

**Documentary Credits and Independent Guarantees:  
A Critique of the 'Fraud Exception' Position in  
English and Jordanian Law**

**By**

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## Student Declaration

\*I declare that while registered as a candidate for the research degree, I have not been a registered candidate or enrolled student for another award of the University or other academic or professional institution

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## Abstract

Underpinning the law on documentary credits and independent guarantees is a legal principle of autonomy which dictates that these financial instruments should, as a matter of law, be treated separately from a trader's contractual agreement. However, despite this, fraudulent behaviour may still occur when these financial and legal instruments are used in practice. In response, a fraud exception to the autonomy principle has been recognised by many national and international courts in an attempt to mitigate the effects of fraudulent trade practices. The application of this exception within the English courts is, however, problematic owing to the narrowness of its construction and application. Additionally, the paucity of alternate legal instruments for regulating fraudulent trade practices means that Jordanian courts are not in any better position than their English counterparts, leaving traders confused as to their legal position when a fraud dispute arises. Given the large financial value of fraudulent transactions and the risks involved, the use of these legal instruments has declined as has the banks' investment in this area creating a problem for legal policy makers.

The aim of this dissertation is to, first, critically examine the fraud exception under English and Jordanian law by exploring the problems associated with the application of the fraud exception; and, second, to propose legal reforms which would alleviate both the legal and practical problems associated with the fraud exception as it stands currently. The thesis is that, whilst the autonomy principle plays a vital role in international trade, the courts should facilitate the fraud exception application and recognise other exceptions, such as the non-genuinity and the underlying contract exception, where the former exception would be unable to prevent fraud occurrence. The approach is based upon a critical evaluation of Anglo-American and Jordanian case law, supplemented by secondary sources and a qualitative examination of the Jordanian approach to the fraud exception based upon interviews with Jordanian judges. The dissertation concludes that an effective legal approach to fraudulent transactions using documentary credits and independent guarantees must be founded upon objective rather than subjective principles and that the courts' use of injunctions should be different in cases involving holders in due course from those not involving such parties. These findings will impact upon legal policy debates within both English common law and international trade law more generally and the examination of the Jordanian position is instructive in that it is the first such study of its kind.

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## **Dedication**

To my father

Who has supported me, waited for me and who made me who I am today.

To the loving memory of my mother

The woman who taught me to love, respect and treat others with kindness.

To my brothers, sisters and their families for their support, love and encouragement  
throughout my life and especially during the period of this PhD.

## Chapter One: Introduction

### 1.1. Context of the problem

A key feature of current commerce is the proliferation of international contracts which involve parties located in different countries.<sup>1</sup> Such proliferation has not been without its own problems as those involved parties may confront various fears as to the ability of each of them to discharge the contractual obligations assigned to them through their underlying contracts.<sup>2</sup> On the one hand, a buyer of a certain quantity of goods would wish not to pay a distant seller the price of the goods without there being assurances that the desired goods will be delivered as agreed. On the other hand, a seller would not want to relinquish possession of his goods before obtaining payment. Taking into consideration that litigation in a foreign country might be time consuming, costly and of non-guaranteed results, mitigating such fears and facilitating the course of international commerce was one of the main reasons which motivated traders to develop documentary credits and independent guarantees.<sup>3</sup>

In view of that, a seller, rather than disrupting the transaction, as a result of fear of sending the goods before receiving payment, would ask the buyer, pursuant to their contract, to obtain a documentary credit in the former's favour before sending the goods. Obtaining such an instrument guarantees to the seller that the price of the

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<sup>1</sup> For example: Todd, P. "*Bills of Lading and Bankers' Documentary Credits*" (Informa Law, 4<sup>th</sup> ed., London, 2007) at p. 10; Ellinger, E. "*Documentary Letters of Credit: A Comparative Study*" (University of Singapore Press, Singapore, 1970) at p. 3

<sup>2</sup> Hooley, R. & Sealy L. "*Commercial Law: Text, Cases, and Materials*" (Oxford University Press, 4<sup>th</sup> ed., 2009) at p. 848; Bulger, R. 'Letters of Credit: A Question of Honor' [1984] *N.Y.U.J. Int'l L. & Pol.* 799 at p. 799

<sup>3</sup> See, for example: Enonchong, N. 'The Problem of Abusive Calls on Demand Guarantees' [2007] *L.M.C.L.Q.* 1, 83 at pp. 86-87; Harfield, H. "*Bank Credits and Acceptances*" (The Ronald Press Company, 5<sup>th</sup> ed., New York, 1974) at p. 80; *United Trading Corp SA and Murray Clayton Ltd v. Allied Arab Bank Ltd* [1985] 2 Lloyds Rep. 554

goods will be received from a third party, usually a bank,<sup>4</sup> upon the former's submission of documents which show that the required goods have been sent.<sup>5</sup> By utilising a documentary credit the buyer in turn will receive assurances that the price of the goods will not be paid unless the seller shows evidence of discharging the obligations assigned to him under their contract of sale.<sup>6</sup>

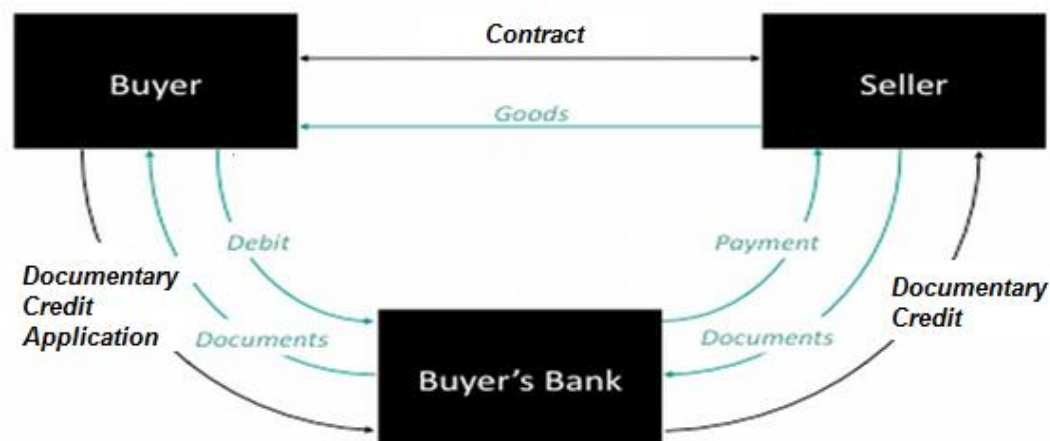


Figure 1: How documentary credits work

Similarly, a buyer might fear that the sellers may not discharge their assigned commitments which exist as a result of their agreement. In such a case, the buyer might ask the seller to obtain an independent guarantee in order to provide an assurance that the latter will duly discharge his commitments.<sup>7</sup> Like documentary credits, the seller would obtain such an instrument from a reliable third party, usually a bank, in return for a small fee.<sup>8</sup> An independent guarantee gives the buyer a right to demand and obtain its amount once the seller breaches one or more of the obligations

<sup>4</sup> Banks are frequently asked to issue documentary credits and independent guarantees because of their creditworthiness.

<sup>5</sup> For example: Carr, I. *“International Trade Law”* (Cavendish Publishing, 3<sup>rd</sup> ed., 2005) at p. 471

<sup>6</sup> Howard QC, M. Masefield, R. & Chuah, J. *“Butterworths Banking Law Guide”* (Butterworths, London, 2006) at p. 495

<sup>7</sup> Ellinger P. & Neo, D. *“The Law and Practice of Documentary Letters of Credit”* (Hart Publishing, Oxford, 2010) at p. 300

<sup>8</sup> See, e.g.: Ellinger P. & Neo, D. *“The Law and Practice of Documentary Letters of Credit”* (Hart Publishing, Oxford, 2010) at p. 2; Sarna, L. *“Letters of Credit: The Law and Current Practice”* (Carswell Legal Publishers, 2<sup>nd</sup> ed., Toronto, 1986) at p. 5

assigned to him under their contract. In an independent guarantee context the buyer does not need to prove that the seller has breached the underlying contract and a mere demand usually will be sufficient for the former to obtain the amount. Such an instrument provides the buyer with a prompt and secure source of compensation in case the seller breaches his contractual obligations.<sup>9</sup>

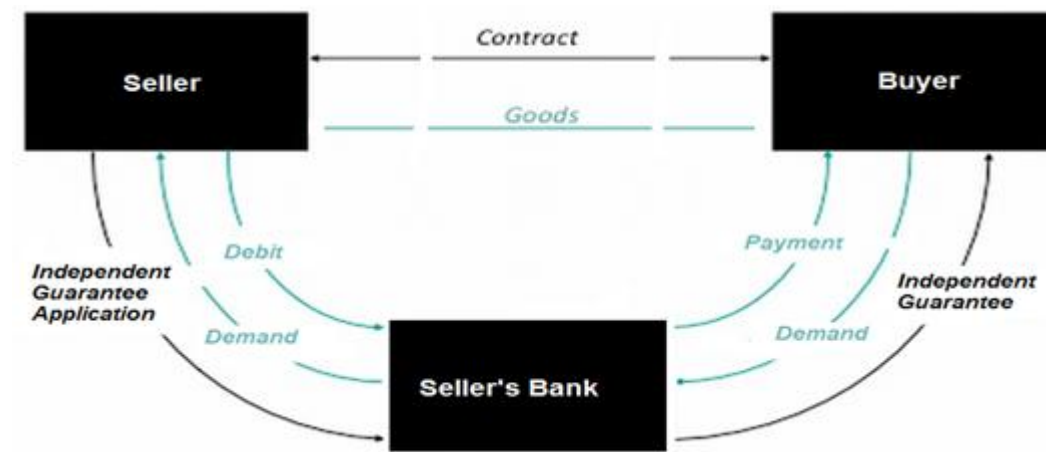


Figure 2: How independent guarantees work

## 1.2. The fraud problem

The autonomy principle, which virtually dictates that the bank’s relationship with each of the seller and the buyer should be independent from the latter parties’ underlying contract, was developed by traders to facilitate and maintain these instruments’ effectiveness.<sup>10</sup> Yet, whilst the autonomy principle facilitates these

<sup>9</sup> Ellinger P. & Neo, D. “*The Law and Practice of Documentary Letters of Credit*” (Hart Publishing, Oxford, 2010) at p. 300. The mechanism and functions of documentary credits and independent guarantees are described in more detail in the next chapter.

<sup>10</sup> One of the early and oft-quoted statements to this effect is Lord Jenkins’ statement, in *Hamzeh Malas & Sons v. British Imex Industries Ltd.* [1958] 1 A11 E.R. 262, where he provided: “We were referred to several authorities, and it seems to be plain that the opening of a confirmed letter of credit constitutes a bargain between the banker and the vendor of the goods, which imposes on the banker an absolute obligation to pay, irrespective of any dispute which there may be between the parties on the question of whether the goods are up to contract or not”, at 263-64. See as well, e.g.,: Guest, A. “*Benjamin’s Sale of Goods*” (Sweet & Maxwell, 7<sup>th</sup> ed., London, 2006) at p. 2054; Fellingner, G. ‘Letters of Credit: The Autonomy Principle and the Fraud Exception’ [1990] 1 *J.B.F.L.P.* 4 at p. 9; *RD Harbottle (Mercantile) Ltd v National Westminster Bank Ltd* [1978] Q.B. 146 at 156. More about the autonomy principle is to be found in Chapter 2.

instruments' function, it has been noticed that it may well in some cases put one of the parties at the mercy of other unscrupulous parties.<sup>11</sup> In an independent guarantee context, as the buyer is able to request the guarantee amount where no breach of contract has occurred at all and as he does not need to show any evidence for such an inexistent breach, the autonomy principle in such cases could work to encourage fraudulent demands.<sup>12</sup> Similarly, in a documentary credit context the autonomy principle may encourage unscrupulous sellers to send valueless or even no goods and, nonetheless, obtain fraudulent documents which falsely show that they have duly discharged their commitments.<sup>13</sup>

In fact, fraud in such a context is not new.<sup>14</sup> However, what is new is the large scale of fraud which has the capacity to have a negative effect on the use of such instruments.<sup>15</sup> It is interesting to note that such a fraud is on the increase.<sup>16</sup> Taking into consideration the huge amount of money involved in the fraud which are perpetrated through these instruments, it is not surprising to see that their use has been

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<sup>11</sup> For example, Ellinger has noted that the buyer in some cases would be “at the mercy of the beneficiary’s judgement”. See: Ellinger P. & Neo, D. “*The Law and Practice of Documentary Letters of Credit*” (Hart Publishing, Oxford, 2010) at p. 318. See as well: Low, H.Y. ‘Confusion and Difficulties Surrounding the Fraud Rule in Letters of Credit: An English Perspective’ [2011] *Int. J.L.M.* 17(6), 462 at p. 463; Bennett, H. ‘Performance Bonds and the Principle of Autonomy’ [1994] *J.B.L.* 574 at p. 576

<sup>12</sup> Gao, X. “*The Fraud Rule in the Law of Letters of Credit: a Comparative Study*” (London, 2002) at p. 113

<sup>13</sup> Demir-Araz, Y. ‘International Trade, Maritime Fraud and Documentary Credits’ [2002] *Int. T.L.R.* Vol. 8(4), 128 at p. 129; Goode, R. “Reflections on Letters of Credit-I” [1980] *J.B.L.* 291 at p. 294

<sup>14</sup> For example, Spalding has noted that fraud was existent in this context on 1921. See: Spalding, W. “*Banker’s Credits*” (The Pitman Press, London, 1921) at p. 94

<sup>15</sup> Zhang, Y. “*Approaches to Resolving the International Documentary Letters of Credit Fraud Issue*” (University of Eastern Finland, Finland, 2011) at p. 21. For example, fraud which is perpetrated in the contexts of documentary credits and independent guarantees was estimated to cost around 1 billion US\$ per year in 2005. See: [www.bolero.net](http://www.bolero.net), referred to in Carr, I. “*International Trade Law*” (Cavendish Publishing, 3<sup>rd</sup> ed., 2005) at p. 503

<sup>16</sup> Low, H.Y. ‘Confusion and Difficulties Surrounding the Fraud Rule in Letters of Credit: An English Perspective’ [2011] *Int. J.L.M.* 17(6), 462 at p. 463. See as well: Schulze, WG. ‘The UCP 600: A New Law Applicable to Documentary Letters of Credit’ [2009] 21 *SA Merc LJ.* 228 at p. 228

somewhat decreasing worldwide in the last few years and that banks' willingness to invest in this field has dramatically declined lately.<sup>17</sup>

In order to protect parties who do utilise documentary credits and independent guarantees from fraud,<sup>18</sup> a fraud exception to the autonomy principle has been recognised by different national and international courts.<sup>19</sup> This exception allows banks and courts to override the autonomy principle and thus examine the different contracts involved in the arrangement of these instruments in order to maintain their utility, to mitigate fraud and to protect the different involved bona fide parties from other unscrupulous parties.<sup>20</sup>

Nevertheless, it has been noticed that it is hard to find a scholarly work that has not criticised the English law application to the fraud exception in this particular area of law. Most commentators have found that the English courts have been reluctant to interfere in order to protect bona fide parties from those unscrupulous ones.<sup>21</sup> It has been said that the 'English approach' "is excessive to the extent of defeating the

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<sup>17</sup> *Ibid.* Into the same effect Todd has found that they "appear to be declining in popularity, losing ground to open account sales". See: Todd, P. "*Bills of Lading and Bankers' Documentary Credits*" (Informa Law, 4<sup>th</sup> ed., London, 2007) at p. 32. According to Sifri: "Fraud is the most destructive illegal act banks face. Not only does it constitute a direct cost to the bank, it also entails large expenses for legal pursuits, investigations fees and cost of executives' time spent on handling fraudulent transactions. Furthermore, fraud has devastating negative effects, that cannot be expressed in terms of money, on the bank's reputation, public trust and staff morale". See: Sifri, J. "*Standby Letters of Credit: A Comprehensive Guide*" (Palgrave Macmillan, New York, 2008) at p. 195

<sup>18</sup> ICC Publications, "*Trade Finance Fraud*" (Barking, 2002) at p. 19

<sup>19</sup> Low, H.Y. 'Confusion and Difficulties Surrounding the Fraud Rule in Letters of Credit: An English Perspective' [2011] *Int. J.L.M.* 17(6), 462 at p. 463

<sup>20</sup> *Simon Carves Ltd v Ensus UK Ltd* [2011] EWHC 657 (TCC); [2011] B.L.R. 340; [2011] C.I.L.L. 3009 (first instance)

<sup>21</sup> For example: Enonchong, N. 'The Problem of Abusive Calls on Demand Guarantees' [2007] *L.M.C.L.Q.* 1, 83 at p. 85; Demir-Araz, Y. 'International Trade, Maritime Fraud and Documentary Credits' [2002] *Int. T.L.R.* Vol. 8(4), 128 at p. 134; Pugh-Thomas, A. 'Can a Buyer Bypass the Guarantor and Stop the Seller from Demanding Payment from the Guarantor?' [1996] *I.C.C.L.R.* Vol. 7(4), 149 at p. 149; Murray, D. 'Letters of Credit and Forged and Altered Documents: Some Deterrent Suggestions' (1993) 98 *Com. L.J.* 504 at p. 515; Kee, H. 'The Fraud Rule in Letters of Credit Transactions' (eds.) in Chinkin, C., Ho, P. & Chan, H. "*Current Problems of International Trade Financing*" (National University of Singapore, 2<sup>nd</sup> ed., 1990) 188 at p. 189

objective of the exception”<sup>22</sup> and that the fraud exception “exists under common law almost like a theoretical concept rather than a practical one.”<sup>23</sup>

It is submitted that such an “unsatisfactory position” is leading to more and not less fraud in this context.<sup>24</sup> Also it is suggested that such a position would lead to a loss in confidence in the use of English law and courts and would similarly affect badly other jurisdictions which do rely on English law because of the uncertainty and increased costs associated with such a loss of confidence.<sup>25</sup> For example, different international traders would refuse to deal with English or other traders who would stipulate for English law to govern their contracts in order to avoid the English courts’ reluctance to interfere with fraud which might afflict them badly.<sup>26</sup>

Similarly, the Jordanian law is not without its own shortfalls in this regard. Jordan suffers from a legislative vacuum and a shortage of supplementary law sources as regards documentary letters and independent guarantees in general and the fraud exception in particular.<sup>27</sup> Equally, it is submitted that the existence of such a fact would cause harmful consequences on the reputation of the Jordanian courts, commerce and parties who are involved in the latter.<sup>28</sup>

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<sup>22</sup> Low, H.Y. ‘Confusion and Difficulties Surrounding the Fraud Rule in Letters of Credit: An English Perspective’ [2011] *Int. J.L.M.* 17(6), 462 at p. 462

<sup>23</sup> Demir-Araz, Y. ‘International Trade, Maritime Fraud and Documentary Credits’ [2002] *Int. T.L.R.* Vol. 8(4), 128 at p. 134

<sup>24</sup> Ulph, J. “*Commercial Fraud: Civil Liability, Human Rights, and Money Laundering*” (Oxford University Press, Oxford, 2006) at p. 535

<sup>25</sup> *Ibid.*

<sup>26</sup> This could be clearly seen in the light of statistics in this respect showing that 44 cases in the UK out of 72 have involved foreign parties in 2000. See: The Right honourable Lord Irvine of Lairg. ‘The Law: An Engine for Trade’ (2001) 64 *Mod. L. Rev.* 333 at p. 333

<sup>27</sup> Al-Kilani, M. “*Amaliat Al-Bonok*” (Dar Al-Thakafa, Amman, 2009) at pp. 325-326; An interview with Judge Israa Al-kharabsheh, of the North Amman Court of First Instance, on 16-09-2011

<sup>28</sup> *Ibid.*

### 1.3. Aim of the thesis

As it has been mentioned above, the English law application of the fraud exception has been a subject of a prolonged argument.<sup>29</sup> As one commentator observes:

“Despite being the most well-established exception to the autonomy principle and the only exception recognised by nearly every jurisdiction in the world, the fraud rule is complicated, riddled with many difficulties and has its own shortcomings”.<sup>30</sup>

On the other hand, because of the shortage of supplementary law sources which govern this area of law, the Jordanian law is not in a better position than that of its English counterpart in this regard. Legal uncertainty does prevail in such a jurisdiction leaving the parties who utilise documentary credits and independent guarantees in a confusing situation as to their legal rights and duties in case a fraud dispute comes up.

Taking this into consideration, this work critically examines the fraud exception application to the autonomy principle of documentary credits and independent guarantees under the English and Jordanian law. This work seeks to explore the problems associated with the fraud exception application in both jurisdictions and consequently to propose some legal reforms which would solve such problems and so prevent or at least mitigate fraud occurrence. The importance of such an examination lies in the fact that independent guarantees and documentary credits are prolific in the international trade realm and that fraud could badly affect these instruments' viability, parties which use them and commerce in general.<sup>31</sup>

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<sup>29</sup> Horowitz, D. “*Letters of Credit and Demand Guarantees: Defences to Payment*” (Oxford University Press, 2010) at p. 234; Blair, W. ‘Commentary on ‘Documents Contractual Congruence in International Trade’ (Eds.) in Worthington, S. “*Commercial Law and Commercial Practice*” (Hart Publishing, Oxford, 2003) 241 at p. 242

<sup>30</sup> Low, H.Y. ‘Confusion and Difficulties Surrounding the Fraud Rule in Letters of Credit: An English Perspective’ [2011] *Int. J.L.M.* 17(6), 462 at p. 463

<sup>31</sup> *Ibid* at p. 463. See as well: Schulze, WG. ‘The UCP 600: A New Law Applicable to Documentary Letters of Credit’ [2009] 21 *SA Merc LJ.* 228 at p. 228



The argument proposed in this work is that, whilst the autonomy principle plays a vital role in international trade, the courts should facilitate the fraud exception application and recognise other exceptions, such as the non-genuinity and the underlying contract exception, where the former exception would be unable to prevent fraud occurrence. Although too many works have examined the fraud problem in the documentary credit and independent guarantee context, the current author argues that such works have failed to identify all of the problems associated with the fraud exception application and accordingly have been unsuccessful in proposing the reforms needed. As far as the author is aware, this thesis is the first of its kind to offer a comprehensive examination to the fraud exception position in documentary credits and independent guarantees under the Jordanian law.

#### **1.4. Structure of the thesis**

This thesis is divided into eight chapters. After the introduction, chapter two introduces a background about the documentary credits and independent guarantees different basic legal principles and characteristics. It is submitted that such a background is necessary in order to understand the fraud exception application discussion which will follow later after this chapter. Indeed, it would be difficult to commence any work in this area of law without introducing these basic legal principles and characteristics.

Chapter three explores the extent to which banks can successfully rely on the fraud exception to refuse tendered documents. This chapter questions the English courts' application to the fraud exception in this regard and, consequently, it seeks to suggest reforms in order to relieve banks and applicants from being defrauded by unscrupulous beneficiaries. In this respect, the current author suggests that a non-

genuinity defence is a more suitable defence to be applied rather than the fraud exception.

Chapter four investigates whether the fraud exception application should be confined to fraud which is perpetrated in documentary credits and independent guarantees documents and whether it can be extended to apply where fraud is perpetrated in the underlying transaction, which through such instruments has ensued, in order to stop the payment process of these instruments.<sup>32</sup> This work argues that the fraud exception application should include both kind of fraud in order to serve as an effective and practical rather than a theoretical weapon against fraudulent conducts.

Chapter five examines the fraud standard which English courts do request to apply the fraud exception in order to restrain the payment of documentary credits and independent guarantees. It is argued in this chapter that the common law fraud standard which has been applied by the English courts in the context of documentary credits is so difficult to obtain and so would be unable to prevent fraud occurrence. Taking this into consideration, this work proposes an objective standard to replace the common law fraud standard which English courts do apply.<sup>33</sup> Furthermore, this work suggests that neither a common law fraud standard nor an objective standard would mitigate fraud from being committed in an independent guarantee context. Hence, other potential exceptions which have the ability to combat fraud are discussed. These potential exceptions which are discussed in chapter five include the unconscionability exception and the underlying contract exception. While the unconscionability

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<sup>32</sup> Fraud perpetrated in such a context can be distinguished, in terms of the place in which it might be perpetrated, into two main categories, namely, fraud in the documents and fraud in the underlying transaction. More about this point is to be found in chapter 4.

<sup>33</sup> See, for example: Stoufflet, J. 'Fraud in Documentary Credit, Letter of Credit and Demand Guaranty' (2001) 106 *Dick. L. Rev.* 21 at p. 22

exception will be refuted because ambiguity is inherent in it, this work argues for the adoption of the underlying contract exception in this respect.

Chapter six examines the English courts' application of injunctions in the documentary credits and independent guarantees context. Such examination focuses on the conditions which the English courts stipulate for in order to grant an injunction based on the fraud exception to stop a documentary credit or an independent guarantee fraudulent payment. In this chapter, it is argued that the application of these conditions is unclear and sometimes contradictory and so an urgent reform is needed in order to make the fraud exception application practical rather than theoretical. Furthermore, in this work it is advocated that the conditions to grant an injunction based on the fraud exception in a documentary credit or an independent guarantee context should be applied differently in cases which involve holders in due course from those not involving such parties. The different application of these conditions could be understood if the special role which holders in due course play in this context is taken into consideration.

Chapter seven seeks to explore the Jordanian law application of the fraud exception in the documentary credits and independent guarantees context in order to identify the problems it suffers from and propose the reforms needed.<sup>34</sup> While the discussion in this chapter will begin with looking at the positions of the different Arabian Middle Eastern countries in this regard, later discussion will focus on Jordan in particular. Such limitation of focus in this chapter is attributed to the fact that the Jordanian

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<sup>34</sup> It should be noted that this work is meant to study the Arabian countries which are located in what has been known as the Traditional Middle East and is not intended to study other Arabian countries which are located in what has been known as the Greater Middle East. Accordingly, Arabian countries, which are located in the Traditional Arabian Middle Eastern region and which this study is concerned with comprise: Egypt, Iraq, Saudi Arabia, Yemen, Syria, United Arab Emirates, Jordan, Lebanon, Palestinian Territories, Oman, Qatar, Bahrain and Kuwait.

judiciary, in contrast to the other Arabian Middle Eastern countries,<sup>35</sup> has heard some fraud cases in the last few years. In this chapter the current author argues that while some aspects of the fraud exception application are recommended in this region, a code of law should be articulated to address practices relating to documentary credits and independent guarantees and to address the fraud exception application in particular.

### **1.5. Methods and methodology**

In order to examine the fraud exception application to the autonomy principle in documentary credits and independent guarantees under both the English and Jordanian Law, this work makes use of the secondary data available in this respect as the main method to complete such an examination.<sup>36</sup> In addition to the secondary data, a large volume of English and Arabian Middle Eastern acts and cases have been used to constitute the legal basis of this work. By critically analysing and comparing the various opinions expressed in these materials the current author will identify the problems which the fraud exception application suffers from under the English and Jordanian law and accordingly to suggest the reforms needed.

While some aspects of documentary letters and independent guarantees law, such as the autonomy principle, are well known, either through usage by the national laws or by reference to the International Chamber of Commerce (ICC) rules, which have

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<sup>35</sup> Indeed, the absence of dedicated legislation, the fact that no fraud cases were ever brought to courts and the lack of scholars and commentators in these countries, made examining their attitude to this area of law a difficult task.

<sup>36</sup> The main sources for these materials are the library of the University of Central Lancashire, the Library of Manchester University, the Library of Birmingham University, the Library of Oxford University, the Library of Cambridge University, the British Library in London, the Library of the University of Jordan and the Library of Cairo University. Moreover, different publishers have been approached in order to obtain some of these materials. These publishers include: Sweet and Maxwell, LexisNexis, Hart Publishing, Butterworths and IIBLP “Institute of International Business Law and Practice”. In addition, many of these materials have been acquired through the internet and electronic data bases, namely, WestLaw UK, Lexis Library and HeinOnline Law Journal Library. Inter-library loan facilities, which the Library of the University of Central Lancashire provides to acquire materials unavailable in their library, have been frequently utilised.

developed in this context, in the Arabian Middle Eastern countries, other aspects are unclear as no international or national provisions have addressed it. One of these most challenging aspects is the fraud exception application to the autonomy principle.

In general, these countries have not regulated provisions to tackle the fraud problem in the documentary credits and independent guarantees context. Moreover, no help in relation to this problem has been provided by the ICC different rules. These countries depend on case law, commercial customs and legal jurisprudence, whenever a dispute is heard by their courts where no legislation covers the disputed matter.<sup>37</sup> Yet, as no case law regarding fraud in these instruments can be found in most of these countries, this supplementary source of law has proved unhelpful. Commercial customs also do not afford help because most of these Arabian Middle Eastern countries have not witnessed disputes regarding fraud in this context and so no customs have developed in his regard.<sup>38</sup> Furthermore, Arabian Middle Eastern legal scholars have not paid much attention to this particular area of law and the publications published in this regard do not exceed the number of the fingers of one hand.<sup>39</sup> It has been suggested that such inattention could be attributed to the fact that the fraud exception is still in its infancy age and that these academics have yet not acquired the necessary expertise in order to examine it.<sup>40</sup>

However, the situation in Jordan is different from the other Arabian Middle Eastern countries in this respect. Whilst no Jordanian special legislation covers this area, the

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<sup>37</sup> For example, Article 3 of the Jordanian Commercial Act (no. 12/1966) provides: “Where no legal provisions are available to be applied to the disputed matter, the judge can apply case law, legal jurisprudence, justice rules and commercial customs”.

<sup>38</sup> Al-Kilani, M. “*Amaliat Al-Bonok*” (Dar Al-Thakafa, Amman, 2009) at pp. 325-326

<sup>39</sup> For example: Al-Kilani, M. “*Mo’amalat Albonok*” (Dar Altahkafah, 2<sup>nd</sup> ed., Amman, 2009); Awad, A. “*Alitimadat Almostanadieh*”, (Dar Alnadh Alarabieh, 1<sup>st</sup> ed., Cairo, 1989); Awad, A. “*Khitabat Aldaman*” (Dar Alnahda Alarabieh, 3<sup>rd</sup> ed., Cairo, 2007); Abdel Hameed, R. “*Alnidam Almali wa Mo’amalat Albonok*” (Dar Abo El Majd, 1<sup>st</sup> ed., Cairo, 2000); Nassar, N & Nassar, S. “*Khitabat Aldaman wa Alitimadat Almsotanadieh*” (Dar Memfees, 1<sup>st</sup> ed., Cairo, 1997)

<sup>40</sup> Al-Kilani, M. “*Amaliat Al-Bonok*” (Dar Al-Thakafa, Amman, 2009) at pp. 325-326

Jordanian judiciary, unlike its neighbours, has recently heard some documentary credits' fraud disputes. Nevertheless, it must be noted that the relatively few cases relating to fraud in documentary credits heard by the Jordanian courts, did not tackle all the different aspects of the fraud exception application. For this reason, the current author conducted interviews with eight Jordanian judges in order to make a comprehensive examination of the Jordanian fraud exception a possible task.<sup>41</sup>

Whilst this work is about the law relating to the fraud exception to the autonomy principle of documentary credits and independent guarantees in England and Jordan, however, in some areas it adopts a comparative approach and so examines other foreign systems' approaches in order to assist evaluating different problems. Indeed, it is not uncommon to see references to and adoption of decided court cases of other jurisdictions in England's case law and vice-versa.<sup>42</sup> Therefore, with no comprehensive account of other foreign laws, it has been possible to highlight authorities from other countries which mainly include: Canada, Singapore, Australia and the United States. Moreover, relevant international initiatives in this regard are examined through the work. These international initiatives include: the UN Convention on Independent Guarantees and Standby Letters of Credit and the international practice as reflected by the International Chamber of Commerce publications, namely, the Uniform Customs and Practice for Documentary Credits (UCP 600), the International Standby Practices (ISP98), the Uniform Rules for Contract Guarantees (URCG) and the Uniform Rules for Demand Guarantees (URDG 758) which entered into effect on 1 July 2010.

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<sup>41</sup> More about the different aspects and mechanisms of the interviews can be found in Appendix 1.

<sup>42</sup> Sarna, L. "*Letters of Credit: The Law and Current Practice*" (Carswell Legal Publishers, 2<sup>nd</sup> ed., Toronto, 1986) at p. 9

## Chapter Two: Documentary Credits and Independent Guarantees: Legal Basic Principles and Characteristics

### 2.1. Introduction

The aim of this chapter is to examine the legal basic principles and characteristics of documentary credits and independent guarantees. This chapter provides a general background for later discussions as issues examined and conclusions reached in this chapter will be necessary for the study of fraud and its implications in this context. In fact, it would be difficult to commence any work in this area of commercial law without consideration of such legal basic principles and characteristics.<sup>1</sup>

This chapter is divided into five sections. After the introduction, the second section examines issues pertaining solely to documentary credits. The first part of this section seeks to illustrate the reasons behind the development of documentary credits by examining their early forms. The following parts of this section are meant to explain the mechanisms of documentary credits, their different types and the different legal relationships which they create. Such an examination is necessary in order to establish a clear understanding of how these instruments came about and the legal and commercial policies behind them.

Similarly, the third section is concerned with issues pertaining solely to independent guarantees. It is suggested that the nomenclature of such instruments is surrounded with confusion for two reasons: firstly, the emergence of a great number of labels to denote such an instrument; secondly, the overlap with ordinary guarantees which,

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<sup>1</sup> Ellinger P. & Neo, D. *“The Law and Practice of Documentary Letters of Credit”* (Hart Publishing, Oxford, 2010); Malek, A & Quest, D. *“Jack: Documentary Credits”* (Tottel Publishing, 4<sup>th</sup> ed., Sussex, 2009); King, R. *“Gutteridge & Megrah’s Law of Bankers’ Commercial Credits”* (Europa Publications Limited, 8<sup>th</sup> ed., London, 2001); Dolan, J. *“The Law of Letters of Credit: Commercial and Standby Credits”* (Warren, Gorham & Lamont, revised ed., Boston, 1996)

while similar in goals, are legally different from independent guarantees. The first part of this section is meant to clarify such terminological confusion. The second and third parts of this section are meant to explain the mechanisms of independent guarantees, their different types and the different legal relationships which they create. The fourth and last part of this section seeks to distinguish independent guarantees and ordinary guarantees which are legally different from each other.

The fourth section focuses on issues related equally to both instruments. It is a distinctive legal characteristic of these instruments that, once they are issued, their issuer cannot revoke the obligation towards their beneficiary. The first part of this section seeks to illustrate the binding nature which these instruments enjoy. The second part of this section aims to examine the autonomy and strict compliance principles which govern documentary credits and independent guarantees. The rationale of such principles and the reasons behind their insertion into this context are discussed. In fact, different international initiatives have realised the importance of such instruments in the world trade realm. The last part of the fourth section examines the role which each of these different international initiatives has played in this regard. Whether the role which they played has helped in mitigating the fraud problem in such a context will be analysed. The conclusion is to be found in the fifth section.

## **2.2. The legal basic principles and characteristics of documentary credits**

### **2.2.1. Early forms**

As noted by one commentator:

“The history of commerce is the history of civilization. In his barbarous state man's wants are few and simple, limited to his physical existence, such as food, clothing and shelter, but as he advances in the scale of



intelligence his wants increase and he requires not only the comforts and conveniences of life but even the luxuries”.<sup>2</sup>

Commerce is one of the ways through which different peoples have at different times supplied their needs. In fact, it is difficult to find a community which produces everything that it needs. Therefore, a portion of what it needs must be supplied through the interchange of products with other communities and this is the beginning of domestic and foreign commerce.<sup>3</sup> Before the introduction of currency, commercial transactions were carried out using gold, silver and other minerals. It was exhausting for a buyer to carry huge amounts of gold from the place where he was to the place where the seller was. The fact that not all of the buyers could travel to buy goods, due to different circumstances, made the situation more difficult, as did the possibility of mislaying these amounts of minerals or of them being stolen.

These risks can be best observed in an international trade context. That is to say, how could a buyer, who did not wish to travel, get assured that the distant seller would send him his required goods with agreed quantities and qualities? On the other hand, how could the seller, who had no opportunity to meet the distant buyer and to get from him the price of the goods in person, be assured that he would get paid? Hence, one can see the need for a compatible payment system. Indeed, it is not the object of this subsection to present all the different early payment methods but rather to give a brief discussion which will illustrate the imperative needs behind developing documentary credits.

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<sup>2</sup> Powers, O. “*Commerce and Finance*” (Powers and Lyons, 1903), see chapter one “History of Commerce: Ancient Commerce”.

