



## **Effect of Standby Letters of Credit and Performance Bond in Facilitating Payment and Protecting Payment Risk in International Transaction and Construction Projects**

**Mohammed Idris; Zainab Dauda Yusuf; & Khadijat Nasir<sup>3</sup>**

*Department of Legal Studies, Federal Polytechnic, Mubi, Adamawa State*

### ***Abstract***

*Bank's stock in trade consequent upon which the adage 'Banks Word is its Sword' seems threatened by the unscrupulous beneficiaries of on demand bond in international transaction and or construction contract. This paper expounded the numerous effects of bond generally and or standby letters of credit and its threatening effects in international commercial transaction and construction contract due to an unfair/abusive call of an on demand bonds by the beneficiaries. The paper also expounded the United Kingdom's and Germany's modern trend in averting the anomalies usually encountered in bonds, guaranty and or standby letters of credit. The paper conclude by proffering solutions in protecting the contractor against the unscrupulous beneficiary's unfair and abusive calls of an on demand bonds in order to enhance the efficacy and sanctity of bonds in commercial transaction generally.*

**Keywords:** *Effect, Standby Letters, Credit, Performance Bond, International Transaction, Construction Projects*

## Introduction

It is a notorious fact all over the world that, the aim of any business transaction (contract inclusive) is to make profit.<sup>92</sup> This can only be possible if the business man or contractor is prudent and or skilful enough to devise a means in achieving business goals. In the same vain, risk avoidance is another cardinal aim of any business venture and to achieve that, it entails risk minimisation. In some cases more especially in international transactions or construction contracts, huge sums of money is involved and the parties may not necessarily know each other, they may be operating under different legal systems and as such there is high cost of litigation in an event of one party breaching the contract terms or conditions. In such kind of situations, parties may resort to financial institutions like banks or insurance companies to provide them with securities in forms of bonds or guarantee and standby letters of credit to ensure guarantee performance and or payment between the contracting parties.

<sup>92</sup> Partnership Act of 1890, s.1

<sup>93</sup> A Haynes, *The Law Relating to International Banking* (Bloomsbury Professional Limited London 2010) 276

<sup>94</sup> A Haynes, *The Law Relating to International Banking* (Bloomsbury Professional Limited London 2010) 276

Bonds or Guarantee and Standby Letters of Credit are mostly used in international supply or construction contracts. They are used in construction contracts to determine the financial strength of a contractor and his readiness to fulfil an undertaking into which he has entered.<sup>93</sup> The word 'Bonds, Bank Guarantee, Contract Guarantee and Standby Letters of Credit' are one and the same, their differences pertains to nomenclature but not substance.<sup>94</sup> Bank Guarantees are instruments issued by banks all over the world, whereas Standby Letters of Credit are instrument used by banks in United States. These instruments have a well establish history. They first used in commercial transaction about three thousand years ago, and they flourished in the intervening years largely because of their inherent reliability, convenience, economy and flexibility.<sup>95</sup> Thus, bonds and standby letters of credit are functionally the same. However, bonds which are of different types (e.g Bid or Tender bonds, Performance bonds, Advance

<sup>95</sup> B J David, 'How to Guarantee Contractor Performance on International Construction Projects: Comparing Surety Bonds with Bank Guarantees and Standby Letters of Credit' (2005) 37 GWU 51-108

payment bonds and Retention money bonds), may be given in either first/on demand or conditional demand form.

## **STANDBY LETTERS OF CREDIT AND PERFORMANCE BONDS**

### **Standby letters of credit:**

A letter of credit is an undertaking made by the 'issuer' (usually a bank), at the request of a 'customer', that the issuer will honour drafts or demands made by the 'beneficiary' for payment after the beneficiary has complied with the terms and conditions set out in the letter of credit.<sup>96</sup> Once the beneficiary has presented documents conforming to the conditions set out in the letter of credit, the issuing bank must pay the beneficiary.

