

Four Uncertainties around the Fraud Exception in Documentary Letters of Credit under English Law

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*The principle of independence underpins the financial attractiveness and utility of documentary credits, since it makes the assurance of payment by banks concrete. Fraud is however a well-known exception upon which the principle of independence can be set aside. It is argued in this article that English law suffers from four uncertainties as to the fraud exception and it is evaluated how such uncertainties can be remedied. It is mainly advocated that English courts should consider the issue of allocating the risk of fraud, as commercially expected by parties, as a factor in fashioning rules and equitable concerns for the fraud exception. Regrettably, the commercial reality of the distinction between complex (chain of banks) and simple documentary credits, as a core factor in determining liability, is overlooked by English courts. In contrary, there is a tendency by courts to overdramatise the role of contractual analysis. Finally, it is argued that the decision of the Privy Council in *Alternative Power* cannot be an authority to accept any kind of fraud that is not related to the presented documents (non-documentary fraud) as an exception to the principle of independence.*

INTRODUCTION

Apart from being a method of payment fulfilling buyers' obligations in a contract of sale, documentary credits, also known as letters of credit or documentary letters of credit, play a leading role in international trade by enhancing the confidence in the circulation of documents in international sales and facilitating finance on the faith of documents. Such a leading role is primarily caused by the norm of independence embedded in documentary credits. According to the norm of independence the bank which issues the documentary credit is under an undertaking to make payment that is conditional *only* on the

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The following abbreviations are used:

UCP 600: ICC, *Uniform Customs and Practice for Documentary Credits*, (ICC No. 600, 2007);

Credit: a documentary letter of credit.

In the language of UCP 600 the undertaking of the issuing bank is to "honour" the credit which means (1) making payment against the presentation of conforming documents under a credit available by sight; (2) discounting the credit that is available by acceptance by accepting the bill of exchange accompanied with conforming documents and then paying the full amount at the maturity date or (3) accepting the conforming documents when the credit is available by negotiation and paying at the maturity date. For the concept of honour: article 2 UCP 600; for the concept of honour in acceptance and deferred credits: article 7 & sub-article 12 (b), (c) UCP 600; G Collyer and R Katz (eds), *ICC Opinions 2009-2011*, (2012) Opinion 722, ICC No 732.

presentation of documents that appear on their face to be in conformity with the required documents in the issued documentary credit.

But fraud changes the rules of the game as it is a cancer that threatens the integrity of commercial transactions and the stability of a smooth flowing of goods and services. English law has therefore developed the doctrine of the fraud exception, in the law of documentary credits, upon which the norm of independence can be set aside, so a payment can be stopped by a fact other than the apparent conformity of the presented documents. The doctrine of the fraud exception however suffers from a number of uncertainties under English law. Whilst there is a good deal of scholarship on documentary credits,² the issue of uncertainties remains relatively under explored. This article seeks to address this gap in the literature. To this end, this article will adopt the following structure.

The first part explores the meaning of the norm of independence and the elements of the doctrine of the fraud exception. The second part identifies the first uncertainty in that the policy reasons underlying the fraud exception are by no means clear. The device of contract analysis however increases such an uncertainty. In light of the recent decision of the Supreme Court in *Patel v Mirza*,³ the article proposes two policy reasons (i.e. the integrity of the legal system and justice and the protection of the reputation of documentary credits from being a vulnerable target by fraudsters) underlying the fraud exception. Such policy reasons are essential to determine the type of the fraud exception.

The third part evaluates the rules that trigger the fraud exception. It asserts that the rule of the bank's knowledge as to the fraud cannot be generally a necessary requirement, and it causes a second uncertainty. The fourth part criticises the courts' approach in the balance of convenience test for rejecting to grant interim injunctions to restrain banks from payment because of fraud, arguing there is a third uncertainty. The main theme underlying the criticisms in the third and fourth parts of the article is that English courts overdramatise the role of contract analysis. English courts, and so the literature on documentary credits, have disengaged with the commercial reality of the distinction between a simple documentary credit (i.e. no chain of banks, so the issuing bank is the only bank that is committed to make payment) and a complex documentary credit (i.e. chain of banks). It is advocated that the issue of who bears the risk of fraud amongst the innocent parties should be given a weight and should be mainly based on the commercial reality as expected by parties.

The fifth part argues that there is no current authority under English law addressing the question of whether or not a non-documentary fraud can trigger the fraud exception. To address the fourth uncertainty, the fifth part evaluates what ought to be the position of English law in light of the decision of the Privy Council in *Alternative Power Solution Ltd v Central Electricity Board and another*,⁴ other common law jurisdictions and policy reasons.

² N Enonchong, *The Independence Principle of Letters of Credits And Demand Guarantees*, 1edn (2013, OUP); P Elinger and D Neo, *The Law and Practice of Documentary Letters of Credit*, 1st edn (Hart, 2010); A Malek and D Quest, *Jack: Documentary Credits*, 4th edn (Tottel, 2009); P Todd, "Non-genuine Shipping Documents and nullities", [2008] 4 L.M.C.L.Q 547; J Dolan, "Tethering the Fraud Inquiry in Letter of Credit Law", [2006] 21 (3); G McLaughlin, *Exploring Boundaries: A Legal and Structural Analysis of the Independence Principle of Letter of Credit Law*, [2002] Banking LJ 521; G McLaughlin, *Letters of credit and illegal contracts: the limits of the independence principle*, [1988] 49 Ohio St. L.J. 1197 Banking and Finance Law Review 479.

³ [2016] 3 W.L.R. 399, [99-101] per Lord Toulson.

⁴ [2015] 1 W.L.R. 697, [59].

Accordingly, the article intends to suggest remedies to the flaws in the position of English law as to the doctrine of the fraud exception. The aim is that the new proposed position will more reflect the expectation of the transnational business community of both documentary credits and documentary sales without offending the integrity of the English legal system.

1. THE NORM OF INDEPENDENCE AND THE DOCTRINE OF THE FRAUD EXCEPTION

A. The meaning of the norm of independence

The reality of the interconnection of the relationships in a documentary credit (i.e. the underlying contract of a documentary credit,⁵ the operative contracts in a documentary credit: contracts between issuing bank and applicant, issuing bank and beneficiary, issuing bank and advising/confirming bank, confirming bank and beneficiary) is replaced by the "fiction of autonomy",⁶ to the effect that such relationships are to be treated themselves as independent from one another.⁷ Banks are expected to be bound to treat their payment undertaking as independent from other relationships.⁸ The "principle of autonomy" makes the security of payment and finance by an independent third party which has a strong financial covenant concrete.⁹

As banks are facilitators and guarantors of payments, their role is a ministerial one in checking the conformity of documents.¹⁰ Given the need for speed in documentary credits,¹¹ and the need for manageable presentation for sellers in order to be assured as to the payment and that banks are not part of – or expert – the underlying transaction, it is a normative presumption that the actual facts are truly represented by the presented documents.¹² This entails the protection of banks, where it turns out that the accepted

⁵ It is well known and fundamental usage that the documentary credit is an independent from the underlying contract; this is the position under sub-article 4 (a) UCP 600 even where a reference in the credit is made to the underlying contract.

⁶ It was eloquently described as trite law per Lord Diplock in *United City Merchants (Investments) Ltd v Royal Bank of Canada (The American Accord)* [1983] 1 AC 168, 182- 183.

⁷ This is well-known and fundamental usage: the author for instance conducted in the summer of 2014 interviews with three judges and six bankers (representative cases) in Jordan and they confirmed the existence of such a binding usage. Such a position is not clearly tackled in the second part of sub-article 4 (a) UCP 600 which merely states "a beneficiary can in no case avail itself of the contractual relationships existing between banks or between the applicant and the issuing bank".

⁸ *Hamzeh Malas & Sons v British Imex Industries Ltd.* [1958] 2 Q.B. 127, 129 per Jenkins LJ.

⁹ Unitarianism stems that the reliance on a secure method of payment by a documentary means in international trade enhances the confidence on international documentary sales and boosts finance deals.

¹⁰ As suggested by the appellate in *Kredietbank Antwerp v Midland Bank plc* [1999] Lloyd's Rep 219, 223.

¹¹ The period for examining documents in documentary credits is maximum of five banking days pursuant to sub- article 14 (d) UCP 600 and was reasonable time up to seven banking days under sub-article 13 (b) UCP 500. Under English law, terms relating to time in international trade are regarded as conditions to the effect that the breach of them gives rise to the right to repudiate the contract: *Bunge Corporation v Tradax Export SA* [1980] 1 Lloyd's Rep 1 HL.

¹² *Gian Singh & Co Ltd v Banque de l'Indochine* [1974] 1 WLR 1234, 1238 per Lord Diplock; *Edward Owen Ltd. v. Barclays Bank* (1978) 1 Q.B 169; *Etablissement Esefka International Anstalt v Central Bank of Nigeria* [1979] 1

documents actually lack authenticity or are not genuine.¹³ In addition, the normative force of the principle of autonomy generates the presumption that banks are not entitled to examine the actual facts represented by the documents.¹⁴ This serves the underlying aim of documentary credits as being a secure means of payment and settlement.

Both the presumption that documents suffice on their face to evidence the actual facts, and the position that banks are not entitled to examine the actual facts, give rise - and constitute - the "principle of appearance". Although the principle of autonomy and the principle of appearance conceptually differ, there is a combination between them and they functionally constitute the "norm of independence" in documentary credits; hence both are treated alike for the fraud exception under English law.¹⁵ As it is driven from, and enforced through, the transnational socio-commercial context,¹⁶ the idea of independence is *norm* and courts need to heavily rely on such a context in dealing with the phenomenon of independence.

