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The French first demand guarantee and the standby credit: a comparative study

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THE FRENCH FIRST DEMAND GUARANTEE AND THE STANDBY CREDIT: A COMPARATIVE STUDY

by

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INTRODUCTION: DIFFERENT DEVICES INSPIRED BY SIMILAR NEEDS

The "allergy of corporations to any kind of risk is a characteristic of modern society."[1] Since World War II new security devices have evolved in both France and the United States. In France the new device is known as a first demand guarantee. In the United States it is called standby letter of credit. The underlying market forces which caused these devices to be developed are the same. But the label applied to the devices and the bodies of existing doctrine with respect to which they are formulated are different. In the French view the difference in the two instruments is just a matter of different labels. But in the American view the distinction between a credit and a guaranty is critical. The purpose of this thesis is to compare the first demand guarantee and the standby credit, identifying both the similarities and the differences in these devices.

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[1] C. Gavalda, *Le renouveau de l'assurance des marches des acheteurs dans le commerce international*, OUVRAGE COLLECTIF CUJAS 75, 75 (1980).

A. Similar Market Forces

Both the standby credit and first demand guarantee were created because of a change in market conditions. An important part of international transactions deals with high technology. But the number of buyers is limited because of the high cost of such technology. Outside of the developed countries, these buyers are mainly situated in the countries member of the OPEC (Organization of Petroleum Exporting Countries). It is crucial for countries in this category to have this technology because they are economically backward. But contrary to the majority of the developing countries, the countries producing petroleum suddenly became rich by exporting oil. They have been able to afford it. Hence, competition has become much higher in these oil rich developing countries, particularly with respect to the building of infrastructure. But too many sellers are unable to impose their conditions on the few buyers. So, there has been a shift in the bargaining power.[2] One of the main consequence of these phenomena has been that all the sellers of high technology have tried to offer the best guarantees to the buyers in order to obtain their contracts.[3] In the developing countries, their nationals are hardly trained to deal with the high

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[2] J. Stoufflet, *La garantie a premiere demande*, CLUNET 2, 265, 266 (1987); C. Gavalda & J. Stoufflet, *La lettre de garantie internationale*, R.T.D.COM.(REVUE TRIMESTRIELLE DE DROIT COMMERCIAL 1, 1 (1980).

[3] *Id.*

technology transferred. They do not always measure the risks involved. But at the same time, the political risks have also become more important.[4] These developing countries are not all stable politically. Then, in these countries unlike in the developed countries, the contracts signed by one government may not necessarily be pursued by the next one. The most obvious example is Iran. After the Iranian revolution, most of the contracts signed by the Imperial Government with either French or American companies were not fulfilled. In order to stop undue payment under first demand guarantee or standby credit, many motions were filed by French or American companies. One such motion was in the KMW International Case,[5] which illustrates both the market forces which gave rise to the new security devices and the risks involved in their issuance. In this case, a standby letter of credit was issued by the Chase Manhattan Bank in favor of an Iranian bank, which in turn issued a performance guarantee in favor of an Iranian purchaser (Water and Power Authority). These two contracts were supposed to cover a breach of the underlying transaction, which was a sale of telephone poles by an Antilles partnership, KMW, to the Water and Power Authority. The payment of the goods ordered was required to be honored by a different letter of credit established by Water and Power Authority in favor KMW. The

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[4] *Id.*

[5] KMW International v. Chase Manhattan Bank, N.A., 606 F.2d 10 (2d Cir. 1979).

underlying contract had been signed and the standby letter issued before the Iranian revolution. Then, because of the Iranian revolution the seller, KMW, asked the court to grant a preliminary injunction in order to restrain Chase Manhattan Bank from making any payment under the standby letter of credit. KMW argued that any demand under the letter of credit would be false and fraudulent because of non-performance of the contract by Water and Power Authority. The motion was granted by the district court. It noted the state of chaos in Iran. It stated that a state of insurrection had occurred which created a "suspension, if not a termination, of the status"[6] of Water and Power Authority. The court doubted the possibility for the Iranian purchaser to perform its contract in the "civil tumult, insurrection and overthrow of the government."[7] Chase Manhattan Bank appealed and the Court of Appeal denied the preliminary injunction. The main reason of this holding was that at the time the preliminary injunction was granted, Chase had received no demand for payment. Then, the "alleged threats of irreparable injury ...(were neither) actual nor imminent."[8] The court did order Chase to give KMW three day

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[6] *Id.*

[7] *Id.*

[8] *Id.* In some later case after the American-Iranian Settlement Agreement, injunction have been granted in similar circumstances. *See* Touche Ross & Co. v. Manufacturers Hanover Trust Co., 107 Misc. 2d 438, 434 N.Y.S.2d 575 (Sup. Ct. 1980); Harris Corp. v. National Iranian Radio & Television, 691 F.2d 1344 (11th Cir. 1982); Rockwell International Systems, Inc. v.

notice of receipt of a demand for payment. The KMW transaction suggests the market pressures which forced Western suppliers to provide standby credits or guarantees in their dealing with countries in the Middle East.

B. Differences in Legal Environment

In France the new device has been treated as a guarantee because of the similarities with the *cautionnement*, which is the main kind of French guarantee. (The cautionnement is analyzed in the next chapter). French banks were already dealing with the *cautionnement*. They are not prohibited from furnishing such third party guarantees. The new device has been qualified as a form of guarantee, familiar to the banks. But French law has also recognized the standby letter of credit. In France the letter of credit mechanism is not perceived as a means to furnish a security device, but rather as a means of payment. Unlike in the U.S., in France letters of credit are especially regarded as being applicable in case of performance under the underlying contract. The French view is more restricted. It would have been possible for the new security device to be qualified as a standby credit, this path has not been taken.

In the U.S., the banks had to find another means to furnish the security device needed by their customers because they are unable by law to grant guarantees. So the

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Citibank, N.A., 719 F.2d 583 (2d Cir. 1983); Itek Corp. v. First National Bank of Boston, 730 F.2d 19 (1st Cir. 1984).

new device has taken the form of a standby letter of credit. Indeed, the provision 12 U.C.C.S. § 24 (seventh) prohibits the national banks to issue third party guarantees. But this prohibition has been for many years no longer considered absolute.[9] "A national bank may be a guarantor or surety if its doing so is the exercise of an incidental power 'necessary to carry on the business of banking.'"[10][11] The applicable provision is 12 C.F.R. 7.7010 revised as of January 1, 1993. It provides:

> a national bank may lend its credit, bind itself as a surety to indemnify another, or otherwise become a guarantor, if it has a substantial interest in the performance of the transaction involved or has a segregated deposit sufficient in amount to cover the bank's total potential liability.[12]

The Federal Reserve Act of 1913 authorizes the banks to accept bills of exchange drawn at a usance.[13] Under this legislation the courts stated that banks were able to issue a letter of credit in which the bank promised the payment of bills of exchange payable at a fixed date or at a given

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[9] E. Guttman, *Bank Guarantees and Standby Letters of Credit: Moving toward a Uniform Approach*, 56 BROOK. L. REV. 167, 171 (1990).

[10] 12 C.F.R. § 7.7010 (1988).

[11] WUNNICKE & WUNNICKE, STANDBY LETTERS OF CREDIT § 2-12 (1989).

[12] 12 C.F.R. 7.7010.

[13] 38 stat. 263 (23 Dec. 1913), 12 U.S.C. § 372.

period after sight.[14] So, the way was cleared for American banks to use the mechanism of the letter of credit in order to furnish the security device needed.

Hence, a new form of letter of credit, the standby letter of credit has been created by banking practice. It has been held that "standby credits are not illegal bank guaranties and are legal obligations of national banks."[15] But to the Federal Deposit Insurance Act[16], a standby letter of credit issued by a bank which has become insolvent is not considered as a deposit and is not insured by the Federal Deposit Insurance Corporation.[17] American banks started developing the standby after the end of World War II. This mechanism became popular in the 1960's.[18] "The standby letter of credit is a document issued to safeguard the position of the beneficiary if another person fails to perform an undertaking."[19] Unlike the traditional letter of credit which is presented for payment after normal performance under the contract, the standby letter of credit

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[14]Border National Bank of Eagle Pass v. American National Bank, 282 F. 73 (5th Cir. 1922) *cert. den.* 260 U.S. 701 (1922).

[15]Barclays Bank D.C.O. v. Mercantile Nat'l Bank, 481 F.2d 1224, 1236 (5th Cir 1973) *cert denied*, 414 US 1139 (1974).

[16]12 U.S.C.A. § 1813(1)(1)(m).

[17]Philadelphia Gear Corp. v. F.D.I.C., 476 U.S. 426, 106 S.Ct. 1931 (1985).

[18]*Id.*

[19]*Id.* at 610.

is presented for payment in case of non-performance or in case of defective performance of the underlying transaction. The French legal authors also called the standby credit, guarantee letter of credit.[20] But this point of view is not acceptable under American law. Under American law payment under a guarantee is not called upon presentation of a document, such as a certificate of default. Under a guarantee, payment is called upon fact of default, which is the major difference with the standby credit. Under standby credit payment can only occur upon presentation of a certificate of default.[21]

C. French View of the Standby Credit

Under French law unlike under American law, the difference between a standby letter of credit and a guarantee is not so obvious. First, French banks can issue either one of them. They are not restricted from issuing third party guaranty as American banks. Secondly, the new device has been created by practice. Then, because the banks were familiar with the mechanism of the guarantee because of the *cautionnement*, they labelled the new device as

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[20] E. Ellinger, *Uses of Letters of Credit and Bank Guarantees in the Insurance Industry*, 6 INT'L BUS. LAW. 604; First Empire Bank v. PDIC, 572 F.2d 1361, 1367 (9th Cir. 1978).

[21] Philadelphia Gear Corp. v. FDIC, 751 F.2d 1131, 1135 (10th Cir. 1984) *cert. granted*, 476 U.S. 426, 106 S.Ct. 245, 88 L.Ed.2d 253 (1985); Arbest Construction Co. v. First National Bank & Trust Co. of Oklahoma City, 777 F.2d 581 (10th Cir. 1985).

guarantee. And third, French law deals with several kinds of guarantees. Indeed, the new device has taken many forms because it was created by practice and was not regulated. The strictest form of first demand guarantee which was the most common form at least at the beginning, cannot borrow the mechanism of the standby letter of credit. This strictest form of first demand guarantee is the one under which payment can be called under simple request. Under this strictest form no certificate of default is required.

CHAPTER I:

THE FRENCH FIRST DEMAND GUARANTEE

I. Introduction

The first demand guarantee (*garantie a premiere demande*) appeared about twenty years ago.[22] Under French law, the words *garantie a premiere demande* (first demand guarantee) refer to a type of device which has been used by French companies in international transactions. It is believed in France that the first type of demand guarantee used was in response to the practice of American bank issuing credits which function to guarantee performance. In fact, according to Gavalda:[23]

> The first French companies facing the performance exigencies were probably the ones that wanted to be in charge of the projects financed by the B.I.R.D. (World Bank) which requires this "American suretyship" (performance bond).

Thus, the French companies had to adapt themselves if they wanted to work in cooperation of the World Bank or wanted to be able to furnish similar guarantees as the American

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[22] J. STOUFFLET, *supra* note 2, at 265 n.21.

[23] C. GAVALDA, *supra* note 1, at 84 n.20.

companies.[24] Hence, creation of the first demand guarantee has been a necessity in order to compete with foreign companies.

