

**Sacrificing the Utility of Counter-Guarantees and Counter Standby  
Letters of Credit for International Infrastructure Projects by  
Neglecting the Virtues of Strict Adherence to the Independence  
Principle: *American Express Bank Ltd. v. Banco Espanol de Credito***

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**Introduction**

From harbors to hospitals, major infrastructure projects in developing countries transform local landscapes with a promise to provide vital services to millions of people all over the globe while offering investors access to highly lucrative construction markets in those parts of the world. But large-scale infrastructure projects involve a complex nexus of a multitude of contracts among various entities from different countries.<sup>1</sup> The need for long-term coordination of action among the multitude of actors from all over the world involved in such construction projects adds to their considerable riskiness.<sup>2</sup> One key factor facilitating the completion of these projects is the ability of the project owners to hedge against the significant risk of non-performance by obtaining independent guarantees or standby letters of credit (“standbys”) from financial institutions located in the host country where the project is being built.<sup>3</sup> These two undertakings

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<sup>1</sup> See David J. Barru, *How to Guarantee Contractor Performance on International Construction Projects: Comparing Surety Bonds with Bank Guarantees and Standby Letters of Credit*, 37 GEO. WASH. INT'L L. REV. 51, 52 (2005).

<sup>2</sup> *Id.*; see ROELAND BERTRAMS, *BANK GUARANTEE IN INTERNATIONAL TRADE: THE LAW AND PRACTICE OF INDEPENDENT (FIRST DEMAND) GUARANTEES AND STANDBY LETTERS OF CREDIT IN CIVIL LAW AND COMMON LAW JURISDICTIONS 2* (3d ed. 2004).

<sup>3</sup> See, e.g., *Foxboro Co. v. Arabian American Oil Co.*, 805 F.2d 34, 36 (1st Cir. 1986); see also JAMES E. BYRNE, *HAWKLAND UNIFORM COMMERCIAL CODE SERIES, VOLUME 6B, [REV.] ARTICLE 5 LETTERS OF CREDIT, § 5-102:55* (West Group Pub. 2010) [hereinafter *HAWKLAND*]; BERTRAMS, *supra* note 2, at 2-3; Barru, *supra* note 1, at 51, 95-96. An independent guarantee or a standby can be formally defined as an irrevocable, definite undertaking by issuer of a standby or independent guarantee to pay upon the presentation by the beneficiary of the documents required by the terms of the standby or independent guarantee, such as a certificate of default, that the beneficiary prepares for its own benefit, alleging that the person who applied for issuance of a standby or independent guarantee defaulted on or failed to perform the underlying contract. *HAWKLAND*, §§ 5-105:125, 5-

have emerged at the same time, serve similar function, namely the furnishing of security to assure performance, and are equivalent at the abstract level of law.<sup>4</sup> Both types of undertakings belong to the letter of credit family of independent undertakings which also includes commercial letters of credit.<sup>5</sup>

Independent guarantees and standbys safeguard against the risk of non-performance because they, being governed by the independence (autonomy) principle, are available even when there are disputes about performance or propriety of payment.<sup>6</sup> According to this principle, the independent guarantee or standby issuer's obligation to pay the beneficiary upon proper demand under the undertaking is not affected by events arising out of the underlying contract.<sup>7</sup> The result is that the independence principle

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105:126; International Chamber of Commerce, *The International Standby Practices (ISP98)*, Rule 1.06, ICC Publication No. 590 (Jan. 1, 1999) [hereinafter ISP98]; *American Express*, 597 F. Supp. 2d at 401–02; Hendry D. Gabriel, *Standby Letters of Credit: Does the Risk Outweigh the Benefits?*, 1988 COLUM. BUS. L. REV. 705, 709 (1988). Importantly, the two types of undertakings do not represent a demand for immediate payment for a transaction in goods or services. HAWKLAND §§ 5-105:125, 5-105:126.

<sup>4</sup> HAWKLAND, *supra* note 3, § 5-101:6; BERTRAMS, *supra* note 2, at 7. Unlike standbys, however, which evolved from the commercial letter of credit, a quintessentially independent undertaking, the matrix for “independent” guarantees was a suretyship or accessory guarantee, an inherently dependent undertaking. HAWKLAND, *supra* note 3, § 5-102:134. Note that there are multitude of names that refer to these types of independent undertakings including bank guarantees, independent bank guarantees, demand guarantees, international demand guarantees, simple demand guarantees and performance guarantees. Barru, *supra* note 1, at 66. A dependent undertaking, such as accessory guarantee or suretyship, means that the accessory guarantor can invoke defenses derived from the contract except to the extent excluded. See BERTRAMS, *supra* note 2, at 2. Independent undertakings by contrast are abstracted from the underlying contract as a class. See HAWKLAND, *supra* note 3, § 5-102:131.

<sup>5</sup> HAWKLAND, *supra* note 3, § 5-103:2.

<sup>6</sup> *Sztejn v. J. Henry Shroder Banking Corp.*, 31 N.Y.S.2d 631, 634–35 (N.Y. Sup. Ct. 1941); BERTRAMS, *supra* note 2, at 2–3, 12; see *Roman Ceramics Corp. v. Peoples Nat'l Bank*, 714 F.2d 1207, 1213 (3d Cir. 1983) (quoting *Intraworld Indus. Inc. v. Girard Trust Bank*, 336 A.2d 316, 323–24 (Pa. 1975)); Barru, *supra* note 1, at 89 (“The independence principle is intended to promote the commercial vitality of letters of credit and bank guarantees by ensuring the beneficiary quick easy payment so long as conforming documents are presented to the issuing bank. The bank’s role is limited to the ministerial function of reviewing the documents for conformance with the terms of credit.”).

<sup>7</sup> BERTRAMS, *supra* note 2, at 11; Ross P. Buckley and Gao Xiang, *The Unique Jurisprudence of Letters of Credit: Its Origin and Sources*, 4 SAN DIEGO INT'L L.J. 91, 118–19 (2003); see International Chamber of Commerce, *ICC Uniform Rules for Demand*

assures the beneficiary of an independent guarantee or standby the benefit of money in hand before any litigation over the underlying contract occurs.<sup>8</sup> In letters of credit, the independent character of the undertaking is linked to its documentary nature.<sup>9</sup> The very core of the concept of independence is reliance on representations embodied in documents without seeking to determine ultimate facts. Rev. UCC Article 5,<sup>10</sup> and private sets of rules for independent undertakings promulgated under the auspices of the International Chamber of Commerce (“ICC”), UCP600<sup>11</sup>, ISP98<sup>12</sup>, and URDG 758<sup>13</sup>, all expressly incorporate the independence principle.

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*Guarantees (URDG 758)*, Art. 5, ICC Publication No. 758 (July 1, 2010) [hereinafter URDG 758]; International Chamber of Commerce, *The Uniform Customs and Practice for Documentary Credits (UCP600)*, Art. 4, ICC Publication No. 600 (July 1, 2007) [hereinafter UCP600]; ISP98, *supra* note 3, Rule 1.06, 1.07; Rev. U.C.C. § 5-103(d) (1995).

<sup>8</sup> *Southern Energy Homes, Inc. v. AmSouth Bank of Alabama*, 709 So. 2d 1180, 1185–87 (Ala. 1998) (citing JOHN DOLAN, *THE LAW OF LETTER OF CREDIT: COMMERCIAL AND STANDBY CREDITS* (REV. ED. 1996)); see Michael Stern, *The Independence Rule in Standby Letters of Credit*, 52 U. CHI. L. REV. 218, 241 (1985) (the important purpose of the letter of credit is to shift “the risk of litigation and avoid expensive premature procedures that test the propriety of a demand.”). The ability of beneficiary to obtain funds before commencement of dispute with the applicant encourages hesitant beneficiaries to enter into international contracts by allowing the beneficiaries to shift onto the applicant the risk of having to bring a claim and the risk that the beneficiary will demand payment under the independent guarantee or standby without justification. *Southern Energy Homes*, 709 So. 2d at 1186–87 (quoting *AmSouth Bank, N.A. v. Martin*, 559 So. 2d 1058, 1062 (Ala. 1990)). At the same time, by making applicants bear some of the risk of default, independent guarantees and standbys provide applicants with forceful incentive to fully perform. See BERTRAMS, *supra* note 2, at 14; Barru, *supra* note 1, at 61–63.

<sup>9</sup> HAWKLAND, *supra* note 3, § 5-103:2.

<sup>10</sup> Rev. U.C.C. § 5-103(d) (1995) (Scope) (“Rights and obligations of an issuer to a beneficiary . . . under a letter of credit are independent of the existence, performance, or nonperformance of a contract or arrangement out which the letter of credit arises or which underlies it, including contracts or arrangements between the issuer and the applicant and between the applicant and the beneficiary.”).

<sup>11</sup> UCP600, *supra* note 7, Art. 4 (“A beneficiary can in no case avail itself of the contractual relationships existing between banks or between the applicant and the issuing bank.”).

<sup>12</sup> ISP98, *supra* note 3, Rule 1.06, 1.07 (affirming the independent, documentary, and binding character of ISP standbys).

<sup>13</sup> URDG 758, *supra* note 7, Art. 5(a) (“A guarantee is by its nature independent of the underlying relationship and the application, and the guarantor is in no way concerned or bound by such relationship.”).

The independence principle is not absolute. The most important exception to the principle is the doctrine of fraud in the transaction.<sup>14</sup> The fraud rule establishes circumstances under which the bank might be required to take into account performance of the underlying contract and under which courts may enjoin payments under a letter of credit.<sup>15</sup>

The independence principle is also the cornerstone of independent undertakings in the form of counter-guarantees and counter-standbys which play a particularly important role in facilitating large-scale infrastructure projects in the developing world.<sup>16</sup> Specifically, a counter-guarantee/counter-standby is a cash-like promise that in turn enables the issuance of independent guarantee/standbys to local beneficiaries from banks located within the beneficiary government's territorial jurisdiction.<sup>17</sup> A counter-guarantee or counter-standby arrangement adds an additional layer of obligations to the typical three separate obligations between applicant and beneficiary, applicant and issuing bank, and issuing bank and beneficiary characteristic of independent guarantees and standby letters of

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<sup>14</sup> Barru, *supra* note 1, at 82–83. *See infra* Part II.B.1

<sup>15</sup> Jacqueline D. Lipton, *Documentary Credit Law and Practice in the Global Information Age*, 22 *FORDHAM INT'L L.J.* 1972, 1979 (1999). Courts have recognized that proliferation of letter of credit fraud threatens their utility no less than the erosion of the independence principle. *See* *Itek Corp. v. First Nat. Bank of Boston*, 511 F. Supp. 1341, 1351 (D. Mass. 1981) (“[T]he failure to issue an injunction where otherwise appropriate would send a clear signal to those inclined to engage in fraudulent activities that they are likely to be rewarded. Such a result would have an even greater adverse impact upon issuing banks and ultimately discourage the use of letter of credit.”), *aff'd*, 730 F.2d 19 (1st Cir. 1984); *Dynamics Corp. of America v. Citizens and Southern Nat. Bank*, 356 F. Supp. 991, 1000 (N.D. Ga. 1973) (“[T]here is as much public interest in discouraging fraud as in encouraging the use of letters of credit.”). On the other hand, because the fraud rule strikes at the heart of the independence principle, an overly expansive fraud rule also threatens the commercial viability of letters of credit. *See* Ross P. Buckley and Gao Xiang, *A Comparative Analysis of the Standard of Fraud Required Under the Fraud Rule in Letter of Credit Law*, 13 *DUKE J. COMP. & INT'L L.* 293, 333–34 (2003).

