because banks in the United States were not normally permitted to issue guarantees, the term ‘standby credit’ was adopted to avoid the language of guarantee. The difference between the two is therefore not of law but of practice and business terminology. Standby credits are used to support a principal’s financial as well as non-financial obligations and to provide credit enhancement for the primary financial undertaking.

The ICC has developed three sets of rules which can be adopted in standby letters of credit and demand guarantees:
- the Uniform Rules for Demand Guarantees (URDG)
- the Uniform Customs and Practice for Documentary Credits (UCP500)
- the International Standby Practices (ISP98).

The UCP500 is based on its predecessor, the UCP400, which gained wide acceptance for the use of documentary credits and was replaced by the UCP500 in 1993. The URDG, which covers demand guarantees, and the ISP98, which covers standby letters of credit, do not yet enjoy the universal acceptance of the UCP500 rules. Because of this, Australian banks often prefer to incorporate the UCP500 rules into demand guarantees and standby letters of credit. However, the URDG’s level of acceptance is increasing, with organisations such as the International Federation of Consulting Engineers incorporating it in their model guarantee forms.

**Fraud**

Given that demand guarantees and standby letters of credit are not concerned with the underlying arrangements between the principal and the beneficiary, there is an obvious potential for beneficiaries to make fraudulent claims. This can expose the guarantor to a claim by the beneficiary while there is no default in the underlying agreement. In such a case, the principal would have to indemnify the guarantor, regardless of whether the beneficiary’s claim was fraudulent, and seek repayment from the beneficiary to recover the funds.

In an attempt to limit the principal’s exposure to fraud, the URDG, UCP500 and ISP98 contain provisions dealing with how a guarantor should examine documents presented by a beneficiary calling upon a demand guarantee or standby letter of credit. However, none of these ICC rules deals directly with the case of a fraudulent demand that passes examination. This is explicitly left to the common law.

For example, Article 9 of the URDG states that a guarantor has a duty to examine the documents presented by a beneficiary making a call upon a demand guarantee. This duty is limited to ensuring the guarantor exercises good faith and reasonable care when checking the apparent good order of the documents. The guarantor is not responsible for the adequacy, accuracy or genuineness of documents presented under a demand guarantee. Its responsibility is restricted to ascertaining whether the documents appear, on their face, to conform with the demand guarantee’s requirements. Accordingly, the guarantor is not obliged to do more than conduct a reasonable visual examination.

Article 13 of the UCP500 states that a guarantor must examine all documents required by a standby letter of credit with reasonable care to ascertain whether or not they appear, on their face, to comply with the terms and conditions of the credit. In this respect, the guarantor need only look at the face of the document. According to the UCP500, the examination required is determined by international standard banking practice as reflected in the UCP500. If multiple documents are submitted for examination and they are inconsistent with one another, they will not be considered as complying with the terms and conditions of a credit. Documents not stipulated in a credit will not be examined by guarantors. Article 15 of the UCP500 stipulates that guarantors assume no liability or responsibility for the form, sufficiency, accuracy, genuineness, falsification or legal effect of any documents, or for the general and/or particular conditions stipulated in the documents or superimposed upon them by a standby letter of credit. The UCP500 in a limited sense codifies some of the potential liability faced by a guarantor.

The ISP98 rules differ considerably from both the URDG and UCP500 rules by taking a much more prescriptive approach to defining the extent of examination that a bank must perform before accepting a beneficiary’s documents in satisfaction of a standby letter of credit. Rule 4, which deals exclusively with examination, contains 21 sub-rules that deal with such issues as examination for compliance, examination for inconsistency and the formality of statements in documents. The ISP98 also contains specific provisions relating to the format that various types of documents associated with a standby letter of credit should take.

The ISP98 rules attempt to qualify the guarantor’s responsibilities very specifically. They set out clearly those
things for which a guarantor can and cannot be liable. This provides the principal to a standby letter of credit with greater certainty as to what responsibilities the guarantor has, unlike the URDG rules which simply rely on concepts such as good faith and reasonable care.

**Recovering fraudulent payments**

The ICC rules discussed above attempt to deal with fraud at the examination stage by ensuring each party knows what its duties are and the guarantor conducts itself in good faith, etc. The common law, on the other hand, has nothing to say about how documents should be examined when a call is made on a demand guarantee or standby letter of credit — everything is left to the arrangements agreed to between the parties. Regardless of any measures to ensure adequate examination, there will always be scope for fraud given the documentary nature of these instruments. If fraudulent documents do pass examination, two possibilities arise.

The first is that the guarantor has failed in its duties to conduct a proper examination of documents presented by a beneficiary. In this case, because the principal would not have to indemnify the guarantor, the guarantor would be left to recover the fraudulently acquired funds itself. Recovery would depend upon the circumstances of the case but could include damages for breach of contract, unjust enrichment, and unconscionability or unfair dealing under the Trade Practices Act 1974. However, this entire scenario is unlikely because the examination requirements upon a guarantor are not particularly stringent.

The second possibility is that the guarantor conducted a thorough examination but the documents were not, on their face, fraudulent. In this case, the principal must indemnify the guarantor and then seek repayment from the beneficiary. This can result in the principal experiencing liquidity problems and a tarnished reputation. Worse still, it may never be able to recover its funds if, for example, the beneficiary dissipates them or becomes insolvent. A principal can attempt recovery by making claims for damages analogous to the ones discussed in the previous paragraph. However, it is often more useful under the common law to prevent payment or prevent the use of proceeds received under a demand guarantee or standby letter of credit.