The main purpose of this security device is to give a guarantee which is totally independent from the underlying transaction. A French company which is exporting services or goods asks its bank to furnish a guarantee to the foreign importer of services or goods. In most of the cases, the French demand guarantee has been required by the importer when this importer has signed a contract involving large construction projects, such as the construction of infrastructure (for example construction of an airport, installation for electricity in some part of the foreign country[25], construction of factories[26], construction of apartments[27], etc.). Since the bank has no relation with the foreign company, this practice is the equivalent of giving a third party guarantee. This independent bank guarantee has become a common form of guarantee in international transactions.

The emergence of the first demand guarantee has not only been caused by an "allergy" to any kinds of risks and

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[24] *Id.*

[25] Judgment of Jan. 20, 1987, Cass. com., 1987 La Semaine Juridique (J.C.P.) II 20764 (Fr.).

[26] Judgment of Oct. 17, 1984, Cass. com., 1985 J.C.P. II 20436 (Fr.).

[27] Judgment of Dec. 11, 1985, Cass. com., 1986 J.C.P. II 20503 (Fr.).

by a change in market forces, but also by the evolution toward a preference for the "personal security devices."

Evolution toward a preference for the "personal security devices"

Under French Law, a difference is traditionally made between two main types of security device, the "real security devices" (*suretes reelles*) and the "personal security devices" (*suretes personnelles*). The "real security devices" include the "real property devices" (*suretes immobilieres*) and the "personal property devices" (*suretes mobilieres*). They are based on property. As for the "personal security devices," they are closely tied to a certain person. They allow someone to engage to pay if the primary debtor does not. In the commercial transactions the "personal security devices" are preferred for several reasons. It is less expensive to create a "personal security device" because it is not necessary for example to register the security document in the Mortgage Registry, called the *Conservation des hypotheques*. Creation of "personal security devices" does not follow the same formalities. The intervention of a public officer is not needed. Hence creation of "personal security devices" is not only easier, but also much faster. If the primary debtor fails to pay, the secured creditor can also immediately claim from the one who has engaged himself to pay in case of deficiency from

the main debtor. This security device is less likely to be impaired by currency devaluation. The security interests based on property do not have the same advantages. They have also lost some of their previous advantages. For example in case of insolvency, during the rehabilitation period, a "period of observation" may be ordered. And creditors of this period have been given preferential rights over the secured creditor with security interest based on property even if its security interest has been perfected before the insolvency.[28] In this context, the creditors prefer the "personal security devices" which are not subject to the constraints of the period of observation that may be ordered with respect to the primary debtor. Traditionally, under French law, only one kind of "personal security device" has existed, the *cautionnement*.[29] But, the judicial intervention with respect to this last security device in favor of the debtor has been so important that the creditors have sought a new form. For example, the *cautionnement* is void if one of the written clauses is too vague. The guarantor (*caution*) can also unilaterally decide to terminate its engagement in the future. The legislature has also intervened in order to protect in a better way the guarantor (*caution*) in requiring for example more

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[28]Act of Jan. 25, 1985, No.85-98, art. 40 (Fr.).

[29]P. Simler, *Les solutions de substitution au cautionnement*, LA SEMAINE JURIDIQUE (J.C.P.), Ed. N, No.42, 387, 387 (1990).

information about its duties.[30] Hence, the first demand guarantee appeared as a new type of "personal security devices."

II. The mechanism of the French demand guarantee

The first demand guarantee is a part of a tripartite transaction. This transaction involves at least a buyer, a seller and a bank. As regard to the first demand guarantee, these parties are called guarantee applicant, beneficiary and guarantor. More recently, a second bank has started to intervene in the transaction at the request of the buyer. These different parties are bound to each other by different contracts. In its simple form, that is in the case of intervention of only one bank, three independent contracts are necessary involved in international transactions. These contracts are all interrelated.

The first contract is the one signed between an exporter, in our case most of the time a French corporation and an importer, which could be either a foreign corporation or either a foreign state entity. This contract constitutes the underlying contract. At the time of the signature of this contract, the importer asks the exporter that a first demand guarantee be furnished to him.

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[30] Act of March 1st, 1984, No.84-148.

The second contract is the one between the exporter and his bank, the guarantor. This contractual relation is not created because of the signature of the underlying contract. Generally, the bank and its customer, that is the exporter have been doing business together for a long time. To furnish a "first demand guarantee" is a very risky transaction, so the bank needs to fully trust its customer.

And finally, the third contract to be involved is the one binding the French guarantor to the importer abroad. This first demand guarantee permits the foreign importer to be covered in case of breach of the underlying transaction. This first demand guarantee has always been given by a bank. Hence, this guarantee is considered a bank instrument and is designated as a bank guarantee.[31] The requirements that are necessary to be fulfilled in order for a first demand guarantee to be called have already been negotiated at the time of the signature of the underlying contract. The kind of stipulations incorporated in the underlying contract are necessary to avoid later problems.[32] In the underlying contract, it is decided that payment under the guarantee will be called without furnishing any documents or only if certain specified documents are furnished. These documents can be given by third parties or by the beneficiary of the guarantee. A situation of fraud is less likely to occur when

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[31] BERTRAMS, BANK GUARANTEES IN INTERNATIONAL TRADE, at 52 (1990).

[32] C. GAVALDA, *supra* note 1, at 80.

the documents requested have to be furnished by third parties. But most of the time, the parties are in a hurry to sign the contract. The guarantee applicant especially, does not realize the consequences of the provisions of the contract. For example, according to the underlying contract, payment under the guarantee is often called without furnishing any documents. Such guarantee is called first demand guarantee or guarantee on first request. Hence, according to the stipulations inserted in the underlying contract concerning payment under the guarantee, the name given to the guarantee will be different. According to the legal authors and commentators, the "first demand guarantee" could be defined as followed, "a contract by which an exporter of services or goods asks his bank to pay a certain amount of money upon simple demand to an importer, under the condition that this request is done before the expiry date."[33]

The first demand guarantee has been created by practice. But, instead of creating a complete set of rules, the legal authors have borrowed the rules from mechanisms close to the first demand guarantee. The first demand guarantee has been analyzed as having a double origin which are the *cautionnement* and the irrevocable documentary

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[33] J. STOUFFLET, *supra* note 2, at 265.

credit.[34] The first demand guarantee has been compared to the *cautionnement* because it is the basic form of "personal security device." Even though the documentary credit is not a security device, the first demand guarantee has been compared to this device because of the similar problems that its integration in the French law system has arisen. So, the judiciary and the arbitration bodies had to formulate rules applicable to these new forms of guarantee contracts which borrow from other bodies of doctrine but at the same time respect the intention of the parties to this security transaction.[35]

III. Comparing The First Demand Guarantee to Other Devices Recognized in French Law

A. The *Cautionnement*

The French demand guarantee or *garantie a premiere demande* has been first compared to a suretyship called the *cautionnement*. This kind of suretyship is common in the contracts signed between two French parties. Under French law, the *cautionnement* is one of these devices covered by the general word *garantie* (guarantee.) The *cautionnement* is a basic kind of *garantie*. It belongs to the category of the

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[34] M. Contamine-Raynaud, *Les rapports entre la garantie a premiere demande et le contrat de base en droit francais*, MELANGES ROBLOT 413, 414 (1984).

[35] J. STOUFFLET, *supra* note 2, at 267.

personal security devices. But in the case of the *cautionnement*, there is no independence between the underlying contract and the guarantee contract in the sense that all the defenses which can be imposed by the guarantee applicant that is the bank's customer to the beneficiary of the guarantee can also be opposed by the guarantor, that is the bank. This characteristic is the main difference between the *cautionnement* and the first demand guarantee.[36] The latter has also been called "independent guarantee," "autonomous guarantee," "abstract guarantee" in order to be differentiated from the *cautionnement*.[37] The definition of this security device is given by Article 2011 of the French Civil Code:[38]

> The one who commits himself to become a "caution" of an obligation, engages himself toward the creditor to fulfill this obligation if the debtor fails in his duty.

The rules concerning this basic form of "personal suretyship" have been inserted in the Civil Code.[39] The most important defense which can be opposed by the *caution* is the one concerning performance under the underlying

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[36]Judgment of Jan. 9, 1990, Cass. com., 1991 Sirey, Somm. 191 note Vasseur (Fr.).

[37]BERTRAMS, *supra* note 31, at 52.

[38]Code civil (C. civ.) art. 2011 (Fr.): "Celui qui se rend caution d'une obligation, se soumet envers le creancier a satisfaire a cette obligation, si le debiteur n'y satisfait pas lui-meme."

[39]C. civ. art. 2011 to 2043 (Fr.).

contract. If the main debtor has performed, the guarantor (*caution*) does not have to perform under the cautionnement. In the *cautionnement* also, the guarantor will only pay the beneficiary of the suretyship, that is the creditor if the principal debtor does not pay its debt. But, the guarantor (the *caution*) can impose any defense which is available to the principal debtor. The *caution* (guarantor) can also ask for example, that the creditor first request payment from the main debtor, except in circumstances where the guarantor (*caution*) has expressly renounced this right. When the banks' customer has started to request its bank that it should furnish it a security device totally independent from the underlying contract, naturally this device has been compared to the basic French kind of guarantee which is the *cautionnement*. And, because of the immediate effect of a request from the beneficiary for performance of the bank, this device has been called "first demand guarantee" (*garantie a premiere demande*) or "guarantee on first request."

B. The documentary credit

The French first demand guarantee has not only been compared to the *cautionnement*, but also it has been compared to the documentary credit (*credit documentaire*). The documentary credit is not a security device as the first demand guarantee or as the *cautionnement*. But, comparisons between the documentary credit and the first demand

guarantee have been done because of the independence principle which applies to these two devices. Until the creation of the first demand guarantee, the independence principle did not apply to any of the security devices. Then, when the first demand guarantee has been created, it has been naturally compared to the documentary credit as regard to the independence of the underlying contract. The documentary credit is a means of payment of the purchase price, and is used in the ordinary course of events when goods are being shipped to the customer. The documentary credit requires that a draft or demand for payment be accompanied by certain documents specified in the contract (for example, a document of title). The reasons for which the bank's payment is made in the documentary credit compared to the first demand guarantee are different. The bank is expected to pay in the ordinary course of business for the documentary credit while in the first demand guarantee, the bank's payment will only be requested if the underlying contract has not been respected. In choosing to call the new security device a type of guarantee, French law does not mean to imply that it is to be contrasted with the standby credit. The mechanism of the guarantee has just appeared more broad and for this reason more adapted to handle all the kinds of guarantees.

IV. Different Forms of Demand Guarantee

In practice several kinds of guarantees exist. The first kind of first demand guarantee is called bid bond (*garantie de soumission ou d'adjudication*). This kind of guarantee covers the case where if the party (exporter, guarantee applicant) which has been successful in winning the contract has withdrawn its offer. With the bid bond, the exporter is furnishing a guarantee to the importer (beneficiary) effective until the exporter will choose the party which has won the contract. This provides a safeguard for the importer against backing out or withdrawal of the exporter (guarantee applicant) from the contract before the importer has opted for one of the different offers of the corporations. The difference of price between the first offer chosen which has been withdrawn and the second offer will be covered by the first demand guarantee furnished by the party which has made the first offer.[40]

A second type of first demand guarantee is furnished by the performance bond (*garantie de bonne execution*)[41]. This guarantee concerns the case of non performance by the exporter after signature of the contract. In case of non-compliance of one of the contractual obligations of the exporter, the beneficiary of the guarantee can call payment

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[40] C. GAVALDA, *supra* note 1, at 79.