B. Elements of the doctrine of the fraud exception

The question of the fraud exception is a question of why and when the norm of independence in documentary credits can be set aside, because it is alleged or established that fraud occurred either in the issue or presentation of the documents specified in a documentary credit (documentary fraud) or in the formation or performance of the contracts touching and concerning a documentary credit (non-documentary fraud). The question of why involves the policy reasons that justify the departure from the norm of independence. The question of when involves: (1) the requirements that are essential to be fulfilled in order to establish the fraud exception at any stage of proceeding; (2) the qualifications at pre-trial for granting courts injunctions prohibiting the bank to pay or discount the credit and/or the beneficiary to draw on the credit and (3) the type of fraud that triggers the fraud exception.

2. THE PUZZLING CASE OF POLICY REASONS UNDERLYING THE FRAUD EXCEPTION: THE FIRST UNCERTAINTY

The first uncertainty in the fraud exception under English law is in relation to the policy reasons. Lord Diplock stated:

"The exception for fraud on the part of the beneficiary seeking to avail himself of the credit is a clear application of the maxim *ex turpi causa non oritur actio* or, if plain English is to be preferred, "fraud unravels all." The courts will not allow their process to be used by a dishonest person to carry out a fraud".¹⁷

Lloyd's Rep. 445; 448; *Kydon Compania Naviera SA v National Westminster Bank Ltd (The Lena)* [1981] 1 Lloyd's Rep. 68; 75.

¹³ Article 34 UCP 600.

¹⁴ *GKN Contractors Ltd v Lloyd's Bank Plc* (1985) 30 B.L.R. 48, 63 Parker LJ; *Consolidated Oil Ltd v American Express Bank Ltd* [2002] C.L.C. 488, 495.

¹⁵ *Montrod Ltd v Grundkotter Fleischvertriebs GmbH & Anor* [2002] C.L.C. 499 [59].

¹⁶ *Hamzeh Malas & Sons v British Imex Industries Ltd.* [1958] 2 Q.B. 127, 129.

¹⁷ *Ibid*, 183.

It is grimly challenging to assert the policy underlying the fraud exception from the above statement. The correct meaning of the maxim *ex turpi causa non oritur actio*, using the words of Lord Mansfield, is that “no court will lend its aid to a man who founds his cause of action upon an immoral or an illegal act”¹⁸ and not “fraud unravels all”. It is either that Lord Diplock meant to apply the maxim *ex turpi causa* or “fraud unravels all”, as each maxim leads to different consequences. To strictly apply “fraud unravels all”, once there is a fraud the whole transaction collapses despite the knowledge of the parties. But for *ex turpi causa* to apply against the claimant, his involvement in wrongdoing should be required.¹⁹

Lord Diplock must have intended to apply the ancient rule of *ex turpi causa* rather than “fraud unravels all”, as it is the one that has triggered the specific rule inserted by Lord Diplock himself that “the courts will not allow their process to be used by a dishonest person to carry out a fraud”. The bank in *The American Accord* was accordingly held liable for refusal to pay, because the sellers and the transferee²⁰ were not dishonest at the time of presentation.²¹ Therefore, the translation by Lord Diplock of *ex turpi causa* as “fraud unravels all” was an error.

In a subsequent case²² however Justice Rix has interpreted the above judgment of Lord Diplock stating that he meant that the consequence of a documentary fraud is to unravel the bank’s *obligation* to pay on the appearance of documents. So there is an implied contractual condition between the bank and the beneficiary that the honour of the documentary credit is conditional upon the honesty of the beneficiary;²³ aligned with a correspondent condition between the bank and the applicant.²⁴ This is the first example in the article illustrating how some judges overestimate the role of contract. Such a proposition cannot be conceptually sound under common law. It is well established that the relationship between the issuing or confirming bank and the beneficiary is based on the trade usage of documentary credits rather than contract,²⁵ and it is treated as a contractual relationship for the purpose of remedies.²⁶

In addition, there cannot be an implied contractual condition between the bank and the beneficiary as to the honesty of the latter (seller) in ‘performing’ or ‘forming’ (i.e. fraud in performance and fraud in formation) the part of the underlying contract - with the applicant (buyer) - that has not been required to be documentary proved in the documentary credit itself. Such an honesty cannot even be legally constructed by

¹⁸ [Holman v Johnson \(1775\) 1 Cowp 341](#), 343.

¹⁹ *Patel v Mirza* [2016] 3 W.L.R. 399.

²⁰ For transferable documentary credits and the claim of damages of the transferee: C Hare, “Transferable letters of credit: responsibility, remoteness and loss of a chance” [2005] 3 L.M.C.Q.L. 350.

²¹ *United City Merchants (Investments) Ltd v Royal Bank of Canada* [1983] 1 AC 168, 182.

²² *Czarnikow-Rionda Sugar Trading Inc v Standard Bank London Ltd* [1999] 2 Lloyd’s Rep 187, 203.

²³ In the context of demand bonds which is applicable to documentary fraud a statement by Lord Dinning in *Edward Owen Engineering Ltd v Barclays Bank International Ltd* [1978] 1 Q.B. 159, 171 suggests that a bank’s duty to pay is conditional upon the honesty of the demand: cited with approval by Mance LJ in *Solo Industries UK Ltd v Canara Bank* [2001] EWCA Civ 104; [2001] 1 W.L.R. 1800, [10].

²⁴ *RD Harbottle (Mercantile) Ltd v National Westminster Bank Ltd* [1978] Q.B. 146, 155-156 per Kerr J; *Czarnikow-Rionda Sugar Trading Inc v Standard Bank London Ltd* [1999] 2 Lloyd’s Rep 187, 203.

²⁵ *Hamzeh Malas & Sons v British Imex Industries Ltd.* [1958] 2 Q.B. 127, 129.

²⁶ R Goode, “Usage and its reception in transnational commercial law”, [1997] *International & Comparative Law Quarterly* 1.

objectively assuming it as a contractual condition because it is rebutted by the passive action of not requiring the relevant documentary proof. The proposition fraud unravels the obligation,²⁷ rather than undertaking, of the bank is incapable therefore to lead to the fraud exception in relation to a non-documentary fraud.

Accordingly had Lord Diplock intended to apply “fraud unravels all”, he would have meant that fraud unravels the bank’s *undertaking*, and not the contractual obligation, to act on the appearance of documents because of public policy rather than a contractual condition. The source of the fraud exception should be public policy and not the private contract between the parties.²⁸

Proposal for the policy reasons underlying the fraud exception

The first is the policy reasons underlying the ancient rule of *ex turpi causa non oritur actio*.²⁹ Two reasons. One is that a person should not be allowed to profit from his own wrongdoing.³⁰ The other is that the law should be consistent by refusing to give by its right hand what it takes by its left hand.³¹ It is effectively to serve the integrity of the legal system and justice, as now laid down, in the context of illegality, by the Supreme Court in *Patel v Mirza*.³²

The second, profound reason, but has regrettably been overlooked, is and should be, the protection of the reputation of documentary credits from being perceived by fraudsters as a vulnerable target. The norm of independence should not become a self-defeated concept by being the accessible façade to fraudsters using it as an excuse to cover their fraud. If the norm of independence became an easy target to fraudsters, the security otherwise afforded to buyers by the presentation of the required documents proving the conditions of shipped goods would be trounced. Such a reason is the missing piece that with the above reasons solve the ambiguity of the policy underlying the fraud exception.

There are two considerations however structuring the interaction and the weight of each of the policy reasons. One is that the integrity of documentary credits as a secure means of payment is served by shielding the norm of independence from being breached. Its function is described as, in the oft-cited phrase, the “life-blood of international commerce”.³³ Not much is needed to be commented here, as courts give such a consideration a profound weight. It needs to be noted that permitting fraud to provisionally set aside the norm of independence can in reality serve the protection of the norm of

²⁷ *Czarnikow-Rionda Sugar Trading Inc v Standard Bank London Ltd* [1999] 2 Lloyd’s Rep 187, 203.

²⁸ For further analysis see below under the heading “the balance of convenience test: the mirage of contract analysis”.

²⁹ *United City Merchants (Investments) Ltd v Royal Bank of Canada* [1983] 1 AC 168, 183 per Lord Diplock; *Czarnikow-Rionda Sugar Trading Inc v Standard Bank London Ltd* [1999] 2 Lloyd’s Rep 187, [39] per Rix J: it was considered as the authoritative source of the implied limitation of the bank’s mandate.

³⁰ The focus should not be that the claimant is getting something out of wrongdoing but rather is the recovery for something which is illegal resulting in inconsistency in the law: *Hall v Hebert* [1993] 2 SCR 159, 175-176 per McLachlin J; cited with approval; *Patel v Mirza* [2016] 3 W.L.R. 399, [100] per Lord Toulson.

³¹ *Patel v Mirza* [2016] 3 W.L.R. 399, [99] per Lord Toulson.

³² [2016] 3 W.L.R. 399, [99-101] per Lord Toulson.

³³ [R D Harbottle \(Mercantile\) Ltd v National Westminster Bank Ltd \[1978\] QB 146](#), 155 per Kerr J.

independence from being an easily targeted by fraudsters to be used as a cover, and it ultimately serves the integrity of documentary credits and law.

