Trade Finance 101

Demand guarantees in international trade.

A brief introduction to the instrument.

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1. Definition and purposes of a demand guarantee.

A "demand guarantee" is generally a short and simple instrument issued by a bank, or any other financial institution, under which the obligation to pay a maximum amount of money arises merely upon the making of a demand for payment in the prescribed form and sometimes also the presentation of documents as stipulated in the guarantee within its period of validity. Many demand guarantees are payable on first demand without any additional documents, although increasingly guarantees require at least a statement indicating that the principal is in breach. A demand guarantee must therefore be honoured on presentation of a written demand that complies with its provisions.

In a broader way, a demand guarantee can be defined as an undertaking given for payment of a maximum amount of money on presentation to the party giving the undertaking of a demand for payment, nearly always required to be in writing, and such other documents as may be specified in the guarantee within the period and in conformity with the other conditions of the guarantee.

In reality, most demand guarantees are payable on "first written demand" or "simple demand" without any additional documents. In its truly simplest form, a demand guarantee authorises the Beneficiary to claim for payment in any form, including oral, and at any time within the period of effectiveness of the guarantee without justifying the legitimacy of the demand. A demand guarantee may also stipulate that the Beneficiary must support his written demand by a statement of breach.

This instrument can be described as a "personal security" (undertaking) in terms of which a bank promises payment to a Beneficiary if a Principal defaults in the performance of his obligation in terms of the underlying contract. The bank has to pay if the documents presented with the demand for payment comply with the documents mentioned in the wording of the guarantee. As a result,: the bank's obligations are autonomous from the underlying contract between the Beneficiary and the Principal: in principle, the bank must pay if proper complying documents are presented, although the Beneficiary and the Principal have not stipulated that there is a default under the original underlying contract. In this regard, demand guarantees differ from surety guarantees, in which the security lender, i.e., surety, is only involved if the Principal party defaults in the performance of an obligation.

The above definitions of a demand guarantee also embrace instruments known as "performance bonds or guarantees", which are mere forms of demand guarantees. In practice, performance guarantees tend to be used where the underlying obligation is not the payment of money, but the performance of other obligations such as those arising under a construction or engineering contract.

The performance guarantee stands on a similar footing to a letter of credit for bank must honour it according to its terms and is not concerned in the least with the relations between the supplier and the customer; nor with the question whether the supplier has performed his contracted obligation or not; nor with the question whether the supplier is in default or not. The bank must pay according to its guarantee, on demand, if so stipulated, without proof or conditions. The only exception is when there is clear fraud of which the bank has notice.

Buyers of goods or services, whether in their own domestic or international sector, often insist on demand guarantees, for their provisions give them security for the due performance of the Seller's obligation in terms of the underlying commercial contract. In order to be effective, a bank will give its personal undertaking to pay in certain circumstances; for example, when a demand for payment is made by the Buyer. If the demand is made in accordance with the strict terms of the guarantee, then the bank is obliged to make payment and to look to the principal for an indemnity.

The purpose of the demand guarantee is to allow the Beneficiary to have immediate access to funds necessary to remedy an alleged default under the underlying contract by the Principal, the idea behind this structure being "pay now and argue later", thus preventing the performance of the project in question from being held up due to lack of funds while the parties in question litigate or arbitrate over the merits of a particular call by the beneficiary under the demand guarantee. This consideration is particularly significant in international transactions where conflicts of law issues may well cause litigation or arbitration to be even more expensive and time-consuming than they would be in a purely domestic transaction. In this respect, demand guarantees are different from the traditional guarantees under the terms of which payment to the Beneficiary is usually conditional on "proof of a default" by the principal.

Demand guarantees are typically used in construction contracts, engineering contracts and contracts for the international sale of goods. However, they could also be used for any other type of contract. Whereas commercial letters of credit are used to ensure that the seller, exporter or supplier is paid, demand guarantees are intended to safeguard the other party (e.g., buyer) against non-performance or late or defective performance by the seller, exporter or supplier to the underlying contract.

2. The structure of a demand guarantee.

Generally, there is a minimum of three parties involved in the provision of a demand guarantee, though sometimes a fourth party may also be involved:

Principal: typically, the party to the underlying contract; for example, a Seller, Exporter, Supplier or Contractor whose performance is required to be covered by the demand guarantee and who gives instructions for its issue. He is also commonly referred to as the "account party".

Guarantor: usually a bank, is the party issuing the demand guarantee on behalf of the principal, normally its customer.

Beneficiary: the other party to the underlying contract; for example, the Buyer, Importer or employer in whose favour the demand guarantee is issued.

Instructing Party: where the Beneficiary requires the demand guarantee to be issued by a bank in his own country and the Principal does not bank with such a bank, the Principal requests his bank to arrange for the issuance of the guarantee by a local bank. Instructions are then given by the Principal's bank, the "instructing party" to a bank in the Beneficiary's country to issue the guarantee against a counter-guarantee, or counter-indemnity, by the instructing party who, in turn, is entitled to an indemnity from its customer, i.e. the Principal. In such a situation, the Beneficiary's bank issues the demand guarantee.

As we have already stated above, a demand guarantee involves a minimum of three parties: (1) the Principal, (2) the Guarantor, and (3) the Beneficiary.
Normally, the Guarantor in the three-party structure is the Principal's bank and runs business in the same country as the Principal, while the Beneficiary runs his own one in a foreign country. Such three-party demand guarantees are known as "direct guarantees", because they are issued directly by the Principal's bank and not locally in the Beneficiary's country.
A bank may transmit the demand guarantee directly to another bank or it may decide to have the guarantee advised and transmitted to the another bank by a local one, without altering the contractual structure as the demand guarantee will remain a direct, three-party one, because the bank's function is limited to checking that the signatures on the guarantee appear to be valid. If the bank merely advises and transmits the demand guarantee issued by another bank, it will not incur liability under the guarantee itself, unless it is requested, and agrees to confirm it; a practice that is common in the case of commercial or standby letters of credit, but is unusual in the case of demand guarantees.
When the Beneficiary wants the demand guarantee to be issued by a bank in his own country and the Principal does not bank with it, the Principal requests his bank to arrange for the issue of the guarantee by a local bank in the country of the Beneficiary. Instructions are then given by the Principal's bank, i.e. the "instructing party' to a bank in the beneficiary's country to issue the guarantee against a counter-guarantee, or counter-indemnity, by the instructing party who, in turn, is entitled to an indemnity from its customer, i.e. the Principal. In such a situation it is the Beneficiary's bank, i.e. a local bank in the country of the Beneficiary, that issues the demand guarantee and is therefore the Guarantor of the demand guarantee.
Therefore, in indirect, four-party demand guarantees there is an additional contract, that is the contract between the instructing party, the Principal's bank, and the Guarantor, the local bank in the country of the Beneficiary. This contract has two aspects: (1) the mandate from the instructing party to the Guarantor regarding the instruction to issue the demand guarantee, which the Guarantor as mandatory must comply with if he accepts the instruction; and (2) the counter-guarantee, or counter-indemnity, that the Guarantor requires from the instructing party as a pre-condition for issuing the guarantee and that is distinct from the mandate. In indirect transactions the Principal's contract (mandate) is with the instructing party, not with the Guarantor.
It is clear that depending on whether or not it is a direct or indirect demand guarantee there will either be three or four separate contracts: (1) the underlying contract (i.e., construction contract) between the principal and the beneficiary, (2) the counter-indemnity contract (or reimbursement contract) between the principal and his bank (the guarantor in the case of a direct guarantee, or an instructing party in the case of an indirect guarantee), (3) the counter-guarantee contract (in the case of an indirect guarantee) issued by the instructing bank (Principal's bank) to the beneficiary's bank (the guarantor) and (4) the contract established by the demand guarantee issued by either the principal's bank or the Beneficiary's bank, depending on whether or not it is a direct or an indirect guarantee.
Each of the contractual relationships established by a demand guarantee is separate from the others. The Guarantor's undertaking to the Beneficiary arises once he issues the demand guarantee, and his obligation to pay

is conditioned only on presentation of a demand and other specified documents in compliance with the terms and within the duration of the guarantee. The guarantor is not a party to the underlying contract and is not concerned with its performance or non-performance.
The relationship between the Principal and guarantor embodies an internal mandate. The Guarantor must act in conformity with the terms of the Principal's mandate, though the strictness of this obligation might differ from one jurisdiction to another. If he fails to do so, he may forfeit his right to reimbursement, but those terms are of no concern to the Beneficiary, whose right to payment depends solely on his acting in accordance with the terms of the demand guarantee.
The Principal is also not concerned with the contract between the Guarantor and the Beneficiary. Similarly, the latter has no interest in the contract between the Guarantor and the Principal; therefore, if the Principal fails to put the guarantor in funds to cover the guarantee liability, the Beneficiary's rights are not affected.