[41] "Garantie de restitution" & "garantie de bonne fin": Judgment of Jan. 20, 1987, Cass. com., 1987 J.C.P., II, 20764; Societe Technique Electrique de l'Oise Telecoise c. Union Mediterraneenne de Banque (U.M.B.) et la Wadha Bank (Fr.).

from the bank under the first demand guarantee. This is the most risky type of guarantee.

A third type is formed by the repayment or down payment guarantee (*garantie de remboursement*). In this case, the importer has already made some advance payment and he wants to make sure that the exporter will reimburse him if the contract is not performed.

Finally, the last main type which can be distinguished is the maintenance bond. By this guarantee, the exporter who has sold goods or has built for example a factory, engages itself to maintain the equipment, the installations or undertakes to make all the repairs which will be necessary. These four types of first demand guarantees are basically the main types which are used in international transactions.[42]

V. Requirements for Calling

The way of calling a first demand guarantee can vary. It depends on the requirements which have been inserted in the guarantee contract. The way payment can be requested by the beneficiary can be easy or not.

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[42] J.L. Rives-Lange, *Les garanties independantes et le role des banques*, REVUE BANQUE, No.468, 11, 11 (Jan. 1987).

We distinguish the first demand guarantee, which can be called on simple request or simple demand[43]. It means that in the underlying contract no specific reason have been stipulated concerning the way payment is to be called under the guarantee. The beneficiary of the guarantee has just to request payment from the bank. In fact, it is a clean first demand guarantee. The first demand guarantee can also be called with "justification"[44]. It implies that in order to request payment from the bank the beneficiary will just have to give a reason to the bank. The highest French Court in this matter stated that the simple fact of informing that the underlying contract has not been respected is enough.[45] The last possibility of calling for a first demand guarantee is to provide documents stating non-performance under the underlying contract. It is named as a documentary or motivated first demand guarantee.[46] This form is close to the American standby letter of credit. The bank has just to verify that the documents comply with the

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[43]Judgment of Mar. 2, 1990, Paris, 1ere Ch. B, IV 197, S.A. Fougerolle et autre c. S.A. Banque de l'Union Europeenne et autre (Fr.).

[44]Judgment of Nov. 20, 1990, Cass. civ. 3e, 1990 Dalloz (D) somm. 195 observation Vasseur (Fr.); Judgment of Mai 19, 1992, Cass. com., 1992 J.C.P., ed.G, IV, No.2030 et ed.E, Pan 920 (Fr.).

[45]Judgment of Nov. 24, 1981, Paris, 5e Ch., sect. A., 1982 J.C.P. II 19876, Societe anonyme Opinter France C. Banque Nationale de Paris et autres (Fr.).

[46]Judgment of Jan. 9, 1991, Paris, 15e Ch. A, Compagnia technica internationale (Fr.).

requirements inserted in the underlying contract. The bank does not have to check if they reflect the real situation. The International Chamber of Commerce (ICC) wanted to encourage the use of this last kind of first demand guarantee.[47] In 1978, the International Chamber of Commerce has promulgated a separate set of rules for contract guarantees called the "Uniform Rules for Contract Guarantees" (U.R.C.G.)[48]. The purpose was to reduce the risk of abuse in case of a call for payment. According to these rules, the proof of judgment or arbitral award was a necessary condition for the beneficiary to get payment. This requirement was too strict. So the U.R.C.G. has failed to achieve their goal, which was to gain general acceptance of these rules. The demand guarantee continued to be called on simple demand or with justification. The U.R.C.G. would have allowed the demand guarantee to become closer to the standby letter of credit. In 1992, new rules have been formulated by the ICC. They are designated "the Uniform Rules for Demand Guarantees" (U.R.D.G.)[49]. New kinds of guarantee are covered by these ICC rules. The definition of a demand guarantee has been extended in order to include all the types of demand guarantee.[50] Article 20 provides that any

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[47]Uniform Rules for Contract Guarantee (U.R.C.G), ICC, Publication No.325 (1978).

[48]ICC, Publication No.325 (1978).

[49]ICC, Publication No.458 (1992).

[50]*Id.* article 2(a).

demand for payment shall be supported by a written statement stating that the guarantee applicant is in breach of his obligations. However, this article can be excluded.[51] "Like the UCP, these new Uniform Rules for Demand Guarantees apply where expressly incorporated into the guarantee."[52] This last type of first demand guarantee is closer to the standby letter of credit because the payment under the security device will only occur upon presentation of certain documents. But, the rules elaborated by the ICC have not been followed. "The 'documentary demand guarantee' is rarely used."[53] The fact that a demand guarantee is most often called on simple demand is the main difference with the standby letter of credit. Drafting uniform rules for the standby letter of credit and the documentary demand guarantee would be possible. Indeed, these uniform rules could easily be incorporated in the legal systems without being contrary to the rules of contract.

VI. The Counter Guarantee

The beneficiary of the first demand guarantee sometimes requires the intervention of another bank, which is located in its own country. But, this bank obviously accepts to give

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[51] *Id.* article 20(c).

[52] *Id.* at 7.

[53] J. STOUFFLET, *supra* note 2, at 266.

a first demand guarantee only if the bank of the guarantee applicant furnishes a counter guarantee. Then, the overseas bank is the one to issue the guarantee. For this reason, the issuing bank is called the first bank. By contrast the exporter's bank becomes a counter guarantor. Then, in this case, two first demand guarantees are issued. The requirement of issuing a counter guarantee is independently negotiated from the other requirements of the first demand guarantee. Its purpose is to make more difficult for the guarantee applicant, to stop the payment by the bank.[54] The counter guarantee qualification has been discussed.[55] "The engagement of a French bank, which is a counter guarantor is neither a *cautionnement* nor a *delegation*, but it is an independent obligation compared to the first demand guarantee and to the underlying contract."[56] The counter guarantor cannot escape its duty to pay the first bank, even if the non-payment is requested by the guarantee applicant.[57] In order to call the counter guarantee, the first bank has just to prove that it has paid the

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[54] J. STOUFFLET, *supra* note 6, at 269.

[55] Judgment of Dec. 12, 1984, (Societe Les Serres Fleuries V. Caisse Nationale de Credit Agricole), Cass. com., 1985 J.C.P. II 20436 note Stoufflet (Fr.).

[56] *Id.*

[57] Judgment of June 18, 1984, (Societe Pomagalaski c. B.N.P.), Trib. com. Grenoble (Fr.).

beneficiary.[58] It is possible to stop payment from the first bank in case of counter guarantee, but the guarantee applicant should get a court order in the foreign country in order to do so.[59] In case of fraud, the payment by the counter guarantor can also be stopped.[60]

VII. Principles Applying to the Device

Two main principles govern the first demand guarantee, the principle of strict compliance and the principle of independence. These principles are similar to the ones applying to the standby letter of credit.

A. Principle of Strict Compliance

This principle of strict compliance implies that any performance under the guarantee has to be in strict compliance with the conditions written in the guarantee. If the beneficiary requests payment from the guarantor and follows the requirements which have been decided during the negotiation of the underlying contract, the guarantor has a duty to pay. This rule has two aspects. The first aspect is positive in the sense that the beneficiary must strictly

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[58]Note J. Stoufflet: Judgment of Dec. 12, 1984, Cass. com., 1985 J.C.P. II 20436 (Fr.).

[59]Note J. Stoufflet: judgment of Nov. 24, 1981, Paris, 5e Ch. A., 1982 J.C.P. II 19876 (Fr.).

[60]Judgment of Dec. 12, 1984 (Societe Les Serres Fleuries V. Caisse Nationale de Credit Agricole), 1985 J.C.P. II 20436 note Stoufflet (Fr.).

adhere to the conditions detailed in the guarantee regarding:

- the documents to be presented
- the need for affirming non-performance of the contract
- the written format to be followed in case of a request for payment
- the expiry date for the validity of the guarantee

If the bank pays without adhering to the stipulations stated, it would not be able to recover the amount of money paid to the beneficiary. And, if all the requirements have been followed, the bank has no choice, it has to pay except in the case of fraud.[61] The second aspect is a negative aspect because the guarantor cannot demand anything more than what has been agreed under the guarantee.

Not much has been written on this issue; nothing has been written on the trivial defects which can be found in a demand for payment. Up till now no French cases have been reported concerning this issue of strict compliance. This situation can probably be explained by the fact that most of the French first demand guarantee do not require any documents.

B. Principle of Independence

Concerning this second principle governing the first demand guarantee, some major difficulties have occurred.

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[61]This defense is discussed in the next chapter.

By definition a first demand guarantee implies that there is independence between the different contracts involved, the obligation of the guarantor is independent from what is happening under the underlying contract even if this guarantee is initially based on this contract signed between the guarantor and the beneficiary. This principle does not only govern the first demand guarantee, but it also governs the counter guarantee if there is a counter guarantee, which is common nowadays.

1. Principle of Independence Applied to the First Demand Guarantee

Independence is a characteristic of the first demand guarantee. Its independence has been affirmed in the courts' decisions.[62] In cases, the courts generally use the expression "the guarantor will immediately pay and upon first demand written of the beneficiary." The courts' decisions also often contain the word "irrevocable" to describe the guarantee contract. The requirements to request payment from the guarantor are written in the commercial agreement, the underlying contract and they cannot be modified.

This fundamental principle has many consequences. If the first demand guarantee was supposed to be furnished against payment of commissions, the guarantor cannot defend

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[62]Judgment of Dec. 20, 1982, Cass. com., 1983 D., 2e esp. note Vasseur (Fr.).

based on the failure of the guarantee applicant to pay.[63] Similarly, the guarantor cannot defend because of non-procurement of securities promised.[64] The guarantor, of course, does not act gratuitously. It normally takes a security interest in collateral from the guarantee applicant. But, if it does not have the security interest in fact and in possession, the bank cannot be exonerated from its duty to pay.[65] No failure from the guarantee applicant as regard to its business relation with its bank can constitute an excuse to avoid reimbursement. Most importantly, the guarantee applicant cannot prove that he has performed under the underlying contract and that the guarantee has no more reasons to be performed. Bringing proof that there is no more reason for calling the first demand guarantee is not sufficient in order to stop the guarantor from executing its engagement.[66] Then, performance under the commercial contract is not a possible discharge. The guarantee has to be performed irrespective of any action or claim brought under the underlying

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[63] J. STOUFFLET, *supra* note 2, at 270.

[64] *Id.*

[65] *Id.*

[66] Judgment Bull. Civ. 1985 IV p.136 No.160, D. 1986 J. 213 1ere esp., note Vasseur (Fr.); Judgment of Feb. 19, 1991 (Konutbank V. Banque Byblos-France), Cass. com., 1991 J.C.P. II 21670 note Vasseur (Fr.): independence between the underlying contract and the first demand guarantee.

contract.[67] Even if the underlying contract is void, it does not directly affect the performance of the guarantee.[68] But, under certain conditions asking for performance of the guarantee could be regarded as improper and abusive.[69]

The duration of the guarantee is also independent from the duration of the underlying contract.[70] But, uniformity in the duration of counter guarantee and first demand guarantee is recommended by the International Chamber of Commerce. Article 3 of the project of the ICC deals with this issue. As for the duration of the guarantee, a prorogation is possible in case of an agreement from all the parties concerned.[71]

The law applicable under the underlying contract is not applicable to the guarantee contract, even if in some circumstances it is possible that the same law regulates the two contracts. Generally, the law of the guarantor will be

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[67] Judgment of Jan. 29, 1981, Paris, 3e Ch.B, 1981 D., J. 336 note Vasseur (Fr.).