The other consideration, as submitted in this article, should be the allocation of risk. Who is to bear the risk of the loss that may be caused by fraud whereby the original parties (i.e. applicant, issuing bank and beneficiary) are all innocent? It is the applicant, or the issuing bank in a back to back documentary credit, who is expected to bear the ultimate risk as he undertakes to pay against apparently conforming documents via an independent facilitator of payment.³⁴ If the presented documents, although appear in conformity, are not genuine, the applicant (typically the buyer) will have remedies in the underlying contract against the beneficiary (typically the seller). So traders accept to take the risk "pay now, argue later", even where fraud by the beneficiary is alleged. It follows the security of reimbursement in the credit should depend on the covenant between the parties rather than the genuine documents. Nevertheless, it is submitted, the risk that cannot be accepted by traders is the real risk of dissipating the beneficiary who is allegedly involved in fraud, since traders would not be able to enforce remedies against such a fraudster.

3. TWO RULES TO ESTABLISH THE FRAUD EXCEPTION: WHICH ONE IS JUSTIFIED? THE SECOND UNCERTAINTY

Whether at full trial, summary judgment or pre-trial there are two requirements, as rules, that must be fulfilled in order to establish the fraud exception under English law. The article argues that one of these rules is not justified; generating a second uncertainty.

A. The rule of the beneficiary's knowledge is justified

The 'rule of beneficiary's knowledge' makes it certain under English law³⁵ that when there is a documentary fraud the issuing and confirming banks are not entitled to abstain the honour³⁶ of the credit unless the beneficiary is actively dishonest,³⁷ having an actual knowledge of fraud,³⁸ as to a material statement (i.e. statement affects the apparent conformity)³⁹ at or before the time of the presentation of documents.⁴⁰

The rule of the time of the beneficiary's knowledge as to fraud (i.e. it should be at or before the presentation of documents)⁴¹ is a necessary legal consequence of the meaning of fraud

³⁴ See below under the heading of "the rule of beneficiary's knowledge is justified".

³⁵ *United City Merchants (Investments) Ltd v Royal Bank of Canada* [1983] AC 168, 183 per Lord Diplock; [Edward Owen Engineering Ltd. v. Barclays Bank International Ltd. \[1978\] Q.B. 159.](#)

³⁶ For the concept of honour: article 2 UCP 600; for the concept of honour in acceptance and deferred credits: article 7 & sub-article 12 (b), (c) UCP 600; G Collyer and R Katz (eds), *ICC Opinions 2009-2011*, (2012) Opinion 722, ICC No 732.

³⁷ *GKN Contractors Ltd v Lloyd's Bank Plc* (1985) 30 B.L.R. 48, 63 Parker LJ; *Consolidated Oil Ltd v American Express Bank Ltd* [2002] C.L.C. 488, 495.

³⁸ Including wilful shutting eyes to the obvious: [Derry v Peek \(1889\) 14 App. Cas. 337](#); A Malek and D Quest, *Jack: Documentary Credits*, 4th edn (Tottel, 2009), [9.18]; P Ellinger and D Neo, *The Law and Practice of Documentary Credit*, 1st edn (Hart, 2010), 142.

³⁹ As rightly suggested in A Malek and D Quest, *Jack: Documentary Credits*, 4th edn (Tottel, 2009), [9.17].

⁴⁰ *Group Josi Re v Walbrook Insurance Co* [1996] 1 W.L.R. 1152, 1161 Stoughton LJ.

⁴¹ *Group Josi Re v Walbrook Insurance Co* [1996] 1 W.L.R. 1152, 1161 Stoughton LJ.

under English law. What makes the call for payment under documentary credits fraudulent is the beneficiary's knowledge of fraud at or before the presentation of documents. It is submitted that the rule of the time of knowledge has also a commercial function that has not been clarified in literature. The bona fide beneficiary ships the goods and procures documents, or buys documents evidencing floating goods, on reliance that he will securely be paid by the bank in the documentary credit against the presentation of documents that appear on their face to be in conformity. Accordingly, from the commercial perspective of the beneficiary, to consider the beneficiary as dishonest the time of knowledge should be prior to the shipment of goods and the procurement of documents. This will however open the door for recklessness in procuring documents, without a careful check of genuine status, and will increase the tolerance of the circulation of forged documents.⁴² The rule of the time of knowledge may act as a latch in fastening the door of recklessness. Thus, the beneficiary who is reckless in checking the genuine status of documents whilst procuring them may run the risk of being prevented from payment under the credit, if anyone informs him as to the committed fraud relevant to the documents.⁴³

B. The rule of the bank's knowledge is not justified – the second uncertainty

Where there is an allegation of fraud, the bank encounters a risk that may not be avoided. On the one hand, if fraud is not established at full trial, a decision of refusal to pay after the presentation of apparently conforming documents may lead to the bank's liability to the beneficiary for a wrongful rejection of payment. On the other hand, if fraud is established at full trial, the bank's decision to make payment may lead to its liability to the applicant who requested the bank to refuse payment on the ground of fraud. This dilemma is caused by the requirement of the bank's knowledge under English law.⁴⁴ It is argued here that this rule is unjustified, and it leads to the second uncertainty under English law in the fraud exception. Once more, it is contended that such uncertainty is mainly caused by overdramatising contract analysis by courts.

To a certain extent the rule of the bank's knowledge protects the bank when it honours the credit. The bank is not liable to the applicant for making payment unless, at or before the time of payment, it can be drawn from the material presented to the bank that *the only realistic inference* that fraud is committed with the actual knowledge of the beneficiary.⁴⁵ Given the principle of appearance, the bank is under *no obligation to investigate* whether there is fraud or not and the onus is on the applicant to present collaboratively strong evidence (i.e. powerful allegation that is considered as evidence at

⁴² *Lambias (Importers and Exporters) Co Pte Ltd v Hong Kong & Shanghai Banking Corp* [1993] 2 SLR 751.

⁴³ But in *Montrod Ltd v Grundkötter Fleischvertriebs GmbH* Court [2002] 1 W.L.R. 1975, [60] Potter LJ approved *dicta* of Goh Phai Cheng JC in the decision of the High Court of Singapore in *Lambias (Importers and Exporters) Co Pte Ltd v Hong Kong and Shanghai Banking Corp* [1993] 2 SLR 751, 765-766 with the effect that recklessness of null documents may become an exception to the norm of independence.

⁴⁴ *Alternative Power Solution Ltd v Central Electricity Board and another* [2015] 1 W.L.R. 697, [59]; *United Trading Corp SA v Allied Arab Bank Ltd (Note)* [1985] 2 Lloyd's Rep 554; *Bolivinter Oil SA v Chase Manhattan Bank (Practice Note)* [1984] 1 Lloyd's Rep 251, 260-261; *Solo Industries UK Ltd v Canara Bank* [2001] EWCA Civ 1059 [34].

⁴⁵ *Turkiye Is Bankasi AS v Bank of China* [1996] 2 Lloyd's Rep 611, 617; *United Trading Corp SA v Allied Arab Bank Ltd* [1985] 2 Lloyd's Rep 554, 560.

pre-trial, although it may be refuted at full trial) of fraud to the bank.⁴⁶ Given the need for speed in examining the documents,⁴⁷ the bank is not obliged to investigate the applicant's presented evidence, even where the investigation would reveal the weakness of the applicant's evidence.⁴⁸ However, the rule does not sufficiently protect banks and contract analysis fails to be a source of liability in the fraud exception as explained below.

Is the bank liable for making payment?

Can the bank which decides to pay or discount the credit be held liable for honouring the credit just because it has actual knowledge of the beneficiary's fraud?

What is certain is that the fraud exception is inoperative against the bank which does not have the required knowledge of fraud prior to the date of payment against apparently conforming documents.⁴⁹ Based on contract analysis, it was held in some cases that the bank is not entitled under its mandate with the applicant to make payment if it has knowledge of the beneficiary's fraud at or prior the presentation of documents.⁵⁰ The subject of these cases was an interlocutory injunction to abstain payment, so it is submitted they do not constitute authority as to the requirement of the bank's knowledge at full trial and summary judgement stages. It cannot be said with certainty therefore that contract analysis should be the basis of the liability of the bank at full trial.

The position of English law at trial, according to *Turkiye Is Bankasi AS v Bank of China*⁵¹ as authority, is that the bank which has actual knowledge of the beneficiary's fraud is *not entitled* to reimbursement by the reimbursing bank in the performance bond and counter guarantee and, by analogy, the applicant in documentary credits. The source of the liability of the paying bank, whether it is based on contract or policy reason of the fraud exception, is not expressed in the decision of the Court of Appeal in *Turkiye Is Bankasi*.

The real quandary the bank encounters is whereby, although it has actual knowledge of the beneficiary's fraud, it is not the first bank in the chain of banks which is obliged to honour the credit, and the bank is already under obligations to reimburse other banks which are committed in the chain to honour the credit. For instance, the issuing bank which has knowledge of the beneficiary's fraud may not have sufficient time to inform the confirming bank as to the beneficiary's fraud. Indeed it may not be able to obligate the confirming bank to restrain from making payment because the fraud exception is not

⁴⁶ *Ibis*.

⁴⁷ The period for examining documents in documentary credit is maximum of five banking days pursuant to sub-article 14 (d) UCP 600 and was reasonable time up to seven banking days under sub-article 13 (b) UCP 500; under English law terms relating to time in international trade are regarded as conditions to the effect that the breach of them gives rise to a repudiatory breach: *Bunge Corporation v Tradax Esport SA* [1980] 1 Lloyd's Rep 1 HL.

