

Guaranteeing the Guarantee Law in Pakistan: The UNCITRAL Convention and the Guarantee Laws of Pakistan, the UK and the USA

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The guarantee laws are important for developing countries as they structure different types of guarantees as investment vehicles, such as the guarantee given to the foreign investors for performance of payment and other obligations on the part of domestic concerns and government organisations in the shape of protections with a view to boost their confidence. This practice is in vogue in Pakistan in all areas of businesses where foreign investment is involved. In this context, this article intends to provide a comparative analysis of the UNCITRAL Convention on independent guarantees and standby letter of credit and the relevant laws of three jurisdictions, UK, USA and Pakistan with a view to explain their similarities and differences inter se.

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CONTENTS

I.	INTRODUCTION	57
II.	STANDBY LETTER OF CREDIT OR INDEPENDENT GUARANTEE	59
	<i>A. Concept and Meaning</i>	59
	<i>B. Relevant International Instruments</i>	60
	<i>C. Applicable Law in Pakistan</i>	61
III.	ANALYSIS OF THE UNICTRAL CONVENTION	63
	<i>A. Consensual Nature of the Convention</i>	63
	<i>B. Application of the Convention</i>	63
	<i>C. Definitional Approach</i>	64
	<i>D. Principle of Independence</i>	64
	<i>E. Non-Documentary Payment Conditions</i>	67
	<i>F. Standard of the Examination of Documents</i>	70
	<i>G. Improper or Fraudulent Calls for Payment</i>	72
	<i>H. Irrevocable Nature of the Undertaking</i>	75
	<i>I. Transfer and Assignment of Proceeds</i>	76
IV.	CRITICISM OF THE CONVENTION.....	77
	<i>A. New Areas Covered by ISP98</i>	79
	<i>B. Lessons Learnt</i>	79
V.	CONCLUSION.....	80

INTRODUCTION

Conformity of laws of developing countries, especially laws that have commercial applications, with international standards is crucial to promote investor confidence for the enhancement of foreign investment. It is also vital in choice of laws in investment agreements and eventual dispute resolutions. Even though the choice of law do not opt for domestic laws, which mostly is the case with developing countries, domestic commercial practices in line with international standards would bring level playing fields with home investors and a general notion of conceptual contiguity would bring better understanding to contracting parties at all levels to negotiate and implement the terms of guarantee, its formalities, the effects and legal consequences it is going to bring for them. (consider splitting into two sentences) The faith of investor in domestic laws of host country cannot only help in the development of domestic laws up to international standards but would also save parties from heavy litigation costs and lengthy arbitration and court procedures.¹

The guarantee laws are thought important in this context because developing countries structure different types of guarantees as investment vehicles, for e.g., the guarantees given to the foreign investors for performance of payment and other obligations on the part of domestic concerns and government organisations in the shape of protections with a view to boost their confidence. This practice is in vogue in Pakistan in all areas of businesses where foreign investment has been attracted. An example can be taken from the case of *Saba Shipyard Company (Pakistan) Limited*.² Though this article is not entirely concerned with *Saba* case, it would not be inappropriate

¹ On need for harmonisation generally, see Rhys Bollen, *Harmonisation of International Payment Law: A Survey of the UNCITRAL Model Law on Credit Transfers*, JOURNAL OF INTERNATIONAL LAW AND REGULATION (2008) at p. 44.

² For details see *Saba Shipyard Pakistan Limited v. Pakistan; Queen's Bench Division (Commercial Court)*, 09 November 2007 [2008] 1 Lloyd's Rep. 210.

to reproduce the brief facts for the better understanding of the issues raised and discussed in this essay.

A combination of standby letter of credit and independent guarantee was used in arrangement for *Saba*'s project to construct barge mounted power plant for a government organisation, Karachi Electric Supply Company (KESC). *Saba* established a standby letter of credit in favour of KESC for completion of project within the prescribed time and the government of Pakistan, in an Implementation Agreement (IA), gave guarantee to *Saba* for "any and every sum of money KESCis obliged to pay to *Saba*". The project could not be completed and KESC drew on the standby letter of credit. *Saba* claimed that drawing on the standby letter of credit was a breach of contract by KESC and obtained an arbitration award for payment of the amount drawn down and under IA's independent guarantee, demanded from Pakistan the payment due from KESC under the award. Pakistan refused to honour on grounds that the IA's independent guarantee was obtained by fraud and misrepresentation on part of *Saba*.

Saba's case could not succeed and two-tyre standby letter of credit and independent guarantee failed for *Saba*, *inter alia*, because the underlying contract of the independent guarantee was itself a guarantee i.e. standby letter of credit.³

In this context, this article intends to provide a comparative analysis of the UNCITRAL Convention on independent guarantees and standby letter of credit⁴ and the relevant laws of three jurisdictions i.e. UK, USA and Pakistan with a view to explain their similarities and differences *inter se*. The objectives are indeed not to yield any innovative ideas but to shed light on the Pakistani law as

³ For the analysis of the *Saba* case, see Brian Cain, *Devil in Detail: Messages from Recent Guarantee Cases*, JOURNAL OF INTERNATIONAL BANKING AND FINANCIAL LAW (March 2008) at p.128.

