

International Financial and Secured Transactions

BERNARDO M. CREMADES

I. Introduction: Purpose and Scope

This report identifies the major legal developments of 1996 in the field of International Financial and Secured Transactions, and is designed to serve as a useful tool for the international practice of U.S. (public or private) attorneys.

II. Letters of Credit (Commercial and Standby)

A. LEGISLATIVE DEVELOPMENTS

1. *New Revision of Article 5 of the Uniform Commercial Code (UCC)*

The new revision of Article 5 of the UCC aims to clarify the difference between letters of credit, other forms of assurance, such as guarantees, and ordinary contracts; preserve flexibility by permitting parties to a letter of credit transaction to vary Article 5 rules by agreement; comprehensively regulate the standby letter of credit; and, finally, accommodate the electronic revolution taking place on banking and commercial practices.

2. *UNCITRAL Convention on Independent Guarantees and Standby Letters of Credit*

On December 11, 1995, the United Nations General Assembly Meeting held in New York adopted and opened for ratification by States this vital text for the uniform regulation of standby letters of credit and guarantees. The Convention applies to "undertakings" which are narrowly defined to include only commitments that indicate (or give rise to the inference) that "payment is due because of a default in the performance of an obligation" or because of another "contingency." The Convention would apply to an "undertaking" only when: (i) the undertaking does not exclude the application of the Convention, (ii) either the issuer's place of business where the undertaking is issued is located in a country that has adopted the Convention, or under international conflict of law principles, the law applicable to the undertaking is the law

Bernardo M. Cremades is a member of the law firm J.Y.B. Cremades y Asociados in Madrid, Spain, and he is co-chair of the International Financial and Secured Transactions Committee.

of a country that has adopted the Convention; and (iii) the undertaking is "international."¹ Thus the Convention, if adopted by the United States, would apply to *international standby credits* issued in the United States, except for credits which state that the Convention is not applicable. The Convention would not normally apply to commercial letters of credit unless the international commercial credit expressly states that it is subject to the Convention.

3. *New ICC Uniform Rules for Bank-to-Bank Reimbursements Under Documentary Credits*

The New ICC Uniform Rules for Bank-to-Bank Reimbursements under Documentary Credits² discuss the responsibilities of the issuing bank, reimbursement authorizations, along with the handling of reimbursement claims, and will be used by banks worldwide. The UCP 500³ has been the international standard for documentary credits but until these Uniform Rules, interbank currency reimbursements were often subject to local custom, except in the United States where banks had formulated their own rules. The hope is that the rules will expedite bank-to-bank reimbursements and a structure for processing.

B. SIGNIFICANT COURT DECISIONS

1. *U.S. Cases*

- **Subrogation of Account Party to Claims of Issuer:** In *Carol Ruth Inc. v. Provident Life & Accident Ins. Co.*,⁴ the court held that letter of credit law does not permit an assignee to assert the issuer's rights through the doctrine of subrogation. Under subrogation principles, a party that pays its own debt rather than the debt of another is not entitled to subrogation.
- **Insufficient Notice of Discrepancies Provided by Issuer:** In *Toyota Tsusho Corp. v. Comerica Bank*,⁵ the court considered whether the notices provided by the issuer of the reasons for dishonor were sufficient under Article 16(d) of UCP 400. The court concluded that the issuer's responsibility to provide notice can be satisfied by any communication from the issuer within the reasonable time following presentment, and such notice can operate independently or in conjunction with a prior notice.
- **Confirming Bank Owes No Duty to Account Party:** In *Polymer Trading, S.A.R.L. v. CIC-Union Européenne et Cie*,⁶ the court held that no privity of contract existed between the account party to a letter of credit transaction and the confirming bank, and that a confirming bank owes no duty to use reasonable care when reviewing documents presented by the beneficiary at the time of a draw on a letter of credit.
- **Review of Draw Documents Within a Reasonable Time:** In *Rhode Island Hospital Trust National Bank v. Eastern General Contractors, Inc.*,⁷ the court considered whether the issuer of a standby letter of credit had acted within a reasonable time when it waited to review draw documents until after the expiration date of the letter of credit. The appellate court

1. Art. 4(1): An undertaking is "International" if any two of the following parties are in different countries: the issuer, the beneficiary, the applicant, a person acting at the applicant's request, or a confirmer.