⁴⁸ *Gian Singh & Co. Ltd. v Banque de l'Indochine* [1974] 1 W.L.R. 1234.

⁴⁹ *European Asian Bank AG v Punjab & Sind Bank (No.2)* [1983] 1 W.L.R. 642, 658; *United Trading Corp SA v Allied Arab Bank Ltd* [1985] 2 Lloyd's Rep 554, 560; *Credit Agricole Indosuez v Generale Bank* [1999] 2 All E.R. (Comm) 1009, 1015; *DCD Factors Plc v Ramada Trading Ltd* [2007] EWHC 2820 (Q.B.), [2008] Bus L.R 654; *Group Josi Re v Walbrook Insurance Co* [1996] 1 W.L.R. 1152, 1161.

⁵⁰ *Alternative Power Solution Ltd v Central Electricity Board and another* [2015] 1 W.L.R. 697, [59]; *United Trading Corp SA v Allied Arab Bank Ltd (Note)* [1985] 2 Lloyd's Rep 554; *Bolivinter Oil SA v Chase Manhattan Bank (Practice Note)* [1984] 1 Lloyd's Rep 251, 260-261.

⁵¹ [1998] 1 Lloyd's Rep 250.

recognised under the applicable law in connection to the confirming bank.⁵² The issue here should be who should bear the risk of fraud? Is it the applicant who has chosen to trade with the fraudulent beneficiary in the first place, the issuing bank which has been sufficiently alerted by its customer (the applicant) as to the fraud, or the confirming bank which has been sufficiently alerted by the issuing bank as to the fraud but it went ahead in paying the credit because it is obliged, or is entitled, to do so under its national law? Such difficulties were not raised in *Turkiye Is Bankasi*.

The ideal solution is that the applicant or the reimbursing party needs to launch a pre-emptive strike for a pre-trial intervention by the courts in the jurisdiction of the paying bank, which is at the forefront of the chain of banks (e.g. confirming bank), in order to restrain them from making payment. This will assert the allocation of risk by the virtue of law. Of course, there are situations that are far more complex (e.g. back to back documentary credits, guarantee of performance involved counter guarantees). However, the situation differs in a simple documentary credit (i.e. there is no chain of banks so the issuing bank is the only bank that is obliged to make payment), because the issuing bank has a truly free choice to abstain payment against the potentially fraudulent beneficiary. Here damages of the bank's reputation are minimal in comparison to complex documentary credits whereby the bank has commitments not only to the beneficiary, but also to various banks with whom it has built years of trust.

Accordingly, the rule that the bank is *not entitled*⁵³ to honour once it has actual knowledge of the beneficiary's fraud prior to the time of payment is justified under simple documentary credits. But such a rule cannot be justified in complex (involves chain of banks) documentary credits. The applicant or reimbursing party who intends to complain against the decision of the bank for payment must act reasonably in order to avoid the risk of fraud, otherwise, it should bear such a risk.

Even if contract analysis applies (i.e. the bank which has knowledge of the beneficiary's fraud is not entitled by the virtue of an implied term under its mandate with the applicant to pay or discount the credit),⁵⁴ it is the most reasonable to take into account a foreseeable context with its complexity in implying contractual terms. To be truly contractual, implied terms should objectively reflect the reasonable expectation of parties.⁵⁵ The liability of the bank must depend on the expected context. Thus, in a documentary credit involves a chain of banks, it is reasonable to expect that the issuing bank will not be able to enforce foreign banks, with whom it has built years of trust, to avoid payment because of the fraud exception. Here it is the applicant who should consequently bear the risk of fraud. If the rule was applied strictly in triggering liability (i.e. once the bank has knowledge it is not entitled under its contract with the applicant to make payment) it would undoubtedly be

⁵² A similar argument was not accepted in *Solo Industries UK Ltd v Canara Bank* [2001] EWCA Civ 1059; [2001] 1 W.L.R. 1800 [39] but the context was in connection to a summary judgement against the decision of the issuing bank to refuse payment which is not parallel to the context of the liability of the issuing bank for making payment.

⁵³ In the oft-cited case of [Edward Owen Case \[1978\] QB 159](#), 169 Lord Denning stated that "the bank ought not to pay under the credit" which differs from the concept of entitlement.

⁵⁴ As asserted *obiter* in the context of the balance of convenience in *RD Harbottle (Mercantile) Ltd v National Westminster Bank Ltd* [1978] Q.B. 146, 155-156 per Kerr J; *Czarnikow-Rionda Sugar Trading Inc v Standard Bank London Ltd* [1999] 2 Lloyd's Rep 187, [39] per Rix J.

⁵⁵ *Investors Compensation Committee Ltd v West Bromwich Building Society* [1998] 1 W.L.R. 896; 913 per Lord Hofman; *Attorney General of Belize v Belize Telecom Ltd* [2009] 1 W.L.R. 1988, [16-27] per Lord Hofman; *Wickman Machine Tool Sales Ltd. v. L. Schuler A.G.* [1974] A.C. 235 see the judgement of Lord Reid.

arbitrary. The emphasis should be on the commercial context and public policy rather than simple contract analysis that the bank is entitled in its contract with the applicant either to pay or not to pay.

Is the knowledge of the bank required if it decides to refuse to honour the credit?

The requirement of the bank's knowledge is not necessary at the procedures of an interlocutory stage as during the time of hearing the injunction *inter parte* the bank would have acquired the required knowledge, if there is sufficient proof of fraud.⁵⁶ Furthermore, it is contended that such a requirement on the basis of contract analysis (i.e. an implied term in the mandate with the bank that it is obliged to pay or discount unless it has knowledge prior to the honour that the beneficiary is involved in fraud) is not conceptually sound. It would be absurd to order the bank to honour the credit despite that the beneficiary's fraud was sufficiently established at full trial or at summary judgment, because the knowledge of the bank as to the fraud had not been sufficiently established at or before the payment or discount (prior to the trial).⁵⁷ In such a situation the Court of Appeal in *Solo Industries UK Ltd v Canara Bank*⁵⁸ rightly decided that the beneficiary was not entitled to payment:

"[By] applying Lord Diplock's underlying principle that the court should not lend its process to assist fraud and that "fraud unravels all"... It would affront good sense, and probably general principles relating to illegality, if courts were obliged to give judgment in favour of a beneficiary now shown to be acting fraudulently".

To clarify, the explanation of the "general principles relating to illegality" should be: the integrity of law (i.e. the first proposed policy reason in the article) dictates that such a fraudulent beneficiary cannot enforce the honour of the credit. Accordingly, contract analysis has failed to be the source of the bank's undertaking in the fraud exception. Clearly therefore the source of the fraud exception should be policy reasons and considerations of commercial context.

4. INTERVENTION BY COURTS AT PRE-TRIAL: A MIRRAGE IN THE BALANCE OF CONVENIENCE – THE THIRD UNCERTAINTY

In all cases the *ex parte* injunctions to restrain the bank from making payment and the beneficiary from drawing on the credit, were discharged at the *inter partes* hearing.⁵⁹

⁵⁶ *Deutsche Rückversicherung AG v Walbrook Insurance Co Ltd* [1995] 1 W.L.R. 1017, 1030 Per Philips J; *United Trading Corporation case* [1985] 2 Lloyd's Rep. 554, 560

⁵⁷ *Balfour Beatty Civil Engineering v Technical and General Guarantee Co Ltd* [2000] CLC 252, 260 per Waller LJ.

⁵⁸ [2001] EWCA Civ 1059; [2001] 1 W.L.R. 1800 [21] per Mance LJ.

⁵⁹ *Edward Owen Engineering Ltd v Barclays Bank International Ltd* [1978] 1 Q.B. 159; [R D Harbottle \(Mercantile\) Ltd v National Westminster Bank Ltd \[1978\] QB 146](#); *Intraco Ltd v Notis Shipping Corp of Liberia (The Bhoja Trader)* [1981] 2 Lloyd's Rep. 256; *State Trading Corp of India Ltd v ED&F Man Sugar Ltd* [1981] Com. L.R. 235; *Bolivinter Oil SA v Chase Manhattan Bank NA* [1984] 1 W.L.R. 392; *United Trading Corp SA v Allied Arab Bank Ltd* [1985] 2 Lloyd's Rep 554; *Czarnikow-Rionda Sugar Trading Inc v Standard Bank London Ltd* [1999] 2 Lloyd's Rep 187;

Damages as to the security of payment in international trade are therefore kept minimal. Moreover, except in two cases,⁶⁰ there has been no grant of an injunctive relief during the whole interlocutory stage pending trial. This is because granting such *inter partes* injunctions at the interlocutory stage encounters two difficulties: (1) the high standard of proof and (2) the balance of convenience.⁶¹

English law is clear and well settled as to the standard of proving fraud at the interlocutory stage in that it is on the material available to the bank the beneficiary's fraud is the only realistic inference.⁶² This standard of proof is stronger than the balance of probabilities at full trial,⁶³ because in comparison to full trial a powerful allegation of fraud cannot in real life be investigated thoroughly at pre-trial.⁶⁴ English law, as argued in this article, is not however well settled in the balance of convenience test.

