Notes From The Field
An English Law Perspective On The Oil & Gas Market
Standby to Safeguard Payment | November 2014

Author: Rebecca Downes | Associate | +44.20.3053.8227
rebeccadownes@andrewskurth.com

Rebecca joined Andrews Kurth from a leading international law firm in London, where she worked in its energy team for three years. She has represented a broad range of clients, including international oil and gas companies, financial institutions and project companies, on a variety of domestic and international upstream oil and gas transactions. Her practice focuses on mergers and acquisitions, project development arrangements, LNG and gas sales agreements and other related commercial contracts.
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Originally a product of the United States of America, standby letters of credit ("standbys") have, in recent decades, attracted global recognition, which has been marked by their adoption and implementation on an international scale. They are employed by oil and gas companies in asset and business acquisitions and disposals, as well as in the development and commercialisation of projects. Their popularity often sets them apart from other financial instruments, such as commercial letters of credit, performance bonds and demand guarantees, as the preferred form of security.

This article briefly analyses two different, but related, bodies of international trade rules which can be applied to standbys; considers the fundamental DNA of standbys; and provides some food for thought to those responsible for their preparation and execution.

**Letters of credit**

A letter of credit is a written obligation (as its name suggests, in letter form), which is issued by a bank to a specified beneficiary, on an applicant's behalf, pursuant to which the issuing bank is obliged to make a monetary payment to the beneficiary or trustee against the presentation of specified documents or a written demand. In return, the issuing bank is paid its costs for setting up the letter of credit, as well as receiving reimbursement from the applicant for any debt it incurs as a result of the credit being drawn down.

Letters of credit largely fall into two baskets: traditional commercial letters of credit and standbys. The commercial letter of credit acts as a payment mechanism, which is put in place to safeguard payment of the purchase price by the buyer to the seller in consideration for the sale of goods or provision of services. Standbys, however, have a slightly different function. They typically provide collateral support for particular financial obligations owed by one party to another under an underlying contract. Despite their subtle difference in purpose, both types of credit are triggered by a contingent event, create a primary obligation on the issuing bank and are a form of documentary credit.

Although this article does not refer to performance bonds and demand guarantees in any detail, it is worth noting that a letter of credit performs a similar function, and is often described as being equivalent, to a performance bond and demand guarantee. Like letters of credit, performance bonds and demand guarantees safeguard a beneficiary against a failed performance, or an alleged failed performance, by an applicant under an underlying contract.

**Trade rules: UCP 600 v ISP98**

Bodies of international trade rules for letters of credit have been published by the International Chamber of Commerce ("ICC") in a successful attempt to standardise their terms and conditions. Most letters of credit are either subject to the ICC’s Uniform Customs and Practice for Documentary Credits ("UCP") or the ICC’s International Standby Practices ("ISP").

UCP is currently in its sixth edition ("UCP 600"). UCP 600 was implemented on 1 July 2007 and evolved from, and superseded, the UCP’s fifth edition ("UCP 500"). Although there are notable similarities between UCP 600 and ISP98, such as their inclusion of rules relating to presentation and examination of credits, it is important to recognise that ISP is a separate set of specific uniform rules.

ISP98 was originally approved on 6 April 1998 by the ICC Commission on Banking Technique and Practice whose objective was to plug the hole it felt had been created by the UCP in respect of standbys, and to provide more detail and clarification around the rules relating to such form of credits. ISP98 provides custom rules for standbys, and has been an alternative body of rules to UCP for the past sixteen years.
The applicant and the beneficiary have the freedom to decide which set of rules to incorporate into their standby, and it is important that the standby expressly states that it is issued subject to whichever set of rules have been chosen. A standby can also expressly modify or exclude particular parts of the selected body of rules from its application. Often this is addressed in the standby by including general language similar to, "except as otherwise expressly stated herein", rather than specifically spelling out each relevant provision that should be modified or excluded.