2. ICC Pub. No. 525, effective July 1, 1996.

3. Uniform Customs and Practice for Documentary Credits, fourth revision, ICC Pub. No. 500, effective January 1, 1994.

4. No. 90 Civ. 2400 (S.D.N.Y. Mar. 24, 1995).

5. 95-71642 (E.D. Mich. July 1, 1996).

6. 640 N.Y.S.2d 32 (N.Y. App. Div. 1996).

7. 647 A.2d 1227 (R.I. 1996).

reversed the trial court's decision, and rejected the motion held by the trial court that the beneficiary assumes the risk of insufficient time to cure when it presents its draw three banking days or less prior to the expiration date of the letter of credit.

- **Nature of Beneficiary's Warranty Under Section 5-111 of the UCC:** In *PNC Bank, N.A. v. Liberty Mutual Insurance Co.*,⁸ the court considered whether the beneficiary who presents draw documents under a standby letter of credit warrants that any factual statements contained in the draw documents are true. The district court recognized that other courts had construed the beneficiary's warranty under Section 5-111⁹ to include a warranty of the truthfulness of assertions in the documents, such that the warranty is breached when the draw documents contain false statements of fact necessary to make the documents conform to the "conditions of the credit." The court, however, swept those decisions aside and held that the warranty extends only to the beneficiary's compliance with the "conditions of the credit" and not the conditions for the draw.
- **Mitigation of Damages:** In *San Diego Gas & Electric Co. v. Bank Leumi*,¹⁰ the court considered whether a beneficiary under a standby letter of credit owes the issuer a duty to mitigate damages and whether any actual mitigation of damages entitles the issuer to a corresponding reduction of the beneficiary's recovery under the letter of credit. The court of appeals held that the reduction of recovery outlined in Section 5-115 was limited to commercial letters of credit where the beneficiary is a seller of goods. Following other decisions, the court held that, in a standby letter of credit context, inquiry into the underlying contract to determine the extent of the beneficiary's actual damages was not permitted.

2. Foreign Cases

- **Fraud Exception:** In *Royal Bank of Canada v. Darlington*,¹¹ an Ontario court recently determined the "Clear and Obvious" threshold that has to be met before the fraud exception with respect to the underlying transaction can be used to claim that an issuing bank erred in honoring the credit. The court, in placing an extremely high burden of proof on an account party claiming fraud, recognized that banks are not necessarily well-suited to make the ultimate determination on the fraud question, and therefore should not be easily targeted for liability based on their decisions.
- **Liability of Issuing Bank:** *69971 Manitoba, Ltd. v. National Bank of Canada*.¹² This decision addressed the liability of an issuing bank for debiting the account of its customer in reimbursement for a payment the bank had improperly made on a letter of credit issued on behalf of that customer. On appeal, the court held the lower court had incorrectly allowed the customer to receive the entire amount of the debit, which was equivalent to the amount of the letter of credit, because the customer had realized proceeds from the sale of the nonconforming goods.
- **Principle of Autonomy of Letter of Credit:** In *Royal Bank of Canada v. Ontario New Home Warranty Program*,¹³ this case proves once more that in Canada, unless clear fraud

8. 912 F. Supp. 169 (W.D. Pa. 1996).

9. U.C.C. Section 5-111(1) provides that a beneficiary presenting a draft for payment warrants to all interested parties that the "necessary conditions of the credit have been complied with."

10. 42 Cal. App. 4th 928, 50 Cal. Rptr. 2d 20 (1996).

11. Canada: 1995 Ont. C.J. LEXIS 1234 (Gen. Div. Apr. 19, 1995).

12. Canada: Manitoba Court of Appeal, Mar. 27, 1995.

13. Canada: Ontario Court of Justice (General Division), Mar. 1, 1996.

is involved, the courts are hesitant not to enforce an issuer's payment obligation under a letter of credit where the conditions to such payment are met, even where the equities of the situation would argue that the beneficiary of the credit not be paid lest the usefulness of the institution of the letter of credit be hampered.