English courts recognised equitable concerns (e.g. damages an adequate remedy, reputation of banks and trade, risk of banks encountering conflicting legal positions and availability of *Mareva* injunctions) that cabin the granting of interim injunctions to set aside the norm of independence.⁶⁵ To be equitably weighted in the right context, such concerns should be interlinked to the policy reasons underlying the fraud exception.⁶⁶ It is argued here that contract analysis in the balance of convenience test is misleading as it does not reflect the commercial reality of documentary credits. It is also asserted that the risk of dissipating the assets of the credit is real in commerce. The distinction between complex and simple documentary credits should be taken into consideration when courts use their discretion to determine the availability of injunctions.

A. The balance of convenience test: contract analysis is a mirage – third uncertainty

The Privy Council in *Alternative Power Solution Ltd v Central Electricity Board and another*⁶⁷ approved the well-known passage of "insuperable difficulty" by Justice Kerr in *R D Harbottle (Mercantile) Ltd v National Westminster Bank Ltd*,⁶⁸ namely, as the bank is entitled by its contract with the applicant either to pay or to refuse payment, once it transpires at full trial that the payment is in breach of the bank's mandate the applicant

Sunderland Association Football Club v Uruguay Montevideo FC [2001] 2 All E.R. (Comm) 828; *Permasteelisa Japan KK v Bouyguesstroi, Banca Intesa SpA* [2007] EWHC 3508 (QB).

⁶⁰ [Themehelp Ltd v West](#) [1996] QB 84; [Kvaerner John Brown Ltd v Midland Bank plc](#) [1998] CLC 446.

⁶¹ As confirmed by the Privy Council in *Alternative Power Solution Ltd v Central Electricity Board and another* [2015] 1 W.L.R. 697, [59].

⁶² *United Trading Corp SA v Allied Arab Bank Ltd* [1985] 2 Lloyd's Rep 554, 561 per Ackner LJ; *confirmed*; *Alternative Power Solution Ltd v Central Electricity Board and another* [2015] 1 W.L.R. 697, [59].

⁶³ *United Trading Corp SA v Allied Arab Bank Ltd* [1985] 2 Lloyd's Rep 554, 561 per Ackner LJ; [Group Josi Re v Walbrook Insurance Co Ltd](#) [1996] 1 WLR 1152, 1160 per Staughton LJ; [Czarnikow-Rionda Sugar Trading Inc v Standard Bank London Ltd](#) [1999] 2 Lloyd's Rep 187, 202 per Rix J.

⁶⁴ [Czarnikow-Rionda Sugar Trading Inc v Standard Bank London Ltd](#) [1999] 2 Lloyd's Rep 187, 202 per Rix J.

⁶⁵ N Enonchong, *The Independence Principle of Letters of Credits And Demand Guarantees*, 1edn (2013, OUP) 247-251.

⁶⁶ As analysed under the heading "proposal for policy reasons".

⁶⁷ [2015] 1 W.L.R. 697, [80].

⁶⁸ [1978] QB 146, 155.

"would have good claims for damages against the bank."⁶⁹ The applicant would not accordingly suffer irreparable damages.⁷⁰ It continues, if the bank pays in accordance with its contract with the applicant then no basis of action can be taken against it. In addition, interfering in the bank's obligation towards other banks may cause damages greater than the applicant can undertake in the cross undertaking.

The Board has approved contract analysis in the balance of convenience passage explained above, in that there is an implied term in the contract that the bank is not entitled to pay the credit if it clearly knows that the beneficiary is clearly fraudulent on his call. The assumption of contract analysis by Justice Kerr in *R D Harbottle*⁷¹ and Justice Rix in *Czarnikow-Rionda*,⁷² with respect, cannot be correct, and it thus causes a third uncertainty as to the fraud exception under English law, for the following reasons.

To begin with, if such analysis was a reflection of law, then, for the consistency of law, it should also be applied to the relationship between the issuing, and/or confirming, bank and the beneficiary which cannot be correct. It is well settled under English law that such a relationship is not based on contract but on the trade usage of documentary credits.⁷³

Second, the assumption of contract analysis leads to a cause of action requirement for granting an injunctive relief, as it was inserted in some cases prior to *Alternative Power*,⁷⁴ because the basis of jurisdiction will be perceived on contract rather than public policy. The problem in requiring a cause of action on the ground of contract for the application of an injunction by the applicant to restrain the confirming bank from payment was illustrated in *United Trading Corpn SA v Allied Arab Bank Ltd (Note)*,⁷⁵ whereby the argument that the applicant had a contract with the confirming bank was rightly rejected by the Court of Appeal as it obviously stretched the elements of contract in law. As an alternative, tort as a cause of action against the confirming bank was accepted. But later in *Czarnikow-Rionda*,⁷⁶ it was rightly stated, *obiter*, that tort was no longer available as a cause of action against the confirming bank, because of the developments in the law of tort subsequent to *United Trading* case.

An injunction against the confirming bank is the most appropriate and effective action to proceed on, obviously in the jurisdiction under which the confirming bank is domiciled. The string of commitments in the chain of banks is actually triggered once the confirming bank, as it is usually the first bank to materialise the documentary credit commitments, pays or discounts the credit. So an injunction against the confirming bank does not really affect the string of commitments between banks. Nor the reputation of the confirming bank is materially damaged when the bank is prevented from payment by a court's injunction as opposed to the bank's choice to refuse payment. So demanding a cause of action – because

⁶⁹ [1978] QB 146, 155.

⁷⁰ Irreparable damages is an essential factor in balance of convenience: *American Cyanamid Co v Ethicon Ltd* [1975] F.S.R. 101, 107.

⁷¹ *R D Harbottle (Mercantile) Ltd v National Westminster Bank Ltd* [1978] QB 146, 155.

⁷² *Czarnikow-Rionda Sugar Trading Inc v Standard Bank London Ltd* [1999] 2 Lloyd's Rep 187, 203.

⁷³ *Hamzeh Malas & Sons v British Imex Industries Ltd.* [1958] 2 Q.B. 127, 129.

⁷⁴ *R D Harbottle (Mercantile) Ltd v National Westminster Bank Ltd* [1978] QB 146, 155; *Czarnikow-Rionda Sugar Trading Inc v Standard Bank London Ltd* [1999] 2 Lloyd's Rep 187, 203; *Montrud Ltd v Grundkotter Fleischvertriebs-GmbH* [2001] 1 All ER (Comm) 368, [41].

⁷⁵ [1985] 2 Lloyd's Rep 554, 559-560.

⁷⁶ *Czarnikow-Rionda Sugar Trading Inc v Standard Bank London Ltd* [1999] 2 Lloyd's Rep 187, 200.

of contract analysis - would prevent a most suitable action to prevent fraud. Fortunately, there is no decisive authority requiring a cause of action to grant an injunctive relief. Judicial opinions are divided as follows.⁷⁷

On the one hand, in asserting the proposition that a cause of action, on the ground of the breach of contract, is unnecessary Sir Donaldson stated in *Bolivinter Oil*:

"The basis of the jurisdiction is wider — the power of the court to intervene where necessary to prevent fraud".⁷⁸

On the other hand, in asserting the proposition that a cause of action is necessary, Justice Rix stated in *Czarnikow-Rionda*:

"If the source of the power to injunct were purely the law's interest in preventing the beneficiary from benefiting from his own fraud, I do not see why there should be the added requirement that the fraud is patent to the bank."⁷⁹

As submitted early,⁸⁰ the knowledge of the bank is an illusionist requirement in the context of interim injunctions and it is in reality only necessary for the issue of triggering the liability of the bank if it pays or discounts a simple type of documentary credits despite its knowledge of fraud. At any case such a liability can be based on policy reasons underlying the fraud exception. We agree therefore with Sir Donaldson in *Bolivinter Oil* and Justice Philips⁸¹ that the fraud exception is based on public policy and accordingly no cause of action is needed for interim injunctions. Relinquishing the cause of action should not lead to a loose hand, in that anyone can bring an action of the fraud exception, since it should be limited to the documentary credit parties as established by trade usage (i.e. applicant, issuing bank, confirming bank, beneficiary and transferee). This is not peculiar as the basis of the undertaking of the issuing and confirming bank to the beneficiary under documentary credits is trade usage.⁸²

Third, contract analysis shifts the responsibility of decision from courts to banks. What is considered to be clear evidence of fraud is a task that can be insuperably difficult to be accomplished by banks. Courts are far more equipped to undertake such a task and banks tend to turn – indirectly through applicants⁸³ to courts for a decision on the evidence of fraud, to at least seeking a declaration determining the duty of the bank. It is unfortunate that contract analysis puts banks in an uncertain position, not knowing whether they will be liable or not. Moreover, the bank cannot be in breach of its contract with the applicant

⁷⁷ A cause of action was required in [R D Harbottle \(Mercantile\) Ltd v National Westminster Bank Ltd \[1978\] QB 146](#), 155 per Kerr J; *Czarnikow-Rionda Sugar Trading Inc v Standard Bank London Ltd* [1999] 2 Lloyd's Rep 187, 203 per Rix J; *Montrod Ltd v Grundkotter Fleischvertriebs-GmbH* [2001] 1 All ER (Comm) 368, [41]; a cause of action was not required and it was considered unnecessary in *Deutsche Ruckversicherung AG v Walbrook Insurance Co Ltd* [1995] 1 W.L.R. 1017, 1030 Per Philips J; [Bolivinter Oil S.A. v. Chase Manhattan Bank N.A. \(Practice Note\) \[1984\] 1 Lloyd's Rep. 251](#), 254 per Sir Donaldson M.R.

⁷⁸ [Bolivinter Oil S.A. v. Chase Manhattan Bank N.A. \(Practice Note\) \[1984\] 1 Lloyd's Rep. 251](#), 254.