⁴UNCITRAL (United Nations Commission on International Trade Law) Convention on Independent Guarantees and Standby Letters of Credit, A / Resolution 50/48 (26 January 1996).

compared to the international standards set forth by UNCITRAL Convention and adherence to these standards by laws of advanced jurisdictions like UK and USA. After brief description of standby letter of credit and independent guarantee, we shall introduce the UNCITRAL Convention following the detailed point-to-point comparisons. In our conclusion we shall endeavour to justify the need for Pakistan to accede to the convention.

I.

STANDBY LETTER OF CREDIT OR INDEPENDENT GUARANTEE

A. *Concept and Meaning*

Standby letter of credit is a specialised letter of credit used as a tool to guarantee an obligation, either monetary or non-monetary, whereby the issuer (usually a bank or financial institution) agrees to pay the beneficiary, if the customer defaults in its obligation. It is also termed as guarantee letter of credit, performance guarantee or independent guarantee in accordance with different purposes for its use in different parts of the world. Independent guarantees, sometimes called on-demand guarantees, are called “independent” for the presumption of independence from the underlying contract attached to them.⁵ Basic purpose behind an independent guarantee is “to allow the person in whose favour the instrument has been made out (the beneficiary) to have immediate access to funds necessary to remedy an alleged default under the underlying contract by the party at whose request the instrument was issued (the ‘account party’).⁶ The generally accepted distinction between surety guarantee and independent guarantee is that the former is exclusively based upon and linked to the underlying contract whereas the latter is not. In the

⁵ See Richard Bethal-Jones, *Guarantees and Indemnities: Some Important Differences*, JOURNAL OF BANKING LAW AND REGULATION (2006).

⁶ Jacqueline Lipton, *Uniform Regulation of Standby Letter of Credit and other First Demand Security Instruments in International Transactions*, JOURNAL OF BANKING LAW (1993) at p. 402.

case of independent guarantee, the beneficiary alleges default on basis of the documentary evidence only and guarantor has to make payment without further investigation or instruction from the client.⁷ Standby letter of credit serves a different function than commercial letter of credit. A commercial letter of credit is primary payment mechanism for a transaction whereas standby letter of credit, just like a guarantee, serves as a secondary payment mechanism. A bank will issue a standby letter of credit on behalf of a customer to provide assurance of his ability to perform under the terms of a contract between the beneficiary and the customer. Parties involved in the transaction do not expect that the standby letter of credit will ever be called upon. Standby letter of credit is the expression used in US to refer independent guarantees and now has a worldwide use. The convention adopted the expression “undertaking” to cover both independent guarantees and standby letters of credit.

B. Relevant International Instruments

United Nations Commission on International Trade Law (“UNCITRAL”) was established in 1966 responding to the needs to eradicate legal obstacles to international trade flow with the object to harmonise and unify the laws of international trade. UNCITRAL has made valuable contributions in the field of International Trade Law. Convention on Independent Guarantees and Standby Letters of Credit (the Convention) was intended to harmonise the diversified area of independent guarantees and standby letters of credit.

⁷ For comparison see Kieran Donnelly, *Nothing for Nothing: a Nullity Exception in Letter of Credit?* JOURNAL OF BUSINESS LAW (2008) at p. 316; Ebenezer Adodo, *Non-documentary Requirements in Letter of Credit Transactions: What is the Bank’s Obligation Today?* JOURNAL OF BUSINESS LAW (2008) at p.103; Martin Hughes, *Standby Letters of Credit and Demand Guarantees*, JOURNAL OF INTERNATIONAL BANKING AND FINANCIAL LAW (2005) at p. 174; Sophia Hughes, *Standby Letter of Credit in Practice*, JOURNAL OF INTERNATIONAL BANKING AND FINANCIAL LAW, (1 March 2008).

Uniform Customs and Practice (UCP)⁸ is the international regime articulating the practice of international documentary credits. While UCP provides general rules and principles for Commercial letters of credit, it does not specifically deal with the Standbys.⁹ The success of UCP made the way to adopt Uniform Rules on Contract Guarantees (URCG) by ICC in 1978. Uniform Rules on Demand Guarantees (URDG) is considered as an unsuccessful effort to regulate on-demand guarantees within URCG.¹⁰

The basic structure of URDG and the convention are almost same but the convention makes a difference by providing standard rules on unfair and fraudulent calls, the area not effectively covered by URDG.¹¹ Another development in the area is International Standby Practices (ISP98) by ICC. In our discussions, we shall examine the variant approaches adapted by ISP98 for some of the areas as compared to the convention.