**Preventing payment**

A principal may seek injunctive relief in order to prevent a beneficiary from making a demand or to prevent a guarantor from making payment under a demand guarantee or standby letter of credit. Generally, an injunction restraining a beneficiary from making a demand is easier to obtain than one restraining a guarantor from making a payment. However, neither may be an effective remedy if the beneficiary or guarantor is in a foreign jurisdiction or if the principal is unaware that the beneficiary intends making a demand.

An injunction restraining a beneficiary from making a demand may be granted if the act of making the demand would be a breach of the underlying contract. The issues a court may consider when determining whether to grant an injunction include:

- the terms of the underlying contract between principal and beneficiary (eg, if the contract positively identifies the circumstances in which a demand can be made, the court will only grant an injunction if those circumstances are not present)
- the purpose of the demand guarantee or standby letter of credit (eg, if a payment is intended to provide a beneficiary with available funds to continue construction, etc, while a dispute is resolved, the court will not grant an injunction)
- any other factors which the court considers relevant.

Courts have traditionally been hesitant to grant injunctions preventing a guarantor from making a payment because the value of demand guarantees and standby letters of credit is supposed to be in their autonomous and immediate nature. The circumstances in which a court will grant such an injunction are therefore limited to fraud, illegality and, more recently, statutory unconscionability.

- To prove fraud, it must be shown that the beneficiary lacked an honest belief in the validity of the demand. What the principal must ultimately show is that there is established or obvious fraud to the knowledge of the guarantor. In practice, this high standard of proof is rarely established.
- Illegality refers to the common law principle that the doctrine of autonomy will not apply, and therefore a guarantor will not be required to make a payment, if to do so would cause a party to commit an illegal act.
- Sections 51A–51AC of the Trade Practices Act makes it unlawful for a corporation to engage in conduct that is unconscionable. Hence, if the beneficiary is a corporation and is making a demand in circumstances which are harsh or oppressive (even if it is strictly within its legal right to make the demand), it may be acting unconscionably. In such cases, a court may grant an injunction. For example, making a demand when the demand guarantee or standby letter of credit was issued to secure the repayment of money, in circumstances where the money has been substantially repaid, may be unconscionable. Note that this is not yet a well settled area of the law.

**Preventing use of proceeds**

If the principal cannot, or chooses not to, prevent payment when a...
demand is made, it can seek a mareva injunction. This prevents the beneficiary from removing the proceeds of a demand from the jurisdiction, or otherwise dealing with the funds, in frustration of a pending court judgment. Hence, the purpose of a mareva injunction is to ensure that a payment by a guarantor to a beneficiary is not dissipated while the principal challenges the validity of the payment. In order for a court to grant a mareva injunction the principal must establish that:

- a prima facie case exists that the demand was in breach of the underlying contract
- a real risk exists that the beneficiary will dissipate the proceeds received or remove them from the jurisdiction
- the injunction ought to be granted on the balance of probabilities.

It is noted, however, that mareva injunctions share a significant practical problem with injunctions to prevent payment. To be effective, a mareva injunction should normally be granted before a payment is made pursuant to a demand. This gives the beneficiary little or no opportunity to dissipate the funds or move them out of the jurisdiction. To do this, a principal must know that the beneficiary is about to make a demand.

Local rules

Although demand guarantees and standby letters of credit are accorded a high degree of autonomy in most countries, leaving it up to the parties to determine the obligations between themselves and to choose the instrument’s governing law, some still impose laws which — for reasons of public policy — cannot be overridden. These are known as mandatory laws or rules. It is important to determine whether a guarantee is subject merely to the obligations settled between the parties or whether the governing law or the laws of the country before whose court a dispute is being heard (the lex fori) apply.

...whether the mandatory rules of lex fori are overriding in their effect or can be displaced by the selection of a foreign law to govern the contract is a matter to be determined by the lex fori. Similarly, the terms agreed between the parties give way to rules of public policy denying or limiting the effect of guarantees when such rules are imposed by the applicable law of the lex fori. In the latter case, they are given overriding effect.7

A standby letter of credit or a demand guarantee will usually state whether the instrument is governed by the URDG, UCP500 or ISP98 rules. Such an instrument will also usually nominate the law of a certain jurisdiction as the law governing the instrument. If this jurisdiction has laws that are inconsistent with one of the ICC’s rules, the governing law will normally override the ICC rule. If the lex fori is different from the governing law of an instrument, it may also have mandatory laws which can override both the ICC and the nominated jurisdiction’s laws. Ultimately, it is up to the court of the lex fori to determine which rules will apply. However, it should be remembered that because the ICC rules are really just clauses that an instrument can import, and not laws in the sense of statute or judicial precedent, they can always be overridden by both the lex fori and the instrument’s governing law.

Conclusion

Although demand guarantees and standby letters of credit are useful instruments of credit support, they are prone to fraud, and that risk should be minimised. The common law offers principals and guarantors some protection against fraudulent demands, but the most common form of dealing with fraud is attempting to prevent it through the incorporation of ICC rules. The ISP98 rules offer all parties the most clarity and certainty as to what the process of examination will entail, but the lesser UCP500 rules currently enjoy broader acceptance.

Over time the ICC has chosen to increasingly codify examination by a guarantor. For example, the URDG rules were released in 1992 and are the most general rules when outlining the process of examination, while the ISP98 rules — released in 1998 — are clearly the most specific. While there is quite a dramatic difference in how each of the URDG, UCP500 and ISP98 rules choose to outline examination, they ultimately aim to achieve the same result, namely that a guarantor examining documents exercises good faith and shows reasonable care. Hence, a guarantor bound by the URDG rules would probably be required to do everything outlined in the ISP98 rules as well.

2. The Law Book Company (2000) The Laws of Australia Volume 18, Part 18.6, Paragraphs 97–100 discuss at length the various authorities which have helped clarify the circumstances in which a court will grant an injunction preventing a guarantor from making a payment.
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