[68] *Id.*

[69] J. STOUFFLET, *supra* note 2, at 273.

[70] *Id.* at 274.

[71] Judgment of Feb. 24, 1989, (Rafidain Bank V. S.A. Credit Industriel et Commercial (C.I.C.) et autre) Cass. com., 1990 J.C.P. 21425 note Mattout & Prum: "extended or Pay" from the first bank has been denied by the court (Fr.).

applicable to the relations between the guarantor and the beneficiary.[72]

The claims and actions taken under the guarantee contract and actions taken under the underlying contract can have different jurisdictions. The choice of forum clause (*clause attributive de juridiction*) and the arbitration clause (*clause compromissoire*) incorporated in the commercial contract do not apply to the first demand guarantee.[73]

2. Application of the Principle of Independence to the Counter Guarantee

Independence is also a characteristic of the counter guarantee. Independence has been affirmed in the courts' decisions.[74] As the direct guarantee, the counter guarantee is independent from the underlying contract. But there is also independence between the obligations of the two guarantors, that is the first guarantor and the counter guarantor. For the purpose of our study it is assumed that the counter guarantor is French and the first bank to issue a first demand guarantee is a foreign bank.

In fact, both banks issue a first demand guarantee. Once the underlying contract has not been complied, the beneficiary

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[72]J. Stoufflet, *supra* note 2, at 274.

[73]Judgment of Dec. 20, 1982, Cass. com., 1983 D., 2e esp. note Vasseur (Fr.)

[74]Judgment of Nov. 19, 1985, Cass. com., Bull. Civ. IV No.274 p.231 (Fr.).

of the guarantee requires payment from the first bank. This first bank is usually located in the same country as the beneficiary. And this first bank calls payment from the second one, which is the counter-guarantor. This second bank is generally established in the same country as the guarantee applicant, that is the exporter.

This principle of independence has many repercussions. Even if the first guarantee is void or if it cannot be performed for any other reason, the counter-guarantee is not affected.[75] The two guarantees can have different kinds of provisions. The way in which they can be "called" can be different. The requirements to be followed in order to request payment can be distinct. The French Supreme Court (*Cour de Cassation*) has held that the counter guarantee can have a subject matter which can be larger than the first guarantee.[76] Then, the performance (execution) of the counter guarantee follows its own requirements which may be different from the first guarantee.[77] The counter guarantor is considered to be bound by the stipulations of its own contract. So it implies that in most of the cases, guarantee and counter guarantee follow different kinds of rules.[78] There is one exception to the principle of

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[75] J. STOUFFLET, *supra* note 2, at 275.

[76] Judgment of Nov. 20, 1985, Cass. com., 1986 D., J.213, note Vasseur (Fr.).

[77] J. STOUFFLET, *supra* note 2, at 276.

[78] *Id.*

independence, that is in case of fraud. The issue of fraud will be dealt later in the chapter.

VIII. Problems

The incorporation of the first demand guarantee in the French legal system has not been easy. The traditional concepts of French law which are inserted in the Civil Code appeared sometimes unadapted to handle this new security device. It seems that all the legal systems based on Civil Law had faced similar problems. Moreover, because of the lack of regulations, some issues arising out of its use have been difficult to resolve. The courts have been reluctant in deciding some issues, for example the issue of the unfair claims and also on the issue of recovery. How a system of written law can accommodate a new judicial mechanism coming from different traditions has been the dilemma to which the courts have had to find a solution. A similar problem had appeared with the use in France of the documentary credit. Only local public policy (*l'ordre public*) could have stopped this accommodation. The first demand guarantee held to be a new form of bank guarantee. It has been regarded by the French judicial system as an application of the principle of liberty to contract. Hence, all the court's decisions

dealing with first demand guarantee have first reaffirmed this fundamental principle of the French Civil Code:[79]

> *Les conventions legalement formees tiennent lieu de loi a ceux qui les ont faites.*[80]

Judicial decisions have not blocked the development of this practice. Instead they have tried to elaborate the legal basis to the development of this new guarantee. The courts have noted the exigencies of international trade and have allowed uniformity in this area of law. Some difficulties have inevitably arisen. They have been due to the lack of statutes and also due to the imprecise character of available formats for guarantees, and due to the lack of uniform rules in this subject at the international level, as the ones elaborated by the ICC in the area of documentary credits.

A) The problem of "cause"

The main difficulty which has arisen under French Law is the problem of "*cause*." According to the French Civil Code a contract is only valid if it fulfills several characteristics concerning the consent of the parties, their capacity, the object of the transaction and the motive (*cause*) of the contract.[81] The *cause* of the first demand guarantee has given difficulties to the French legal authors

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[79] C. civ. art. 1134 (Fr.).

[80] "The contracts legally formed constitute law for the ones who have created them."

[81] C. civ. art. 1108 (Fr.).

and commentators. The engagement of the bank was first seemed as being without any reason or any motive because of the independence between the underlying contract and the first demand guarantee. And under French law, such contracts without any *cause*, reason or motive is not a valid contract.[82] A contract without *cause* is not a contract. Every obligation of the parties needs to have a *cause*, otherwise the transaction is void. This imperative requirement in each contract is supposed to bring a better protection to the parties. The legal authors and commentators have been divided in two groups, the ones called the *causalistes* finding a *cause* to the bank duty to pay and the others called the *non causalistes* finding no cause. The most acceptable theory is the one given by some *causaliste*. They have concluded that the bank duty was just an arrangement of the underlying contract which is the "law of the parties[83]" under the French Civil Code.[84] It is an "instrumental for the realization of the underlying relationship, but the obligation of the bank is detached from that cause."[85] The legal writers proved this conclusion with the case of fraud. When fraud is used in

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[82] C. civ. art. 1131 (Fr.).

[83] C. civ. art. 1134 (Fr.).

[84] M. CONTAMINE-RAYNAUD, *supra* note 34, at 426 n.64.

[85] BERTRAMS, *supra* note 31, at 179.

order to call the first demand guarantee, the bank does not have to perform.

But, no explanation is perfectly satisfactory. This new practice is in fact a sui generis contract which follows with difficulties the traditional concepts of Civil Law. Once the bank guarantee was accepted and was incorporated in the French legal system, the courts had to face other issues concerning the mechanism itself. These issues have not only arisen under French law, but also in the other legal systems and in particularly in the American legal system, such as the issue about a possible recovery and the one concerning the unfair claims.

B) Unfair Claims

Another issue on which courts have been hesitant to decide is the one concerning the unfair claims coming from the beneficiary of the guarantee. Three grounds could have been used in order to stop any unfair claims, the *ordre public* (public order), the concept of fraud and the concept of "manifest abuse."[86]

As regard to the first ground, Article 6 of the French Civil Code states that any contract which is in contradiction with the "public order" is void.[87] As for the two other grounds, they are close to each other, but

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[86] M. Azencot, note sous Trib. com. Paris, Ref., 1er aout 1984: 1986 J.C.P. II 20526 (Fr.).

[87] C. civ. art 6 (Fr.): "on ne peut deroger, par des conventions particulieres, aux lois qui interessent l'ordre public et les bonnes moeurs."

they are used in two different types of cases. The concept of "fraud" is used "when a party is intentionally acting with disloyalty in order to cause trouble or to gain an advantage."[88] But in order to invoke the concept of "manifest abuse," it is necessary that "a party has a right and is using this right in order to cause trouble or in a way which is obviously not correct."[89] The French legal authors have tried to clarify the concept of "fraud" and the concept of "manifest abuse of right." When the payment under the first demand guarantee is called with some documents as stipulated, but without authenticity, it is an unfair claim. This claim can be qualified as unfair according to the concept of "fraud." A demand for payment can also be unfair in case of a written fact in the request which is obviously in contradiction with the real situation. Very soon the concept of "fraud" was accepted as being able to stop an unfair claim from the beneficiary of the first demand guarantee.[90] It has been the first exception to the independence principle of this new security device. According to the principle, "fraus omnia corrumpit." In fact, in order for the court to admit "fraud," it is

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[88]Judgment of Mai 26, 1988, Trib. com. Bruxelles, 1989 Dalloz Sirey (D.S.), somm. com. 153 observation Vasseur (Fr.).

[89]*Id.*

[90]Judgment of Mai 4, 1980, Riom, 1981 D.S., J., 336 note Vasseur (Fr.); Judgment of Jan. 7, 1983, Paris, 1983 D.S., I.R., 304 (Fr.).

necessary to prove a wrong behavior from the guarantor.[91] In various cases, courts have used similar expressions to characterize "fraud." "Fraud" must be established "beyond doubt" or must be "evident," "clear" or must "strike the eye of the beholder" (*creve les yeux*).[92] "Fraud" can come from the "whole of the circumstances."[93] As regard to a counter guarantee, it seems that it could only be stopped if "fraud" was proved in the relations between the first bank and the counter guarantor.[94] In the case of Banque Tejarat c. Societe Auxiliaire d'Entreprise (S.A.E.) et Credit Lyonnais,[95] the *Cour de Cassation* stopped the payment under a counter guarantee because of the "fraudulent collusion" between the beneficiary and the first bank. In a 1992 case[96], the Court of Lyon has held that a call of

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[91]C. Hannoun, *Reflexions sur la distinction de la fraude et de l'abus dans les garanties a premiere demande*, REVUE DE DROIT BANCAIRE, Chronique 187, 188 (1988).

[92]Judgment of Dec. 12, 1984, Cass. com., 1985 D., J. p.269 (Fr.); Judgment of Mai 21, 1985, Cass. com., 1986 D., J., p.213 (Fr.); Judgment of June 10, 1986, Cass. com., 1987 D., J., p.17 (Fr.).

[93]Judgment of June 10, 1986, Cass. com., 1987 D., J. 17 (Fr.); Judgment of Sept. 23, 1988, Paris, 1989 D., Somm. p.156 (Fr.).

[94]Judgment of Dec. 12, 1984, Cass. com., 1985 J.C.P., ed. G., II 20436, 2e espece note J. Stoufflet (Fr.); Judgment of Dec. 11, 1985, 1986 J.C.P. II 20593 note J. Stoufflet (Fr.).

[95]Judgment of Dec. 11, 1985, Cass. com., 1986 J.C.P. II 20593 note J. Stoufflet (Fr.).

[96]Judgment of Mar. 23, 1992, (B.F.C.E. V. Ste Merrieux), Lyon, R.T.D. Com. et Eco. (Sirey No.3, juillet, sept. 1992) (Fr.).

guarantee by the first bank can be a "manifest abuse" of its rights if this bank knows that the call for payment is malafide. Then, the call can be stopped by the court.[97]

For sometime the two concepts of "fraud" and "manifest abuse" were used in the same circumstances. But, according to some French legal authors and commentators, they should not have normally applied to the same facts. However according to Hannoun[98], a French legal author the highest court of France, the *Cour de Cassation* is having the same approach to all the cases. This confusion between the two concepts appeared in a case of 1986.[99] The concept of "manifest abuse" seems to have definitively been admitted as an exception to the principle of independence by the case of 1987.[100] For J. Stoufflet, the independence principle of the guarantor obligation still applies.[101] The "manifest abuse of a right" has to be definitively proved.