C. Applicable Law in Pakistan

There is no special law applicable on independent guarantee or standby letters of credit in Pakistan. The general law of contract relating to guarantee as contained in Section 126 in Chapter VIII of Contract Act, 1872 has been referred by the courts while deciding issues relating to all types of guarantees. Section 126 reads as follows:

“A contract of guarantee is a contract to perform the promise, or discharge the liability of a third person in case of his default. The person who gives the guarantee is called the “surety”; the person in respect of whose default the guarantee is given is called the

⁸ International Chamber of Commerce (ICC), Publication No. 500 and 600 (1 July 2007).

⁹ However, the parties may provide, by specific incorporation that UCP is governing law in any standby letter of credit.

¹⁰ Goode, *The New ICC Rules for Demand Guarantees*, [1992] LMCLQ 190.

¹¹ Lars Gorton, *Draft UNCITRAL: Convention on Independent Guarantees*, [1997] JOURNAL OF BANKING LAW 240.

“principal debtor”; and the person to whom the guarantee is given is called the “creditor”. A guarantee may be oral or in writing.”

The general notion of Pakistani courts while dealing with commercial laws is discussed in *Doha Bank Limited v. Pangrio Sugar Mills Limited*¹² in the following terms:

“Indeed, all secured financial dealings and business transactions such as execution of a bank guarantee etc. are based on commercial morality and mutual trust and confidence which should not be shaken by taking a turn much against the terms of the guarantee itself. The bank guarantee is a tripartite contract of guarantee between the bank, the beneficiary and the person at who’s instance the bank issues such guarantee; the banker is not supposed to question the nature of accounts and liabilities between two parties.....in order to restrain the operation of, inter alia, a bank guarantee there should be a serious dispute and there should be a good prima facie case of fraud and special equities in the form of preventing the irretrievable injustice otherwise the very purpose of Bank Guarantee would be negative and the fabric of trading operations would get jeopardized.”

The courts have applied the subjective test in interpretation of guarantees and emphasise on the terms and conditions incorporated by parties therein to determine the true nature of guarantee. In this regard, guarantees have been classified as either “absolute” or “conditional” where the latter depends upon performance of a condition founded in the underlying contract by either party within the terms of guarantee.¹³ It clarifies that the general distinction between an “independent” and “dependent” guarantee is recognised by Courts in Pakistan.

¹² 2003, Corporate Law Decisions (CLD), 661 atpara 23.

¹³ United Bank Limited vs. Pakistan Industrial Credit and Investment Corporation Limited, PLD 2002 Supreme Court 1100.

II.

ANALYSIS OF THE UNICTRAL CONVENTION

A. Consensual Nature of the Convention

The convention is also based on principles of party autonomy. Art. 13 clearly provide that the rights and obligations under the convention “are to be determined by the terms and conditions set forth in the undertaking...” Full freedom is provided for parties to exclude even complete application of the convention.¹⁴ The convention is described as ancillary rather than mandatory and wide range options are available to contract the provisions of the convention out in undertakings.¹⁵ An undertaking that does not meet the terms of the convention is not necessarily invalid but is not governed by the convention. This is a distinguishing feature of the convention as compared to domestic laws that are rarely available as an option.

B. Application of the Convention

The primary focus of the convention is to govern the relationship of the guarantor/issuer and the beneficiary. The relationship between the guarantor/issuer and its customer and the relationship between the guarantor/issuer and the instructing party, is not covered by the convention.¹⁶ The convention seems to cover the situations arising before the payment is made under such undertakings and not to the situations arising thereafter.¹⁷

¹⁴ Art. 1.

¹⁵ The *Explanatory Note* by the UNCITRAL Secretariat on the convention (Explanatory Note) at para 11.

¹⁶ Explanatory Note, at para 6.

¹⁷ E.g., there is no alternative of UCC Article 5-117 relating to subrogation in the convention.

C. Definitional Approach

Art. 6 of the convention provide definitions of relevant terms. A neutral term “undertaking” is used to refer to both independent guarantees and standby letters of credit.¹⁸ The definition of independence in Art. 3 and other definitions under Art. 6 bring uniformity and harmonisation in international trade practices. Art.2 (a) defines an undertaking as:

“For the purposes of this Convention, an undertaking is an independent commitment, known in international practice as an independent guarantee or as a stand-by letter of credit, given by a bank or other institution or person (“guarantor/issuer”) to pay to the beneficiary a certain or determinable amount upon simple demand or upon demand accompanied by other documents, in conformity with the terms and any documentary conditions of the undertaking, indicating, or from which it is to be inferred, that payment is due because of a *default in the performance of an obligation, or because of another contingency, or for money borrowed or advanced, or on account of any mature indebtedness.*” [Emphasis added]

The emphasis highlights the situations under which demand for payment can be made under an undertaking covered by the convention.