<sup>16</sup> BERTRAMS, *supra* note 2, at 18–19, 196.

<sup>17</sup> *See* HAWKLAND, *supra* note 3, §§ 5-101:6, 5-102:55; Barru, *supra* note 1, n.248 (quoting BROOKE WUNNICKE ET AL., *STANDBY AND COMMERCIAL LETTERS OF CREDIT* 2.08, at 2-56 (3d ed. 2000 & 2004 Supp.)) (“In some countries and for some projects, a bank guarantee is required to be issued by a bank in the host country. The bank may refuse to do so without a supporting guarantee from another bank. The latter guarantee is known as a counter-guarantee and could take the form of a standby letter of credit issued by a U.S. bank.”).

credit.<sup>18</sup> Under a counter-guarantee/counter-standby arrangement the local bank becomes the beneficiary of the counter-guarantee/counter-standby (“local bank”) and applicant’s bank issues and undertakes to honor the counter-guarantee/counter-standby upon a complying presentation (“counter-guarantor”, “issuer of counter-standby”).<sup>19</sup> This arrangement became prevalent in international project finance because beneficiaries located in developing countries are often leery of working with unfamiliar foreign institutions and prefer to deal with a bank located within the beneficiary country’s jurisdiction.<sup>20</sup> Banks located in the beneficiary’s country are willing to issue a separate undertaking in favor of the beneficiary, a Middle Eastern company for example, if the applicant’s bank assures the local bank’s separate undertaking by issuing a counter-guarantee/counter-standby naming the local bank as beneficiary.<sup>21</sup> The counter-guarantor/issuer of counter-standby agrees to reimburse the local bank upon complying with the terms of the counter-guarantee/counter-standby.<sup>22</sup> Importantly, although the local undertaking need not be independent, the undertaking of the local bank that is the beneficiary of the counter-guarantee/counter-standby is independent from that of the counter-guarantor/issuer of the counter-standby.<sup>23</sup> ISP98 and URDG 758, the ICC-

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<sup>18</sup> *Enesco Env'tl. Serv. V. United States*, 650 F. Supp 583, 588 (W.D. Mo. 1986); Buckley & Xiang, *supra* note 7, at 98. The three obligations consist of (i) the underlying contract between the beneficiary and the applicant/principal; (ii) the contract between the applicant/principal and the bank issuing the independent guarantee or standby in favor of the beneficiary, describing the terms the issuer must incorporate into the credit and establishing the reimbursement agreement between applicant/principal and issuer; and (iii) the issuing bank’s obligation to pay the beneficiary of the independent guarantee or standby upon proper demand. HAWKLAND, *supra* note 3, § 5-102:126; BERTRAMS, *supra* note 2, at 18–20; Lipton, *supra* note 15, at 1973.

<sup>19</sup> See HAWKLAND, *supra* note 3, § 5-102:126.

<sup>20</sup> *American Express Bank, Ltd. v. Banco Espanol de Credito*, 597 F. Supp 2d. 394, 398 (S.D.N.Y. 2009) (citing JOHN DOLAN, *THE LAW OF LETTER OF CREDIT: COMMERCIAL AND STANDBY CREDITS 1-16* (REV. ED. 1996)); HAWKLAND, *supra* note 3, § 5-102:55 (“This practice emerged as a result of the experience of Middle Eastern companies and governments with excessive issuance of injunctions and similar orders issued by Western courts, including those in the US. It has effectively immunized Middle Eastern counter parties by enabling them to draw on undertakings issued subject to their own law issued by banks subject to their jurisdiction.”).

<sup>21</sup> HAWKLAND, *supra* note 3, § 5-102:55.

<sup>22</sup> BERTRAMS, *supra* note 2, at 196.

<sup>23</sup> HAWKLAND, *supra* note 3, §§ 5-102:55, 5-102:126.

endorsed rules designed to govern independent guarantees and standbys, respectively, expressly recognize the independence of the counter-standby or counter-guarantee from any local undertaking issued by the beneficiary of the counter-guarantee or counter-standby.<sup>24</sup>

However, the commercial utility of counter-guarantees/counter-standbys is not invulnerable. Contrary to the limitations imposed by the independence principle, applicants and issuers of independent undertakings do attempt to invoke the status of the underlying contract to prevent honor of the undertakings when disputes over that contract erupt.<sup>25</sup> Given that the independence principle is the source of commercial vitality of counter-guarantees/counter-standbys, judicial circumvention of the independence principle warrants caution because any such action potentially risks eroding the commercial utility of these types of undertakings.<sup>26</sup>

In *American Express Bank Ltd. v. Banco Espanol de Credito*<sup>27</sup> the United States District Court for the Southern District of New York (“district court”) confronted such a situation where the dispute in the underlying international construction contract between an applicant and a beneficiary from different countries lead to cancellation of the beneficiary’s

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<sup>24</sup> URDG 758, *supra* note 7, Art. 5(b) (“A counter-guarantee is by its nature independent of the guarantee, the underlying relationship, the application and any other counter-guarantee to which it relates, and the counter-guarantor is in no way concerned with or bound by such relationship.”); ISP98, *supra* note 3, Rule 4.21; JAMES E. BYRNE, THE OFFICIAL COMMENTARY ON THE INTERNATIONAL STANDBY PRACTICES 197 (1998) (A “counter-standby” may recite or even contain in an exhibit the terms of the separate undertaking, and the request that the standby beneficiary (Bank X) issue the undertaking. [Rule 4.21] affirms the understanding of the standby community that these two undertakings are separate and independent from one another, and the standby issuer has no relationship with the beneficiary (Bank X) other than that evidenced by the standby itself.”). Although Rev. U.C.C. Article 5 does not expressly address counter-guarantees or counter-standbys, it incorporates inferentially the independence of local undertaking from the counter-guarantee/standby by virtue of encompassing independent guarantees and standbys. See HAWKLAND, *supra* note 3, § 5-102:55.

<sup>25</sup> See Buckley & Xiang, *supra* note 15, at 308–09 (“In the commercial world, there are almost limitless ways in which an applicant’s bargain with a beneficiary may go sour. When this happens, the applicant will be tempted to use every means to escape from its original bargain.”).

<sup>26</sup> See *Roman Ceramics*, 714 F.2d at 1213; *Southern Energy Homes*, 709 So. 2d at 1185–86; Barru, *supra* note 1, at 88–89.

<sup>27</sup> 597 F. Supp 2d. 394 (S.D.N.Y. 2009).

independent guarantees and to an injunction to prevent the honoring of local bank's counter-guarantee.<sup>28</sup> The district court incorrectly held that the local bank does not have a right to immediate payment under its counter-guarantees regardless of whether the local bank has paid the beneficiary under its independent guarantees and despite its refusal to do so.<sup>29</sup> The court reasoned that in light of the ICC arbitral award in favor of the applicant, under Rev. UCC § 5-109 (Forgery and Fraud) the beneficiary lacked "any basis in law or fact" to demand payment under the independent guarantees.<sup>30</sup> Accordingly, the district court reasoned that the local bank had no obligation to pay the beneficiary under the beneficiary's independent guarantees. Therefore, the district court concluded that until a court of law vacates or modifies the arbitral award, neither the beneficiary nor the local bank has a "colorable right" to demand honor of the independent guarantees and counter-guarantees, respectively.<sup>31</sup>

The district court's ruling unduly circumscribed the independence principle by making the ability of local banks to obtain payment under their counter-guarantees/counter-standbys be noticeably sensitive to the status of the underlying construction contract. To demonstrate this, Part I will present the Statement of the Case. Part II, the analysis section, will then show that relying on decisions of arbitral panels concerning the underlying contract as basis for not enforcing payment obligations under independent guarantees/standbys and counter-guarantees/counter-standbys is not well grounded in contract law, international law, standard international letter of credit practice and New York law. Part II will show that contrary to the independent nature of the relationship between the local undertaking and the counter-guarantee/counter-standby, the district court effectively treated the two undertakings as dependent, thereby conflating them. This part will

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<sup>28</sup> *Id.* at 402. Legal decisions coming out of New York State on letters of credit issues have significant impact on that area of jurisprudence and practice. New York is a major world commercial and financial center having highly developed commercial law and as such generates a considerable amount of letter of credit case law. *Banco Nacional De Mexico, S.A. v. Societe Generale*, 820 N.Y.S.2d 588, 592 (N.Y. App. Div. 2006) ("As a primary financial center and a clearinghouse of international transaction, the state of New York has a strong interest in maintaining its preeminent financial position and in protecting the justifiable expectation of the parties who choose New York law as the governing law of a letter of credit."). See SCOTT L. HOFFMAN, *THE LAW AND BUSINESS OF INTERNATIONAL PROJECT FINANCE*, 409 (3d ed. 2008).

<sup>29</sup> *American Express*, 597 F. Supp. 2d at 400, 403–05.

<sup>30</sup> *Id.* at 403.

<sup>31</sup> *Id.*

also demonstrate that the district court failed to properly observe the case law-developed standard for issuing injunctions when the court effectively upheld (i) the Spanish court's injunction to prevent the counter-guarantor from honoring the local bank's counter-guarantee; and (ii) the ICC arbitral panel's decision directing the beneficiary to cancel the beneficiary's independent guarantees. Finally, this part will argue that the district court's ruling negatively impacts the commercial vitality of counter-guarantee/counter-standby arrangements because it raises the costs of these undertakings and undermines the utility of counter-guarantees/counter-standbys as security devices in support of locally-issued independent guarantees/standbys.

### I. The Case

In *American Express Bank Ltd. v. Banco Espanol de Credito*, the District Court for the Southern District of New York was asked to analyze what impact, if any, a foreign arbitral award canceling the beneficiary's independent guarantees as part of dispute resolution over performance of the underlying contract should have on the rights and obligations of the beneficiary, the bank that issued the counter-guarantee, and the local bank beneficiary of the counter-guarantee/issuer of the local undertaking.<sup>32</sup> The development of joint ventures with the advent of globalization has resulted in greater willingness to submit to international commercial arbitration<sup>33</sup> so that arbitration has become "by far the favoured method of dispute settlement in international trade" with major international supply and construction contract containing arbitration clauses.<sup>34</sup> In light of this trend and the fact that the State of New York is the pre-eminent jurisdiction for development of letters of credit law, the district court's ruling in this case has the potential to significantly impact the counter-guarantee/counter-standby letter of credit legal landscape.<sup>35</sup>

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<sup>32</sup> 597 F. Supp 2d. 399–400 (S.D.N.Y. 2009).

<sup>33</sup> Christine Lecuyer-Thieffry and Patrick Thieffry, *Negotiating Settlement of Disputes Provisions in International Business Contracts: Recent Developments in Arbitration and Other Processes*, 45 BUS. LAW. 577, 578 (1990).