- *Loomcraft Fabrics CC v. Nedbank Ltd. and Another*.¹⁴ An interdict restraining payment will only be granted at the instance of the buyer in exceptional circumstances. This case represents the Appellate Division's first reported confrontation with the difficult subject of exceptions to the principle of autonomy. It evidences a conservative approach to the autonomy principle which should be welcomed by banks.
- *GPA Group PLC v. The Governor and Company of the Bank of Ireland and the European Organization for the Safety of Air Navigation*.¹⁵ In a split decision, the court ruled that an account party could maintain an action against the beneficiary who had collected on a letter of credit, even though the beneficiary had arguably complied with the terms of the credit. It was the account party's contention that the beneficiary had breached an agreement between the parties as to what conditions had to be satisfied before the beneficiary could collect on the credit.
- **Taxation of Letter of Credit:** *Harold Gross Machinery v. Ministry of France*.¹⁶ This case addressed whether accounts payable secured letters of credit could be viewed as "paid up capital" for the purposes of the Corporations Tax Act (CTA). The court found that letters of credit securing a company's accounts payable could be taxed, citing the purpose of the CTA to tax capital used by a corporation in the operation of its business.
- **Injunction Against Beneficiary's Abusive Demand for Payment:** *Themebelp Ltd. v. West and Others*.¹⁷ In this case, the courts have for the first time set out the principles to be applied where the party in default under the main contract seeks (without involving the guarantor in the proceedings at all) to restrain the beneficiary from taking any step to enforce the performance guarantee, allowing buyers to apply to the courts for an injunction against the beneficiary, preventing his making any demand at all.
- **Letter of Credit Does Not Imply Discharge of Debtor's Obligations:** *Chloride Batteries SE Asia PTE Ltd. v. BPS International PLC*.¹⁸ The Queens Bench found that a seller, who had accepted a letter of credit issued at the behest of a party to whom the buyer had subsequently resold the goods, was not precluded from claiming directly against the buyer after payment on the letter of credit was not made. Nevertheless, the court did note that, under certain circumstances, an agreement can be implied to exist that delivery of a letter of credit discharges a purchaser's payment obligations.
- **Governing Law:** In *Bank of Credit and Commerce Hong Kong Ltd. v. Sonali Bank*,¹⁹ an English court was asked to decide what law should govern the reimbursement obligation owed by a Bangladeshi issuing bank to a Hong Kong confirming bank. The court held that in the absence of an express choice of law clause in the relevant contract, the law that governs the credit should also govern the reimbursement obligation.

14. South Africa: 1996 (1) SA 812 (A).

15. Ireland: Supreme Court, Nov. 9, 1995.

16. Canada: Ontario Court of Justice (General Division), Commercial List, July 19, 1996.

17. United Kingdom: [1995] 3 WLR 751.

18. United Kingdom: Queens Bench Division (Commercial Court), Mar. 21, 1996.

19. United Kingdom: [1995] 1 Lloyd's Rep. 22, Queen's Bench Division (Commercial Court).

- **Obligations of Confirming Bank:** *Bundesgerichtshof, Ger., 1996 Zeitschrift für Wirtschaftsrecht* 454.²⁰ The German Supreme Court held that the obligation of a bank under Section 14(d)(i) of the UCP 500 to examine the submitted documents and notify the beneficiary of their incompleteness only applies in situations in which the beneficiary is not already aware that the submitted documents are incomplete.

C. OTHER LEGAL DEVELOPMENTS

1. *U.S. Council on International Banking: New Certification Program*

A certification program to test the skills of letters of credit professionals has been devised by the U.S. Council on International Banking. Two types of experts will be tested: Certified Documentary Credit Specialists and Certified Documentary Credit Managers. It is expected that this program will be beneficial for both letter of credit specialists (since they will receive recognition of their expertise) and employers looking for experienced professionals in the field (since it will be easier to assess the candidate's knowledge). The first testing is scheduled to take place in 1997.