D. Principle of Independence

Art. 3 defines the principle of independence by providing that the undertaking does not depend upon the underlying transaction, or upon any other undertaking. The later reference to other undertaking clarifies the independent nature of a counter guarantee from the guarantee that it relates to and of a confirmation from the standby letter of credit and independent guarantee that it confirms.¹⁹ Art. 2(1) also provides that an undertaking under the convention is an independent commitment. The independent nature of the commitment

¹⁸ Art. 2(1).

¹⁹Explanatory Note, at para 17.

is strengthened by requiring the issuer of such undertaking to pay the beneficiary on simple demand or upon demand accompanied by other documents.²⁰ For payment, only “facial” conformity of the demand and accompanying documents with the terms and condition of the undertaking is required by the convention and the issuer/guarantor is not required to look into the performance or validity of the underlying contract while payment is made to the beneficiary in pursuant to an undertaking.²¹ This is in accordance with the notion that the role of the issuer/guarantor is one of paymaster rather than investigator.²²

1. In USA

In US, Article 5 of the Uniform Commercial Code (UCC), the law applicable to letters of credit, also governs standbys.²³ Section 5-109 of revised article 5²⁴ reads:

An issuer’s obligation to its customers...does not include liability or responsibility;

(a) for performance of the underlying contract for sale or other transaction between the customer and the beneficiary...

This is clearly in line with the principle of independence provided by the convention.

2. In English law

English law maintains the principle of independence. English courts had viewed the independence principle in the context of fraud. A series of cases suggest that the issuing bank cannot refuse payment on documentary letter of credit merely on the basis that by the time of

²⁰ Art. 2(1).

²¹ Art. 16(1).

²² Explanatory Note, at para 18.

²³ American Bar Association, Section of Business Law, Summary of Recommendations, Report to the House of Delegates, (1998 Annual Meeting Toronto. Canada.)

²⁴ The model statute was revised in 1995. All provisions quoted in this essay are from revised article 5.

payment one or more of the documents presented under the credit was not what it appeared to be on its face, but was a nullity. In *Montrod Ltd. v Grundkotler Flaschvertriebs-gmbtt and Others*,²⁵ Potter LJ said the autonomy (independence) principle under English law had hitherto restricted to and should remain based on the fraud or knowledge of fraud on the part of the beneficiary or other party seeking payment under or in accordance with the terms of the credit. It should not be avoided or extended by the argument that a document presented, which conforms on its face with the terms of the letter of credit, was nonetheless of a character which disentitled a person making the demand to payment because it was fraudulent in itself, independently of the knowledge and *bonafides* of the demanding party. That is the clear import of the Lord Diplock's observation in *Gian Singh & Co. Ltd v Banque de I Indochine*²⁶ and *United City Merchants Bank (Investment) Ltd. v Royal Bank of Canada*.²⁷

3. In Pakistan

It is also an established law in Pakistan that the performance of guarantee stands on similar footing to an irrevocable letter of credit. The guarantor must honour the guarantee when the terms provide absolute liability. The bank guarantee is treated as an autonomous contract imposing an absolute obligation on the bank for payment.²⁸ In such cases of absolute guarantee, the bank must pay on demand irrespective conditions imposed in the underlying contract. The only exception to the principle is when there is a clear fraud in which bank has a clear notice. In *Shipyard K. Damen International v. Karachi Shipyard and Engineering Works Limited*,²⁹ Supreme Court of Pakistan unequivocally confirmed the consensus of courts by providing:

²⁵ Queen's Bench Division (Commercial Court) (Transcript) 28 Nov. 2000.

²⁶ [1947] 1 WLR at 1234, 1238.

²⁷ [1983] 1 AC 168.

²⁸ *National Construction Limited v. Aiwane Iqbal Authority*, PLD 1994 SC 311.

²⁹ PLD 2003 SC 191; See also *Doha Bank Case*, 2003 CLD 14 at p. 66, para 22.

“[the bank] is not concerned in the least with the relations between the supplier has performed his contractual obligation or not nor with the question whether the supplier is in default or not. The bank must pay according to its guarantee all demands if so stipulated without proof or condition. The only exception is when there is a clear fraud of which bank has notice.”

This trend is clearly in accord with the Convention, and the laws in USA and UK.

E. Non-Documentary Payment Conditions

An undertaking under the convention must possess a “documentary” character. The convention suggest that the duty of the issuer on demand for payment is limited to examining the demand and any supporting documents to ascertain only the “facial” conformity of the demand and other documents with what is called for under the terms of an undertaking.³⁰ The only documentary condition allowed by the convention is that which relate to acts or events within the sphere of operations of the issuer/guarantor. For instance, a determination by the issuer/guarantor as to whether a required monetary deposit had been made in a designated account maintained with the guarantor/issuer.³¹ This principle is in line with Art. 4 of UCP. Art. 13(c) of UCP allows the banks to disregard the conditions in a credit that do not state any documents to be presented in compliance therewith. This seems to be a step ahead of the convention and a better approach to support the documentary nature of conditions and should also be available in standbys.