<sup>34</sup> Hussain M. Al-Baharna, *International Commercial Arbitration in Perspective*, 3 ARAB L.Q. 3, 4 (1988).

<sup>35</sup> See *supra* note 28.

### A. Facts and Legal Proceedings Leading up to the Case

This case is ultimately the fallout of a dispute over a construction contract in a developing country. In 1995, a government entity of Pakistan, the Pakistan Water and Power Development Authority (“WAPDA”) and Isolux Wat S.A. (“Isolux”) entered into a USD 35 million contract for the construction of two electrical power stations in Pakistan.<sup>36</sup> WAPDA (“Beneficiary”) is a semi-autonomous agency of the government of Pakistan responsible for coordinating infrastructure development projects in the water and power sectors. Isolux (“Applicant”) is an engineering firm from Spain.<sup>37</sup> To secure Applicant’s performance, Beneficiary required the engineering company to procure two independent (demand) guarantees in its favor. Applicant requested Banco Espanol de Credito (“Counter-Guarantor”) located in Spain to issue the independent guarantees in favor of Beneficiary in Pakistan.<sup>38</sup> The condition for payment under the independent guarantees was the presentation of a written declaration of default. Counter-guarantor in turn requested the Pakistan branch of American Express Bank (“Local Bank”) to execute the independent guarantees in favor of Beneficiary, whereby Counter-Guarantor would reimburse Local Bank for honoring the Beneficiary’s independent guarantees upon a presentation complying with the terms of the counter-guarantee.<sup>39</sup> Thus, Counter-Guarantor issued a counter-guarantee in favor of Local Bank.<sup>40</sup> Specifically, the language of the counter-guarantee stated that Counter-Guarantor undertook to pay Local Bank on its “first demand notwithstanding any contestation from us or our applicants part [sic] or third party.”<sup>41</sup>

#### 1. Contract Arbitration Clause

In addition to arranging for independent guarantees and the counter-guarantee, Beneficiary and Applicant inserted an arbitration clause in their contract. The clause provided that “any difference, dispute or question arising out of or with reference to this agreement which cannot be settled

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<sup>36</sup>*American Express*, 597 F. Supp. 2d at 400.

<sup>37</sup> *Id.*

<sup>38</sup> *Id.*

<sup>39</sup> *Id.* at 398.

<sup>40</sup> *Id.* at 397–98.

<sup>41</sup> *Id.* at 398.

amicably . . . shall within 60 days from the date that either party informs the other in writing that such difference [,] dispute or question exists, be referred to arbitration of three arbitrators” and that “[t]he award of the majority of the [arbitrators] shall be final and binding on both parties.”<sup>42</sup> Importantly however, the terms of neither the independent guarantees nor the counter-guarantee featured the outcome of arbitration in favor of Beneficiary as a condition for the fulfillment of obligations under the independent guarantees and the counter-guarantee.<sup>43</sup>

## 2. The Underlying Contract Dispute and the Subsequent Unraveling

By 2004, a dispute arose between Applicant and Beneficiary over Applicant’s performance.<sup>44</sup> While the district court did not explain the details of the dispute, apparently Beneficiary wanted Applicant to complete repairs on the power stations.<sup>45</sup> On February 11, 2004, Applicant submitted a request for arbitration to the ICC International Court of Arbitration.<sup>46</sup> Applicant sought money damages and an order requiring Beneficiary to return all the guarantees issued in connection with the construction contract. At the same time Applicant obtained a preliminary injunction from the Spanish court to prevent Counter-Guarantor from honoring Local Bank’s counter-guarantee.<sup>47</sup> Five months later, Beneficiary informed Local Bank that Applicant failed to perform and demanded payment under the independent guarantees.<sup>48</sup> Fearing it would not be reimbursed due to the injunction issued by the Spanish court, Local Bank sent Counter-Guarantor

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<sup>42</sup> *American Express*, 597 F. Supp. 2d at 397.

<sup>43</sup> The language of the independent (demand) guarantees required Local Bank “to pay [Beneficiary] without delay upon [Beneficiary’s] first written request any amount claimed by [Beneficiary] upto [sic] the sum named herein, against [Beneficiary’s] written declaration that [Applicant] refused or failed to perform the aforementioned contract.” *American Express*, 597 F. Supp. 2d at 398. Per the text of the counter-guarantee, Counter-Guarantor undertook “to pay to [Local Bank] on [Local Bank’s] first demand notwithstanding any contestation from us or our applicants part [sic] or third party.” *Id.*

<sup>44</sup> *American Express*, 597 F. Supp. 2d at 399.

<sup>45</sup> See CFI, April 12, 2004 (R.J., No. 286/04-9), Walker Decl. Ex. H at 13.

<sup>46</sup> *American Express*, 597 F. Supp. 2d at 399.

<sup>47</sup> See CFI, April 12, 2004 (R.J., No. 286/04-9), Walker Decl. Ex. H at 13.

<sup>48</sup> *American Express*, 597 F. Supp. 2d at 399.

a SWIFT message demanding payment under the counter-guarantees.<sup>49</sup> Citing the Spanish court's injunction, Counter-Guarantor refused.<sup>50</sup> In February 2005, Beneficiary filed an action in Pakistan against Local Bank to recover on its independent guarantees.<sup>51</sup> On February 6, 2007, the ICC arbitral panel ruled in favor of Applicant and determined that Beneficiary owed Applicant approximately USD 788,066, while Applicant owed Beneficiary nothing. Importantly, the ICC arbitral panel ordered Beneficiary to cancel the two independent guarantees.<sup>52</sup> Undeterred by the arbitral panel's decision, Beneficiary continued its efforts to enforce its independent guarantees in Pakistan. As of the date of district court's written opinion, the Pakistani court had not yet ruled on Beneficiary's challenge to the ICC award.<sup>53</sup> Before the arbitral panel issued its decision, Local Bank filed a suit in the Southern District of New York and moved for summary judgment. In anticipation of having to pay on its local undertakings to Beneficiary, Local Bank sought to enforce Counter-Guarantor's obligation to reimburse it.<sup>54</sup> In the alternative, Local Bank sought a declaratory judgment that it would be entitled to payment from Counter-Guarantor if Local Bank is ordered to pay Beneficiary by the Pakistani court.<sup>55</sup>

As a threshold matter, the district court concluded that the independent guarantees and the counter-guarantee at issue are governed by letter of credit law because they share defining characteristics of standbys: the essential feature of independence and the "parties' expectation that [Beneficiary] would receive money promptly if it submitted a facially valid certification that [Applicant] failed to perform its obligations."<sup>56</sup>

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<sup>49</sup> *Id.* at 399–400.

<sup>50</sup> *Id.* at 400.

<sup>51</sup> *Id.*

<sup>52</sup> *Id.*

<sup>53</sup> *American Express*, 597 F. Supp. 2d at 406.

<sup>54</sup> *Id.* at 400.

<sup>55</sup> *Id.*

<sup>56</sup> *American Express*, 597 F. Supp. 2d at 402.

## B. The Decision and Holding

The district court held that the ICC award had conclusively established the rights and liabilities of Beneficiary and Local Bank until such time as Beneficiary succeeded in vacating or modifying the arbitral award.<sup>57</sup> According to the district court, the ICC award precluded Beneficiary's continued demands for payment because in light of the award, under N.Y. UCC § 5-109, the letters of credit fraud provision, payment under Beneficiary's independent guarantees would facilitate "material fraud."<sup>58</sup> Consequently, according to the district court, Local Bank had no obligation to pay under its independent guarantees and no good faith basis to demand payment on its counter-guarantee issued by Counter-Guarantor.<sup>59</sup> The district court thus determined that under such facts Counter-Guarantor's refusal to honor Local Bank's presentation was proper because under Rev. UCC § 5-109 (Fraud and Forgery) as adopted verbatim by New York as state law neither Beneficiary nor Local Bank had a "colorable right" to demand the honor of the independent guarantees and the counter-guarantee, respectively.<sup>60</sup> Moreover, the district court refused to grant Local Bank's request for declaration that it would be entitled to reimbursement by Counter-Guarantor should a Pakistani court force it to honor the independent guarantees. In light of the fact that the Pakistan court has not yet ruled on Beneficiary's request to enforce the independent guarantees, the district court deemed such a claim not to be presently justiciable.<sup>61</sup> Thus, the district court dismissed Local Bank's entire motion for summary judgment without prejudice.<sup>62</sup>

## C. The Court's Reasoning

The district court explained that in light of the ICC award against Beneficiary canceling Beneficiary's independent guarantees, Beneficiary's

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<sup>57</sup> *Id.* at 404.

<sup>58</sup> *Id.* at 403.

<sup>59</sup> *Id.* at 404.

<sup>60</sup> See N.Y. U.C.C. § 5-109 (McKinney 2006); Rev. U.C.C. § 5-109 (1995) (Fraud and Forgery).

<sup>61</sup> *American Express*, 597 F. Supp. 2d at 405–06.

<sup>62</sup> *Id.* at 406.

demand for payment under the independent guarantees and Local Bank's demand for payment under its counter-guarantee lacked any basis in law or fact under contract law, international law and New York law.<sup>63</sup> The court intimated that honoring of such a demand would thus facilitate letter of credit fraud by Beneficiary under New York's verbatim adoption of Rev. UCC Article 5 – N.Y. UCC § 5-109.<sup>64</sup>

### 1. Contract Law

The district court held that contract law fully and firmly established the rights and obligations of Beneficiary. First, the court reasoned that per the arbitration clause included in the contract signed by both Beneficiary and Applicant, the award of the ICC arbitral panel was “final and binding on both parties.”<sup>65</sup> The district court further pointed out that courts adhere to the principle that the “scope of authority of arbitrators generally depends on the intention of the parties to an arbitration, and is determined by the agreement or submission.”<sup>66</sup> Thus the court concluded that contract law precluded Beneficiary from demanding payments under its independent guarantees because it contracted for final and binding arbitration.<sup>67</sup>

### 2. International Law

The district court also determined Beneficiary's continued demands for payment under the independent guarantees to be inconsistent with the 1958 United Nations Convention on the Recognition and Enforcement of Arbitral Awards (“The New York Convention”).<sup>68</sup> Thus, the court reasoned that the ICC arbitral award was also final and binding under the New York

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<sup>63</sup> *American Express*, 597 F. Supp. 2d at 403.

<sup>64</sup> *Id.*

<sup>65</sup> *Id.* at 404.

<sup>66</sup> *Synergy Gas Co. v. Sasso*, 853 F.2d 59, 63 (2d Cir. 1988) (citing *Ottley v. Schwartzberg*, 819 F.2d 373, 376 (2d Cir. 1987)).

<sup>67</sup> *See American Express*, 597 F. Supp. 2d at 403 (“WAPDA's continued demands for payment are flatly inconsistent with its contractual obligations.”).

<sup>68</sup> United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards, Art. III, June 10, 1958, 330 U.N.T.S. 3 [hereinafter *New York Convention*] (“[e]ach Contracting State shall recognize arbitral awards as binding and enforce them in accordance with the rules of procedure of the territory where the award is relied upon.”).