<sup>3</sup> *Ibid.*

### 2.2.1.1. Documents against acceptance

Taking into consideration the above mentioned problems facing commerce in its early forms, merchants have devised various payment methods to facilitate their trade and surmount such problems.<sup>4</sup> One of these early methods was the documents against acceptance system.<sup>5</sup> In such a method the seller, after dispatching the goods, in order to get the purchase price attaches a bill of exchange to the goods' documentation and sells them to an exchange house. As a result, the seller obtains the goods' price before the buyer would, in ordinary course, pay. The exchange house would be reimbursed by the buyer when it presents the documents to the latter. The exchange house, until the time at which the documents are accepted by the buyer, has the security of a pledge in the form of these documents and the goods which they represent.<sup>6</sup>

Yet such a system is not without its own shortcomings. From a seller's point of view, such a payment system did not provide a secure payment method. The seller faces the peril of non-payment as he/she acts upon a mere promise from a distant buyer who at any point might change his mind.<sup>7</sup> Therefore, the seller faces the risk of non-acceptance of his documents by the exchange house through whose offices he intends to discount the draft. In such a context, the exchange house would not readily become embroiled in such a potential dilemma where it might accept the documents and pay but later the buyer refuses to pay for them.<sup>8</sup> Such a situation pushed exchange houses into refraining from accepting such documents and this eventually resulted in an

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<sup>4</sup> Bulger, R. 'Letters of Credit: A Question of Honor' [1984] *N.Y.U.J. Int'l L. & Pol.* 799 at p. 799

<sup>5</sup> See, for example: *Td Bailey, Son & Co v Ross T Smyth & Co Ltd* (1940) 56 T.L.R. 825 at 828. According to Lord Wright: "The general course of international commerce involves the practice of raising money on the documents so as to bridge the period between the shipment and the time of obtaining payment against documents".

<sup>6</sup> *Per Scrutton L.J. in Guaranty Trust Co. of New York v. Hannay & Co.* [1918] 2 K.B. 623 at 659-60

<sup>7</sup> Hooley, R. & Sealy L. "Commercial Law: Text, Cases, and Materials" (Oxford University Press, 4<sup>th</sup> ed., 2009) at p. 848

<sup>8</sup> Ellinger P. & Neo, D. "The Law and Practice of Documentary Letters of Credit" (Hart Publishing, Oxford, 2010) at p. 2

abandonment of the system as a whole. Moreover, under such a system, buyers are at risk as they would pay an exchange house and might receive nothing later. These observed troubles were the reasons which made traders seek a more secure and efficient way of payment.<sup>9</sup> The next subsection is meant to illustrate another two early payment methods which preceded the emergence of documentary credits.

### **2.2.1.2. *Open letters of credit and buyer's credit***

It has been suggested that open letters of credit and buyer's credit are the origins from which documentary credits have emanated and developed.<sup>10</sup> In an open letter of credit, an exchange house requests other persons to advance money to its customer and promises to repay such advanced money.<sup>11</sup> The main aim of this payment method was to raise funds for buyers in their overseas travelling.<sup>12</sup> However, such a method offered help to buyers who wished to travel but not to those who did not wish to travel for a variety of different reasons. Besides, such a payment method has been described as "...the document which...is lost more often than any other document in the world."<sup>13</sup> In addition, holding this letter in his hands does not mean that a seller would for sure accept the buyer's offer. A seller might fear that the promisor would not perform his promise when he approaches him for the goods' price. Buyers might find it difficult to find a person who would honour their request where he knows nothing about their or the distant promisor's trustworthiness and solvency.

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<sup>9</sup> Ellinger, E. "*Documentary Letters of Credit: A Comparative Study*" (University of Singapore Press, Singapore, 1970) at pp. 3-4

<sup>10</sup> *Ibid.* at pp. 24-38

<sup>11</sup> Story, J. "*Commentaries on the Law of Bills of Exchange, Foreign and Inland as Administrated in England and America*" (2<sup>nd</sup> ed., Boston, 1860) at Ch. XIII Para. 459. Cited in Gao, X "*The Fraud Rule in the Law of Letters of Credit*", (Kluwer Law International, 2002) at p. 9

<sup>12</sup> Spalding, W. "*Banker's Credits*" (The Pitman Press, London, 1921) at p.12

<sup>13</sup> *Ibid.*

In a buyer's credit, all that the seller gets is a promise from the buyer himself that he will get paid.<sup>14</sup> In this method the buyer performs the role of an exchange house by sending a direct letter to the seller promising him that he will pay.<sup>15</sup> Yet, such a method is not always welcomed by sellers who do not easily trust a distant buyer which with whose reputation and solvency they are not familiar and accordingly it is not always a guarantee that the buyer will get the required facilitation. In addition, such a method did not provide buyers who do not wish to travel with an adequate payment method. Also, it is possible that such a letter might get lost or stolen.

### 2.2.2. Mechanism

Some authors have suggested that a: “documentary credit therefore evolved as mechanism for payment, in order partially to overcome some of these difficulties.”<sup>16</sup> Compared to its early forms, documentary credits are “Fairly modern instruments.”<sup>17</sup> Furthermore, documentary credits have been described as “...the most common method of payment in international sales.”<sup>18</sup> The great increase in world trade, fluctuations in foreign exchange, unstable economics and the involvement of dishonest people in commercial transactions were the reasons behind such growth.<sup>19</sup>

This work adopts the ‘documentary credit’ concept rather than ‘letters of credit’ to denote the payment instrument which constitutes the main focus of this section as using the latter concept is misleading as one might create some confusion between it

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<sup>14</sup> Malynes, “*The Ancient Law Merchant*”, (1629) at p. 104. cited in Kozolchyk, B. ‘The Legal Nature of the Irrevocable Commercial Letter of Credit’ [1965] 14 *Am J Comp L* 395, at pp. 396-397

<sup>15</sup> McCurdy, W. ‘Commercial Letters of Credit’ (1922) 35 *Harv. L. R.* 539 at p. 546

<sup>16</sup> Howard QC, M. Masefield, R. & Chuah, J. “*Butterworths Banking Law Guide*” (Butterworths, London, 2006) at p. 495

<sup>17</sup> Ellinger, E. “*Documentary Letters of Credit: A Comparative Study*” (University of Singapore Press, Singapore, 1970) at p. 26

<sup>18</sup> Hooley, R. & Sealy L. “*Commercial Law: Text, Cases, and Materials*” (Oxford University Press, 4<sup>th</sup> ed., 2009) at p. 849

<sup>19</sup> Davis, A. “*The Law Relating to Commercial Letters of credit*” (The Pitman Press, 3<sup>rd</sup> ed., London, 1963) at p. 10

and a standby letter of credit, the latter being one form of independent guarantees (which will be examined below). Moreover, the use of the concept of documentary credit is more appropriate as the word documentary denotes one of its main features, which is using documents. A commercial credit and a banker's credit are synonyms of a documentary credit and in English law they can be used interchangeably.<sup>20</sup> However, and as has been suggested above, this work will use the documentary credit concept to denote one of the two instruments with which this work is concerned, independent guarantees being the other instrument. The concept 'letters of credit' will be used to denote both independent guarantees and documentary credits where discussion will be applicable to these two instruments.

The current writer seeks to illustrate the mechanism of documentary credits by using the following example: B, a buyer located in the UK is eager to buy laptops' consignment from S, a seller in Jordan. On the one hand, B does not know S very well and is not certain about S's creditworthiness. Therefore, B is reluctant to send S the price for the laptops without an assurance that S will send them. On the other hand, S is in an unenviable position facing the same hesitation as B. In fact, S is unwilling to part with the laptops without assurance that he will get paid for them. Involving a third creditworthy person is one of the most successful solutions which might occur to B and S.<sup>21</sup> In view of that, B will instruct his bank I (the issuing bank) to open a documentary credit in favour of S. I, in his turn, will instruct S that a documentary credit has been opened in his favour by B and that I is pleased to pay the amount of money stipulated in the documentary credit to S on behalf of B once S shows that he

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<sup>20</sup> Hooley, R. & Sealy L. "*Commercial Law: Text, Cases, and Materials*" (Oxford University Press, 4<sup>th</sup> ed., 2009) at p.853; Sarna, L. "*Letters of Credit: The Law and Current Practice*" (Carswell Legal Publishers, 2<sup>nd</sup> ed., Toronto, 1986) at p. 1

<sup>21</sup> Davis, A. "*The Law Relating to Commercial Letters of credit*" (The Pitman Press, 3<sup>rd</sup> ed., London, 1963) at p. 10

has complied with the credit terms supplied by B. These terms usually dictate the submission of documents which include: a bill of lading, a commercial invoice and an insurance policy which provide proof of the goods having been sent as B desires.

In relation to this Mugasha has found that: “The interposition of a binding undertaking by a neutral third party makes the letter of credit a superior method of ensuring payment”.<sup>22</sup> Both of the parties will be in a better position when compared with the earlier forms mentioned above. S obtains the shipped laptops’ price by presenting the stipulated documents to I who will pay once these have been submitted.<sup>23</sup> B gains assurance that the laptops are on their way to the UK and that I will not pay unless it obtains documents ensuring such a fact. I in its turn will get a commission in return for its services.<sup>24</sup> In addition, as observed by Todd:

“...a documentary credit can be used to finance the entire transaction from the buyer’s viewpoint, resolving his cashflow problems entirely. Furthermore, sellers can use the credit as security to raise further capital, which may be required to ship or manufacture the goods in the first place”.<sup>25</sup>

In such a context the buyer does not need to travel and the seller would not refuse to send the goods as he now relies on a bank’s promise rather than that of an unknown distant buyer or exchange house. Indeed, utilizing such an instrument brings satisfaction to all parties involved.

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<sup>22</sup> Mugasha, A. “*The Law of Letters of Credit and Bank Guarantees*” (Federation Press, Sydney, 2003) at p. 10

<sup>23</sup> Carr, I. “*International Trade Law*” (Cavendish Publishing, 3<sup>rd</sup> ed., 2005) at p. 471

<sup>24</sup> See: Sarna, L. “*Letters of Credit: The Law and Current Practice*” (Carswell Legal Publishers, 2<sup>nd</sup> ed., Toronto, 1986) at p. 5; Ellinger P. & Neo, D. “*The Law and Practice of Documentary Letters of Credit*” (Hart Publishing, Oxford, 2010) at p. 2

<sup>25</sup> Todd, P. “*Bills of Lading and Bankers’ Documentary Credits*” (Informa Law, 4<sup>th</sup> ed., London, 2007) at p. 13

### 2.2.3. Various relationships and types

As can be noticed above, there are three relationships in a documentary credit context: firstly, the sale contract between the seller (known as the beneficiary) and the buyer (known as the applicant); secondly, the contract between the buyer and his bank (known as the issuing bank); thirdly, the documentary credit between the issuing bank and the seller.<sup>26</sup> Normally a distant seller, who is located in a faraway country, prefers to get the goods' price from a bank in his country.<sup>27</sup> Consequently, the buyer will instruct the issuing bank to request a correspondent bank to represent it in the seller's country. The involvement of a second bank gives rise to the need for a new contract between the issuing bank and the former.

The obligations of such a bank differ according to the instructions that it receives from the issuing bank which usually emerges from the buyer's contract with the seller. The corresponding bank might merely advise the seller that a documentary credit has been opened. The correspondent bank in such a context is called an 'advising bank' and its worth mentioning that the seller does not acquire any rights against such a bank. However, the correspondent bank might, through the issuing bank's instructions, add its confirmation to the documentary credit. Such a bank is called the 'confirming bank' and in such a context the sellers do acquire rights against this correspondent confirming bank which replaces the issuing bank vis-à-vis its obligations towards the seller but this time in the seller's country. Moreover, the documentary credit might give the opportunity to the seller to choose any bank or

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<sup>26</sup> Indeed, such a relationship does not acquire the elements which would allow its recognition as a contract. Different theories have been advocated to illustrate the nature of this relationship. Yet none has been accepted. See subsection 2.4.1. for more discussion in this point.

<sup>27</sup> Many factors are behind such an inclination. Firstly, by getting the money from a bank in his country, the seller saves the costs of travelling and seeking the money from a foreigner bank or buyer which he is not familiar with. Secondly, if anything went wrong, the presence of such a bank in his country gives the seller a right to sue the bank in his country instead of chasing a bank or a buyer in a foreign country.

some banks in his country to obtain the price of the goods. In such a context the bank is called the ‘negotiating bank’. For now, it is noteworthy to point out that requesting these banks to enter such contracts is not without its own troubles.<sup>28</sup>

It is worth noting that documentary credits themselves have many divergent types.<sup>29</sup> For this reason Harfield has described them as automobiles because of the variety of types which were created to serve various needs and purposes.<sup>30</sup> Two of these types, concerning the documentary credit’s enforceability, are the revocable and irrevocable credits. Where a revocable credit is used, a bank can revoke its promise to the seller. However, where an irrevocable credit is used the bank cannot do so. Therefore, using revocable documentary credits is very rare as it does not provide the seller with the security that he needs.<sup>31</sup> Other types of documentary credits are the confirmed and unconfirmed credits. These types of documentary credit indicate the bank’s obligations. If the credit is a confirmed one, the bank is obliged to pay as an issuing bank does. However, if the credit is an unconfirmed one then the bank is called an advising bank, and such a bank is merely required to notify the seller that a documentary credit has been opened in his favour.<sup>32</sup>

According to their negotiability, documentary credits are divided into transferable and non-transferable credits.<sup>33</sup> A transferable credit is rarely used or issued by banks as it would put them in a complicated position. Pertaining to the time of payment, deferred

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<sup>28</sup> More about this point is provided in Chapter 6.

<sup>29</sup> For a good discussion in the types of letters of credit see: Enonchong, N. “*The Independence Principle of Letters of Credit and Demand Guarantees*” (Oxford University Press, Oxford, 2011) at pp. 17 to 22

<sup>30</sup> Harfield, H. ‘Who Does What to Whom: The Letter-of-Credit-Mechanism’ [1985] 17 *UCCLJ* 291, at p. 291

<sup>31</sup> Traders are not using revocable documentary credits anymore. UCP 600 shows that documentary credits are confined to irrevocable forms. Article 2 describes this as: “Any arrangement, however named, that is irrevocable and thereby constitutes a definite undertaking of the issuing bank to honour a complying presentation”.

<sup>32</sup> Unconfirmed documentary credits, like revocable ones, are rarely used.

<sup>33</sup> It is noteworthy that documentary credits even if transferable can be transferred only once.



and on-acceptance credits are further types of documentary credits. Documentary credits can also be divided into straight and negotiated credits. A documentary credit is straight if available merely to the beneficiary. On the other hand, it is negotiated if it is available to people other than the beneficiary (e.g., negotiating banks).

Given the scope of this work, it is not intended to examine the different relations and types of documentary credits in a detailed manner. This work's main focus is the fraud exception in letters of credit, and accordingly the next chapters will examine the notion of fraud irrespective of the special type or relationship within which it exists. Whilst different types and relations are focused on in different parts throughout this work, it is the case that, unless otherwise indicated, irrevocable confirmed credits either issued merely by issuing banks or confirmed by correspondent banks, will constitute the main focus of this dissertation. This fact emanates from traders' predominant tendency to use those types of documentary credits which provide sellers with a prompt, certain and secure way of payment. After providing a background on documentary credits, the next section provides a similar background on independent guarantees, which is the other instrument with which this work is concerned.

## **2.3. The legal basic principles and characteristics of Independent guarantees**

### **2.3.1. Terminology**

In *Edward Owen Engineering Ltd. v Barclays Bank International Ltd.*, Lord Denning MR., deciding an independent guarantee case, noted that "This case concerns a new business transaction called a 'performance guarantee' or 'performance bond'".<sup>34</sup> It is suggested that to illustrate the nature of what the author has chosen to describe as an

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<sup>34</sup> [1978] 1 ALL ER 976 at 977

independent guarantee, it will be important firstly to clear up some terminological confusion which arises from the lack of consistency in the use of labels which denote such an instrument.<sup>35</sup> This subsection seeks to clear up one of two elements which are the reasons behind such confusion in this area. The other element is to be identified in subsection 2.3.4.

It has been suggested that: “Both terminologically and conceptually the entire area of guarantees is, or at least was, marked by confusion, uncertainty and inconsistency”.<sup>36</sup>

While an independent guarantee is ‘a new creature’,<sup>37</sup> too many terms have been fashioned and used interchangeably in order to denote it. These terms include: ‘performance bond’; ‘performance guarantee’; ‘demand guarantee’; ‘first-demand guarantee’; ‘on-demand guarantee’; ‘demand bond’; ‘first-demand bond’; ‘on-demand bond’; ‘bank guarantee’; ‘unconditional bond’ and ‘documentary guarantee’. However, while different from a business perspective, from a legal perspective there is no difference between these various terms as they are used interchangeably to denote the same functional instrument.<sup>38</sup>

Furthermore, in the USA an independent guarantee is most commonly called a standby letter of credit.<sup>39</sup> In fact, standby letters of credit were developed in the 1950s in the USA and have become widely used since that time.<sup>40</sup> The reason behind the development of standby credits was “to circumvent legal restrictions on the

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<sup>35</sup> Goode, R & McKendrick E. “*Goode on Commercial Law*” (Penguin Books, 4<sup>th</sup> ed., London, 2010) at p. 1124

<sup>36</sup> Bertrams, R. “*Bank Guarantees in International Trade: The Law and Practice of Independent (First Demand) Guarantees and Standby Letters of Credit in Civil Law and Common Law Jurisdictions*” (Kluwer Law International, 3<sup>rd</sup> ed., The Hague (Netherlands), 2004) at p. 4

<sup>37</sup> [1978] 1 ALL ER 976, at 981 *per* Lord Denning and at 986 *per* Lord Geoffrey Lane.

<sup>38</sup> Guest, A. “*Benjamin’s Sale of Goods*” (Sweet & Maxwell, 7<sup>th</sup> ed., London, 2006) at p. 2068

<sup>39</sup> Wunnicke, B. Wunnicke D. & Turner P. “*Standby and Commercial Letters of Credit*” (Wiley Law Publications, 2<sup>nd</sup> ed., New York, 1996) at p. 16. With regard to the concept ‘standby letter of credit’ they stated: “In a standby letter of credit, the issuer is merely ‘standing by’ just in case the obligation in the underlying transaction is not performed by the obligor”

<sup>40</sup> Buckley, R. ‘Potential Pitfalls with letters of credit’ (1996) 70 *ALJ* 217 at p. 227

enforceability of guarantees in US law”.<sup>41</sup> Indeed, while they might differ if looked at from a business perspective, standby letters of credit share the same legal characteristics as independent guarantees.<sup>42</sup> It has been suggested that a standby letter of credit is a special type of independent guarantee<sup>43</sup> and that distinguishing between both is “illusory or, perhaps of a semantic nature”.<sup>44</sup> As has been advocated by Goode, it is important to appreciate that the differences between a standby credit and an independent guarantee:

“lie in business practice, not in law, in much the same way as the labels, ‘lease’, ‘rental’, ‘contract hire’ are used by leasing companies to distinguish transactions which in a business sense are different from each other though legally they are the same.”<sup>45</sup>

It is submitted that “Standby credits have been judicially recognised as functionally equivalent to [independent guarantees].”<sup>46</sup> For instance, in *Kvaerner John Brown Ltd v Midland Bank Plc & Anor*,<sup>47</sup> an obligation to provide an independent guarantee was satisfied by the procurement of a standby letter of credit.<sup>48</sup> As has been noted, taking

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<sup>41</sup> Bradgate, R. White, F. & Fennell, S. “*Commercial Law*” (Oxford University Press, 9<sup>th</sup> ed., Oxford, 2002) at p. 271; Ellinger, E. ‘Standby Letters of Credit’ (1978) 6 *Int’l Bus Lawyer* 604, at p. 611

<sup>42</sup> Goode, R & McKendrick E. “*Goode on Commercial Law*” (Penguin Books, 4<sup>th</sup> ed., London, 2010) at p. 1130.; Carr, I. “*International Trade Law*” (Cavendish Publishing, 3<sup>rd</sup> ed., 2005) at p. 507; Mugasha, A. “*The Law of Letters of Credit and Bank Guarantees*” (Federation Press, Sydney, 2003) at p. 43

<sup>43</sup> Hedley, W. & Hedley, R. “*Bills of Exchange and Bankers’ Documentary Credits*” (LLP Professional Publishing, 4<sup>th</sup> ed., London, 2001) at p. 293

<sup>44</sup> Ellinger, P. ‘Standby Letters of Credit’ 6 *Int’l Bus Law* 604 at p. 622; Ellinger P. & Neo, D. “*The Law and Practice of Documentary Letters of Credit*” (Hart Publishing, Oxford, 2010) at p. 5

<sup>45</sup> Goode, R. “*Commercial Law*” (Penguin Books, 3<sup>rd</sup> ed., London, 2004) at pp. 1017-1018. The same has been expressed by Bertrams who stated that: “...the American standby letter of credit and the European independent guarantee represent conceptually and legally the same device. All one could say is that there are some minor differences which relate to practice and terminology”. See: Bertrams, R. “*Bank Guarantees in International Trade: The Law and Practice of Independent (First Demand) Guarantees and Standby Letters of Credit in Civil Law and Common Law Jurisdictions*” (Kluwer Law International, 3<sup>rd</sup> ed., The Hague (Netherlands), 2004) at p. 7

<sup>46</sup> Buckley, R. ‘Potential Pitfalls with Letters of Credit’ (1996) *A.L.J.* Vol. 70, 217 at p. 229

<sup>47</sup> [1998] CLC 446; see as well *Howe Richardson Scale Co Ltd v. Polimex-Cekop* [1978] 1 Lloyd’s Rep 161, 165

<sup>48</sup> [1998] C.L.C. 446 *per* Creswell J.

the purpose of this work into consideration, standby letters of credit and different variations of independent guarantees mentioned above do serve the same purpose.<sup>49</sup>

In this dissertation, to denote all of these variations and terms, the term ‘independent guarantees’ has been chosen. Into this term, independent guarantees, fall different nomenclatures such as: standby credits, unconditional performance bonds and demand guarantees.<sup>50</sup> In order to clear the confusion and uncertainty in this regard, this dissertation uses a generic and neutral label to denote such instruments. Using the term independent guarantee to denote such an instrument reflects one of its most important characteristics which is being independent from other relationships created in order to bring this instrument into existence.

### 2.3.2. Mechanism

The aim of this subsection is to illustrate the mechanism of independent guarantees in the same way that has been pursued above in the context of documentary credits. For instance, B is a buyer located in the UK who is eager to buy a consignment of laptops from S, a seller in Jordan. B does not know S very well and is not certain about S’s creditworthiness; therefore, B is reluctant to deal with S without an assurance that S will duly perform the assigned obligations that will ensue from the laptops’ contract. Occasionally, reliant on his superior bargaining powers, B would ask S to afford some credit in order to secure the transaction and to guarantee that the latter will perform

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<sup>49</sup> Guest, A. “*Benjamin’s Sale of Goods*” (Sweet & Maxwell, 7<sup>th</sup> ed., London, 2006) at p. 2054; Sarna, L. “*Letters of Credit: The Law and Current Practice*” (Carswell Legal Publishers, 2<sup>nd</sup> ed., Toronto, 1986) at p. 127

<sup>50</sup> Goode, R & McKendrick E. “*Goode on Commercial Law*” (Penguin Books, 4<sup>th</sup> ed., London, 2010) at p. 881

his contractual obligations to the fullest. Involving a third creditworthy person is one of the most successful solutions which might come to the minds of these parties.<sup>51</sup>

In view of that, S will instruct his bank I, the issuing bank, to open an independent guarantee in favour of B. I, in its turn, will notify B that an independent guarantee was opened in his favour by S and that I is pleased to pay the independent guarantee to B on behalf of S once B presents signs that S has defaulted in performing the obligations assigned to him by the laptops' contract. Contrary to the situation with documentary credits, where payment depends on commercial documents, the signs in an independent guarantee usually take the form of a plain demand.<sup>52</sup>

Accordingly, with the existence of such an independent guarantee, B will be assured, to a great extent, that S will perform the obligations assigned to him. If S does not perform his obligations in the required manner, B will find it useful to demand the independent guarantee. In such a case, B will not need to commence litigation against S for the loss that he might suffer. Through utilising an independent guarantee, all that B has to do, in the case that he has suffered loss from S's tardy performance, is to demand the guarantee amount. In such a situation, it is the seller, who did not fulfil his obligations, who would initiate litigation and bear its expenses.

I, the bank which provided the independent guarantee and made the transaction easier and securer for B and S, will get an appropriate commission in return for its services.<sup>53</sup> B gets a bank's guarantee to compensate him for any loss that could be

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<sup>51</sup> Davis, A. *"The Law Relating to Commercial Letters of credit"* (The Pitman Press, 3<sup>rd</sup> ed., London, 1963) at p. 10

<sup>52</sup> Bertrams, R. *"Bank Guarantees in International Trade: The Law and Practice of Independent (First Demand) Guarantees and Standby Letters of Credit in Civil Law and Common Law Jurisdictions"* (Kluwer Law International, 3<sup>rd</sup> ed., The Hague (Netherlands), 2004) at p.3

<sup>53</sup> Ellinger P. & Neo, D. *"The Law and Practice of Documentary Letters of Credit"* (Hart Publishing, Oxford, 2010) at p. 2; Sarna, L. *"Letters of Credit: The Law and Current Practice"* (Carswell Legal Publishers, 2<sup>nd</sup> ed., Toronto, 1986) at p. 5

caused by S. On the other hand, S would benefit from the bank's facility in order to obtain the buyer's contract where the latter would not risk dealing with the former unless assured that such an independent guarantee is provided. Moreover, S would become motivated to fulfil his obligations in order not to pay the independent guarantee amount. Like documentary credits, utilizing such an instrument brings benefit to all the parties involved.

### **2.3.3. Various relationships and types**

Three relationships exist in a simple independent guarantee: firstly, the contract between the seller, S (referred to as the applicant or the principal), and the buyer, B (the beneficiary); secondly, the contract between S and his bank I (the issuing bank); thirdly, the independent guarantee between the issuing bank, I, and the buyer, B.<sup>54</sup> Commonly, a distant buyer prefers to get the independent guarantee from a bank situated in his country rather than a bank located in the seller's country. Thus, the former will require the seller to provide him with an independent guarantee available through the desks of his local bank.<sup>55</sup> The involvement of a second bank in the buyer's country gives rise to the need for a new contract between the issuing bank and the corresponding bank. In an independent guarantee context, the correspondent bank is called the issuing bank and the bank in the seller's country, which instructs the correspondent bank to open the independent guarantee, is called the instructing bank. Such different terms should be kept in mind as they will be used hereinafter frequently to denote the different banks and different parties involved.

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<sup>54</sup> Indeed, such a relationship does not acquire the elements which would allow its recognition as a contract. Different theories have been advocated to illustrate the nature of this relationship. Yet none has been fully accepted. For more discussion of this point see section 2.4.1

<sup>55</sup> Many factors make up the essence of such an inclination. Firstly, by getting the money from a bank in his country, the buyer saves the costs of travelling and seeking the money from a foreign country which he is not familiar with. Secondly, if anything goes wrong, the presence of such a bank in his country, gives the buyer a right to sue the bank in his country instead of chasing a bank or a seller in a foreign country.

It has been said that “[independent guarantees] may readily be adapted to provide financial support for any transaction”.<sup>56</sup> Unlike documentary credits, which are usually used to facilitate international sales contracts, independent guarantees are used to facilitate various contracts. For example, an independent guarantee has been used to guarantee a marriage promise in Canada.<sup>57</sup> Such an instrument could be found used in the construction industry to protect employers from the contractors’ tardy performance of different construction contracts. Also, it could be found in international sales contracts to protect buyers and sellers against the defaults which they both may perpetrate.<sup>58</sup> In the three examples provided above the independent guarantee is usually referred to as a performance guarantee. Such a term denotes the kind of act which the independent guarantee protects which is, namely, the performance of the underlying contracts.

Another type, for example, is the tender guarantee which is used to guarantee the seriousness of a bidder to obtain a particular tender contract. Such a guarantee is meant to protect the beneficiaries’ interests in case the party who tendered it withdraws prior to entering into a binding contract. Overall, each different type of business may necessitate the issuance of a specific type of independent guarantee.<sup>59</sup>

As Bertrams has observed: “One might safely assume that major transactions today do not take place without some kind of guarantee support.”<sup>60</sup>

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<sup>56</sup> Harfield, H. “*Letters of Credit*” (ALI-ABA Comm, New York, 1979) at p. 2

<sup>57</sup> See: *Rosen v Pullen* (1981) 126 DLR 3rd 62

<sup>58</sup> *Bolivinter Oil SA v Chase Manhattan Bank NA* [1984] 1 W.L.R. 392; [1984] 1 Lloyd’s Rep. 251; *Deutsche Ruckversicherung AG v Walbrook Insurance Co. Ltd and Others* [1996] 1 W.L.R. 1552; [1995] C.L.C. 1532 (CA); *Edward Owen Engineering Ltd. v Barclays Bank International Ltd.* [1978] Q.B. 159; [1977] 3 W.L.R. 764 (CA)

<sup>59</sup> Gao, X. “*The Fraud Rule in the Law of Letters of Credit: A Comparative Study*” (Kluwer Law International, The Hague, 2002) at p. 6

<sup>60</sup> Bertrams, R. “*Bank Guarantees in International Trade: The Law and Practice of Independent (First Demand) Guarantees and Standby Letters of Credit in Civil Law and Common Law Jurisdictions*” (Kluwer Law International, 3<sup>rd</sup> ed., The Hague (Netherlands), 2004) at p. 1

### 2.3.4. Comparison with ordinary guarantees

In order to get a better understanding and appreciation of the remarkable role which independent guarantees serve, it would be useful to compare them with what has been known as ordinary guarantees. In comparing independent guarantees with ordinary guarantees, the other element instigating confusion and lack of consistency in this area of law will be identified.<sup>61</sup> In fact, using the word ‘guarantee’ in both documentary guarantee and ordinary guarantee terms is a reason for confusion and lack of consistency. While both instruments share similar goals, both instruments embrace different rights and obligations for the parties utilising them.<sup>62</sup> Accordingly, different outcomes could ensue from utilising each of these instruments of which the different parties should be aware before such utilization.<sup>63</sup>

In England, the term guarantee has been conventionally used to indicate an ordinary, secondary, or conditional sort of commitment.<sup>64</sup> The core of this relevantly deep-rooted instrument is a promise to fix the default of others once they have defaulted.<sup>65</sup> What the promisee gets is a third party’s promise to answer the default of the person with whom the promisee deals once he/she defaults. Contrary to independent guarantees, the promisor guarantor would not pay as the result of a mere demand, but only in situations where an actual default could be proven by the promisee. Besides, the promisor in such event could raise any defence or counter-claim available to the

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<sup>61</sup> Goode, R & McKendrick E. “*Goode on Commercial Law*” (Penguin Books, 4<sup>th</sup> ed., London, 2010) at p. 1124. The first element causing confusion and lack of consistency to this area of law has been identified in subsection 2.3.1 above.

<sup>62</sup> Ventris, M. “*Bankers’ Documentary Credits*” (Lloyd’s of London Press Limited, 3<sup>rd</sup> ed., London, 1990) at p. 141; *Marubeni Hong Kong & South China Ltd v Mongolia* [2005] 2 Lloyd’s Rep. 231 at 236 (CA)

<sup>63</sup> *Canmer International Inc v UK Mutual Steamship Assurance Association (Bermuda) Ltd (The Rays)* [2005] 2 Lloyd’s Rep. 479 at 487

<sup>64</sup> Radin, X. ‘Guaranty and Suretyship’ (1929) 17 *Cal. L. Rev.* 605 at pp. 606-609. Different names have been developed to denote such a commitment such as: suretyship guarantee, common law guarantee, conditional guarantee, accessory guarantee, mere ‘guarantee’ and ordinary guarantee.

<sup>65</sup> *Trafalgar House Construction (Regions) Ltd v General Surety & Guarantee Co Ltd* [1996] A.C. 199 at 205



party that he is promising in favour in order to negate payment. For instance, if it later becomes apparent to the promisor that the parties' contract was void and null, the promisor could grasp such a defence against the promisee to avoid paying the guarantee amount.<sup>66</sup> The promisor in an ordinary guarantee could raise other defences which are not available for the party which he guarantees in case of the latter's default.<sup>67</sup> Such defences include set off and changes and alterations in the contract which have been made without the knowledge of the promisor and which would increase the latter risks.<sup>68</sup>

In an independent guarantee the payment process is different. While in an ordinary guarantee the payment is conditional on actual default, in an independent guarantee the beneficiary does not need to prove the applicant's default but a mere written demand will qualify him to obtain its amount. Banks are not concerned with the underlying contract terms and so cannot raise defences available to applicants against beneficiaries in order to refuse payment.<sup>69</sup> Therefore, as observed by Mugasha: "[an independent guarantee] is usually cheaper than its counterpart the surety bond".<sup>70</sup> In such a context, as it is not required to investigate whether actual defaults have occurred, banks do charge relatively cheap prices. Banks do not like the idea of investigating facts in order to pay and accordingly it is other entities such as sureties and insurance companies which usually provide ordinary guarantees and usually for a better-paid commission taking into consideration the factual risky type of work

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<sup>66</sup> *Associated Dairies v Pierce* (1982) 43 P. & C.R. 208 at 216

<sup>67</sup> *Trafalgar House Construction (Regions) Ltd v General Surety & Guarantee Co Ltd* [1996] A.C. 199 at 207-208

<sup>68</sup> For further analysis on the defences available to the issuer see: Jones, G. 'Performance Guarantees in Construction Contracts: Surety Bonds Compared to Letter of Credit as Vehicles to Guarantee Performance' (1994) 11 *I.C.L.R.*, at pp. 15-18

<sup>69</sup> For example: *I.E. Contracts Ltd v Lloyds Bank Plc and Rafidain Bank* [1989] 2 Lloyd's Rep 205, *per* Leggatt J. at 207; *Siporex Trade SA v Banque Indosuez* [1986] 2 Lloyd's Rep. 146 at 158

<sup>70</sup> Mugasha, A. 'Enjoining the Beneficiary's Claim on a Letter of Credit or Bank Guarantee' [2004] *J.B.L.* 515 at p. 535

connected with it.<sup>71</sup> As a result of the different approach taken in order to effect payment, the independent guarantees payment process is easier and quicker than that of its counterpart.<sup>72</sup>

An ordinary guarantee has been described as an instrument which “provides little security for the beneficiary”.<sup>73</sup> Ordinary guarantees are applicant oriented as they serve the applicants’ interests more than that of beneficiaries. However, independent guarantees are beneficiary oriented as they serve the beneficiaries’ interests more than that of the applicants.<sup>74</sup> Therefore, independent guarantees and ordinary guarantees, while sharing similar goals, embrace different rights and obligations for the parties utilising them.<sup>75</sup>

In fact, it should be noted that there is much terminological confusion and lack of certainty in deciding whether a certain guarantee is an independent or an ordinary guarantee.<sup>76</sup> Such a fact is well-embodied in different recent cases as well as in older cases.<sup>77</sup> No precise approach has yet been adopted by English courts in determining how to distinguish between them.<sup>78</sup> Indeed, labels do not constitute the conclusive evidence in deciding whether an instrument is an ordinary or independent guarantee.<sup>79</sup>

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<sup>71</sup> *Ibid.*

<sup>72</sup> *Cargill International SA v Bangladesh Sugar & Food Industries Corp* [1996] 2 Lloyd's Rep. 524 at 528

<sup>73</sup> Bradgate, R. White, F. & Fennell, S. “*Commercial Law*” (Oxford University Press, 9<sup>th</sup> ed., Oxford, 2002) at p. 275

<sup>74</sup> McLaughlin, G. ‘Symposium: The Restatement of Suretyship: Standby Letters of Credit and Guaranties: An Exercise in Cartography’ (1993) 34 *Wm and Mary L. Rev.* 1139 at pp. 1140-1141

<sup>75</sup> *Marubeni Hong Kong & South China Ltd v Mongolia* [2005] 2 Lloyd's Rep. 231 at 236 (CA)

<sup>76</sup> Howard QC, M. Masefield, R. & Chuah, J. “*Butterworths Banking Law Guide*” (Butterworths, London, 2006) at p. 554

<sup>77</sup> *Howe Richardson Scale Co Ltd v. Polimex-Cekop* [1978] 1 Lloyd's Rep 161, at 165; *Marubeni Hong Kong & South China Ltd v Mongolia* [2005] 2 Lloyd's Rep. 231 at 236 (CA); *Edward Owen Engineering Ltd v Barclays Bank International Ltd* [1978] QB 159; *Trafalgar House Construction (Regions) Ltd v General Surety and Guarantee Co Ltd* [1995] 3 ALL ER 737

<sup>78</sup> *Ibid.*

<sup>79</sup> Ellinger P. & Neo, D. “*The Law and Practice of Documentary Letters of Credit*” (Hart Publishing, Oxford, 2010) at p. 306; Goode, R & McKendrick E. “*Goode on Commercial Law*” (Penguin Books, 4<sup>th</sup> ed., London, 2010) at pp. 881-882; *Marubeni Hong Kong and South China Ltd v Mongolia* [2005] EWCA Civ 395

As suggested by Enonchong: “It is generally accepted that the correct characterization depends on the construction of the instrument”.<sup>80</sup>

Ordinary guarantees are legally different from independent guarantees and therefore will not be discussed further. This study is concerned with independent guarantees which through their distinctive legal characteristics the fraud exception has found its way to develop.<sup>81</sup> In the next chapters, the term guarantee denotes an independent guarantee as opposed to an ordinary guarantee.

#### **2.4. Issues pertaining to both documentary credits and independent guarantees: a background**

Documentary credits and independent guarantees, while different in terms and goals, do share the same legal principles and characteristics.<sup>82</sup> Both share an irrevocable binding nature which is acquired once they are issued by the concerned bank. Besides, they both share two important inherited principles which are, namely: autonomy and strict compliance principles. Also, given the great attention that they receive in the area of international trade and the lack of national law codification to this area, a number of different international initiatives have emerged to guarantee their smooth running.