1. In USA

UCC Art. 5-108(g) requires a bank to disregard non-documentary conditions in a letter of credit and enforce only documentary conditions. In case of a non-documentary condition being the only payment condition in a standby, the bank may treat this instrument

³⁰ Art. 16(1)

³¹ Point 19 of the Explanatory Note

not as a letter of credit but as a suretyship obligation but the banks in US normally cannot validly issue a suretyship obligation.³²

2. In English law

In English law a performance bond is presumed to be conditional on the presentation of documents rather than a state of facts. In *IE Contractors Ltd. v Lloyds Bank Plc.*³³ the court of appeal held that the liability of the issuer of the counter guarantee was conditional on whether the issuer of guarantee was legally obliged to pay on the guarantee. Obviously, issuers of undertakings usually would not want to be making such factual or legal evaluations.

In *J.H.Raynor & Co. Ltd. v. Hambro's Bank Ltd.*³⁴ the court held that the issuing bank need not have any specific knowledge in the field of the underlying contract. The bank, however, must have the extensive knowledge of the documents involved and payment must be made if the documents conform.³⁵

3. In Pakistan

The position of non-documentary conditions in an Independent Guarantee in Pakistan appears to be in divergence with the Convention. The decided cases provide the objectivity as the litmus test for a guarantee and tend to honour the terms of the contract as agreed by the parties. The nullity principle regarding the non documentary conditions provided by the English courts is not followed by apex courts in Pakistan. In the case of *Attock Industrial Products v. Heavy Mechanical Complex (Pvt.) Limited*,³⁶ the court suggests that the terms of a guarantee permitting the bank to withhold payment or stop encashment on the ground of dispute arising out of

³² THE CALIFORNIA INTERNATIONAL PRACTITIONER, Vol. 10:2 (2000).

³³ [1990] 2 Lloyds Rep. 496 (Court of Appeal).

³⁴ [1943] 1 KB 37.

³⁵ Jonathan R.C. Arkins, *Snow White v. Frost White: The New Cold War in Banking Law*, JOURNAL OF INTERNATIONAL BANKING LAW (2000) at 32.

³⁶ 1999 MLD 1876 (Lahore).

non performance of the underlying contract or any provision therein by the creditor/beneficiary may restrain the bank from payment or encashment of the guarantee. The same subjective approach was adopted by the Rawalpindi Bench of the Lahore High Court in *Saudi Pak Industries v. ALBP*,³⁷ where the guarantee expressly provided for the payment to the beneficiary on mere demand thus expressly provided non documentary condition, the bank is obliged to pay on such demand without recourse to the underlying contract.

This approach provides freedom to the contracting parties to subject the intended guarantee to the non documentary conditions and the bank is not allowed in Pakistan to disregard such condition by its own. In *Shipyards K. Damen International v. Karachi Shipyards and Engineering Works Limited*,³⁸ the Supreme Court of Pakistan provided different types of expressions used in guarantees in the following:

“the guarantee as defined and discussed here-above would indicate that it contains the ingredients of “dedicated commitment”, “absolute undertaking”, “an unambiguous assurance”, “unconditional willingness”, “definite certainty”, “compliance without objections”, “sacred obligation”, and “defined responsibility”. In view of the ingredients as mentioned hereinabove which constitute a guarantee on the basis whereof its bidding effect can be well-adjudicated,....”

Again on page 24 the court provides:

“if bank guarantees are unconditional, there is no other option for bank and more so, the bank would have no defense, when its guarantee is sought to be enforced. The guarantee as provided could be scanned to ascertain, whether conditional, unconditional or an autonomous contract by itself or otherwise? If it is found unconditional, except in the cases where fraud has been alleged and noticed by bank, the commitment is to be honored.”

³⁷ PLJ 2002 Lahore 1938 at p. 1941.

³⁸ 2003 CLD 1 at p. 21.

It is only such terms of the guarantee which shall decide the conditions whether documentary or not, on the proof and basis of which a guarantee might be called.

F. Standard of the Examination of Documents

A large number of disputes in the area of letter of credit are caused by the difference over whether the documents conform. The undertaking to pay embodied in a standby L/C is conditional upon the "facial" compliance with its terms and conditions.³⁹ The guarantor/issuer is required to act in good faith and exercise reasonable care having due regard to the generally accepted standard of international practice of independent guarantees and standby letters of credit.⁴⁰ The same standard of reasonable care and international standard banking practices are provided by UCP.

1. In English law

English courts are divided while dealing with standard of documentary conformity. One line of cases hold the strict compliance rule⁴¹ and the others bent towards the substantial compliance.⁴² The arguments in favour of the substantial compliance are equity, fairness, commercial equity and protection of beneficiary from unscrupulous applicant, and arguments against it are that it includes uncertainty, put applicant at risk and the nature of applicant-issuing party relationship. Majority of the cases favour strict compliance.⁴³

³⁹ Art. 16(1). The same facial conformity is required under Art. 13(a) of UCP.