⁷⁹ *Czarnikow-Rionda Sugar Trading Inc v Standard Bank London Ltd* [1999] 2 Lloyd's Rep 187, 203.

⁸⁰ See above under the heading "the rule of the bank's knowledge is not justified".

⁸¹ *Deutsche Ruckversicherung AG v Walbrook Insurance Co Ltd* [1995] 1 W.L.R. 1017, 1030

⁸² *Hamzeh Malas Sons v British Imex Industries Ltd* [1958] 2 Q.B. 127.

⁸³ E.g. the position of the issuing bank in *Czarnikow-Rionda Sugar Trading Inc v Standard Bank London Ltd* [1999] 2 Lloyd's Rep 187; *State Trading Corp of India Ltd v ED&F Man Sugar Ltd* [1981] Com. L.R. 235.

or the reimbursing party if the injunction had not been granted because of the lack of proof to establish the fraud exception in accordance with the pre-trial standard, assuming no further proof was subsequently presented to the bank. Therefore the contract analysis in *R D Harbottle* and *Czarnickow-Rionda*, if it was correct, should be based on a "narrow approach": conferred to the situation where the court accepts the existence of strong proof of fraud, as the only realistic inference, but refuses to grant an injunction for purely balance of convenience reasons.

Fourth, contract analysis shifts the risk of bearing the consequences of the beneficiary's fraud from the applicant to the issuing or confirming bank. Even if one assumes the narrow approach suggested above under the third point, the contract analysis as perceived by Justice Rix and Justice Kerr asserts that once the bank has actual knowledge of fraud - because of the strong proof as declared by courts at an interlocutory stage - it becomes inevitably liable to the applicant for breach of contract for making payment. Such a proposition may not reflect the expectation of the parties as to who should bear the risk of fraud in complex documentary credits as suggested early.⁸⁴

In conclusion, the assumption that the applicant will not suffer irreparable damages, if the bank goes ahead and make payment, as it will have good remedy against the bank, cannot be generally correct. This is because, as suggested early, the applicant in complex (chain of banks) documentary credits may not have remedy at all against the bank which makes payment despite its knowledge of fraud.⁸⁵ The so called "insuperable difficulty" is therefore an exaggerated concern to refuse granting interlocutory injunctions. The Board in *Alternative Power* merely disagreed with the lower court's decision on the balance of convenience issue without tackling and applying the identified difficulties in the approved passage of "insuperable difficulty" to the matrix of facts before the Board. At any case, as the Board has already found that the fraud was not established, strictly speaking, the approval of contract analysis should be treated as an *obiter* because it was not necessary for the decision of rejecting the injunction. However, the approval of the Board as to the potential irreparable damages of the bank because of the court interference can be real if the documentary credit involves chain of banks as explained below.

B. Balance of convenience: reality and not mirage

Although the decision of the majority of the Court of Appeal in *Themehelp Ltd. v West and Others*⁸⁶ was heavily criticised,⁸⁷ it is submitted that it is still good law in some respects. The subject of the interim injunction was to prevent the beneficiary from drawing on the credit. Lord Justices Waite and Balcombe were wrong in deciding that such an injunction, distinguishing it from the one restraining the bank from making payment, did not set aside

⁸⁴ See the heading "the rule of the bank's knowledge is not justified".

⁸⁵ See the heading "the rule of the bank's knowledge is not justified".

⁸⁶ [1996] Q.B. 84.

⁸⁷ *Czarnickow-Rionda Sugar Trading Inc v Standard Bank London Ltd* [1999] C.L.C. 1148; 1152 per Rix J; [Group Josi Re v Walbrook Insurance Co Ltd \[1996\] 1 WLR 1152](#); see particularly Staughton LJ judgment, 1161; [Bolivinter Oil S.A. v. Chase Manhattan Bank N.A. \(Practice Note\) \[1984\] 1 Lloyd's Rep. 251](#), 256 per Sir Donaldson M.R; *Intraco Ltd v Notis Shipping Corp of Liberia (The Bhoja Trader)* [1981] 2 Lloyd's Rep. 256, per Sir Donaldson M.R; *Dong Jin Metal Co Ltd v Raymet Ltd* [1993] Lexis Citation 1996, Lloyd LJ.

the norm of independence. It is the restraint of payment on a ground other than the apparent conformity of documents undermines the security of payment available upon "pay now, argue later".⁸⁸ They were correct however on emphasising the risk of dissipating the assets of the credit by beneficiaries,⁸⁹ as there was a finding that the beneficiaries, in that case, lived outside the jurisdiction and intended to permanently domicile abroad. The decision of the majority was to grant an interlocutory injunction pending trial in order to prevent the beneficiary from drawing on the credit. If fraud was the only realistic inference at interlocutory stage, which had not been established, then the decision of the majority would have been correct for the following reasons.⁹⁰

Firstly, fraud would have been real in *Themehelp*. In documentary credits and performance bonds fraud is real when there is a real risk that the beneficiary intends to dissipate the assets in order to defeat any judgement against it.⁹¹ In *Sunderland Association Football Club v Uruguay Montevideo FC*⁹² Blofeld J stated *obiter* in relation to the risk of dissipating: "I have no doubt that should the claimant succeed on the first ground, the balance of convenience would be to grant this injunction". It is such a risk that triggers the policy reason of protecting the reputation of documentary credits and bonds from being abused by fraudsters.⁹³ Assuming that the proof of fraud was powerfully alleged at pre-trial, a fraudulent beneficiary who was financially sound would realistically be sued later. From the perspective of merchants, in such a situation there would be no reason to set aside the norm of independence as they enter into documentary credits on the basis of taking the risk "pay now, argue later". The decisive role of the risk of dissipating is recognised in other common law jurisdictions.⁹⁴

Secondly, the guarantee in *Themehelp* was simple in that it did not involve a chain of banks. Therefore the interference by the court did not affect obligations that would otherwise have been already arisen on the basis of the guarantee (i.e. there was no counter guarantee by an instructing bank).

Thirdly, the policy reason of the integrity of law underlying the fraud exception would have been - assuming fraud was powerfully alleged - realistically triggered, because the guarantee was simple. Both the bank and the beneficiary were subject to one jurisdiction, so there was no risk of putting the bank into conflicting legal positions.

Accordingly, when there is a real risk of dissipating assets and that the fraud is powerfully alleged, there are no compelling reasons in simple documentary credits that prevent courts to intervene at an early stage to stop payment. The proposition that the risk of dissipating only belongs to the *Mareva* jurisdiction⁹⁵ is misleading in the context of the commercial reality of documentary credits as explained above. Assets that are under a freezing order,

⁸⁸ *Themehelp Ltd v West* [1996] Q.B. 84, 103-104 per Evan LJ in his dissenting judgment; [Group Josi Re v Walbrook Insurance Co Ltd](#) [1996] 1 WLR 1152, 1161 per Stoughton LJ.

⁸⁹ *Themehelp Ltd v West* [1996] Q.B. 84, 97 & 107.

⁹⁰ But the dissenting judgement by Lord Justice Evans that the injunction was "an unwarranted extension of the *Mareva* jurisdiction would have been incorrect *Themehelp Ltd v West* [1996] Q.B. 84, 105.

⁹¹ *Sunderland Association Football Club v Uruguay Montevideo FC* [2001] 2 All E.R. (Comm) 828, 834 Blofeld J. [2001] 2 All E.R. (Comm) 828, 834.

⁹³ As analysed under the heading "proposal for policy reasons".

⁹⁴ USA: *Hendricks v. Bank of America, N.A.* 408 F.3d 1127 (9th Cir., 2005); Canada: *New Home Warranty of British Columbia Inc Re* 2004 CarswellBC 678.

⁹⁵ *Themehelp Ltd v West* [1996] Q.B. 84, 105 per Evans LJ.

a *Mareva* injunction, are subject to claims by other creditors in insolvency and of course applicants or even banks prefer courts to intervene early in order to prevent payment so other creditors would not be able to seize the assets of the documentary credit.

A *Mareva* injunction is the ideal solution in, as suggested, complex documentary credits or bonds (i.e. a chain of banks) if the beneficiary has assets within the jurisdiction of the court granting the injunction.⁹⁶ This is mainly because the bank would not be restrained to fulfil its obligations towards other banks in the chain. It was held in *The Bhoja Trader*⁹⁷ that such an injunction restraining the beneficiary from removing his assets from the jurisdiction is unlike interim relief pending execution in terms that it does not set aside the norm of independence. Functionally, however, a *Mareva* injunction restrains the beneficiary from receiving the benefits of the documentary credit, so he will lose a strong bargaining position in negotiating a settlement with the applicant.⁹⁸ A further reason supporting the *Mareva* solution, in a complex documentary credit one jurisdiction cannot enforce its approach, throughout, on other jurisdictions in order to ensure consistency of results. For example, it may be that under the national law of the issuing bank, the bank is not entitled to make payment but under the national law of the confirming bank, the bank is not entitled to abstain payment. So the policy reason of the integrity of law may not be realistically applied in complex documentary credits. But the same concern is not real under simple documentary credits.