Although, as noted above, UCP 600 can apply to standbys if it is expressly incorporated to do so, the authors of ISP98 would argue that the rules embodied in ISP98 are better suited to standbys. For instance, article 18 (commercial invoice) to article 28 (insurance documentation and coverage), inclusive, of UCP 600, and article 30 (tolerance in credit amount, quantity and unit prices) to article 32 (instalment drawings or shipment), inclusive, of UCP 600, are clearly more applicable to commercial letters of credit than they are to standbys.

Having said that, applicants and beneficiaries in the oil and gas industry are increasingly opting to incorporate the rules of practice set out in UCP over those in ISP into their standbys. There appears to be no real logic for this trend. One explanation may be that applicants and beneficiaries alike have a greater familiarity with UCP rules than those of the ISP. Although ISP98 was introduced as an, "evolutionary product of the application of the UCP to standbys", UCP 600 has been implemented by the ICC more recently than ISP98 (i.e. by nine years), and so potentially may be given a higher status by those negotiating standbys as a consequence. Another explanation may be that some applicants may feel that UCP 600 is too detailed and is drafted too far in favour of issuing banks and beneficiaries.

Model form contracts in the oil and gas industry may also play a part in the confusion surrounding which body of rules to incorporate into standbys. For instance, the form of letter of credit for estimated decommissioning costs in appendices 3A and 3B of the Oil & Gas UK Industry Model Form Decommissioning Security Agreement (September 2013) state that they are, "issued subject to (except insofar as otherwise expressly stated) Uniform Customs and Practice for Documentary Credits, 2007 revision, ICC Publication No. 600". As a consequence of imitating the approach taken in this pro-forma, decommissioning security related standbys often incorporate UCP 600 rules over the more customised ISP98 rules.

In a similar way, other oil and gas industry precedents may have contributed to the misunderstanding over which version of the UCP rules should be applied to standbys. Exhibit E1 of the AIPN 2012 Model LNG Master Sale and Purchase Agreement ("2012 LNG MSPA") and schedule 5 of the AIPN 2002 Model Well Services Agreement ("2002 WSA") both include forms of standby which are subject to UCP 500. Given that UCP 600 was implemented in 2007, it would appear incongruous that the 2012 LNG MSPA incorporates the previous, rather than the current, version of the UCP rules. This is perhaps just an oversight. As the 2002 WSA preceded UCP 600, it is logical that this model form contract incorporates the earlier UCP 500 rules, albeit that parties basing their well service agreements on the 2002 WSA should now consider updating the reference in schedule 5 from UCP 500 to UCP 600.

**DNA of standbys**

Whether or not standbys incorporate the body of rules captured by UCP 600 or ISP98, they comprise four fundamental principles: autonomy, irrevocability, strict liability, and short-term nature, which are described in more detail below.

1. **Autonomy**

   Arguably, autonomy is the most significant of the four fundamental principles as it goes to the heart of the standby. This principle is weighted most heavily in favour of protecting the issuing bank. It neither obliges the issuing bank to analyse the documents presented to it by the beneficiary or trustee, nor does it expect the issuing bank to examine the relationship between the applicant and the beneficiary or trustee, before making payment under the standby. The issuing bank merely provides a service and acts as the gatekeeper.
2. **Strict liability**

The strict liability principle is closely related to the principle of autonomy, and applies to the issuing bank’s payment obligation. This requires an issuing bank to make payment on written demand by the beneficiary, and an issuing bank cannot rely on particular defences in order to avoid making such payment. This fundamental principle is evidently much more focused on the needs and concerns of beneficiaries than those of applicants.

3. **Irrevocability**

A standby takes effect on a specified date and exists until the earlier of when an issuing bank’s obligations thereunder expire and a specified time. It is irrevocable in nature and cannot be amended and/or cancelled unless all those parties involved expressly agree to do so.

4. **Short-term nature**

Even if a standby is required for the term of an underlying oil and gas contract, or the lifetime of an asset, it will typically be issued by a bank for a term no longer than one calendar year, after which time the standby will need to be renewed. Standbys are, therefore, not normally revolving in nature. This may create problems for the applicant and the beneficiary if the issuing bank refuses to renew a standby on the same terms, or if the beneficiary makes a written demand in the short period between one standby expiring and the immediately following standby taking effect.