2. *International Finance Corporation: Russian Trade Enhancement Facility*

During the final quarter of 1995, the International Finance Corporation (IFC) established the Russian Trade Enhancement Facility Program, a guarantee facility that is designed to enable Russian banks to more cheaply and more frequently finance the imports of Russian companies. The facility operates by guaranteeing a portion of the obligations of Western banks acting as confirming banks on letters of credit issued by Russian banks. Although Russian issuing banks may still be required to provide a partial cash deposit, the facility will enable the Russian banks to finance international trade on more favorable terms, as it will eliminate the need for Russian banks to tie up all their cash as security. Similarly, the facility should also allow Russian importers to lessen their reliance on "advanced payment transactions" and thus enjoy the benefits of documentary credits more readily. The letters of credit covered by the facility will all be subject to UCP 500 and will have maximum expiry dates of 90 days.

III. Cross-Border Lending Guarantees and Security Issues

A. LEGISLATIVE DEVELOPMENTS

1. *Proposal of EU Directive on Setting-Off and Constitution of Guarantees*

In March 1996, a new Directive was proposed by the Directorate General XV of the European Commission. The aims of the Directive are the regulation and effectiveness of national and transnational payments between banks within the EU based on the set-off systems and the guarantees given by those who participate in such systems so that insolvency or bankruptcy procedures of the participants could not affect the setting-off or the guarantees granted. The proposed Directive is envisaged for implementation in the EU countries in January 1998, although some delays to this timetable are foreseen based on the amendments expected to be proposed by the countries involved.

20. Germany: Jan. 23, 1996.

2. *New Pledge Regulation in France*

The implementation of the Investment Services Directive²¹ in France by means of the enactment of the Law Modernizing Financial Activities²² has brought changes of a particular interest in structured finance transactions such as new provisions which facilitate collateralism with securities on many financial transactions. These new provisions²³ enable any individual to pledge a "financial instrument" account, this term being broadly defined. The flexibility of the new schemes also extends to the simplification of the execution procedures.

3. *New Securities Law in China*

The Peoples Republic of China (PRC) Security Law²⁴ is the first piece of national legislation dealing with security, and is a step forward in the development of a uniform set of legislation to govern the creation, registration, and most importantly, the enforcement of different forms of security which can be granted to a creditor. The Security Law also, for the first time, sets out clearly the extent of the guarantor's liability and regulates the interrelationship between the debtor, the creditor, and the guarantor. Any contravention of the Security Law or failure to meet its requirements may render a guarantee or mortgage unenforceable against the PRC guarantor or mortgagor; therefore it is important for foreign lenders to ensure its terms have been complied with.

4. *New Legislation in Luxembourg on Settling of Financial Claims*

New legislation²⁵ has been implemented in Luxembourg by which netting agreements or clauses between credit institutions are expressly recognized as valid even following bankruptcy and even when these concern transactions or instruments of a different nature. This new legislation represents a major advance in the safety and security of international financial transactions, since it promotes netting structures as an effective mechanism to reduce financial risk exposure, particularly in insolvency situations.

B. SIGNIFICANT COURT DECISIONS

1. *U.S. Cases*

- **Minority Rights in Loan Participations:** In *Den Norske Bank AS v. First National Bank of Boston*,²⁶ the U.S. Circuit Court of Appeal for the First Circuit held that it is a common, industry-wide practice to incorporate minority participant veto powers over loan forgiveness arrangements, and the wording of the loan participation agreements should be interpreted in light of this practice.

2. *Foreign Cases*

- **Use of Insolvency Proceedings as a Means of International Debt Enforcement:** The *CTIETCC*²⁷ case shows how a winding up order filed in Hong Kong with regard to a

21. EU Directive 93/22 of May 10, 1993, on investment services (the ISD).

22. Loi de modernisation des activités financières, July 2, 1996.

23. Particularly in article 102.

24. Effective as of Oct. 1, 1995.

25. Law of May 9, 1996, on netting in the financial sector, published in the Official Journal of the Grand Duchy of Luxembourg on May 29, 1996.

26. 75 F.3d 49 (1st Circuit 1996).

27. *Re China Tianjin International Economic and Technical Cooperative Corporation*, [1994] 2 HKLR 327, at 328 ([1995] 1 HKC 720, at 721 to 722).

Chinese company (the debtor) is a useful mechanism to reaching a settlement of the underlying dispute, with it being unnecessary that the facts of said dispute have any connection whatsoever with Hong Kong.