The aim of this section is to provide a background for the common legal basic principles and characteristics which both instruments share. By providing such a background the main aim of this chapter, which is providing a general background to these instruments in order to help understand the following discussion in subsequent

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<sup>80</sup> Enonchong, N. *“The Independence Principle of Letters of Credit and Demand Guarantees”* (Oxford University Press, Oxford, 2011) at p. 53

<sup>81</sup> Gao, X. *“The Fraud Rule in the Law of Letters of Credit: A Comparative Study”* (Kluwer Law International, The Hague, 2002) at p. 9

<sup>82</sup> *Ibid* at pp. 8-9

chapters, will be accomplished. Taking this into account, subsection 2.4.1 is intended to discuss the binding nature characteristic. The following subsection provides a discussion in regard to two important inherited principles, the autonomy and strict compliance. Finally, subsection 2.4.3 will offer enlightenment in relation to the different initiatives that have been constructed in this area.

#### 2.4.1. The binding nature

A bank that has once issued a documentary credit or an independent guarantee cannot revoke such a commitment. While the matter seems to be simple, legal scholars have had a prolonged debate with regard to this.<sup>83</sup> They have noted that such a binding nature cannot be justified from a contractual perspective. In Goode's words:

“...the problem is to reconcile the binding nature of the bank's undertaking with traditional concepts of general law, which deny legal effect to a simple promise unless consideration is furnished...”<sup>84</sup>

In fact, English law has some theoretical problems with justifying such a binding nature. In English law, what is called the doctrine of consideration necessitates that a contract cannot be recognised as binding unless each party gives something to the other.<sup>85</sup> In other words, in order to find a contractual relationship between the bank and the beneficiary, some finding of a valid consideration moving from the latter to the bank is required. According to Sarna: “This consideration, to be valid, must not be past consideration, that is, arising from a previous bargain”.<sup>86</sup> For example, the

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<sup>83</sup> For example: Goode, R & McKendrick E. “*Goode on Commercial Law*” (Penguin Books, 4<sup>th</sup> ed., London, 2010); Rowe, M. “*Letters of Credit*” (Euromoney Books, 2<sup>nd</sup> ed., London, 1997); Sarna, L. “*Letters of Credit: The Law and Current Practice*” (Carswell Legal Publishers, 2<sup>nd</sup> ed., Toronto, 1986); Ellinger, E. “*Documentary Letters of Credit: A Comparative Study*” (University of Singapore Press, Singapore, 1970); Thayer, P. ‘Irrevocable Credits in International Commerce: Their Legal Nature’ (1936) 36 *Colum. L. Rev.* 1031; Finkelstein, H. “*Legal Aspects of Commercial Letters of Credit*” (Columbia University Press, New York, 1930)

<sup>84</sup> Goode, R & McKendrick E. “*Goode on Commercial Law*” (Penguin Books, 4<sup>th</sup> ed., London, 2010) at p. 1078

<sup>85</sup> Rowe, M. “*Letters of Credit*” (Euromoney Books, 2<sup>nd</sup> ed., London, 1997) at pp. 58-59

<sup>86</sup> Sarna, L. “*Letters of Credit: The Law and Current Practice*” (Carswell Legal Publishers, 2<sup>nd</sup> ed., Toronto, 1986) at p. 29

promise to deliver the goods, which has been made in the sale contract prior to the issuance of a documentary credit, does not provide a valid consideration as it is a past one. Moreover, a consideration used to affect a particular contract cannot be used “a second time to constitute the basis of the bank-beneficiary transaction”.<sup>87</sup>

This specific point has been raised by the English courts in three different cases. In *Urquhart Lindsay & Co., Ltd. v. Eastern Bank Ltd.*,<sup>88</sup> Rowlatt J. was of the opinion that a documentary credit or an independent guarantee is an offer made by banks to sellers and that it becomes binding when the seller acts upon it. In his opinion, the binding nature of the credit commences merely when the seller acts on it. Similarly, such an opinion has been pursued in *Elder Dempster Lines Ltd. v. Ionic Shipping Agency Inc*<sup>89</sup> by Donaldson J. who found that the best explanation of the legal phenomenon constituted by these instruments is that it is an offer which is accepted by being acted upon.<sup>90</sup> However, it is submitted that such an opinion does not provide an answer to the following question: why before the seller acts upon these instruments the bank cannot revoke such an offer which has not yet been accepted by the beneficiary?

A different view was expressed in *Dexters, Ltd. v. Schenker & Co.*<sup>91</sup> where Greer J. suggested that such instruments become binding when they reach the seller’s hands. It is unclear whether his Lordship intended to lay down a general rule regarding this point or only to explain the point at which such a credit becomes binding. Interestingly, a defence of lack of consideration has been pleaded in this case but it

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<sup>87</sup> *Ibid* at p. 30

<sup>88</sup> [1922] 1 K.B. 318. See also Devlin J. in *Midland Bank, Ltd. v. Seymour* [1955] 2 Lloyd’s Rep. 147 at 166

<sup>89</sup> [1968] 1 Lloyd’s Rep. 529 at 535

<sup>90</sup> Ellinger, E. “*Documentary Letters of Credit: A Comparative Study*” (University of Singapore Press, Singapore, 1970) at p. xvii

<sup>91</sup> (1923) 14 L.L.R. 586 at 588

has been found that it does not affect the binding nature of such instruments. As seen above, the English courts have not given a final decision on this point yet. The *dicta* provided did not affect either the binding nature or the operation of such instruments and “if the point were taken the courts would uphold the binding nature of the bank’s undertaking”.<sup>92</sup>

Since the beginnings of the last century, a string of “peculiarly unsatisfactory”<sup>93</sup> theories have been advanced by different scholars to explain the binding effect of these instruments.<sup>94</sup> Rowe,<sup>95</sup> Malek,<sup>96</sup> Roy,<sup>97</sup> Goode,<sup>98</sup> Finkelstein,<sup>99</sup> Ellinger,<sup>100</sup> and many others<sup>101</sup> refused such theories.<sup>102</sup> In Rowe’s words:

“None of these [theories] quite fits the commercial realities. The courts recognise the binding effect of bankers’ irrevocable credits nonetheless,

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<sup>92</sup> Bradgate, R. White, F. & Fennell, S. “*Commercial Law*” (Oxford University Press, 9<sup>th</sup> ed., Oxford, 2002) at p. 273

<sup>93</sup> Mugasha, A. “*The Law of Letters of Credit and Bank Guarantees*” (Federation Press, Sydney, 2003) at p. 31

<sup>94</sup> Ellinger, E. “*Documentary Letters of Credit: A Comparative Study*” (University of Singapore Press, Singapore, 1970); Thayer, P. ‘Irrevocable Credits in International Commerce: Their Legal Nature’ (1936) 36 *Colum. L. Rev.* 1031; Finkelstein, H. “*Legal Aspects of Commercial Letters of Credit*” (Columbia University Press, New York, 1930)

<sup>95</sup> Rowe, M. “*Letters of Credit*” (Euromoney Books, 2<sup>nd</sup> ed., London, 1997) at pp. 58-59

<sup>96</sup> Malek, A & Quest, D. “*Jack: Documentary Credits*” (Tottel Publishing, 4<sup>th</sup> ed., Sussex, 2009) at p. 7

<sup>97</sup> Rooy, F. “*Documentary Credits*” (Kluwer Law and Taxation Publishers, Deventer, 1984) at p. 99

<sup>98</sup> With regard to this he argued: “All of these fall to the ground because, in an endeavour to produce an acceptable theoretical solution, they distort the character of the transaction and predict facts and intentions at variance with what is in practice done and intended by the parties. The defects in these various theories show the undesirability of trying to force all commercial instruments and devices into a strait-jacket of traditional rules of law”. Goode, R & McKendrick E. “*Goode on Commercial Law*” (Penguin Books, 4<sup>th</sup> ed., London, 2010) at 1078; Goode, R. ‘Abstract Payment Undertakings’ in Cane P. & Stapleton, J. (eds.), “*Essays for Patrick Atiyah*”, (Clarendon Press, Oxford, 1991) 209 at p. 219

<sup>99</sup> Finkelstein, H. “*Legal Aspects of Commercial Letters of Credit*” (Columbia University Press, New York, 1930) at p. 111

<sup>100</sup> Ellinger P. & Neo, D. “*The Law and Practice of Documentary Letters of Credit*” (Hart Publishing, Oxford, 2010) at p. 111

<sup>101</sup> Hughes, M. ‘Standby Letters of Credit and Demand Guarantees’ [2005] *B.J.I.B. & F.L.* Vol. 20(5), 174 at 175; Qiman, L. ‘The Practice of Judicial Preservation for Documentary Credits’ (eds.) in Byrne, J. “*2003 Annual Survey of Letter of Credit Law & Practice*” (The Institute of International Banking Law & Practice Inc., USA, 2003) at p. 105; Leacock, S. ‘Fraud in the International Transaction: Enjoining Payment of Letters of Credit in International Transactions’ [1984] *Vand. J. Transnat’l L.* 885 at p. 891

<sup>102</sup> Indeed, it is not intended to examine the several theories which have been advanced to explain such a binding nature in this work.

which is what the parties want. English law may not be too certain what letters of credit are, but English judges enforce them.”<sup>103</sup>

It has been frequently reiterated by these learned authors that independent guarantees and documentary credits are of “a special nature”<sup>104</sup> and that they are “*sui generis*” instruments.<sup>105</sup> It has been also suggested that it is impossible to apply “general contractual concepts such as consideration and offer and acceptance” to these instruments.<sup>106</sup> This position has been accepted by courts for the past 200 years<sup>107</sup> and it suffices to say that it is now accepted all over the world.<sup>108</sup> It is suggested that the reason for the binding nature of these instruments is the way it has been intended that they operate through merchants.<sup>109</sup> The lack of a cogent theory to justify the

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<sup>103</sup> Rowe, M. “*Letters of Credit*” (Euromoney Books, 2<sup>nd</sup> ed., London, 1997) at pp. 58-59. An interesting view relating to this point could be borrowed from the Canadian courts where it has been provided by the Supreme Court of Canada that: “There is no doubt that there are important differences between the civil law and the common law concerning the rationale, in contract theory, for the legally enforceable nature of the issuing bank’s obligation to the beneficiary under an irrevocable letter of credit. The general opinion appears to be that the obligation is of a *sui generis* contractual nature for which no completely satisfactory rationale has been found in the established categories of contract theory, but the judicial recognition of its legal enforceability is now beyond dispute”. See: *Bank of Nova Scotia v Angelica-Whitewear Ltd* [1987] 1 SCR 59 at 82.3

<sup>104</sup> Malek, A & Quest, D. “*Jack: Documentary Credits*” (Tottel Publishing, 4<sup>th</sup> ed., Sussex, 2009) at p. 7

<sup>105</sup> Goode, R & McKendrick E. “*Goode on Commercial Law*” (Penguin Books, 4<sup>th</sup> ed., London, 2010) at p. 1078; Howard QC, M. Masefield, R. & Chuah, J. “*Butterworths Banking Law Guide*” (Butterworths, London, 2006) at p. 508; Mugasha, A. “*The Law of Letters of Credit and Bank Guarantees*” (Federation Press, Sydney, 2003) at p. 31; Leacock, S. ‘Fraud in the International Transaction: Enjoining Payment of Letters of Credit in International Transactions’ [1984] *Vand. J. Transnat’l L.* 885 at p. 891; Rooy, F. “*Documentary Credits*” (Kluwer Law and Taxation Publishers, Deventer, 1984) at p. 99; Ellinger, E. “*Documentary Letters of Credit: A Comparative Study*” (University of Singapore Press, Singapore, 1970) at p.122; Kozolchik B, ‘letters of credit’ in IX *International Encyclopaedia of Comparative Law* (eds.) Zweigert, K. & Drobniig U. (1978) at pp. 138-143

<sup>106</sup> Malek, A & Quest, D. “*Jack: Documentary Credits*” (Tottel Publishing, 4<sup>th</sup> ed., Sussex, 2009) at p. 7

<sup>107</sup> Hughes, M. ‘Standby Letters of Credit and Demand Guarantees’ [2005] *B.J.I.B. & F.L.* Vol. 20(5), 174 at p. 175. As Finkelstein had put it nearly one hundred years earlier: “The basis of this action was the custom of the merchants. To look at it, therefore, from the point of view of the requirements of the strict contract action-consideration, offer and acceptance- would be to adopt a false perspective”. See: Finkelstein, H. “*Legal Aspects of Commercial Letters of Credit*” (Columbia University Press, New York, 1930) at p. 111; in the same manner Ellinger provides: “Indeed, the letter of credit is such a well-established form of trade financing that any attempt to raise an argument otherwise based on the lack of consideration seems to be doomed to failure”, see Ellinger P. & Neo, D. “*The Law and Practice of Documentary Letters of Credit*” (Hart Publishing, Oxford, 2010) at p. 111

<sup>108</sup> Goode, R. ‘Abstract Payment Undertakings’ in Cane P. & Stapleton, J. (eds.), “*Essays for Patrick Atiyah*”, (Clarendon Press, Oxford, 1991) 209 at p.219; Ellinger, E. “*Documentary Letters of Credit: A Comparative Study*” (University of Singapore Press, Singapore, 1970) at p. 179

<sup>109</sup> Harfield, H. “*Letters of Credit*” (ALI-ABA Comm, New York, 1979) at p. 1; Mugasha, A. “*The Law of Letters of Credit and Bank Guarantees*” (Federation Press, Sydney, 2003) at p. 31

instruments' legal operation did not weaken their practical value as can be seen by their increasing use.<sup>110</sup>

It is submitted that such a debatable point is an academic one. Authors in England, USA, France and other countries have agreed that wading into the midst of this debate, in order to justify the mechanism of such instruments, is of a little practical help.<sup>111</sup> Irrespective of the existent lack of consideration, it is difficult to imagine that a bank would attempt to escape paying these instruments as the bank's commercial reputation would be acutely damaged.<sup>112</sup> In Harfield's words:

“the banker's letter of credit is a legally enforceable instrument, rooted in the law merchant and contractual in its nature. There is neither need nor utility to employ Procrustean techniques to establish its validity”.<sup>113</sup>

## 2.4.2. Two distinct principles

### 2.4.2.1. *The autonomy principle*

Also well-known as the abstraction or the separation principle, this subsection is concerned with the autonomy principle which plays an important role in this context. According to Sarna, “The notion of autonomy has long been accepted as the very basis of the letter of credit system, permitting both assurance and immediacy of payment”.<sup>114</sup> The principle of autonomy is based on the fact that documentary credits and independent guarantees do create several legal relationships with other parties who are not involved in the underlying contract which brings up these instruments.<sup>115</sup>

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<sup>110</sup> Mugasha, A. “*The Law of Letters of Credit and Bank Guarantees*” (Federation Press, Sydney, 2003) at p. 32

<sup>111</sup> Sarna, L. “*Letters of Credit: The Law and Current Practice*” (Carswell Legal Publishers, 2<sup>nd</sup> ed., Toronto, 1986) at p. 54

<sup>112</sup> Hooley, R. & Sealy L. “*Commercial Law: Text, Cases, and Materials*” (Oxford University Press, 4<sup>th</sup> ed., 2009) at p. 851

<sup>113</sup> Harfield, H. “*Bank Credits and Acceptances*” (The Ronald Press Company, 5<sup>th</sup> ed., New York, 1974) at p. 55

<sup>114</sup> Sarna, L. “*Letters of Credit: The Law and Current Practice*” (Carswell Legal Publishers, 2<sup>nd</sup> ed., Toronto, 1986) at p. 125

<sup>115</sup> Rooy, F. “*Documentary Credits*” (Kluwer Law and Taxation Publishers, Deventer, 1984) at p. 100



As been explained above,<sup>116</sup> a minimum of three legal relationships are involved in order to bring a documentary credit or an independent guarantee to existence. The principle of autonomy dictates that each of these legal relationships should be kept separated from other relationships. This is to say, the contract of the buyer with the seller should be kept separated from the bank's legal relationship with both the seller and the buyer. Similarly, the buyer's legal relationship with the bank should be kept separated from the bank's relationship with the beneficiary and from that of the latter's relationship with the former. In addition, the beneficiary's legal relationship with the bank should be kept separate from the bank's relationship with the buyer and from that of the latter's relationship with the former. If a correspondent bank is involved, each of its relationships, with the issuing (instructing) bank, seller or the buyer, should stand alone and none of the different legal relationships should affect any other relationship.

The main basis of the bank's obligation to pay emanates from the independent guarantee or the documentary credit itself.<sup>117</sup> An independent guarantee is not an ordinary guarantee and thus the bank's payment obligation is primary, not secondary, as it is the first port which the beneficiary will approach to obtain money against the damages it has sustained. On the other hand, a documentary credit is not a sale of goods which the parties complete in person, but a payment instrument which the bank affects as a principal and not as an agent of the buyer.<sup>118</sup> Parties cannot benefit themselves from the different legal relationships which exist in such contexts. Accordingly, a beneficiary could not escape submitting a required document in a documentary credit context relying on a variation in the sale contract terms between

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<sup>116</sup> See subsections 2.2.3. & 2.3.3.

<sup>117</sup> Goode, R. 'Abstract Payment Undertakings' in Cane P. & Stapleton, J. (eds.), "*Essays for Patrick Atiyah*", (Clarendon Press, Oxford, 1991) 209 at p. 229

<sup>118</sup> *Ibid.*

him and the buyer. Likewise, a buyer could not force the bank to stop its payment process relying on some problems that have arisen between him and the beneficiary. Moreover, the bank cannot negate payment relying on disputes that might ignite between beneficiaries and applicants.

While the autonomy principle has been contained in a code in some civil law jurisdictions such as France, it has been recognised as a part of the common law in England.<sup>119</sup> One of the early and oft-quoted statements to this effect is Lord Jenkins' statement, in *Hamzeh Malas & Sons v. British Imex Industries Ltd.*, where he provided:

“We were referred to several authorities, and it seems to be plain that the opening of a confirmed letter of credit constitutes a bargain between the banker and the vendor of the goods, which imposes on the banker an absolute obligation to pay, irrespective of any dispute which there may be between the parties on the question of whether the goods are up to contract or not.”<sup>120</sup>

#### 2.4.2.1.1. Why autonomy?

As noted above,<sup>121</sup> it is difficult to reconcile the interests of different sellers and buyers unless a third party, usually a bank, interposes. Such interposition resolves many of the concerns that sellers and buyers had been experiencing before documentary credits and independent guarantees came into practice.<sup>122</sup> Banks do not have knowledge of the sale contract terms, nor of any subsequent variations or repudiation of such a contract by the trading parties.<sup>123</sup> Whilst banks do have expertise in handling documentary work, a contract of sale dispute could relate to the goods

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<sup>119</sup> Enonchong, N. “*The Independence Principle of Letters of Credit and Demand Guarantees*” (Oxford University Press, Oxford, 2011) at p. 69

<sup>120</sup> [1958] 1 A11 E.R. 262 at 263-64

<sup>121</sup> At 2.2.1

<sup>122</sup> Todd, P. “*Bills of Lading and Bankers' Documentary Credits*” (Informa Law, 4<sup>th</sup> ed., London, 2007) at p. 10

<sup>123</sup> Malek, A & Quest, D. “*Jack: Documentary Credits*” (Tottel Publishing, 4<sup>th</sup> ed., Sussex, 2009) at p. 177

themselves about which the bank will have no knowledge.<sup>124</sup> As noted by Carr: “In practice, it would be extremely rare to find a bank willing to get involved beyond the level of payment against documents”.<sup>125</sup> If banks were required to intervene in such contracts, “it is evident that the modern system of commercial credits would not exist”.<sup>126</sup>

From the bank’s point of view, the autonomy principle does make good commercial sense, since in practice they will find it difficult to verify different contracts which they may finance or guarantee. It is also difficult to verify different disputes as a result of which the parties may come and make claims at the bank’s offices.<sup>127</sup> Irrevocable binding documentary credits and guarantees would become revocable if banks or applicants could raise different defences available to them on the underlying contract in order to avoid payment. As Sarna noted:

“It would be of little consolation to the beneficiary to know that his recourse against a solvent debtor was theoretically good but that payment could only be had after expensive lengthy litigation in a foreign jurisdiction.”<sup>128</sup>

From the beneficiary’s point of view, many risks, e.g. the applicant’s or the bank’s refusal to pay, are weakened by the existence of the autonomy principle.<sup>129</sup> Banks could not rely on their relation with applicants to stop paying beneficiaries. If the applicant changes his mind, the bank cannot change its mind and will remain

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<sup>124</sup> Todd, P. “*Bills of Lading and Bankers’ Documentary Credits*” (Informa Law, 4<sup>th</sup> ed., London, 2007) at p. 17

<sup>125</sup> Carr, I. “*International Trade Law*” (Cavendish Publishing, 3<sup>rd</sup> ed., 2005) at p. 480. Into the same effect, see: Bennett, H. ‘Performance Bonds and the Principle of Autonomy’ [1994] *J.B.L* 574 at p. 579

<sup>126</sup> Sarna, L. “*Letters of Credit: The Law and Current Practice*” (Carswell Legal Publishers, 2<sup>nd</sup> ed., Toronto, 1986) at pp. 128-129

<sup>127</sup> Howard QC, M. Masefield, R. & Chuah, J. “*Butterworths Banking Law Guide*” (Butterworths, London, 2006) at 503

<sup>128</sup> Sarna, L. “*Letters of Credit: The Law and Current Practice*” (Carswell Legal Publishers, 2<sup>nd</sup> ed., Toronto, 1986) at pp. 128-129

<sup>129</sup> Gable, C. ‘Standby Letters of Credit: Nomenclature Has Confounded Analysis’ [1980] *Law & Pol’y Int’l Bus.* 903 at p. 906

responsible towards the beneficiary.<sup>130</sup> However, it should be noted that the addition of such instruments does not alter the original contract's different rights and duties. Parties could have an accounting session or a court lawsuit if needed later in order to settle their disputes.<sup>131</sup>

Utilizing documents assures that bankers will not become involved in different underlying contracts and disputes that might follow.<sup>132</sup> The essence of these instruments is that they are conditioned only by the terms of the documents which they contain. The autonomy principle is the principle which makes documentary credit and guarantees distinguishable from the above mentioned non-autonomous instruments.<sup>133</sup> Nevertheless, it is important to keep in mind that using third parties to finance such transactions is not without its own problems. It should be noted that the presence of the autonomy principle gave way to indirect inducements of fraud on the part of the beneficiaries. Taking into consideration that: "The effect of the rule of autonomy is multi-edged,"<sup>134</sup> the autonomy principle has been deemed as "not absolute" opening the doors for some exceptions to exist in order to narrow the boundaries of such a principle.<sup>135</sup>

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<sup>130</sup> Thayer, P. 'Irrevocable Credits in International Commerce: Their Legal Effects' (1937) 37 *Colum. L. Rev.* 1326 at pp. 1330-1331

<sup>131</sup> Leacock, S. 'Fraud in the International Transaction: Enjoining Payment of Letters of Credit in International Transactions' [1984] *Vand. J. Transnat'l L.* 885 at p. 888

<sup>132</sup> Guest, A. "*Benjamin's Sale of Goods*" (Sweet & Maxwell, 7<sup>th</sup> ed., London, 2006) at p. 2054

<sup>133</sup> See subsections 2.2.1 and 2.3.4

<sup>134</sup> Sarna, L. "*Letters of Credit: The Law and Current Practice*" (Carswell Legal Publishers, 2<sup>nd</sup> ed., Toronto, 1986) at p. 127

<sup>135</sup> Hooley, R. & Sealy L. "*Commercial Law: Text, Cases, and Materials*" (Oxford University Press, 4<sup>th</sup> ed., 2009) at p. 866

#### 2.4.2.1.2. Autonomy principle: for the benefit of whom?

It has been suggested that the very basis of the autonomy principle is to provide the seller with “assurance and immediacy of payment”.<sup>136</sup> In support of this Lord Diplock has provided:

“The whole commercial purpose for which the system of confirmed irrevocable documentary credits has been developed in international trade is *to give to the seller an assured right to be paid* before he parts with control of the goods...”<sup>137</sup>

While it has been frequently reiterated that the purpose of such instruments is to “assure the seller’s payment,”<sup>138</sup> it is suggested that the autonomy principle does serve applicants’, beneficiaries’ and banks’ interests. It is submitted that one of the main objects of documentary credits is to safeguard buyers against situations where they may pay but not obtain the goods. Such a view has been echoed by different commentators.<sup>139</sup> Indeed, a bank wishes “not to get involved in disputes, complexities arising from the underlying contract”,<sup>140</sup> and the autonomy principle has been inserted in order to make such a wish come true. The nature of these instruments and the banks’ lack of abilities to scrutinize each of the transactions which involves such instruments are reasons for the autonomy principle manifestation in this context. Protecting the beneficiaries’ right of payment is another reason for the autonomy principle addition. Neither banks nor applicants could negate the beneficiaries’ right

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<sup>136</sup> Sarna, L. “*Letters of Credit: The Law and Current Practice*” (Carswell Legal Publishers, 2<sup>nd</sup> ed., Toronto, 1986) at p. 125

<sup>137</sup> *United City Merchants v Royal Bank of Canada* [1982] 2 ALL E.R. 720 at 725 [Emphasis added]. See also: *Hamzeh Malas & Sons v. British Imex Industries Ltd.* [1958] 1 All E.R. 262 at 263-64; *Esal (Commodities) Ltd and Reltor Ltd v Oriental Credit Ltd and Wells Fargo Bank NA* [1985] 2 Lloyd’s Rep 546 (CA) at 549 where Ackner LJ observed that if the performance bond is so conditional the result would be “wholly inconsistent with the entire object of the transaction, namely *to enable the beneficiary to obtain prompt and certain payment*” [Emphasis added].

<sup>138</sup> Gable, C. ‘Standby Letters of Credit: Nomenclature Has Confounded Analysis’ [1980] *Law & Pol’y Int’l Bus.* 903 at p. 908

<sup>139</sup> See: Murray, D. ‘Letters of Credit and Forged and Altered Documents: Some Deterrent Suggestions’ (1993) 98 *Com. L.J.* 504, at p. 504; Ellinger, E. ‘Fraud in Documentary Credit Transactions’ [1981] *J.B.L.* 258 at p. 266

<sup>140</sup> Bennett, H. ‘Performance Bonds and the Principle of Autonomy’ [1994] *J.B.L.* 574 at p. 579

to payment relying on a dispute that has arisen from the underlying transaction. Besides, guarding the applicants' expectations regarding the goods is a third reason for the autonomy principle existence. The bank would not pay the beneficiary unless the documentary conditions, instructed by the applicant, are fulfilled. In sum, it is submitted that the autonomy principle aims to serve all the involved parties' expectations and needs in order to facilitate the running of such instruments.

#### **2.4.2.2. The strict compliance principle**

The strict compliance principle works hand in hand with the autonomy principle to preserve the effectiveness of these instruments.<sup>141</sup> As has been suggested: "Strict compliance may be the best legal rule which can be devised to govern how closely tendered documents ought to comply with the terms of the credit".<sup>142</sup> In *English, Scottish and Australian Bank v Bank of South Africa*, Bailhache J. has illustrated the strict compliance notion. In his words:

"It is elementary to say that a person who ships in reliance on a letter of credit must do in exact compliance with its terms. It is also elementary to say that a bank is not bound or indeed entitled to honour drafts presented to it under a letter of credit unless those drafts with the accompanying documents are in strict accord with the credit as opened".<sup>143</sup>

The strict compliance principle reflects the terms of the contractual obligation allocated to the bank. A bank can only claim reimbursement from the account party "if the conditions on which it authorised to accept are, in the matter of the accompanying documents, strictly observed".<sup>144</sup> According to Mackinnon L.J. in *JH Rayner & Co Ltd v Hambro's Bank Ltd*:

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<sup>141</sup> *Credit Agricole Indosuez v Chalease Finance Corp* [2000] 1 All E.R. (Comm) 399; [2000] 1 Lloyd's Rep. 348 (CA)

<sup>142</sup> Buckley, R. 'Potential Pitfalls with Letters of Credit' (1996) *A.L.J.* Vol. 70, 217 at p. 223

<sup>143</sup> (1922) 13 Ll. L. Rep. 21, at 24

<sup>144</sup> Fellingner, G. 'Letters of Credit: The Autonomy Principle and the Fraud Exception' [1990] 1 *J.B.F.L.P.* 4 at p. 9

“...it is quite impossible to suggest that a banker is to be affected with knowledge of the customs and customary terms of every one of the thousands of trades for whose dealings he may issue a letter of credit”.<sup>145</sup>

Such a principle does protect bankers’ and applicants’ expectations. The applicant instructs the bank not to pay the beneficiary unless he strictly fulfils the former’s instructions.<sup>146</sup> Under such a principle, an apparently trivial discrepancy would justify rejecting the documents submitted by the beneficiary if the credit is precise as to that requirement.<sup>147</sup> If such rejection is limited to documents with material discrepancies, banks would have to judge materiality which they do not have the relevant expertise to judge.<sup>148</sup>

The necessity of the strict compliance principle in an independent guarantee has been debated as it is rare that an applicant asks for documents in such a context.<sup>149</sup> Documents required in this context are prepared by the beneficiary himself who would have no problem attaining any strictly complying document as long as it is produced by him. As Guest has noted: “...neither the drafting of the default certificate nor the execution of the bill of exchange requires any specific skills.”<sup>150</sup> It should be noted that, however, there are cases where the beneficiary fails to present one of the required documents such as the bill of exchange or where he tenders the entire set after the expiry date of the independent guarantee itself.

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<sup>145</sup> *JH Rayner & Co Ltd v Hambro’s Bank Ltd* [1943] KB 37 at 41

<sup>146</sup> For example: *Frans and Maas UK) Ltd v Habib Bank AG Zurich* [2001] Lloyd’s Rep Bank 14. In this case it was held that a demand did not comply with the guarantee construction because it did not strictly comply with its content.

<sup>147</sup> Hooley, R. & Sealy L. “*Commercial Law: Text, Cases, and Materials*” (Oxford University Press, 4<sup>th</sup> ed., 2009) at p. 859

<sup>148</sup> Todd, P. “*Bills of Lading and Bankers’ Documentary Credits*” (Informa Law, 4<sup>th</sup> ed., London, 2007) at p. 275

<sup>149</sup> Hapgood, M. “*Paget’s Law of Banking*” (Butterworths, 13<sup>th</sup> ed., London, 2007) at p. 868; Guest, A. “*Benjamin’s Sale of Goods*” (Sweet & Maxwell, 7<sup>th</sup> ed., London, 2006) at p. 2059

<sup>150</sup> Guest, A. “*Benjamin’s Sale of Goods*” (Sweet & Maxwell, 7<sup>th</sup> ed., London, 2006) at p. 2059

The matter has been disputed in the English courts. In *Ermis Skai Radio and Television v Banque Indosuez Europa SRL*,<sup>151</sup> Thomas J. held that the strict compliance principle is applicable in independent guarantees. However, in *Siporex Trade SA v Banque Indosuez*,<sup>152</sup> the High Court held that the strict compliance rule should not to be applied in such a context. It is suggested that the best approach in this regard can be borrowed from Staughton LJ in *IE Contractors Ltd v Lloyd's Bank Plc* where he provided:

“The degree of compliance required by a performance bond may be strict or not so strict. It is a question of construction of the bond. If that view of the law is unattractive to banks, their remedy lies in their own hands”.<sup>153</sup>

### 2.4.3. International initiatives

The law which governs independent guarantees and documentary credits has developed “largely through customs”<sup>154</sup> which have been established through the bankers dealing with different parties in this context.<sup>155</sup> Such customs are now largely embodied in different set of rules issued by the International Chamber of Commerce (hereinafter ICC).<sup>156</sup> These sets of rules include: the Uniform Customs and Practice for Documentary Credits (hereinafter UCP), the Uniform Rules for Contract Guarantees (hereinafter URCG), the Uniform Rules for Demand Guarantees (hereinafter URDG) and the International Standby Practices (hereinafter ISP98). As

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<sup>151</sup> Unreported, 26 February 1997

<sup>152</sup> [1986] 2 Lloyd's Rep 146 at 159, see also: *Frans Maas v Habib Bank* [2001] Lloyd's Rep Bank 14, where Sir Christopher Bellamy sitting as a High court Judge agreed with the *Siporex* case dicta.

<sup>153</sup> [1990] 2 Lloyd's Rep 496 at 500-501. While the current author suggests that Lord Staughton's statement is the best approach, it should be noted that such a statement has been criticised. See for example, Hapgood, M. “*Paget's Law of Banking*” (Butterworths, 13<sup>th</sup> ed., London, 2007) at p. 868 where he provided: “It is submitted that this is a perilous approach for those charged with the examination of documents because it adds an additional process of having to make an initial judgement about the required degree of strictness of compliance. The better approach is to adopt the same standard of strict compliance as applies to letters of credit”.

<sup>154</sup> Bradgate, R. White, F. & Fennell, S. “*Commercial Law*” (Oxford University Press, 9<sup>th</sup> ed., Oxford, 2002) at p. 270.

<sup>155</sup> Mugasha, A. “*The Law of Letters of Credit and Bank Guarantees*” (Federation Press, Sydney, 2003) at p. 47

<sup>156</sup> Carr, I. “*International Trade Law*” (Cavendish Publishing, 3<sup>rd</sup> ed., 2005) at p. 471



well as these sets of rules which have been shaped by the ICC, a Convention known as the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit (hereinafter UN Convention) has been promulgated by the UNCITRAL as an attempt to set an international legal framework to regulate the operations of independent guarantees.

The fact that national laws are few in this regard made most traders depend on the above mentioned international initiatives.<sup>157</sup> Taking this into consideration, this subsection seeks to examine the role which each of these different international initiatives has played in this regard. Whether the role which they played has helped in mitigating the fraud problem in such a context will be analysed. Substantive issues regarding the fraud exception, with which this dissertation is concerned and which can be found in these initiatives, are to be examined where relevant in the next following chapters.

#### **2.4.3.1. UCP**

Today, most documentary credits are governed by the UCP which has been established by the ICC. The UCP has been described as the “most successful harmonising measure in the history of international commerce”.<sup>158</sup> It has been stated that: “the UCP unification is a consequence of necessity and use of banks as agents in international trade”.<sup>159</sup> Indeed, “The UCP was by no means an overnight success”.<sup>160</sup> It is important to note that documentary credits have undergone many changes in the

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<sup>157</sup> Bradgate, R. White, F. & Fennell, S. “*Commercial Law*” (Oxford University Press, 9<sup>th</sup> ed., Oxford, 2002) at p. 270.

<sup>158</sup> Goode, R. “*Commercial Law*” (Penguin Books, 3<sup>rd</sup> ed., London, 2004) at p. 968

<sup>159</sup> Ellinger, E. “*Documentary Letters of Credit: A Comparative Study*” (University of Singapore Press, Singapore, 1970) at p. 1

<sup>160</sup> Carr, I. “*International Trade Law*” (Cavendish Publishing, 3<sup>rd</sup> ed., 2005) at p. 472

current and last century.<sup>161</sup> Such changes have been mainly due to the “increased sophistication in banking practice, shipping and communication.”<sup>162</sup> While the first version of the UCP was established in Vienna in 1933, taking the changes that documentary credits have undergone into consideration, many other versions have been produced by the ICC since that time. The last version, which is called UCP600, was issued on the 1<sup>st</sup> of July, 2007.

The UCP draftsmen had a “realistic and modest goal,” namely, “not to codify all the relevant rules of law, customary or otherwise, but rather to compile international banking customs and other rules that facilitate banking functions.”<sup>163</sup> It is submitted that it is not surprising that uniformity has been achieved in this respect. Whilst the goal of documentary credits is to provide different parties’ involved in international trade with a secure method of payment, it is normal that such parties, who do not reside in the same country, agree on a unified interpretation of a documentary credit involved in their transactions. Indeed “a set of rules providing regulations of world-wide application has always been necessary for the proper function of the system.”<sup>164</sup> Parties are not bound by the UCP unless they expressly incorporate it in their contract. Interestingly, some writers have gone further and have described the UCP as a code which is operative of its own force without even the necessity of incorporation in the contract.<sup>165</sup> In this effect, Goode, for example, has regarded the UCP as:

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<sup>161</sup> For a detailed discussion of each of these changes and the reasons for them, see: Gao, X. “*The Fraud Rule in the Law of Letters of Credit: A Comparative Study*” (Kluwer Law International, The Hague, 2002) at pp. 16-18

<sup>162</sup> Sarna, L. “*Letters of Credit: The Law and Current Practice*” (Carswell Legal Publishers, 2<sup>nd</sup> ed., Toronto, 1986) at p. 9

<sup>163</sup> Kozolchik B, “*Letters of Credit*”, in. Ziegel, J. (ed.), *International Encyclopaedia of Comparative Law*, Vol. 9. Ch 5 (Hamburg, 1980) p. 146

<sup>164</sup> Ellinger, E. “*Documentary Letters of Credit: A Comparative Study*” (University of Singapore Press, Singapore, 1970) at p. 3

<sup>165</sup> Goode, R. “*Commercial Law*” (Penguin Books, 3<sup>rd</sup> ed., London, 2004) at pp. 968-969. See as well. Gao, X. “*The Fraud Rule in the Law of Letters of Credit: A Comparative Study*” (Kluwer Law International, The Hague, 2002) at p. 18

“...directly incorporated by implication into the contract on the basis that their adoption is so much a matter of course that the parties must be taken to have intended to contract with reference to them even if the contract does not state this in terms and even if one of the parties was not aware of the UCP.”<sup>166</sup>

Whilst Goode’s suggestion is commendable, it is submitted that, so far as the English law is concerned, the position of the UCP does not constitute a law in the technical sense.<sup>167</sup> However, it should be said that even if the parties do not incorporate the UCP in their contract, this does not mean that a court cannot look into the UCP to find an answer for a specific point not tackled by the contract. In fact, English courts have relied on UCP in some cases even where there was no reference to it in the contract.<sup>168</sup>

The UCP does not mention anything regarding the fraud problem which constitutes the main focus of this dissertation. It has been suggested that the reason for such a vacuum is the “difference and uncertainty of the position in municipal laws and that every court should give its decision according to the related municipal law.”<sup>169</sup> Taking this into account, later discussion about the fraud exception will not include provisions derived from the UCP. However, such a discussion will benefit from different related provisions such as those which address the autonomy principle.