3. The legal nature, characteristics and fundamental principles of demand guarantees.

A demand guarantee is an abstract payment undertaking which, though intended to protect the Beneficiary from a loss in relation to the underlying contract, is separated from the contract between Principal and Beneficiary, and is in form a "primary undertaking" between Guarantor and Beneficiary that becomes binding solely by way of its issue and the Beneficiary's acceptance. Once the terms and conditions of the Guarantee are met, the Beneficiary is entitled to claim payment and he need not show default in any other way than the one stipulated in the terms of the guarantee.
Guarantees are usually taken to provide a second pocket to pay if the first should be empty and, together with indemnities, which are also described as "securities", are distinct arrangements in terms of which a third party, the surety, agrees to assume liability in case the debtor defaults or causes loss to the creditor. The former arrang ement is a suretyship, while the latter involfves an indemnity. A guarantee is therefore usually issued to cover a credit transaction and, in other words, it is issued as financial security by a third party in favour of the creditor.
Sometimes the word "guarantee", or variants of the word, are used while suretyship is meant.; in other occasions, the word is meant to be used as a verb, whose meaning is then more straightforward. In recent years this practice of using the terms "guarantee" and "suretyship" synonymously and interchangeably has been criticised, since the generic term "guarantee" can comprise two very different devices: the primary guarantee, i.e. demand guarantee, and the secondary, or accessory, guarantee, i.e., suretyship guarantee. As demand guarantees and letters of credit, including standbys, are sometimes regarded as either forms of guarantees, particularly contracts of suretyship, or closely related to them, though with peculiar features, a clear distinction should be done between demand guarantees, commercial letters of credit and suretyship guarantees, i.e. the or traditional guarantee, from one another.
A demand guarantee is unique in character and actually stands between the suretyship guarantee, where the undertaking to pay is secondary both in intent and in form, i.e., accessory to the principal debt, and the commercial letter of credit, where the undertaking to pay is primary both in form and intent, meaning that it is secondary in intent but primary in form, i.e., the Guarantor has a secondary intent to pay, although the payment obligation is primary in form. It is a question of construction whether a particular contract is a true guarantee or a demand guarantee.
The undertaking of the surety is accessory to the main contract, the liability under which he does not disturb, but it is an undertaking that the obligation of the Principal debtor will be discharged, and, if not, that the creditor will be indemnified. The suretyship can be defined as an accessory contract by which a subject, the surety, undertakes to the creditor of another, the Principal debtor, primarily that the Principal debtor, who remains bound, will perform his obligation to the creditor and, secondarily, that if and so far as the Principal debtor fails to do so, the surety will perform it or, failing that, indemnify the creditor.
\The fact that the surety's obligation is an accessory one simply means that in order to constitute a valid suretyship between surety and creditor, there must be a valid principal obligation between the debtor and the creditor. The suretyship is said to be accessory to the transaction that creates the obligation of the Principal debtor; in other words, every suretyship is conditional upon the existence of a principal obligation and, in the absence of a valid principal obligation, the surety is generally not bound and the surety can raise any defence that the Principal debtor can raise.
A "guarantee" is sometimes defined as a promise to be liable for the debt, or failure to perform some other legal obligation, of another subject. The subject to whom the promise is made may be called the "creditor", the subject that makes the promise is the surety or Guarantor, and the other, whose obligation is guaranteed, is the Principal debtor. A suretyship is secondary and accessory to the obligation, the performance of which is guaranteed; it undertakes that the principal debtor will perform his obligation to the creditor and that the guarantor, or surety, will be liable to the creditor if the principal debtor does not perform, which means that if it turns out that the Principal debtor's obligation does not exist, is void, discharged or diminished, the surety's obligation in respect thereof is also. This is contrary to the situation where a primary or direct undertaking has been given to perform the customer's obligation. If this is the nature of the undertaking, then the promise will be enforceable whether or not the Principal debtor's one is enforceable.
When a bank advances money to its customer, it often requires security from a third party by way of a contract of suretyship to secure such amount. Suretyship is the generic term given to contracts in terms of which the surety agrees to answer for some existing or future liability of the Principal to the creditor, and by which the surety's liability "is in addition to", and not "in substitution for", that of the Principal's: a suretyship guarantee is secondary both in intent and in form as the intention of the parties is that the surety will be called upon to pay or, instead, to perform the Principal debtor's obligations under the underlying contract, only if the Principal debtor defaults in performance, and then only to the extent of the Principal debtor's liability and subject to any defences available to the Principal debtor. This intention is reflected in the form of the suretyship guarantee, which is expressed to become payable only upon the Principal debtor's default.

In contrast to this, demand guarantees and letters of credit create another kind of duty that is a primary one which is not materially, that is, substantively conditional on bringing proof of the breach or failure of the primary obligor under the transaction. These instruments are in this regard materially independent, and may become due and payable before any such duty arises under the transaction or even entirely regardless of whether or not any such duty matures now or later on.
Performance guarantees, or bonds, may either be formulated positively, in case the insurer becomes an immediate surety in solidum for, and co-principal debtor jointly and severally with, the contractor or supplier for the due and punctual performance and due discharge by the contractor or supplier of all his obligations under the contract; or negatively, in which case the contract of guarantee comes into existence once actual proof of default by the contractor has been established. When issued, these types of guarantee are known as a "surety" or "contract bond" and the normal principles of suretyship apply, since its essence is the existence of the Principal obligation of the debtor to which that surety becomes accessory. This type of guarantee is issued conditionally and is accessory to the underlying contract. Demand guarantees differ specifically from "contract bonds" or "surety bonds" in that the security lender is only involved if the Principal party actually defaults in the performance of an obligation.
A bank demand guarantee in contrast can be described as a "personal security" under which a bank promises payment in favour of a Beneficiary, if a Principal, the bank's customer, defaults in the performance of his obligation: the bank pays if the documents presented with the demand for payment, where applicable, comply with the documents mentioned in the wording. The obligations of the bank are autonomous from the underlying contract between the Beneficiary and the Principal, which means that, in principle, the bank must pay if proper complying documents are presented, even though the Beneficiary and the Principal have not stipulated that there is a default under the original underlying contract.
Contrary to the suretyship guarantee, the commercial letter of credit is a credit in which the bank's undertaking to pay is primary both in form and intent and the classic case is one covering the price of a shipment of goods under an international sale transaction. The agreed method of payment of the price is not payment by the Buyer, but payment by the bank pursuant to its independent undertaking, as the bank is the first "port of call" for payment, and the Buyer's direct payment obligation under the contract of sale is "suspended" pending presentation of the documents and payment by the bank: only if the documents are properly presented and the bank declines to pay, does the Buyer's own duty of payment revive. If the credit is honoured, that duty is extinguished; while if the bank refuses to pay because of the Seller's failure to tender conforming documents, the Buyer is entitled to withhold payment and, indeed, to treat the contract of sale as repudiated in the absence of a fresh and conforming tender within the period of the credit.
In this scenario, the intention of the parties to the underlying contract of sale is that the bank issuing the commercial letter of credit is to be the first "port of call" for payment and this is the effect of the agreement between them. Whereas in the case of a suretyship guarantee the Beneficiary cannot make a call for payment on the Guarantor without establishing default by the Principal debtor, the opposite is true of the commercial letter of credit where the parties have elected payment by the bank as the primary method of payment. Only if this fails without fault on the part of the Beneficiary, is he, the beneficiary, entitled to resort to the Buyer / Principal under the underlying contract of sale.
The demand guarantee stands between the suretyship guarantee and the commercial letter of credit in the sense that it is **secondary in intent but primary in form.** Performance in terms of the underlying contract is due, in the first instance, from the Principal and the demand guarantee is intended to be resorted to only if the Principal has failed to perform. Although this is the intention of the parties, the demand guarantee is not in form linked to default under the underlying contract, nor is there any question of performance of that contract by the Guarantor. The only purpose of the demand guarantee is to hold the Beneficiary risk-free up to the agreed maximum amount; and the only condition of the guarantor's payment liability is the presentation of a demand and all the other documents specified in the guarantee in the prescribed manner and within the period of the guarantee, if any.
The demand guarantee is unique in its character, since the Guarantor is not concerned with the underlying contract, and if the demand is duly presented, payment must be made, in spite of allegations by the Principal that the Principal has fully performed in terms of that contract, in the absence of established fraud or other event constituting grounds for non-payment under the applicable law. The Guarantor of a demand guarantee therefore promises, or gives a primary or direct undertaking to perform the principal's obligation, irrespective of whether or not the Principal's obligation is enforceable.
The fundamental difference between a suretyship guarantee and a demand guarantee is that the liability of a surety of a true guarantee is secondary, whereas the liability of the Guarantor of a demand guarantee is primary. A surety's liability is co-extensive with that of the Principal debtor and, if the surety disputes default by the Principal debtor, the creditor must prove such default. Neither statement applies to a demand guarantee: the principle underlying demand guarantees is that each contract is autonomous and, more specifically, the Guarantor 's obligations of a demand guarantee are not affected by disputes under the underlying contract

between the Beneficiary and the Principal. If the first makes an honest demand, it does not matter whether between himself and the Principal, he is entitled to payment; the Guarantor must honour such a demand, the Principal must reimburse the Guarantor or counter-guarantor, i.e. the instructing party, and any disputes between the Principal and the Beneficiary must be resolved in separate proceedings to which the Guarantor will not be a party. If actual proof of breach or non-performance is required under the guarantee, the facility is not a demand guarantee, but a true guarantee in the strict sense.
The Guarantor of the demand guarantee undertakes an absolute obligation to pay the Beneficiary according to the tenor of the guarantee, whose purpose is to guarantee performance of the underlying contract, whereas liability under a true guarantee is secondary in nature, dependent upon breach of the underlying contract. Furthermore, a demand guarantee generates a primary liability on its issuer, dependent merely upon the Beneficiary calling on the guarantee in conformity with any requirements stipulated therein. This independence of the demand guarantee from the underlying contract is enshrined in the cardinal principle of autonomy of the guarantee.