- **Nonperformance of Bank Guarantees:** In *Torrespapel and others v. SRIW, Nofipac, Banque Internationale à Luxembourg*,²⁸ the Court of Appeals of Liège acknowledged that guarantors may refuse payment if the underlying obligation violates a rule of public policy under the law applicable to the guarantee, although in order to excuse the nonperformance of the guarantee, violation of the public order must be obvious and not simply invoked.
- **Performance Bonds:** In *Turkiye IS Bankasi v. Bank of China*,²⁹ the Court once again sustained the view that performance bonds are primary obligations, independent of the underlying contract, with the bank being obliged to pay (subject to certain narrow exceptions).
- **Effectiveness of Letters of Comfort:** Various recent decisions of the supreme court of Sweden³⁰ have established that the intention of the parties regarding the relevance of a letter of comfort is paramount to the interpretation of the extent of the obligation thereunder, and thus the mere wording of the document may not be sufficient for consideration of the comfort letter as something less than a guarantee.
- **Bill of Guarantee Void:** A recent decision of the supreme court of Austria³¹ held that if a bill of guarantee is void for formal reasons, such guarantee may be converted into a simple guarantee and may be sufficient legal grounds for claiming payment under civil law unless there is a clear indication of the parties to the contrary.

C. OTHER LEGAL DEVELOPMENTS

1. *Amendment to EMTA's Standard Terms for the Assignment of Loan Assets*

In July 1996, the Emerging Markets Traders Association (EMTA) amended their Standard Terms for the Assignment of Loan Assets³² for the purpose of reducing settlement periods and encouraging prompt repayments. The Standard Terms were drafted with the aim of having standard documentation which could facilitate the trading of sovereign loan assets. In this respect, the usual practice is to incorporate the Standard Terms through their reference in the confirmation of an assignment. It is expected that the continuous use and improvement of the Terms will encourage and promote the field of loan assignments over sovereign loan assets.

2. *Comptroller of the Currency (OCC) Revised Interpretative Ruling Section 7.7016*

Effective April 1, 1996, U.S. banks may issue and commit to issue Letters of Credit *and* other independent undertakings, including bank guarantees. On February 5, 1996, the Office of the Comptroller of the Currency (OCC) issued its final revised Interpretative Ruling Section 7.7016 under which national banks have now been authorized to issue letters of credit *and* "other independent undertakings" to pay against documents, such as bank guarantees, that are within the scope of applicable law or legally recognized rules of practice.³³ Revised Section

28. Court of Appeals of Liège, September 15, 1995, *Revue Pratique des Sociétés*, 1995, at 416.

29. Queen's Bank Division, February 8, 1996.

30. *International Financial Law Review*, April 1996, page 60.

31. Supreme Court, March 28, 1996, 8 Ob 2082/96a.

32. The initial Standard Terms for the Assignment of Loan Assets were adopted in January 1995.

33. Such as U.C.C. Article 5, UPC 500, the UNICITRAL Convention on Independent Guarantees and Standby Letters of Credit, and the Uniform Rules for Bank-to-Bank Reimbursements Under Documentary Credits.

7.7016 is a major change expanding the authority of national banks to include not only letters of credit and standby letters of credit but also—but not limited to—independent guarantees, authorized confirmations, commitments to purchase documents, irrevocable reimbursement undertakings, and preliminary advices.

IV. Project Finance

A. MARKET DEVELOPMENTS

1. *Latin America*

The expansion of project finance structures in South America as a result of privatization and development of infrastructure projects has been accompanied by important decisions in areas of law such as security interest legislation and trusts. Examples of this expansion are countries like Argentina (introduction of new laws eliminating discrimination against foreign creditors secured through registered pledges and the creation of financial trusts),³⁴ Colombia (implementation of the National Gas Plan, wider use of concession mechanisms, development of financial, commercial and guarantee trusts), and Mexico (use of trust structures as a method of overcoming obstacles posed by local law).³⁵

2. *Western Europe*

In the United Kingdom, the first capital markets financing of the U.K. Government's Private Finance Initiative Project (PFI) has taken place: The aim of the PFI is to encourage private sector investment in areas where the provision of services and infrastructure have traditionally been regarded as exclusively the remit of the public sector. In this case, the PFI consisted in DBFO contracts for two important U.K. highways, and the innovative financial structure achieved a number of notable milestones, which are the following: (i) first capital markets financing of a PFI project, (ii) first financing of two projects through a single public bond issue, (iii) first monoline guaranteed bond issue financing of a PFI or any UK project, and (iv) largest sterling-denominated bond issue guaranteed by AMBAC Indemnity Corporation, a U.S. monoline insurer.