Convention, to which Pakistan was a party.<sup>69</sup> Moreover, the court adopted one commentator's view that "the principle that a valid determination, either judgment or award, produces a conclusive effect with regard to the subject matter and the parties of the dispute constitutes a fundamental legal principles embedded in every legal system."<sup>70</sup> Thus the court concluded that the arbitral award here was *res judicata* – i.e. produced an ultimate non-reviewable legal outcome on the issue of Beneficiary's rights under its independent guarantees.<sup>71</sup>

### 3. New York Law

Finally, according to the court, New York law recognized the final and conclusive nature of international arbitral awards on parties who participated in such proceedings.<sup>72</sup> In support of its contention, the court cited *Guard-Life Corporation v. S. Parker Hardware Manufacturing Corporation*.<sup>73</sup> In that case, the New York Court of Appeals held that the plaintiff was bound by the outcome of the arbitration proceedings under the principles of issue preclusion and collateral estoppel.<sup>74</sup> The Court of Appeals reasoned that these principles applied because the plaintiff agreed to resolution of disputes arising under the contract by arbitration in Japan.<sup>75</sup> Presumably in the present case, issue preclusion and collateral estoppel bound Beneficiary by the outcome of the ICC award even more so since that the arbitration clause was part of its contract with Applicant.

### 4. Payment under the Independent Guarantee Would Violate N.Y. UCC § 5-109

The district intimated that in light of the *res judicata* nature of the ICC arbitral award against Beneficiary, any honor of Beneficiary's demand

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<sup>69</sup> *American Express*, 597 F. Supp. 2d at 403.

<sup>70</sup> Stavros Brekoulakis, *The Effect of An Arbitral Award and Third Parties in International Arbitration: Res Judicata Revisited*, 16 AM. REV. INT'L ARB. 177, 179 (2005).

<sup>71</sup> *Id.*

<sup>72</sup> *American Express*, 597 F. Supp. 2d at 403.

<sup>73</sup> 428 N.Y.S.2d 628 (N.Y. 1980).

<sup>74</sup> *Id.* at 635.

<sup>75</sup> *Id.*

under the independent guarantees “would facilitate a material fraud by the beneficiary on the issuer or applicant.”<sup>76</sup> The district court cited a number of international construction cases that considered the letter of credit fraud standard and whether an injunction to prevent honor was warranted.<sup>77</sup> The court relied on these cases to show that it was appropriate to preclude payment under Local Bank’s counter-guarantee and Beneficiary’s independent guarantees when the contract dispute arbitral award directed Beneficiary to cancel its independent guarantees because the situation here fell under the general understanding of what constitutes “material fraud by the beneficiary.”<sup>78</sup> The district court did not elaborate on how the cases it cited in support of its holding applied to the facts at hand.

## II. Analysis

This section argues that the district court’s holding lacks basis in standard international letter of credit practice, contract law, international law, New York law, case law-developed standard for issuing injunctions, and policy. First, this section will demonstrate that the court incorrectly concluded that the ICC arbitral award precludes Local Bank’s and Beneficiary’s continuous demand for payment of their respective undertakings under contract law, international law, and New York law. Second, this section will show that the court failed to observe the independence of counter-guarantees/counter-standbys from the local undertakings. Third, this section will show that the court’s affirmation of the ICC arbitral panel’s decision to cancel Beneficiary’s independent guarantees and the injunction to prevent payment under the counter-guarantee is not in accord with the legal standard developed by United States federal and state courts for issuing injunctions to prevent letter of credit fraud. Last but not least, this section will argue that the district court’s holding hurts the utility of counter-guarantees and counter-standbys for enabling international infrastructure projects.

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<sup>76</sup> N.Y. U.C.C. § 5-109(b) (McKinney 2006).

<sup>77</sup> *American Express*, 597 F. Supp. 2d at 404. For citation to and parenthetical summary of a number of these cases see *supra* Part II.F., note 124.

<sup>78</sup> N.Y. U.C.C. § 5-109(b) (McKinney 2006); Rev. U.C.C. § 5-109(b) (1995) (Fraud and Forgery); *American Express*, 597 F. Supp. 2d at 403.

## A. District Court's Ruling Conflicts with Letters of Credit Law and Practice

### 1. Validity of Beneficiary's Demand under International Law and Contract Law

The district court erroneously concluded that honoring the independent guarantees in light of the ICC arbitral award conflicts with the stipulation of the underlying contract's arbitration clause that the arbitral award is "final and binding on both parties."<sup>79</sup> In determining that Beneficiary's continued demand for payment is inconsistent with the arbitration clause of the underlying contract, the court relied on the proposition in *Synergy Gas Corporation v. Sasso* that the "scope of authority of arbitrators generally depends on the intention of parties to an arbitration, and is determined by agreement or submission."<sup>80</sup> However, the district court did not acknowledge that the same case points out that section 10 of the Federal Arbitration Act provides that an arbitral award can be vacated "[w]here the arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final, and definite award upon the subject matter was not made."<sup>81</sup> Moreover, under the Private International Law Statute of Switzerland which governed the ICC arbitration, the arbitral award may be annulled "[i]f the Arbitral Tribunal's decision went beyond the claims submitted to it, or failed to decide one of the items of the claim."<sup>82</sup> Thus, when the arbitrators rule on a matter beyond the scope of the underlying contract, that part of their decision is invalid for lack of adjudicative authority. If an arbitral panel's ruling is *ultra vires*, the ruling's res judicata effect is irrelevant.

Similarly, in concluding that Beneficiary's continued demand for payment under the independent guarantees is inconsistent with its ratification of the New York Convention, the district court did not evaluate Article III of the convention in light of Article V. Under Article III, States shall recognize arbitral awards as binding and enforce them subject "to the conditions laid down in the following article."<sup>83</sup> According to Article V-

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<sup>79</sup> *American Express*, 597 F. Supp. 2d at 403.

<sup>80</sup> *Id.* (citing *Synergy Gas Co. v. Sasso*, 853 F.2d 59, 63–64 (2d Cir. 1988)).

<sup>81</sup> *Synergy Gas Co.*, 853 F.2d at 63 (citing 9 U.S.C. §10(a)(4)).

<sup>82</sup> Cadarso Decl. Ex. C at 7 (citing Private International Law Statute art. 190(1)(c)(1987)).

<sup>83</sup> New York Convention, *supra* note 68.

1(c), “recognition and enforcement of the award may be refused” if “[t]he award deals with a difference not contemplated by *or not falling within the terms of the submission, or it contains decision on matters beyond the scope of the submission to arbitration . . .*”<sup>84</sup> Thus, just like the Private International Law Statute of Switzerland and the Federal Arbitration Act, the New York Convention also renders unenforceable arbitral awards on issues the arbitral panel had no authority to address under the underlying contract.

The district court’s reliance on the ruling of the ICC arbitral panel on the dispute between Applicant and Beneficiary over the underlying construction contract cannot serve as a basis for not enforcing Counter-Guarantor’s obligations with respect to Local Bank under both contract law and the New York Convention.

First, under the arbitration clause of the underlying contract, while the arbitral panel was free to determine the rights and obligations of Applicant and Beneficiary with respect to each other, based on the independence principle, the panel’s decision did not affect Local Bank’s obligations with respect to the independent guarantees and Counter-Guarantor’s obligations with respect to the counter-guarantee. Under the independence principle the obligations to Beneficiary under the independent guarantees were separate and distinct from “performance or non performance of a contract” between “the applicant and the beneficiary.”<sup>85</sup> Since the arbitration clause was part of the contract between Applicant and Beneficiary, per the independence principle<sup>86</sup> neither Counter-Guarantor nor Local Bank were in any way concerned with or bound by such contract. Indeed, if a beneficiary’s ability to obtain funds under its locally-issued independent guarantees is made contingent on submission of arbitral or judicial award establishing whether the local beneficiary breached the contract, the independence principle loses practical significance and the purportedly “independent” guarantee in question starts to closely resemble the traditional suretyship or accessory guarantee.<sup>87</sup>

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<sup>84</sup> New York Convention, *supra* note 68, art. V-1(c) (emphasis added).

<sup>85</sup> N.Y. U.C.C. § 5-103(d) (McKinney 2006); Rev. U.C.C. § 5-103(d) (1995) (Scope).

<sup>86</sup> *See supra* note 7.

<sup>87</sup> *See* BERTRAMS, *supra* note 2, at 11.

Second, under the New York Convention, the status of Local Bank's obligations under Beneficiary's independent guarantees and Counter-Guarantor's obligations under Local Bank's counter-guarantee, respectively, did not fall "within the terms of the submission to arbitration."<sup>88</sup> While Applicant was in a contractual relationship with Counter-Guarantor to arrange for the issuance of the independent guarantees, Local Bank was not in privity with Applicant and was not a party to the arbitration clause in the underlying contract between Applicant and Beneficiary. Similarly, under the counter-guarantee/counter-standby structure, the local beneficiary acts without any contractual relationship to the counter-guarantor/issuer of counter-standby.<sup>89</sup> Accordingly, the ICC arbitral panel's decision directing Beneficiary to cancel its independent guarantees could not have voided Local Bank's obligations to honor a complying presentation under Beneficiary's independent guarantees and Counter-Guarantor's obligations to honor Local Bank's complying presentation under Local Bank's counter-guarantee, respectively. If the arbitral panel's decision to cancel the independent guarantees were to have such an effect, the panel's decision would not be in conformity with the New York Convention's Article V-1(c) because the panel's decision would have "contain[ed] decisions on matters beyond the scope of the submission to arbitration."<sup>90</sup> Thus, the fact that the ICC arbitral panel ruled in favor of Applicant cannot serve as one of the legal bases for upholding Counter-Guarantor's refusal to honor the counter-guarantee.<sup>91</sup>

Third, also in conflict with the independence principle, the district court failed to appreciate the independence of a local independent guarantee from a corresponding counter-guarantee when it held that Local Bank also has "no good faith basis" to demand honor of its counter-guarantee, until the arbitral award is modified or vacated.<sup>92</sup> The independence principle in counter-guarantee/counter-standby context means that defenses originating from the local undertaking are not available to the counter-guarantor/issuer

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<sup>88</sup> New York Convention, *supra* note 68, art. V-1(c).

<sup>89</sup> See BERTRAMS, *supra* note 2, at 18–19.

<sup>90</sup> *Id.*

<sup>91</sup> Rev. U.C.C. § 5-109(b) cmt. 1 (1995) (Fraud and Forgery).