The cardinal principles to the letter-of-credit transaction is the concept of independence, the bank's duty on the letter of credit is entirely different from any of the contractual obligations to the underlying transaction between the parties, either that of the buyer to pay the seller under ordinary principles that govern sales transactions, or any obligation that the buyer might have under an agreement or common-law principles to reimburse the bank for payments made on its behalf under the letter of credit. The bank's obligation depends solely on the beneficiary's presentation of documents that correspond with the terms of the letter of credit<sup>97</sup>

### **Performance bonds:**

Performance bonds or demand guarantee, unlike the documentary credit which is designed to ensure the discharge of a payment obligation, is used almost exclusively to secure performance of a non-monetary obligation (normally the execution of construction works or delivery of specified goods under the contract of sale) and is conceived as a default mechanism. It is the principal (equivalent of the applicant for the credit in the documentary credit transaction) who is primarily responsible for the performance to which the demand guarantee/performance bond relates, and the agreement between the principal and beneficiary requires, directly or indirectly, that the beneficiary resort to bank only if the principal defaults. Thus, a bank pays a documentary

---

<sup>96</sup> M Stern, 'The Independence Rule in Standby Letters of Credit' (1985) 52 UCLR 28

<sup>97</sup> R J Mann, 'The Role of Letters of Credit in Payment Transactions' (2000) 98 MLR 406

credit/letters of credit only if things go right, performance bonds/demand guarantee will be called upon to pay only if things go wrong.<sup>98</sup>

Performance bonds ensure the definite compliance by the contractor in discharging his duties based on the terms and or conditions provided by the parties in the underlying agreement. Failure of a contractor to perform under a building contract may cause an unwarranted loss to the employer which may lead to delay in not only completing the project, but the date when the tenant may enter into the property and the consequent loss of rent.<sup>99</sup> One of the characteristics of performance bonds is that, the issuer (which most of the time could be either Bank, Insurance Company or Surety), safeguards the position of an employer by indemnifying him for the failure of the contractor and as such the employer remain safeguarded even if the failure of the contractor is as a result of an insolvency, employer is entitle to full amount under the bonds.

As stated earlier, bonds may be issued on first/on demand or conditional demand. To determine the undertaking made by the issuing bank toward the beneficiary of the bonds, the exact wording of the said bond has to be taking into consideration so as to identify the kind of the bonds issued. For there is a general presumption that all bonds or guarantees are issued on first demand save if it is a banking instrument.<sup>100</sup>

### **Making Payment & Protecting Payment Risk through First/On Demand and Conditional Bonds in Letters of Credit and Performance Bonds.**

#### **First Demand:**

As the names implies, under the first/on demand bonds popularly referred to by bankers as ‘Suicide form’, the bankers obligation to make payment based on the said bonds triggered automatically with just a simple demand without the need to proof any terms and or conditions under it. This is the most important feature of this bond, since the beneficiary can claim under it without proof of lost as a result of any breach of the underlying contract.<sup>101</sup>

---

<sup>98</sup> R Goode, ‘Abstract Payment Undertaking in International Transaction’ (1996) 22 BJIL 15

<sup>99</sup> R Pike, ‘Security of Performance-Bonds and Guarantee’ (2013) Construction Newsletter Feb. 5-6, 1

<sup>100</sup> See the case of *Marubeni Hong Kong & South China Ltd v Mongolian Government* [2005] EWCA Civ 395,

<sup>101</sup> A Haynes, *The Law Relating to International Banking* (Bloomsbury Professional Limited London 2010) 280

This feature is the most fundamental basis why letters of credit is used in not only the constructions contract but all types of contract transactions more especially at international level. The documents evidencing the bond of this nature must be clearly spelt out devoid of any ambiguity. In *Edward Owen Engineering Ltd v Barclays Bank International*,<sup>102</sup> the clause in a bond reads ‘on demand without proof or conditions’. Lord Denning said that,

*‘the performance guarantee stand on a similar footing to the letter of credit. A bank which gives a performance guarantee must honour that guarantee 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. The bank must pay according to its guarantee, on demand, if so stipulated, without proof or conditions. The only exception is where there is a clear fraud of which the bank has notice’.*

According to Chua,<sup>103</sup> reference in Lord Denning dicta (without proof or condition) ‘is exceedingly important’. Thus, it is my humble view that, this is the major reason why standby letters of credit (more especially if issued on demand) is used to facilitate payment in construction contract.

Unlike simple guarantee i.e those not on first demand, in which default has to be proof before payment, in on demand guarantee, the surety’s liability to make payment will be triggered by simple demand or assertion of default by the beneficiary without any need to proof same. Sometimes it is difficult to determine the wording of an instrument as to whether it is a demand or simple guarantee. See the case of *Trafalgar House Construction (Regions) Ltd v General Surety and Guarantee Co Ltd*.<sup>104</sup> Where performance bond was

---

<sup>102</sup> *Edward Owen Engineering Ltd V Barclays Bank International* [1978] QB 159.