**Timing considerations**

Timing considerations of when a standby should be issued and when a payment demand can be made is something that applicants and beneficiaries may be concerned with in practice.

1. **Fraudulent behaviour - risk for applicants**

   In some cases, the provision of a standby by a buyer or seller may be a condition precedent to the completion of the sale and purchase of an oil and gas asset or business. In other cases, the provision of a standby may be a condition that is imposed by one or more co-venturers on a transferor, prior to consent being granted to a proposed transfer of a transferor’s participating interest in an asset.

   In these examples, standbys are required to be handed over to the buyer or seller before completion of the sale and purchase of the asset, or to the co-venturers before they grant their consent to the transfer. This often leaves the applicant in an uncomfortable position, particularly in cases where a standby has been issued in order to fulfil a condition precedent or to satisfy a condition, but the sale and purchase or transfer has failed to complete for whatever reason.

   Rule 1.05(c) of ISP98 quite clearly states that the rules do not provide for, “defences to honour based on fraud, abuse or similar matters”. This is an issue given that, pursuant to Rule 2.03 of ISP98, “a standby is issued when it leaves an issuer’s control unless it clearly specifies that it is not then ‘issued’ or ‘enforceable’”, and, pursuant to Rule 3.10 of ISP98, “an issuer is not required to notify the applicant of receipt of a presentation under the standby”. The same point is a potential issue for standbys that incorporate UCP 600. Although UCP 600 does not make any specific reference to fraud, Article 34 of UCP 600 states that a bank assumes no liability or responsibility for the genuineness or falsification of any document.

   This means that, when a standby is issued in order to fulfil a condition precedent or to satisfy a condition, it is a live document, pursuant to which a beneficiary could potentially present a written demand to the issuing bank for payment, and as a consequence of the fundamental principles of standbys (particularly autonomy and strict liability), the issuing bank would be obliged to make payment thereunder to the beneficiary. Rule 8.01(b)(ii) of ISP98 even goes as far as to say that an applicant must indemnify the issuer against all claims, obligations and responsibilities arising out of, “the fraud, forgery, or illegal action of others”.

   **Articles**
At this point, it is important to note that neither UCP 600 nor ISP98 contain provisions dealing with the determination of the governing law of the standby. It is, therefore, necessary for a standby to incorporate a governing law and jurisdiction provision so that the standby can be interpreted alongside the applicable national law. If the law and courts of England and Wales are chosen as the governing law and jurisdiction of the standby, the rules of either UCP 600 or ISP98 (as applicable) should be read in light of the fraud exception to the principles of autonomy and strict liability that have been recognised by the English courts. United City Merchants (Investments) Ltd v Royal Bank of Canada remains the leading authority on this subject. In this case, Lord Diplock opined that, “there is one established exception: that is, where the seller, for the purpose of drawing on the credit, fraudulently presents to the confirming bank documents that contain, expressly or by implication, material representations of fact that to his knowledge are untrue”. It is clear from Lord Diplock’s judgment that fraud is an exception to the principles of autonomy and strict liability governing the letter of credit, so long as the beneficiary knew at the time it presented the specified documents or the written demand to the issuing bank that it was misrepresenting its right to do so. This may provide some comfort to applicants faced with the risks involved with issuing a standby to a beneficiary before the sale and purchase or transfer has completed.

2. Expiry date - risk for beneficiaries

Another timing issue is created by the short-term nature of standbys. Typically standbys will include a provision which states that the standby will expire upon the earlier of: (i) the date upon which the issuing bank has fully performed its obligations under the letter of credit; and (ii) [X] p.m. upon the date on which the letter of credit expires, unless a valid written demand has been made on the issuing bank before this cut-off point. This reflects the requirements set out in Articles 6(d)(i) and 6(e) of UCP 600, and, to the extent that ISP98 is incorporated into the standby, prevents the position set out in Rule 9.04 of ISP98 from becoming the default position.