5. NON-DOCUMENTARY FRAUD – THE FOURTH UNCERTAINTY (THE DIVORCE BETWEEN DOCUMENTARY CREDITS AND PERFORMANCE BONDS)

A non-documentary fraud is a fraud that is committed in the underlying contract or any one of the operative documentary credit contracts but is not related to the presented documents in that the presented documents truly represent the actual facts required to be proved by the credit. Fraud in the credit between the bank and the beneficiary challenges the validity of the credit itself and not the norm of independence.⁹⁹ However, a fraud that is committed in the *underlying contract*, or any of the other operative documentary credit contracts, would impeach the independence norm, since the right of the beneficiary to payment under a documentary credit would be dependent upon the rights of the applicant or other parties against the beneficiary. There is no decisive authority under English law ruling the issue of a non-documentary fraud. Unlike other uncertainties in the fraud exception, this fourth uncertainty is not caused by contract analysis. This part evaluates what ought to be the position of English law.

A. Fraud in the performance

⁹⁶ Courts are reluctant to grant *Mareva* injunctions freezing assets outside the jurisdiction (world-wide *Mareva*: *Derby & Co Ltd v Weldon* (No 8) [1990] 3 All ER 762); e.g. *Intraco Ltd v Notis Shipping Corp of Liberia (The Bhoja Trader)* [1981] 2 Lloyd's Rep. 256.

⁹⁷ *Intraco Ltd v Notis Shipping Corp of Liberia (The Bhoja Trader)* [1981] 2 Lloyd's Rep. 256.

⁹⁸ J Dolan, "Tethering the Fraud Inquiry in Letter of Credit Law", [2006] 21 (3) Banking and Finance Law Review 479.

⁹⁹ *Bolivinter Oil SA v Chase Manhattan Bank NA* [1984] 1 W.L.R. 392, 393.

In *Alternative Power Solution Ltd v Central Electricity Board and another*¹⁰⁰ there was an allegation, at the interim stage,¹⁰¹ that the beneficiary of a documentary credit committed a non-documentary fraud in the performance of the underlying contract. It was alleged that the beneficiary acted dishonestly by diverting from their undertaking that had been given by them in the court - which initially heard the application for an injunction to abstain payment under the documentary credit - to allow the claimant to verify the goods prior to the shipment of goods. The Privy Council decided that there was no sufficient evidence that the beneficiary acted fraudulently nor, in any case, it was proved that the bank knew that. The standard of proof as to fraud at pre-trial was established in this case as explained above.¹⁰² However, the non-objection by the Privy Council on the availability of the ground of a non-documentary fraud exception on the performance of the underlying contract, may indicate their acceptance of such a fraud as an exception to the norm of independence. It is too early to draw such a conclusion and the case should be treated cautiously. Firstly, an objection to the validity of such a non-documentary fraud was not raised; the beneficiary maintained throughout the defence that they did not act in a dishonest way. Secondly, the alleged fraud in performance was in relation to an undertaking that formed a part of court proceedings.

It is postulated that fraud in the performance of the underlying contract only taints the documentary credit contract between the beneficiary and the bank if it is either a documentary fraud or a non-documentary fraud relates to a performance that forms part of courts proceedings. It is neither understandable nor justifiable, to set aside the norm of independence on the basis of fraud in the performance of the underlying contract where the fraud does not relate to facts which are required to be proved by the presented documents. The applicant in documentary credits is able to require a documentary proof for performing what is perceived as material to the applicant in the underlying contract. Unlike demand bonds, the role of documents in documentary credits is essential,¹⁰³ for they function as a documentary proof of performing certain contractual terms that are perceived by the buyer as being essential for the security of his bargain. Lord Denning eloquently described the nature of demand bonds:¹⁰⁴

“These performance guarantees are virtually promissory notes payable on demand. So long as the Libyan customers make an honest demand, the banks are bound to pay”.

In contrast to documentary credits, the role of documents in demand bonds functions as a mere notice, usually as to the breach of the performance of the underlying contract that is supposed to be conducted by the applicant (not the beneficiary as in documentary credits).¹⁰⁵ The beneficiary's notice triggers the demand of payment upon which the bank is irrevocably obliged to honour as long as the beneficiary is honest in making the demand.¹⁰⁶ It follows a fraud that is committed by the beneficiary in the performance or

¹⁰⁰ [2015] 1 W.L.R. 697, [59].

¹⁰¹ For the qualifications of fraud exception at the interim stage see the heading ‘Intervention by courts at pre-trial’.

¹⁰² Under the heading ‘intervention by courts at pre-trial’.

¹⁰³ P Elinger and D Neo, *The Law and Practice of Documentary Letters of Credit*, 1st edn (Hart, 2010), 143.

¹⁰⁴ *Edward Owen Engineering Ltd v Barclays Bank International Ltd* [1978] 1 Q.B. 159, 172.

¹⁰⁵ E.g. *Kvaerner John Brown Ltd v Midland Bank Plc* [1998] C.L.C. 446.

¹⁰⁶ *Edward Owen Engineering Ltd v Barclays Bank International Ltd* [1978] 1 Q.B. 159, 171; cited with approval by Mance LJ in *Solo Industries UK Ltd v Canara Bank* [2001] EWCA Civ 104; [2001] 1 W.L.R. 1800, [10].

formation¹⁰⁷ of the underlying contract in order to demand payment under the bond is considered as a dishonest demand which permits the infringement of the independence norm. Such an application of the fraud exception being broader in demand bonds than in documentary credits, provides critical insight in explaining why most cases of the fraud exception are under English law in respect of demand bonds.¹⁰⁸ Little wonder that Justice Browne underlined the right of the bank to refuse payment under documentary credits on the basis of a *documentary* fraud.¹⁰⁹ In *The American Accord*¹¹⁰ Lord Diplock emphasised the role of documents as to the fraud exception in documentary credits.

It is regrettable that such a decisive dichotomy between documentary credits and performance bonds did not come to the attention of the Canadian Supreme Court in *Bank of Nova Scotia v. Angelica-Whitewear Ltd*¹¹¹ where the Court cited the statement of Lord Denning “the request for payment is made fraudulently in circumstances when there is no right to payment” in *Edward Owen Engineering*,¹¹² a performance bond case, to suggest that a non-documentary fraud in the underlying contract can be an exception to the norm of independence in documentary credits. The Supreme Court of Canada went on to opine:

“If it is of such a character as to make the demand for payment under the credit a fraudulent one ... it should extend to any act of the beneficiary of a credit the effect of which would be to permit the beneficiary to obtain the benefit of the credit as a result of fraud”.¹¹³

Such a Canadian test should functionally however lead to the result that only a documentary fraud in documentary credits, and not performance bonds, can be said to render the call for payment under a documentary credit as a fraudulent one. This is because one can imagine the deliberate presentation of false documents, appearing to be in conformity, as the only fraudulent act that is capable to be construed as it is done to crystallize the benefit of a documentary credit. What can trigger the payment under the documentary credit? It is only the act of presenting conforming documents.

Furthermore, the policy reason of the integrity of law¹¹⁴ should not apply rigorously as to disentitle the beneficiary from payment simply because he is dishonest in the performance of the underlying contract. Otherwise numerous claims for restraining payment in documentary credits on the basis of a deliberate breach, whether as to condition or

¹⁰⁷ *Themehelp Ltd v West* [1996] Q.B. 84.

¹⁰⁸ *Edward Owen Engineering Ltd v Barclays Bank International Ltd* [1978] 1 Q.B. 159, 172-173; *Bolivinter Oil SA v Chase Manhattan Bank NA* [1984] 1 Lloyd's Rep 251; *United Trading Corp SA v Allied Arab Bank Ltd* [1985] 2 Lloyd's Rep 554, 561; *GKN Contractors Ltd v Lloyds Bank Plc* (1985) 30 B.L.R. 48, 63; *Themehelp Ltd v West* [1996] Q.B. 84; *Turkiye Is Bankasi AS v Bank of China* [1998] 1 Lloyd's Rep 250, 253; *Balfour Beatty Civil Engineering v Technical & General Guarantee Co Ltd* [2000] CLC 252; *Solo Industries UK Ltd v Canara Bank* [2001] EWCA Civ 1041; [2001] 1 W.L.R. 1800; *Consolidated Oil Ltd v American Express Bank Ltd* [2002] C.L.C. 488, 495; *Banque Saudi Fransi v Lear Siegler Services Inc* [2007] 2 Lloyd's Rep 47; *Enka Insaat Ve Sanayi AS v Banca Popolare dell'Alto Adige SpA* [2009] EWHC 2410 (Comm); [2009] C.I.L.L. 2777; *RD Harbottle (Mercantile) Ltd v National Westminster Bank Ltd* [1978] Q.B. 146, 155-156; *Tukan Timber Ltd v Barclays Bank Plc* [1987] 1 Lloyd's Rep 171, 174; *Kvaerner John Brown Ltd v Midland Bank Plc* [1998] C.L.C. 446.

¹⁰⁹ *Bank Russo-Iran v Gordon, Woodroffe & Co. Ltd* (Unreported), October 3, 1972; *Edward Owen Engineering Ltd v Barclays Bank International Ltd* [1978] 1 Q.B. 159, 171, 172.

¹¹⁰ *United City Merchants (Investments) Ltd v Royal Bank of Canada* [1983] 1 AC 168, 182- 183.

¹¹¹ [1987] 1 S.C.R. 59 [17].

¹¹² *Edward Owen Engineering Ltd v Barclays Bank International Ltd* [1978] 1 Q.B. 159, 171.

¹¹³ *Bank of Nova Scotia v. Angelica-Whitewear Ltd* [1987] 1 S.C.R. 59 [17].

¹¹⁴ See above under the heading “proposal for policy reasons”.

warranty term, in the performance of underlying contracts would be allowed, and this would undermine the security of payment. However, the policy of the integrity of law necessary applies where the fraud by the beneficiary relates to a performance in the underlying contract that forms part of courts proceedings.