#### **2.4.3.2. URDG**

Whilst the UCP has been intended to cover both documentary credits and independent guarantees,<sup>170</sup> it has been noted that “The majority of the provisions are simply

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<sup>166</sup> Goode, R & McKendrick E. “*Goode on Commercial Law*” (Penguin Books, 4<sup>th</sup> ed., London, 2010) at p. 1077

<sup>167</sup> Lord Mustill in *Royal Bank of Scotland Plc v. Cassa di Risparmio delle Provincie Lombarde*, Court of Appeal 21 January 1992, unreported case, (available in Westlaw)

<sup>168</sup> For example: *Siporex Trade SA v Banque Indosuez* [1986] 2 Lloyd's Rep. 146

<sup>169</sup> Demir-Araz, Y. ‘International Trade, Maritime Fraud and Documentary Credits’ [2002] *Int. T.L.R.* Vol. 8(4), 128

<sup>170</sup> “In the 1983 revision the UCP were extended to [independent guarantees], in which the bank’s payment undertaking, though primary in form, is not properly invoked unless the principle has defaulted. This extension is maintained in UCP 500”. Goode, R. “*Commercial Law*” (Penguin Books, 3<sup>rd</sup> ed., London, 2004) at p. 952

inappropriate”<sup>171</sup> to apply to independent guarantees.<sup>172</sup> Accordingly, the ICC has issued a set of rules which are directed to address the operation of independent guarantees. The new rules called the URDG 458 were first issued in 1992. URDG 758 is the second and most recent edition of the URDG.<sup>173</sup> URDG 758 became operative on the 1<sup>st</sup> of July, 2010. The URDG, “which is strongly influenced by the UCP”,<sup>174</sup> is applied if incorporated by the parties into their contract. URDG seeks to balance the interests of the different parties who utilise an independent guarantee by setting clear unified definitions and rules to control its operation. As UCP600, URDG 758 has been issued in order to cope with the changes that have occurred in the field of independent guarantees lately.

However, what distinguishes URDG from UCP is that the former have inserted some provisions to mitigate fraudulent practices.<sup>175</sup> Indeed, URDG “impose some constraint on unfair calling of the guarantee without undermining its efficacy as a swift remedy in the event of perceived default”.<sup>176</sup> Article 15 of URDG 758 requires the beneficiary to present a written default statement in order to obtain the independent guarantee amount. It also requires the beneficiary to indicate the respect in which the applicant has breached his obligations. It has been suggested that:

“Requiring such written statements may discourage improper demands on a guarantee or counter-guarantee, as even a beneficiary who might not

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<sup>171</sup> Goode, R & McKendrick E. “*Goode on Commercial Law*” (Penguin Books, 4<sup>th</sup> ed., London, 2010) at p. 1059

<sup>172</sup> Sifri, J. “Standby Letters of Credit: A Comprehensive Guide” (Palgrave Macmillan, New York, 2008) at p. 3. The UCP includes provisions respecting transport documents, provisions concerning insurance policies and provisions respecting invoices which are clearly of no relevance in independent guarantees transactions.

<sup>173</sup> International Chamber of Commerce Publication No. 758

<sup>174</sup> Gao, X. “*The Fraud Rule in the Law of Letters of Credit: A Comparative Study*” (Kluwer Law International, The Hague, 2002) at p. 20

<sup>175</sup> Jones, R. & Gwynne, R. ‘Uniform Rules for Demand Guarantees: URDG 758’ [2010] *Bank. Law* Vol. 3(3), 4 at p. 5

<sup>176</sup> Goode, R & McKendrick E. “*Goode on Commercial Law*” (Penguin Books, 4<sup>th</sup> ed., London, 2010) at p. 1140

hesitate to make an improper demand might think twice before presenting a false written statement”.<sup>177</sup>

While it offers some preventive measures, the URDG does not offer practical solution for the fraud problem where it happens. Moreover, it is noteworthy that a recent SITPRO study has found that only a minority of independent guarantees which were issued in the UK are made subject to URDG.<sup>178</sup> As been noticed by one commentator: “in the UK, URDG 458 is very rarely seen in practice”.<sup>179</sup> It remains to be seen whether URDG 758 will follow the footsteps of its precedent or not. For now it is sufficient to say that URDG pertinent articles to the fraud discussion following in the next chapters will be discussed where relevant.

#### **2.4.3.3. URCG**

The URCG was issued in 1978 by the ICC.<sup>180</sup> In fact, it has been suggested that the URCG does not deal with independent guarantees but rather it has been set out in order to deal with uncertainties and ambiguities related to ordinary guarantees.<sup>181</sup> However, URCG has been rarely accepted or used since its publication as it has “proved too far removed from market practice to be acceptable”.<sup>182</sup>

URGG did not made clear whether it is a set of rules which aim to unify independent guarantees or ordinary guarantees practices. Article 9 requires the beneficiary to present a judgement, an arbitral award or the principal’s written acceptance in order to obtain the guarantee amount. While such numerous requirements could be seen as

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<sup>177</sup> Ellinger P. & Neo, D. “*The Law and Practice of Documentary Letters of Credit*” (Hart Publishing, Oxford, 2010) at p. 348

<sup>178</sup> SITPRO, Report on the Use of Demand Guarantees in the UK (2003); see <http://www.sitpro.org.uk>

<sup>179</sup> Jones, R. & Gwynne, R. ‘Uniform Rules for Demand Guarantees: URDG 758’ [2010] *Bank. Law* Vol. 3(3), 4 at p. 6

<sup>180</sup> International Chamber of Commerce Publication No. 325

<sup>181</sup> Edwards, R. ‘The Role of Bank Guarantees in International Trade’ (1982) *A.L.J.* Vol. 56, 281 at p. 286

<sup>182</sup> Goode, R & McKendrick E. “*Goode on Commercial Law*” (Penguin Books, 4<sup>th</sup> ed., London, 2010) at p. 1130

treatment for the fraud problem which frequently occurs in such a context, URCG has been heavily criticized as it has “virtually turned independent guarantees to accessory ones.”<sup>183</sup> Taking this into consideration, URCG will not constitute a part of the following discussion.

#### **2.4.3.4. ISP98**

Taking into consideration that the UCP is a set of rules more pertinent to documentary credits and the long American battle with guarantees,<sup>184</sup> the United States centred Institute for International Banking Law and Practice with ICC support has promulgated a set of rules specifically designed for standby letters of credit.<sup>185</sup> The ISP98 came into effect in 1999. These rules have been drafted similarly to UCP and URDG. It shares the same different characteristics which have been explained above in regard UCP and URDG. Yet, ISP98 states expressly that it does not provide for “defences to honor based on fraud, abuse or similar matters.”<sup>186</sup>

#### **2.4.3.5. UNCITRAL Convention**

The United Nations Convention on Independent Guarantees and Stand-by Letters of Credit has been prepared by the United Nations Commission on International Trade Law (UNCITRAL).<sup>187</sup> This Convention which deals with independent guarantees was

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<sup>183</sup> Gao, X. “*The Fraud Rule in the Law of Letters of Credit: A Comparative Study*” (Kluwer Law International, The Hague, 2002) at pp. 19-20

<sup>184</sup> See subsection 2.3.1.

<sup>185</sup> Goode, R. “*Commercial Law*” (Penguin Books, 3<sup>rd</sup> ed., London, 2004) at p. 952

<sup>186</sup> ISP98 Rule 1.05(c)

<sup>187</sup> UNCITRAL is an intergovernmental body of the General Assembly that prepares international commercial law instruments designed to assist the international community in modernizing and harmonizing laws dealing with international trade. Other legal instruments prepared by UNCITRAL include, e.g., the following: United Nations Convention on Contracts for the International Sale of Goods (*Official Records of the United Nations Conference on Contracts for the International Sale of Goods, Vienna, 10 March-11 April 1980* (United Nations publication, Sales No. E.82.V.5), part I); Convention on the Limitation Period in the International Sale of Goods, 1974 (New York) (*Official Records of the United Nations Conference on Prescription (Limitation) in the International Sale of Goods, New York, 20 May-14 June 1974* (United Nations publication, Sales No. E.74.V.8), part I). Such information is available at:

adopted by the General Assembly by its resolution 50/48 of 11 December 1995.<sup>188</sup> This Convention entered into force on 1, January, 2000. To this date, only eight countries have utilised this Convention.<sup>189</sup> The Convention has been mainly designed to assist the practice of independent guarantees. It seeks to solidify the recognition of its basic principles and characteristics. It also emphasizes the common umbrella of rules provided for independent guarantees to overcome divergences that may exist in terminology.<sup>190</sup> While it could be applied to documentary credits,<sup>191</sup> it mainly applies to independent guarantees.<sup>192</sup>

What is special about the Convention is that, contrary to the above mentioned rules, it has dealt explicitly with the fraud problem in a comprehensive manner.<sup>193</sup> It has been suggested that the UN convention took “a middle way”<sup>194</sup> as it has neither left a vacuum in respect to the fraud issue (like UCP, URDG, and ISP98) nor burdened the parties with difficult requirements (like URCG). It has been suggested that such a treatment “constitute[s] a good barometer of international consensus on the topic of

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<http://www.uncitral.org/pdf/english/texts/payments/guarantees/guarantees.pdf> , last accessed on 30-11-2012.

<sup>188</sup> See note 1 of the Explanatory note prepared by the UNCITRAL secretariat on the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit. Available at: <http://www.uncitral.org/pdf/english/texts/payments/guarantees/guarantees.pdf> , last accessed on 30-11-2012.

<sup>189</sup> These countries are: Belarus, Ecuador, El Salvador, Gabon, Kuwait, Liberia, Panama and Tunisia. This convention has also been merely signed by the USA. Available at [http://treaties.un.org/pages/ViewDetails.aspx?src=TREATY&mtdsg\\_no=X-15&chapter=10&lang=en](http://treaties.un.org/pages/ViewDetails.aspx?src=TREATY&mtdsg_no=X-15&chapter=10&lang=en), last accessed on 30-11-2012.

<sup>190</sup> See note 2 of the Explanatory note prepared by the UNCITRAL secretariat on the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit. Available at: <http://www.uncitral.org/pdf/english/texts/payments/guarantees/guarantees.pdf> , last accessed on 30-11-2012.

<sup>191</sup> Article 1(2) of the UNCITRAL Convention on Independent Guarantees and Stand-by Letters of Credit.

<sup>192</sup> Article 1(1) of the Convention provides: “(a) If the place of business of the guarantor/issuer at which the undertaking is issued is in a Contracting State, or (b) If the rules of private international law lead to the application of the law of a Contracting State, unless the undertaking excludes the application of the Convention.”

<sup>193</sup> Article 19 and 20 of the Convention has dealt with this problem.

<sup>194</sup> Chuah, J. ‘Performance Guarantees and the Fraud Exception’ [1999] *S.L. Rev.* 26, 49 at p. 50

fraud”.<sup>195</sup> Yet it should be recalled that the UN Convention “has very limited application”.<sup>196</sup> This could be attributed to the fact that it is only a few countries that have made use of the Convention.

## 2.5. Conclusion

The popularity of documentary credits and independent guarantees in international commerce has led judges to describe them as “the life blood of international commerce”.<sup>197</sup> Taking into consideration the problems that their predecessors have been confronting, these instruments have been devised by merchants to facilitate their different transactions. Different names and various types have been developed in this context to satisfy the numerous requirements of the different parties. Moreover, the autonomy and the strict compliance principles have been inserted to ensure the smooth running of these instruments and to protect the parties’ different expectations.

Principles borrowed from contracts or other instruments are not always applicable to documentary credits and independent guarantees as they are neither contracts nor usual payment methods or ordinary guarantees. It should be always kept in mind that these unique instruments have evolved in an exceptional way to ensure a smooth operation of international trade finance.

The manifestation of different initiatives to unify the customs and practices of documentary credits and independent guarantees is a normal consequence which reflects the importance of these instruments in the international commerce realm.

However, the fact that these rules have overlooked the fraud problem is regrettable.

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<sup>195</sup> Mugasha, A. “*The Law of Letters of Credit and Bank Guarantees*” (Federation Press, Sydney, 2003) at p. 138

<sup>196</sup> Davidson, A. ‘Fraud; the Prime Exception to the Autonomy Principle in Letters of Credit’ [2003] 8 *Int’l Trade & Bus. L. Ann.*, 23 at p. 46

<sup>197</sup> *United City Merchants Ltd v. Royal Bank of Canada* [1982] 2 QB 208, at 222; *Harbottle Ltd v. National Westminster Bank Ltd* [1978] QB 146, at 155



Having allocated some rules, the UNCITRAL Convention approach is commendable in this regard. Nevertheless, under such a lax attitude, it is suggested that the true remedy against the fraud problem lies in the courts' hands. Unless a certain court is willing to interfere in order to stop fraud, a documentary credit or an independent guarantee governed by the UCP, URDG, ISP98 or URCG would remain susceptible to fraud practises. The same applies in regard to the UN Convention especially if its limited application is taken into consideration.

After providing a general background dealing with the important basic legal principles and the characteristics of documentary credits and independent guarantees, the next chapters aim to deal with the fraud exception to the autonomy principle in both documentary credits and independent guarantees.

## Chapter Three: Non-genuine Documents: A Bank Defence to Payment

### 3.1. Introduction

The aim of this chapter is to examine the extent to which banks can successfully rely on the fraud exception to refuse tendered documents in a letter of credit context. This chapter seeks to answer the following questions: is the approach adopted by English courts acceptable in this respect? Does this exception meet the banks' and applicants' expectations? If not, what other solutions can be submitted in order to relieve banks and applicants from fraud perpetrated by unscrupulous beneficiaries?

Accordingly, after the introduction, the second section examines the American seminal case in this regard: the *Sztejn* case.<sup>1</sup> Examining this case, which is acknowledged as the first case to recognise the fraud exception and upon which later English authorities have erected their decisions, is an indispensable necessity in this regard in order to understand the precise nature of the fraud exception. The third section is meant to examine the English seminal case in this regard: the *American Accord* case.<sup>2</sup> Examining this case is also important in order to understand how English authorities have applied this exception and in order to appreciate the different implications of such an application. The following section explores the nullity exception, the tenor of which advocates that a bank should be able to reject a null document notwithstanding whether it is fraudulent or not, and discusses whether such an exception should be recognised or not. The fifth section is the conclusion.

For the purposes of this work, fraud perpetrated in a letter of credit context is divided into two potential categories: firstly, fraud which can be found by merely examining

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<sup>1</sup> *Sztejn v. J. Henry Schroder Banking Corp* 177 Misc. 719, 31 N.Y.S.2d 631 (1941)

<sup>2</sup> *United City Merchants (Investments) Ltd v. Royal Bank of Canada (The American Accord)* [1983] 1 A.C. 168

the documents accompanying the seller's demand for payment (e.g., where there has been falsification of a signature or a date on a certain document): secondly, fraud which cannot be found by examining the documents alone and which needs an investigation of external facts in order to determine whether a call on a letter of credit is fraudulent or not (e.g., examining the underlying transaction which the documents represent or the underlying contract which has been issued through a letter of credit). Whilst it is submitted that fraud in either of the categories would certainly result in fraud in both, this should not obscure the fact that a fundamental differentiation does exist between them. On the one hand, documents are presented by sellers to banks and hence it is the latter that would discover a "documentary" fraud such as a falsified signature on a bill of lading. On the other hand, it is an inherited particularity of the letters of credit law that bankers are merely concerned with documents.<sup>3</sup> Hence, if the fraud is one which does not relate to the documents but to the goods (e.g., the shipment of water rather than petrol) or the underlying contract between the seller and the buyer (e.g., the seller misrepresents some facts in order to make the buyer enter into the contract), the only relief for buyers would be to seek the intervention of courts by means of injunctions to stop the letter of credit payment.

Legal and practical issues arising from such differentiation is the core of the next chapter (chapter four). The second category, which relates to fraud which needs external investigation, is to be discussed in chapters five and six respectively. However, it is the object of this chapter to examine the first "documentary" fraud category and its relation to the fraud exception. It should be noted that the focus of this chapter is centred on documentary letters of credit. The reason behind such a focus on documentary credits is that the use of documents is of such a limited

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<sup>3</sup> *Hamzeh Malas & Sons v British Imex Industries Ltd* [1958] 2 Q.B.127

application in independent guarantees.<sup>4</sup> Nonetheless, it would be appropriate to apply the concluded outcomes equally to both documentary credits and independent guarantees as some of the latter require some documents to be presented in order to affect their payment.

### 3.2. The *Sztejn* case

Fraud in documentary credits is not new; indeed it came into existence simultaneously with the early stages of the life of documentary credit.<sup>5</sup> However, fraud had not been fully developed as an exception to the banks' obligation to pay under documentary credits, until the evidence of the well-known American case *Sztejn v. J. Henry Schroder Banking Corp.*<sup>6</sup> Admittedly with approval, the *Sztejn* case, which has been described as the 'seminal',<sup>7</sup> 'landmark'<sup>8</sup> and 'the most illuminating',<sup>9</sup> sets the general framework of the fraud exception which has been adopted by later authorities who confronted a fraud allegation in a letter of credit context.<sup>10</sup> As has been recently stated by one commentator: "It is customary, in any discussion on fraud and letters of credit, to begin with an analysis of the decision in *Sztejn*... Indeed, it is almost

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<sup>4</sup> See, for example: Driscoll, R. 'The Role of Standby Letters of Credit in International Commerce: Reflections After Iran' (1980) 20 *Va. J. Int'l L.* 459 at p. 482

<sup>5</sup> Gao, X. "*The Fraud Rule in the Law of Letters of Credit: A Comparative Study*" (Kluwer Law International, The Hague, 2002) at p. 32

<sup>6</sup> *Sztejn v. J. Henry Schroder Banking Corp* 177 Misc. 719, 31 N.Y.S.2d 631 (1941). According to Horowitz, the *Sztejn* case is: "accepted as the first judicial acceptance of a fraud defence to payment under letters of credit". See: Horowitz, D. "*Letters of Credit and Demand Guarantees: Defences to Payment*" (Oxford University Press, Oxford, 2010) at p. 18

<sup>7</sup> See Gao, X. "*The Fraud Rule in the Law of Letters of Credit: a Comparative Study*" (Kluwer Law International, London, 2002) at p. 38

<sup>8</sup> *United City Merchants (Investments) Ltd v. Royal Bank of Canada (The American Accord)* [1983] 1 A.C. 168 at 183

<sup>9</sup> *Edward Owen Engineering Ltd v. Barclays Bank International* [1978] 1 Lloyd's Rep. 166

<sup>10</sup> See, for example: *Discount Record Ltd v. Barclays Bank Ltd.* [1975] 1 Lloyd's Rep. 444; *Edward Owen Engineering Ltd. v. Barclays Bank International Ltd* [1987] 1 Lloyd's Rep. 166; *United City Merchants (Investments) Ltd v Royal Bank of Canada (The American Accord)* [1983] 1 A.C. 168

unavoidable”.<sup>11</sup> The decision of the *Sztejn* case is of central importance to the fraud exception discussion and hence it will be discussed below.

### 3.2.1. The facts

A brief summary of the *Sztejn* case facts are important in order to understand the discussion which will follow. In this case the buyer, Sztejn, contracted with the seller Transea to purchase a quantity of bristles. The parties agreed to finance the transaction by means of a documentary letter of credit. Therefore, Sztejn instructed his bank, Schroder, to open an irrevocable documentary credit in Transea’s favour. Accordingly, Schroder undertook the obligation to pay the seller once it had presented a bill of lading and an invoice evidencing the shipment of the required bristles and which conformed to the documentary credit terms. In his turn, to obtain the documentary credit amount, the seller presented the required conforming documents to a collecting bank called Chartered Bank of India, Australia and China which duly presented the documents to Schroder in expectation of the payment.

Unexpectedly, and before the payment, Sztejn applied to the Supreme Court of New York for an injunction to stop the documentary credit payment.<sup>12</sup> The basis of the injunction sought was that the seller had shipped worthless material instead of the agreed bristles. Sztejn alleged that Transea had in fact shipped: “fifty crates with cowhair, other worthless material and rubbish with intent to simulate genuine merchandise and defraud the plaintiff”.<sup>13</sup> In its role, Chartered Bank resisted Sztejn’s

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<sup>11</sup> See: Horowitz, D. “*Letters of Credit and Demand Guarantees: Defences to Payment*” (Oxford University Press, Oxford, 2010) at p. 15. See as well: Mugasha, A. “*The Law of Letters of Credit and Bank Guarantees*” (Federation Press, Sydney, 2003) at p. 138

<sup>12</sup> It is noteworthy that banks usually do not interfere to stop the payment of a letter of credit unless the applicant provides them with an established evidence of fraud. Banks do insist on being provided with established evidence of fraud in order to justify their refusal if a letter of credit beneficiary sues them later. In fact, most banks do not interfere even with the existence of such an established evidence of fraud and rather they advise their applicants to get a court injunction.

<sup>13</sup> *Sztejn v. J. Henry Schroder Banking Corp* 177 Misc. 719, 31 N.Y.S.2d 631 (1941) at 720

allegations and argued that they were solely “concerned with the documents on their face and on their face these conformed to the requirements of the letter of credit”.<sup>14</sup> Chartered Bank argued that it had not breached any of its obligations under the documentary credit and, consequently, it could not see a reasonable cause of action to restrain the payment.

### 3.2.2. The decision

#### 3.2.2.1 *Genuine documents: a pre-requisite to the autonomy principle*

At the beginning of his judgment, Justice Shientag stressed the significance of the autonomy principle in a way which made Chartered Bank believe that it would succeed in the case.<sup>15</sup> Justice Shientag observed that without the autonomy principle the efficiency needed in letters of credit would be undermined. To that effect, he noted that banks should not be obliged to look behind the required documents and that such an approach if allowed would embroil banks in controversies which they are ill equipped to deal with.<sup>16</sup> Nevertheless, he found that there is a pre-requisite which a documentary letter of credit beneficiary has to discharge in order to be appropriately covered under the autonomy principle umbrella. In this regard he provided that:

“...Of course, *the application of this doctrine* [the autonomy principle] *presupposes that the documents accompanying the draft are genuine and conform in terms to the requirements of the letter of credit*”.<sup>17</sup>

He underpinned the latter *dictum* by citing a statement from *Old Colony Trust Co. v. Lawyers Title and Trust Co*<sup>18</sup> which reads as follows:

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<sup>14</sup> *Ibid.*

<sup>15</sup> *Ibid* at 721

<sup>16</sup> According to Jack QC, in *Montrod Limited v. Grundkotter Fleischvertriebs GmbH* [2001] C.L.C. 466 at 477: “...a bank is entitled to go behind the appearance and to take account of other information to say that the document is not what it appears to be and to refuse to pay, but if it chooses to go by the appearance alone and to pay, it is entitled to be reimbursed”. See as well: *Commercial Banking Co of Sydney Ltd v Jalsard Pty Ltd* [1973] AC 279 at 286

<sup>17</sup> *Sztejn American case v. J. Henry Schroder Banking Corp* 177 Misc. 719, 31 N.Y.S.2d 631 (1941) at p. 721 [Emphasis added]

“...obviously, when the issuer of a letter of credit *knows that a document, although correct in form, is, in point of fact, false or illegal, he cannot be called upon to recognise such a document as complying with the terms of credit...*”<sup>19</sup>

The last two quotations, where Justice Shientag evaluated the documents’ significance in a documentary credit transaction, are interesting. He found that a bank which knows that a certain document presented by a beneficiary is not genuine, in the sense that it includes a point of fact which is false, although correct in form and facially conforming to the documentary credit terms, has to refuse such a document on the basis of non-conformity with the credit terms. The question of who has perpetrated the falsity, whether the seller or a third party, or how it has been done, whether intentionally or innocently, or how material it is, whether it is trivial or significant, are issues that are of no relevance to the bank. In other words, whether the reason is a forgery, fraudulent misrepresentation or an unauthorised mistake resulting in the document being null, the bank would be justified in its refusal to pay. The bank’s obligation is to pay under genuine conforming documents and nothing other than that.<sup>20</sup> Accordingly, it was submitted that a document being false in any respect will be refused by the bank without any further investigations.<sup>21</sup> It is noteworthy that establishing any kind of fraud on the seller’s side at this stage is not required to justify the documents’ rejection.<sup>22</sup>

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<sup>18</sup> *Old Colony Trust Co. v. Lawyers Title and Trust Co* (1924) 297 F 152

<sup>19</sup> *Ibid.* at 155 [Emphasis added]. A complying presentation is defined by the UCP 600 in Article 2 as: “a presentation that is in accordance with the terms and conditions of the credit, the applicable provisions of these rules and international standard banking practice”.

<sup>20</sup> Ellinger P. & Neo, D. “*The Law and Practice of Documentary Letters of Credit*” (Hart Publishing, Oxford, 2010) at p. 173; Bridge, M. “*The International Sale of Goods*” (Oxford University Press, 2<sup>nd</sup> ed., Oxford, 2007) at pp. 300-301; Arora, A. ‘Fraud and Forgery in Commercial Documentary Credits’ [1983] *C.L.B.* 9, 271 at p. 272; Arora, A. ‘False and Forged Documents under a Letter of Credit’ [1981] *Co. Law Vol.* 2(2), 66 at p. 67

<sup>21</sup> Davis, A. “*The Law Relating to Commercial Letters of credit*” (The Pitman Press, 3<sup>rd</sup> ed., London, 1963) at p. 151

<sup>22</sup> *Sztejn v. J. Henry Schroder Banking Corp* 177 Misc. 719, 31 N.Y.S.2d 631 (1941) at 721

Justice Shientag illustrated that genuinity of the documents precedes the application of the autonomy principle and that the question of whether the documents are genuine or not has nothing to do with the autonomy principle which separates the documents from the underlying transaction which they represent. Whilst the autonomy principle dictates that a bank should not look into the underlying transaction to determine if a document is truthful or not, the same principle does not deprive a bank of the right to refuse to pay when it knows that a certain document is not a genuine one.<sup>23</sup> As can be inferred from the above quotations, genuinity is a pre-requisite for banks to accept the documents. Once the documents presented are seen as genuine and conforming to the documentary letter of credit terms, one can say that the autonomy principle has been activated to protect the beneficiaries.<sup>24</sup> Goode has noted the conformity and genuinity pre-requisite and described it as a ‘threshold test’ to activate the autonomy principle.

In his words:

“When the seller passed the *threshold test by presenting documents which do in fact conform to the undertaking*, he is in a strong position, for it is well established that *the contract is independent of the underlying transaction*.”<sup>25</sup>

Having illustrated the genuinity point underlined in the *Sztejn* case, other aspects of the decision which comprise the fraud exception application are the substance of the discussion of the next subsection.

### **3.2.2.2. Fraud as an exception to the autonomy principle**

A dispute regarding the genuinity of the documents in the *Sztejn* case cannot be found. The documents were genuine and conforming to the documentary credit terms and both the issuing and the collecting bank were unable to find any evidence of falsity or

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<sup>23</sup> Borrowdale, A. ‘The Autonomy Rule and Fraud Exception in Documentary Credits’ (1982) 99 *S. African L.J.* 136 at pp. 142-143

<sup>24</sup> *Ibid.*

<sup>25</sup> Goode, R. “Abstract payment undertakings” in Cane, P. & Stapleton, J. (eds.) “*Essays for Patrick Atiyah*” (Oxford, 1991) 209 at p. 233 [Emphasis added]



non-conformity in the documents. Documents presented to the bank although genuine and conforming in form were fraudulent in their substance as the fraud was existent in the goods. As one commentator noted:

“...it is not a difficult task to fabricate or forge these documents. Particularly with developing technology, every single person can fabricate an identical copy of a shipping document that is commonly used in trade, or they can buy one from related associations and fill it up according to their own wishes”.<sup>26</sup>

It is also possible that a beneficiary could obtain a document through a conspiracy with its own maker. It is submitted that fraud in the goods renders the documents fraudulent and vice-versa (i.e. a documentary credit stipulates for a bill of lading evidencing the shipment of petrol and the seller, although he has shipped water instead of petrol, submits the stipulated facially confirming bill of lading). Such fraud, related to the goods and consequently rendering the documents fraudulent, is difficult to examine by banks and accordingly they refuse to interfere and stop the payment process unless they are provided with soundly established evidence of the perpetrated fraud in order to justify its refusal when sued by a beneficiary.<sup>27</sup> Even if the former were provided with that kind of proof, in practice banks fear getting embroiled with such controversies and consequently advise their customers to obtain a court's injunction to stop the payment process.<sup>28</sup> This can be seen from the facts of the *Sztejn* case which is an appropriate example of a fraud case.

Justice Shientag noted that, in situations such as the aforementioned, the sacrosanct autonomy principle which the beneficiary obtains even by submitting genuine documents should no longer be preserved to protect such fraudulent deeds. He noted

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<sup>26</sup> Demir-Araz, Y. “International Trade, Maritime Fraud and Documentary Credits” (2002) 4 *Int. T.L.R. & R.* 128 at p. 132

<sup>27</sup> Sarna, L. “*Letters of Credit: The Law and Current Practice*” (Carswell Legal Publishers, 2<sup>nd</sup> ed., Toronto, 1986) at pp. 184-185

<sup>28</sup> Chapter 6 considers the injunctions issue separately.

that there are few exceptions to this rigid principle and that fraud is one of them.<sup>29</sup>

Whilst he observed the courts' reluctance to interfere with the machinery of letters of credit and to act upon them in light of the underlying contract which led to their issuance, that did not prevent him from finding that:

“...there is overwhelming approval of the notion that the *fraud of the beneficiary in relation to the documentary evidence and the actual performance of his personal obligation* should not go unpunished, or at least, unnoticed insofar as payment upon the credit is concerned.”<sup>30</sup>

In considering the facts of the present case, he found for the plaintiffs on the basis of the fraud exception and as a result an injunction was granted.<sup>31</sup> As a procedural requirement the allegations were considered as referring to *established* fraud.<sup>32</sup> He, justifying the decision, noted that the case:

“is not...concerning *a mere breach of warranty regarding the quality of the merchandise*; on the present motion, it *must be assumed* that the seller has *intentionally* failed to ship any goods ordered by the buyer...*the principle of the independence of the bank's obligation under the letter of credit should not be extended to protect the unscrupulous seller*...No hardship will be caused by permitting the bank to refuse payment where fraud is claimed, where the merchandise is not merely inferior in quality but consists of worthless rubbish”.<sup>33</sup>

This statement sets out two key principles in regard to documentary credits law. Firstly, a distinction was made between mere breaches of warranty (such as one regarding the quality of the merchandise) and situations where fraud has been perpetrated deliberately in order to deceive a documentary credit applicant. Indeed, it is true that if courts were allowed to interfere in situations concerning a breach of warranty, the effectiveness of documentary credit would be damaged. However, as

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<sup>29</sup> *Sztejn v. J. Henry Schroder Banking Corp* 177 Misc. 719, 31 N.Y.S.2d 631 (1941) at 721

<sup>30</sup> *Ibid.* [Emphasis added]

<sup>31</sup> One can notice that the issuing bank did not assist the applicant to stop payment, rather, the applicant asked for a court injunction.

<sup>32</sup> The fraud proof standard is considered in detail in chapter 6.

<sup>33</sup> *Sztejn v. J. Henry Schroder Banking Corp* 177 Misc. 719, 31 N.Y.S.2d 631 (1941) at 722 [Emphasis added]

Justice Shientag observed “The distinction between a breach of warranty and active fraud on the part of the seller is supported by authority and reason”.<sup>34</sup> The court had found, from the case’s particular facts, that the seller had ‘intentionally’ perpetrated the fraud.<sup>35</sup> It is noteworthy that such a finding might not usually be available to courts and banks due to the short period between the demand and the payment of the documentary credit. Furthermore, proving a defendant’s intention or state of mind is an extremely difficult task. Consequently, it is submitted that the dictum delivered by Shientag J. regarding fraud is not confined to situations where fraud can be proved to be perpetrated ‘intentionally’; rather, the existence of this piece of evidence in this particular case was a coincidence which made the allegation more compelling. The second key principle is that, as a consequence of fraud, the autonomy principle should not in any way be extended to protect an unscrupulous seller. As has been stated “...while the autonomy principle is paramount, the abstraction of the credit may be diminished by an application of the fraud defence”.<sup>36</sup>

After illustrating the *Sztejn* case facts, one can notice the difference between genuinity as a pre-requisite before the autonomy principle is activated and fraud as an exception to obstruct the autonomy principle after it has been activated. Genuinity of the documents is a pre-requisite for payment to occur; however, fraud is an exception to the payment occurrence. In sum, as has been set out by the *Sztejn* case, fraud and non-genuinity are two different defences to payment in a letter of credit context. Having revealed the difference between genuinity (the pre-requisite) and fraud (the exception) in *Sztejn*, one might ask: have English courts adopted a similar approach? The

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<sup>34</sup> *Ibid.*

<sup>35</sup> English courts stipulated for fraud to be intentional in order to apply the fraud exception.

<sup>36</sup> Horowitz, D. “*Letters of Credit and Demand Guarantees: Defences to Payment*” (Oxford University Press, Oxford, 2010) at p. 18

following sections will examine the related English authorities in this regard in order to answer this question.

### 3.3. The *American Accord* case

The *Sztejn* case echoes have crossed the geographical boundaries of the American continent and became an international reference wherever fraud is alleged in a letter of credit context.<sup>37</sup> Consequently, to date, English courts have been keen to cite *Sztejn* whenever a case of fraud comes before them.<sup>38</sup> In fact, it has been described as “the foundation stone of English Law in this area”.<sup>39</sup> The doors to discussions of letters of credit fraud had been widely opened in *United City Merchants (Investments) Ltd v Royal Bank of Canada (The American Accord)*.<sup>40</sup> Interestingly, this case which has “...a profound effect on the letter of credit jurisprudence”<sup>41</sup> took five years to settle. Whilst one might think that the English courts have adopted the American approach in this regard, yet the following discussion of the *United City Merchants* case is important and will demonstrate that a contrary approach to the *Sztejn* has been pursued.

#### 3.3.1. The facts

In the *United City Merchants*, Vitro a Peruvian company entered into an F.O.B. contract to buy manufacturing equipment from an English company called Glass

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<sup>37</sup> For example: *United City Merchants (Investments) Ltd v Royal Bank of Canada (The American Accord)* [1983] 1 A.C. 168; *Discount Record Ltd v. Barclays Bank Ltd.* [1975] 1 Lloyd’s Rep. 444; *Edward Owen Engineering Ltd. v. Barclays Bank International Ltd* [1987] 1 Lloyd’s Rep. 166;

<sup>38</sup> *Ibid.*

<sup>39</sup> Jack, R. Malek, A. & Quest, D. “*Documentary Credits*” (Tottel Publishing, 4<sup>th</sup> ed., London, 2009) at p. 271

<sup>40</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada (The American Accord)* [1983] 1 A.C. 168

<sup>41</sup> Ademun-Odeke. “Double Invoicing in International Trade: The Fraud and Nullity Exceptions in Letters of Credit-Are the *America Accord* and the UCP 500 Crooks’ Charters!?” [2006] *Denning Law journal* 115 at p. 115

Fibres.<sup>42</sup> The parties agreed that the payment was to be carried out by means of documentary letters of credit. Thus, Vitro instructed its bank, Banco Continental S.A., to open an irrevocable documentary credit in Glass Fibres' favour. The documentary credit was confirmed by the London branch of the Royal Bank of Canada. The credit terms included the following: that payment was to be triggered through a sight draft drawn on the confirming bank accompanying a full set of clean 'on board' bills of lading. The credit required the shipment from London to Callao on or before the 15<sup>th</sup> of December 1976.

Pursuant to the contract, the seller early in December 1976 had the goods ready to be shipped. Unfortunately, "owing to some breakdown",<sup>43</sup> the ship that was supposed to transport the goods was cancelled. Therefore, and to rectify the situation, the carrier's agent (the loading brokers) chose another vessel, the American Accord, to undertake the voyage intended. In fact, the American Accord left Felixstowe on 16 December 1976, a day later than the agreed time. The loading broker's employee, called Mr. Baker, "knowing that the correct date was a matter of importance in relation to a letter of credit"<sup>44</sup> fraudulently produced bills of lading stating the 15<sup>th</sup> of December as the shipment day. Honestly believing in their accuracy, the beneficiary's assignees, United City Merchants, tendered the documents to the Royal Bank of Canada requesting the documentary credit sum. Surprisingly, the latter refused to pay alleging that "information in [their] possession suggests that shipment was not in fact affected as it appears by the bill of lading".<sup>45</sup> Accordingly, the seller's assignees brought an

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<sup>42</sup> F.O.B. stands for free on board which is a kind of sale of goods contract which is usually made use of by ships.