<sup>103</sup> C T Chua, ‘*Law of International Trade: Cross Border Transactions Commercial* (4<sup>th</sup> edn Sweet & Maxwell 2009) 562

<sup>104</sup> [1995] 3 All ER 737

provided to tackle losses resulting from subcontractor's completion of leisure complex. The bond categorically stated that '*on default by the subcontractor the surety shall satisfy and discharge the damages sustained*'. The subcontractor thereafter became insolvent and could not be able to complete the contract. The claimant filed a claim under such bonds and an issue was raised as to whether it amounted to a demand guarantee or common law guarantee. The court held that it was a common law guarantee based on the reference to the word 'damages sustained'.<sup>105</sup>

Thus, Solicitors or banks drafting bonds agreement has to be cautious in the choice of words in order not to leave any lacuna that would be subjected to court interpretation as to whether such wording is a demand guarantee or common law guarantee. If the wording is clear and unambiguous, the banks duty is to pay and leave the contracting parties to sort out their problems. In *Frans Maas v Habib Bank*,<sup>106</sup> the wording of the bonds reads;

*'we....hereby guarantee, waiving all right of objection and defence, the payment to yourselves a sum not exceeding [£500,000] on your first demand...your claims should be received by us in writing stating therein that the principals have failed to pay you under their contractual obligations'*.

Based on those wordings, the court arrived at its decision that, it is a demand guarantee.<sup>107</sup> Where however, there is an inconsistency in the wording of the bonds, a claim under it would be defeated, for the court's duty is to interpret the contractual documents the way it is but not otherwise.<sup>108</sup> The significance of an on demand or first demand bonds in international transaction and construction contract cannot be overemphasised. It derives tremendous popularity with overseas buyers and bankers who are always refining same in order to suit the market needs of such instrument. Syndicated bond facility is one of the products of such adjustment in order to cater for the market needs.<sup>109</sup>

---

<sup>105</sup> A Haynes, *The Law Relating to International Banking* (Bloomsbury Professional Limited London 2010) 280

<sup>106</sup> [2001] Llyod's Rep Bank 14

<sup>107</sup> C T Chua, *Law of International Trade: Cross Border Commercial Transaction* (4<sup>th</sup> edn Sweet & Maxwell 2009) 563

<sup>108</sup> A Haynes, *The Law Relating to International Banking* (Bloomsbury Professional Limited London 2010) 281

<sup>109</sup> G A Penn, 'On Demand Bonds – Primary or Secondary Obligation', (1986) 1 (4) JIBL 224 230

While banks are the usual institutions that issue on demand or first demand bonds, conditional bonds are mostly issued by Insurance Companies because the latter consider the on demand bonds commercially unsafe. Though banks preferred to issue on demand bonds, they also issue conditional bonds.

**Conditional Demand:**

Conditional bond provides a minimum measure of protection towards the seller/contractor, this is because, the beneficiary can only claim under such circumstances if he can prove by evidence that;

- There is a breach of the contractual terms from the part of the seller/contractor which is unremedied;
- That he (the beneficiary) suffered lost as a result of the breach;

Under these situations, the issuing bank, unlike its obligation under on demand bond, must necessarily involve itself in the underlying contract so as to determine as to whether of course the condition of payment has been met by the beneficiary in order to effect payment. This may likely cause discomfort to the banking business, and in order to protect itself from such inconveniences, the issuing bank usually demand that appropriate terms and condition be inserted in the underlying bond agreement so as to free itself from any likely issues that may arise between the contracting parties.<sup>110</sup> The bank may also escape been drawn into the parties dispute by making the bond subject to an arbitral letter of award by an independent arbitrator.<sup>111</sup> Where parties fail to agree to a conditional bond, the contractor can safe its commercial goodwill by properly-drafted confidentiality clause, thus preserving the secrecy of such call and any subsequent arbitral proceeding. This can be done in order to avoid any damage to the contractor's general reputation towards the future would-be employers. Thus, by inserting some terms relating to documentary evidence or arbitral awards, it would seems that, such bonds are a half-way house, they are neither truly on demand nor truly conditional. May be the terminology has to be amended to categorise such bonds as to either documentary (triggered on

---

<sup>110</sup> A Haynes, *The Law Relating to International Banking* (Bloomsbury Professional Limited London 2010) 281

<sup>111</sup> L Adams, 'New Clots in the Life of International Construction Projects: Enjoining Employers Calls on Performance Bond (2014) 30 Const. L J 325, 335

presentation of document) or non-documentary (ie based on proof of actual default).<sup>112</sup>

It has become a practice now that, the beneficiary has to make a formal declaration (while tendering his demand) as to the employee's breach of undertaken despite such is not warranted in the underlying contract.<sup>113</sup> However, in Germany banks may, if not satisfy, demands additional details base on these clauses.<sup>114</sup> The International Chamber of Commerce (ICC) make the Uniform Rules for Contract Guarantees that set out the internationally standard guideline for some categories of contract guarantees.