4. Fundamental Principles of Demand Guarantees: independence.

Demand guarantees share many of the essential characteristics of the commercial letter of credit. Undertakings are given to support a commercial contract between the Principal and the Beneficiary, though considered in law distinct from, and largely independent of, that contract. -Such payment instruments are the commercial letter of credit, the standby letter of credit and the demand guarantee.
These abstract payment undertakings do not fall within the ordinary contract principles, neither do they involve offer and acceptance, being considered binding as from the time of issue unless and until rejected by the Beneficiary. The demand guarantee comprises an abstract payment undertaking, which becomes binding solely by way of issue of the guarantee, subject to the Beneficiary not rejecting it, since they are best regarded as mercantile specialties; undertakings which, through the usage of merchants, have effect by virtue of their issue without any additional requirements, often treated as engagements rather than contractual promises in the strict sense, or as contractual in character, since the grounds for avoiding them and the remedies for their breach are determined by ordinary contract principles.
In addition to this, the rules of customary law or trade usage also play an important role in explaining many of the aspects of the relationship between the issuing or guarantor bank. They also confirm that it is settled law that a contractual obligation comes into existence by way of an offer and an acceptance. However, when it comes to the relationship between the bank that issued a letter of credit/demand guarantee and the beneficiary it is evident that there was no prior negotiation between them. Consequently, the bank's undertaking of, for example, a revocable letter of credit can only be regarded as an offer to the beneficiary. When the Beneficiary presents the documents to the bank and claims payment or acceptance of his bill of exchange, this may be regarded as his acceptance of the bank's offer. It would therefore seem that such a contract between the issuing bank and the Beneficiary comes into existence only at the time when the beneficiary presents the documents to the issuing bank. The bank's obligation will become legally binding only when the Beneficiary receives and takes notice of the document of the letter of credit. This construction is in line with the information theory regarding the moment of formation of a contract, which rests on the principle that the primary basis for contractual liability is actual and conscious agreement between the parties to the contract. Generally, an agreement is concluded only when the acceptance is communicated to the issuing bank/Guarantor. The general principles of the law of contract provide for exceptions to the information theory where the bidder expressly or tacitly waives or abandons its right to notification of the other party's acceptance of its offer. It is also a customary rule that Beneficiaries do not expressly notify the issuing or Guarantor bank of their acceptance of the latter's offer. A fundamental characteristic of documentary credit law is the autonomy of the credit, since the payment undertaking embodied in the letter of credit is independent of both the performance of the underlying contract between the applicant of the credit and the Beneficiary, and of the relationship between the Applicant and the issuing bank.
Generally, it is not a defence to a claim on the commercial letter of credit that the Beneficiary appears to have committed a breach of the underlying contract, that the contract is unenforceable or that the Applicant for the credit has failed to put funds in the issuing bank: the issuing bank is simply not concerned with any dispute arising out of the possible breach of the underlying contract. This is hardly surprising, for the traditional letter of credit transaction sets up a string of commitments involving different parties, and it would be strange if a breach of contract between, for instance, the Beneficiary and the Applicant for the credit were to constitute a defence to a claim under a totally separate commitment between the issuing bank and Beneficiary; one to which the applicant for the credit is not a party.
The autonomy principle is also fundamental to demand guarantees; although their issuing follows from the underlying contract between the Principal and the Beneficiary, the demand guarantee is separate from that underlying contract, and the rights and obligations created by the guarantee are independent of those arising from the underlying contract, with which the Guarantor is generally not concerned. Most demand guarantees issued in practice are payable "on demand", or "on first demand", which clearly implies that such guarantees create a "binding obligation" to pay against the simplest of demands by the Beneficiary without any proof of any default by the Principal on the underlying contract: a bank that gives a demand guarantee must honour it according to its terms. The bank is not concerned in the least with relationships between the Principal and the Beneficiary, nor with the question of whether or not the Principal has performed in terms of the underlying contract; and nor with the question of whether or not the Principal is in default; the Guarantor undertakes an absolute obligation to pay the Beneficiary according to the direction of the guarantee.
The principle of autonomy is also codified in articles 3 and 4 of the 1993 version of the Uniform Customs and Practice for Documentary Credits (**UCP 500**). In the context of documentary credits, which include standby letters of credit, and by implication also demand guarantees, the autonomy principle was confirmed and expressed in **article 3**, in particular **article 3(a)**. The first part of this article provided that "*credits, by their nature, are separate transactions from the sales or other contract(s) on which they may be based and banks are in no way concerned with or bound by such contract(s), even if any reference whatsoever to such contract(s) is*

included in the Credit. Consequently, the undertaking of a bank to pay, accept and pay Draft(s) or negotiate and/or to fulfil any other obligation under the Credit, is not subject to claims or defences by the Applicant resulting from his relationships with the Issuing Bank or the Beneficiary."

In addition to this, **article 4** of the **UCP 500** provided that when dealing with documentary credits, all the parties involved, banks included, were concerned with documents, and not with goods, services, and/or other performances to which the documents might have related. The article aimed at complementing **article 3** by making it very clear that in determining whether the Beneficiary was entitled to be paid, banks were concerned with one question only: whether the documents presented to them conformed to the credit.

In the UCP 600 the principle of autonomy is again clearly confirmed. **Article 4(b)** the **UCP 600** even goes as far as specifically stating that an issuing bank should discourage any attempt by the Applicant to include, as an integral part of the credit, copies of the underlying contract. However, the principle of autonomy is set out in particular in **article 4(a)**, and then confirmed in article 5. The first part of article 4(a) provides: "*A credit by its nature is a separate transaction from the sale or other contract on which it may be based. Banks are in no way concerned with or bound by such contract, even if any reference whatsoever to it is included in the credit. Consequently, the undertaking of a bank to honour, to negotiate or to fulfil any other obligation under the credit is not subject to claim or defences by the applicant resulting from its relationship with the issuing bank or the beneficiary*". Article 5 provides that "banks deal with documents and not with goods, services or performance to which the documents may relate". Both articles are basically the same as their counterparts that were found in articles 3 and 4 of UCP 500. The only basic difference between the two versions in this regard, seems to be found in the fact that the latest version sets out the autonomy principle in a more user-friendly way.

By their very nature, guarantees are transactions separate from the contract or tender conditions on which they may be based, and are in no way concerned with or bound by such contract(s), or tender conditions, despite the inclusion of a reference to them in the Guarantee. The duty of a Guarantor under a Guarantee is to pay the sum or sums therein stated on the presentation of a written demand for payment and other documents specified in the Guarantee which appear on their face to be in accordance with the terms of the Guarantee.

The autonomy principle of demand guarantees and standby letters of credit is also expressly incorporated into the URDG and **rule 1.06(a)** and **(c)** of the **ISP98**.

The UNCITRAL Convention, which applies to an international undertaking such as a demand guarantee or a standby letter of credit, also mentions the autonomy principle of these credits and guarantees in **articles 2** and **3**; the first declares that the Convention is concerned with an undertaking that "is an independent commitment", whereas the second describes the independence of the undertaking as follows:

> *For the purposes of this Convention, an undertaking is independent where the guarantor/issuer's obligation to the beneficiary is not:*
>
> *(a) Dependent upon the existence or validity of any underlying transaction, or upon any other undertaking (including stand-by letters of credit or independent guarantees to which confirmations or counter-guarantees relate); or*
>
> *(b) Subject to any term or condition not appearing in the undertaking, or to any future, uncertain act or event except presentation of documents or another such act or event within a guarantor/issuer's sphere of operations.*

The applicability of the principle of autonomy to demand guarantees may well put the Principal at the mercy of an unscrupulous Beneficiary; the total detachment of the demand guarantee from the underlying contract generally denies any right to prevent performance in the event of an unjustified call upon the guarantee. However, the independence of the demand guarantee, standby letter of credit and commercial letter of credit have boundaries and are not absolute, all jurisdictions acknowledge certain exceptions to the autonomy principle. Established fraud on the part of the Beneficiary or his agent, e.g., where the Beneficiary or his agent makes a demand knowing that the Principal has fully performed his obligations under the underlying contract, disentitles him to payment and the bank is entitled to refuse payment, i.e. the Beneficiary's fraud is a valid defence to an action brought on the demand guarantee. Furthermore, in the event of the bank contemplating payment, nearly all jurisdictions allow an interdict or injunction, either against the bank to prohibit payment, and/or against the Beneficiary in order to forbid him from making a demand or receiving payment.