<sup>92</sup> *American Express*, 597 F. Supp. 2d at 404; see 2010 ANNUAL REVIEW OF INTERNATIONAL BANKING LAW & PRACTICE 430–31 (2010) [hereinafter 2010 ANNUAL REVIEW].

of counter-standby.<sup>93</sup> The counter-guarantee/counter-standby is payable in accordance with its own terms.<sup>94</sup> The language of the counter-guarantee here stated that it is payable “on your first demand notwithstanding any contestation from us or our applicants part [sic] or third party.”<sup>95</sup> Thus, Local Bank’s counter-guarantee was a “first demand” type of independent undertaking, also referred to as “clean” or “suicide” guarantee.<sup>96</sup> Under a “first demand” guarantee no documentation of the applicant’s default is required and a bare demand for payment, usually by presenting a sight draft, is sufficient. Therefore, a “first demand” guarantee is the riskiest type of independent undertaking from the vantage point of counter-guarantor/issuer of counter-standby because documentary certification of default which can offer more protection to counter-guarantor/issuer of counter-standby is not available.<sup>97</sup> Indeed, courts rely on false certification as a ground for court-ordered injunctive relief to prevent letter of credit fraud.<sup>98</sup> It is true that a “written declaration that [Applicant] has refused or failed to perform the aforementioned contract” was the condition for honoring the local independent guarantees.<sup>99</sup> However, the only term for payment under the counter-guarantee, by contrast, was that Beneficiary make a bare demand for payment. Moreover, the language of the counter-guarantee was absolute – “notwithstanding any contestation from us or our applicants part [sic] or third party.” Thus, the independence principle should have insulated Local Bank’s ability to draw on the counter-guarantee from the controversy over Beneficiary’s right to draw on the local independent guarantees. Since a written certification of default was not one of the terms of the counter-

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<sup>93</sup> See *supra* note 23; BERTRAMS, *supra* note 2, at 3.

<sup>94</sup> BERTRAMS, *supra* note 2, at 196.

<sup>95</sup> *American Express*, 597 F. Supp. 2d at 398.

<sup>96</sup> BERTRAMS, *supra* note 2, at 13; Barru, *supra* note 1, at 64–65.

<sup>97</sup> BERTRAMS, *supra* note 2, at 13; Barru, *supra* note 1, at 64–65.

<sup>98</sup> See, e.g., *Brenntag Int’l Chem. Inc. v. Bank of India*, 175 F.3d 245, 249, 251 (2d Cir. 1999) (affirming an injunction to prevent negotiating bank from collecting payment under the standby based on letter of credit fraud, reasoning that the default the “default letter” purported to certify had not and could not have occurred at the time the letter was written; court concluded that despite having actual knowledge that applicant was not in default, the negotiating bank nonetheless date-stamped the original undated default letter signed by a party not authorized to sign on behalf of beneficiary and attempted to collect payment under the standby using the materially inaccurate and non-compliant default letter).

<sup>99</sup> *American Express*, 597 F. Supp. 2d at 398.

guarantee, Local Bank could not have logically been falsely certifying as to Applicant's default in light of the ICC arbitral award in favor of Applicant. In other words, the pending action by Beneficiary against Local Bank in Pakistani courts to enforce the local independent guarantees furnished Local Bank with a "colorable right" to draw on the counter-guarantee.<sup>100</sup> The reason Local Bank had a "colorable right" is that in contrast to the terms of the local independent guarantees, the counter-guarantee did not require the submission of written certification of Applicant's default as one of its terms. The only way Local Bank's "first demand" for payment under the counter-guarantee would have "lack[ed] any basis in law or fact"<sup>101</sup> was if the court in Pakistan issued a final ruling against Beneficiary, denying Beneficiary's request to force Local Bank to honor Beneficiary's independent guarantees.<sup>102</sup>

## 2. Validity of Beneficiary's Demand under New York Law

In addition to being poorly grounded in contract law, international public law, and standard international letter of credit practice, the district court's conclusion that in light of the ICC arbitral award Beneficiary and Local Bank "lack[] any basis in law and fact" to demand payment under the local guarantees and counter-guarantee, respectively, clashes with New York case law. In *Banco Nacional De Mexico, S.A. v. Societe Generale*,<sup>103</sup> a case that closely resembles the situation here, the local bank honored the Mexican government infrastructure agency's demand under the standby letters of credit.<sup>104</sup> A contractual dispute between the applicants and the Mexican beneficiary arose and the two commenced arbitration.<sup>105</sup> Meanwhile, the applicants obtained a provisional injunction to prevent the issuing bank from honoring the standby.<sup>106</sup> The confirming bank subsequently sued the issuer to obtain reimbursement for honoring the

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<sup>100</sup> See 2010 ANNUAL REVIEW, *supra* note 91, at 430–31.

<sup>101</sup> *American Express*, 597 F. Supp. 2d at 403.

<sup>102</sup> See 2010 ANNUAL REVIEW, *supra* note 91, at 430–31.

<sup>103</sup> *Banco Nacional De Mexico, S.A. v. Societe Generale*, 820 N.Y.S.2d 588 (N.Y. App. Div. 2006).

<sup>104</sup> *Banco Nacional De Mexico*, 820 N.Y.S.2d at 588.

<sup>105</sup> *Id.*

<sup>106</sup> *Id.* at 589.

Mexican beneficiary's standby.<sup>107</sup> The New York State Supreme Court, Appellate Division, held that under New York law, the issuing bank must honor a complying presentation regardless of whether there is a dispute concerning the underlying contract.<sup>108</sup> The court explained that in accordance with the independence principle, the standby created a relationship between the issuing bank and the confirming bank, which was separate and independent of the underlying transaction in Mexico between the beneficiary and the applicant. The court further reasoned that payment under the standby to the beneficiary was not conditioned on any "arbitral award" and that the written request for payment to the issuer under the standby strictly conformed to the documentary conditions of the standby.<sup>109</sup>

Here just as in *Banco Nacional De Mexico*, the outcome of arbitration was neither one of the conditions for payment under the local independent guarantees nor under the counter-guarantee.<sup>110</sup> Thus, similar to the beneficiary in *Banco Nacional De Mexico*, as long as Beneficiary and Local Bank strictly complied with the terms of their respective undertakings, i.e. – by submitting facially valid certification that Applicant failed to perform its obligations in the case of Beneficiary and by making a bear demand in the case of Local Bank, under New York law, the outcome of the ICC arbitration should have had no bearing on the right to draw on either undertaking.

### **B. Injunction to Prevent "Material Fraud" under Rev. UCC § 5-109**

In holding that Beneficiary had no "colorable right" to demand payments under its local independent guarantees and Local Bank had "no good faith basis" to demand payment under the counter-guarantee, the district court effectively affirmed the injunction of the Spanish Court to prevent Issuer from honoring the counter-guarantee and the ICC arbitral panel's cancellation of Beneficiary's local independent guarantees.<sup>111</sup> Indeed, the district court's holding cited Official Comment 1 to Rev. UCC § 5-109 which states that "material fraud by the beneficiary occurs only when

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<sup>107</sup> *Id.*

<sup>108</sup> *Id.* at 591.

<sup>109</sup> *Banco Nacional De Mexico*, 820 N.Y.S.2d at 591.

<sup>110</sup> *See supra* Part I.A.

<sup>111</sup> *American Express Bank, Ltd. v. Banco Espanol de Credito*, 597 F. Supp 2d. 394, 403 (S.D.N.Y. 2009).

the beneficiary has no colorable right to expect honor and where there is no basis in fact to support such a right to honor.”<sup>112</sup> Upon a finding of “material fraud”, Rev. UCC § 5-109(b) grants a court of competent jurisdiction the right to issue an injunction to prevent the honoring of a letter of credit. In reaching its conclusion, however, the district court failed to observe the case law standard for issuing injunctions to prevent banks from paying on letters of credit on the grounds of fraud. Indeed, the district court affirmed the injunction to prevent the honor of the counter-guarantee and the arbitral award canceling the local guarantees solely on the basis of the “likely to succeed on the merits” prong. The district court concluded that the drawdown on the counter-guarantee would facilitate material fraud within the meaning of Rev. UCC § 5-109 but the court did not analyze whether absent the injunction Applicant would suffer “irreparable harm”.

### **1. Legal Standard for Issuing Injunction to Prevent Letter of Credit Fraud**

The party seeking an injunction to prevent payment under a letter of credit has to establish that honoring the credit would facilitate material fraud.<sup>113</sup> The landmark United States case that launched the development of the letter of credit fraud doctrine is *Sztejn v. Henry Schroeder Banking Corp.*<sup>114</sup> That case “has . . . been codified in the Uniform Commercial Code (“UCC”) and followed by nearly all subsequent letter of credit fraud cases in the United States.”<sup>115</sup> In *Sztejn*, the underlying contract was for bristles. The beneficiary, however, instead shipped the merchandise “not merely of inferior quality but [that] consists of worthless rubbish.”<sup>116</sup> The court held that the bank, which had been given notice of the beneficiary’s fraud, was thus justified in refusing to honor the beneficiary’s demand under the letter of credit.<sup>117</sup>

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<sup>112</sup> *Id.* at 403.

<sup>113</sup> *Brenntag Int’l*, 175 F.3d 249–51; *Itek Corp. v. The First Nat’l Bank of Boston*, 730 F.2d 19, 24–25 (1st Cir. 1984).

<sup>114</sup> 31 N.Y.S.2d 631 (N.Y. Sup. Ct. 1941).

<sup>115</sup> Ross P. Buckley and Gao Xiang, *The Development of the Fraud Rule in Letter of Credit Law: The Journey So Far and the Road Ahead*, 23 U. PA. J. INT’L ECON. L. 663, 676 (2002).

<sup>116</sup> *Sztejn*, 31 N.Y.S.2d at 634–35.

<sup>117</sup> *Id.*

The exception created by *Sztejn* for fraud in the transaction has been recognized and adopted by courts in England,<sup>118</sup> and codified in UCC § 5-114.<sup>119</sup> Rev. UCC § 5-109 is the modern formulation of fraud which replaced UCC § 5-114.<sup>120</sup> While § 5-109 still allows relief if fraud is present in the underlying transaction, the revised fraud provision adds the qualification that to trigger court review there must be an allegation of “material fraud.”<sup>121</sup> In essence, under Rev. UCC § 5-109, an applicant claiming that “a required document is forged or materially fraudulent or that honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant” is able to seek relief through enjoining the issuing bank from paying on the letter of credit.<sup>122</sup> Moreover, under that provision the counter-guarantor/issuer of counter-standby may refuse to honor the local bank’s presentation, if the local bank honored its local undertaking not in good faith – i.e. with “notice of forgery and material fraud.”<sup>123</sup>

United States courts have struggled to develop guidelines for determining when a conduct constitutes letter of credit fraud and is serious enough and clear enough to warrant injunctive relief.<sup>124</sup> However, finding

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<sup>118</sup> See *United City Merchants Ltd. v. Royal Bank of Canada*, [1979] 1 Lloyd’s L.R. 267, 276; *R.D. Harbottle Ltd. v. Nat. Westminster Bank*, [1977] 1 Q.B. 146, 156.

<sup>119</sup> U.C.C. § 5-114(2) (1978) (Issuer’s Duty and Privilege to Honor; Right to Reimbursement).

<sup>120</sup> Rev. U.C.C. § 5-109 cmt. 1 (1995); Buckley and Xiang, *supra* note 115, at 684–85.

<sup>121</sup> Rev. U.C.C. § 5-109 cmt. 1 (1995); Rev. U.C.C. § 5-109 cmt. 3 (1995) (“If the applicant were able to show that the beneficiary were committing material fraud on the applicant in the underlying transaction, then payment would facilitate a material fraud by the beneficiary on the applicant and honor could be enjoined.”).

<sup>122</sup> *Id.* § 5-109(b).

<sup>123</sup> See *id.* § 5-109(a) (2).