To the extent that the issuing bank has agreed to issue a new standby on the same terms as the previous one, the beneficiary takes a credit risk on the applicant becoming insolvent between the time of [X] p.m. on the expiry date or the close of business at the place of presentation (as applicable) and the following day, which is the day on which the new standby takes effect.

One solution for the beneficiary could be to have the current standby overlap with the new standby by one day (i.e. the day on which the current standby expires and the new standby takes effect). From the applicant’s perspective, however, not only will this overlap be an added expense that the applicant will be obliged to finance, there is also a slim risk for the applicant as the beneficiary could attempt to make a demand under each separate letter of credit within the overlapping window. To the extent that the applicant is willing to entertain any overlap, the applicant should be advised to keep any such amount of time to a minimum. Seconds, rather than minutes or days, should be the applicant’s overlap limit (if any).

Conclusion

Although only a short document, it is clear that a lot of careful thought and consideration should be exercised by those responsible for the preparation and execution of standbys.

In summary, the first, and most important, decision the drafter will need to make is which body of international rules should apply. Whilst ISP98 provides custom rules for standbys, its thorough content and attention to detail may be off-putting to those who are considering whether or not to incorporate its terms. Although not strictly relevant in all respects to standbys, UCP 600 may be seen as a more favourable alternative, and affords more flexibility to those who have an interest in the standby. Once the drafter has made this initial decision, they will then need to consider whether any of the rules that have been selected need to be modified or excluded in some way, bearing in mind the fundamental building blocks which make up the DNA of standbys; determine what other provisions should be incorporated into the standby, including a governing law and jurisdiction clause; and give some thought to timing issues around at what point the standby should be issued and what measures, if any, should be put in place on the expiry of the standby.
Costs, timing and the relationship the applicant has with the issuing bank, may all also have a part to play in the decision making process. It would be a mistake to blindly mirror the wording of a standby from a previous deal, or from a model form contract, without giving its content and purpose any further thought.

Other articles from this issue of Notes from the Field – An English Law Perspective On The Oil & Gas Market.

- Oil and Gas in Greenland – Still on Ice?
- A Drafting Reminder: Remember the Recitals

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1. Article 1 of UCP 600 states that these rules apply to any documentary credit, “(including, to the extent to which they may be applicable, any standby letter of credit)’.

2. International Standby Practices ISP98, International Chamber of Commerce, Foreword, by Maria Livanos-Cattaui, Secretary General of ICC.

3. Rule 1.06(c) of ISP98 states that a standby is independent and so its enforceability is not dependent on the issuer’s rights, any reimbursement agreement or any underlying transaction. In the same vein, Article 4(a) of UCP 600 states that, “a credit by its nature is a separate transaction from the sale or other contract on which it may be based”, and Article 5 states that banks deal with documents and not the underlying contracts to which those documents relate.

4. Article 4(a) of UCP 600 states that, “the undertaking of a bank to honour, to negotiate or to fulfil any other obligation under the credit is not subject to claims or defences by the applicant resulting from its relationships with the issuing bank or the beneficiary”. Similarly, Rule 2.01 of ISP98 states that, “an issuer undertakes to the beneficiary to honour a presentation that appears on its face to comply with the terms and conditions of the standby in accordance with these Rules supplemented by standard standby practice”.

5. Rule 1.06(a) of ISP98 states that, “a standby is an irrevocable, independent, documentary, and binding undertaking when issued and need not so state”, and, similarly, Article 3 of UCP 600 concurs, stating that, “a credit is irrevocable even if there is no indication to that effect”.


7. These state that a credit must include an expiry date for presentation, and that such presentation must be made by the beneficiary on or before the expiry date, except where the expiry date of the credit or the last day for presentation falls on a day when the issuing bank is closed (other than for reasons of force majeure), in which case the expiry date or the last day for presentation, will be extended to the following banking day. The exception is set out in Article 29(a) of UCP 600.

8. Rule 9.04 of ISP98 states that, “if no time of day is stated for expiration, it occurs at the close of business at the place of presentation”.