The guidelines bring about a uniformity of practice among the parties and seek to stabilise their interest without disregarding the commercial efficacy upon which the instrument based. The most important areas covered by ICC rules includes; the definition terms mostly used in bonds or guarantee, guarantors liability towards beneficiary, the due dates for claims in bonds, the necessary documents demanded in support of such claims, the closing dates and dispute settlement plus arbitration guidelines.

However, the efficacy of ICC rules is limited, this is because it is international in nature ( i.e persuasive only) and as such it cannot override any foreign legislation that provides for the wording of any bonds or periods in which claims be made. But nevertheless it provides rules that categorically take care of likely issues arising from on demand bonds and as such the parties may simply draft their underlying contract with a clause 'ICC rules terms apply save where otherwise provided herein'.<sup>115</sup>

### **Nature of Relationship in Letters of Credit/Bonds**

Parties to letters of credit or bonds are either three or four; they may be four in circumstances where the beneficiary demands for a corresponding bank (usually from his home country for convenience and guarantee). The first relationship is that in the underlying contract between the employer and employee consequent upon which the bond is issued. The second relationship will be between the

---

<sup>112</sup> G A Penn, 'On Demand Bonds – Primary or Secondary Obligation', (1986) 1 (4) JIBL 224 225

<sup>113</sup> See the case of Esal (Commodities) Ltd and Reltor Ltd v Oriental Credit Ltd and Wells Fargo Banks [1985] 2 Lloyds Rep 546

<sup>114</sup> G A Penn, 'On Demand Bonds – Primary or Secondary Obligation', (1986) 1 (4) JIBL 224 225

<sup>115</sup> A Haynes, *The Law Relating to International Banking* (Bloomsbury Professional Limited London 2010) 282



employee and his bank (otherwise called the instructing bank), this is because the employee is the one that will instruct his bank to engage the correspondent bank to issue a bond in favour of the beneficiary. The instructing bank will charge the employee the administrative cost plus obtaining an indemnity by debiting the employees account in its possession in case of demand and subsequent payment to the corresponding bank. The third relationship is between the instructing bank and correspondent bank in which the latter will obtain a counter indemnity from the former for any payments it make to the beneficiary. The fourth and last relationship in bonds agreement is that of the correspondent bank and the beneficiary in which the correspondent bank will be oblige to make payment at demand or upon condition if provided in the underlying agreement.<sup>116</sup>

### **Main risks facing someone relying on such an arrangement to make payment?**

Among the risk normally encounter in letters of credit and bonds agreements is an abusive call of bonds by the beneficiary. The on demand feature of bonds has been causing problems to contractors as a result of such abusive calls through which the beneficiary obtain huge sums of money despite the fact that, the underlying contract has not been violated. These causes quantifiable financial lost and unquantifiable reputational damage as the bank will not issue future bonds for the contractor, and the intending employer will not transact with a contractor that will not guarantee suitable performance bonds.<sup>117</sup>

This abusive calls has caused a worrisome situation to the international business community and as such, injunctions are usually applied in English courts to restraint the bank from making payment when such calls has no basis of making. However, banks are unwilling to be submissive to such injunctions for the sake of maintaining the efficacy and esteem of its instrument, for it is an adage that ‘banks word is it sword’. The English judiciary has taken a drastic measure to the enforcement of such instruments, and it is now a rule that the only excuse to the general rule, that banks must honour first demand bonds ‘*without proof or condition*’, is in situations where the bond is called unjustly,

---

<sup>116</sup> On Demand Bonds – Primary or Secondary Obligation’ (n 18 above) 226-227. See also *The Law Relating to International Banking* (n 2 above) 290

<sup>117</sup> L Adams, ‘New Clots in the Life of International Construction Projects: Enjoining Employers Calls on Performance Bond (2014) 30 Const. LJ 325, 333

and the bank is aware of same. Other instances in which calls has been denied are where the calls or demand are by way of forgery, illegality and or is invalid.<sup>118</sup>