<sup>43</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada (The American Accord)* [1979] 1 Lloyd's Rep. 269 at 271

<sup>44</sup> *Ibid.* at 273

<sup>45</sup> *Ibid.* at 275

action against Royal Bank of Canada alleging that its refusal to pay constituted a wrongful dishonour.

### 3.3.2. The Court of first instance: fraud is the only defence

Justice Mocatta noted that the proceedings are “of some complexity and difficulty both on fact and law”.<sup>46</sup> The defendant bank argued that producing a bill of lading which lies about its place and time of shipment made it a non-genuine document which allows the bank to refuse it. The bank supported its allegation regarding the *genuinity pre-requisite* notion, well-illustrated in the *Sztejn* case, by citing a number of English and American cases.<sup>47</sup> Justice Mocatta acknowledged that the act committed by the loading carriers resulted in the document being a non-genuine document.<sup>48</sup> Moreover, he found that predating the bill of lading which was “so very indifferently altered that one can discern the figure 16 below the superimposed 15”<sup>49</sup> constituted fraud. Nevertheless, after citing some cases assuring the significance of the autonomy principle, he refused the bank’s arguments and admitted just one exception to the bank duty to pay, namely, fraud.<sup>50</sup> Justice Mocatta found that the case is vitally different from the *Sztejn* as “...there was no fraud on the part of the plaintiffs, nor...that they knew the date on the bills of lading to be false when they presented the documents”.<sup>51</sup>

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<sup>46</sup> *Ibid.* at 269

<sup>47</sup> For example: English cases: *Societe Metallurgique v. British Bank for Foreign Trade* (1922) 11 L.L. Rep. 168; *Stein v. Hambro's* (1921) 9 L.L. Rep.433; *Urquhart Lindsay & Company Limited v. Eastern Bank* (1922) 1 K.B. 318. American cases: *Old Colony Trust v. Lawyers Title & Trust Co.* (1924) 297 F 152; *Maurice O'Meara Company v. National Park Bank* (1925) 239 N.Y. 386

<sup>48</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada (The American Accord)* [1979] 1 Lloyd's Rep. 269 at 277

<sup>49</sup> *Ibid.* at 273

<sup>50</sup> *Urquhart Lindsay v. Eastern Bank* [1922] 2 Q.B. 127; *Malas v. British Imex* [1957] 2 Lloyd's Rep. 549; [1958] 2 Q.B. 127; *Edward Owen v. Barclays Bank* [1978] 1 Lloyd's Rep. 166

<sup>51</sup> [1979] 1 Lloyd's Rep 267, 278

Justice Mocatta found that to be liable for fraud, the seller or his agents had to be the one who perpetrated the fraud, or at least that fraud had been committed under their knowledge.<sup>52</sup> Accordingly, the fact that neither the seller nor his agents (the carrier) were responsible for the fraud exempted the former from bearing the liability occurred by such a fraud. Justice Mocatta noted that allowing banks to refuse payment on the ground of non-genuinity or even third parties fraud unknown to the beneficiary “might greatly hold up the smooth running of international trade and might place on banks exceptionally onerous investigations, which they are ill fitted to perform”.<sup>53</sup> Nevertheless, surprisingly, he added:

“It was suggested by Mr. Brodie [for the bank] that the plaintiffs could readily have verified the date the containers were loaded on board by getting in touch with United States Lines [the carrier] at Felixstowe. This is no doubt true but the same can be said of the defendant”.<sup>54</sup>

But this is contradictory. For example, one might ask, how could a bank facing a non-genuine document know who has perpetrated such falsity? How could the bank know if it is the beneficiary, his agents or others without exceptionally onerous investigations? In addition, how could a bank ill fitted to perform onerous investigations, as described by Justice Mocatta, know if the falsity had been perpetrated intentionally to deceive other parties or if it happened innocently? While he claimed that banks should not investigate the underlying facts, he ironically justified the plaintiff’s failure to verify the goods’ loading date by alleging that the bank could know if they contacted the carriers. Indeed, how could the latter’s task be achieved while Justice Mocatta calls for not investigating?

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<sup>52</sup> To this point Justice Mocatta cited *Derry v. Peek* (1889) L.R. 14 App. Cas. 337, which comprises the common law fraud elements.

<sup>53</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada (The American Accord)* [1979] 1 Lloyd’s Rep. 269 at 278

<sup>54</sup> *Ibid.* at 274

Banks, according to Justice Mocatta's approach, which recognise only fraud as a valid defence to payment, are required to pursue onerous investigations to find such information and not the other way around. Under such an approach, a bank might be held liable for a wrongful payment if it paid a beneficiary who presented a non-genuine document which later is found to be fraudulent where fraud is perpetrated by the beneficiary or his agents. In contrast, a bank might be held liable for a wrongful dishonour if it refuses to pay a non-genuine document which later is found to be fraudulently perpetrated by third parties other than the beneficiary and his agents.<sup>55</sup> Moreover, banks might be held liable for damages if it is later found that the falsity has been done innocently. As one commentator puts it:

“It would be surprising if the legal position were that if on the day of tender of documents the issuing bank knew, but the beneficiary did not, that the bill of lading was falsely dated, and the issuing bank were obliged to pay, whereas if the beneficiary did know, the issuing bank were not obliged to pay”.<sup>56</sup>

Here is an example which would better show the results of Justice Mocatta's questionable approach: a documentary credit requires the beneficiary to submit an invoice signed by one of the bank clients (which the bank is familiar with). However, the beneficiary submits an invoice with a false signature. Under such circumstances, what is the bank's duty where it is without a doubt sure about the falsity of the signature? Unfortunately, as can be seen, applying Justice Mocatta's approach, which calls for exempting the banks from exceptionally onerous investigations, ultimately will lead banks to investigate in order to protect their interests. As has been stated recently by one commentator:

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<sup>55</sup> Ademun-Odeke. “Double Invoicing in International Trade: The Fraud and Nullity Exceptions in Letters of Credit-Are the *America Accord* and the UCP 500 Crooks' Charters!?” [2006] *Denning Law journal* 115 at p. 128

<sup>56</sup> Ho, P. ‘Documentary Credit: Null Documents’ [1997] 32 *Hong Kong Lawyer*, at p. 33



“It is submitted that such a restrictive approach although simplistic in theory is difficult to apply in practice. It leads to the already demonstrated dilemmas that this puts the banks in... Consequently, a bank confronted with fraudulent documents will have to work out who committed fraud before it can decide whether to pay or not. Yet banks are supposed to assume no liability or responsibility for the form, sufficiency, genuineness or legal effects of any documents. Furthermore, they are also not supposed to ask any questions and to deal in documents only not goods”.<sup>57</sup>

It is submitted that the better approach is that which limits the bank duty to documents and nothing other than documents. External facts and parties’ intents should be of no relevance to banks. A bank’s decision to accept documents should be confined to a practical criteria and the question of who perpetrated falsity or why it is perpetrated should be irrelevant to the bank.

Justice Mocatta justified the approach he has taken by contending that: “there is no plea either by way of an implied term or by way of a warranty imposed by the law that the presenter of documents under a letter of credit warrants their accuracy”.<sup>58</sup> With respect, if the presenter (the beneficiary) of the documents does not guarantee their accuracy who will do this?<sup>59</sup> If this approach is applied, the essence of the beneficiaries’ transactions which is the shipment of the goods will be relegated into becoming a secondary matter and the main concern will be the documents whatever their source is.<sup>60</sup> Such a statement allows delinquent beneficiaries to demand payment

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<sup>57</sup> Ademun-Odeke. “Double Invoicing in International Trade: The Fraud and Nullity Exceptions in Letters of Credit-Are the *America Accord* and the UCP 500 Crooks’ Charters!?” [2006] *Denning Law Journal* 115 at p. 128. Furthermore, he added at p. 125: “the process puts the banks in jeopardy and makes a mockery of the system. If they do not pay they are crucified by the beneficiary and the courts. If they do pay despite the fraud they are crucified by the buyer and his bank (issuing, corresponding, confirming and paying). Tails they lose heads they do not win”.

<sup>58</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada (The American Accord)* [1979] 1 Lloyd’s Rep. 269 at 278

<sup>59</sup> Sarna, L. “*Letters of Credit: The Law and Current Practice*” (Carswell Legal Publishers, 2<sup>nd</sup> ed., Toronto, 1986) at p. 149; Harfield, H. “*Letters of Credit*” (ALI-ABA Comm, New York, 1979) at p. 41

<sup>60</sup> Ellinger P. & Neo, D. “*The Law and Practice of Documentary Letters of Credit*” (Hart Publishing, Oxford, 2010) at p. 173

where they possess facially conforming documents irrespective of their tenor.<sup>61</sup> In other words, the beneficiaries' worry will be concentrated on documents rather than the goods which are the essence of the transaction between them and buyers.<sup>62</sup> Such an approach if followed would have harmful implications for vigilant sellers, who would know that there is fraud perpetrated in the transaction, and accordingly they will be deprived of payment.<sup>63</sup> In contrast, delinquent reckless sellers will benefit from this approach by merely alleging that they did not know about such a fraud.<sup>64</sup>

Furthermore, such an approach if allowed will give the opportunity to involve unscrupulous agencies who would issue fraudulent documents and flee after. In fact, litigation will not be an adequate remedy in the face of deceived banks or applicants in such situations because finding these fraudsters will be an almost impossible task.<sup>65</sup> Moreover, such a statement overlooks the documents' importance and the role which it plays in international trade transactions. In fact, every document required by the buyer has its own function.<sup>66</sup> A bill of lading is a carrier receipt, a document of title and an evidence of the carriage contract. An insurance policy is the buyer's only way to compensate any loss which might happen to the goods whilst they are in transit. Furthermore, a certificate of origin will be an entrance requisite for the goods by the

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<sup>61</sup> Donnelly, K. 'Nothing for Nothing: A Nullity Exception in Letters of Credit?' [2008] *J.B.L.* Vol.4, 316 at p. 339

<sup>62</sup> Gao, X. "The Identity of the Fraudulent Party under the Fraud Rule in the Law of Letters of Credit" in Byrne, J. & Byrnes, C. (eds.) "*Annual Survey of Letter of Credit Law and Practice*" (Institute of International banking Law and Practice, Inc, 2003) 62 at pp. 74-77

<sup>63</sup> Smith, G. 'Irrevocable Letters of Credit and Third Party Fraud: The American Accord' (1983) 24 *Virginia Journal of International Law* 55, at pp. 70-71

<sup>64</sup> *Ibid.*

<sup>65</sup> Todd, P. "*Bills of Lading and Bankers' Documentary Credits*" (Informa Law, 4<sup>th</sup> ed., London, 2007) at p. 273

<sup>66</sup> Busto, C. 'Are Standby Letters of Credit A Viable Alternative to Documentary credits' (1991) *J.I.B.L.* Vol. 6(2), 72 at p. 72

authorities in different countries. Any of these documents if not stating the truth will jeopardise the bank's and the applicant's interests.<sup>67</sup>

It seems that Justice Mocatta overlooked the fact established in the *Sztejn* case that the documents' genuinity pre-requisite precedes that of the fraud exception application. Justice Mocatta has leaped over the genuinity question, which banks raise usually as a pre-requisite for payment, to discuss the fraud exception which comes later where genuine conforming documents are presented. In the present author's view, the inability to distinguish between these two defences is the first reason which led Justice Mocatta to his conclusion. Blindly applying common law doctrines which have been developed out of the letter of credit context, such as the intentional fraud standard which Mocatta applied, is the second reason.<sup>68</sup> It has been noted by Lord Griffiths that: "It would be most unfortunate if we had to look to the technicalities of our criminal law to determine the validity of international commercial transactions".<sup>69</sup> Finally, exaggerated emphasis on the autonomy principle, which has been created by merchants to protect their interests, in a way which eliminates such interests, is another reason for reaching such a decision. As professor Goode noted:

"Unfortunately, English courts have become so beguiled by the autonomy principle that they decline to allow refusal of payment in favour of a beneficiary acting in good faith even where the documents are forged or otherwise fraudulent, on the supposed principle that the beneficiary's duty is to tender documents which appear to conform to the credit, even if they are in fact fraudulent and worthless. Such an approach, far from enhancing the documentary credit system, does a disservice to its integrity, and it will be argued a little later that it is high time it was abandoned."<sup>70</sup>

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<sup>67</sup> Ellinger, E. "*Documentary Letters of Credit: A Comparative Study*" (University of Singapore Press, Singapore, 1970) at p. 171

<sup>68</sup> Rooy, F. "*Documentary Credits*" (Kluwer Law and Taxation Publishers, Deventer, 1984) at p. 99

<sup>69</sup> Lord Griffiths in *United City Merchants (Investments) Ltd v Royal Bank of Canada (The American Accord)* [1981] 1 Lloyd's Rep. 604 at 633

<sup>70</sup> Goode, R. "*Commercial Law*". (London, 2004) at p. 972

Unsurprisingly, the matter went to the Court of Appeal.<sup>71</sup> The Court of Appeal decision is the core of the next following subsection.

### 3.3.3. The Court of Appeal: genuinity is a pre-requisite

As a repercussion of the decision reached by Justice Mocatta, the case was brought before the Court of Appeal. Stephenson, Ackner and Griffiths L.J.J.<sup>72</sup> respectively were the Bench who ruled the court's verdict. To this Lord Stephenson held:

“...if a document false in the sense that it was forged by a person other than a beneficiary could entitle the bank to refuse payment there was no reason why a document in any way false to the knowledge of a person other than the beneficiary should not have the same effect...here the bill of lading was a dishonest document, it was *not a genuine document* and the defendants were entitled to reject it”.<sup>73</sup>

In choosing who should bear the loss that would ensue from a defective presentment of the documents, between the honest parties involved in a letter of credit (bank, seller and buyer), Lord Stephenson did not hesitate to choose the beneficiary.<sup>74</sup> In his view, it is the beneficiary's duty to obtain such documents and if he dealt with fraudulent parties, it is he, neither the bank nor the applicant, who should bear the consequences of his selection.<sup>75</sup> He further noted that a document should not merely facially accord

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<sup>71</sup> Indeed, it is the seller and his assignees that brought the matter before the Court Appeal. Although they won the above discussed part of the motion, they lost it in another part on the basis of illegality. In fact, half of the glass fibre price was a disguise transaction in order to transfer a sum of money from Peru to the United States, which is prohibited under the Peruvian Law.

<sup>72</sup> L.J.J. is the acronym of Lords Justice of Appeal. The singular is L.J.

<sup>73</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada (The American Accord)* [1981] 1 Lloyd's Rep. 604 at 606 [Emphasis added]. Similarly, see: Lord Denning MR in *Establishment Esefka International Anstall v Central Bank of Nigeria* [1979] 1 Lloyd's Rep 445 at 447: “The documents ought to be correct and valid in respect of each parcel. If that condition is broken by forged or fraudulent documents being presented – in respect of any parcel – the defendants [the bank] have a defence in point of law against being liable in respect of that parcel”

<sup>74</sup> To this point his Lordship cited Davis, A. “*The Law Relating to Commercial Letters of credit*” (The Pitman Press, 3<sup>rd</sup> ed., London, 1963) at p. 145: “If a draft drawn under a credit is forged, the issuing banker is undoubtedly entitled to refuse payment, his undertaking being to pay a valid draft”.

<sup>75</sup> To this point his Lordship further added: “Even though the Judge was not able to find that Baker was the plaintiffs' agent in making the bill of lading for presentation to the defendants, the plaintiffs were the innocent party who put him in the position in which he made the bill, and made it fraudulently, and in my judgement it is they rather than the defendants...who should bear the loss”. *United City Merchants (Investments) Ltd v Royal Bank of Canada (The American Accord)* [1981] 1 Lloyd's Rep.

with the credit requirements but rather it should accord with the facts shown on its face.<sup>76</sup> He supported this view by citing one of Goode's statements which states of the beneficiary that<sup>77</sup>:

“He himself has a duty to tender documents which are in order, and the fact that he acted in good faith in tendering forged documents is thus irrelevant. This fundamental point appears to have been overlooked by Mr. Justice Mocatta...A fraudulently completed bill of lading does not become a conforming document merely because the fraud is that of a third party”.<sup>78</sup>

In his turn, Lord Ackner suggested that the documents in documentary credit transactions might be the only available security for the banks.<sup>79</sup> It is true that a bank does not open documentary credits unless it is assured about its customer's (the documentary credit applicant's) solvency.<sup>80</sup> Nevertheless, where banks are uncertain about the customer's creditworthiness, and to enhance its precautions, it usually requires the documents to be issued for its own order.<sup>81</sup> Such stipulation protects banks in situations where they pay the documentary credit amount and applicants refuse or are unable to reimburse them later due to some difficult financial circumstances.<sup>82</sup> A bank which stipulates that documents should be in its order might

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604 at 623; Sarna, L. “*Letters of Credit: The Law and Current Practice*” (Carswell Legal Publishers, 2<sup>nd</sup> ed., Toronto, 1986) at pp. 184-185

<sup>76</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada (The American Accord)* [1981] 1 Lloyd's Rep. 604 at 620; Harfield, H. “*Letters of Credit*” (ALI-ABA Comm, New York, 1979) at p. 41

<sup>77</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada (The American Accord)* [1981] 1 Lloyd's Rep. 604 at 622

<sup>78</sup> Goode, R. “Reflections on Letters of Credit-I” [1980] *J.B.L.* 291 at p. 294

<sup>79</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada (The American Accord)* [1981] 1 Lloyd's Rep. 604 at 628. His Lordship further added: “The bank is prepared to provide finance to the exporter because it holds shipping documents as collateral security for the advance”.

<sup>80</sup> Ellinger, E. ‘The Tender of Fraudulent Documents under Documentary Letters of Credit’ (1965) 7 *Malaya L. Rev.* 24 at p. 24

<sup>81</sup> Todd, P. “*Bills of Lading and Bankers' Documentary Credits*” (Informa Law, 4<sup>th</sup> ed., London, 2007) at p. 8; Sarna, L. “*Letters of Credit: The Law and Current Practice*” (Carswell Legal Publishers, 2<sup>nd</sup> ed., Toronto, 1986) at p. 40; Finkelstein, H. “*Legal Aspects of Commercial Letters of Credit*” (Columbia University Press, New York, 1930) at p. 238

<sup>82</sup> Sarna, L. “*Letters of Credit: The Law and Current Practice*” (Carswell Legal Publishers, 2<sup>nd</sup> ed., Toronto, 1986) at p. 40; Ellinger, E. “*Documentary Letters of Credit: A Comparative Study*” (University of Singapore Press, Singapore, 1970) at p. 171

sell or at least preserve the goods till the money is paid.<sup>83</sup> Accordingly, his Lordship refused the appellants' allegations and held that a bank which knows that the documents are "waste paper" is under no obligation to accept these documents or to pay against them. He further noted that "To hold otherwise would be to deprive the banker of that security for his advances, which is a cardinal feature of the process of financing carried out by means of the credit".<sup>84</sup>

Ackner L.J. further noted that applying the fraud exception in such circumstances is inadequate. He found that the fraud test had been wrongly applied before the genuinity test and therefore Mocatta J. was mistaken in applying the *ex turpi causa non oritur actio* doctrine.<sup>85</sup> His Lordship observed that to apply the proper test in the proper manner one must go back to the first principles which govern letters of credit operations. In view of that he found for the defendants on the point that a buyer mandates his bank to pay the seller only if the latter presents genuine documents.<sup>86</sup> Conversely, if a non-genuine document is presented it should be refused irrespective of the reason or the identity of the person which makes the document non-genuine because "It is the character of the document, not its origin, that must decide whether

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<sup>83</sup> Todd, P. "Cases and Materials on International Trade Law" (Sweet & Maxwell, London, 2003) at p. 396; *Westpac Banking Corp v Stone Gemini* [1999] FCA 917

<sup>84</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada (The American Accord)* [1981] 1 Lloyd's Rep. 604 at 628

<sup>85</sup> *Ibid.* As noted by Enonchong: "The phrase 'fraud unravels all' is a more accurate translation of the maxim *fraus omnia corrumpit*, which is probably a more precise basis for the exception than the maxim *ex turpi causa non oritur actio*. The latter maxim is more commonly associated with the illegality defence. In some civil law jurisdictions the fraud exception is based on the maxim *fraus Omnia corrumpit*". See: Enonchong, N. "The Independence Principle of Letters of Credit and Demand Guarantees" (Oxford University Press, Oxford, 2011) at p. 97

<sup>86</sup> Todd, P. "Bills of Lading and Bankers' Documentary Credits" (Informa Law, 4<sup>th</sup> ed., London, 2007) at p. 271; Megrah, M. 'Risk Aspects of the Irrevocable Documentary Credit' (1982) 24 *Arizona Law Review* 225, at p. 257

or not it is a “conforming” document, that is a document which complies with the terms of the credit”.<sup>87</sup>

Griffiths L.J. agreed with Ackner L.J. that the identity of the forger is immaterial and that what does count is the document’s genuinity.<sup>88</sup> He further found for the bank in the strict compliance point which dictates that banks are obliged to refuse documents which do not strictly comply with a letter of credit terms.<sup>89</sup> His Lordship found it a strange rule to oblige banks to accept false but facially conforming documents which they are obliged to refuse by the virtue of the strict compliance principle if the documents correctly showed up such a falsity.<sup>90</sup>

In short, the Court of Appeal revived the decision of the *Sztejn* case by applying the genuinity pre-requisite in such a case. Yet when the matter went to the House of Lords another view was reached. The following section is dedicated to investigating the various views raised in this venerable court.

### **3.3.4. The House of Lords: fraud is the only exception**

In the House of Lords, Lord Diplock, with whom other Lords concurred, found the present case a unique case which “falls to be decided by reference to first principles”<sup>91</sup> and reversed the Court of Appeal judgment. It is submitted that his Lordship’s rationalization for the decision is not without its own problems. Indeed, Lord Diplock raised up two debatable key points, namely, the banks’ and sellers’ duty related to

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<sup>87</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada (The American Accord)* [1981] 1 Lloyd’s Rep. 604 at 628

<sup>88</sup> *Ibid.* at 632

<sup>89</sup> The strict compliance principle has been discussed in chapter two.

<sup>90</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada (The American Accord)* [1981] 1 Lloyd’s Rep. 604 at 632. To this effect, his Lordship quoted a statement from the American case *Maurice O’Meara Company v. National Park Bank* (1925) 239 NY 386 which provides that: “The bank’s obligation was to pay sight drafts when prescribed, if accompanied by *genuine documents* specified in the letter of credit”.

<sup>91</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada (The American Accord)* [1983] 1 A.C. 168 at 182

documents and whether the seller acquires the status of a bill of exchange “holder in due course”. Each of these two points is examined below.

#### **3.3.4.1. Banks’ and sellers’ duty: conforming or any documents?**

Lord Diplock observing that “the stipulated documents...constitute a security available to the issuing bank”<sup>92</sup> had cited one of the most related UCP Articles and concluded that the seller and the confirming bank “deal in documents and not in goods”.<sup>93</sup> His Lordship found that, if, on their face, the documents presented to the bank conform to the credit requirements as stipulated by the bank that “bank is under a contractual obligation to the seller to honour the credit”.<sup>94</sup>

Yet, one might ask, even if sellers and bankers only deal in documents, why are the latter obliged to accept documents which they know are not stating the truth. A careful examination of Article 8 of the UCP400, which Lord Diplock relied on in underpinning his aforementioned conclusion, reveals that his Lordship’s approach was mistaken. It is submitted that the main aim of this Article is to protect a good faith banker which accepts documents and pays without knowledge of fraud or falsity, and not to protect delinquent and unscrupulous sellers.<sup>95</sup> Indeed, on this assumption, that they are not responsible for what is behind the face of the documents, banks issue letters of credit.<sup>96</sup> However, to say that banks are obliged to pay documents which are facially conforming while they know that they are not overstates such a duty and

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<sup>92</sup> *Ibid.* at 183

<sup>93</sup> Article 8 of UCP 400

<sup>94</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada (The American Accord)* [1983] 1 A.C. 168 at 183

<sup>95</sup> Goode, R & McKendrick E. “*Goode on Commercial Law*” (Penguin Books, 4<sup>th</sup> ed., London, 2010) at pp. 1084-1085; Demir-Araz, Y. ‘International Trade, Maritime Fraud and Documentary Credits’ [2002] *Int. T.L.R.* Vol. 8(4), 128 at p. 128

<sup>96</sup> Hooley, R. ‘Fraud and Letters of Credit: Part 1’ [2003] *B.J.I.B. & F.L.* Vol. 18(3), 91 at p. 95



makes it a superfluous one.<sup>97</sup> If this Article is applied the way Lord Diplock construed it, it will be with harmful implications for banks and applicants.

It is true that it is an inherited particularity of letters of credit law that banks are not responsible for the goods' condition and that the nature of their obligations is a documentary one.<sup>98</sup> It is true also that banks and applicants do turn a blind eye to the goods, on the assumption that the documents required in the credit evidence the shipment of the agreed goods in the agreed condition, in order to facilitate the trade transaction process.<sup>99</sup> But it goes too far to say that whilst banks and applicants cannot raise disputes regarding the goods' they are obliged to accept any facially conforming documents irrespective of the known contrary facts.<sup>100</sup> Moreover, the suggestion that banks are under an absolute obligation to pay is flawed because banks initially do examine documents and if they conform to the credit requirements they pay.<sup>101</sup> Ironically, it is submitted that applying Lord Diplock's findings would confine banks' responsibility in relation to a letter of credit to only scrutinizing commas and full stops.

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<sup>97</sup> Jeffery, S. 'Standby Letters of Credit and the Fraud exception – An Update' [2003] 18 *B.F.L.R.* 67 at p. 82; Ho, P. 'Documentary Credit: Null Documents' [1997] 32 *Hong Kong Lawyer* at p. 33

<sup>98</sup> See *Gian Singh & Co Ltd v. Banque de l'Indochine* [1974] 1 W.L.R. 1234 at 1238; Bigham J. observations in *Basse and Selve v. Bank of Australasia* (1904), 20 T.L.R. 431; Sifri, J. "Standby Letters of Credit: A Comprehensive Guide" (Palgrave Macmillan, New York, 2008) at p. 197

<sup>99</sup> Enonchong, N. "The Independence Principle of Letters of Credit and Demand Guarantees" (Oxford University Press, Oxford, 2011) at p. 16; Davis, A. "The Law Relating to Commercial Letters of credit" (The Pitman Press, 3<sup>rd</sup> ed., London, 1963) at p. 146

<sup>100</sup> Goode, R & McKendrick E. "Goode on Commercial Law" (Penguin Books, 4<sup>th</sup> ed., London, 2010) at pp. 1084-1085; Donnelly, K. 'Nothing for Nothing: A Nullity Exception in Letters of Credit?' [2008] *J.B.L.* Vol.4, 316 at pp. 342-343; Busto, C. 'Are Standby Letters of Credit A Viable Alternative to Documentary credits' (1991) *J.I.B.L.* Vol. 6(2), 72 at p. 72; Davis, A. "The Law Relating to Commercial Letters of credit" (The Pitman Press, 3<sup>rd</sup> ed., London, 1963) at pp. 149-150

<sup>101</sup> Unfortunately, it has been reiterated by Potter L.J. in *Montrod Limited v. Grundkotter Fleischvertriebs GmbH, Standard Chartered Bank* [2002] 1 W.L.R. 1975 at 1985, that banks are obliged to pay beneficiaries by the virtue of the UCP where documents are facially conforming. In Potter L.J.'s words: "The combination of the autonomy principle and the rule that banks concerned deal in documents and not in goods (articles 3 and 4 [UCP 500]), together with the issuing bank's undertaking of payment if the stipulated documents presented conform with the terms of the credit (see article 9 [UCP 500]) plainly entitled GK as beneficiary to obtain, and obliged SCB as issuing bank to make payment, against the documents' presented, provided that they complied "on their face" with the requirements of the credit". See: Goode, R. 'Abstract Payment Undertakings' in Cane P. & Stapleton, J. (eds.), "Essays for Patrick Atiyah", (Clarendon Press, Oxford, 1991) 209 at p. 229

His Lordship further called for the equation of the different parties' duties involved in a documentary letter of credit transaction.<sup>102</sup> In his opinion, if banks are protected from any unknown contrary facts regarding documents which might be discovered later, there is nothing preventing sellers from enjoying the same protection. To this effect, his Lordship stated:

“It would be strange from the commercial point of view, although not theoretically impossible in law, if the contractual duty owed by confirming and issuing banks to the buyer to honour the credit on presentation of apparently conforming documents despite the fact that they contain inaccuracies or even are forged, were not matched by a corresponding contractual liability of the conforming bank to the seller/beneficiary (in the absence, of course, of any fraud on his part) to pay the sum stipulated in the credit upon presentation of apparently conforming bank”<sup>103</sup>.

With respect, Lord Diplock was unable to distinguish between two dissimilar contractual obligations under a letter of credit transaction.<sup>104</sup> That is to say, contractual obligations between the conforming bank, the issuing bank and the buyer on the one hand, and contractual obligations between the beneficiary and the banks on the other hand. Lord Diplock reached this conclusion after citing one of the UCP Articles which provides that:<sup>105</sup>

“...confirming banks and issuing banks assume no liability or responsibility to one another or to the buyer ‘for the form, sufficiency, accuracy, genuineness, falsification or legal effect of any documents’”<sup>106</sup>.

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<sup>102</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada (The American Accord)* [1983] 1 A.C. 168 at 184-185; see as well: Qiman, L. ‘The Practice of Judicial Preservation for Documentary Credits’ (eds.) in Byrne, J. “2003 Annual Survey of Letter of Credit Law & Practice” (The Institute of International Banking Law & Practice Inc., USA, 2003) at 105 at p. 110

<sup>103</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada (The American Accord)* [1983] 1 A.C. 168 at 184-185

<sup>104</sup> Bridge, M. “*The International Sale of Goods*” (Oxford University Press, 2<sup>nd</sup>, ed., Oxford, 2007) at p. 30; Bridge, M. ‘Documents and Contractual Congruence in International Trade’ (eds.) in Worthington, S. “*Commercial Law and Commercial Practice*” (Hart Publishing, Oxford, 2003) 213 at p. 233; Arora, A. ‘Fraud and Forgery in Commercial Documentary Credits’ [1983] *C.L.B.* 9, 271 at p. 277

<sup>105</sup> Article 9 UCP 400

<sup>106</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada (The American Accord)* [1983] 1 A.C. 168 at 184

Whilst the Article quoted clearly limited its application to the first contractual obligations set out above, it goes too far in saying that this would govern the second contractual obligations set.<sup>107</sup> Whereas it is the seller/beneficiary duty to present genuine conforming documents, the banks' duty is confined to scrutinizing the documents' face unless fraud or falsity is established before them. As has been stated by Jack QC in *Montrod Limited v. Grundkottler Fleischvertriebs GmbH, Standard Chartered Bank*:

“There may be found in the different wording of these articles [UCP] support for a distinction between the rights of beneficiaries to payment, and the rights of banks to reimbursement, namely that beneficiaries must present the correct documents to have a right to payment, not merely documents which appear correct, while banks need only be concerned with the appearance to have a right of reimbursement”.<sup>108</sup>

It is submitted that Lord Diplock's equation of the two different contractual obligations is based on a questionable reasoning.<sup>109</sup> It is in no way correct that the applicant mandates a bank to pay in lieu of non-conforming documents but, in contrast, common sense and commercial motivations advocate the necessity for conforming documents.<sup>110</sup> Moreover, his Lordship's attempts to justify the approach he pursued by highlighting the need to provide “...the seller an assured right to be

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<sup>107</sup> Todd, P. ‘Non-genuine Shipping Documents and Nullities’ [2008] *L.M.C.L.Q.* Vol. 4, 547 at p. 552; Bridge, M. “*The International Sale of Goods*” (Oxford University Press, 2<sup>nd</sup>, ed., Oxford, 2007) at p. 301

<sup>108</sup> [2000] C.L.C. 466 at 477

<sup>109</sup> To this point Lord Diplock, in *United City Merchants (Investments) Ltd v Royal Bank of Canada (The American Accord)* [1983] 1 A.C. 168 at 184, cited *Gian Singh & Co. Ltd v. Banque de L'Indochine* [1974] 1 W.L.R. 1234, and stated: “where the customer was held liable to reimburse the issuing bank for honouring a documentary credit upon presentation of an apparently conforming document which was ingenious forgery, a fact that the bank had not been negligent in failing to detect upon examination of the document”.

<sup>110</sup> Bridge, M. “*The International Sale of Goods*” (Oxford University Press, 2<sup>nd</sup>, ed., Oxford, 2007) at p. 301; Goode, R & McKendrick E. “*Goode on Commercial Law*” (Penguin Books, 4<sup>th</sup> ed., London, 2010) at p. 1105; Finkelstein, H. “*Legal Aspects of Commercial Letters of Credit*” (Columbia University Press, New York, 1930) at p. 239; Thayer, P. ‘Irrevocable Credits in International Commerce: Their Legal Effects’ (1937) 37 *Colum. L. Rev.* 1326 at p. 1335

paid before he parts with control of the goods”<sup>111</sup> is taken from a one sided perspective and therefore is untenable.<sup>112</sup> While his Lordship assured on the seller aspect of the bargain, yet one might ask, what about the bank and the applicant aspects?<sup>113</sup> Indeed, any contract contains more than one party and each of these parties has its own aspirations and expectations under such contract. Overemphasising the right of one of these parties more than the others will inevitably lead the latter to avoid utilising this kind of contract.<sup>114</sup>

#### **3.3.4.2. *Is a documentary credit’s seller a bill of exchange “holder in due course”?***

Lord Diplock further found for the plaintiffs in relation to what can be described “the holder in due course” point. Matching the rights of the documentary credits’ beneficiaries with that of bills of exchange holders in due course under the American Uniform Commercial Code<sup>115</sup> directed his Lordship to suggest:

“...I see no reason why, and there is nothing in the Uniform Commercial Code to suggest that, a seller/beneficiary who is ignorant of the forgery should be in any worse position because he has not negotiated the draft before presentation”<sup>116</sup>.

Indeed, it is undeniable that the law of negotiable instruments is connected to that of letters of credit as many of the latter stipulate for the former to be presented with the seller’s documents in order to obtain payment. Furthermore, for example, Professor

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<sup>111</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada (The American Accord)* [1983] 1 A.C. 168 at 183

<sup>112</sup> Mann, R. ‘The Role of Letters of Credit in Payment Transactions’ (2000) 98 *Mich. L. Rev.* 2494 at p. 2512

<sup>113</sup> Murray, D. ‘Letters of Credit and Forged and Altered Documents: Some Deterrent Suggestions’ (1993) 98 *Com. L.J.* 504 at p. 504

<sup>114</sup> Murray, C. Holloway, D & Timson-Hunt, D. “*Schmitthoff’s Export Trade: The Law and Practice of International Trade*” (Sweet & Maxwell, 11<sup>th</sup> ed., London, 2007) at pp. 238-239

<sup>115</sup> The Uniform Commercial Code is a statutory code which regulates the different commercial aspects in the United States of America. Article 5 of this Code is the one concerned with letters of credit.

<sup>116</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada (The American Accord)* [1983] 1 A.C. 168 at 187-188. In the same manner, it has been stated earlier that: “A letter of credit is like a bill of exchange given for the price of the goods. It ranks as cash and must be honoured... Whereas a bill of exchange is given by buyer to seller, a letter of credit is given by a bank to seller”. Per Lord Denning M.R. in *Power Curber International Ltd v National Bank of Kuwait* [1981] 1 W.L.R. 1233 at 1241

Kozolchyk claims that a documentary letter of credit belongs to “the realm of negotiable instrument law”.<sup>117</sup> Interestingly, one court took a further step and stated that: “[a] letter of credit is like a bill of exchange...it ranks as cash and must be honoured”.<sup>118</sup>

However, while the historical roots of bills of exchange and letters of credit are close, one cannot ignore that both instruments serve different functions and are utilised by different parties to serve different expectations.<sup>119</sup> Unfortunately, the use overlap between the two instruments made Lord Diplock construe it as their being identical.