⁴⁰ Art.14(1).

⁴¹ *Equitable Trust v. Dawson Partners* (1927) 27 111 Rep. 49.

⁴² *Banco Espanol de Credito v. State Bank* (1967); *Flagship Cruises v. New England Merchants Bank* (1978); See also *Solo Industries v. Canada Bank* (2001) 2 Lloyds Rep.

⁴³ See generally, *Midland Bank v. Seymour* (1995) 2 Lloyds Rep. 147 at 151.

2. In USA

In USA, the traditional problem of strict v. substantial approach is tried to be cured on the lines of the convention by providing that the standard of compliance shall be determined in accordance with international standard banking practices as reflected in the practice of institutions who regularly issue and act upon the letter of credit in order to determine compliance.⁴⁴ Typically, US courts follow the strict compliance rule.⁴⁵

3. In Pakistan

In *Saudi Pak Industries v. ALBP*⁴⁶ the terms of guarantee provided that the demand shall be made by the General Manager/Chief Executive of the creditor. Hence, where the demand was in-fact made by the Chief Finance Division/secretary of the creditor company who was authorised to do by a resolution of the creditor company, the court observed:

“Approach and attitude to avoid the liability and obligation by making a fetish of the technicality is not reflective of a healthy approach. As we find that the [*beneficiary/creditor*] has filed the claim within the validity period of bank guarantee, therefore [*the bank*] was legally bound to honour its commitment and obligation arising under the guarantee and was liable to make the payment.”

Again in *Shipyards K. Damen International v. Karachi Shipyards and Engineering Works Limited*,⁴⁷ the Supreme Court held:

“The rule is well established that the bank issuing a guarantee is not concerned with the underlying contract between the parties. Duty of the bank under a performance guarantee is created by the document itself. Once the documents are in order, the bank giving the guarantee must honor by making payment.”

⁴⁴ UCC Art. 5-108(a) and (e).

⁴⁵ See generally, *Tosco v. FDIC*, 723 f2d 1242(6th circulation 1983).

⁴⁶ PLJ 2002 Lahore 1938 at p. 1941.

⁴⁷ PLD 2003 SC 191 at p. 205.

And, at page 209 the Supreme Court held:

“The guarantor cannot resort to the technicalities to defeat the claim of the creditor. Even though the contract becomes unenforceable against the principal debtor, guarantor would still be liable....”

The stance of Supreme Court on the conformity of the demand with the terms of the guarantee seems to provide the “substantial compliance” rather than the strict compliance.

G. Improper or Fraudulent Calls for Payment

One of the major achievements of the convention is the successful effort to deal with the problem of fraudulent and abusive demands for payment under independent guarantees and standby letters of credit. This was an area of great uncertainty in practice since these demands are linked to the non-performance of underlying contract. The convention articulated the solution by providing:

- a. an internationally agreed general definition of the type of situation in which an exception to facially compliant demand would be justified;⁴⁸
- b. a binding set of rules for the provisional court measures to block the payment on applicant/principal’s application when the demand for payment falls under one or more of the situations provided by Art 19.

The convention provides an exhaustive list of the situations that can lead to the blocking of payment obligation i.e. the situation under which it is clearly established that the document is not genuine or has been falsified; that no payment is due on the basis asserted in demand or that the demand has no conceivable basis.⁴⁹ The convention also provides illustrative examples of cases in which a demand would be

⁴⁸ Art. 19(1).

⁴⁹ Art. 19.

deemed to have no conceivable basis.⁵⁰ The convention imposes no duty but gives a right to the issuer/guarantor as against the beneficiary to refuse payment under any of the situations in Article 19(1) and therefore creates a sort of balance in the clashing interests. The only duties of the issuer/guarantor is to act in good faith and exercise reasonable care having due regard to generally accepted standards of international practice of independent guarantees and standby letters of credit.⁵¹ The convention establishes a standard of proof to be met in order to obtain a provisional measure.⁵² An immediately available evidence of high probability is required for the presence of fraudulent or abusive circumstances. The harm likely to be caused in the absence of a provisional relief to the principle/applicant has also a bearing on provisional court measures. In this way, the duties of investigation into factual situations are rightly shifted to courts being proper forums for this responsibility.

The convention also authorises the blocking of payment in case of use of undertaking for a criminal purpose.⁵³

1. In English Law

Blocking of payment by provisional court measures is broadly consistent with English law. English courts permit the blocking of payment under a letter of credit or other independent undertaking if the demand for payment involves the personal fraud of the beneficiary.⁵⁴ The fraud exception to the independence principle of letters of credits is strictly granted and a high standard of proof is required.