Fraud and forgery are certainly the most proclaimed exceptions to the autonomy principle with respect to both demand guarantees and documentary credits. There are also other accepted grounds besides fraud on which payment under a demand guarantee may be restrained, for example, illegality or the infringement of international obligations. The grounds for non-payment under a commercial letter of credit also often constitute a similar ground for non-payment under a demand guarantee.

In the absence of established fraud by the Beneficiary, or some other accepted grounds for non-payment under the applicable law, the Guarantor is not entitled to refuse payment, and the Principal is not entitled to have

payment restrained merely because of a dispute between the Principal and the Beneficiary as to whether or not the principal has, in fact, defaulted on the underlying contract.
In the same way, the demand guarantee is separate from the contract between the Principal and the Guarantor, and the Guarantor is not entitled to invoke a breach of that contract, e.g., failure of the Principal to indemnify him, as a ground for refusing payment of a demand.

5. Documentary character of the guarantee.

A fundamental aspect of the autonomy principle is the documentary character of the demand guarantee, standby letter of credit and the commercial letter of credit. The demand guarantee is documentary in character, i.e. the amount and duration of the duty to pay, the conditions of payment and termination of the payment obligation depend exclusively on the terms of the guarantee itself, e.g., the expiry date, and the presentation of a demand and such other documents, if any, as may be stipulated in the guarantee. The Guarantor's duty is to pay against specified documents that are presented within the period and in accordance with the other conditions of the guarantee; he is also under no obligation to authenticate the documents submitted. Article 15 of UCP 500 provided that banks assumed no liability or responsibility for the form, sufficiency, accuracy, genuineness, falsification or legal effect of any document, the description, quantity, weight, quality, condition, packing, delivery, value or existence of the goods represented by any document, or the good faith, acts or omissions, solvency or performance of any other party associated with the transaction.

The Guarantor is therefore not interested in the investigation of external facts, such as the Principal's default in performance of the underlying contract or the amount of loss actually suffered by the beneficiary as a result of that default. The documentary character of the documentary credit, standbys and demand guarantees is also confirmed in **article 5** of the **UCP 600** which provides that "*banks deal with documents and not with goods, services, or performance to which the documents may relate.*" The purpose of such article is to complement **article 4** of the UCP by making it clear that in determining whether the Beneficiary is entitled to be paid, banks are concerned with one question only: are the documents presented to them in conformity with the credit? The same idea was expressed, though in different language in **article 2(b)** of the **URDG 458**: "*The duty of a Guarantor is to pay the sum on the presentation of a written demand for payment and other documents*". The documentary nature of a letter of credit is also further confirmed by **article 14(a)** of the **UCP 600** which provides that banks must examine a presentation to determine, on the basis of the documents alone, whether or not they appear on their face to constitute a complying presentation. The documentary nature of letters of credit was also confirmed by **article 13(a)** of the **UCP 500** which provided that banks had to examine all documents stipulated in the credit with reasonable care, to determine whether or not they appeared, on their face to be in compliance with the terms and conditions of the credit. It is a fundamental rule of the UCP 600, just as it was with their predecessor, that banks deal only with documents, not with goods or services or with external facts, and that only documentary conditions for payment can properly be included in the credit.

The ISP98 also affirm the documentary character of the standby letter of credit, including other independent undertakings, such as demand guarantees. **Rule 1.06(a)** of the **ISP98** provides that a standby, to which the it applies, is an irrevocable, independent, documentary, and binding undertaking when issued irrespective of whether or not it states so. Furthermore, **rule 1.06(d)** provides that because a standby is documentary in character, an issuer's obligations depend on the presentation of documents and an examination of required documents on their face. This rule emphasises the principle that an issuer's obligation turns upon the presentation of documents. The documentary character of a standby is closely linked to its independence. Furthermore, **rule 4.08** of the **ISP98** even goes as far as providing that even if a standby does not specify any required document, it will still be deemed to require a documentary demand for payment. In addition to **rule 1.06** that reinforces the documentary character of standbys, **rule 2.01** also emphasises the documentary character by providing that an issuer of a standby merely undertakes to the Beneficiary to honour a presentation that appears on its face to comply with the terms and conditions of the standby in accordance with these rules supplemented by standard standby practice. In other words, the undertaking is to honour a document "that appears on its face to comply" and not to consider the facts it represents

6. Non-documentary conditions in demand guarantees.

It often happens that a non-documentary condition is included in a commercial letter of credit, standby or demand guarantee. A non-documentary condition is a requirement under the credit/guarantee that cannot be satisfied by presenting a document nd that requires the Guarantor to pay the Beneficiary when, for instance, the Applicant is in breach of a lease is a non-documentary condition. The satisfaction of such a condition depends on an whether the Applicant is in breach of the lease, not on the presentation of a document. In contrast, a condition in the credit/Guarantee that requires the Beneficiary to present a document stating that the Applicant is in breach of the lease would be a documentary condition that may be satisfied by presenting such document.

Conceptually, non-documentary conditions are alien to commercial letters of credit, standby letters of credit and demand guarantees; though, many Applicants do not understand the importance of adhering to the rule that banks only deal with documents, not with goods, services or other performances, and instruct their banks to incorporate into credits or guarantees conditions that are non-documentary in character. Despite their better judgement, they often act on these instructions, whereas they should explain to their customers that non-documentary conditions are unacceptable. Such conditions were outside the scope of the UCP 500 altogether and, if literally construed, compelled the banks to satisfy themselves that the specified conditions were satisfied; a task for which banks were ill-equipped and which they were reluctant to undertake. Non-documentary conditions are also outside the scope of the current UCP 600. In the past banks often found practical solutions by converting these apparent non-documentary conditions into documentary conditions by construing them as requiring the production of a document reasonably evidencing fulfilment of the stated condition.

Many banks dislike the inclusion of such conditions in letters of credit and demand guarantees, since their aversion to non-documentary conditions are based on an appreciation of the fundamental character of the letter of credit/demand guarantee as an undertaking independent of factual determinations apart from those within the control of the examiner. A bank cannot in any way avoid its undertaking due to non-documentary conditions not being fulfilled, since the independent character of the letter of credit/guarantee would be threatened. The bank's determination of facts outside its domain is not reliable. Most such facts are subject can ultimately be decided with finality only by a court or arbitral tribunal that has the power to compel the production of evidence and to command testimony under penalty of perjury. If banks had to make such judgements subject to being second-guessed by tiers of fact, it is inevitable that they would choose the most conservative approach, namely refusal to pay until ordered to do so. As a result, the distinction between accessory guarantee and the letter of credit would disappear; the documentary character of the letter of credit, or guarantee, undertaking is the practical manifestation of the principle of autonomy.

It has has always been a controversial issue, especially for banks, to decide what to do about non-documentary conditions that were inserted in undertakings, intended to be either letters of credit or demand guarantees. There were various courses of action available: to treat the undertaking as accessory, giving effect to the non-documentary condition, to disregard the non-documentary condition or to require that a document embodying its fulfilment be submitted. It later became evident that banks were not able to determine what type of document would be appropriate to satisfy such a non-documentary condition in all circumstances and they were reluctant to impose a documentary requirement not stipulated in the letter of credit. While the ICC was revising the 1983 version of the UCP, the letter of credit community reached consensus on the issue of non-documentary conditions and decided that where such conditions were inserted in a letter of credit, they had to be disregarded. Accordingly, a provision was specifically incorporated, firstly, into the UCP 500 and, secondly, also into the the UCP 600.