If the request was "fraudulent" or "manifestly abusive," then the only party which is able to stop the payment is the account party i.e. the exporter. The account party/exporter can try to prevent the payment by appealing to a court for a

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[97] *Id.*

[98] C. HANNOUN, *supra note* 91, at 190.

[99] Judgment of June 10, 1986, Cass. com., 1987 D., 5, 17, note Vasseur (Fr.).

[100] Judgment of Jan. 20, 1987, Cass. com., 1987 J.C.P. II 20764 (Fr.).

[101] J. Stoufflet under judgment of Jan. 20, 1987, Cass. com., 1987 J.C.P. II 20764 (Fr.).

provisional and "conservatory" decree (stop payment) prohibiting the bank from paying.[102] "Such a provisional remedy has its basis in French law in Article 873 of the New Code of Civil Procedure which permits the President of the Commercial Court to prescribe preventive or conservatory measure to avoid imminent harm or to stop a manifestly illicit transaction."[103] But, such a provisional remedy could not be used in case of a counter-guarantee. And except in the three above situations (contradiction with the "public order," "fraud" or "manifest abuse") the bank has to pay even if the request was unjustified. It has no choice.[104]

C) Subrogation

A question which could arise in the near future is the one concerning the possibility for the guarantor to be subrogated in the rights of the beneficiary once it has paid the amount due. Indeed, if the beneficiary of the guarantee has also taken a security interest in a collateral of the guarantee applicant, can the guarantor claim the collateral once it has paid the beneficiary of the guarantee?

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[102] J. STOUFFLET, *Payment and Transfer in Documentary Letters of Credit: Interaction between the French General Law of obligations and the Uniform Customs and Practice*, 24 ARIZONA L. REV. 267, 273 (1982).

[103] *Id.* at 273.

[104] Judgment of Feb. 6, 1990, Cass. com., 1990 D.S., 467 (Fr.); Judgment of Mar. 1, 1990, Bordeaux, 1990 D.S., Somm. comm., 210, observation Vasseur (Fr.).

Under French law, two kinds of subrogation can be invoked, the "conventional subrogation"[105] and the "legal subrogation"[106].

As for the "legal subrogation,"[107] it can be only used in four situations. The first, second and fourth are non applicable. Only the third situation[108] can apply. In this situation, the party which has paid a debt is "legally subrogated," when it has to pay the same debt with several other debtors or when it has to pay a debt for another debtor.[109] But, in the mechanism of the first demand guarantee, the guarantor does not pay a debt for another debtor. "The guarantor pays its own debt,"[110] according to the independence principle.

If the "legal subrogation" cannot be used, the "conventional subrogation" could be the only ground to claim the guarantee applicant security interest. The "conventional subrogation" has to be expressly agreed to the time of the payment.[111] A certain written document, called the

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[105] C. civ. art. 1250 (Fr.).

[106] C. civ. art. 1251 (Fr.).

[107] *Id.*

[108] C. civ. art. 1251-3e (Fr.).

[109] *Id.*

[110] Juris Classeur (J-Cl), Banque et Credit, fascicule 32, Garantie bancaire internationale, No.134 et s.

[111] C. civ. art. 1250-1 (Fr.).

"quittance subrogative"[112] is necessary. But, the way the guarantee works is negotiated at the time of the underlying contract signature. Then, in order to accept subrogation of the guarantor, subrogation has to be expressly considered before the guarantor gets payment.[113]

IX. Recovery and Claims

It is possible for the different parties to recover or to claim once they have performed under the contract by which they were bound. If they have respected their obligation to pay according to the way stipulated, they can recover even if in some cases some legal authors have doubted this possibility.

The guarantor bank can recover from the guarantee applicant/exporter. At the beginning, the possibility to be reimbursed seemed to be in contradiction with the principle of independence. This issue has been solved by considering the rationale that the bank that has paid the requested amount of money has a right to receive or recover the same from the guarantee applicant. As this money is a form of advance payment made because the guarantee applicant

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[112] C. civ. art. 1250-2 (Fr.).

[113] Juris Classeur (J-Cl), Banque et Credit, fascicule 32, Garantie bancaire internationale, No.134 et s.

requested the bank to furnish this type of security device.[114] In order to recover from the guarantee applicant, the guarantor bank has just to prove that he has performed under the guarantee contract and that he has paid the amount required according to the requirements inserted in the first demand guarantee.[115] The account party/guarantee applicant cannot escape its duty to pay the amount of money by proving that the request of the beneficiary was unjustified, except in case of "fraud" or "manifest abuse."[116] Even if the request is unjustified, the bank has no choice, it has to pay. It can recover for the same amount that it has paid. In order to avoid this payment, the guarantee applicant can not argue that he has performed under the underlying contract, except if he can prove that the bank and the beneficiary were in connivance.[117] This right to recover is based on the contract binding the bank and the exporter. The bank had no other motive to engage itself to pay on first demand of a third party. This engagement can just be explained by the willingness of the bank to help its customer to clinch an

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[114] RIPERT-ROBLOT, *Traite de Droit Commercial*, L.G.O.J. § 2408, at 458 (1992).

[115] J. STOUFFLET, *supra* note 2, at 286; C. GAVALDA & J. STOUFFLET, *supra* note 2, at 21.

[116] Judgment of Feb. 6, 1990, Cass. com., 1990 D.S., 467 (Fr.); Judgment of Mar. 1, 1990, Bordeaux, 1990 D.S., Somm. comm., 210, observation Vasseur (Fr.).

[117] J. STOUFFLET, *supra* note 2, at 286.

international contract. Hence, if the first demand guarantee is called, it is normal that the bank expects to recover the sum of money spent. But, in order to avoid any difficulties at the time the bank is going to ask to be reimbursed, this bank should rather take security interest in some property of its customer. At least, it should expressly state in the contract that it has the right to recover the amount of money. In certain cases, the guarantee applicant can engage itself to pay back also on first demand the amount of money to the bank. But, it is wise to avoid the creation of another first demand guarantee between the guarantor and the guarantee applicant because the demand guarantee is considered to be too dangerous to be used between two French parties.

The guarantor has also the possibility of claiming against the beneficiary. This type of recovery is recognized by the courts as in the case of the documentary credit.[118] Once the guarantor has performed according to the first demand guarantee, can he recover the amount of money paid in only proving that the guarantee applicant did not owe anything to the beneficiary? This action has been widely recognized by the German courts' decisions.[119] In France, the guarantor can exercise by the *action*

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[118] C. GAVALDA & J. STOUFFLET, *supra* note 2, at 22.

[119] *Id.*

oblique[120] the motion which is normally reserved to the guarantee applicant. Article 1166 of the French Civil Code states that the creditors can exercise all the rights and claims of their debtor, except the ones that are exclusively tied to the debtor.

The recovery of the guarantee applicant against the beneficiary creates a more equal balance to the automatic mechanism of the guarantee.[121] But till now this action is unknown in the French courts' decisions. The right to recover the debt cannot be compensated by a debt owed by the beneficiary except if the conditions of "compensation" are proved. First, "compensation" implies that the debt be "certain." No claims should have been brought into court concerning the existence of the debt. Secondly, the debt has to be "monetary." The debt should consist in a certain amount of money. And third, the debt has to be immediately "exigible."[122] The debt should be due at the time "compensation" is requested.

The claim which one bank can raise against another bank is similar to the recovery between the guarantee applicant and the guarantor[123], mentioned above. This kind of action is identical to the one which can be exercised in the

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[120] C. civ. art. 1166 (Fr.).

[121] J. STOUFFLET, *supra* note 2, at 86.

[122] C. civ. art. 1291 (Fr.).

[123] C. GAVALDA & J. STOUFFLET, *supra* note 2, at 22; J. STOUFFLET, *supra* note 2, at 86.

case of the documentary credit.[124] It seems obvious that the bank which has furnished the "first demand guarantee" can claim against the guarantee applicant because of the authorization, which it has received from the guarantee applicant. According to the French Civil Code, the *mandat* is defined as:

> an act by which a person gives someone the power to do something for the *mandant* and on his behalf.[125]

Le *mandant* (the party which has received the power) is bound by the acts of the *mandataire* (the party which has given the authorization) stipulated in the *mandat* limits.

But the counter guarantor cannot directly recover from the exporter because they have not signed any contract which would have bound each other.

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[124] *Id.*

[125] C. civ. art. 1984 (Fr.).

CHAPTER II:

THE AMERICAN STANDBY LETTER OF CREDIT

I. Applying Article 5 to Standby Credits

As it has been discussed, it was necessary in France to recognize a category of new security device. But in the U.S., the standby credit has been developed under the previously established rules governing commercial letters of credit, stated in Article 5 of the Uniform Commercial Code. The Code including the aforesaid article has been adopted in all the States even if there are some non-uniform provisions in particular states. Article 5 has been applied to both the traditional letter of credit also called documentary credit and the standby letter of credit. However, the courts recognize that the standby credit has a different role. The role of a standby is similar to the one of a surety bond in contrast to the traditional letter of credit. In Arbest Construction Co. Inc. v. First National Bank & Trust Co. of Oklahoma City,[126] the plaintiff argued that since the standby is not a simple payment mechanism, the U.C.C.

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[126] 777 F.2d 581 (10th Cir. 1985).

provisions should not be applied. The court recognized that the standby letter of credit is merely "a backup," that is similar to a surety bond.[127] But it nevertheless applied Article 5. According to the court, the framers of the U.C.C. intended that Article 5 be applied to other types of letters of credit transaction besides the ones involving sale of goods. The standby letter of credit meets the requirements which are necessary to be fulfilled in order for a device to be qualified as a credit. As under a traditional letter of credit, payment under a standby letter of credit occurs upon proper presentation of documents, even if the nature of these documents is different. Indeed, the certificate of default required under a standby credit transaction is a document. This certificate of default is a prerequisite, and serves to distinguish the standby credit from the surety contract in American eyes. Payment under a standby credit cannot be due upon the fact of default.[128] The difference between payment upon a certificate of default and upon the fact of default is crucial. Unlike a fact of default, a certificate of default constitutes a documentary payment condition. In contrast, a fact of default constitutes a non-documentary condition. A standby credit in which has been

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[127] *Id.*

[128] Wichita Eagle & Beacon Publishing Co. Inc. v. Pacific National Bank, 343 F.Supp. 322 (N.D. Cal. 1971), *rev'd* 493 F.2d 1285 (9th Cir. 1974). This issue will be later analyzed.

inserted fundamental non-documentary payment conditions would be re-qualified as a guarantee.[129]

II. Establishing the Basic Theory of the Standby Credit

Article 5 has been said insufficient because it represents only a partial codification of the law of letter of credit. This article is so broad that it constitutes more a theory than a practical interpretation.[130] It was conceived to provide a legal basis for letters of credit by defining the basic rights and obligations of the parties involved.[131] According to some legal authors and commentators, these provisions concerning the letter of credit have failed to achieve their goal as they did not "attempt to hinder the development of new practices and uses"[132] or "to impede the flexibility of the letter of credit."[133] The Code adopted by the different States does not even mention in most of the cases the term "standby letter of credit." However, Article 5 establishes the basic theory on which the standby is grounded.

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[129]This issue is later analyzed in this chapter.

[130]U.C.C. § 5-101 cmt.

[131]C. Harris, *Commercial Letters of Credit: Development and Expanded Use in Modern Commercial Transactions*, 4 CUMB. STAM. L. REV. 134, 160 (1973).