In contrast, as one commentator suggests:

“The analogy of letters of credit to bills of exchange, while of value in many ways, has its limitations. This might be expected in view of the rather specialized function which the modern documentary credit has come to perform”.<sup>120</sup>

Hence, applying legal doctrines which have been tailored to serve negotiable instruments’ particular characteristics to documentary letters of credit without fully considering its implications is inadequate.<sup>121</sup> It is suggested that the application of the “holder in due course” doctrine, which is an inherited feature of bills of exchange law, to the letters of credit law in the manner which Lord Diplock has pursued in respect of beneficiaries is not without its own pitfalls.<sup>122</sup> As Stephenson L.J. in the Court of

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<sup>117</sup> Kozolchyk, B. ‘The Legal Nature of irrevocable Commercial Letters of Credit’ (1965) 14 *Am. J. Com. L.*, 395 at p.418

<sup>118</sup> Lord Denning M.R in *Power Curber International Ltd v National Bank of Kuwait SAK* [1981] 1 W.L.R. 1233, at 1241

<sup>119</sup> Ellinger, E. ‘The Autonomy of Letters of Credit after the American Accord’ [1983] *A.B.L.R.* 118 at p. 128

<sup>120</sup> T, R. ‘Letters of Credit-Negotiable instruments’ (1926) 31 *Yale.L.J.* 245, at pp. 253-254

<sup>121</sup> Rooy, F. “*Documentary Credits*” (Kluwer Law and Taxation Publishers, Deventer, 1984) at p. 99

<sup>122</sup> Goode, R & McKendrick E. “*Goode on Commercial Law*” (Penguin Books, 4<sup>th</sup> ed., London, 2010) at pp. 1105-1106; Donnelly, K. ‘Nothing for Nothing: A Nullity Exception in Letters of Credit?’ [2008] *J.B.L.* Vol.4, 316 at p. 327; Ellinger, E. ‘The Autonomy of Letters of Credit after the American Accord’ [1983] *A.B.L.R.* 118 at p. 128. Contrary views to that of Lord Diplock have been expressed by the Singapore High Court in *Lambias (Importers & Exporters) Co Pte Ltd v Hong Kong & Shanghai Banking Corp* [1993] 2 S.L.R. 751; *Beam Technology (MFG) PTE Ltd v Standard Chartered Bank* [2003] 1 S.L.R. 597 at 610

Appeal noted, a letter of credit "... is not a negotiable instrument, though it resembles a bill of exchange or a cheque in some respects".<sup>123</sup>

The "holder in due course" doctrine has been attached by merchants to bills of exchange to serve a special need.<sup>124</sup> The lack of currency and the fear of theft or losing the money while traders are on their long commercial trips are the reasons behind bringing up bills of exchange to practice.<sup>125</sup> Consequently, to help bills of exchange perform these functions it has inevitably been necessary to insert the "holder in due course" rule in order to ensure the effectiveness of such an instrument.<sup>126</sup> Such a doctrine gives the party holding a bill of exchange the merit of the right to return to any of those who previously accepted or negotiated the bill and to ask for payment notwithstanding any dispute between those latter parties.<sup>127</sup> This doctrine was inserted to encourage parties to become engaged in transactions that contain bills of exchange on the assurance that they will get paid irrespective of any defence which might arise from previous dealings.<sup>128</sup> Indeed, those new holders might not know anything about other distant parties involved in the bill of exchange or the

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<sup>123</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada (The American Accord)* [1981] 1 Lloyd's Rep. 604 at 612

<sup>124</sup> Kobrin, D. & Stott, V. "Negotiable Instruments" (Anderson Keenan Publishing, 1<sup>st</sup> ed., London, 1980) at p. 25; Chuah, J. 'Is There a Nullity Defence in Documentary Credits?' [2002] *F. & C.L.* 1, 3 at pp. 3-4. The concept holder in due course was first used in England's Bills of Exchange Act of 1882. Before that it was known as a bona fide purchaser or assignee.

<sup>125</sup> As one commentator provided: "The holder in due course doctrine had two primary functions, both of which can now be better performed by other means. One function was to create a currency substitute, greatly needed in the seventeenth and eighteenth centuries when there was insufficient currency and inadequate means to transport the currency for the economy of the day... Another function of the holder in due course doctrine was to make negotiable instruments more easily transferable by removing a great barrier to their transferability, the fear that the maker of a note will have a defense to it". See: Eggert, K. 'Help Up in Due Course: Codification and the Victory of Form Over Intent in Negotiable Instrument Law' (2002) 35 *Creighton L. Rev.* 363 at p. 376

<sup>126</sup> As one Appellate Court had noted: "The purpose of conferring HDC [holder in due course] status is to encourage and facilitate the circulation of commercial paper. It is sometimes said that the holder in due course doctrine is like oil in the wheels of commerce and that those wheels would grind to a quick halt without such lubrication". See: *W. State Bank v. First Union Bank & Trust Co.*, 360 N.E.2d 254, 258 (Ind. Ct. App. 1977)

<sup>127</sup> Carr, I. "International Trade Law" (Cavendish Publishing, 3<sup>rd</sup> ed., 2005) at p. 468

<sup>128</sup> Eggert, K. 'Help Up in Due Course: Codification and the Victory of Form Over Intent in Negotiable Instrument Law' (2002) 35 *Creighton L. Rev.* 363 at p. 375; Ellinger, E. 'The Autonomy of Letters of Credit after the American Accord' [1983] *A.B.L.R.* 118 at p. 128

reason why it was issued. Common sense and commercial marketability in allocating the risk of these defences necessitated putting the risk on previous parties.<sup>129</sup> The main reason for such allocation is that those previous parties were in a better position than the latter holders to find out any defence which might be discovered later.<sup>130</sup> Hence, the urgent need for such a doctrine for such commercial instruments is appreciated.

However, to say that this doctrine applies to a documentary letter of credit beneficiary is erroneous and inconsistent because the commercial purpose and the parties' expectations are totally different in each instrument.<sup>131</sup> Unlike a bill of exchange, the beneficiary under a documentary letter of credit is a seller who is required to carry out some duties which can be proven by documents in order to get paid.<sup>132</sup> The seller's position cannot be equated with that of a holder in due course in a bill of exchange transaction.<sup>133</sup> Such a seller is not a stranger person to the underlying transaction which led to the issuance of the documentary credit, but rather the seller himself is the person who is supposed (in most cases) to manufacture, insure and send the goods with the properly contracted for documents.<sup>134</sup>

While the beneficiary can, after presenting the documents if accompanied with a bill of exchange, negotiate the bank's accepted draft with a third party resulting in the

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<sup>129</sup> Eggert, K. 'Help Up in Due Course: Codification and the Victory of Form Over Intent in Negotiable Instrument Law' (2002) 35 *Creighton L. Rev.* 363 at p. 366; Goode, R. 'Abstract Payment Undertakings' in Cane P. & Stapleton, J. (eds.), "*Essays for Patrick Atiyah*", (Clarendon Press, Oxford, 1991) 209 at p. 211

<sup>130</sup> Eggert, K. 'Help Up in Due Course: Codification and the Victory of Form Over Intent in Negotiable Instrument Law' (2002) 35 *Creighton L. Rev.* 363 at p. 366

<sup>131</sup> Goode, R & McKendrick E. "*Goode on Commercial Law*" (Penguin Books, 4<sup>th</sup> ed., London, 2010) at pp. 1105-1106; Murray, C. Holloway, D & Timson-Hunt, D. "*Schmitthoff's Export Trade: The Law and Practice of International Trade*" (Sweet & Maxwell, 11<sup>th</sup> ed., London, 2007) at p. 190; Rooy, F. "*Documentary Credits*" (Kluwer Law and Taxation Publishers, Deventer, 1984) at p. 99; Harfield, H. "*Letters of Credit*" (ALI-ABA Comm, New York, 1979) at p. 2

<sup>132</sup> Goode, R. "Reflections on Letters of Credit-I" [1980] *J.B.L.* 291 at p. 294

<sup>133</sup> Harfield, H. "*Letters of Credit*" (ALI-ABA Comm, New York, 1979) at p. 2

<sup>134</sup> Horowitz, D. "*Letters of Credit and Demand Guarantees: Defences to Payment*" (Oxford University Press, 2010) at p. 48

latter being a holder in due course that cannot make the former a holder in due course.

According to Ackner L.J:

“We do not have to consider the complications which may arise when a claim is made under a letter of credit by a bona fide holder for value of, for example, a draft, because what was forged and false here was not a draft but a bill of lading and the point that the plaintiffs were bona fide holders for value was not raised at the trial”.<sup>135</sup>

Courts should take into consideration that the motives which led to the creation of documentary credits is not the same as that of bills of exchange. A court, accordingly, before establishing hasty dictums, has to ask itself: what are the different parties' expectations under these commercial instruments? Are the dictums it is applying consistent with these expectations? If not, it is suggested that it would probably be better if it tries to find an approach which is acceptable to all.

#### **3.3.4.3.      *The conclusion: fraud is the only exception***

Lord Diplock restored the judgement of Justice Mocatta which the latter provided in the Court of first instance. His Lordship, in relation to the autonomy principle, found one established exception, namely:

“...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”.<sup>136</sup>

This exception requires the existence of intent by the beneficiary to defraud other parties or at least the knowledge of such fraud.<sup>137</sup> Yet, the difference between Lord

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<sup>135</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada (The American Accord)* [1981] 1 Lloyd's Rep. 604 at 623

<sup>136</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada (The American Accord)* [1983] 1 A.C. 168 at 186-187 [Emphasis added]

<sup>137</sup> His Lordship underpinned the reached exception by citing the *Sztejn* Case. In his words: “Although there does not appear among the English authorities any case in which the exception has been applied, it is well established in the American cases of which the leading or ‘landmark’ case is *Sztejn v. J. Henry Schroder*”. See *United City Merchants (Investments) Ltd v Royal Bank of Canada (The American Accord)* [1983] 1 A.C. 168 at 183



Diplock and Mocatta J.'s exceptions is the added on materiality requirement.<sup>138</sup> It is submitted that this further requirement (materiality), at this stage, places on the banks a greater burden of investigation which supposedly they are exempted from by the virtue of the autonomy principle.<sup>139</sup> Unfortunately, in accordance with what his Lordship found, if they select not to pay, banks presented with non-genuine documents have to prove that there is intent or knowledge of fraud on the beneficiary's side and that such fraud is material. In spite of all these conditions which require banks' external investigations, English courts still claim that they are maintaining the autonomy principle.

Remarkably, his Lordship further stated that "The courts will not allow their process to be used by a dishonest person to carry out a fraud".<sup>140</sup> However, applying the *maxim ex turpi causa non oritur actio* doctrine which his Lordship employed leads to the conclusion that "The instant case, however, does not fall within the fraud exception".<sup>141</sup> Therefore, it is correct to say that English courts will eliminate fraud but, unfortunately, that elimination is limited to the fraud of beneficiaries and not all fraud. Fraud of other parties will be allowed to go unpunished.

After all the motives which he alleged as the foundation of his, described as "unnecessary and erroneous",<sup>142</sup> judgement, Diplock L.J argued that to accept the non-genuinity pre-requisite "would embrace the fraud exception and render it

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<sup>138</sup> It has been argued by the defendants' Counsel that: "By 'material inaccuracy' is meant an inaccurate statement in respect of any matter which the letters of credit requires to be in the documents. It would thus include, in the present case, the misstatement of the loading port and of the shipment day". See *United City Merchants (Investments) Ltd v Royal Bank of Canada (The American Accord)* [1983] 1 A.C. 168 at 175

<sup>139</sup> Todd, P. "Bills of Lading and Bankers' Documentary Credits" (Informa Law, 4<sup>th</sup> ed., London, 2007) at p. 236

<sup>140</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada (The American Accord)* [1983] 1 A.C. 168 at 183

<sup>141</sup> *Ibid.* at 184

<sup>142</sup> Arora, A. 'Fraud & Forgery in Commercial Documentary Credits' (1983) 9 *C.L.B.*, 271 at p. 277

superfluous” and that it would “undermine the whole system of financing international trade by means of documentary credit”.<sup>143</sup> Indeed, his approach has been strongly criticised.<sup>144</sup> With respect, a moment’s reflection would show that the contrary is the sound approach. In Goode’s words:

“The root of the difficulty underlying Lord Diplock’s reasoning lies in the conflation of two distinct principles of documentary credit law. The first is that the documents must conform to the credit; the second, that fraud on the part of the beneficiary or his agent absolves the bank of its duty to pay. Where a document is forged, the fraud involved is potentially relevant not only *qua* fraud but as rendering the document non-conforming. Forgery as fraud is not a defence within the second principle unless perpetrated by the beneficiary or his agent. *What was overlooked by the House of Lords in the American Accord is that the selfsame forgery also means that the document is not genuine and cannot, therefore, be a confirming document*”.<sup>145</sup>

The *raison d’être* for what the House of Lords in the *American accord* reached was the conflation between two distinct defences, namely non-genuinity (non-conformity) and fraud. Applying the question of fraud before that of non-genuinity is what led Lord Diplock to reach his conflated decision. The current author agrees with Goode’s view that: “what should have been the threshold question, namely conformity with the

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<sup>143</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada (The American Accord)* [1983] 1 A.C. 168 at 184

<sup>144</sup> Low, H.Y. ‘Confusion and Difficulties Surrounding the Fraud Rule in Letters of Credit: An English Perspective’ [2011] *Int. J.L.M.* 17(6), 462 at p. 466; Goode, R & McKendrick E. “*Goode on Commercial Law*” (Penguin Books, 4<sup>th</sup> ed., London, 2010) at p. 1104; Todd, P. “*Maritime Fraud and Piracy*” (Lloyd’s List, 2<sup>nd</sup> ed., London 2010) at p. 138; Horowitz, D. “*Letters of Credit and Demand Guarantees: Defences to Payment*” (Oxford University Press, 2010) at p. 24; Murray, C. Holloway, D & Timson-Hunt, D. “*Schmitthoff’s Export Trade: The Law and Practice of International Trade*” (Sweet & Maxwell, 11<sup>th</sup> ed., London, 2007) at pp. 238-239; Ulph, J. “*Commercial Fraud: Civil Liability, Human Rights, and Money Laundering*” (Oxford University Press, Oxford, 2006) at p. 514; Gao, X. ‘The Identity of the Fraudulent Party under the Fraud Rule in the Law of Letters of Credit’ (eds.) in Byrne, J. “*2003 Annual Survey of Letter of Credit Law & Practice*” (The Institute of International Banking Law & Practice, Inc., USA, 2003) 62; Buckley, R. ‘Potential Pitfalls with Letters of Credit’ (1996) *A.L.J.* Vol. 70, 217 at p. 226; Ellinger, E. ‘Documentary Credits and Fraudulent Documents’ (eds.) in Chinkin, C., Ho, P. & Chan, H. “*Current Problems of International Trade Financing*” (National University of Singapore, 2<sup>nd</sup> ed., 1990) 139 at p. 148; Fellingner, G. ‘Letters of Credit: The Autonomy Principle and the Fraud Exception’ [1990] 1 *J.B.F.L.P.* 4 at p. 25; Arora, A. ‘Fraud & Forgery in Commercial Documentary Credits’ (1983) 9 *C.L.B.*, 271 at p. 277; Houten, S. ‘Letters of Credit and Fraud: A Revisionist View’ (1984) 62 *Can. Bar. Rev.* 371 at p. 372

<sup>145</sup> Goode, R. “Abstract payment undertakings” in Cane, P. & Stapleton, J. (eds.) “*Essays for Patrick Atiyah*” (Oxford, 1991) 209 at p. 232 [Emphasis added]

credit, was submerged beneath what should have been the second-stage question, the defence of fraud.”<sup>146</sup>

Yet this was not the end of the story. Lord Diplock’s last words in this case kept the hope for non-genuinity to apply as an exception in some limited situations. To that effect, his Lordship stated:

“I would prefer to leave open the question of the rights of an innocent seller/beneficiary against the confirming bank when a document presented by him is a nullity because unknown to him it was forged by some third party; for that question does not arise in the instant case”.<sup>147</sup>

The last statement regarding what is described as a null document, and whether the case should be different if a document presented to a bank is null, comprises the focus of the discussion in the remaining parts of this chapter.

### 3.4. The nullity exception

#### 3.4.1. Introduction

As seen above, Lord Diplock seemed to be accepting that what he held in the *American Accord* might not be applied when a document is a null one. Consequently a demand arose for recognising nullity as a separate exception that exempts banks and applicants from their obligation to pay. Bridge,<sup>148</sup> Hooley<sup>149</sup>, Neo<sup>150</sup> and many others were amongst those who demanded the recognition of such an exception.<sup>151</sup> They

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<sup>146</sup> *Ibid.*

<sup>147</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada (The American Accord)* [1983] 1 A.C. 168 at 188

<sup>148</sup> Bridge, M. ‘Documents and Contractual Congruence in International Trade’ (eds.) in Worthington, S. “*Commercial Law and Commercial Practice*” (Hart Publishing, Oxford, 2003) 213; Bridge, M. “*The International Sale of Goods*” (Oxford University Press, 2<sup>nd</sup> ed., Oxford, 2007) at p. 301

<sup>149</sup> Hooley, R. ‘Fraud and Letters of Credit: Is there a Nullity Exception?’ [2002] *C.L.J.*, 279

<sup>150</sup> Neo, D, ‘A Nullity Exception in Letter of Credit Transactions?’ [2004] *Singapore Journal of Legal Studies* 46

<sup>151</sup> Lu, L. ‘The Fraud Rule in Documentary Credits’ [2009] *Plymouth L. Rev.* 1, 157 at p. 167; Donnelly, K. ‘Nothing for Nothing: A Nullity Exception in Letters of Credit’ [2008] *J.B.L.* 316; Ademun-Odeke, ‘Double Invoicing in International Trade: The Fraud and Nullity Exceptions in Letters of Credit-Are the *America Accord* and the UCP 500 Crooks’ Charters!?’ [2006] *Denning Law Journal*

suggest that if banks have a significant interest in the documents as one of the main securities available, there is nothing that prevents them from refusing to pay when presented with such worthless documents. Indeed, at the first glance and without taking into consideration the implications of it, one might be taken by the attractiveness of this proposition. Yet, before getting into argument with the commentators who favour recognising a nullity exception some questions arise: what is the meaning of nullity? When can it be said that a certain document is a null one? Is the fact of being null confined to certain documents rather than other documents? Is there any correlation between the fraud exception and the demanded nullity exception? The subsequent sections of this chapter carry the answer.

#### **3.4.2. When a document can be considered as null?**

Part of the answers to the questions raised above can be found in the *American accord* case which is indisputably the seminal English case in regard to the discussion of fraud and nullity. Lord Diplock in respect of the nullity point noted that:

“The bill of lading with the wrong date of loading placed on it by the carrier’s agent was far from being a nullity. It was a valid transferable receipt for the goods giving the holder a right to claim them at their destination, Callao, and was evidence of the terms of the contract under which they were being carried”<sup>152</sup>

In *Kwei Tek Chao v. British Traders and Shippers*<sup>153</sup> a bank paid the seller after the presentation of a backdated bill of lading. The buyer brought an action for damages against the seller alleging that a fraudulently backdated bill of lading is a null

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115; Chin, L. & Wong, Y. ‘Autonomy – A Nullity Exception at Last?’ [2004] *L.M.C.L.Q.* 14 at p. 18; Ho, P. ‘Documentary Credit: Null Documents’ [1997] *Hong Kong Lawyer*, 32. It is noteworthy that the Singapore courts have accepted the nullity exception in *Beam Technologies v standard chartered bank* [2003] 1 SLR 597. In that case, payment under the credit was to be made against a clean set of air waybills issued by freight forwarders, Link Express (s) Pte Ltd. The air waybills were duly presented, though there was no such entity as Link Express (s) Pte Ltd. The Singapore Court of Appeal found that such a document was a nullity and therefore entitled the bank to refuse the documents when they were presented by the seller.

<sup>152</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada (The American Accord)* [1983] 1 A.C. 168 at 188

<sup>153</sup> [1954] 2 Q.B. 459

document. The House of Lords refused the buyer's allegations and held that not every forgery would render a document null and void. Lord Devlin held that the bill of lading in this case was "valueless but not a complete nullity".<sup>154</sup> The court found that to constitute a nullity it is necessary that the forgery "goes to the essence of the instrument" and "corrupts the whole of the instrument or its heart".<sup>155</sup> The dictum held in the cases above finds more support in *Lombard Finance v. Brookplain Trading*<sup>156</sup> where the court held that what constitutes a nullity is limited to a forgery which goes to the essence of a certain document. Similarly, in the *American Accord* Court of Appeal, Lord Ackner rejected the bank submission that backdating a bill of lading would render it a nullity.<sup>157</sup> He found that "...a bill of lading on which the date of shipment has been forged is not a nullity, since such a forgery would not go to the essence of the document."<sup>158</sup> Stephenson L.J., basing his suggestions on the Forgery Act 1913,<sup>159</sup> provided some hints as to what can constitute a nullity and what cannot.

In his words:

"A document may tell a lie about itself, e.g., about the person who made it, or the time or place of making. If it tells a lie about the maker, it is a forgery; if it tells a lie about the time or place of making "where either is material", it is a forgery... *In the former case it may be a nullity; in the latter not*".<sup>160</sup>

However, in *Ruben and Another v. Great Fingall Consolidated and Others*,<sup>161</sup> where the maker of a share certificate himself forged the document, Lord Loreburn held that

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<sup>154</sup> *Kwei Tek Chao v. British Traders and Shippers* [1954] 2 Q.B. 459 at 475-476

<sup>155</sup> *Ibid.* at 476

<sup>156</sup> [1991]1 W.L.R. 271

<sup>157</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada (The American Accord)* [1981] 1 Lloyd's Rep. 604 at 618

<sup>158</sup> *Ibid* at 628

<sup>159</sup> Section 1(2)

<sup>160</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada (The American Accord)* [1981] 1 Lloyd's Rep. 604 at 618 [Emphasis added]

<sup>161</sup> [1906] A.C. 439

the forged certificate is a “pure nullity”.<sup>162</sup> Similarly, in *Kreditbank Cassel G.m.b.H. v. Schenkers, Ltd.*,<sup>163</sup> Bankes L.J. held that a document forged in any respect is a null and void. Moreover, in *Egyptian International Foreign Trade v. Soplex Wholesale Supplies (The Raffaella)*<sup>164</sup> Leggatt J. found that a misdated bill of lading was a “sham piece of paper”.<sup>165</sup>

Moreover, legal scholars have their own view in this regard. For example, one commentator found that nullity as an exception is confined to situations where an element of fraud is existent. In his opinion “...fraud by third parties should be recognised by English law as an independent and separate nullity exception”.<sup>166</sup> Hedley was of the view that “All forgeries are nullities”.<sup>167</sup> Another commentator suggests that an element of fraud is unnecessary and that an innocent mistake may result in the document being null.<sup>168</sup>

### 3.4.3. The nullity exception quarrel

As it can be seen above, a clear and sustainable test does not exist at least in determining when a document is null or not.<sup>169</sup> In Lord Diplock’s view, the one day difference, between the time stipulated in the documentary letter of credit and the

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<sup>162</sup> [1906] A.C. 439 at 443

<sup>163</sup> [1927] 1 K.B. 826

<sup>164</sup> [1984] 1 Lloyd’s Rep. 102

<sup>165</sup> *Egyptian International Foreign Trade v. Soplex Wholesale Supplies (The Raffaella)* [1984] 1 Lloyd’s Rep. 102 at 116

<sup>166</sup> Ademun-Odeke. “Double Invoicing in International Trade: The Fraud and Nullity Exceptions in Letters of Credit-Are the *America Accord* and the UCP 500 Crooks’ Charters!?” [2006] *Denning Law Journal* 115 at p. 115. See as well: Malek, A & Quest, D. “*Jack: Documentary Credits*” (Tottel Publishing, 4<sup>th</sup> ed., Sussex, 2009) at p. 256

<sup>167</sup> Hedley, W. & Hedley, R. “*Bills of Exchange and Bankers’ Documentary Credits*” (LLP Professional Publishing, 4<sup>th</sup> ed., London, 2001) at p. 104. See as well: Mugasha, A. “*The Law of Letters of Credit and Bank Guarantees*” (Federation Press, Sydney, 2003) at p. 144

<sup>168</sup> Ho, P. ‘Documentary Credit: Null Documents’ [1997], *Hong Kong Lawyer*, 32 at p. 32. See as well: Bridge, M. “*The International Sale of Goods*” (Oxford University Press, 2<sup>nd</sup> ed., Oxford, 2007) at pp. 298-299

<sup>169</sup> Enonchong, N. “*The Independence Principle of Letters of Credit and Demand Guarantees*” (Oxford University Press, Oxford, 2011) at p. 152; Ellinger P. & Neo, D. “*The Law and Practice of Documentary Letters of Credit*” (Hart Publishing, Oxford, 2010) at p. 173; Donnelly, K. ‘Nothing for Nothing: A Nullity Exception in Letters of Credit?’ [2008] *J.B.L.* Vol.4, 316 at p. 317; Chin, L. & Wong, Y. ‘Autonomy – A Nullity Exception at Last?’ [2004] *L.M.C.L.Q.* 14 at p. 17

actual shipment day, was insignificant. In his opinion, the non-genuine bill of lading in that case was far from demonstrating nullity and therefore this “would not justify the confirming bank’s refusal to honour the credit in the instant case” as “the realisable value on arrival at Callao could not be in any way affected by its having been loaded on board a ship at Felixstowe on December 16, instead of December 15, 1976”.<sup>170</sup> But, how and why did the House of Lords in *American Accord* reach the conclusion that the bill of lading in that case was not a nullity? If the “realisable value” test Lord Diplock applied is the appropriate one, how did he ensure that the goods’ price would not be affected on its arrival at Callao?<sup>171</sup>

Letters of credit are utilised purely by parties with tough commercial minds who should be committed to their own words. Thus, if the terms manifested on the face of a documentary credit are construed by courts in a way which does not take into consideration what it means, then the whole purpose of such instruments will be undermined resulting in their being abandoned.<sup>172</sup> Following the approach of Lord Diplock’s thinking, one might sympathetically argue that a one day difference between what was stipulated in both the documentary credit and the underlying contract and the actual day of shipment is trivial and therefore entitles the seller to get paid.<sup>173</sup> Ironically, by the same token, another seller might argue that a two or three days’ difference is also insignificant entitling him to obtain payment. Accordingly, difficult questions which are not easy to answer arise: where should courts place the boundary between what could be a nullity and what could not? How many days

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<sup>170</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada (The American Accord)* [1983] 1 A.C. 168 at 186

<sup>171</sup> Leacock, S. ‘Fraud in the International Transaction: Enjoining Payment of Letters of Credit in International Transactions’ [1984] *Vand. J. Transnat’l L.* 885 at p. 916. In Leacock’s view the day difference in the *United City Merchants* case was material and the bank was right to refuse the bill of lading.

<sup>172</sup> Bridge, M. ‘Documents and CIF Contracts’ [1998] *Amicus Curiae* Vol. 3, 4 at p. 6

<sup>173</sup> Carr, I. “*International Trade Law*” (Cavendish Publishing, 3<sup>rd</sup> ed., 2005) at p. 503; Ventris, M. “*Bankers’ Documentary Credits*” (Lloyd’s of London Press Limited, 3<sup>rd</sup> ed., London, 1990) at p. 123

should a seller be allowed to delay till the document which he presents could be considered as a nullity?

It can be suggested that even a one day difference could result in the document being a nullity.<sup>174</sup> For example, concurrently, a buyer of a meat consignment himself could be a seller for the same consignment to a third party. The contract between him and his own buyer stipulates for the 20<sup>th</sup> of March as the last day to deliver the meat. The buyer in this chain of contracts knows that the shipment needs 15 days till it arrives at his local port and accordingly asks his seller to send the meat on the 5<sup>th</sup> of March in order to reship it on the 20<sup>th</sup> to his own buyer. Notwithstanding this fact if the meat is sent on the 6<sup>th</sup> of March then it will certainly reach the buyer's port on the 21<sup>st</sup> of March. As a result, the second buyer would lawfully reject the documents submitted by the first buyer where it states the 21<sup>st</sup> of March as the shipment date.

One might argue that even if the second buyer in such a chain of contracts refused the goods, the first buyer could sell it to any other person. In fact, such a suggestion is true as the buyer could sell the goods and he might make more profit. However, there is a possibility that he will sustain a large loss also. The buyer imported the meat on the assumption that there is another buyer who is ready to get the consignment directly and for a profit. The former did not import without being sure that there was a buyer standing by. Yet to say that he is still in a good position to sell the goods for the same price or even more is erroneous as the goods might perish before the buyer could find someone to buy the meat. Moreover, he might face a falling unstable

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<sup>174</sup> Low, H.Y. 'Confusion and Difficulties Surrounding the Fraud Rule in Letters of Credit: An English Perspective' [2011] *Int. J.L.M.* 17(6), 462 at p. 467; Arora, A. 'Fraud and Forgery in Commercial Documentary Credits' [1983] *C.L.B.* 9, 271 at p. 276



market resulting in a large loss.<sup>175</sup> There is also the possibility that a day's difference might cause many other days of stoppage in various ports due to different holidays, strikes or any other unforeseen events. Furthermore, as the bank's counsel argued in the *American Accord*:

“There is also the matter of insurance. If a buyer purchases on an f.o.b. contract, the buyer will himself insure and the buyer will have to declare the date of shipment and the nature of the goods. The date may be critical if the market is very volatile. The fact that the false date is very close to the true date may nevertheless in the circumstances have considerable financial implications.”<sup>176</sup>

A day's difference would result in the goods' being out of the insured period of time. Accordingly, a buyer who insures for the envisaged 15 days of shipment might be unable to obtain any compensation from his insurance company should the ship carrying his goods have an accident or sink on the 16<sup>th</sup> day which is out of the insured period. This begs the question: who would compensate the buyer in such circumstances?

As has been noted in the *American Accord* case: “The nullity test put forward by the appellants is not sustainable.”<sup>177</sup> That is to say, in deciding whether a certain document is null or not, many factors should be considered such as the underlying contracts, the parties' intentions and the nature of the goods. As seen above, the nullity concept is not yet fully developed by English courts. What is meant by nullity will differ from one judge to another judge and from one court to another. Since many

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<sup>175</sup> Low, H.Y. ‘Confusion and Difficulties Surrounding the Fraud Rule in Letters of Credit: An English Perspective’ [2011] *Int. J.L.M.* 17(6), 462 at p. 467

<sup>176</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada (The American Accord)* [1983] 1 A.C. 168 at 174

<sup>177</sup> *Ibid* at 176

of these judges are not letters of credit specialists, one can expect flawed doubtful decisions where certainty is of vital importance.<sup>178</sup>

Where courts are confused in determining when a certain document is a nullity, the following pertinent questions may arise: what are the banks' obligations in this respect? How could a bank that is poorly equipped to investigate external facts establish whether a certain document is a nullity or not?<sup>179</sup> How could it assess an applicant's allegation that a bill of lading is null and void in the light of the aforementioned "goes to its essence" or the "realisable value" tests which English courts failed to settle on? As one commentator puts it:

"...the banker is not concerned as to whether the documents stipulated by the buyer serve any useful commercial purpose or as to why the customer called for tender of a document or a particular description or as to the legal effect of the document or *vis a vis* the applicant. It forms no part of the bank's function, when considering whether to pay against the documents presented to it, to speculate about the underlying facts. Neither should the bank question the usefulness or sufficiency of the documents."<sup>180</sup>

It is suggested that, if recognised, such an exception would result in more inconsistencies to banks further to those associated with the fraud exception such as that which necessitates establishing who perpetrated fraud in order to apply it.<sup>181</sup> Indeed, to insert consistency and efficiency in a letter of credit context, applying the non-genuinity test is recommended whether a document is null, fraudulent or not.<sup>182</sup>

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<sup>178</sup> *Montrod Limited v. Grundkötter Fleischvertriebs GmbH, Standard Chartered Bank* [2001] C.L.C. 466 at 477

<sup>179</sup> It has been said that "it is not for the bank to reason why". Per Donaldson M.R. in *Banque de l'Indochine et de Suez SA v JH Rayner (Mincing Lane) Ltd* [1983] Q.B. 711 at 729

<sup>180</sup> Ademun-Odeke. "Double Invoicing in International Trade: The Fraud and Nullity Exceptions in Letters of Credit-Are the *America Accord* and the UCP 500 Crooks' Charters!?" [2006] *Denning Law Journal* 115 at p. 121

<sup>181</sup> Todd, P. "*Bills of Lading and Bankers' Documentary Credits*" (Informa Law, 4<sup>th</sup> ed., London, 2007) at pp. 271-272; Sifri, J. "*Standby Letters of Credit: A Comprehensive Guide*" (Palgrave Macmillan, New York, 2008) at p. 197

<sup>182</sup> Mugasha, A. "*The Law of Letters of Credit and Bank Guarantees*" (Federation Press, Sydney, 2003) at p. 146

Otherwise, the English approach will provide a theoretical illusion rather than practical solutions.

#### 3.4.4. Nullity with fraud: the *Montrod* case

One might think that the English courts puzzling approach to banks stopped at this point. Yet, in addition to the above-mentioned violations to the autonomy principle, English courts have also confined the application of the nullity exception to certain situations. The repercussions of the latter point have been raised in a relatively recent case, *Montrod Ltd v. Grundkötter Fleischvertriebs GmbH*.<sup>183</sup>

The case concerned a documentary credit sale of 400 tons of frozen pork meat by Grundkötter (a German seller) to Ballaris (a Russian buyer).<sup>184</sup> Ballaris who was described as “an uncertain entity”<sup>185</sup> was unable to obtain a bank credit and hence it used the service of Montrod (a finance company located in London which provides documentary credits facilities to companies involved in international trade). Accordingly, Montrod ordered its bank Fibi to instruct Standard Chartered Bank to issue the credit in Grundkötter’s favour.<sup>186</sup> The credit terms called for the presentation of a number of documents including an inspection certificate which has to be signed by Montrod itself. The reason behind the requirement of this “locking clause”

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<sup>183</sup> [2002] 1 W.L.R. 1975, CA

<sup>184</sup> The credit was subject to UCP 500.

<sup>185</sup> *Montrod Limited v. Grundkötter Fleischvertriebs GmbH, Standard Chartered Bank* [2001] C.L.C. 466 at 468

<sup>186</sup> It is noteworthy that “These arrangements differ from the usual in two respects. First, the issuing bank, Standard Chartered, was acting on the instructions of another bank, Fibi Bank, which was in turn instructed by the applicant. Secondly, and more important, the applicant, Montrod, was not a party to the underlying contract of sale. It is this which has enabled the outcome, namely a fraud by Ballaris on Montrod.” *Montrod Limited v. Grundkötter Fleischvertriebs GmbH, Standard Chartered Bank* [2001] C.L.C. 466 at 468. Furthermore, “The basic issue is whether Grundkötter or Montrod should bear the consequences of the fraud carried out by Ballaris. The unusual feature of the relationship is that Montrod is not a party to the contract of sale which underlies the credit. It is that underlying contract which will normally be the source of any remedy which the applicant has against the beneficiary. That possibility is not available here.” See at 478.

document was to guarantee Montrod that the credit would not be operable until it is put in funds by Ballaris.<sup>187</sup>

Yet, unpredictably, Ballaris fraudulently persuaded Grundkotter that it was eligible to sign the inspection certificate on behalf of Montrod. Presented by facially conforming documents, Standard Chartered paid Grundkotter. Accordingly, Montrod commenced proceedings against the seller Grundkotter. Jack QC who was sitting as a judge of the Queen's Bench Division in the Commercial Court held that:

“...Grundkotter was not fraudulent but acted innocently in thinking that Montrod had given its authority to Mr Wieler [for Grundkotter] to sign the inspection certificates on its behalf”.<sup>188</sup>

Allegations that Grundkotter was fraudulent could not be found in this case, rather it has been argued that the innocently mistaken signed inspection certificate was nullity and so payment should have been refused.<sup>189</sup> However, Jack QC refused such allegation and held that:

“In my judgment the ‘nullity exception’ should and does form no part of English Law. It is unsupported by authority. It provides a further complication where simplicity and clarity are needed. There are problems in defining when a document is a nullity. The exception could have unfortunate consequences in relation to the rights of third parties”.<sup>190</sup>

This judgment was confirmed when heard again by the Court of Appeal.<sup>191</sup> Potter L.J. held “...that to create a general nullity exception, which could not be precisely formulated, would make undesirable inroads on principles of autonomy”<sup>192</sup> While, in

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<sup>187</sup> *Montrod Limited v. Grundkotter Fleischvertriebs GmbH, Standard Chartered Bank* [2001] C.L.C. 466 at 466

<sup>188</sup> *Ibid.* at 475

<sup>189</sup> *Ibid.* at 471

<sup>190</sup> *Ibid.* at 477

<sup>191</sup> *Montrod Limited v. Grundkotter Fleischvertriebs GmbH, Standard Chartered Bank* [2002] 1 W.L.R. 1975

<sup>192</sup> *Ibid.* at 1975

the present author's view, both courts' conclusions were reasonable,<sup>193</sup> yet the justifications for reaching this conclusion were "flawed".<sup>194</sup>

One of Lord Potter's arguments is "...that there was no authority which supported the existence of such a nullity exception, apart from certain dicta of lord Diplock [in the *American Accord*]."<sup>195</sup> With respect, such argument for not recognising a nullity exception is untenable. The only reason why the nullity exception is not supported negatively or positively by authority is that the latter issue has not been before a court prior to this case. The only *dicta* regarding this issue can be found by Lord Diplock in the *American Accord* and has been described as a very slender support.<sup>196</sup> Indeed, nothing prevents the development of new legal doctrines if needed to guarantee the smooth running of international trade by means of documentary credits, especially since such financial instruments are fairly new.

