Feature

KEY POINTS

- The reflex reaction of autonomy does not always procure the most just result, even if it appears to afford a form of commercial certainty.
- Where a certification exercise is required, there is clearly a legal and factual interconnection between the underlying contractual arrangements and the enforceability of the standby.
- There is no judicial traction for a further ground of "unconscionability" in addition to the so-called fraud exception.

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Standby letters of credit, the "fraud" exception and commercial certainty – English law orthodoxy challenged

Recent cases have highlighted perceived problems caused by the largely unfettered availability of calls on standby letters of credit or performance bonds in circumstances where the underlying parties are already embroiled in some form of relevant dispute resolution procedure. In this article, Andrew Ayres QC questions the reluctance of the courts to interfere with the cashflow dynamics between the parties to a standby.

The recent cases of *Petrosaudi Oil Services (Venezuela) Ltd v Novo Banco S.A.* [2017] EWCA Civ 9 and *NIDCO v Banco Santander* [2017] EWCA 27, [2016] EWHC 2990 (Comm), decided almost on the same day in January 2017, have highlighted on the part of some finance stakeholders perceived problems caused by the largely unfettered availability of calls on standby letters of credit or performance bonds in circumstances where the underlying parties, the applicant and the beneficiary, are already embroiled in some form of relevant dispute resolution procedure. One might ask the question: what commercial purpose or finance policy objective is served by changing the cashflow dynamics between two parties already fully engaged in a process which will determine conclusively their liability to one another in relation to the very issue or issues to which the standby or bond is directed? Once that liability is determined, and subject to its terms, the standby or bond can be used in part or in full to satisfy any adjudicated liability, and all parties, including the applicant and the participating banks, will be protected and properly served.

The answer to this question often given, and the current orthodoxy now reinforced by the two 2017 English Court of Appeal cases, is that such a question is simply irrelevant and proceeds on the basis of a "category" error:

(a) standbys perform a specific purpose, being equivalent to cash;
(b) they are part of the settled bundle of rights, obligations and "security" available to the parties, should they so choose to enter into them at the inception or during the currency of a project, trade or transaction; and
(c) banks, as much for their own protection as for the protection of the underlying parties, are not concerned with the rights or wrongs of the underlying dispute but only with the performance of the obligations which they themselves have voluntarily confirmed.

A different answer might be that deviations from the principle of "autonomy", like the so-called "fraud" exception, are part of a wider policy objective such that calls on standbys or performance bonds must always serve a legitimate commercial purpose consistent with the underlying circumstances of the project, trade or transaction; whether one wants to put that in terms of "fraud" or "unconscionability" or some other label, the reflex reaction of autonomy does not always procure the most just result, even if it appears to afford a form of commercial certainty. That is particularly so in those cases where the "autonomous" nature of the standby or bond is under greatest strain.

It is important to recognise that, from the point of view of understanding where English law currently stands, there is no change to the orthodoxy. In both recent cases, reliance on the so-called "fraud" exception, based upon challenging an honest belief on the part of the beneficiary in the enforceability of the relevant underlying financial obligation, failed albeit for different reasons. The principle of autonomy, whereby the sanctity of the standby contract as an agreement separate from the underlying commercial arrangements and thus independently enforceable, remains closely respected and is the guiding and almost overriding driver: see also the Privy Council in *Mauri Garments Trading and Marketing Ltd v Mauritius Commercial Bank Ltd* [2015] UKPC 14, an indemnity case. It is not hard to see why the court should lean against being swayed by claims by the applicant or by a confirming bank to the effect that payment under a standby or a bond should not be honoured, or honoured immediately. But some clear dissonance arises when standbys are used to procure payment where there remains some real uncertainty about the entitlement of the beneficiary to payment from the applicant, and that uncertainty is shortly to be resolved.

PETROSAUDI

Petrosaudi concerned a contractually required certificate by the beneficiary of the right to receive payment ('[w]e certify that the applicant is obligated to the beneficiary … to pay the amount demanded under the drilling contract'), which was asserted to have been fraudulently made. The applicant, resisting payment, succeeded at first instance in preventing payment by the bank, but the English Court of Appeal overturned that decision. The parties were already involved in arbitration, and the tribunal had issued a

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partial award to the effect that Venezuelan law, which was contractually incorporated, did not permit payment until a State authorisation process had occurred. This led the judge at a first instance trial to take a robust view of the accuracy of the demand for payment (to the effect that the applicant was not obligated to pay because no sum was then due and owing) and, in that light, of the bona fides of the beneficiary in asking for payment. In the Court of Appeal, however, Christopher Clarke LJ, in one of his last cases on the bench before retirement from full-time sitting, found that the statement of an obligation to pay was true and thus there was no question as to the state of mind of the beneficiary.