## **Fraud**

The 1941 American case of *Sztejn v Henry Schroder Banking Corp*,<sup>119</sup> brought with it an important development based on compassionate remark from two prior cases, the Supreme Court of New York emphasised that, it would have been an unwarranted invasion of business dealings if banks will be required to investigate the bond instrument at the instance of the buyer before honouring a drafts made upon it by the beneficiary thereby delving itself into a controversy between the parties.<sup>120</sup> The court went further to state that,

*‘Where the sellers fraud has been called to the bank’s attention before the drafts and documents have been presented for payment, the principle of the independence of banks obligation under the letter of credit should not be extended to protect the unscrupulous seller’.*<sup>121</sup>

Some points need to be highlighted with regard to this exception. The first point is that, it has to be observed that, the general rules prohibiting fraud in all aspect of commercial transactions between individuals and its resulting effect or remedies also govern transaction of these nature (i.e bonds or letters of credit), and it is those same principles that should be resorted to. The fraud exception exist as a further remedy considering the fact that, its (bonds/letter of credit) strict compliance rules renders these ordinary rules and the remedies its provides seriously ineffective. The second point is that, the remedy provided by the exception is basically transient, this is because, the fact that an injunction is granted does not mean is the final determination of the parties rights in the underlying contract. This is because, the party against whom an injunction is granted can sue base on the underlying contract on the ground that, he

---

<sup>118</sup> A Haynes, *The Law Relating to International Banking* (Bloomsbury Professional Limited London 2010) 284

<sup>119</sup> 31 NYS 2d 631 (1941)

<sup>120</sup> A Odeke, ‘The Judicial Approach to Injunctions in Letters of Credit and Performance Bond Transaction; The Fraud Exception Re-examined’. (1995) 10 Denning LJ 35, 39

<sup>121</sup> *Sztejn v Henry Schroeder Banking Corp*. 31 NYS 2d 631, 634 (1941)

discharged his own obligation whereas the account party is in breach by seeking the injunction thereby foreclosing payment. Lastly, it is the duty of the account party, not the bank, to file actions for injunction provided he obtain evidence pointing toward fraud attempt by the beneficiary, though such evidence is not easy to obtain in the ordinary course of business.<sup>122</sup>

Sztejn case was followed later in England by the House of Lords in *United City Merchants (Investments) Ltd v Royal Bank of Canada*.<sup>123</sup> Where it was held that,

*‘to this.... There is one established exception, that is where the seller, for the purpose of drawing on the credit, fraudulently presents to the confirming bank documents that contain, expressly or by implication, material representations of fact that to his knowledge are untrue’.*<sup>124</sup>

However, in the above mentioned case, the sellers succeeded based on the fact that, they were not the cause of the fraud and they presented the bills honestly believing same to be valid. The Court of Appeal in *Edward Owen Engineering Ltd v Barclays Bank Ltd*,<sup>125</sup> confirmed the fraud exception to the ‘strict rule’ compliance of bonds instrument (more especially the on demand one) where it is clearly shown that, the demand is tainted with fraud and such comes to the knowledge of the bank. But a successful plea of fraud seems to be a mirage, because in practice, it has always pleaded unsuccessfully.<sup>126</sup> Some of the reasons include;

**Manner and standard of proof;** the cases showed that, high standard of proof are needed. Moreover, the courts distaste the plea of fraud traditionally and this can be discerned from the general rules regarding its plea. Mere allegation of fraud is not enough, the pleader has to proof same by evidence because, in law, the burden is on the person who asserts and that must be very clearly established. A fraudulent call can be perpetuated in two ways. It may be by

---

<sup>122</sup> A Odeke, ‘The Judicial Approach to Injunctions in Letters of Credit and Performance Bond Transaction; The Fraud Exception Re-examined’. (1995) 10 Denning LJ 35, 40

<sup>123</sup> [1983]1 AC 168 (HL)

<sup>124</sup> A Haynes, *The Law Relating to International Banking* (Bloomsbury Professional Limited London 2010) 284

<sup>125</sup> [1978] 1 QB 159 (Lord Denning)

<sup>126</sup> W S Chong, ‘The Abusive Calling of Performance Bonds’ (1990) JBL Sept, 414, 416

presentation of forged or fraudulent document or where no any right exist for demanding payment but yet it is made fraudulently.<sup>127</sup>

**Life blood: Mercantile usage and bank reputation;** the court recognition of commercial importance of performance bond in foreign trade has shown in two concurrent policy grounds. First, performance bonds are the ‘lifeblood of international commerce’, if court step and obstruct this mercantile practice, that will definitely cause problems. Therefore, it is only in rare cases do court intervene to this irrevocable obligation assume by banks. For such confidence will be lost if the banks are prevented from honouring its bond. Kerr J. in *R D Harbottle (Mercantile) Ltd v National Westminster Bank Ltd*,<sup>128</sup> described banks reputation as part of its stock in trade in fulfilling its obligation.