Banks had to take cognisance of **article 13** of the **UCP 500,** in particular of **article 13(c)**, which provided that "*if a credit contains conditions without stating the document(s) to be presented in compliance therewith, banks will deem such conditions as not stated and will disregard them*". **Article 13(c)** was incorporated into the UCP in an attempt to eradicate the totally wrong practice of incorporating non-documentary conditions; this provision required banks to ignore conditions in which the issuer sought to embody in the documentary credit some of the terms of the contract between the Beneficiary and the Applicant without setting out the documents to be tendered to establish compliance therewith. The practice of incorporating non-documentary conditions into documentary credits defeated the underlying principle of the documentary credit itself and directly contradicted the wording of various articles of the UCP 500, all of which clearly indicated that payment, acceptance or negotiation under a documentary credit was to be effected against documents stipulated in the documentary credit. The ICC Banking Commission expressed its strong disapproval of the fact that, notwithstanding the provision of **article 13(c)**,, certain banks continued to issue documentary credits and amendments containing non-documentary conditions. The commission therefore reminded banks that, where a documentary credit or amendment thereto contained one or more conditions and did not state the documents to be presented to evidence compliance therewith, **article 13(c)** clearly provided that banks had to deem such conditions as not stated and had to disregard them. Accordingly, it suggested that banks should have included any appropriate condition in the detail of the documents stipulated, or stated expressly the document which was to evidence compliance with a specific

condition., which was not deemed to be a non-documentary one, if it could be clearly linked to a document stipulated in the credit. Today, **article 14(h)** of the **UCP 600** also sets out how banks should deal with non-documentary conditions in letters of credit: "*If a credit contains a condition without stipulating the document to indicate compliance with the condition, banks will deem such condition as not stated and will disregard it.*". Furthermore, **article 14(g)** provides that "*A document presented but not required by the credit will be disregarded and may be returned to the presenter.*"
The ISP98 also formulated a rule regarding non-documentary conditions included in standbys. **Rule 4.11** deals specifically with this. **Rule 4.11(a)** provides that a standby term or condition that is non-documentary must be disregarded whether or not it affects the issuer's obligations to treat a presentation as complying or to treat the standby as issued, amended or terminated. **Rule 4.11(b)** goes on and states that terms and conditions are non-documentary if the standby letter of credit does not require presentation of a document in which they are to be evidenced and if their fulfilment cannot be determined by the issuer from its own records or its normal operations. **Rule 4.11(c)** furthermore provides that determinations from the issuer's own records or within its normal operations include determinations of:

i. *when, where, and how documents are presented or otherwise delivered to the issuer;*
ii. *when, where, and how communications affecting the standby are sent or received by the issuer, beneficiary, or any nominated person;*
iii. *amounts transferred into or out of accounts with the issuer; and*
iv. *amounts determinable from a published index (e.g., if a standby provides for determining amounts of interest accruing according to published interest rates.)*

Rule 4.11(d) merely addresses the situation where a document contains a calculation or computation and provides that the issuer need not verify its accuracy
The approach that was taken in **article 13(c)** in the UCP 500 raised a series of questions with respect to conditions that were within the operational purview of the bank to confirm. Some standbys require that a deposit be made to an account maintained at the issuer as a condition to the availability of the standby. It was therefore asked whether or not such a provision was non-documentary and had to be disregarded. Therefore, the ISP98 attempted to address these issues and, accordingly, **rules 4.11(b)** and **(c)** were inserted.
Rules **1.06(d)** and **4.11** can be understood both to formulate the non-documentary condition principle and to address the question that has been raised regarding its application. It is common for standbys to refer to external sources. Such a provision is often not declared in a document; it is within the operational purview of a financial institution acting as as issuer of a standby to be aware of, and have access to, major financial publications and the rates published in them. Such a provision does not require a factual determination other than the examination of information to which the examiner has ready access in the normal course of its business. The same principle would apply to a deposit in an account maintained with the examiner; **rules 4.11(c)(iii)** and **(iv)** provide that such matters are not non-documentary and are not to be disregarded.
Including non-documentary conditions into commercial letters of credit, standbys or demand guarantees is undesirable, and banks should rather explain the dangers of including such conditions into their credits and guarantees than to try to convert them into documentary ones.

7. The Principle of Strict Compliance: the requirement of compliance of the demand with the terms of the guarantee

How strictly the documents must conform to the terms of the letter of credit or demand guarantee? Is the standard a strict one, so that even the slightest deviations entitle the bank to refuse payment and, indeed, oblige it to do so unless otherwise authorised by the Applicant/Principal of the credit/guarantee? Or is it a substantial compliance standard in terms of which deviations that the bank has no reason to believe of commercial significance are ignored? Or does the law adopt a bifurcated standard, i.e. a strict compliance in suits by the Beneficiary against the issuing bank, but only substantial compliance in suits by the Applicant against the issuing bank, in terms of which the bank is free to invoke a strict standard of compliance against the Beneficiary, but is entitled to the benefit of a more relaxed standard face to its customer in choosing to pay despite minor deviations?

The doctrine of strict compliance is well established for commercial letters of credit; it entails that the documents presented in terms of a letter of credit must be precisely those the letter of credit calls for.

The doctrine of of strict compliance is usually applied to documents provided in conformance with a letter of credit and indeed it is not the same as "exact compliance". It does not mean, for instance, that a document will be treated as non-conforming if every 'i' is not dotted or every 't' is not crossed or contains obvious typographical errors. A rigid and meticulous fulfilment of precise wording is not required in all cases. It is impossible to define exhaustively the nature and extent of the bank's duty with regard to the exactness of compliance of documents presented to it under a credit, and each case must be considered on its own merits in the light of the language of the credit and the circumstances in which it has been established. A dogmatic generalised approach must be rejected, as a measure of common sense is used when the standard, which is in principle strict, is applied.

The UCP 600, as well as their predecessor, UCP 500, contain a number of provisions that aim at relaxing the requirements of strict conformity; by incorporating one of these versions of the UCP into their contract, either expressly or tacitly, the Applicant / Principal and the Beneficiary agree to a certain relaxation of the required degree of compliance regarding the documents.

The advantage of a strict rule is that it is reasonably clear and absolves the bank from making judgemental decisions; if one looks at international uniform rules, it becomes clear that this strict rule has come under some pressure. The UCP 500 prescribed a standard of compliance with which the stipulated documents presented had to comply, though they did not address directly the problem of how to measure the compliance of the presented documents with the requirements of the credit. In this regard, **article 13(a)** merely provides as follows: "*Banks must examine all documents stipulated in the Credit with reasonable care, to ascertain whether or not they appear, on their face, to be in compliance with the terms and conditions of the Credit. Compliance of the stipulated documents on their face with the terms and conditions of the Credit, shall be determined by international standard banking practice as reflected in these Articles. Documents which appear on their face to be inconsistent with one another will be considered as not appearing on their face to be in compliance with the terms and conditions of the Credit*". The article required banks to examine documents with reasonable care and provided that compliance of the stipulated documents on their face with the terms and conditions of the credit had to be determined by *international standard banking practice* as reflected in the UCP 500, and the reason of this was because in the past the doctrine of strict compliance was construed as prescribing a rigid proofreading exercise devoid of mercantile reality. This article was in line with a later trend that manifested in a few decisions that suggested that not every minor mistake in a document constituted a discrepancy. Therefore, one of the aims of this article was to deter the courts from being too ritualistic in treating documents as non-conforming where the defects are trivial and obvious. The other is to discourage courts from being too liberal by invoking considerations, such as good faith or the lack of commercial importance of the discrepancy.

In terms of its wording, if the international standard banking practices are not embedded in the UCP 500, they are not relevant. The international standard banking practices to which reference is to be made are only those practices "as reflected in these Articles". The words of the article do not allow for expert testimony on what is standard banking practice beyond the extent to which other articles of the UCP 500 reflect it. The difficulty with this article was where international standard banking practice was to be found, as such a practice was not reflected in the UCP 500. Real doubt has been expressed that "international standard banking practices" even exist. Various banks had different rules on acceptability and checking of documents presented under documentary credits and standby letters of credit. The words "as reflected in these Articles" tie in with the standard for compliance, the other provisions of the UCP 500 and only the international banking practice that those other provisions reflect. This for instance includes provisions such as **article 37(c)** in terms of which the description of the goods on the invoice must correspond with the description in the credit, whereas in all other documents the goods may be described in general terms not inconsistent with the description of the credit. For this purpose, the UCP 500 should be read as a whole. The banking practice that is embodied or reflected in the other provisions may be considered to be determinative. There is no other provision that deals directly with the standard for compliance; it is not clear from **article 13(a)** whether strict compliance is necessary or whether