[132]*Id.*

[133]*Id.*

One basic issue concerns consideration. As regard to this issue of consideration, Article 5-105 states that "no consideration is necessary to establish a credit or to enlarge or otherwise modify its terms." Because of the existence of this provision, documents qualifying as letters of credit are recognized as being enforceable. But under French law since such provision does not exist, incorporation of the new security device has been troublesome. Thus, the *cause* of the new security device have raised difficulties (the *cause* can be compared to consideration under American law).[134]

The second major point established by Article 5 is that standby credit is an independent engagement of the issuer. Because it is a credit, standby is subject to the principle of independence stated in U.C.C. Section 5-114 (1). That section reads as follows:

> An issuer must honor a draft or demand for payment which complies with the terms of the relevant credit regardless of whether the goods or documents conform to the underlying contract for sale or other contract between the customer and the beneficiary.[135]

This provision applies not only to the traditional letter of credit but it also applies perfectly to the standby transaction. As with the first demand guarantee, the standby credit is a part of a transaction involving three contracts.

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[134]The issue of *cause* has been analyzed in the previous chapter.

[135]U.C.C. § 5-114 (1).

These three contracts are independent from each other. The standby credit is one of them. Independence means that a party cannot find defenses in the contracts. Under the standby credit, the issuer will not perform only if the documents do not comply with the term of the credit (except the case of fraud). Section 5-103 (1) (a) of the U.C.C. states that a documentary demand for payment which is a standby, "is conditioned upon presentation of a document or documents."[136] The issuer cannot claim that he has not performed because the beneficiary of the credit was under default under the underlying transaction. These provisions show how similar the basic mechanism of the standby credit is the one of the first demand guarantee.

The existence of Article 5 explains why the standby has remained more faithful to the guiding principles of its progenitor, the commercial letter of credit, than has the bank guarantee.[137]

III. Documentary Compliance

Article 5 does not address the issue of documentary compliance. Thus because of the lack of statutory rules, the courts provide the necessary interpretative principles. The

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[136] U.C.C. § 5-103 (1) (a).

[137] B. Kozolchyk, *Bank guarantee and letter of credit: Time for a return to the fold*, U.PA. J. INT'L BUS. L. 44, 50 (1991).

courts generally follow strict compliance.[138] For example, in the case of Armac Industries,[139] according to the stipulations inserted in the credit, the bank was supposed to pay the beneficiary upon a draft and a performance statement. But the beneficiary requested payment with an unsigned draft and a bill of lading. Thus, the bank refused to honor the beneficiary's demand. The credit expired without the beneficiary attempting to modify the documents. In this case, the court upheld the bank's dishonor and concluded that the unsigned draft was sufficient for dishonoring the credit and noted that a bill of lading was different from a "signed statement." The court added that "the issuer can only protect its right of reimbursement if it is entitled to insist on strict compliance by the beneficiary."[140] In Marino Industries v. Chase Manhattan Bank,[141] the issue was similar. The beneficiary was supposed to present a certificate of receipt showing that freight charges had been prepaid to the job site. But instead of presenting the document as it was described, the beneficiary presented a receipt with the

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[138]Old Colony Trust Co. v. Lawyers' Title & Trust Co.,297 F.2d 152 (2d Cir. 1924); Armac Industries, Ltd. v. City Trust, 203 Conn. 394, 525 A.2d 77 (1987); Beyene v. Irving Trust Co., 596 F.Supp. 438 (S.D.N.Y. 1984); Exxon Co., U.S.A. v. Banque de Paris et des Pays-Bas, 828 F.2d 1121 (5th Cir. 1987).

[139]Armac Industries, Ltd. v. Citytrust, 203 Conn. 394, 525 A.2d 77 (1987).

[140]525 A.2d at 81.

[141]686 F.2d 112 (2d Cir. 1982).

notation "cash," with the word "cash" crossed out. Thus, the Second Circuit held that the defect in the document justified the bank's refusal to pay.

However, in case of trivial defects in the documents, the courts have held that issuers are still obligated to make payment. A standby letter of credit which carries trivial defects has been held payable.[142] For example, in Tosco Corp. v. FDIC,[143] the bank dishonored the credit for non-compliance. But the court held that the bank's strict compliance defense was without merit. In this case, the bank claimed that the draft was not in strict compliance with the stipulations of the credit because a small "l" was used instead of a capital "L," and that "No" was used instead of "Number." Thus, the Sixth Circuit accepted the district court's conclusion that,

> Any asserted deviations from the conditions and terms of the letter of credit are so unsubstantial that they would not have jeopardized the bank's position in an action for recovery against Lankford Corporation (the account party) nor is there any possibility that the bank could have reasonably been misled to its detriment.[144]

In fact, Article 5's broadness has permitted the courts to freely interpret the rules applying to the new security device.

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[142] Tosco Corp. v. F.D.I.C., 723 F.2d 1242 (6th Cir. 1983); Temple-Eastex Inc. v. Addison Bank, 672 S.W.2d 793 (Tex. 1984). This issue will be later analyzed.

[143] 723 F.2d 1242 (6th Cir. 1983).

[144] *Id.* at 1247-48.

IV. Clarifications in the New Revision of Article 5

The new proposed draft revision of U.C.C. takes into consideration some of the courts' decisions and tends to harmonize the domestic rules with the international practice. According to the new proposed draft revision of U.C.C. Article 5,[145] a letter means:

> an engagement that satisfies the requirements of section 5-104 by an issuer to a beneficiary at the request or for the account of an applicant or for its own account to honor a draft or other demand upon proper presentment of the documents specified in the letter of credit.

Article 5-106 (a) which deals with revocability or irrevocability of a letter of credit, shows the willingness to adapt the U.C.C. provisions concerning letters of credit to the U.C.P. which is the international set of rules recognized in this area. This article states that "a letter of credit may be revocable or irrevocable."[146] But "a letter of credit that is silent as to its revocability is irrevocable."[147] Indeed, this solution is the same than the one adopted by the U.C.P. 500.[148] Several courts have decided accordingly to the U.C.P.[149] "After issuance of

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[145] Proposed March 31, 1993 Draft Revision of Article 5.

[146] Proposed March 31, 1993 Draft Revision of Article 5, § 5-106(a).

[147] *Id.*

[148] Article 6, ICC, Publication No.500 (May 1993).

[149] See, e.g. Weyerhauser Co. v. First Nat. Bank, 27 U.C.C. Rep. Ser. 777 C.S.D. Iowa 1979; West Va. hous. Dev. Fund v. Stroka, 415 F.Supp. 1107 (W.D. Pa. 1976).

an irrevocable, in contrast of a revocable, standby letter of credit, it can be confirmed by one or more other banks."[150] In regard to the confirming and advising bank, harmonization with international practice will also improved if the new U.C.C. draft is adopted. A confirming bank adds its own liability to that of the issuing bank, undertakes to honor the draft and was directly obligated as though it were the letter's issuer to the extent of its confirmation.[151] The legal consequences of being a confirmor are stated in Section 5-107(2). They are similar to the ones formulated under the U.C.P. But under American law, unlike under the U.C.P. provisions, an advising bank, or notifying bank is only obligated "for the accuracy of its own statement."[152] Under the U.C.P., the duty of the advising bank is increased, but the proposed 1993 draft[153] will impose a similar obligation. Under the U.C.P., the advising bank "shall take reasonable care to check the apparent authenticity of the credit."[154] The advising bank has

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[150] WUNNICKE & WUNNICKE, *supra* note 11, § 3-5.

[151] Venizelos, S.A. v. Chase Manhattan Bank, 425 F.2d 461 (2d Cir. 1970).

[152] U.C.C. § 5-107(1); Merchants Bank of New York v. Credit Suisse Bank, 585 F.Supp. 304 (S.D.N.Y. 1984).

[153] Proposed March 31, 1993 Draft Revision of Article 5, § 5-107(c).

[154] Article 7(a), ICC, Publication No.500 (1993).

also in some cases a high duty of informing without delay the other party.[155]

V. Requirements for Calling

American law distinguishes three types of transactions where French law distinguishes only one. First, under American law, if the bank engages to pay on demand alone, it has issued a "clean" letter of credit. Secondly, if the bank engages to pay upon a certificate of default, it has issued a standby credit. And third, if the bank pays only if the customer has defaulted, the bank has issued a guarantee. In contrast under French law, a transaction taking any of these forms is a first demand guarantee. Under American law, issuing a credit with the customer's default as a payment condition is improper. This has been held in Wichita Eagle and Beacon Publishing Co. Inc. v. Pacific National Bank.[156] Such contract is not a credit; it is a guarantee. Under American law, a problem has been raised with this kind of payment conditions which are non-documentary. For example, in the Wichita Eagle Case,[157] the trial court held that the instrument involved was a

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[155]Articles 7(a) & (b), ICC, Publication No.500 (1993).

[156]Wichita Eagle & Beacon Publishing Co. Inc. v. Pacific National Bank, 343 F.Supp. 322 (N.D. Cal. 1971), *rev'd* 493 F.2d 1285 (9th Cir. 1974).

[157]*Id.*

letter of credit because it was labelled as being one, it had been drafted by a lawyer and it had been approved by both the beneficiary and the issuing bank.[158] But, the Ninth Circuit Court reversed because payment from the issuer depended on certain conditions extrinsic to the credit. Indeed, payment by the issuer depended upon some conditions such as, the refusal of a building permit by the City of Wichita and the lessee's failure to comply with the lease terms. Thus, the court re-qualified the instrument as a guarantee.

But, by practice, some "borderland" payment obligations have been created.[159] They borrow characteristics from the traditional guarantee contract and from the standby letter of credit. Qualification of these "borderland" obligations sometimes gives trouble. The courts control the qualification given by the parties and if necessary they re-classify the instrument as a guarantee.

Another major difference between standby credits and guarantees consists in the relation between the seller (applicant in the case of a guarantee or customer of the bank in case of a standby credit) and the buyer if for example the underlying contract is a sale. Under a guarantee contract, the guarantor is secondarily liable and becomes

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[158] *Id.* at 338-39.

[159] G. McLaughlin, *Standby letters of credit and guaranties: an exercise in cartography*, 34 WM & MARY L. REV. 1139, 1144 (Summer '93).

primarily liable only in case of breach from the buyer under the underlying contract. But under a standby credit, if there is breach under the underlying contract, only one party, the bank, has to perform. Under French law, a similar analysis can be done concerning guarantees. This explains why in a first demand guarantee the independence principle is so crucial. Without the independence principle the guarantee applicant would become primarily liable. But because of this principle, the bank is the only party which is liable.

In the new proposed draft revision of 1993, the devices named credits by the parties have been divided into two categories, the ones with fundamental non-documentary payment conditions and the ones with ancillary non-documentary conditions. The ancillary non-documentary conditions will have no effect on the nature of the letter of credit. But as for the fundamental non-documentary conditions, they will affect the nature of the letter of credit. Such letter of credit with fundamental non-documentary conditions will be re-qualified and treated as a guarantee. It is possible to include some non-documentary conditions in a letter of credit without affecting the nature of the device, however these conditions should not constitute a fundamental part of the issuer's

obligation.[160] Hence, the position adopted by Wichita Eagle[161] has been adopted by the new U.C.C. draft.