B. Fraud in the formation

It is postulated that the policy reason of the protection of documentary credits from being abused by fraudsters necessarily applies to the situation where fraud is committed by the beneficiary in the formation of the underlying contract. If this were not the case, a fraudster would be allowed to set up a sham transaction of which the documentary credit would be an integral part. Unlike fraud in the performance of the contract, the applicant will not be able to require a documentary proof of performance in the credit, since the fraud here precedes the credit.¹¹⁵ The position of *The American Accord*¹¹⁶ whereby Lord Diplock associated the fraud exception to the presented documents indicates that English courts may not be in favour of recognising a non-documentary fraud in the underlying transaction. Accordingly, if a non-documentary fraud is to be allowed to infringe the norm of independence under English law, it would be narrowly limited. The reference to the materiality as to the documentary fraud in *The American Accord*¹¹⁷ does not lead to an ambiguity in practice, as it implicitly means the fraud that affects the apparent conformity of documents. But what does 'materiality' mean in the context of a non-documentary fraud?

In the USA,¹¹⁸ section 5 of the Uniform Commercial Code provides that a material fraud in the underlying transaction is an exception to the norm of independence.¹¹⁹ In one case materiality of such a fraud was defined as: "fraud in which the wrongdoing of the beneficiary has so vitiated the entire transaction that the legitimate purposes of the independence of the issuer's obligation would no longer be served".¹²⁰ In another case it was described as "egregious fraud."¹²¹ None of these explanations have overcome the ambiguity or at least provided some sort of certain standards as to the scope of materiality,¹²² and they were instead relevant to the subject of standby letters of credit (equivalent to performance bonds).

¹¹⁵ This would include the situation where the credit contract is opened as a financial facility to a third party contracting with the applicant who lends its name for opening a documentary credit: *Czarnikow-Rionda Sugar Trading Inc v Standard Bank London Ltd* [1999] 2 Lloyd's Rep 187.

¹¹⁶ *United City Merchants (Investments) Ltd v Royal Bank of Canada* [1983] 1 AC 168, 182- 183.

¹¹⁷ *United City Merchants (Investments) Ltd v Royal Bank of Canada* [1983] 1 AC 168, 182- 183.

¹¹⁸ X Gao & RP Buckley, "A Comparative Analysis of the Standard of Fraud Required Under the Fraud Rule in Letter of Credit Law", [2003] *Oxford University Comparative Law Forum* and Vol 13 No 2 *Duke Journal of Comparative and International Law*, 293-336.

¹¹⁹ UCC, § 5-109 (official comment .1.2d para 8th sentence).

¹²⁰ *Intraworld Industries, Inc. v. Girard Trust Bank*, 336 A.2d 316 (Pa. S.C. 1975), 324 : the case was on a standby letter of credit but the court assumed that the same principle applies to letters of credit.

¹²¹ *New York Life Insurance Co. v. Hartford National Bank & Trust Co.*, 378 A.2d 562 (Conn. S.C. 1977), 567 : the case was on a standby letter of credit but the court assumed that the same principle applies to letters of credit.

¹²² As criticised in a Canadian case: *Bank of Nova Scotia v. Angelica-Whitewear Ltd.* [1987] 1 S.C.R. 59 [13].

Fortunately, however, in *NMC Enterprises Inc v Columbia Broadcasting System Inc*,¹²³ a documentary credit case, the New York Supreme Court adopted the approach “tainted with intentional fraud” and “tainted with fraud in its inducement” which provided certainty; to the effect that, as submitted, materiality in a non-documentary fraud denoted to a fraud in the formation of the underlying contract. Unfortunately, such a certainty has not been adopted as the decisive test, after the enactment of section 5, by the New York Court of Appeals in *United Bank Ltd. v. Cambridge Sporting Goods Corp*,¹²⁴ a documentary credit case, whereby a flexible approach was rather approved. As such the uncertainty of what is material in the fraud exception has been revived.

This article proposes that materiality of a non-documentary fraud should denote to fraud in the formation of the underlying contract. This provides certainty, since such fraud’s boundaries are well defined in *Derry v Peek*¹²⁵ as “a false representation has been made: (1) knowingly; or (2) without belief in its truth; or (3) recklessly, careless whether it be true or false”.¹²⁶ Active dishonesty¹²⁷ is the fundamental element. Such an approach is in line with the English rule of the beneficiary’s knowledge, for triggering the fraud exception¹²⁸

Where the underlying contract is voidable for fraudulent misrepresentation,¹²⁹ the applicant (typically the buyer) may, on the one hand, waives his right to rescind the contract and accept the performance by the beneficiary (typically the seller) but, on the other hand, trying to escape liability of payment under the documentary credit on the basis of the fraud exception. Surely for the policy of integrity of law (consistency of law), the applicant who is requesting the court or the bank to dishonour the credit should have already exercised his right to rescind the underlying contract. In summary, to be material, it is proposed, a non-documentary fraud should be proved, or powerfully alleged as the only realistic inference at pre-trial, in the formation (with the complicit of the beneficiary) of the underlying contract and it should be proved that the applicant exercises the right to rescind the underlying contract.

6. CONCLUSION

Given the recent decision of the Supreme Court in *Patel v Mirza*,¹³⁰ in the context of illegality, the time is ripe for solving the uncertainty of policy reasons underlying the fraud exception. It should become clear now that the principal policy reason underlying the fraud exception is the integrity of law, so law should be consistent by refusing to give by its right hand what it takes by its left hand. For the integrity of security of payment underpinning documentary credits, the protection of the reputation of documentary credits from being a vulnerable target by fraudsters should be the other policy reason underlying the fraud exception. Applying contract analysis to the policy underlying the fraud exception is not

¹²³ (1974) 14 UCC Rep Serv 1427.

¹²⁴ 392 N.Y.S.2d 265, 271 (N.Y. 1976).

¹²⁵ (1889) 14 App. Cas. 337.

¹²⁶ (1889) 14 App. Cas. 337, 374, Per Lord Herschell.

¹²⁷ The term indicates telling of a lie.

¹²⁸ *United City Merchants (Investments) Ltd v Royal Bank of Canada* [1983] 1 AC 168, 182- 183.

¹²⁹ *Johnson v Agnew* [1980] AC 367; Beale and others (eds), *Chitty on Contracts*, 31st edn (Sweet and Maxwell, 2012) para 6.111.

¹³⁰ [2016] 3 W.L.R. 399.

conceptually sound nor it generates consistent results, and it is futile for a non-documentary fraud.

English courts should not be too technical and fall into the trap of pure law and contract analysis in dealing with the inquiry of the fraud exception. The requirement of the bank's knowledge of fraud in order to trigger the fraud exception generates a second uncertainty. Instead of a mere simple contract analysis, reasonable commercial expectations of the documentary credit's parties should be considered. Amongst the innocent parties, it is usually the applicant who is expected to bear the risk of fraud. Even if the bank has actual knowledge of the beneficiary's fraud, it may not in reality be able to restrain payment in complex documentary credits (i.e. a chain of banks), particularly when it is not the first bank in the chain to honour the credit. It is regrettable that such a commercial reality is not reflected in law and literature.

Furthermore, the technicality of contract analysis dictates that the applicant will have a contractual remedy against the bank which chooses to honour the credit despite having knowledge of the beneficiary's fraud. This is considered by courts as a factor that heavily militates against granting interim injunctions to restrain the bank from payment. In reality, such a factor does not generally exist and it is therefore a mirage that causes a third uncertainty in the fraud exception under English law. This is chiefly because the bank may not be liable for the decision to honour in complex documentary credits. Another problem emanated from contract analysis is the judicially, disputed, suggestion of requiring a cause of action for pre-trial injunctions. The requirement of a cause of action may deprive the parties from the most suitable solution in fighting fraud in documentary credits (i.e. an injunctive relief by the applicant against the bank at the forefront in the chain of banks to honour the credit).

The position of English law should therefore be remedied. The fraud exception in law should be triggered by the policy reasons, the beneficiary's knowledge of fraud and, at pre-trial, a high standard proof that fraud is the only realistic inference. The bank's knowledge must be qualified by being only material in triggering the bank's liability in simple documentary credits whereby there is no chain of banks. In reality, two equitable concerns that should heavily be weighted in the balance of convenience for interim injunctions to stop payment, namely, the real risk of dissipating assets and whether there is chain of banks (complex documentary credits) or not (simple documentary credits). In commerce, if there is no real risk of dissipation the commercial understanding of "pay now, argue later" underpinning documentary credits prevails. In law, the policy of the integrity of law cannot be realistically applied in a complex documentary credit that involves chain of banking obligations that subject to various laws.

The lack of authority under English law as to the fraud that is not related to the presented documents (non-documentary fraud) in the underlying contract causes the fourth uncertainty. For reasons explained in the article the decision of the Privy Council in *Alternative Power* is *not* an authority for accepting a non-documentary fraud as an exception to the norm of independence. Because of the role of documents, documentary credits and performance bonds cannot be treated alike on a non-documentary fraud. English courts should not therefore follow the misleading position of the Canadian Supreme Court. The policy reasons and the logic of the role of documents dictate that to be material, so an exception to the norm of independence, a non-documentary fraud should (1) occur in the formation of the underlying contract rather than the performance (fraudulent misrepresentation) - except where performance constitutes part of court proceedings - and (2) be annexed with a proof of exercising the right to rescind the underlying contract.