3. *Central and Eastern Europe*

As a consequence of political and economic changes in Central and Eastern Europe there has been an upsurge in the number and variety of planned project financing transactions in the region, particularly those involving build-operate-transfer (BOT) concessions. Hungary and Poland are the most advanced countries in the use of private capital, evidenced in the recent privately financed motorway concessions in both countries. Plans are underway in both countries to privately fund the renovation of their power generation and distribution system. Also countries such as Kazakhstan, Russia, Romania, Bulgaria and the former Yugoslav Republics of Slovenia and Croatia are open to and making progress in the use of private financing structures.

4. *Asia*

The need to receive financial assistance from countries in the developed world has forced Asian governments to encourage foreign private investment and finance in infrastructure projects

34. Law 24,441.

35. For example, in the U.S. \$647 million financing of the Samalayuca II Power Plant.

with both the assistance of multilateral agencies and the substantial support and involvement from the respective governments. Government support can be seen not only in the enactment of specific regulations, such as BOT legislation, but also in new aspects such as the issue of undertakings, letters of support and guaranties, the waiver of immunity of jurisdiction and acceptance of international arbitration, allowance of one hundred percent foreign ownership over project finance vehicles, etc. Recent examples in these areas are the Sual³⁶ and Cilicap³⁷ financings.

B. ROLE OF EXPORT CREDIT AGENCIES AND FINANCIAL INSTITUTIONS

1. *The MEDA Program*

A financial tool called MEDA was envisaged by the Barcelona conference held in November 1995, with the aim of preparing Mashrek and Maghreb economies to face open competition with the European Union in the next century. The total amount for the 1996-99 period dedicated to financially assisting these countries is ECU 3,424 million. Almost ECU 500 million are already financing projects in Lebanon, Tunisia, Egypt, Syria, and Jordan.

2. *The TACIS Program*

In July 1996, the European Union adopted a new Regulation on TACIS (financial aid for countries formerly part of the U.S.S.R. and Mongolia). The TACIS Program was established in 1991 for an initial period of five years and has already assisted in the development of more than 2,000 projects. The new Regulation on TACIS intends to devote a total of ECU 2,224 million during the period 1996-99.

3. *The ECIP Program*

In January 1996, the European Council of Foreign Affairs adopted the third phase of the ECIP (European Community Investment Partners), a program aimed at developing a flexible vehicle to assist European private sector firms to invest in developing countries. This third phase is represented by a financial package of ECU 250 million for the next five-year period. The geographical scope of ECIP was originally limited to 28 countries in Asia, Latin America and the Mediterranean, but now covers approximately 60 countries.

4. *Activities of Credit Agencies*

- **IFC:** The leading role of the IFC in structuring loans to emerging market borrowers continues with transactions such as the U.S. \$100 million loan to Apasco (Mexico), the U.S. \$130 million loan to Grupo Industrial Bimbo (Mexico), the U.S. \$226 million loan for the Sual plant (The Philippines), or the management of the U.S. \$60 million Global Depository Receipts issue made by Banque Marocaine du Commerce Extérieur.
- **Eximbank:** Recent major deals in which Eximbank has been involved are the co-financing of the construction loan for the Cilicap project (U.S. \$630 million), the U.S. \$150 million loan support for the Sual plant (The Philippines), and the U.S. \$440 million commitment for the Samalayuca II Power Project (Mexico).

36. BOT 1200 MW power plant in the Philippines financed by a syndicate for U.S. \$1.35 billion.

37. Increase of production capacity at Indonesia's largest refinery which involved financing in the amount of U.S. \$630 million.