In regard to the documents which are necessary to be produced in order for payment under a standby credit to be made, the seller should choose them carefully. Because the standby credit is not supposed to be honored unless the buyer defaults, it is necessary for this seller to draft the instructions so that it becomes difficult for the buyer to draw under the credit.[162] It is advised, for example, that the seller "requires documents signed by third parties rather than the beneficiary (buyer) whenever possible."[163]

VI. Subrogation

Subrogation is defined as a right acquired when one (the subrogee), pursuant to an obligation and not as a volunteer, fulfills the duties of another (the subrogor) and therefore becomes entitled to assert the rights of the other (the subrogor) against third persons.[164] Subrogation

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[160] Comment § 5-110 (d).

[161] 343 F.Supp. at 322.

[162] M. Hall, *Standby letters of credit: tactical transactional tools*, 80 ILL. B. J. 356, 358 (Jl '92).

[163] *Id.* at 359.

[164] In re Minnesota Kicks, Inc., 48 Bankr. 93, 105 (Bankr. D. Minn. 1985).

implies that the surety who pays the creditor is subrogated not only to the creditor's claims against the principal debtor but also to any collateral securing the debtor's obligation. Under American Law, "courts and commentators alike have disagreed whether subrogation should be permitted in the letter of credit context."[165] "Some have argued that subrogation is antithetical to fundamental letter of credit principles, particularly the independence principle, and consequently should not be permitted in the letter of credit context."[166] Others have argued that subrogation and letter of credit principles can and should coexist in harmony."[167] In the Uniform Commercial Code, Article 5 affirms the principle of independence. But, the drafters have avoided to mention the issue of subrogation in Article 5. As a result, one of the consequences is that the courts' decisions give a different solution to this issue. The right to be subrogated to the beneficiary's security interest is left to other law. This right is recognized in U.C.C. § 9-504(5) and in Bankruptcy Code § 509(a). The Bankruptcy Code provisions recognize subrogation for an entity "liable with the debtor." The question of a possible subrogation has been raised in cases concerning bankruptcy and the solution given by the courts has varied. In some cases involving a standby

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[165] M. Avidon, *Subrogation in the letter of credit context*, 56 BROOK. L. REV. 129 (1990).

[166] *Id.*

[167] *Id.* at 129 n.3.

letter of credit, the courts have held that subrogation was not available[168] and they have held that subrogation principles should not be imported.[169] In re Kaiser Steel Corporation, subrogation of the bank to the right of the secured creditor was also denied. In this case, the bank had issued two standby letters of credit to secure two debts of Kaiser Steel Corporation. The first letter of credit was issued in favor of the California Workers Compensation Self Insurance Plan and was secured by a cash collateral. The security agreement provided that the collateral secured payment of any obligations of Kaiser Steel Corporation to the bank. The second letter of credit was issued in favor of GATX Leasing Corporation to secure a loan obtained by Kaiser Steel. This standby credit was also secured by a cash collateral. Moreover, Kaiser gave a lien to GATX on all its assets. The issue of the case involved only the second letter of credit. Kaiser defaulted on its payment to GATX, but it had already filed its Chapter 11 petition in bankruptcy. After paying the Steel Corporation debt, the bank claimed that it should be subrogated to GATX rights. But the court denied any such rights because the "debt to

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[168]Bank of America National Trust & Savings association v. Kaiser Steel Corp., 89 B.R. 150 (Bankr. D. Colo. 1988); Tudor Dev. Group Inc. v. United States Fidelity & Guar. Co., 968 F.2d 357, 362 (3d Cir. 1992); United States Fidelity & Guar. Co. v. United Penn Bank, 524 A.2d 958, 963 (Pa. Sper. Ct.).

[169]Tudor Dev. Group Inc. v. United States Fidelity & Guar. Co., 968 F.2d 357, 362 (3d Cir. 1992).

GATX evidenced by the standby letter of credit was primarily the obligation of the bank."[170] The court held "the issuer of the standby letter of credit assumes an independent obligation to pay the creditor upon presentation of the demand."[171] Indeed even in case of the account party's default, the bank was obligated under the irrevocable standby letter of credit.[172] According to the court, "when the issuer pays its own debt it cannot then step into the shoes of the creditor to seek subrogation, reimbursement or contribution from the debtor."[173] But, even if letters of credit are distinct from guarantees and suretyship, some case law[174] suggest that standby credits should be accorded the same rights of equitable subrogation as are granted to guarantors and to sureties. This has been held in re Sensor Systems, Inc[175]. In this case, the claimants had made payment under a standby letter of credit, which had been issued in favor of a secured lender. The

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[170]Kaiser Steel Corp., 89 B.R. at 150.

[171]*Id.*

[172]*Id.* at 153.

[173]*Id.*

[174]In re Minnesota Kicks, Inc., 48 B.R. 93 (D. Minn. 1985); In re Glade Springs, Inc., 826 F.2d 440 (6th Cir. 1987); In re National Service Lines, Inc., 80 B.R. 144 (Bankr. E.D. Mo. 1987); In re Sensor Systems, Inc., 79 B.R. 623 (Bankr. E.D. Pa. 1987); In re Guy C. Long, Inc., 74 B.R. E.D. Pa. 1987).

[175]Re Sensor Systems, Inc., 79 B.R. 623 (Bankr. E.D. Pa. 1987).

trustee in bankruptcy objected to the secured proof of claim and considered the group of claimants as not being entitled to subrogation. But, the bankruptcy court stated that "a party issuing a letter of credit in favor of another is logically characterized as a guarantor or a codebtor.[176] The courts have also held for example that "the advances made by the financial institutions on behalf of their account party are collateralized.[177] However in these cases, the financial institutions are not involved in the underlying transaction."[178]

The new proposed draft revision of U.C.C. Article 5 draft does not mention the problem of subrogation. The right to subrogation is still left to other law. According to the new U.C.C. draft comments, however, this right is not inconsistent with the independence principle embodied in the section 5-103 (d).[179] "This comment endorses the position of dissenting Judge Becker in Tudor Development Group Inc. v. United States Fidelity and Guaranty Co."[180] In this case, the majority refused to equitably subrogate the issuer

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[176] *Id.* at 626.

[177] Barclays Bank D.C.O. v. Mercantile Nat'l Bank, 481 F.2d 1224, 1238-39 (5th Cir. 1973).

[178] *Id.*

[179] Proposed March 31, 1993 Draft Revision of Article 5, § 5-103 (d) comments.

[180] 968 F.2d 357, 17 U.C.C. Rep. Ser. 2d 112 (3d Cir. 1992).

of a standby credit to the rights of its customer in the absence of an express assignment.

In cases involving bankruptcy issues, a significant exposure for the beneficiary is the risk that the transfer of collateral to the issuer to induce issuance of the credit will be held to be a voidable preference under section 547 of the Bankruptcy Code.[181] In the Blue Quail case,[182] the "court made clear that a creditor cannot secure payment of an unsecured antecedent debt by means of a standby credit transaction when it could not secure non-preferential payment through any other type of transaction."[183] Since the new U.C.C. draft does not deal with subrogation, the courts' decisions will continue to be uncertain. Indeed, "with only comments to guide them, courts confronted with subrogation issues in letter of credit context will continue to struggle without the enlightened guidance of those knowledgeable in the field."[184]

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[181] Kellog v. Blue Quail Energy, Inc. (In re Compton Corp.) 831 F.2d 586 (5th Cir. 1987), *add'l remand*, 835 F.2d 584 (5th Cir.), *reh'g denied* (1988).

[182] *Id.*

[183] WUNNICKE & WUNNICKE, *supra* note 11, at § 11-5.

[184] A. Boss, *Suretyship and letters of credit: subrogation revisited*, 34 WM & MARY L. REV. 1087, 1137 Summ '93.

VII. Fraud

The banks have a duty to honor a standby letter of credit when it is presented if there is compliance with its terms.[185] Strict compliance in presentment is required.[186] If the letter of credit is not following the provisions of Article 5 of U.C.C. but is following the U.C.P., the duty of the bank is similar.[187] The only exception of the bank's duty to honor the credit appears "when the documents are forged or fraudulent or there is fraud in the transaction."[188] Hence, section 5-114(2) of the Uniform Commercial Code constitutes an exception to the principle of independence. It states:

> Unless otherwise agreed when documents appear on their face to comply with the terms of a credit but a required document does not in fact conform to the warranties made on negotiation or transfer of a document of title (section 7-507) or of a certificated security (section 8-306) or is forged or fraudulent or there is fraud in the transaction.

The first important case to limit the principle of independence is the Sztejn case.[189] In this case, Sztejn contracted with Transea Traders Ltd, an Indian corporation

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[185] U.C.C. § 5-114(1).

[186] Old Colony Trust Co. v. Lawyers' Title & Trust Co., 297 F. 152 (2d Cir. 1924).

[187] Article 8(1), ICC, Publication No.500 (May 1993).

[188] U.C.C. § 5-114(2).

[189] Sztejn v. Schroder Banking Corp., 177 Misc. 719, 31 N.Y.S. 2d 631 (1941).

to purchase a quantity of bristles. Schroeder issued an irrevocable standby credit for the account of its customer, Sztejn. Under the stipulations inserted in the letter of credit, the issuer was supposed to pay Transea upon shipment of the merchandise and presentation of a draft, invoice and bill of lading covering the shipment. But instead of shipping the bristles, Transea shipped "cowhair, other worthless material and rubbish with intent to simulate genuine merchandise and defraud the plaintiff."[190] Thus, Sztejn sued Transea in order to have the draft declared void and the payment enjoined. The court stated that "the principle of independence of the obligation under the letter of credit should not be extended to protect the unscrupulous"[191] and held in favor of the plaintiff. With the Sztejn case, the doctrine of fraud in the transaction started. According to the courts, fraud in the inception infects and vitiates the letter of credit itself.[192] The provision 5-114(2)(b) of the U.C.C. is deemed to be a codification of the Sztejn case. Difference has always been made between fraud in the underlying transaction and fraud in the documents. Fraud in the underlying transaction and

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[190] *Id.* at 635.

[191] *Id.*

[192] Bossier Bank & Trust Co. v. Union Planters Nat'l Bank, 550 F.2d 1077, 1080 (6th Cir. 1977); Baker v. National Boulevard Bank, 399 F.Supp. 1021,1024 (N.D. Ill. 1975).

fraud in the documents are the two grounds which can be invoked in order to obtain injunctive relief.

According to the courts,[193] injunction for fraud in the transaction is justified if; first, fraud comes from the beneficiary of the credit and second, if fraud is of a nature that has "vitiated the entire transaction."[194] Fraud in a collateral transaction is not considered.[195] As for fraud in the documents, the courts have held that "falsified documents are the same as no documents at all."[196] There is one exception to the U.C.C. allowing the issuer the option of dishonoring for fraud. This exception concerns the case when a draft is presented by a holder in due course. "The Sztejn case and the U.C.C. both give explicit recognition to the subordination of the equitable rights of an aggrieved account party to the equitable rights of one who has become a bona fide holder of a claim to payment under a letter of credit."[197] Then, the presenter has to be paid if he had no knowledge of the forgery or falsification concerning the documents presented.

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[193] Intraworld Industries, Inc. v. Girard Trust Bank, 461 Pa. 343, 336 A.2d 316 (1975).

[194] *Id.*

[195] WUNNICKE & WUNNICKE, *supra* note 11, at § 10-4.

[196] Voest Alpine Int'l Corp. v. Chase Manhattan Bank, 707 F.2d 230, 239 (5th Cir. 1983).

[197] H. Hartfield, *Identity Crises in Letter of Credit Law*, 24 ARIZ. L. REV. 129, 242 (1982).