substantial compliance is enough. The other provisions of the UCP 500 are silent on this issue, and under the wording of **article 13(a)**, the practice of bankers with regard to the standard remains inadmissible.
Under "international standard banking practice", the great majority of courts, as stated above, have held that documents must "strictly comply" with the terms and conditions of the credit. Strict compliance, as measured by "standard banking practice", is not the equivalent of "mirror image" compliance. Courts have experienced common sense in applying the strict compliance standard; typographical and spelling errors, and other obviously trivial differences between the wording in the credit and the wording in the presented documents have been held not to render the presentation non-compliant under the strict compliance standard measured by standard practice. The ICC attempted to address this problem by the publication of the International Standard Banking Practice for the Examination of Documents Under Documentary Credits ('ISBP') in 2003. The ISBP was created with a mere view to define the international banking practice regarding the examination of the different documents tendered under documentary credits. Paragraph 24 of the ISBP provides that "*documents presented under a credit must not appear to be inconsistent with each other. The requirement is not that the data content be identical, merely that the documents not be inconsistent*"'.
The ISBP cannot be incorporated into a documentary credit and cannot therefore be regarded as comprising standard terms governing the contractual relationships created in documentary credit transactions. Its effect is bound to depend on it being accepted as a declaration of the international practice developed by banks and referred to in **article 13(a)** of the **UCP 500**. The drafting of the ISBP was not based on an extensive study of existing banking practice and its purpose was merely to explain how practices set out in the UCP 500 were to be applied by documentary practitioners. The drafters of the ISBP recognised that the law in certain countries may compel a practice different from that stated in it. After all, the UCP was created with the goal to harmonise banking practice and prescribe a uniform set of rules. The adoption of different compliance standards in different jurisdictions tends to undermine the very uniformity the rules are designed to promote. When read with the ISBP, the UCP 500 provides no more than a very generalised statement as to the compliance standard applicable to documentary credits and standby letters of credit, still leaving it to be dealt with by the courts in the different jurisdictions.
Article 13(a) of the UCP 500 (the third sentence) states: 'Documents which appear on their face to be inconsistent with one another will be considered as not appearing on their face to be in compliance with the terms and conditions of the Credit.' Therefore, article 13(a) provides that the data content of documents presented must be consistent not only with the terms and conditions of the credit, but with that of the other documents presented as well. In the context of a commercial letter of credit, inconsistencies in the documents may indicate that the goods are non-conforming. Commercial letters of credit normally deal with integrated transactions in which it is to be expected that all the documents presented relate to payment of the purchase price against documents evidencing the same transaction. The purpose of the consistency rule is to allow the issuer to assure itself that the documents relate to the same transaction. In the context of a standby letter of credit, no useful purpose is normally served by requiring that the issuer search for, or take note of inconsistencies among the documents. This requirement is not illogical in a commercial letter of credit, since the transaction is typically a holistic exercise in which internal consistency can be expected. This expectation does not necessarily follow for standby letters of credit; while there may be consistency as to some data, the very reason for the drawing may require an inconsistency between two documents, thereby evidencing the default. The problem is even more distinct in commercial standbys where the goods are usually in the possession of the applicant before the drawing. To dishonour commercial documents for inconsistencies between themselves where the documents comply with the terms and conditions in the letter of credit is normally without justification in a standby situation. Even more importantly, the examiner is never in a position to know whether an apparent inconsistency in a standby presentation is intended to reflect a default and often lacks the data to determine the context of how the entire transaction was structured so as to give isolated figures some contextual meaning, as would be the case in a commercial letter of credit.
Since the UCP 500 were replaced with the UCP 600, it also became necessary to update the ISBP in order to bring it in line with the new set of rules. Accordingly, the new International Standard Banking Practice for the Examination of Documents Under Documentary Credits, 2007 Revision for UCP 600 ("ISBP (2007 revision)") came about. The ISBP (2007 revision) is an updated version of ISBP and its aims are similar to those of the ISBP, i.e. providing document checkers and other participants with the interpretation of what international standard banking practice represents in relation to the UCP, a credit and the examination of documents.
The most common basis on which documents presented under documentary credits are rejected by banks worldwide is the inconsistency of the data in the different documents presented. A vote by the national committees prevented the Drafting Group of the UCP 600 from addressing this problem by a provision in the UCP to the effect that the data in a document should only be considered against the requirements in the credit for that document and the UCP rules. **Article 14(d)** provides that "*data in a document, when read in context with the credit, the document itself and international standard banking practice, need not be identical to, but must not conflict with, data in that document, any other stipulated document or the credit*". The wording used in **article**

14(d) of the **UCP 600** does away with the less-precise and difficult-to-interpret requirements in **article 13(a)** of the UCP that the documents must "*appear, on their face, to be in compliance with the terms and conditions of the Credit*" and must not "*appear on their face to be inconsistent with one another*", which is believed to be a major improvement.
There are also two other important articles of the **UCP 600**, namely **article 14(a)** and **article 2**. The first provides that "*a nominated bank acting on its nomination, a confirming bank, if any, and the issuing bank must examine a presentation to determine, on the basis of the documents alone, whether or not the documents appear on their face to constitute a complying presentation*". **Article 2** of the **UCP 600** introduces the definition of "complying presentation" and states that "*a complying presentation means a presentation that is in accordance with the terms and conditions of the credit, the applicable provisions of these rules and international standard banking practice*". This definition lays the foundation for the test applied in **article 14(a)** relating to the bank's duty to examine the documents.. **Article 14** does in the **UCP 600** establishes the basic responsibility of banks to examine documents presented under letters of credit.
The reference to "international standard banking practice" in this context means international standard banking practice in the wider sense, which definitely includes the ISBP (2007 revision) and the ISBP, although not limited to them. As mentioned above, it appears that under "international standard banking practice", the great majority of courts have held that the doctrine of strict compliance is applicable. However, strict compliance as measured by "standard banking practice" is not the equivalent of "mirror image" compliance. Therefore, it would appear that international standard banking practice favours "fairly strict compliance", ignoring trivial discrepancies, and obvious typographical and spelling errors. The UCP 600 have not watered down the principle of strict compliance; simply, they have eliminated the possibility of rejecting documents for inconsequential discrepancies, with the results that the possibility of documents being rejected for inconsequential discrepancies has been dramatically reduced.
This problem has been addressed in **ISP98** by way of **rule 4.03 (Examination of Inconsistency)** which establishes the opposite rule. **Rule 4.03** deals with the examination of inconsistency between documents and provides that the issuer is required to examine documents for inconsistency with one another only to the extent provided in the standby; the only consistency at issue in the examination of documents under a standby, even documents regarding a transaction for the sale of goods, is with respect to the terms and conditions of the standby itself. The test is whether each document relates to the standby. Each document under a standby must comply with the terms and conditions of the standby itself and the examination and comparison of the documents with one another is not required, because there is not necessarily any one underlying obligation from which the examiner can determine what constitutes consistency. Documents may well be related to different obligations under the same or different transactions and, indeed, in the case of a default, may well be expected to be inconsistent with one another.
The ISP98, like the UCP, refer to the "standard practice" when the documents presented under the standby or any other independent undertaking, are examined. **Rule 2.01** provides that an issuer of a standby merely undertakes to the Beneficiary to honour a presentation that appears on its face to comply with the terms and conditions of the standby in accordance with these rules supplemented by standard standby practice. Furthermore, **rule 4.01** also provides in this regard as follows:

> ***4.01 Examination for Compliance***
> *a.* *Demands for honour of a standby must comply with the terms and conditions of the standby.*
> *b.* *Whether a presentation appears to comply is determined by examining the presentation on its face against the terms and conditions stated in the standby as interpreted and supplemented by these Rules which are to be read in the context of standard standby practice.*

Rules 4.01 and **2.01** state once more the fundamental undertaking of letter of credit practice: the issuer undertakes to honour complying demands. Both the presentation and the documents must be examined in the light of the terms and conditions of the standby. **Rule 4.01** avoids the term "strict compliance", which is a crude and abstract formulation in terms of which the standard of examination is described and one which is used primarily because it is less inaccurate than the notion of "substantial compliance", by which it is usually contrasted. The test of compliance turns on the role of the particular document in standby practice; the text of some documents must correspond with the one of the standby, others must be identical or exact, while others again merely need be not inconsistent with the standby. The issuer is therefore responsible for examining documents "on their face" and has no duty to investigate or inquire into matters beyond the face of the documents.
Rule 4.02 deals with the non-examination of extraneous documents and provides that documents presented that are not required by the standby need not be examined and, in any event, will be disregarded for purposes of

determining compliance of the presentation; they may then, without responsibility, be returned to the presenter or passed on with the other documents presented.
While **rule 4.01** helpfully states that the ISP98 are to be read in the context of standard practice, the ISP98 drafters were not content to let the standard practice dictate how documentary compliance is to be measured. Instead, they attempted in rule 4.09 to formulate new rules to apply when the documents presented to the examining bank do not reflect the mirror image of the documents described in the credit. Rule 4.09 was also inserted because the counterparties to the underlying contract often specify the wording (terms) to be used by inserting it in the standby accompanied by some indication that the required document(s) that must be presented is to contain these terms. The indication also typically appears in the form of quotation marks surrounding the desired phrase, an indented and blocked portion of the text of the standby, or an entire document, which is attached as an exhibit. In order to cater for this practice and the situation where the documents presented do not reflect the "mirror image" of the documents described in the credit, **rule 4.09** was inserted into the ISP98; it provides the following:

> *If a standby requires:*
> *a. a statement without specifying precise wording, then the wording in the document presented must appear to convey the same meaning as that required by the standby;*
> *b. specified wording by the use of quotation marks, blocked wording, or an attached exhibit or form, then typographical errors in spelling, punctuation, spacing, or the like that are apparent when read in context are not required to be duplicated and blank lines or spaces for data may be completed in any manner not inconsistent with the standby; or*
> *c. specified wording by the use of quotation marks, blocked wording, or an attached exhibit or form, and also provides that the specified wording be "exact" or "identical", then the wording in the documents presented must duplicate the specified wording, including typographical errors in spelling, punctuation, spacing and the like, as well as blank lines and spaces for data must be exactly reproduced.*