The second of Lord Potter's arguments asserts that: "the nullity exception was not supported by UCP".<sup>197</sup> In fact, fraud is a well-known exception which English courts are applying and the best evidence is Lord Diplock and his suggestions in the *American accord*. Yet, one might ask: is the fraud exception supported by the UCP? The answer is undoubtedly no. Hence, Potter's suggestion in this respect is unsound. Furthermore, Lord Potter raised another argument, which resembles that one contended by Lord Diplock in the *American Accord*, calling for the inconsistent equation between a documentary credit beneficiary and a holder in due course of a

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<sup>193</sup> Chuah, J. "*Law of International Trade: Cross-Border Commercial Transactions*" (Sweet and Maxwell, 4<sup>th</sup> ed., London, 2009) at p. 537

<sup>194</sup> Horowitz, D. "*Letters of Credit and Demand Guarantees: Defences to Payment*" (Oxford University Press, 2010) at p. 39

<sup>195</sup> *Montrod Limited v. Grundkötter Fleischvertriebs GmbH, Standard Chartered Bank* [2002] 1 W.L.R. 1975 at 1983

<sup>196</sup> *Montrod Limited v. Grundkötter Fleischvertriebs GmbH, Standard Chartered Bank* [2001] C.L.C. 466.

<sup>197</sup> *Montrod Limited v. Grundkötter Fleischvertriebs GmbH, Standard Chartered Bank* [2002] 1 W.L.R. 1975 at 1983

negotiable instrument.<sup>198</sup> As has been explained before, the equation between a letter of credit beneficiary and a bill of exchange holder in due course cannot stand either legal or commercial sound analysis.<sup>199</sup> The expectations of the different parties under these two different financial instruments are not the same due to the special characteristics which both enjoy. Yet his Lordship adopted one of Lord Diplock's arguments without considering its implications.

After affirming that, "If a general nullity exception were to be introduced as part of English law it would place banks in a further dilemma as to the necessity to investigate facts...",<sup>200</sup> Lord Potter confined the possibility to accept a nullity exception to situations where there is an element of fraud. While he admitted that Lord Diplock had left the question open to be answered by later authorities, he found:

"...there is nothing to suggest that he [Lord Diplock] would have recognised any nullity exception as extending to a document which was not forged (i.e., fraudulently produced) but was signed by the creator in honest error as to his authority; nor do I consider that such an exception should be recognised".<sup>201</sup>

In his opinion, Lord Diplock himself confined the application of the nullity exception to situations where a document is forged and fraudulent. His Lordship concluded this by recalling one of Lord Diplock's often-cited statements which provides:

"I would prefer to leave open the question of the rights of an innocent seller/beneficiary against the confirming bank when a document presented by him is a nullity because unknown to him it was forged by some third party; for that question does not arise in the instant case".<sup>202</sup>

Interpreting the last statement literally has led Lord Potter to limit the boundaries of a nullity exception, if it should be recognised, to situations where an element of forgery

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<sup>198</sup> *Ibid.* at 1992

<sup>199</sup> See subsection 3.3.4.2.

<sup>200</sup> *Montrod Limited v. Grundkotter Fleischvertriebs GmbH, Standard Chartered Bank* [2002] 1 W.L.R. 1975 at 1992

<sup>201</sup> *Ibid.* at 1991-1992

<sup>202</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada (The American Accord)* [1983] 1 A.C. 168 at 188

and fraud is existent in the presented documents. However, the current author argues that Lord Diplock in the *American Accord* intended something else different to this conclusion submitted by Lord Potter. Revisiting another statement of Lord Diplock in the *American Accord* would illustrate the matter. In Lord Diplock's words:

“The Court of Appeal reached their half-way house solution in the instant case by starting from the premise that a confirming bank could refuse to pay against documents that it knew to be forged, even though the seller/beneficiary had no knowledge of that fact. From this premise they reasoned that if forgery by a third party relieves the confirming bank of liability to pay the seller/beneficiary, fraud by a third party ought to have the same consequence. I would not wish to be taken as accepting that the premise as to forged documents is correct, even where the fact that the document is forged deprives it of all legal effect and makes it a nullity and so worthless to the confirming bank as security for its advances to the buyer.”<sup>203</sup>

Lord Diplock distinguished two situations in the last statement; the first is forgery by a third party and the second is fraud by a third party. A moment's reflection would reveal that Lord Diplock's used expression to distinguish between the two different situations is misleading. Indeed, a person forges a document in order to deceive other parties as was the case in the *American Accord*. The forgery of the bill of lading therein constituted fraud. To this point Lord Griffiths in the *American Accord*<sup>204</sup> provided:

“I am unable to draw any distinction between a false document which is a forgery according to English criminal law and a document which fraudulently conveys false information but is not technically a forgery.”

Forging a document would make it a fraudulent document and accordingly there is no point to distinguish between fraudulent documents due to forgery and fraudulent documents due to other reasons. Indeed, what Lord Diplock meant by a forged document was a non-genuine document irrespective of the reason which makes it non-

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<sup>203</sup> *Ibid.* at 187

<sup>204</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada (The American Accord)* [1981] 1 Lloyd's Rep. 604 at 633

genuine. Indeed, if the word “forged” is replaced by “non-genuine” then the distinction would make sense. Accordingly, Lord Potter’s statement relying on forgery as fraud does not find support in Lord Diplock’s findings in the *American Accord*. What Lord Diplock meant by forgery by third parties was any act which makes a certain document non-genuine whether due to fraud or not.

While Lord Potter seemed militant for the views which he expressed above, he found that in some situations, even where forged documents, whether null or not, are presented by a bona fide seller, the conduct of the latter would not deserve the protection which the autonomy principle presents to sellers. His Lordship to this point stated:

“...I would not seek to exclude the possibility that, in an individual case, the conduct of a beneficiary in connection with the creation and/or presentation of a document forged by a third party might though itself not amounting to fraud, be of such character as not to deserve the protection available to a holder in due course.”<sup>205</sup>

Whilst his Lordship repeatedly articulated the sensitive nature of the banks’ role in a letter of credit transaction, he undermined it by this later suggestion. Indeed, it is an inherited characteristic of letters of credit that banks would not go behind documents to search for facts.<sup>206</sup> Yet to confine situations in which banks can refuse the documents’ tender to the abovementioned situation “which could not precisely formulated” is cumbersome.<sup>207</sup> As Hooley argues:

“When will the conduct of the beneficiary in connection with the creation of the presentation of a nullity document, although not amounting to fraud, be of such character as to prevent him claiming under the letter of

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<sup>205</sup> *Montrod Limited v. Grundkotter Fleischvertriebs GmbH, Standard Chartered Bank* [2002] 1 W.L.R. 1975 at 1992-1993

<sup>206</sup> Ellinger, E. “*Documentary Letters of Credit: A Comparative Study*” (University of Singapore Press, Singapore, 1970) at pp. 168-169

<sup>207</sup> Goode, R & McKendrick E. “*Goode on Commercial Law*” (Penguin Books, 4<sup>th</sup> ed., London, 2010) at p. 1106



credit?... How is the bank meant to know about the conduct of the beneficiary?”<sup>208</sup>

Lord Potter confined the possibility to recognising a nullity exception in situations where an element of fraud is existent. As a result, a document innocently signed by mistake which is deprived of all its legal effects cannot be refused by a bank unless it includes a fraud element. With respect, the course his Lordship applied is bewildering. Is it the fact that a certain document is worthless and without any legal effect or that it is fraudulent that matters to banks and applicants?<sup>209</sup> Lord Potter’s approach can be excused to some extent due to the unusual facts of the case; firstly, the credit’s applicant (*Montrod*) was not the buyer and hence was not privy to the contract with the beneficiary (*Grundkotter*) which prevents the former from suing the latter. Secondly, there is the fact that the issuing bank (*Standard Chartered Bank*) had already paid. It may be argued that if the bank had chosen not to pay and that the credit’s applicant was the buyer, the court’s conclusion would have been different.

Far from the complexity raised above, and the question whether a document is null or not, the non-genuinity test expounded in *Sztejn* can be used to overcome such difficulties.<sup>210</sup> As the bank’s counsel in the *American Accord* argued:

“If the buyer in the seller-purchaser contract is promising to pay by the bank, it is to pay against genuine documents. The difference between a document which is a forgery and not a nullity and the document which is a

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<sup>208</sup> Hooley, R. “Fraud and Letters of Credit: Part 1” (2003) 4 *J.I.B.F.L.*, 91 at p. 95. For a similar treatment, see: Bridge, M. ‘Documents and Contractual Congruence in International Trade’ (eds.) in Worthington, S. “*Commercial Law and Commercial Practice*” (Hart Publishing, Oxford, 2003) 213 at p. 237; Blair, W. ‘Commentary on ‘Documents Contractual Congruence in International Trade’ (Eds.) in Worthington, S. “*Commercial Law and Commercial Practice*” (Hart Publishing, Oxford, 2003) 241 at p. 247

<sup>209</sup> Goode, R & McKendrick E. “*Goode on Commercial Law*” (Penguin Books, 4<sup>th</sup> ed., London, 2010) at p. 1106

<sup>210</sup> Davidson, A. ‘Fraud; the Prime Exception to the Autonomy Principle in Letters of Credit’ [2003] 8 *Int’l Trade & Bus. L. Ann.*, 23 at p. 29

forgery and, therefore, a nullity is a distinction which is not relevant in the present case”.<sup>211</sup>

### 3.5. Conclusion

Letters of credit were developed to reconcile the traders’ different expectations. On the one hand, a seller without the bank’s assurance of payment, which the former acquires by the issuance of a documentary credit, is exposed to non-payment risks. On the other hand, buyers use banks’ services to ensure that payment to the sellers is to be discharged by a creditworthy and solvent party on the assumption that sellers, in order to get paid, submit genuine documents which evidence the shipment of the agreed goods.

Whilst the English approach protects sellers from the risks which they used to suffer before the advent of documentary credits, it does not offer other parties the protection they envisage. A seller, who was exposed to the risk of non-payment where no documentary credit was issued, will now get paid by utilising the latter. However, a buyer, who used to have the merit of not parting with the goods’ price unless the goods were received, is now obliged to pay even when the documents presented by the seller are non-genuine.

On the one hand, it is suggested that this can be attributed to the English courts’ misapplication of the “holder in due course” and the “*ex turpi cause*” doctrines in this regard. Applying such doctrines which have been developed outside the letters of credit context without considering its various implications might cause harmful results as seen.<sup>212</sup> On the other hand, it is submitted that the inability to distinguish between non-genuinity and fraud as two distinct defences is the other reason why English

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<sup>211</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada (The American Accord)* [1983] 1 A.C. 168 at 178

<sup>212</sup> Rooy, F. “*Documentary Credits*” (Kluwer Law and Taxation Publishers, Deventer, 1984) at p. 99

courts have failed to provide applicants and banks with the protection which they need. The *Sztejn* and the *American Accord* Court of Appeal decisions are recommended in this regard.

While many commentators call for recognising a nullity exception, it is suggested that such an exception will add complexity to this area of law.<sup>213</sup> As stated by Lord Justice Ackner in the *American Accord* Court of Appeal:

“...whether or not a forged document is a nullity, it is not a genuine or valid document entitling the presenter of it to be paid and if the banker to which it is presented under a letter of credit knows it to be forged he must not pay.”<sup>214</sup>

It can be concluded that the fraud exception should not be applied when the matter is between a bank and its beneficiary at the documents level. It is enough for banks to show that a certain document is a non-genuine one. It is submitted that the latter test is the one which should be applied at this level. The position of the UN Convention is noteworthy in this regard. Article 19 provides that it is an exception to the payment obligation: “(1) if it is manifest and clear that: (a) any document is not genuine or has been falsified”. Indeed, “The genuineness of the documents is the foundation of the success of letters of credit”.<sup>215</sup>

It is suggested that determining whether a particular document is a genuine one or not is not a difficult task anymore. The Commercial Crime Services (CCS), a division of the ICC, offers such a service which is fee-free for members.<sup>216</sup> Pursuant to this, a bank can send the documents to the CCS which will check their authenticity. In fact,

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<sup>213</sup> Enonchong, N. “*The Independence Principle of Letters of Credit and Demand Guarantees*” (Oxford University Press, Oxford, 2011) at p. 153

<sup>214</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada (The American Accord)* [1981] 1 Lloyd’s Rep. 604 at 623

<sup>215</sup> Gao, X. ‘The Identity of the Fraudulent Party under the Fraud Rule in the Law of Letters of Credit’ (eds.) in Byrne, J. “*2003 Annual Survey of Letter of Credit Law & Practice*” (The Institute of International Banking Law & Practice, Inc., USA, 2003) 62 at p. 75

<sup>216</sup> See: <http://www.icc-ccs.org/icc/imb>, Last accessed on 01-04-2013

the Commercial Crime Bureau has a database which is provided by various and different information from all parts of the world. In addition, this Bureau's expert members are very helpful in determining whether a particular document is a genuine one or not. It is noteworthy that any request to this Bureau will be answered within a few hours or, at the maximum, two days.<sup>217</sup> Interestingly, as one commentator has noted:

“The author's favourite neighbourhood drug store routinely uses a technical device to check every twenty dollar bill for its genuineness while supposedly sophisticated banks pay millions of dollars daily without checking the genuineness of documents such as bills of lading. Letters of credit developed in an age when it was impossible to confirm speedily that the presented documents were legitimate – this is no longer true”.<sup>218</sup>

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<sup>217</sup> Demir-Araz, Y. 'International Trade, Maritime Fraud and Documentary Credits' [2002] *Int. T.L.R.* Vol. 8(4), 128 at p. 134

<sup>218</sup> Murray, D. 'Letters of Credit and Forged and Altered Documents: Some Deterrent Suggestions' (1993) 98 *Com. L.J.* 504 at p. 515

## **Chapter Four: The Fraud Scope**

### **4.1. Introduction**

In the previous chapter it has been illustrated that fraud in documentary credits and independent guarantees can be divided, in terms of the circumstances in which it takes place, into two main categories, namely, fraud in the documents and fraud in the underlying transaction. This chapter aims to examine whether a successful fraud allegation should be confined to the first fraud category, fraud in the documents, and whether it can be alleged in the second fraud category and thus include fraud perpetrated in the underlying transaction as a valid ground to stop the process of letters of credit payment.

The first section of this chapter is concerned with the meaning, differences and boundaries in the concepts of both ‘fraud in the documents’ and ‘fraud in the underlying transaction’. The following section seeks to examine the fraud scope debate. This section is divided into four subsections. The first subsection highlights the genesis of this debate. The second subsection examines the English courts’ approach to this particular area. A succinct investigation of the way other common law jurisdictions have dealt with the fraud scope is provided in the third subsection. The final subsection focuses on the arguments for and against expansion of the fraud scope.

### **4.2. Terminology**

As one commentator puts it:

“While the courts recognise that several sets of circumstances will interfere with the parallel flow of goods and documents and they do apply

several exceptions to the autonomy principle, circumstances involving...the application of the fraud exception remain the most notorious”.<sup>1</sup>

It is submitted that one of the notorious aspects of the fraud exception is its scope of application; that is the need to clarify whether it applies where fraud has been perpetrated in the underlying transaction as distinct from that carried out in the documents.<sup>2</sup> Indeed, it is suggested that one main reason behind the notoriety of this particular area of the letters of credit law is that the boundaries of the “fraud in the documents” and “fraud in the underlying transaction” concepts are unclear.<sup>3</sup> Taking this into account, the following subsections are meant to clarify such ambiguity.

#### 4.2.1. Fraud in the documents

Fraud in the documents is a broad concept. In the *United City Merchants*, Lord Diplock in his frequently cited statement has described fraudulent documents as those where a documentary letter of credit seller:

“...for the purpose of drawing on the credit, fraudulently presents to the [bank] documents that contain, expressly or by implication, material representation of fact that to his knowledge are untrue.”<sup>4</sup>

Documents could be fraudulent for a number of different reasons. This includes, but is not limited to, the following instances; first, a document issued by the fraudulent beneficiary himself in order to deceive other parties. An example of this is where a beneficiary presents to the bank an invoice which is alleged to be covering a

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<sup>1</sup> Fellingner, G. ‘Letters of Credit: the Autonomy Principle and the Fraud Exception’ (1990) 1 *J. Banking and Finance L. & Practice*. 4. at p. 9

<sup>2</sup> *Ibid.*

<sup>3</sup> Krimm, J. ‘U.C.C.-Letters of Credit & “Fraud in the Transaction”’ (1986) 60 *Tul. L. Rev.* 1088 at p. 1097. To that Krimm stated: “The distinction between fraud in the documents and fraud in the transaction is not always clear”.

<sup>4</sup> *United City Merchants (Investments) Ltd v. Royal Bank of Canada (The American Accord)* [1983] 1 A.C., 168 at 183

consignment of grapes, for instance, when it actually does not.<sup>5</sup> Secondly, documents are fraudulent also when obtained from a fraudulent third party. Such documents can be obtained through a conspiracy between the beneficiary and a third party in order to deceive the bank or the applicant for the credit.<sup>6</sup> The bill of lading issued fraudulently by the loading brokers in the *United City Merchants* case is a clear example of such a kind of fraudulent document.<sup>7</sup> Thirdly, a document forged by the beneficiary is another reason for a document being fraudulent. For instance, a letter of credit requires a bill of lading which evidences the shipment of 10000 tons of grapes. The beneficiary ships 4000 tons, acquires a bill of lading which evidences the shipment of the 4000 tons and alters it in order to show that 10000 tons have been shipped.<sup>8</sup> Finally, a document can be described as fraudulent when it contains false information and the beneficiary knows about such falsity.

#### 4.2.2. Fraud in the underlying transaction

In a letter of credit context, it can be said that the “the underlying transaction” concept itself is misleading.<sup>9</sup> It has been sometimes used to denote the seller and the buyer underlying contract which stipulates for a letter of credit to finance or secure some parts or the whole of the parties’ transaction.<sup>10</sup> On the other hand, the same

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<sup>5</sup> *Sztejn v. Henry Schroder Banking Corp.*, 31 N.Y.S.2d 631 (Sup. Ct. 1941); *Discount Record Ltd v. Barclays Bank Ltd.* [1975] 1 Lloyd’s Rep. 444

<sup>6</sup> *Banco Espanol de Credito v. State Street Bank & Trust Co.*, 409 F. 2d 711 (1<sup>st</sup> Cir. 1969)

<sup>7</sup> *United City Merchants* [1983] A.C. at 183

<sup>8</sup> *Tukan Timber v. Barclays Bank* [1987] 1 Lloyd’s Rep. 171 at 173; *Andina Coffee v. National Westminster*, 560 N.Y.S.2d 1 (A.D. 1 Dept. 1990)

<sup>9</sup> Leacock, S. ‘Fraud in International Transaction: Enjoining Payment of Letters of Credit in International Transactions’ [1984] 17 *Vanderbilt. J. Trans’l L.* 885 at p. 920, to that Leacock stated: “the meaning ‘fraud in the transaction’ ...is also troublesome”.

<sup>10</sup> For example, see: Gao, X. “*The Fraud Rule in the Law of Letters of Credit: A Comparative Study*” (London, 2002), at p. 112; Austin, L. ‘Letter of Credit: Gold Bullion?’ 45 *La L Rev* 927, at p. 936; Getz, H. ‘Enjoining the International Standby Letter of Credit: The Iranian Letter of Credit Cases’ (1980) 21 *Harv Int’l LJ* 189, at p. 208; Note. ‘Letters of Credit: Injunctions as a Remedy for Fraud in UCC Section 5-114’ (1979) 63 *Minn L Rev* 487, at p. 502; *Bank of Newport v. First National Bank*, 687

“underlying transaction” concept has been used to denote the letter of credit arrangement itself which arises between the issuing bank and the beneficiary of such a credit.<sup>11</sup>

One example which explains this misleading approach in particular and which explains the debate pertaining to the scope of fraud in general can be found in three different publications by the same author.<sup>12</sup> In one of these, Goode found that the English authorities implicitly assume that “fraud is a defence where it arises in relation to the tender of documents or the *underlying sale transaction*”.<sup>13</sup> In another publication, Goode retreated from the position he had previously adopted and questioned the matter again:

“...does fraud by the beneficiary which does not affect the documents but relates only to the *underlying transaction*- for example a fraudulent misrepresentation which induced the account party’s entry into the contract affect his right to payment under the credit? Probably not, but the position is unclear”.<sup>14</sup>

However, in a relatively recent publication, Goode further stated that the bank is both entitled and obliged to refuse to honour a credit if “...the issue of the letter of credit

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F 2d 1257, 1260-1261 (1982); *United Bank Ltd. v. Cambridge Sporting Goods Corp.*, 392 N.Y.S.2d 265 at 268, 270 (1976)

<sup>11</sup> For example, see: Horowitz, D. “*Letters of Credit and Demand Guarantees: Defences to Payment*” (Oxford University Press, 2010), at p. 25; Dolan, J. “*The Law of Letters of Credit: Commercial and Standby Credits*” (Boston, 1996) at 7-48; Dolan, J. ‘Standby Letters of Credit and Fraud’, (1985) 7 *Cardozo L.R.* 1, 13, 22; Harfield, H. ‘Enjoining letter of Credit Transactions’ (1978) 95 *Bank. L.J.* 596, at pp. 605-606; Justice, J. ‘Letters of Credit: Expectations and Frustrations-Pts 1 & 2’ (1977) 94 *Bank. L.J.* 424, 493; *F.D.I.C. v. Bank of San Francisco*, 817 F.2d 1395, 1399 (9<sup>th</sup> Cir. 1987); *Shaffer v. Brooklyn Park Garden Apts.*, 250 N.W.2d 172, 180 (Sup. Ct. of Minnesota 1977)

<sup>12</sup> Goode’s changes of view regarding the question of whether the fraud exception should be confined to documents or should it be extended to include fraud in the underlying transaction, is interesting. However, the discussion in this section is limited to explain the meaning of the underlying transaction concept. The fraud scope debate is discussed in section 4.3.

<sup>13</sup> Goode, R. ‘Reflections on Letters of Credit-1’ [1980] *J.B.L.* 291 at p. 293. [Emphasis added]

<sup>14</sup> Goode, R. ‘Abstract payment undertakings’ in Cane, P. & Stapleton, J. (eds.) “*Essays for Patrick Atiyah*” (Oxford, 1991) 209, at p. 234 [Emphasis added]



was induced by fraud or misrepresentation [or] there is other established fraud, whether in relation to the credit or the *underlying transaction*”.<sup>15</sup>

As one commentator proposed “Different perceptions of the locus of fraud or readings by courts of the term ‘fraud in the transaction’ may produce sharply contrasting results”.<sup>16</sup> Indeed, what is meant by “fraud in underlying transaction” is unclear.<sup>17</sup> Goode in the first quotation has divided letters of credit fraud (in terms of place) to documents fraud and the underlying sale transaction fraud. In the second quotation he distinguishes such fraud into two categories: fraud in the documents and fraud in the underlying transaction. In the third quotation mentioned above, Goode found that fraud could be a good basis to restrain a letter of credit payment if it is related to the credit or the underlying transaction.

#### **4.2.3. Distinguishing between both categories**

A letter of credit is a “multi-transaction arrangement”.<sup>18</sup> In fact, a letter of credit transaction involves at least three transactions: (a) the underlying contract between the applicant and the beneficiary through which these parties agree to issue a letter of credit, (b) the applicant’s application to his bank in order to open a letter of credit, (c) the letter of credit transaction between the bank and the beneficiary which usually stipulates for some documents to be submitted by the latter in order to obtain the amount named in the letter of credit.<sup>19</sup>

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<sup>15</sup> Goode, R. “*Commercial Law*” (Butterworths, 3<sup>rd</sup> ed., 2004) at pp. 990-991

<sup>16</sup> Gao, X. “*The Fraud Rule in the Law of Letters of Credit: A Comparative Study*” (London, 2002), at p. 107

<sup>17</sup> Mugasha, A. “*The Law of Letters of Credit and Bank Guarantees*” (The Federation Press, Sydney 2003) at p. 144. In Mugasha’s words: “the issue has been whether ‘transaction’ means the letter of credit transaction or includes the underlying transaction”.

<sup>18</sup> Gao, X. “*The Fraud Rule in the Law of Letters of Credit: A Comparative Study*” (London, 2002) at p. 101

<sup>19</sup> A confirming bank is usually the fourth party in a letter of credit transaction.

The beneficiary's fraud on the applicant can be envisaged only in transactions (a) and (c).<sup>20</sup> Transaction (c) is the letter of credit transaction which usually stipulates for the documents presentation. In this sense, if the documents are fraudulent this would mean that there is fraud in the letter of credit transaction.<sup>21</sup> By the same token, if there is fraud in the letter of credit transaction this would be directly reflected in the documents stipulated for in such a credit. Examples provided above to illustrate fraud in the documents can be said to constitute equally fraud in the letter of credit transaction.<sup>22</sup> Hence, it could be understood that fraud in the documents is the same as that described as fraud in the letter of credit transaction (or even that called 'fraud in the credit'). Both cover the different fraudulent actions happening in the same transaction. The *Sztejn* case is an example of such fraud.<sup>23</sup> Worthless cow hair was sent instead of the contracted for bristles and, accordingly, although apparently conforming, the documents were fraudulent. As one commentator suggests "This fraud will usually relate to the documents themselves. They may be forged or untrue in relation to the goods to which they refer."<sup>24</sup>

In order to determine whether the presented documents are fraudulent or not, scrutinizing the documents merely would not be sufficient. Examining the letter of credit transaction which the documents cover would be necessary to reveal such a

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<sup>20</sup> Indeed, in transaction (b) the two parties involved are the bank and the applicant. Fraud by the applicant upon the bank in his application to open the letter of credit cannot constitute a defence of fraud against the beneficiary. A beneficiary's fraud could not be envisaged in such an arrangement unless there is a conspiracy between the applicant and the beneficiary to defraud the bank. An example where the applicant and beneficiary conspired to defraud the bank is *Rafsanjan Pistachio Producer v. Bank Leumi* [1992] 1 Lloyd's Rep. 513. Irrespective of the difficulty arising from such a distinction between the two concepts "fraud in the documents" and fraud in the underlying transaction", a bank could stop the letter of credit payment process when it has the knowledge of such a fraudulent conspiracy. For more discussion in this point, see: Gao, X. at p.117.

<sup>21</sup> Kimball, G. & Sanders, B. 'Preventing Wrongful Payment of Guarantee Letters of Credit-Lessons from Iran' (1984) 39 *Bus. Law.* 417 at p. 424

<sup>22</sup> See section 4.2.1.

<sup>23</sup> *Sztejn v. Henry Schroder Banking Corp.*, 31 N.Y.S.2d 631 (Sup. Ct 1941)

<sup>24</sup> Murray, C. Holloway D & Timpson-Hunt, D. "*Schmitthoff's Export Trade: The Law and Practice of International Trade*" (Sweet & Maxwell, London, 11<sup>th</sup> ed., 2007) at p. 236

fraud. It would be very difficult for the bank itself to verify fraud allegations which stem from such cases except in situations which the current author describes as technical documentary fraud (e.g. where the letter of credit beneficiary submits a fraudulently signed certificate of inspection which should be signed from one of the bank's clients with whose signature the bank is familiar).<sup>25</sup> It should be noted that, unlike independent guarantees, this kind of fraud (fraud in the documents/fraud in the letter of credit transaction) is more pertinent to documentary letters of credit contexts. In an independent guarantee context no documents are usually required but a mere demand by the guarantee's beneficiary, without even stating that the applicant has defaulted, would be sufficient for obtaining its amount.<sup>26</sup>

Transaction (a) is the underlying contract through which the applicant for credit and the beneficiary agree to utilise a letter of credit in order to facilitate their intended business. Fraud in the underlying contract can be committed at the stage of formation of the contract. There is no case better than that of *Themehelp Ltd v. West*<sup>27</sup> to provide an example of this kind of fraud. In the case of *Themehelp*, the plaintiff contracted with the defendant, West, to buy some shares by instalments. An independent guarantee had been opened by the plaintiff in the seller, West's, favour to secure the third and largest instalment of the contract. Indeed, the parties negotiated their contract on the assumption that a major customer of the seller's business would continue to deal and order from the new buyer. However, the seller, who knew that the major customer had ceased his dealings with the company engaged in

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<sup>25</sup> Such kind of fraud is of a technical nature including instances of fraudulent signatures, fraudulent dates or even where documents are obtained from a non-existent company. *United City Merchants (Investments) Ltd v Royal Bank of Canada* [1983] 1 AC 168 and *Montrod Ltd v Grundkötter Fleischvertriebs-GmbH* [2002] 1 WLR 1975 are examples of such a kind of fraud. This technical nature of fraud is the core of the chapter three discussion.

<sup>26</sup> *McCormack v. Citibank NA* [1997] 6 Bank. L.R. 381 at 385, *Edward Owen Ltd.* [1978] 1 Q.B. 169, at 171

<sup>27</sup> [1996] Q.B. 84

misrepresentation in relation to this fact in order to facilitate the sale process.<sup>28</sup> The plaintiff, alleging fraud in the underlying contract, acquired a court's injunction to stop his bank from paying the seller, West. Indeed, this kind of fraud in the underlying contract is what Goode provided as an example of fraud in the underlying transaction in his second and third quotations cited above.<sup>29</sup>

In addition to fraud committed in its formation, fraud in the underlying contract can be carried out in the performance of such a contract. Shipping cowhair instead of the contracted for bristles is an example of fraud in performing the underlying contract.<sup>30</sup> While one might think that this kind of fraud would constitute fraud in the documents, this is not the case always. An example of this fraud is where the underlying contract stipulates for the shipment of a number of cars produced in the year 2003 and the letter of credit only requires documents attesting the shipment of the cars without mentioning the production year. The seller fraudulently ships a 1999 set of cars, acquires the required documents which do not show the year when the cars were manufactured and obtains the letter of credit amount. Whilst fraud in such an example does not exist in the documents and the bank-beneficiary letter of credit transaction, fraud is pertinent to the underlying contract between the applicant and the beneficiary.<sup>31</sup>

In order to determine whether fraud in the underlying contract does exist or not it would be necessary to return and consider the beneficiary-applicant contract itself.<sup>32</sup>

Examining the documents and the letter of credit transaction only, which the

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<sup>28</sup> *Themehelp Ltd v. West* [1996] Q.B. 84

<sup>29</sup> See section 3.2.2.

<sup>30</sup> *Sztejn v. Henry Schroder Banking Corp.*, 31 N.Y.S.2d 631 (Sup. Ct 1941)

<sup>31</sup> Horowitz, D. "Letters of Credit and Demand Guarantees: Defences to Payment" (Oxford University Press, 2010) at p. 26

<sup>32</sup> Krimm, J. "U.C.C.-Letters of Credit & "Fraud in the Transaction"" (1986) 60 *Tul. L. Rev.* 1088 at 1095

documents represent, would not reveal such a kind of fraud.<sup>33</sup> It would be very difficult for banks to verify allegations of this kind of fraud where there is no fraud in the documents which limits its relation with both the credit's applicant and beneficiary.<sup>34</sup> It should be noted that, unlike documentary letters of credit, this kind of fraud is more pertinent to the context of independent guarantees where no documents are usually required. Indeed, to discover if a demand is fraudulent or not in an independent guarantee context, returning to the underlying contract itself is usually inevitable.

Whilst fraud in the underlying contract, whether in its formation or performance, will sometimes constitute fraud in the documents,<sup>35</sup> in some cases it does not.<sup>36</sup> In order to make common sense and to denote something other than fraud in the documents, and though not being redundant, it is submitted that the concept of fraud in the underlying transaction connotes that fraud having been committed in the underlying contract. The letter of credit transaction and the documents fraud being two sides of the same coin, there would be no sense in distinguishing between them. Accordingly, fraud where a letter of credit is utilised should be divided (in terms of place) into: fraud in the documents (transaction c) and fraud in the underlying transaction (transaction a).<sup>37</sup>

### 4.3. The fraud scope debate

Having illustrated the difference between fraud in the documents and that in the underlying transaction, this section proceeds to clarify the fraud scope debate, as to

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<sup>33</sup> Horowitz, D. *Letters of Credit and Demand Guarantees: Defences to Payment* (Oxford University Press, 2010) at p. 26

<sup>34</sup> Note, 'Letters of Credit: Injunctions as a Remedy for Fraud in U.C.C. Section 5-114' (1979) 63 *Minn Law Review* 487, at p. 510

<sup>35</sup> For example: *Sztejn v. Henry Schroder Banking Corp.*, 31 N.Y.S.2d 631 (Sup. Ct 1941)

<sup>36</sup> For example: *Themehelp Ltd v. West* [1996] Q.B. 84.

<sup>37</sup> Hooley, R & Sealy, L. *Commercial Law-Text, Cases, and Materials* (Oxford University Press, 4<sup>th</sup> ed., 2009), at p. 866. To that Hooley stated: "The autonomy principle is not absolute. The most important exception to the rule is where there is fraud in the part of the beneficiary or his agent in relation to the presentation of documents to the bank or in relation to the underlying contract of sale".

whether the fraud exception should be confined to fraud perpetrated in the documents or should include, as well as that perpetrated in the documents, fraud carried out in the underlying transaction. The first subsection is meant to trace the genesis of this debate. The reason behind such a trace is of great benefit in assessing the soundness of the debate.

#### 4.3.1. The debate genesis

The genesis of the fraud scope debate can be traced back to the 1950s in the USA. More precisely, such a debate has emanated from the prior UCC Article 5.<sup>38</sup> Section 5-114(2) of the prior UCC Article 5 provides that banks and courts can enjoin a letter of credit from being honoured if the “documents appear on their face to comply with the terms of a credit but a required document... is forged or fraudulent or there is fraud in the transaction”.<sup>39</sup> Whilst prior UCC Article 5 explicitly recognised that both fraud in the documents and fraud in the transaction could restrain a letter of credit payment, this explicit recognition was not without its own problem.<sup>40</sup> The concept ‘fraud in the transaction’ was the core of the problem and the reason behind the emergence of two opposing trends. Supporters of the first trend advocated a narrow approach reading of the ‘fraud in the transaction’ concept.<sup>41</sup> Indeed, the supporters of

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<sup>38</sup> According to Gao: “When article 5 of the UCC was first drafted in the 1950s, it was not a complete ‘code’ like some other articles. Instead, it was intended to set up an ‘independent theoretical framework for the further development of letters of credit’. ‘The drafters felt that no statute could effectively or wisely codify the law of letters of credit without hampering development of the device’. According to Official Comment 2 on Prior UCC Article 5, s 5-102, Article 5 was to be applied in accordance with ‘the canon of liberal interpretation’ of UCC s 1-102(1), so as to promote the underlying purposes and policies of the article.” See Gao, X. “*The Fraud Rule in the Law of Letters of Credit: a Comparative Study*” (London, 2002) at p. 22

<sup>39</sup> Prior UCC Article 5, s 5-114(2)

<sup>40</sup> Andrews, M. ‘Standby Letters of Credit: Recent Limitations on the Fraud in the Transaction Defense’ (1988) 35 *Wayne L. Rev.* 119

<sup>41</sup> For example: in *Cromwell v. Commerce and Energy Bank* 450 So 2d 1 (1984), the court held at p. 9, that: “Due to the conclusions we have reached in this case, it is not necessary that we make a factual determination of whether the trial court was correct in finding that fraud had been committed in the underlying transaction. We have concluded that, assuming arguendo, such fraud did exist, the presence of such a fraud, in these cases, cannot serve as a basis for injunctive relief...”; *Federal Deposit Insurance Corp v Bank of San Francisco*, 817 F 2d 1395, 1399 (1987): “It is open to us to reject such

this trend argued that such a concept is intended to cover merely the letter of credit transaction. On the other hand, most of the courts and commentators, who constituted the second trend, were of the view that such a concept should be read broadly to cover fraud perpetrated beyond the letter of credit transaction and which is carried out in the underlying contract.<sup>42</sup> Supporters of the latter broad trend were of the view that both banks and courts should be allowed not only to look to the letter of credit transaction but also to the underlying contract, which stipulates for a letter of credit to finance it, in order to find any potential evidence of fraud. Gao, for example, found that this narrow view did not withstand analysis or stand up in practice because:

“a narrow reading of the phrase encounters logical difficulties from the language of the section since it uses both ‘a required document...is forged or fraudulent’ and ‘fraud in the transaction’ simultaneously. If the latter phrase is interpreted as ‘fraud in the documents’, the former becomes logically irrelevant”.<sup>43</sup>

The emergence of such conflicting trends is understandable where neither the original text of s 5-114(2) of prior UCC Article 5 nor its Official Comment have made clear the meaning of the ‘fraud in the transaction’ concept. However, it was not too late for

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[submission] and confine fraud in the transaction’ to fraud in the presentation of the required documents”; *Xantech Corp v RAMCO Industries Inc*, 643 NE 2d 918, 921 (1994): “We agree...that the fraud in the transaction’ exception ...applies only to those circumstances where a fraudulent credit transaction is alleged, as opposed to fraud in the underlying contract”; Andrews, M. ‘Standby Letters of Credit: Recent Limitations on the Fraud in the Transaction Defense’ (1988) 35 *Wayne L. Rev.* 119; Bulger, R. ‘Letters of Credit: A Question of Honour’ (1984) 16 *N.Y.U.J. Int’l L. & Pol.* 799 at 814; Harfield, H. ‘Enjoining Letter of Credit Transactions’ (1978) 95 *Bank. LJ* 596

<sup>42</sup> See, e.g., *Bossier Bank & Trust Co v Union Planters National Bank of Memphis*, 550 F 2d 1077, 1083 (1977): “The [phrase] seems to cover fraud in the factum and not fraudulently calling the letter of credit”; *Banque Worms v Banque Commerciale Privee*, 679 F Supp 1173, 1182 (1988): “Fraud in the transaction ...is limited to situations in which the wrongdoing of the beneficiary has permeated the entire transaction”; *Temtex Products Inc v Capital Bank & Trust Co*, 623 F Supp 816, 821(1985): “Fundamentally, ‘fraud in the transaction’...must stem from conduct by the beneficiary of the letter of credit as against the customer of the bank”; Gao, X. “*The Fraud Rule in the Law of Letters of Credit: a Comparative Study*” (London, 2002) at p. 101-2; Kimball, G. & Sanders, B. ‘Preventing Wrongful Payment of Guarantee Letters of Credit-Lessons from Iran’ (1984) 39 *Bus. Law.* 417 at p. 424; Note. ‘Enjoining Letters of Credit During the Iranian Revolution’ (1980) 93 *Harv L Rev* 992, 1004; Note, ‘Letters of Credit: Injunction as a Remedy for Fraud in UCC Section 5—114’ (1979) 63 *Minn LR* 487, 501 *et seq*

<sup>43</sup> Gao, X. “*The Fraud Rule in the Law of Letters of Credit: a Comparative Study*” (London, 2002) at p. 103. Other commentators who support this argument: Clark, B. “*The Law of Bank Deposits Collections and Credit Cards*” (1981), 8-70; Comment, “‘Fraud in the Transaction’: Enjoining Letters of Credit During the Iranian Revolution’ (1980) 93 *Harv L Rev* 992, 1004

such discussion to arise until the new revised UCC Article 5 became law in 1995 and ended the fraud scope debate in the United States of America.<sup>44</sup> New Article 5, s 5-109 provides that a fraud allegation can succeed:

“If a presentation is made that appears on its face strictly to comply with the terms and conditions of the letter of credit, but a required document is forged or materially fraudulent, or honour of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant”

Obviously, new Article 5 put an end, at least in the USA, to the controversy regarding the ‘fraud in the transaction’ concept where it replaced such a concept with a loose sentence which explicitly did not confine a successful fraud allegation to that fraud perpetrated in the documents as distinct from that of the underlying contract. This new replaced part of Article 5 has unequivocally given permission to American courts to interfere and interrupt the letter of credit honour where, in addition to fraud in the documents, the ‘honour of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant’.<sup>45</sup> It is submitted that the effect of such an explanatory sentence was to reassure that what was meant previously by the concept of ‘fraud in the transaction’ is fraud in the underlying contract as being different from that of fraud in the documents.