<sup>124</sup> See, e.g., *Brenntag Int’l Chem. Inc. v. Bank of India*, 175 F.3d 245, 251 (2d Cir. 1999) (holding that a nominated bank committed letter of credit fraud warranting injunction when it presented the issuing bank with a facially invalid default certificate which the nominated bank produced by date-stamping the undated long-held original default letter, thus making the applicant’s default occur a full year prior to the earlier possible date of default under the standby, and by having the default letter be signed by a party not authorized to sign on behalf of beneficiary); *Rockwell Int’l Sys., Inc. v. Citibank, N.A.*, 719 F.2d 583, 589 (2d Cir. 1983) (decided under Prior U.C.C. Article 5) (explaining that “the ‘fraud’ inheres in first causing the default and then attempting to reap the benefits of the guarantee” and granting an injunction to prevent issuing bank from honoring confirm bank’s demand under

that honoring the beneficiary's presentation would facilitate material fraud is not by itself sufficient for courts to enjoin a bank from paying on the independent undertaking. To justify injunctive relief the party seeking an injunction must demonstrate that: (i) it will suffer "irreparable harm" absent the injunction; and (ii) that the party is either (a) likely to succeed on the merits or (b) there exist sufficiently serious questions going to the merits to make them a fair ground for litigation and a balance of hardships tips decidedly in favor of the moving party.<sup>125</sup> The finding of material fraud can only satisfy the "success on the merits" prong of the injunction test.<sup>126</sup>

Courts have also worked to flesh out the "irreparable harm" element of the injunction test. In general terms, a party is irreparably harmed "where, but for the grant of equitable relief, there is a substantial chance that upon final resolution of the action the parties cannot be returned to the positions they previously occupied."<sup>127</sup> Specifically, courts find "irreparable

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the counter-standbys); *Roman Ceramics Corp. v. Peoples Nat'l Bank*, 714 F.2d 1207 (3d Cir. 1983) (decided under Prior U.C.C. Article 5) (adopting the principle that the circumstances which will justify an injunction against honor must be narrowly limited to situations "in which the wrongdoing of the beneficiary has so vitiated the entire transaction that the legitimate purpose of the independence of the issuer's obligation would no longer be served" and on the basis of this formulation holding that an intentional and knowing submission by the beneficiary of documents with the intention of drawing on the letter of credit so as to be paid twice for the invoices has "no basis in fact" and thus rises to the level of fraud warranting an injunction); *cf.* *3Com Corp. v. Banco do Brasil*, 171 F.3d 739, 747-48 (2d Cir. 1999) (holding that the beneficiary presenting invoices that were in the name of, and for goods shipped to the applicant's purchasing agent, rather than the applicant itself pursuant to terms of the standby did not constitute an "outright fraudulent practice" because the applicant had unconditionally guaranteed agent's obligations to the beneficiary and waived any right to require the beneficiary to proceed against the agent rather than the applicant directly); *Ground Air Transfer, Inc. v. Westates Airlines, Inc.*, 899 F.2d 1269 (1st Cir. 1990) (decided under Prior U.C.C. Article 5) (holding that a beneficiary does not act fraudulently as long as the record indicates that the beneficiary's demand for payment under the standby letter of credit is at least "colorable" and not obviously without merit); *Recon/Optical, Inc. v. Government of Israel*, 816 F.2d 854 (2d Cir. 1987) (decided under Prior U.C.C. Article 5) (denying an injunction to prevent beneficiary from drawing on a standby on the grounds that the drawdown by the beneficiary would not rise to the level of "fraud in the transaction" given that the beneficiary did not cause the applicant to interrupt the performance of the construction contract.).

<sup>125</sup> *Brenntag Int'l*, 175 F.3d at 249-50; *Rockwell Int'l Sys.*, 719 F.2d at 586; *Lentjes Bischoff GmbH v. Joy Envtl. Techs., Inc.*, 986 F. Supp. 183, 185-86 (S.D.N.Y. 1997).

<sup>126</sup> *Brenntag Int'l*, 175 F.3d 249-51; *Itek Corp.*, 730 F.2d at 24-25.

<sup>127</sup> *Brenntag Int'l*, 175 F.3d at 249-50.

harm” warranting an injunction when the party that might have to pay monetary damages is insolvent, facing imminent bankruptcy, or in a perilous financial state.<sup>128</sup> United States courts also find “irreparable harm” warranting injunctive relief when absent the injunction the party seeking it would have no adequate remedy under law.<sup>129</sup> A party seeking an injunction may lack adequate legal remedy if the amount of monetary damages is difficult to establish.<sup>130</sup> A party also has no adequate legal remedy when “the very availability of a legal forum is called into question.”<sup>131</sup>

Several cases provide an apt illustration of the “no adequate legal remedy” principle. In *Rockwell International Systems v. Citibank*, the applicant entered into a standby-backed contract with the beneficiary, the pre-revolutionary government of Iran, to provide engineering and advisory services.<sup>132</sup> The court granted the applicant injunction to prevent the issuing bank from honoring the local bank’s counter-standby *inter alia* on the ground that the applicant would otherwise have no adequate relief under law. The court reasoned that resort to Iranian courts per the choice-of-forum terms of the contract would be futile in light of the collapse of justice

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<sup>128</sup> *Brenntag Int’l*, 175 F.3d at 250 (holding that the district court correctly concluded that the beneficiary’s insolvency, together with the weak claims of the applicant would have against the issuing or the confirming bank were a demand under the letter of credit errantly paid, was sufficient to bring this case within insolvency exception); *Centauri Shipping Ltd. v. Western Bulk Carriers KS*, 528 F. Supp.2d 186, 194 (S.D.N.Y. 2007) (“[M]onetary injury may suffice to establish irreparable harm in situations where the party that might ultimately be ordered to pay the monetary damages is insolvent or facing imminent bankruptcy, or is in a perilous financial state.”).

<sup>129</sup> *Rockwell Int’l Sys.*, 719 F.2d at 586; *Itek Corp.*, 730 F.2d at 22; *Southern Energy Homes*, 709 So. 2d at 1187.

<sup>130</sup> *JSG Trading Corp. v. Tray-Wrap, Inc.*, 917 F.2d 75, 79 (2d Cir. 1990) (“Irreparable injury is one that cannot be redressed through a monetary award. Where money damages are adequate compensation a preliminary injunction should not issue.”); *Rockwell Int’l Sys.*, 719 F.2d at 586 (“We note, for example, that a remedy at law may be considered inadequate when the amount of damages would be difficult to prove.”).

<sup>131</sup> *Rockwell Int’l Sys.*, 719 F.2d at 586; *see Itek Corp.*, 730 F.3d at 22 (holding that the applicant has no remedy under law for fraudulent drawdown of the letters of credit because *inter alia* in light of the Iranian Revolution and the resulting strained relations between the U.S. and Iran, applicant’s efforts at post hoc monetary recovery through Iranian courts would be futile).

<sup>132</sup> 719 F.2d at 584.

administration in the wake of post-revolutionary turmoil in Iran and the strained relations between the new Iranian regime and the United States.<sup>133</sup>

In another international construction case, *American Bell International v. Islamic Republic of Iran*<sup>134</sup> triggered by the Iranian Revolution, the court held that the bank failed to show irreparable harm which would support the injunction. The court concluded that although attempts by the issuing bank to resort to Iranian courts would be futile, the bank did not demonstrate that it was without adequate remedy in New York courts against the Iranian defendants under the Foreign Sovereign Immunities Act.<sup>135</sup>

Similarly, in *Foxboro Co. v. Arabian American Oil Co.*,<sup>136</sup> the First Circuit Court held that the applicant failed to demonstrate irreparable harm as required to support preliminary injunction to prevent the local bank from paying under the counter-guarantee and the issuer of the counter-guarantee from paying the local bank in a “four-way” security arrangement. The court reasoned that the applicant had adequate remedy under law for harm done to it by the allegedly fraudulent demand because (i) it had several avenues open to recover any money due from the allegedly fraudulent demand including Saudi Arabian arbitration, international arbitration, an action in Saudi court and an action in Federal U.S. court; and (ii) the applicant had not demonstrated that the beneficiary of the local undertaking lacked sufficient assets in the U.S. or would be unwilling or unable to pay any judgment debt.<sup>137</sup>

Finally, in *Southern Energy Homes, Inc. v. AmSouth of Alabama*, the Supreme Court of Alabama held that the applicant did not meet the “irreparable harm” requirement for issuing an injunction on the exercise of the letter of credit. The court reasoned that the applicant could sue in a German court to recover money for the alleged fraud.<sup>138</sup> The court further

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<sup>133</sup> *Id.* at 588–89.

<sup>134</sup> 474 F. Supp. 420 (S.D.N.Y. 1979).

<sup>135</sup> *Id.* at 423.

<sup>136</sup> 805 F.2d 34 (decided under Prior U.C.C. Article 5).

<sup>137</sup> *Id.* at 36–37.

<sup>138</sup> 709 So. 2d at 1187–88.

reasoned that the applicant bargained for the advantages and disadvantages of the standby letter of credit and for the choice of forum provision.<sup>139</sup>

The requirement that the party seeking an injunction demonstrate that absent the injunction it would suffer irreparable harm is motivated by the need to interpret the fraud provision narrowly.<sup>140</sup> An injunction should be the option of the last resort because “examining the rights and wrongs of a contract dispute to determine whether a letter of credit should be paid risks depriving its beneficiary of the very advantage for which he bargained, namely that the dispute would be resolved while he is in possession of the money.”<sup>141</sup> Indeed, Rev. UCC § 5-109 supports the notion that being an equitable remedy, injunctive relief is only appropriate when there is no adequate legal remedy.<sup>142</sup> The official commentary to Rev. UCC § 5-109 moreover recognizes that courts should have “hostility” towards the use of injunctions because their expanded use threatens the independence principle.<sup>143</sup>

## **2. The Court Failed to Evaluate Whether Absent an Injunction to Prevent the Honoring of Counter-Guarantee Applicant Would Have No Adequate Remedy Under Law.**

Here, the district court solely focused on the results of the arbitration without analyzing whether Applicant would have an adequate remedy under law if Beneficiary was to illegitimately draw on its local independent guarantees and Applicant had to as a result reimburse Counter-Guarantor

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<sup>139</sup> *Id.*

<sup>140</sup> *Itek Corp. v. The First Nat'l Bank of Boston*, 730 F.2d 19, 24 (1st Cir. 1984).

<sup>141</sup> *Itek Corp.*, 730 F.2d at 24; *see also Southern Energy Homes*, 709 So. 2d at 1187 (“Clearly, a dispute exists between [the applicant] and [the beneficiary] based on the underlying contract . . . To invoke the fraud exception in this case would require an inquiry into the underlying contract, further disrupting the important commercial functions of credit law.”).

<sup>142</sup> Rev. U.C.C. § 5-109(b) (1995) (Fraud and Forgery) (“If an applicant claims that a required document is forged or materially fraudulent or that honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant, a court of competent jurisdiction may temporarily or permanently enjoin the issuer from honoring a presentation or grant similar relief against the issuer or other persons . . .”).