NIDCO

NIDCO v Banco Santander related to a major highway project on the island of Trinidad. The beneficiary was contractually required by the standbys to certify to the confirming bank that the sums which it was demanding from the bank were "due and owing" from the applicant. The underlying parties to the construction project fell out and one of the points taken by the bank was that the beneficiary could not have had an honest belief in the required statement on the basis of what was said to be revealed by the available evidence and given that the dispute between the parties was the subject matter of an extant arbitration which would, soon enough, determine the rights and liabilities between them. The English Commercial Court disagreed with these arguments, and granted summary judgment on all the standbys.

The English Court of Appeal clarified a small but important point as to the correct test for summary judgment in standby or performance bonds cases: it is not whether it was seriously arguable that, on the material available, the only realistic inference was that the beneficiary could not honestly have believed in the validity of its demands (a heightened test which, together with knowledge on the part of the bank, applies in the context of seeking prior injunctive relief to halt payment: *Alternative Power Solution Ltd v Central Electricity Board* [2014] UKPC 31), but whether any of the defences put forward had a real prospect of success, the normal test for a claimant's summary judgment in the English court (confirming Teare J at first instance in *Enka Insaat Ve Sanayi A.S. v Banca Popolare Dell'Alto Adige SpA* [2009] EWHC 2410 (Comm) [24–25]). As for the substance, the court dismissed the appeal in robust terms:

> 'No doubt lawyers can have a debate as to whether a current entitlement to claim damages for repudiation entitles one to say that the amount of such damages is due and owing (and I have summarised my own views on that interesting question above) but it borders on the absurd to say that the only realistic inference from the fact that businessman did not have (or may not have had) that debate is that they could not have believed in the validity of their demands.'

Instead of granting a stay of execution or otherwise allowing the arbitration to determine whether any particular sum was "due and owing" in circumstances where there was clearly a reasonable debate which could be had among both lawyers and non-lawyers about the beneficiary's entitlement to repudiation damages, the court simply shut down the ability of the bank to challenge the basis upon which the beneficiary honestly believed that monies were due and owing, thus attenuating the certification exercise to a box-ticking exercise.

But where such a certification exercise is required, there is clearly a legal and factual interconnection between the underlying contractual arrangements and the enforceability of the standby. This linkage means that it is impossible to view the standby as completely independent.

In neither of the above cases was there any real prospect of the English court considering the approaches taken by some common law jurisdictions, notably Singapore, to distinguish between letters of credit, which are used to settle primary payment obligations, and standby letters of credit and performance bonds, which are used to secure performance obligations. The former clearly are the life blood of commerce; the latter are not: see *JBE Properties Pte Ltd v Gammon Pte Ltd* [2010] SGCA 46 at [10] and *Arab Banking Corp (B.S.C.) v Boustead Singapore Ltd* [2016] SGCA 26 at [100–105]. This has been subject to some academic comment, but there appears to be no appetite in England for allowing obligations to be held in abeyance (perhaps by using stays or stays of execution on conditions) in order to do justice between the parties where the obligations are of a "security" nature and the parties are already engaged in a proper dispute resolution procedure.

CONCLUSION

Interference with standby letters of credit or performance bonds is rightly rare and subject to a high level of judicial tolerance. Kerr J said in *Harbottle v National Westminster Bank Ltd* [1978] QB 146 at 155:

> 'It is only in exceptional cases that the courts will interfere with the machinery of irrevocable obligations assumed by banks. They are the lifeblood of international commerce… Except possibly in clear cases of fraud … the courts will leave the merchants to settle their disputes under the contracts by litigation or arbitration as available to them in stipulated contracts.'

But where the "merchants" are already in the process of settling their disputes by litigation or arbitration, it is more difficult to see what commercial purpose is fulfilled other than to fulfil the cashflow expectations of the parties, a dynamic which may be subject to change soon thereafter. Clearly, there must be a mechanism to deal with those cases where a dispute is merely engineered, but it may be time for English law to recognise that international commercial certainty can still incorporate a more flexible, nuanced and rationalist approach to the role of standbys and bonds when the circumstances require. ■

Further Reading:

- Testing the principle of autonomy in letters of credit [2012] 10 JIBFL 615.
- Standby letters of credit [2008] 3 JIBFL 150.
- LexisNexis Loan Ranger blog: Letters of credit and the fraud exception (*Petrosaudi Oil Services (Venezuela) Ltd v Novo Banco SA and others*).