It also needs to be established whether the doctrine of strict appliance applies with equal force to demand guarantees. If the demand guarantee is governed by the URDG 459, article 9 will apply. The article provides that: "*all documents specified and presented under a Guarantee, including the demand, shall be examined by the Guarantor with reasonable care to ascertain whether or not they appear on their face to conform with the terms of the Guarantee. Where such documents do not appear so to conform or appear on their face to be inconsistent with one another, they shall be refused*". It also requires the Guarantor to examine documents with reasonable care to ascertain whether they appear on their face to conform with the terms of the guarantee. The intention is that the standard of compliance regarding a demand guarantee, governed by the URDG, should be the same as for a documentary letter of credit.
If the UNCITRAL Convention were to apply to the demand guarantee or standby, regard should be had for the articles in the Convention establishing what the standard of documentary compliance is that is required for guarantees/credits governed by the Convention. The standard of compliance is found in **article 16**, but articles **13(2)** is also relevant to establish the standard required: "*in interpreting terms and conditions of the undertaking and in settling questions that are not addressed by the terms and conditions of the undertaking or by the provisions of this Convention, regard shall be had to generally accepted international rules and usages of independent guarantee or stand-by letter of credit practice*".
Article 14(1) spells out that "*the Guarantor/Issuer shall act in good faith and exercise reasonable care having due regard to generally accepted standards of international practice of independent guarantees or stand-by letters of credit*". Furthermore, **paragraph (2) of article 14** also states that the Guarantor/Issuer "*may not be exempted from liability for its [the guarantor's/issuer's] failure to act in good faith or for any grossly negligent conduct*". **Article 16** lays down the principles for the care to be used by the Guarantor/Iissuer in its examination of the demand and the accompanying documents: "*the Guarantor/Issuer shall examine the demand and any accompanying documents in accordance with the standard of conduct referred to in paragraph (1) of article 14. In determining whether documents are in facial conformity with the terms and conditions of the undertaking, and are consistent with one another, the guarantor/issuer shall have due regard to the applicable international standard of independent guarantee or stand-by letter of credit practice*." By incorporating into the document the examination article, the notion that the Guarantor/Issuer must examine documents with "*due regard to the applicable international standard of independent guarantee or stand-by letter of credit practice*", The Convention clearly adopts the strict standard of compliance over the minority substantial compliance standard, together with the rule that, in order to obtain payment, the Beneficiary must present documents to the Guarantor/Issuer that comply strictly with the terms of the demand guarantee or standby.
It is an international rule that the Beneficiary becomes entitled to payment only by conforming strictly to the terms of the demand guarantee; if he neglects to present a document specified by the guarantee or presents a

document that does not meet all the requirements of the guarantee or if the demand is not made in the manner and within the prescribed period of the guarantee, the Beneficiary is not entitled to payment.
The Guarantor is not responsible for the adequacy, correctness or genuineness of the documents presented under a demand guarantee, merely for ascertaining with reasonable care whether they appear on their face to conform to the requirements of the guarantee. He is not therefore obliged to do more than conduct a reasonable visual examination. His duty is restricted to the exercise of good faith and reasonable care in the performance of his duties, since he is also not liable for acts outside his control.
When a counter-guarantee is issued, that is, in an indirect, four-party structure, it possesses the same independence from the demand guarantee as the latter from the underlying contract between the Principal and the Beneficiary. Accordingly, as long as the Guarantor's demand complies with the requirements of the counter-guarantee, the Guarantor is entitled to payment in the absence of established fraud or another ground for non-payment, whether or not he has paid the Beneficiary or has received a demand for payment or is legally liable to pay a demand received.
As the counter-guarantee, like the demand guarantee, is documentary in character and comprises an abstract payment undertaking, it is in principle independent of the distinct contractual relationship created by the mandate given by the instructing party to the Guarantor. For this reason, a breach of that mandate by the Guarantor, in respect of the terms on which the guarantee was to be issued, is a matter internal to the dealings between the Guarantor and the instructing party, and is not in itself grounds for refusal to pay the Guarantor's demand, except in so far as the terms of the mandate are incorporated into the counter-guarantee.

8. Key elements in a demand guarantee.

Although the form and content of demand guarantees differ significantly, there are certain key elements that every properly drawn guarantee must contain, and in particular, the parties involved, a reference to the underlying contract, the amount or maximum amount of the guarantee and any agreement for reduction or increase, the currency of payment, the documents, if any, to be presented for the purpose of a demand or of reduction or expiry and the expiry date, or expiry provisions and any agreement for extension, not to forget about the date of issue. If the intention is that the demand guarantee should not commence until presentation of a specific document, this fact should also be stipulated.
In the event of a direct, three-party demand guarantee, the parties to be identified are the Principal, the Guarantor and the Beneficiary, while in the event of an indirect, four-party demand guarantee, this must identify the Principal, the Guarantor and the Beneficiary, while the counter-guarantee must identify the Principal, the instructing party and the Guarantor, and may also identify the Beneficiary. The demand guarantee may be advised and transmitted directly or through an advising bank, but the bank, although concerned with checking that the signatures on the guarantee appear to be genuine, assumes no responsibility under the guarantee itself and has no contractual status except in its dealings with the Guarantor, which usually may consist of a sole Guarantor or joint Guarantors, and whose responsibilities may be distributed by virtue of syndication or participation.
An amendment to a demand guarantee, as the guarantee itself, takes effect upon issue and the Beneficiary's acceptance of it; if he rejects the amendment, the effect of this is that the demand guarantee continues in force in its unamended form.
It is said that demand guarantees are on a similar footing to a commercial letter of credit. It shares many similarities to a letter of credit. When a letter of credit is issued and confirmed by a bank, this must pay it if the documents are in order and the terms of the credit are satisfied. Any dispute between Buyer and Seller must be settled between themselves: the bank must honour the credit. A demand guarantee stands on a similar footing as a bank must honour it according to its terms. It is not concerned in the least with the relations between the Supplier and the Customer; nor with the question whether the Supplier has performed his contracted obligation or not; nor with the question whether the Supplier is in default or not: it must pay according to its guarantee, on demand, if so stipulated, without proof or conditions. The only exception is when there is clear fraud of which the bank has notice.
Commercial letters of credit and demand guarantees have many common features.-Both are:

- **abstract payment undertakings:** they are not required to conform to the ordinary conditions for a valid and binding contract;
- **autonomous in character**: in principle the bank's duty is to pay against conforming documents without regard to whether, in the case of commercial letters of credit, there has been proper performance of the underlying contract by the Beneficiary or, in the case of demand guarantees, there has been a breach of the underlying contract;
- **documentary in character:** the obligation is triggered simply by presentation of documents within the time and on the terms specified in the undertaking without regard to external facts or events. In both cases, the bank fulfils its duty by paying against documents that appear, on reasonable examination, to conform to the credit/guarantee. This occurs even if it becomes apparent that without the bank's knowledge one or more of the documents have been forged or fraudulently altered, or contain false data.

Owing to the nature of demand guarantees, their equation with commercial letters of credit is therefore valid. This similarity between these two instruments brings the demand guarantee within the ambit of the law relating to documentary credits. In other respects, there are vital differences between these two instruments though.
In international trade, documentary credits have long been commonly used instruments to secure the claim of the Seller to obtain payment of the contractual price. The essence of every letter of credit is an independent promise by a bank, or other issuer-of such letter, to pay the purchase price to the exporter against presentation of precisely described documents, such as a bill of lading or another document representing the goods sold.
A vital difference between commercial letters of credit and bank demand guarantees can be found in their payment function; the letter of credit constitutes a normal mode of payment; the bank demand guarantee does not. For instance, when parties to an export contract agree on a letter of credit, their common intention is that the Supplier receives its money through by using it. The bank demand guarantee, in contrast, will only be used if a risk occurs that is to be covered by that Guarantee, if the goods are not delivered in time; or if they are not delivered in conformity with the contract; or if an advance payment is to be repaid for lack of performance. The parties do not expect that such a risk will materialise and the one that furnishes the guarantee hopes that it will never be used. Thus, payment on a guarantee is the exception, while payment on a letter of credit is the normal course in the execution of the contract. In a nutshell, the commercial letter of credit is designed in order to

ensure the discharge of a payment obligation; by contrast, the demand guarantee is used almost exclusively to secure the performance of a "non-monetary obligation", classically, the execution of construction works or the delivery of conforming goods under a contract of sale, and is conceived as a default mechanism. It is the Principal, the equivalent of the Applicant in a documentary credit transaction, who is primarily responsible for the performance to which the demand guarantee refers, and the agreement between him and the Beneficiary requires, expressly or by implication, that the latter resorts to the bank only if the Principal defaults. Thus, while a bank pays a documentary credit only if things go right, in the case of a demand guarantee it is intended that the bank will be called upon to pay only if things go wrong.
The agreement as to the default nature of the demand guarantee is internal to the Principal–Beneficiary relationship and does not concern the bank, whose duty it is to pay against a written demand and such other documents, if any, as the guarantee may stipulate. Demand guarantees are different from documentary credits in that they are properly invoked only if the Principal has defaulted. Then again, the Guarantor of a demand guarantee, like the issuer of a documentary credit, is not concerned with the fact of default, but only with documents. Therefore, the demand guarantee shares with the commercial letter of credit the characteristic that it is an abstract payment undertaking, separate from the underlying contract, but differs from the letter of credit, in that it is improper for the Beneficiary to call the guarantee if he does not honestly believe that the Principal has committed a breach of the underlying contract. In view of that, the problem of unfair or abusive calls is peculiar to demand guarantees and cannot be raised in relation to commercial letters of credit, where it is agreed from the beginning that the bank, not the Principal, is to be the first port of call for payment.
There are also further differences between commercial letters of credit and demand guarantees: firstly, documentary credits normally involve the presentation of a substantial volume of documents, whereas the documentation required for a claim on a demand guarantee is skeletal in the extreme, entailing in most instances presentation of no more than the written demand itself. Secondly, the making of "extend or pay" demands is a particular feature of demand guarantee practice for which the URDG made special provision.