Once payment is made under an undertaking, the blocking of proceeds in the hands of the beneficiary by the English courts seems

⁵⁰ Art. 19(2).

⁵¹ Art. 14(2).

⁵² Art. 20(1).

⁵³ Art. 20(3).

⁵⁴ *United City Merchants v. Royal Bank of Canada*, [1983] 1 AC 168.

relatively less strict.⁵⁵ The argument in favour of liberal approach is that the policy consideration to protect the international payment mechanism ends when payment is made under such mechanism. The proceeds in the hands of the beneficiary are dealt with as the cash proceeds like any other cash assets of the beneficiary.

Under English law, unlike the convention, third party is also entitled to bring an action to block the payment.⁵⁶

The convention as compared to English law does not seem to make it any easier to blocking of payment in procedural terms. However, the convention does give broader grounds on which such relief can be granted. The concept of improper demand provided by the convention is also broader than the limited fraud exception under English law.⁵⁷

2. In USA

The fraud exception to the independence principle was first enunciated in New York in 1941.⁵⁸ The court granted an injunction preventing the bank that had issued a letter of credit at issue from honouring a draft presented by the beneficiary. The court stated “[w]here seller’s fraud has been called to the bank’s attention before the draft and documents had been presented for payment, the principle of independence of bank obligation under the letter of credit should not be extended to protect the unscrupulous seller.” The court further added that “[a]lthough the bank is not interested in the exact detailed performance of the sale contract, it is vitally interested in assuring itself that there are some goods represented by the documents.”

⁵⁵ *The Bhoja Traders*, [1981] 2 Lloyds Rep. 256.

⁵⁶ *Themehelp Ltd. v West*, [1996] QB 84.

⁵⁷ Mark Sneddon, *The Draft Convention on Independent Guarantees and Stand-by Letters of Credit*, AUSTRALIAN BUSINESS LAW REVIEW (1995).

⁵⁸ *Szrejn v. Hennery Schroder Banking Corporation*, 31 NYS2C 631 (Supp. 1941).

Art. 5-114(2) of UCC codify the fraud exception. The Kansas Supreme Court in *Prairie State Bank v Universal Bonding Insurance Company*,⁵⁹ after recognising that the letter of credit at issue is a standby letter of credit, provide that the banks are allowed to dishonour fraudulent calls for payment under such letters of credit as provided by Art.5 UCC.

UCC Art. 5-114(2) give the issuer of a letter of credit an option of refusing to honour in certain cases involving fraud. The section is an exception to the rigid rule provided by the preceding section [Art.5-114 (1)], that an issuer must honour a letter of credit when it is presented with facially conforming documents. The blocking of payment in a way similar to the convention is granted in many US court decisions.

3. In Pakistan

Fraud exception is undoubtedly recognised in Pakistan. There are plenty of cases in which this exception has been reiterated and applied. The general principle established by these cases is that the courts cannot grant temporary injunction to enjoin the payment under guarantee unless there is a prima facie case of fraud. Usually the prima facie fraud is the only exception to the absolute obligation on the bank at any time without demur, reservation, recourse, contest, or protest or without any reference to the principal debtor.

H. Irrevocable Nature of the Undertaking

Another important achievement of the convention is that it addresses the uncertain area in the field of standby letters of credit and independent guarantees regarding the time and place of issuance of undertaking and the time when it becomes operative. The convention provides that the issuance occurs when and where the undertaking leaves the sphere of the control of the guarantor/issuer,

⁵⁹ 24 KAN. App. 2d 740

e.g. when it is sent to the beneficiary.⁶⁰ Unless expressly stipulated in an undertaking being revocable, it is irrevocable.⁶¹ Similar approach has been adopted in Art. 6 of UCP.

1. In USA

Art.5-106 UCC provides same rules as does the convention.

2. In English Law

English law do not interfere the autonomy of the parties to enter the terms of their own choice. A letter of credit is treated as irrevocable unless expressly provided by the agreement.⁶²

3. In Pakistan

While interpreting the contract of guarantee, the courts in Pakistan look into the terms of the guarantee agreed upon by the parties. After perusal of the decided cases, it appears that the guarantee does not automatically become irrevocable if the parties have not specifically incorporated this in the terms of guarantee. This seems to be a divergence from international practices and the practices of the developed jurisdictions.

I. Transfer and Assignment of Proceeds

The convention recognises the general Common law distinction between assignment and transfer of the beneficiary's right to the proceeds of an undertaking. In case of an assignment as compared to a transfer, the right to demand payment remains with the original beneficiary.

For transfer, the convention provides for two requirements:

⁶⁰ Art. 7(1).

⁶¹ Art. 7(4).

⁶² *Hamzeh Malas v. British Imex Industries*, [158] 2QB 127.

- a. the undertaking must be expressly designated as being transferable;
- b. the consent of the issuer/guarantor of the undertaking for such transfer is also required.⁶³

These are in line with UCP Art. 48 and UCC Art. 5-112 and 114 of USA.