And, a bank which has paid a bona fide holder has a right to be reimbursed.

In case of fraud, injunctive relief can be requested. Under American law as under French law, "a party seeking a preliminary injunction has the burden of establishment."[198] Federal Rule of Civil Procedure 65 applies to the issuance of injunctive relief in the federal courts. Rule 65 provides for three types of injunctive relief, which are temporary restraining order, preliminary injunction, permanent injunction.

The temporary restraining order is only issued if two conditions are fulfilled. First, it has to "clearly appear" from specific facts shown in writing that immediate and irreparable loss or damage will result to the applicant before the adverse party can be heard. Secondly, written certification has to be provided to the court of any efforts made to give notice and why notice should not be required.[199] "The purpose of a temporary restraining order is to preserve the status quo for ten days until a hearing after notice can be had to determine if a preliminary injunction should issue."[200] As for the

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[198] B. Wheble, *"Problem Children"-Standby Letters of Credit and Simple First Demand Guarantees*, 24 ARIZ. L. REV. 301, 311 (1982).

[199] WUNNICKE & WUNNICKE, *supra* note 11, at § 10-7.

[200] *Id.*

preliminary injunction[201], it requires notice to the adverse party and a hearing. The third kind of injunction, that is the permanent injunction is only granted after trial on the merits. Rule 65 provides that no temporary restraining order or preliminary injunction may be issued except upon the applicant's giving security in such amount as the court shall deem proper. The amount shall be a sum sufficient to pay costs and damages sustained by the party who may be later be found to have wrongfully restrained or enjoined.[202]

In Dynamics Corp. v. Citizens & Southern Bank[203], the court granted a preliminary injunction "despite this emphatic recognition of the credit's independence from the underlying contract." The court stated that the beneficiary should "not be allowed to take unconscientious advantage of the situation and run off with plaintiff's money on a pro forma declaration which has absolutely no basis in fact."[204] According to some legal authors and commentators, "in international letter of credit transactions, the beneficiary should give consideration to

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[201] *See* American Bell International and American Telephone & Telegraph Co. v. Manufacturers Hanover Trust Co., No.3157 (N.Y. Sup. Ct. Feb. 28, 1979); G.T.E. International and G.T.E. Iran Inc. v. Manufacturers Hanover trust Co. and Credit Lyonnais, No.3525 (N.Y. Sup. Ct. Mar. 2, 1979).

[202] *Id.*

[203] 356 F.Supp. 991 (N.D. Ga. 1973).

[204] *Id.* at 999.

any potential political instability of the foreign country involved as an account party ar as the domicile of an account party."[205]

In the new proposed draft revision of the U.C.C. Article 5, fraud in the transaction, as it was previously stated in section 5-114 of the U.C.C. has been omitted in order "to reduce the cases where an applicant may procure an injunction."[206] In the U.C.C. project, fraud in the documents has been the only one recognized for the letters of credit. Hence, "now any fraud must appear in the form of a forged or fraudulent document to justify an injunction."[207] Moreover, in order for an injunction to be granted, it is necessary that fraud in the documents be "material."[208] These provisions are different from the rules recently elaborated by the French courts, which have extended the cases granting an injunction. According to the new Article Five, "fraud by persons other than the beneficiary does not justify an injunction unless such acts result in the beneficiary's knowing presentment of forged or fraudulent documents." Hence, the court position held in the

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[205] WUNNICKE & WUNNICKE, *supra* note 11, at § 10-8.

[206] Proposed March 31, 1993 Draft Revision of Article 5.

[207] Proposed March 31, 1993 Draft Revision of Article 5, §5-110(f) Comments.

[208] Proposed March 31, 1993 Draft Revision of Article 5, §5-110(f) Comments.

Cromwell case[209] is likely to be rejected. In this case, the court denied injunctive relief to limited partners who fraudulently had been induced by the general partner in their partnership to procure a letter of credit payable to a beneficiary that was not a party to the fraud. The holding of Dynamic Corporation of America[210] is also rejected. This case involved an analysis similar to that in Griffin Companies.[211] In these two cases, fraud in the documents was not "material." But, the preliminary injunction designed to preserve the status quo was granted. The court held that "when the presenter is not a holder in due course, the bank may honor the draft on presentment but is not required to, and a court may enjoin honor."[212] Under the new U.C.C. draft in order for an injunction to be granted, it is necessary that fraud be "material," that is appears in the documents.

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[209]Cromwell v. Commerce & Energy Bank, 464 So.2d 721 (La. 1985).

[210]Dynamic Corp. of Am. v. Citizens & S Nat. Bank, 356 F.Supp. 991 (N.D. Ga. 1973).

[211]Griffin Cos. v. First Nat. Bank, 374 N.W. 2d 768 (Minn. App. 1985).

[212]Dynamic Corp., 356 F.Supp. 991; Griffin Cos., 374 N.W. 2d 768.

VIII. ICC Rules

Up to now, the first demand guarantee and the standby letter of credit have had different international sources. Standby credits have developed into all purpose financial support instruments which are used in a much wider range of financial and commercial activity than demand guarantees."[213] They have been used in transactions concerning real property, also in financial transactions and in order to secure the payment of business loans.[214] The fact that the standby letter of credit has been used to secure financial transactions has been for a long time one of the differences with the first demand guarantee, at least with the French version of this independent security device. They also regularly involve practices and procedures which are not often encountered in case of a demand guarantee.[215] One of the main source of rules for credits is the U.C.P. enacted by the International Chamber of Commerce. The ICC has tried to elaborate different sets of rules at the international level not only for the "first demand guarantee," but also for the standby letter of credit. All the sets of uniform rules for guarantees formulated by the ICC do not have force of law. In order to be applied, they must be incorporated by a reference clause.

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[213] ICC, Publication No.458, at 4 (1992).

[214] *Id.*

[215] *Id.*

Concerning the standby credits, the ICC has enacted the Uniform Customs & Practice for Documentary Credits (U.C.P.). The U.C.P. is the universally recognized set of rules governing letters of credit."[216] It has been several times revised. But it has still been regarded as insufficient by the ICC. The last set[217] has come into effect in 1994. The previous version of the U.C.P.[218] has concerned the inclusion of the standby letter of credit. Article 1 of the U.C.P. 500 states as previously that "these articles apply to documentary credits, including to the extent to which they may be applicable, standby letter of credit." But unlike commercial credits, which regularly include a printed clause incorporating the Uniform Customs[219], there appear to be many instances in which credits remain to be governed by domestic laws."[220]

In regard to fraud, in the U.C.P., no provision has been included. "In the United States, when a letter of credit is expressly made subject to the U.C.P., the U.C.C.

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[216]ICC, Publication No.400, at back cover (1983).

[217]ICC, Publication No.500 (1993).

[218]ICC, Publication No.400.

[219]"Uniform Customs" is the abbreviation for "Uniform Customs and Practices for Documentary Credits" (U.C.P.) which is a set of rules elaborated by the International Chamber of Commerce.

[220]E. Ellinger, *Uses of Letters of Credit and Bank Guarantees in the Insurance Industry*, 6 INT'L BUS. LAW. 604, 623 (1978).

provisions regarding fraud have been held applicable."[221] But, "New York has adopted a non-conforming amendment to § 5-102 of the U.C.C. which does not apply to a letter of credit made subject, either in whole or in part, to the U.C.P."[222] However, the U.C.C. provisions regarding fraud have been applicable in the Rockwell International Systems case,[223] even though the letter of credit was deemed to follow the U.C.P. provisions.

In the U.C.P., the advising bank's duty has been increased in 1983.[224] Hence, it became more important than under the Uniform Commercial Code. It has been considered as "a major innovation."[225] "The article now imposes a duty of responsibility on the advising bank and the consensus is that it is a fair responsibility."[226] "This new U.C.P. obligation for advising banks emphasizes the importance to beneficiaries of making credits both (1) subject to the U.C.P. and (2) advised in order to obtain the protection of valid signatures on the documents of

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[221] WUNNICKE & WUNNICKE, *supra* note 11, at § 10-3.

[222] *Id.*

[223] Rockwell Int'l Sys., Inc. v. Citibank, N.A., 719 F.2d 583 (2d Cir. 1983).

[224] Article 8, ICC, Publication No.400 (1983).

[225] del Busto, *Operational Rules for Letters of Credit: Effect of New Uniform Customs and Practice Rules*, 17 U.C.C. L.J. 298, 301 (Spring 1985).

[226] *Id.*

credit."[227] "The beneficiary thereby obtains an invaluable protection of valid issuance, a protection that the U.C.C. does not explicitly provide."[228] But, with the proposed new draft revision of Article Five, the advising bank duty also been increased and is quite similar to the one imposes by the U.C.P. Thus, the advantage presented by the U.C.P. as regard to the duty of the advising bank has disappeared. The U.C.P. does not really govern the letter of credit with non documentary conditions. Then, a clean letter of credit is better governed by the U.C.C. The U.C.P. is a general guidance for the documents used in a letter of credit transaction.[229] It has many detailed articles concerning the documents which can be used in a letter of credit transaction.

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[227] WUNNICKE & WUNNICKE, *supra* note 11, at § 3-6.

[228] *Id.*

[229] Articles 30 to 38, ICC, Publication No.500 (1993).

CONCLUSION:

If the mechanism of the standby credit and the French first demand guarantee are similar, many points concerning these two security devices vary. The mechanism is the same because both instruments are part of a tripartite transaction and they involved three contracts which have been recognized under the two legal systems as being independent. However, the difference between the standby credit and the first demand is more than a question of label. The French device has until now especially been used in the international transaction, and the rare cases in which it has been used in the domestic relations have been very much criticized. Indeed, giving a first demand guarantee under its strictest form is like giving a "blank check." Under this form, the beneficiary has to be paid upon its simple request. So the French attitude is that the device should only be used to meet the requirements of international competition. Interpretation of the rules regulating the two devices also differs.

A. Requirements for calling payment

Concerning this issue, under American law, the requirements are well known. They do not vary as under French law because there is only one form of standby credit. These requirements are strict compliance and a certificate of default. But under French law, the guarantee device can take many forms. Like in the United States, strict compliance is a prerequisite in order to obtain payment. But as regard to the document, the rules differ. Payment under a first demand guarantee can be called with the support of a document. But this situation is very rare. The standard French first demand guarantee would be called a "clean" letter of credit under U.S. law.

B. Fraud

In regard to fraud, under French law, two concepts can be used to stop an unfair payment, the concept of "fraud" and the concept of "manifest abuse." These two grounds are accepted. It is possible to compare the two French concepts and the two American concepts. The American concept of fraud in the transaction is close to the French concept of "manifest abuse." And, the American concept of fraud in the documents is also quite similar to the French concept of "fraud." Right now, in the U.S., the two grounds can also permit an injunction to be granted. But if the new U.C.C. draft is adopted, the only ground available to the parties will be the one based on fraud in the documents.

C. Subrogation

The U.S. courts are divided on the question of an issuer being subrogated to the rights of the beneficiary. This decision reflects the fact that the American surety device is still evolving. Since subrogation is a standard feature of the American law of suretyship, increased acceptance of subrogation by U.S. courts would indicate that standby credit has at least one of the feature of an American suretyship contract. But the issue of subrogation has not yet reached the French courts. But, according to French legal commentators, subrogation will undoubtedly be recognized, the parties adhere strictly to the provisions of the French Civil Code concerning this issue.