9. Calling of a demand guarantee.

The minimum prerequisite of the Guarantor's obligation to pay the demand guarantee is that the Beneficiary presents a demand for payment, which is almost invariably required to be in writing. The applicable law determines what constitutes "writing"; **Article 2(d)** of the URDG 458 specifically provided that writing includes any authenticated teletransmission or tested electronic data interchange messages equivalent to it. Sometimes other documents are specified, for example, the demand guarantee may also stipulate that the Beneficiary must support his written demand by a statement of breach of the underlying contract. If a party incorporates the URDG into his demand guarantee, any demand for payment must be in writing and must, in addition to such other documents as may be specified in the guarantee; be supported by a written statement, whether in the demand itself or in a separate document accompanying the demand and referred to in it, stating: that the Principal is in breach of his obligations under the underlying contract. The purpose of these provision is to discourage unfair calling, while preserving the speed and simplicity of remedy that the needs and practice of the market require. The demand guarantee may, of course, also stipulate other documents, for example, the production of a judgment or an arbitral award. Obviously the demand and any other specified documents must relate to the underlying contract covered by the guarantee, and must be presented within the specified time and in the manner prescribed by the guarantee itself.

The independence of the demand guarantee from the underlying contract has the effect that, in principle, the guarantor must pay a demand presented in compliance with the terms of the guarantee, irrespective of whether or not the Principal has, in fact, committed a breach of the underlying contract with the Beneficiary. All legal systems acknowledge that there are exceptions to this principle. The most common of these take place when there is fraud on the part of the Beneficiary; a concept that varies slightly from a jurisdiction to another, although characterised by the Beneficiary making a dishonest demand, knowing full well that the Principal is not in breach, because it is practically difficult to prove that the Principal has complied fully with all the terms of the underlying contract, but also that he knew this at the time of the demand.

Fraud is certainly the most proclaimed exception to the autonomy principle with respect to both demand guarantees and commercial letters of credit and it is dutifully acknowledged as an exception, but yet it remains elusive to the point of being illusory in practice, save in the most exceptional circumstances. The difficulty is even more acute in the case of indirect guarantees, because what the Principal then needs to show is not fraud on the part of the Beneficiary, but fraud by the Guarantor. This concept has not been fully developed by the courts and in various jurisdictions fraud is not limited to dishonesty or fraudulent intent, but extends to an absence of objective good faith, as where no reasonable person would have considered the demand to be justified.

Although fraud is the most declared exception to the duty to pay a conforming demand, it is not the only one; there are also a few other established exceptions to the autonomy principle and the absolute detachment of demand guarantees from their underlying contracts. Illegality in the demand guarantee contract or underlying contract, or the infringement of international obligations and express contractual derogation from the principle of autonomy. Another possibility is the total failure of the basis of the contract, i.e. the reason for its existence.

Should the principal hear that the Beneficiary intends to make an unjustified call on the demand guarantee, an interlocutory injunction may be sought, either against the Guarantor preventing payment, and/or against the Beneficiary, preventing him from making a demand on the guarantor.

In some countries it has become common practice for Beneficiaries to present "pay or extend" or "extend or pay" demands. Although the two differ according to the primary action demanded of the Guarantor, the message is the same, namely that payment is required immediately, unless the Guarantor complies with the Beneficiary's demand to extend the guarantee beyond the expiry date. Consecutive pay or extend demands are fairly common and if complied with, they may result in a significant prolongation of the guarantee period.

These types of demands are not necessarily unfair or inappropriate; the Beneficiary may honestly believe that there has been non-performance by the Principal that entitles the Beneficiary to demand payment and may offer the alternative of an extension that allows the Guarantor to avoid having to make immediate payment. However, not all such demands are always made in good faith and may be presented in order to force an extension of the guarantee when the Principal has not defaulted in performance of the underlying contract.

Upon receiving the extend or pay demand, the Guarantor must, without delay, inform the party who gave him his instructions and must suspend payment for as long as is reasonable to enable the principal to arrange for such an extension to be issued. Irrespective of whether or not the pay or extend demand is made in good faith, the Guarantor must have regard to his mandate from the Principal, in the case of a direct guarantee, or instructing party, in the case of an indirect guarantee, to whom he may incur a liability if he grants an extension without authorisation. Likewise, before agreeing to an extension, the instructing party must consider his own mandate from the Principal. These respective mandates are of no concern to the Beneficiary, whose contract is with the Guarantor and who is entitled to rely on any extension, irrespective of whether or not the Guarantor was authorised to grant it. Not all extensions are unilaterally imposed in this way; they may be provided for in the guarantee itself or subsequently agreed without any demand being made. If the demand is triggered

automatically because of non-extension of the guarantee, it must be a demand that conforms to the applicable rules. If it can be proved that the demand is fraudulent, the Guarantor will be entitled to refuse payment. The applicable law may also give the Guarantor other grounds for such refusal. In the absence of established fraud or other grounds for non-payment, the Guarantor must pay if the extension is not granted, provided, obviously, that all the other terms and conditions of the guarantee have been complied with.
The most controversial problem related to demand guarantees is the problem of unfair or abusive callings. The problem of fraudulent documents in relation to commercial letter of credit transactions was demonstrated in various cases already during the 1920s. The similarity between such situations and corresponding problems in connection with demand guarantees appears in case law from the 1970s and 1980s and are, to a large extent, due to their independent nature. Whereas the payment obligation of a surety of a true guarantee is linked to the underlying transaction, the Beneficiary's right to payment in a commercial letter of credit is independent of the underlying transaction and said to be absolute, or almost absolute. This is also the idea in relation to a demand guarantee, where the Beneficiary is entitled to payment, irrespective of the underlying transaction, immediately upon the calling for payment under the guarantee or upon the presentation of some documents.
The UCP 600 acknowledge that the presentation of non-conforming documents is a valid defence available to a bank against the Beneficiary. **Rules 1.06(d)**, **2.01** and **4.01** of the **ISP98** also confirm that an issuer of a standby is under an obligation to honour only complying demands. Furthermore, **articles 9(a)** and **(b)** of the **UCP 500** also provide that the liability of the Guarantor to the Beneficiary is dependent on presentation of the stipulated documents, and compliance with the terms and conditions of the credit.
The question of whether or not the documents conform is mostly determined with reference to what type of standard for compliance, strict or substantial, is used and how it is applied in the different jurisdictions. The UCP 600, URDG, ISP98 and the UNCITRAL Convention all set out what standard of documentary compliance is required for letters of credit and demand guarantees.
In principle, a bank must refuse payment if the documents and/or demand tendered under a letter of credit/demand guarantee presented does not comply strictly with the requirements stipulated in the credit/guarantee; where a demand is not in conformity with the demand guarantee, because incorrect documentation is presented, the payment may be refused, in keeping with the principle of strict compliance. A bank must also refuse payment if the documents are presented after the expiry date or where the demand is made after the expiry date of the guarantee. The bank's liability under a letter of credit and demand guarantee is conditional. Its liability depends on the presentation of conforming documents within the stipulated period. The late presentation and the presentation of non-conforming documents and/or defective demands are clearly valid defences against non-payment; although they are valid defences, they are in no way concerned with the autonomy principle.
The presentation of non-conforming documents and/or demands has been raised successfully as a defence of non-compliance; for this to be raised successfully, good faith is not a requirement. One result of the doctrine of strict compliance is that the person to whom the documents are tendered may raise any lawful objections against the documents, even if in fact his objection is purely technical and the true reason for his rejection of the tender is to be found in extraneous circumstances.
Whether or not documents comply will clearly depend on the standard of compliance that is required and how it is interpreted in the different jurisdictions. Whether or not a demand guarantee is subject to any specific rules, such as the UCP, URDG, or ISP98, or is subject to the UNCITRAL Convention, will also be important in establishing whether or not the documents and/or demand complies with the standard of compliance set out in the rules or the Convention. These defences are in no way concerned with the autonomy principle of demand guarantees.