1. In Pakistan

Section 139 of the Contract Act 1872 seems to deal with this issue. The section provides restrictions on the beneficiary to refrain from doing anything which will eventually result in impairment of the guarantor's rights against the principal debtor. In other words, the beneficiary is allowed to transfer or assign the rights in the guarantee:

- a. If the debt itself do not extinguish by such act;
- b. If the remedy of the guarantor against the principal debtor is not impaired or reduced.

Though the law does not restrict the creditor to transfer or assign his rights under the guarantee, the express dictum in the guarantee itself would be appropriate to empower the creditor to this effect.

III.

CRITICISM ON THE CONVENTION

The convention generally attracted a favourable treatment. Seven countries have ratified the convention until now including US.⁶⁴ There is almost no criticism at all on the general principles carried on by the convention. US commentators have criticised the use of the term "the observance of good faith" in Art. 5 of the Convention. There is a theoretical controversy of the term i.e., whether the

⁶³ Art. 9.

⁶⁴ UNCITRAL, Status of Conventions and Model Laws,

question is subjective or objective and the practical difficulties regarding the scope of the issue to be set before a jury. The UCC Art.5-102 (a)(7) provides a narrow alternative of the term “good faith” by providing the notion of “honesty in fact in the conduct or transaction concerned”. Similar objections have been raised in connection with the term “reasonable care”.

Certification by the beneficiary on demand provided by Art. 15(3) that the demand is not in bad faith is criticised by US on the grounds that it would be interpreted as a warrantee dependent on the underlying contract. This may lead to duplication of remedies in conjunction with the provisional remedies provided by the convention. UCC Art. 5-110(a)(1) allows such alternative remedies. New Zealand Law Commission⁶⁵ has recommended that New Zealand should not accede to the convention on the following grounds:⁶⁶

1. There is no universal ratification of the convention and US is the only major New Zealand’s trading partner who has signed the text.
2. Parties under the convention are free to subject their undertaking to the convention provisions simply by express incorporation into the text of guarantee or letter of credit. This is the practice of other guidelines such as UCP that have to be expressly incorporated and have indeed been applied by the courts in New Zealand without any recognition in the domestic law.⁶⁷
3. The convention generally codifies the basic general principles recognised internationally as applicable to guarantees and letters of credits, New Zealand parties need not formally adopt the convention to benefit from its provisions.

⁶⁵ New Zealand Law Commission, Special Report No. 5.

⁶⁶ Id at p. 12.

⁶⁷ Same is the case in England.

A. New Areas Covered by ISP98

ISP98 generally reiterates rules provided by the convention but it touches some of the areas not covered by the convention. For instance, it creates an obligation on the part of the applicant to reimburse the issuer and to indemnify against certain costs of the issuer.⁶⁸ It allows the issuer to waive some of the provisions of an undertaking unilaterally without any effect to its right of reimbursement.⁶⁹ Moreover, ISP98 also establishes three different levels of documentary compliance and provides different rules for each level.⁷⁰

B. Lessons Learnt

The use of guarantees in the domestic laws is of no doubt not less important. Especially the use of such contracts to attract foreign investment and to afford protections on part of developing states as in case of *Saba* and many others has made the application of guarantee law more significant and its application more diverse.

The Convention provides internationally formulated rules and principles preferable in many situations and reflective of sound banking practices. It is no doubt of great help and importance for emerging economies that do not have a developed body of law in standbys and independent guarantees.

In our comparisons, we have realised that the convention mostly gives principles similar to those provided by advanced jurisdictions whereas there are certain differences in the law and practices followed in Pakistan especially relating to the non documentary payment conditions and the unincorporated irrevocability of independent guarantee.

⁶⁸ ISP Rule 8.01.

⁶⁹ ISP Rule 3.11.

⁷⁰ ISP Rule 4.09.

Due to the absence of specific legislations in the field of independent guarantees the courts apply the general law of guarantee provided by Section 126 of the Contract Act 1872. This general law do not appreciate the distinction between the independent and dependent guarantee and the courts apply the subjective test of interpretation on guarantees which may not correspond to the internationally recognised principles.

IV.

CONCLUSION

Pakistani law generally adheres to the principles envisaged by the convention and US and UK laws. As compared to the situation of New Zealand, there are certain areas which are not in line with the international practices and standards. It is also observed that there is also less degree of certainty in the independent status of the guarantee since the objective test of the terms of guarantee may result in what is known as re-characterisation of the guarantee converting it into a guarantee which is dependent upon the underlying contract. There is also a divergence regarding the built in irrevocability and the non documentary payment conditions.

Acceding to the convention is one readily available option to overcome these differences because the convention easily fits into the general scheme of law of contract in Pakistan. Another option would be the amendments in the Contract Act 1872 by introducing new and additional provisions regarding Independent Guarantees.