**Bank insulated position;** the difficulty in proving fraud more especially with proving bank knowledge of same considering the latter’s attitude of insulating itself in the underlying contract makes it difficult to prove fraud. Lastly, for the plaintiff to succeed he must equip the bank with knowledge of established fraud before payment to the beneficiary and that will adds more burden in pleading fraud.<sup>129</sup>

The unwarranted and abusive call for payment at the instance of the beneficiary is a potential problem. In practice, it proved to be tasking to be able to convince the guarantors (i.e banks) that the demand made by the beneficiary is fraudulent. Moreover, banks proved to be reluctant in delving into the underlying contract to investigate fraud and to possibly refuse payment. The problems is still unabated by the other contracting party’s strong conviction and subsequent application for an injunction before the court, that the demand is unjustified, for the court is also seems to be unwilling to substitute their own decision to that of the bank.<sup>130</sup>

## Forgery

Forgery in letters of credit and bonds are serious problems, such conduct has been referred to as ‘cancer in international trade’.<sup>131</sup> To this end, it is wrong that

---

<sup>127</sup> Ibid 417

<sup>128</sup> [1978] QB 146, 155

<sup>129</sup> W S Chong, ‘The Abusive Calling of Performance Bonds’ (1990) JBL Sept, 414, 418

<sup>130</sup> A Pugh-Thomas, ‘Letters of Credit – Injunction – The Purist and the Pragmatist: Can a Buyer Bypass the Guarantor and Stop the Seller from Demanding Payment from the Guarantor’ (1996) 11 JIBL 220,213

<sup>131</sup> K Donnelly, ‘Nothing for Nothing: A Nullity Exception in Letters of Credit’ (2008) 4 JBL 316, 339

a beneficiary who tendered a forged document that is nullity to be entitled to payment under it. Likewise, refusal to recognise nullity exception would pave way for the circulation of forged and nullity document in international trade, thus ridiculing the trust which form the background of international trade.

It is debateable as to whether forgery forms part of the area covered by fraudulent claim.<sup>132</sup> Thus, if a claim is made by a beneficiary with a signature other than his own and the bank that is requested to make payment over same became aware of such forgery, the latter should not oblige to such demand, because in law, forged signature is a nullity. However, in practice, if it is a third party that perpetuated the forgery, such may attract different consideration since refusing payment in such circumstances may undermine the commercial reliability of letters of credit. An alternative way to restrict the scope of third party fraud is to determine whether the security of the bank is affected by forgery, if it does affect, payment should be refused.<sup>133</sup> Though Lord Diplock remarked in *United City Merchants Ltd v Royal Bank of Canada*<sup>134</sup> that, ‘*fraud unravel all*’, but in the same case the House of Lords held that, the bank was obliged to pay even though it had knowledge of the fraud since the beneficiary therein lack same and is not in any way connected to such fraud.

The judgement of the House of Lords in the above case goes to show that, forgery committed by a third party, independent of beneficiaries knowledge, cannot be used in denying payment to the beneficiary. These negate the doctrine of strict compliance of an autonomous principle of letters of credit. Professor Goode also criticised the decision and he states that, a bill of lading that has been completed fraudulently does not become a conforming merely because such fraud has been committed by a third party.<sup>135</sup>

Thus, I am in firm support of the reasoning advanced by Goode on the ground that, accepting document forged by a third party in letters of credit or bonds agreements will put the other contracting party in disadvantage position and same conduct would ridicule the efficacy and esteem of letters of credit or bonds agreements.