<sup>143</sup> *Id.* § 5-109 cmt. 5.

after Local Bank drew on its counter-guarantee.<sup>144</sup> However, there is all the reason to believe that Applicant would have adequate remedy under law if Beneficiary exercised its rights under its locally-issued independent guarantees. First, there would be no difficulty determining the precise calculation of pecuniary damages to Applicant. The ICC arbitral panel determined that Beneficiary owed Applicant approximately USD 788,066, and Applicant owed Beneficiary nothing.<sup>145</sup> In addition to this sum, should Beneficiary illegitimately draw on the local independent guarantees, it would owe Applicant the sum of the two independent guarantees totaling USD 1,778,571.50.<sup>146</sup>

Second, contrary to *Rockwell International Systems v. Citibank* where the court enjoined the issuing bank from honoring the confirming bank's demand on the counter-standbys, the government of Pakistan is not obviously hostile to the United States unlike the post-revolutionary government of Iran. In fact, Pakistan is a strategic partner of the United States in the "war on terrorism",<sup>147</sup> receiving arms transfers as well as billions of dollars in direct foreign aid.<sup>148</sup> Moreover, Pakistan's government is functioning and not in a state of turmoil akin to that of Iran during its 1979 Revolution.<sup>149</sup> Thus, unlike the situation in *Rockwell International Systems v. Citibank*,<sup>150</sup> Beneficiary country's judicial administration is presumably intact. This means that Applicant would be able to avail itself of Pakistan as a forum for obtaining damages under contract law and an attempt to use this forum would not be futile in the eyes of law.

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<sup>144</sup> See *American Express*, 597 F. Supp. 2d at 403 ("In view of the ICC award -- and as a question of basic contract law, international law, and New York law -- WAPDA's continued demands for payment of the guaranties lack any basis in law or fact. Thus, until the award is modified or vacated, neither WAPDA nor AEB has a 'colorable right' to demand honor of the guaranties or counter guaranties.").

<sup>145</sup> *Id.* at 400.

<sup>146</sup> *Id.* at 401.

<sup>147</sup> ALAN K. KRONSTADT, CONG. RESEARCH SERV., PAKISTAN AND TERRORISM: A SUMMARY, 2 (2007).

<sup>148</sup> *Id.* at 4-5.

<sup>149</sup> See, e.g., Merle D. Kellerhals, Stability in Pakistan Is Central to U.S. Efforts in Afghanistan, AMERICA.GOV, Apr. 24, 2009, <http://www.america.gov/st/peacesec-english/2009/April/20090424143251dmslahrellek0.3880884.html&distid=ucs>.

<sup>150</sup> 719 F.2d at 586-88.

As in *American Bell International v. Islamic Republic of Iran*<sup>151</sup> in which the court denied an injunction on the exercise of standby letter of credit and in *Foxboro Co. v. Arabian American Oil Co.*<sup>152</sup> where the court denied preliminary injunction to prevent payment under the local guarantee and counter-guarantee, Applicant here may be able to avail itself of Spain or New York as adequate legal forums, if not Pakistan.<sup>153</sup>

Similar to *Southern Energy Homes, Inc. v. AmSouth of Alabama*,<sup>154</sup> Applicant in this case could try to recover for alleged fraud in Pakistan. Moreover, just like the applicant in *Southern Energy Homes*,<sup>155</sup> Applicant bargained for such a disadvantage of independent guarantees/standbys. Finally, while it is understandable that Applicant may not find the prospect of having to litigate in Pakistan particularly appealing given Pakistan's "history of instability and unreliable political and judicial systems"<sup>156</sup>, Applicant may not have to be confined to this legal forum to successfully recover damages for fraudulently drawn local independent guarantees. Similar to *Foxboro Co. v. Arabian American Oil Co.*,<sup>157</sup> Applicant had not demonstrated that Beneficiary lacked sufficient assets in the United States or would be unwilling or unable to pay any judgment debt. Indeed, since Beneficiary is a government agency<sup>158</sup> there may be significant attachable

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<sup>151</sup> 474 F. Supp. at 423, 427.

<sup>152</sup> 805 F. 2d 34, at 36–37 (1st Cir. 1986) (decided under Prior U.C.C. Article 5).

<sup>153</sup> See N.Y. Gen. Oblig. Law § 5-1401 (McKinney's 2001). New York permits its law to govern rights and obligations of parties to a contract from another country "whether or not such contract, agreement or undertaking bears a reasonable relation to this state." *Id.*; *American Express*, 597 F. Supp. 2d at 401.

<sup>154</sup> 709 So. 2d at 1187–88.

<sup>155</sup> *Id.* at 1887.

<sup>156</sup> Mark Kantor, *International Project Finance and Arbitration with Public Sector Entities: When is Arbitrability a Fiction?* 24 FORDHAM INT'L L.J. 1122, 1125–26 (2001).

<sup>157</sup> 805 F.2d at 37.

<sup>158</sup> *American Express*, 597 F. Supp. 2d at 397 ("WAPDA is a semi-autonomous agency of the government of Pakistan, which is responsible for coordinating infrastructure development schemes in the water and power sectors.").

assets outside of Pakistan.<sup>159</sup> Moreover, another promising avenue available to Applicant is the prospect of enforcing damage claims against receivables owing to the Pakistan government on account of export transactions. Additionally, third country enforcement prospects open up if Applicant-built power stations begin generating hard currency revenues. In essence, in order to recover for damages under contract law, Applicant would not necessarily have to litigate in Pakistan, but would need to prevail in any jurisdiction where there are attachable assets.

### **C. Vitality of Counter-Guarantees/Counter-Standbys as Commercial Device**

#### **1. Raises the Cost of Counter-Guarantees/Counter-Standbys**

In addition to conflicting with standard international letters of credit practice and domestic law on issuing injunctions in case of letters of credit fraud, the district court's holding in *American Express Bank v. Banco Espanol de Credito* hurts the commercial utility of counter-guarantees/counter-standbys by raising the cost of these undertakings. First, in addition to the already existing layer of litigation between applicants and beneficiaries over the underlying contract, the *American Express* rule adds a second layer of litigation – litigation between beneficiaries and local banks and litigation between counter-guarantors/issuers of counter-standbys and local banks. Making the disputes over the underlying contract affect the relationships between financial institutions participating in counter-guarantee/counter-standby arrangements creates the need to enforce each party's rights and obligations through courts when an arbitral panel rules in favor of the applicant and cancels the beneficiary's local independent guarantees/standbys.

Here, Local Bank reinitiated its legal action against Counter-Guarantor in response to Beneficiary continuing its efforts to enforce Local Bank's obligations under the independent guarantees through Pakistani courts after the ICC arbitral panel ruled against Beneficiary and canceled Beneficiary's independent guarantees.<sup>160</sup> Thus, the very fact that Beneficiary sued Local Bank and Local Bank sued Counter-Guarantor in

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<sup>159</sup> See Kantor, *supra* note 156, at 1176 (discussing the advantages of enforcing awards against government entities of third world countries in contrast to enforcing awards against private obligors).

<sup>160</sup> *American Express*, 597 F. Supp. 2d at 400.

the aftermath of the arbitral panel's decision and the Spanish court's injunction to prevent the honoring of the counter-guarantee should have served as indication to the district court that refusal to enforce payment under the counter-guarantees/counter-standbys catalyzes litigation. However, by holding that in light of the arbitral award Beneficiary had no legitimate basis to demand payment and Local Bank consequently had no good faith basis to pay Beneficiary under the independent guarantees<sup>161</sup> the district court paved the way for increase in bank litigation. Under the *American Express* holding, local banks will refuse to honor the local independent guarantees/standbys when there is an injunction in place preventing the counter-guarantor/issuer of the counter-standby from honoring the local bank's counter-guarantee/counter-standby; or an arbitral award resolving the dispute over the underlying contract against the local beneficiary; or both. Under such a scenario, local beneficiaries will be motivated to resort to local courts to enforce their rights under the independent guarantees/standbys. If local courts rule in favor of the local beneficiary and force the local bank to pay under the independent guarantees/standbys and the counter-guarantor/issuer of the counter-standby refuses to honor the local bank's complying demand, the local bank will have to in turn initiate an action against the counter-guarantor/issuer of the counter-standby to obtain payment under its counter-guarantee/counter-standby. Indeed, as the district court acknowledged:

Undeniably, this decision leaves AEB [Local Bank] in a difficult position. If Pakistan's courts order that AEB [Local Bank] honor the principal guaranties, AEB honors the guaranties, and Banesto [Counter-Guarantor] refuses to honor the counterguaranties or otherwise reimburse AEB [Local Bank], AEB [Local Bank] will be required to initiate a new action to recoup payment from Banesto [Counter-Guarantor].<sup>162</sup>

To compensate for increased risk of litigation with other banks and with the local beneficiary if a contractual dispute between the applicant and the beneficiary erupts, banks will charge higher fees for participating in the "four way" security arrangements consisting of local independent guarantees/standbys backed by counter-guarantees/counter-standbys or even

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<sup>161</sup> Stern, *supra* note 8, at 235.

<sup>162</sup> *American Express*, 597 F. Supp. 2d at 406.

refuse to provide such services altogether for certain projects at the economic margin.<sup>163</sup>

The district court's rule also promises to raise the cost of resorting to counter-guarantees/counter-standbys by increasing the administrative expenses of banks involved in such arrangements. The independence principle provides banks with a significant advantage by reducing the bank's function to only a ministerial one: the bank is required to examine documents to determine whether on their face they comply with the terms of the letter of credit.<sup>164</sup> Thus, banks keep the costs of independent undertakings down by not having to engage in fact finding or in judgment making as to performance or non-performance of the underlying contract. However, in *American Express* the district court conditioned the ability of a local bank to get paid under its counter-guarantee/counter-standby on the outcome of arbitration proceedings over the underlying construction contract and thereby failed to observe the independence of counter-guarantees/counter-standbys from local undertakings. Such a rule gives local banks that issue independent-guarantees/standbys backed by counter-guarantees/counter-standbys an incentive to engage in investigation and monitoring of the underlying contract. Indeed, local banks would be motivated to look beyond the four corners of the document in order to minimize the risk of an injunction, the inability to obtain payment from counter-guarantors/issuers of counter-standbys and the resulting litigation with counter-guarantors/issuers of counter-standbys. To compensate for having to perform these functions local banks will naturally charge higher fees. Some local banks may even refuse to issue local undertakings backed by counter-guarantees/counter-standbys for certain projects altogether if the local banks perceive there is a serious risk they will not be able to obtain prompt payment under their counter-guarantees/counter-standbys prior to any litigation in case of a major contractual impasse between the applicant and the beneficiary.

The increase in cost associated with issuing independent guarantees/standbys that are backed by counter-guarantees/counter-standbys as a result of having to investigate and monitor the underlying contract may

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<sup>163</sup> Cf. Stern, *supra* note 8, at 239 (arguing that under "breach of contract" fraud standard, as issuing banks became involved in more litigation, their expense would be increased and this added cost would be passed on, in the form of higher fees, to those who use standby letters of credit).