---

<sup>132</sup> A Haynes, *The Law Relating to International Banking* (Bloomsbury Professional Limited London 2010) 289

<sup>133</sup> H Y Low, ‘Confusion and Difficulties Surrounding the Fraud Rule in Letters of Credit: an English Perspective’. (2011) 17 JIML 462, 469

<sup>134</sup> [1983] 1 AC 168

<sup>135</sup> R Goode, ‘Reflections on Letters of Credit’ (1980) 1 JBL 291, 294

## Nullity

The concept of nullity has faced with the problem of definition, this is because any formulation of nullity exception will certainly oblige bank wishing to refuse payment on such exception to show that the document in question is a nullity. The concept is not developed in law relating to documentary credit and as such since a workable definition of it cannot be established, this shows a strong argument against recognising nullity exception.<sup>136</sup>

Since banks are usually confronted with matters of whether a document is a nullity or not, it is expected that, such matter has been determined. However, such is yet to be the case. English cases exists which shows the uncertainty in regard to when a documentary letter of credit will be regarded as a nullity. For e.g different views exist as to the degree of falsity required before a bill of lading be rejected by the bank as constituting a sufficient serious nullity. Devlin J. in *Kwei Tek Chao v British Traders and Shippers*,<sup>137</sup> opined that a misdated bill of lading is ‘valueless but not a complete nullity’, whereas in *Egyptian International Foreign Trade Co v Soplex Wholesale Supplies*,<sup>138</sup> Leggatt J. described a misdated bill that coupled with a misstatement about the vessels name as ‘sham piece of paper’,<sup>139</sup>

Therefore, nullity or null documents are those kinds of documents that were created, with or without fraudulent intent, which is void ab initio as a result of defect contain in it.<sup>140</sup> Once a documentary letter of credit contain defect in it, it’s erode the importance of such document and render same worthless. Enonchong categorised null documents into forged documents that are nullities (created with fraudulent intent), and those created innocently that are nullities.<sup>141</sup> With regard to former, if the beneficiary partake in or have knowledge of such forgery, the situation falls under the fraud rule and that will entitle the bank to deny payment, but where the forgery is unknown to the beneficiary, the situation is less clear.

The above are some of the risks associated with standby letters of credit and performance bonds. Like I mentioned earlier, the most usual risk in letters of

---

<sup>136</sup> K Donnelly, ‘Nothing for Nothing: A Nullity Exception in Letters of Credit’ (2008) 4 JBL 316, 317

<sup>137</sup> [1954]2 QB 459

<sup>138</sup> [1984] 1 Lyoids Rep 102

<sup>139</sup> K Donnelly, ‘Nothing for Nothing: A Nullity Exception in Letters of Credit’ (2008) 4 JBL 316, 317

<sup>140</sup> A M Anthoniou, ‘Nullities in Letters of Credit: Extending Fraud Exception’. (2014) 29 (4) JIBLR 232

<sup>141</sup> N Enonchong, *The Independent Principles of Letters of Letters of Credit and Demand Guarantees* (OUP 1<sup>st</sup> edn 2011) 145-149

credit and bonds related contract is an unfair and abusive call of an on demand bonds. Such has to be protected in order to maintain the efficacy and esteem of the international letters of credit and bonds agreements.

## CONCLUSION/RECOMMENDATION

In conclusion, the possibility of making an unfair call by the beneficiary in bonds, more particularly in performance bonds, can be reduce by inserting the following clauses in the underlying contracts:

**Beneficiaries written statement of contractors default;** the bond should make it a condition precedent that, the beneficiary should, before making calls, serve the bank with a written statement of contractors default and that should also state the reasons of the beneficiaries assertion. That can be used by the contractor against the beneficiary in prosecuting civil claims if such statements are untrue.

**Contract administrators default notice;** the beneficiary would be oblige by bond to, as a condition precedent to payment, furnish the bank with a contract administrators default notice.<sup>142</sup>

**Conditions in underlying contract;** conditions be provided in the underlying contract governing the circumstances that will entitled the beneficiary to press a demand. Similar conditions are provided in Standard Australia contracts e.g. (Clause 5.5 of AS 2124-1992),<sup>143</sup> thus affording the contractor an opportunity to protest the call made by the beneficiary. The clause if inserted would oblige beneficiary to inform the contractor before time of any demand the former intent to make which invariably afford the latter an opportunity to oppose same before the court.

**Reduction mechanism;** the bond should include reduction formula whereby the amount be decrease proportionate to performance.