<sup>164</sup> BERTRAMS, *supra* note 2, at 12; Barru, *supra* note 1, at 89.

be considerable because banks are ill equipped to handle the task.<sup>165</sup> Banks have a comparative advantage in “the business of banking, most of which involves paper work” and “cannot function properly if they are compelled to investigate and verify facts outside their normal business.”<sup>166</sup> Indeed, applicants and beneficiaries are the least cost monitors of their underlying contract, not banks. Banks are not in control “of either the underlying transaction or the applicant’s selection of the beneficiary.”<sup>167</sup> The applicant and the beneficiary however are the experts in their field of business, just as Beneficiary, the Pakistani infrastructure development government agency, and Applicant, the Spanish engineering firm, are experts in international construction. Applicants and beneficiaries are thus in the best position to minimize the risk that the contract goes awry by shaping the terms of the contract. For instance, the parties may structure the independent guarantee/standby to afford applicants more protection. They can designate the terms of the independent guarantee/standby to require payment upon proper presentation of “statements from the beneficiary in the form of correspondence or certificates, or certificates from independent surveyors, especially from those nominated by the beneficiary, or from the engineer in the case of construction contracts” which the applicant could then present to the courts to prevent payment under the independent guarantee/standby based on a letter of credit fraud or breach of warranty claim.<sup>168</sup> Parties could also contract to make “initial orders in smaller lots until the good faith of international seller can be assured” or secure performance bonds “where the seller’s creditworthiness or good faith is unknown.”<sup>169</sup> Ultimately, local banks may pass the increase in administrative expenses associated with issuing independent guarantees/standbys backed by counter-guarantees/counter-standbys onto the beneficiaries and applicants in the form of higher fees for their services. This in turn will translate into

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<sup>165</sup> See Boris Kozolchik, *The Emerging Law of Standby Letters of Credit and Bank Guarantees*, 24 ARIZ. L. REV. 319, 331 (1982) (“Banks are only equipped to safely handle assurances of payment and not of completion of performance of underlying obligations. Not only do they lack the necessary expertise, but once the banks undertake the assurance of completion of performance they cannot escape the liability inherent in the innumerable trades or professions involved in such assurance.”).

<sup>166</sup> Buckley & Xiang, *supra* note 7, at 122; see Kozolchik, *supra* note 164, at 331.

<sup>167</sup> Buckley & Xiang, *supra* note 7, at 122.

<sup>168</sup> BERTRAMS, *supra* note 2, at 363; Barru, *supra* note 1, at 65.

<sup>169</sup> Mark S. Blodgett & Donald O. Mayer, *International Letters of Credit: Arbitral Alternative to Litigating Fraud*, 35 AM. BUS. L.J. 443, 460 (1998).

increase in the total cost of the underlying infrastructure project, reducing beneficial gains from joint ventures in the developing world.

## **2. Decreases Utility of Counter-Guarantees/Counter-Standbys as Security Devices**

In addition to hurting the commercial vitality of counter-guarantees/counter-standbys by raising expenses of local banks and counter-guarantors/issuers of counter-standbys, the *American Express* rule decreases the commercial utility of counter-guarantees/counter-standbys by harming their ability to assure independent guarantees/standbys issued by a financial institution located within the beneficiary government's territorial jurisdiction. Counter-guarantees and counter-standbys are attractive as security devices in support of locally-issued independent undertakings precisely because in case of applicant's non-performance the local bank has assurance of prompt and certain payment from the counter-guarantor/issuer of counter-standby when faced with the prospect of having to honor a local independent guarantee/standby. Indeed, as a result of the independence principle payment will not be delayed by litigation or by the local bank's investigation into performance of the underlying contract.<sup>170</sup> By holding that a beneficiary has no "colorable right" to demand payments under its local guarantees and the local bank in turn has "no good faith basis" to demand payment under its counter-guarantees when an arbitral panel set up to resolve a dispute over the performance of the underlying contract rules against the beneficiary, the district court not only weakened the advantages of independent guarantees/standbys for beneficiaries but also harmed the assurance utility of counter-guarantees/counter-standbys for local banks. Under this rule, a beneficiary and a local bank no longer have assurance of quick and certain payment under their respective undertakings in case of non-performance. Contrary to the independence of the independent guarantee/standby from the underlying contract and from the counter-guarantee/counter-standby, according to the *American Express* holding, local bank beneficiary of the counter-guarantee/counter-standby and local beneficiary of the independent guarantee/standby cannot obtain payment until the final resolution of the underlying contact dispute, should such a dispute arise. Moreover, under *American Express* the ability of local bank and beneficiary of the independent guarantee/standby to obtain their respective payment is contingent upon the arbitral panel ruling in the

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<sup>170</sup> See BERTRAMS, *supra* note 2, at 196; Barru, *supra* note 1, at 80; John F. Dolan, Commentary of Legislative Developments in Letter of Credit Law: An Interim Report, 8 B.F.L.R. 53, 56 (1993).

beneficiary's favor and not canceling beneficiary's independent guarantees/standbys. The rule in *American Express* essentially shifts the burden of going forward with litigation back onto the beneficiary,<sup>171</sup> – precisely the risk that local banks and local beneficiaries seek to avoid when asking for a counter-guarantee/counter-standby and independent guarantee/standby, respectively.<sup>172</sup> The placement of burden of going forward with litigation onto the beneficiary's side is not the arrangement for which Applicant, Beneficiary and Local Bank bargained for when Applicant requested Counter-Guarantor to procure independent guarantees in favor of Beneficiary, and when Local Bank entered into a counter-guarantee/counter-standby agreement with Counter-Guarantor. Ultimately, by generating an additional layer of litigation and administrative costs for banks, and decreasing the predictability and promptness of payment for local banks on their counter-guarantees/counter-standbys and beneficiaries on their independent guarantees/standbys, the *American Express* rule promises to harm the commercial utility of resorting to counter-guarantee and counter-standby arrangements in international project finance.

### 3. The Souder Approach to American Express-Type Scenario

The district court could have preserved the integrity of the independence principle by affirming the counter-guarantee rights and obligations of Local Bank and Counter-Guarantor with respect to one another despite the injunction by a court in Spain to prevent the honoring of the counter-guarantees and the contract dispute arbitral award cancelling Beneficiary's independent guarantees. The court should have reached that conclusion absent a showing that but-for the injunction on payment under counter-guarantee/counter-standby, Applicant will suffer "irreparable harm" in the form of having no adequate remedy under law for the alleged material fraud. Admittedly, courts have recognized that proliferation of letter of credit fraud threatens the utility of independent undertakings no less than the erosion of the independence principle.<sup>173</sup> However, a rule that does not neglect to perform the case law-developed injunction analysis before deciding to leave intact an injunction on the use of counter-guarantee/counter-standbys preserves the independence principle's robustness. It does this by preventing the status of the underlying contract to

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<sup>171</sup> Stern, *supra* note 8, at 245.

<sup>172</sup> BERTRAMS, *supra* note 2, at 13, 174; Stern, *supra* note 8, at 245.

<sup>173</sup> See *supra* note 15.

affect the rights and obligations under the independent guarantees and standbys, and counter-guarantees/counter-standbys, respectively, in all but the extraordinary cases. At the same time such a rule ensures that letter of credit fraud does not remain unpunished because the rule would require courts to satisfy themselves that the applicant would have a viable opportunity under law to obtain damages for fraud and to recover the amount of the independent guarantees or standbys. As long as the applicant would have adequate legal remedy for the alleged fraud, there is no reason to deviate from adherence to the independence principle at the price of undermining the commercial utility of counter-guarantee/counter-standby arrangements.

Moreover, upholding the counter-guarantee/counter-standby rights and obligations of local bank beneficiaries of counter-guarantee/counter-standbys and the issuers of those undertakings absent a showing of no adequate remedy under law would encourage careful drafting of arbitration agreements so that they help protect the applicant without undermining the independence principle. Such agreements would on the one hand expressly limit the scope of the arbitrators' authority so as to prohibit them from canceling the local independent guarantees/standbys, while on the other hand make the sum of local independent guarantees be recoverable as part of damages should the beneficiary fraudulently draw on its independent guarantees.<sup>174</sup> One key advantage of arbitration over court proceedings is that in light of the wide-spread ratification of the New York Convention, it may be comparatively easier to enforce arbitral awards in signatory countries in which the other party to the dispute has assets.<sup>175</sup> Arbitration agreements could also deter letter of credit fraud by including clauses allowing for award of punitive damages if the case involves conduct that the arbitrators find particularly outrageous.<sup>176</sup>

### Conclusion

The district court's holding that until the contract dispute arbitral award canceling Beneficiary's independent guarantees is vacated or modified, neither Beneficiary nor Local Bank has a "colorable right" to demand honor of its independent guarantees and counter-guarantee, respectively, lacks foundation in standard international letter of credit practice, contract law,

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<sup>174</sup> Blodgett and Mayer, *supra* note 169, at 461–62.

<sup>175</sup> Lecuyer-Thieffry & Thieffry, *supra* note 33, at 618.

<sup>176</sup> Blodgett & Mayer, *supra* note 169, at 462.

international public law, New York law, case law-developed standard for issuing injunctions, and policy. First, the independence principle, contract law, Article V-1(c) of the New York Convention, and New York case law do not support the conclusion that an arbitral panel's decision on the underlying contract dispute can alter bank obligations under independent guarantees and counter-guarantees when the outcome of such arbitration is not one of the terms of either undertaking. Second, the court failed to account for the independence of counter-guarantees/counter-standbys from local undertakings: since the only condition for honoring the counter-guarantee was that Local Bank make a bear demand, Local Bank's demand on its counter-guarantee in response to a pending action in Pakistan aimed at forcing Local Bank to pay Beneficiary on its independent guarantees was at least "colorable." Third, contrary to case law-developed standard for issuing injunctions, the district court effectively affirmed an injunction to prevent the honoring of the counter-guarantee and the independent guarantees without first satisfying itself that absent the injunction Applicant would be left out in the cold with no adequate remedy under law against Beneficiary for the amount of the independent guarantees. There is substantial indication that Applicant could have a viable legal remedy here. Third, by failing to treat counter-guarantees/counter-standbys as independent from local undertakings and conditioning the right of local beneficiaries to obtain payment under their independent guarantees/standbys on the outcome of the underlying contract arbitration, the district court's holding hurts the commercial vitality of counter-guarantees/counter-standbys. The court's rule raises the expense of resorting to counter-guarantees/counter-standbys by creating a costly layer of litigation between local banks and local beneficiaries and between local banks and counter-guarantors/issuers of counter-standbys. The court's rule also raises the expense of resorting to counter-guarantee/counter-standby arrangements by forcing local banks to investigate and monitor the underlying contract – the task for which banks are completely ill-suited. Furthermore, the district court's rule decreases the utility of counter-guarantees/counter-standbys and independent guarantees/standbys as security devices by making the prospect of a guaranteed and prompt payment prior to any litigation much less certain. A contrary rule would have been a sounder one. Under such a rule, if the local bank complies with the terms of the counter-guarantee/counter-standby, courts would in general uphold the obligation of a counter-guarantor/issuer of a counter-standby to honor the local bank's demand under its counter-guarantee/counter-standby irrespective of the outcome of the underlying contract dispute arbitration. Derogation from this general rule would only be appropriate in cases where the aggrieved applicant would be left without an adequate remedy under

law. On the one hand, this alternative rule would protect the commercial vitality of counter-guarantee/counter-standby arrangements through strict adherence to the independence principle. On the other hand, the rule would assure that letter of credit fraud does not remain unpunished.