**Beneficiary's bond;** condition be imposed on the beneficiary that, while making demand, he should procure a bond in favour of the contractor on similar terms as performance bond so that it should serve as a security to contractor that would guarantee re-imburement if it turns out that the beneficiary's demand is unjustified.<sup>144</sup>

---

<sup>142</sup> J Lurie, 'On Demand Performance Bonds: Reducing the Risk of Abuse' (2008) 161 (3) MPAL 121, 122

<sup>143</sup> Standards Australia. General Conditions of Contract. Standard Australia International, Sydney 1992

<sup>144</sup> J Lurie, 'On Demand Performance Bonds: Reducing the Risk of Abuse' (2008) 161 (3) MPAL 121, 123

**Governing law and jurisdiction;** the determination of applicable law and forum is essential in construction contract because parties may reside in different jurisdiction. Therefore, choice of law and forum is vital in order to avoid not only the likely problems of conflict of laws but to have sense of security against risk in payment under the underlying contract.

## REFERENCES

### Books

- Chua, C T, *Law of International Trade: Cross Border Commercial Transaction* (4<sup>th</sup> edn Sweet & Maxwell 2009)
- Enonchong, N, *The Independence Principles of Letters of Credit and Demand Guarantees* (OUP 1<sup>st</sup> edn 2011)
- Haynes, A, *The Law Relating to International Banking* (Bloomsbury Professional Limited, Haywards Heath, West Sussex 2010)

### Journal

- Adams, L, 'New Clots in the Life of International Construction Projects: Enjoining Employers Calls on Performance Bond' (2014) 30 Const. L J 325, 335
- Anthoniou, A M, 'Nullities in Letters of Credit: Extending Fraud Exception'. (2014) 29 (4) JIBLR 232
- Chong, W S, 'The Abusive Calling of Performance Bonds' (1990) JBL Sept, 414, 416
- David, B J, 'How to Guarantee Contractor Performance on International Construction Projects: Comparing Surety Bonds with Bank Guarantees and Standby Letters of Credit' (2005) 37 GWU 51-108
- Donnelly, K 'Nothing for Nothing: A Nullity Exception in Letters of Credit' (2008) 4 JBL 316, 339
- Goode, R, 'Abstract Payment Undertaking in International Transaction' (1996) 22 BJIL 15
- Goode, R, 'Reflections on Letters of Credit' (1980) 1 JBL 291, 294
- Low, H Y, 'Confusion and Difficulties Surrounding the Fraud Rule in Letters of Credit: an English Perspective'. (2011) 17 JIML 462, 469
- Lurie, J, 'On Demand Performance Bonds: Reducing the Risk of Abuse' (2008) 161 (3) MPAL 121, 122
- M Stern, 'The Independence Rule in Standby Letters of Credit' (1985) 52 UCLR 28
- Mann, R J, 'The Role of Letters of Credit in Payment Transactions' (2000) 98 MLR 406
- Odeke, A, 'The Judicial Approach to Injunctions in Letters of Credit and Performance Bond Transaction; The Fraud Exception Re-examined'. (1995) 10 Denning LJ 35, 39
- Penn, G A, 'On Demand Bonds – Primary or Secondary Obligation', (1986) 1 (4) JIBL 224 230
- Pike, R, 'Security of Performance-Bonds and Guarantee' (2013) Construction Newsletter Feb. 5-6, 1
- Pugh-Thomas, A, 'Letters of Credit – Injunction – The Purist and the Pragmatist: Can a Buyer Bypass the Guarantor and Stop the Seller from Demanding Payment from the Guarantor' (1996) 11 JIBL 220,213



## Cases

*Edward Owen Engineering Ltd v Barclays Bank International* [1978] 1 QB 159

*Egyptian International Foreign Trade Co v Soplex Wholesale Supplies* [1984] 1 Lloyds Rep 102

*Esal (Commodities) Ltd and Reltor Ltd v Oriental Credit Ltd and Wells Fargo Banks* [1985] 2 Lloyds Rep 546

*Frans Maas v Habib Bank* [2001] Lloyds Rep Bank 14

*Kwei Tek Chao v British Traders and Shippers* [1954] 2 QB 459

*Marubeni Hong Kong & South China Ltd v Mongolian Government* [2005] EWCA Civ 395,

*R D Harbottle (Mercantile) Ltd v National Westminster Bank Ltd* [1978] QB 146

*Sztejn v Henry Schroder Banking Corp* 31 NYS 2d 631 (1941)

*Trafalgar House Construction (Regions) Ltd v General Surety and Guarantee Co Ltd.* [1995] 3 All ER 737

*United City Merchants (Investments) Ltd v Royal Bank of Canada* [1983] 1 AC 168

## Table of Statute

Partnership Act, 1890