#### **4.3.2. The English legal position and the fraud scope debate**

One commentator suggests that the problem of the fraud scope in the letters of credit context is one which merely concerns the USA, because of the abovementioned diversity in interpreting the ‘fraud in the transaction’ concept which existed in the

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<sup>44</sup> This is the new UCC article 5 which was revised in 1995 and adopted in most of the United States by May 2002. Indeed, one of the main reasons for this new edition, which was drafted by a special task force, was to fill the gaps and to solve the problems which the old edition was suffering from such as the fraud scope discussed in this chapter.

<sup>45</sup> For relatively recent American cases supporting such a view see, for example: *In re Tabernash Meadows, LLC*, 56 UCC Rep Serv 2d 622, 2005 WL 375660 (Bankr. D. Colo. 2005); *Levin v. Meagher*, 2004 Cal. App. LEXIS 7060 (Cal. App. 2004); *Aztec, Inc. v. S.A. Toffulutti*, 336 F. Supp.2d 578 (M.D.N.C. 2004)



prior UCC article 5, and that such a debate does not arise in other jurisdictions such as England.<sup>46</sup> Yet, Mugasha, among others, argues that the same problem regarding the fraud scope does arise in England.<sup>47</sup> Mugasha argues that “English law does not recognise such an exception (fraud in the underlying transaction)”.<sup>48</sup> Indeed, as another commentator opines “this aspect seems to be far from settled”.<sup>49</sup> Accordingly, this section seeks to examine the English position towards the fraud scope debate.

In *Discount Records Ltd v Barclays Bank Ltd*<sup>50</sup> the plaintiffs discovered that only a small fraction of the goods which they contracted for with a French seller had been shipped. The other bulky part of the goods was mostly damaged and not as described. The Chancery Division refused to grant the plaintiff, ‘Discount’, an injunction to restrain Barclays Bank from honouring the French seller drafts. Justice Megarry refused to grant the injunction because Discount did not meet the proof standard required for granting an injunction. He found that the fraud was merely alleged and had not been proven clearly.<sup>51</sup> Fraud in this case was pertinent to the documents and accordingly it was unnecessary for the court to consider the fraud scope dilemma. It can be said that the *Discount* case is neutral in this regard.

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<sup>46</sup> Gao, X. “*The Fraud Rule in the Law of Letters of Credit: a Comparative Study*” (London, 2002) at p. 101. To that he stated: “It appears that this has not become a question in other jurisdictions, but it did become an issue in the United States before the promulgation of Revised UCC Article 5.”

<sup>47</sup> Mugasha, A. ‘Enjoining the Beneficiary’s Claim on a Letter of Credit or Bank Guarantee’ [2004] *J.B.L.* 515 at p. 524; Horowitz, D. “*Letters of Credit and Demand Guarantees: Defences to Payment*” (Oxford University Press, 2010) at p. 33

<sup>48</sup> Mugasha, A. ‘Enjoining the Beneficiary’s Claim on a Letter of Credit or Bank Guarantee’ [2004] *J.B.L.* 515 at p. 524

<sup>49</sup> Oelofse, A. “*The Law of Documentary Letters of Credit in Comparative Perspective*” (Pretoria; Interlegal, 1997) at p. 406

<sup>50</sup> [1975] 1 ALL E.R. 1071

<sup>51</sup> [1975] 1 ALL E.R. 1071 at 1075. The court found that an injunction, to be granted, needs an established evidence of fraud. Similarly, for the same reason the Queen’s Bench Division refused to grant an injunction in *R.D. Harbottle v. National Westminster Bank* [1977] 2 ALL E.R. 862. Another reason for not granting the required injunction was that the confirming bank in France, pursuing Barclays’ mandate, had already accepted the draft presented by the French beneficiary. The latter situation and its repercussions are discussed in more detail in chapter 6.

Unlike the *Discount* case, the case of *Edward Owen Engineering Ltd v Barclays Bank International Ltd*<sup>52</sup> provides more relevant and useful information in relation to the fraud scope point. In the *Edward* case, Lord Denning stated that:

“there is this exception to the strict rule [the autonomy principle]: the bank ought not to pay under the credit if it knows that the documents are forged or *that the request for payment is made fraudulently in circumstances where there is no right to payment*”.<sup>53</sup>

Whilst Lord Denning’s statement is broad enough to comprise fraud in the underlying transaction as well as that in the documents, Horowitz argues that the *dicta* provided by his Lordship regarding the underlying transaction should be limited to independent guarantees as the current case under consideration was one concerning an independent guarantee and accordingly such a statement does not provide support for the broad approach. In her words:

“The central point is that Lord Denning then applied the encapsulation in a demand guarantee case, and the second formulation-‘the request for payment is made fraudulently’-was the relevant one. This is because on-demand guarantees involve very few documents, so ‘fraud in the documents’ is an inappropriate defence...*Edward Owen* does not support a fraud in the transaction defence. Instead, it offered an alternative formulation that was appropriate to demand guarantees cases...”<sup>54</sup>

Horowitz’s comments in this regard are problematic. Firstly, Lord Denning in this case stated unequivocally that an independent guarantee stands on a similar footing to a documentary letter of credit.<sup>55</sup> Hence, it is right to expect that the *dicta* offered by his Lordship could apply to independent guarantees and documentary letters of credit indifferently.<sup>56</sup> Secondly, if his Lordship’s *dicta* were confined to independent guarantees where very few documents are involved, what made his Lordship mention

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<sup>52</sup> [1978] 1 QB 159

<sup>53</sup> *Ibid.* at 169 [Emphasis added]. Seller L.J. statement in *Hamzeh Malas & Sons v British Imex Industries Ltd* [1958] 2 QB 127 (CA) is worth noting. In this regard his Lordship stated: “There may well be cases where the court would exercise jurisdiction as in a case where there is a fraudulent transaction”.

<sup>54</sup> Horowitz, D. “*Letters of Credit and Demand Guarantees: Defences to Payment*” (Oxford University Press, 2010) at p. 30

<sup>55</sup> [1978] QB 159 at 171

<sup>56</sup> *Bank of Nova Scotia v. Angelica-Whitewear* [1987] SCR 59, at 83

the first formulation, fraud in the documents, as a base which a bank or a court can rely on in its refusal to pay? It is difficult to understand the legal means which Horowitz erected on her claim to determine that the *dicta* was concerning merely an independent guarantee and neglected the first formulation ‘the documents are forged’ which predominantly cannot be envisaged except in a documentary letter of credit context.

Thirdly, supposing that Lord Denning’s statement is one which concerns independent guarantees, what prevents its application in a documentary letter of credit context? Isn’t it an inherited characteristic that independent guarantees are more abstract than documentary credits?<sup>57</sup> Therefore, one would think that the opposing position is more convincing. Finally, Horowitz’s admittance that Lord Denning had accepted looking into the underlying transaction in an independent guarantee context, itself is a strong supportive indication for the trend which argues that the English courts do not confine the fraud exception to fraud in the documents as distinct from the underlying transaction. While there are many differences between an independent guarantee and a documentary letter of credit, it is suggested that this should not be the case in relation to the fraud scope.<sup>58</sup> It is submitted that his Lordship’s statement is broad enough to include both fraud in the documents and that in the underlying transaction in both independent guarantees and documentary letters of credit contexts. In view of that, the *Edward Owen* should be considered as a case supporting the English courts’ recognition of fraud in the underlying transaction as well as that in the documents as sufficient to stop a letter of credit payment.

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<sup>57</sup> Horowitz, D. “*Letters of Credit and Demand Guarantees: Defences to Payment*” (Oxford University Press, 2010) at p. 4

<sup>58</sup> Fellingner, G. ‘Letters of Credit: the Autonomy Principle and the Fraud Exception’ (1990) 1 *J. Banking and Finance L. & Practice*. 4. at p.18

In the *United City Merchants (Investments) Ltd v Royal Bank of Canada*,<sup>59</sup> Lord Diplock, in his frequently quoted passage, stated 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 could be said that Lord Diplock’s utilization of the word ‘documents’ above suggests that his Lordship has limited the fraud scope specifically to fraud perpetrated in the documents as distinct from fraud in the underlying transaction. However, it is suggested that Lord Diplock did not intend such a limitation. Indeed, Lord Diplock’s utilisation of the word document arose from the fact that the *United City Merchants* case itself was a case of fraud in the documents.<sup>60</sup> No fraud in the underlying transaction had been existent and accordingly his Lordship did not address such a type of fraud. Another point which supports the author’s suggestion, that Lord Diplock did not intend to limit the fraud exception to that fraud perpetrated in the documents only, can be found in the following statement propounded by his Lordship:

“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 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 fraud.”<sup>61</sup>

His Lordship in the last statement has explicitly articulated the main reason for recognising the fraud exception which is combating fraudulent conducts by dishonest persons. Indeed, if ‘fraud unravels all’, as his Lordship has stated, it would be difficult to accept that he intended to limit the fraud exception to fraud in documents while not including the underlying transaction fraud.<sup>62</sup> Hooley, for example, supports such a conclusion when he states that “Extending the fraud exception to fraud in the

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<sup>59</sup> [1983] 1 AC 168

<sup>60</sup> Hooley, R. ‘Fraud and Letters of Credit: Part 1’ (2003) 4 *J.I.B.F.L.* 91 at p. 95

<sup>61</sup> [1983] 1 AC 168 at 184

<sup>62</sup> *Cromwell v. Commerce and Energy Bank* 464 So 2d 721, 733 (1985)

underlying transaction is consistent with Lord Diplock's view that fraud unravels all.<sup>63</sup>

In the *Themehelp v West*<sup>64</sup> case, which is a case of fraud in the underlying transaction as has been illustrated above,<sup>65</sup> the independent guarantee applicant has been granted an injunction to restrain the beneficiary from demanding payment from the bank. In this case, Lord Justice Waite stated:

“The assumption upon which [the beneficiary's] argument proceeds is that the autonomy of a performance guarantee is threatened if the beneficiary is placed under a temporary restraint from enforcing it. That is not an assumption, however, which appears to me to have any validity. In a case where fraud is raised as between the parties to the main transaction at an early stage, before any question of the enforcement of the guarantee, as between the beneficiary and the guarantor, has yet arisen at all, it does not seem to me that the slightest threat is involved to the autonomy of the performance guarantee if the beneficiary is enjoined from enforcing it in proceedings to which the guarantor is not a party”.<sup>66</sup>

In the same manner as that which Lord Justice Waite has pursued, Todd<sup>67</sup> and Horowitz<sup>68</sup> argue that ‘restraining a demand’ is different from ‘restraining a payment’ in a letter of credit context. That is to say, applying for an injunction to restrain a beneficiary from demanding a letter of credit payment is different from applying for an injunction to restrain a bank from paying after a payment demand has been already made by the beneficiary.<sup>69</sup> In their opinion, in the former case no diminution to the autonomy principle occurs as the bank has not been involved yet and accordingly

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<sup>63</sup> Hooley, R & Sealy, L. “*Commercial Law-Text, Cases, and Materials*” (Oxford University Press, 4<sup>th</sup> ed., 2009) at p. 877

<sup>64</sup> [1996] QB 84

<sup>65</sup> See subsection 4.2.3.

<sup>66</sup> *Themehelp v West* [1996] QB 84. at 98-9

<sup>67</sup> Todd, P. “*Bills of Lading and Bankers' Documentary Credits*” (Informa, London, 4<sup>th</sup> ed., 2007) at p. 268

<sup>68</sup> Horowitz, D. “*Letters of Credit and Demand Guarantees: Defences to Payment*” (Oxford University Press, 2010) at p. 28-9

<sup>69</sup> Injunctions in general and differences in their application depending on the party they are sought against are discussed in detail in chapter 6.

there is no need to apply the fraud exception.<sup>70</sup> Such a fact made Horowitz conclude that the *Themehelp* case does not support the trend which argues that the English law recognises fraud in the underlying transaction.<sup>71</sup>

However, it is suggested that the approach which Todd, Horowitz and Lord Justice Waite took is untenable for a number of reasons.<sup>72</sup> First, it is true that a beneficiary who stipulates for a letter of credit to finance a contract between himself and a buyer of his goods, services or etc..., enters such contract on the assumption that nothing will prevent him from obtaining the credit amount once he has fulfilled the duties assigned to him.<sup>73</sup> The autonomy principle which a letter of credit enjoys is one of the main reasons why a beneficiary enters into such a contract. Even where the beneficiary did not submit his documents or demand the amount stated in the letter of credit, such an injunction would deprive him of his right to do so. Hence, if the beneficiary's demand or the bank payment is restrained doesn't it lead to the same consequences for the beneficiary? In both situations the beneficiary is prevented from obtaining the money due to him by virtue of an abstract payment and as a result the advantage from using such an instrument would be hampered.<sup>74</sup> Moreover, it is one of the autonomy principle's most prominent characteristics that the relationship between the beneficiary and the bank is independent and that it should be kept away from the underlying transaction between the other parties. Hence, what other than interfering with the autonomy principle can be seen in the above case? Preventing the beneficiary

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<sup>70</sup> Todd, P. "*Bills of Lading and Bankers' Documentary Credits*" (Informa, London, 4<sup>th</sup> ed., 2007) at p. 268

<sup>71</sup> Horowitz, D. "*Letters of Credit and Demand Guarantees: Defences to Payment*" (Oxford University Press, 2010) at pp. 28-9

<sup>72</sup> Hooley, R & Sealy, L. "*Commercial Law-Text, Cases, and Materials*" (Oxford University Press, 4<sup>th</sup> ed., 2009) at p. 878

<sup>73</sup> Todd, P. "*Bills of Lading and Bankers' Documentary Credits*" (Informa, London, 4<sup>th</sup> ed., 2007) at p. 241

<sup>74</sup> Mugasha, A. 'Enjoining the Beneficiary's Claim on a Letter of Credit or Bank Guarantee' [2004] *J.B.L.* 515, at pp. 525-526

from obtaining or demanding the letter of credit amount is an intervention affecting the beneficiary's relationship with his bank and accordingly it diminishes the autonomy principle.<sup>75</sup>

Second, if no detriment to the autonomy principle would arise in such a situation, the approach of Todd and Horowitz would allow a mere breach of contract to stop the letter of credit payment. Indeed, one might ask what other reasons than that of fraud would have led to the *Themehelp* court granting the applicant an injunction? Would the court in this case have interfered and granted the injunction if the wrongful action perpetrated by the beneficiary was merely an ordinary breach of contract which did not amount to fraud? It is submitted that the court would not have granted the injunction if the applicant's allegation had been one concerning a breach of contract. It is the fraud exception which has been relied on by the court to restrain the beneficiary from demanding the letter of credit.

Third, it is noteworthy that later English authorities have criticised Lord Justice Waite's rationale pursued in the *Themehelp* case.<sup>76</sup> In *Group Josi v. Walbrook Insurance Company Ltd*,<sup>77</sup> Lord Justice Staughton found that distinguishing between restraining a beneficiary from demanding a letter of credit and restraining a bank from paying such a letter of credit is contrary to the established doctrine. To that effect he stated: "the effect on the lifeblood of commerce would be precisely the same whether the bank is restrained from paying or the beneficiary is restrained from asking for

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<sup>75</sup> Debattista, C. 'Performance Bonds and Letters of Credit: A Cracked Mirror Image' [1997] *J.B.L.* 289. To this point Debattista stated at 295: "The distinction drawn in this case between an action seeking to restrain the bank from paying-requiring proof of fraud-and one seeking to restrain the beneficiary from calling-where fraud would not need to be proved- is difficult to reconcile with the principle of autonomy".

<sup>76</sup> For example, see: *Czarnikow-Rionda Sugar Trading Inc v. Standard Bank of London Ltd* [1999] 1 All ER 890; *Deutsche Ruckversicherung AG v. Walbrook Insurance Company Ltd* [1996] 1 All ER 791; *Group Josi v. Walboork Insurance Co Ltd* [1996] 1 WLR 1152 (CA)

<sup>77</sup> [1996] 1 WLR 1152 (CA)

payment”.<sup>78</sup> Moreover, the rationale that Lord Justice Waite pursued in illuminating the reasons behind granting the injunction did not pass without an internal objection from the members of the same court. Evans LJ took the view that an injunction whether against a bank or a beneficiary would inevitably interrupt the autonomy principle.

Finally, it is suggested that Lord Justice Waite’s approach is based upon a misunderstanding of the precise nature of the autonomy principle and its fraud exception. It seems that he was aware of the repercussions that would occur if he overlooked gross allegations of fraud, but at the same time he did not want to depart from the traditional English position which allegedly adheres to the autonomy principle and, thus, he tried to rationalize granting the injunction in a way which shows that he did not impinge the autonomy principle. In fact, the *Themehelp* court itself did not have a problem concerning the fraud scope. The court did not confine itself to examining the documents only but also went on to assess the fraud allegation pleaded in the underlying transaction by the applicant and found for him eventually on that evidence. The approach of Todd and Horowitz should be disregarded because the autonomy principle was hampered and the reason for the injunction was fraud in the underlying transaction. Arguments which support the view that an injunction to restrain a beneficiary from demanding payment (as distinct from restraining the bank) does not diminish the autonomy principle should be abandoned as they do not stand

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<sup>78</sup> *Ibid.* at 1161-1162, citing *Bolivinter Oil SA v. Chase Manhattan Bank NA* [1984] 1 Lloyd’s Rep. 251, 254 *per* Sir John Donaldson M.R.; *Intraco Ltd. v. Notis Shipping Corp.* [1981] 2 Lloyd’s Rep. 256 *per* Donaldson L.J.; *Dong Jin Metal* case (unreported) 13 July 1993 *per* Lloyd L.J.



legal analysis. *Themehelp* is a case which supports that potential fraud allegations could be accepted irrespective of their scope.<sup>79</sup>

In *Kvaerner John Brown Ltd v Midland Bank Plc*<sup>80</sup>, Mr Justice Creswell rejected a request to discharge a pre-trial injunction which restrained the bank (Midland Bank) from paying the letter of credit beneficiary. The injunction was granted due to the beneficiary's fraudulent demand. Indeed, whilst the beneficiary was required to give notice to the applicant before demanding the letter of credit, he did not give such notice. The court did not find it difficult to assess the underlying transaction in order to find for the letter of credit applicant and his bank.<sup>81</sup>

In *Czarnikow-Rionda Sugar Trade Inc v Standard Bank London Limited and others*,<sup>82</sup> Standard Bank issued three letters of credit at the request of Czarnikow in favour of Vivalet.<sup>83</sup> The negotiable letters of credit were payable at the counters of two Swiss banks after 390 days.<sup>84</sup> Due to the fact that the letters of credit were negotiable, the beneficiaries before the maturity date discounted them at the Swiss banks and as a result the latter obtained the status of a holder in due course where no questions of fraud had arisen at that point. Few days before the maturity date of the letters of credit, Czarnikow alleging fraud had successfully obtained an ex-parte order to restrain Standard Bank from paying the Swiss banks.<sup>85</sup> However, when the matter reached the trial court, it discharged the restraining order because of the special facts

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<sup>79</sup> Hooley, R & Sealy, L. "*Commercial Law-Text, Cases, and Materials*" (Oxford University Press, 4<sup>th</sup> ed., 2009), at pp. 877-878; Jack, R. Malek, A & Quest, D. "*Jack: Documentary Credits*" (Tottel Publishing, 2009) at p. 259

<sup>80</sup> [1998] CLC 446

<sup>81</sup> Horowitz does admit that this case is an exception supporting the broad approach. See Horowitz, D. "*Letters of Credit and Demand Guarantees: Defences to Payment*" (Oxford University Press, 2010) at p. 27

<sup>82</sup> [1999] 2 Lloyd's 187

<sup>83</sup> Vivalet was purchasing alcohol on behalf of a Brazilian group called the Dine Group.

<sup>84</sup> The banks are: the United European Bank and the Banque Cantonale De Geneve.

<sup>85</sup> In fact, no injunctions were sought against the Swiss banks.

of the case in that the confirming banks in Switzerland had duly discounted the letters of credit and paid the beneficiary under the mandate assigned to them by the issuing bank. Discharging an injunction or declining to grant it does not necessarily mean that the court's reason for doing this is one relating to the fraud scope. The *Czarnikow* court did not discuss the scope problem as it found for the Swiss banks on other primary grounds.<sup>86</sup> If these other grounds had not been present, the author believes that the court would have had no problems in granting an injunction regardless of the fraud scope.<sup>87</sup>

Moreover, in *Solo Industries Ltd v Canara Bank*,<sup>88</sup> Lord Justice Mance stated that:

“...the first task of any judge faced with an application for interim injunctive relief was to ‘ask whether there was any challenge to the validity of the instrument’ and ‘if there is not or if the challenge is not substantial, prima facie no injunction should be granted’... in principle a misrepresentation inducing the opening of a credit may give rise to a defence or other compelling reason for trial.”<sup>89</sup>

In considering whether to grant or refuse to grant an injunction, his Lordship's concern related to what he called the validity of the letter of credit. The fraud scope did not seem to constitute a problem in front of his Lordship as he suggested that a misrepresentation inducing the opening of the credit could challenge the validity of

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<sup>86</sup> The holder in due course status which the Swiss banks acquired by virtue of the negotiable letters of credit opened in favour of the beneficiary was on one of these grounds. The balance of convenience requirement to grant an injunction, which will be discussed in chapter 6, was the other main ground in this case for not granting an injunction. Loble, S. ‘Legal Issues: Restraining Payment’ [1999] *Trade & Forfeiting Review* 2 (9). In fact this article's author was representing Standard Bank in this case. To this he stated: “The judge formed the provisional view that the credits were available “by negotiation” and therefore the Swiss banks had negotiated the documents because they had given value for them. Accordingly Standard's obligation to reimburse the Swiss banks was taken long before any question of fraud arose and in the judge's provisional view this could not be affected by any subsequent invocation of the fraud exception. For the same reason the judge did not think that CR [Czarnikow-Rionda] or Standard were in time to invoke any fraud exception against the Swiss banks as confirming banks.”

<sup>87</sup> Hooley argues that the *Czarnikow* case does support the extension of the fraud exception to include fraud in the underlying transaction. See, Hooley, R. ‘Fraud and Letters of Credit: Part 1’ (2003) 4 *J.I.B.F.L.* 91 at p. 96. In the same manner does Jack, see: Jack, R. Malek, A & Quest, D. “*Jack: Documentary Credits*” (Tottel Publishing, 2009) at p. 259

<sup>88</sup> [2001] 2 ALL ER 217

<sup>89</sup> *Ibid.* at 228

the letter of credit and accordingly an injunction could be granted in such a case.<sup>90</sup> In *Solo*, Lord Justice Mance has repeatedly cited the *SAFA v Banque Du Caire*<sup>91</sup> case. In *SAFA*, the bank refused to pay the beneficiary the letter of credit amount and as a result the latter resorted to the court seeking a summary judgement. Waller LJ, who was sitting as a member of the Court of Appeal in this case, stated:

“Gathering the threads from [previous] authorities and adapting them to the circumstances of this case, my view is as follows: The principle that letters of credit must be treated as cash is an important one, and must be maintained...[but]...If a bank can establish a claim with a real prospect of success, *either that the demand was fraudulent even if it had no clear evidence of the fraud at the time of demand, or that there was a misrepresentation by the beneficiary directed at persuading the bank to enter into the letter of credit, it may also be unjust to enter summary against the bank*”.<sup>92</sup>

His Lordship made it clear that while the autonomy principle adds a touch of temptation to those who utilize letters of credit that should not mean that this principle should protect fraudulent conducts.<sup>93</sup> To that effect, he found that a bank or a court can interfere to stop payment in situations where there is either a fraudulent demand on the letter of credit or a misrepresentation inducement to open it. Accordingly, it is suggested that the *Solo* and the *SAFA* cases do not provide support for the view that confines successful fraud allegations to that which appears merely on documents, but they constitute a strong corroboration for the view that permits looking to the underlying transaction in order to verify fraudulent allegations.

*Sirius International Insurance Company (PUBL) v FAI General Insurance Ltd*<sup>94</sup> is an interesting case in this regard. The *Sirius* Court of Appeal found that a beneficiary could not draw on a letter of credit where the underlying contract does expressly

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<sup>90</sup> Jack, R. Malek, A & Quest, D. “*Jack: Documentary Credits*” (Tottel Publishing, 2009) at p. 259. Indeed Jack is with the view that the *Solo* case supports an extension of the exception to a situation where the documents presented are truthful but there is fraud in the underlying transaction.

<sup>91</sup> [2000] 2 ALL ER 567.

<sup>92</sup> *SAFA v Banque Du Caire* [2000] 2 ALL ER 567 at 579 [Emphasis added]

<sup>93</sup> *Ibid.* at 579

<sup>94</sup> [2003] EWCA Civ 470

contain some conditions which restrict drawing on the letter of credit unless the beneficiary fulfils such conditions. In Lord Justice May's words:

“Although those restrictions were not terms of the letter of credit, and although the bank would have been obliged and entitled to honour a request to pay which fulfilled its terms, that does not mean that, as between themselves and FAI, Sirius were entitled to draw on the letter of credit if the express conditions of this underlying agreement were not fulfilled. They were not so entitled. I reject [the plaintiff's] submission that in the present case the parties must be taken, as between themselves, to have afforded Sirius the right to draw on the letter of credit in defiance of the conditions of this underlying contract.”<sup>95</sup>

In fact, in *Sirius* there was no fraud but a disagreement on whether the conditions which the underlying contract provided in relation to the letter of credit had been satisfied. The Court of Appeal did not find any problem in investigating the underlying contract to determine whether the conditions which allow a demand on the letter of credit had been materialised or not.<sup>96</sup> Indeed, the court expressed its willingness to grant injunctions to restrain the bank from honouring the letter of credit in such situations. If in cases like that of *Sirius*, where no fraud has been perpetrated, the English courts have showed readiness to examine the underlying transaction and thus interfered with the operation of letters of credit, isn't it *fortiori* that cases of fraud should be treated, at least, in the same way by the virtue of the well enshrined 'fraud unravels all' principle? It is suggested that the *Sirius* case, even though no fraud had been existent in its proceedings, is another case of the chain discussed above which supports looking to the underlying transaction in order to protect *bona fide* banks and applicants. The same has been pursued in the more recent case of *Simon Carves Ltd v Ensus UK Ltd*.<sup>97</sup>

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<sup>95</sup> [2003] EWCA Civ 470, at 27

<sup>96</sup> However, the House of Lords later reversed the Court of Appeal judgement as it found that the conditions which restricted drawing on the letter of credit have been satisfied. See, *Sirius International Insurance Company (PUBL) v FAI General Insurance Ltd* [2004] 1 WLR 3251

<sup>97</sup> [2011] EWHC 657 (TCC); [2011] B.L.R. 340; [2011] C.I.L.L. 3009 (first instance)

As seen above, the majority of the cases discussed have shown that the English courts do not mind investigating the underlying transaction in order to punish fraudulent conducts. The other few cases have been neutral to this point because the circumstances surrounding it were not such as these which could give support to such an expansion. Furthermore, in England, as yet, there is no explicit text in any of the various heard fraud cases, which suggests that applying the fraud exception is or should be limited to fraud in the documents. Consequently, it is submitted the English fraud exception is not confined to fraud perpetrated merely in documents but rather it does involve that fraud that has been perpetrated in the underlying transaction. Arguments which favour the view that English courts do not permit looking to the underlying transaction to examine fraud allegations should be disregarded. As one commentator puts it:

“...the [English] courts appear willing to look to the underlying transaction for such [fraud] evidence. The cases dealing with performance bonds or standby credits indicate that fraud sufficient to invoke the exception may not have to revert directly to documents but may simply taint the demand made under the instrument”.<sup>98</sup>

#### **4.3.3. The conventional view**

Mugasha argues that the courts should not be allowed to assess fraud allegations pertinent to the underlying transaction, because “the conventional view is that the inquiry should be limited to documents”.<sup>99</sup> Whilst it is not so clear what he meant by the conventional view, the context in which he discussed such a concept suggests that the situation in England and other analogical common law countries is what he meant

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<sup>98</sup> Fellinger, G. ‘Letters of Credit: the Autonomy Principle and the Fraud Exception’ (1990) 1 *J. Banking and Finance L. & Practice*. 4. at p. 18. Indeed, Fellinger noted that the English courts deal equally with independent guarantees and documentary credits with regard to the fraud scope.

<sup>99</sup> Mugasha, A. ‘Enjoining the Beneficiary’s Claim on a Letter of Credit or Bank Guarantee’ [2004] *J.B.L.* 515 at p. 520

by the conventional view.<sup>100</sup> Indeed, this subsection seeks to investigate Mugasha's view regarding what he described as the 'conventional view'. As seen above, the American position does not support limiting the fraud exception to documents as distinct from the underlying transaction.<sup>101</sup> Moreover, the English position also does not support such a line of thought.<sup>102</sup> Accordingly, this subsection is concerned with other common law countries which have a remarkable authority in this regard.

In the Canadian seminal case regarding the fraud exception, *Bank of Nova Scotia v Angelica-Whitewear*,<sup>103</sup> the Supreme Court of Canada laid down a number of general rules to be applied in future fraud cases, and submitted that fraud should not be confined to that of documents only.<sup>104</sup> In Justice Le Dain's words:

“...the fraud exception to the autonomy of *documentary letters of credit* should not be confined to cases of fraud in the tendered documents but should include fraud in the underlying transaction of such a character as to make the demand for payment under the credit a fraudulent one...Moreover, the words of Lord Denning MR in *Edward Owen Engineering*-‘the request for payment is made fraudulently in circumstances when there is no right to payment’-suggest that it was not intended to limit the fraud exception to documentary fraud, strictly speaking. In my view the fraud exception to the autonomy of a documentary credit 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.”<sup>105</sup>

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<sup>100</sup> *Ibid.* at p. 520. See footnote 23 in Mugasha's article for more insights into what he meant by the conventional view. In this footnote he himself noted that the “conventional view” is entirely not that in neither the United States (under the UCC Article 5) nor Canada (the seminal case of *Bank of Nova Scotia* case) where these countries' courts are ready to issue injunctions if there is “fraud in the transaction” as distinct from that in the documents.

<sup>101</sup> See subsection 4.3.1.

<sup>102</sup> See subsection 4.3.2.

<sup>103</sup> [1987] SCR 59

<sup>104</sup> Hooley, R. & Sealy, L. “*Commercial Law-Text, Cases, and Materials*” (Oxford University Press, 4<sup>th</sup> ed., 2009) at p. 877

<sup>105</sup> *Bank of Nova Scotia v Angelica-Whitewear* [1987] SCR 59, at 83. [Emphasis added]. The same view has been expressed before in *Henderson v Canadian Imperial Bank of Commerce* [1983] 40 B.C.L.R. 318 where the Supreme Court of British Columbia found that the fraud exception should be applied: “to what amounts in the particular circumstances of a case, to a fraudulent demand for payment, and it has been said that the exception should not be confined, as possibly suggested in *United City Merchants*, to fraud in the tendered documents”.

Justice Le Dain made it clear that fraud should be taken in its broad sense and should not be limited to cover the narrow approach only which calls for limiting the fraud exception to that of documents.<sup>106</sup> Interestingly, his Justice's last sentence in the above quoted statement, where he found that the fraud exception "should extend to any act of the beneficiary which would be to permit the beneficiary to obtain the benefit of the credit as a result of fraud" resembles the English 'fraud unravels all' principle. It is noteworthy that his Justice has relied on the *Edward Owen* case in justifying the approach he pursued. Indeed, this fact tips the balance in favour of recognising the *Edward Owen* as a case supporting the approach which asserts that English courts do not limit the fraud exception to documents.

Mugasha himself has noted that whilst a few cases in Australia have suggested that looking into the underlying transaction should not be allowed to restrain a letter of credit, the largest number of cases have suggested the contrary.<sup>107</sup> In *Olex Focas Pty Ltd v Skodaexport Co Ltd*,<sup>108</sup> the Australian court has "delved into the underlying transaction and engaged in a quantification exercise in relation to the amount paid and

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<sup>106</sup> Horowitz argues that Justice Le Dain's reasoning is flawed because the case of *Edward Owen* which he relied on was one regarding an independent guarantee and accordingly the *dicta* stated should be confined to independent guarantees. However, the approach pursued by Horowitz in this regard is questionable. Firstly, Justice Le Dain's reasoning, in addition to the *Edward Owen* case, has been based on other documentary letters of credit cases such as *Sztejn*, *Cambridge Sporting Goods* and *Etablissement Esefka International Anstalt v. Central Bank of Nigeria* [1979] 1 Lloyd's Rep. 445 (C.A.). Secondly, mentioning *Edward Owen* was only as a support to the *dicta* he stated and no more. Thirdly, as stated before, the current author does not find it erroneous to apply *dicta* provided in a case of an independent guarantee to a case of documentary letter of credit in this particular point of law. Finally, Horowitz herself tried to articulate many of her arguments in this regard through using *dicta* and examples from independent guarantees cases such as *Themehelp*, *Solo* and *SAFA*. It is surprising that she examined independent guarantees cases to prove that English courts do not recognise fraud in the underlying transaction as a base to invoke the fraud exception while at the same time she criticises others for doing the same thing to prove the opposite. For other recent and new Canadian cases which pursued the *Bank of Nova* case, for example, see: *B.C. Ltd. v. KPMG, Inc.*, [2004] 238 D.L.R. (4th) 13 (B.C.Ct. App.)

<sup>107</sup> Mugasha, A. 'Enjoining the Beneficiary's Claim on a Letter of Credit or Bank Guarantee' [2004] *J.B.L.* 515 at p. 518

<sup>108</sup> (1996) 134 F.L.R. 331, (Sup. Ct, Vic)

the amount repaid”<sup>109</sup> in order to determine whether or not to restrain a letter of credit payment. While the court in this case found for the applicant on other grounds rather than fraud, this does not eliminate the fact that the *Olex* court has initially examined the underlying transaction in order to judge in the plaintiff’s favour.<sup>110</sup> Had it found fraud in the underlying transaction, it is suggested that the *Olex* case result would be the same. Earlier and in the same manner as that pursued in the English *Sirius* case, the Australian High Court in *Wood Hall Ltd v Pipeline Authority*<sup>111</sup> expressed its readiness to interfere with the letter of credit payment if the underlying contract does stipulate for some conditions in order to release the credit, which have not been satisfied.<sup>112</sup>

Moreover, Singaporean cases have not deviated from the pattern which has been pursued by the abovementioned countries in this regard. In its decisions which resemble that of the *Olex* court, the Singaporean Court of Appeal in *Samwoh Asphalt Premix Pte Ltd v Sum Cheong Piling Pte Ltd*<sup>113</sup> and *Dauphin Offshore Engineering & Trading Ltd v The Private Office of HRH Sheikh Sultan bin Khalifa bin Zayed Al Nahyan*<sup>114</sup> did not find it a problem to examine the underlying transaction in order to restrain the letters of credit involved in such transactions.<sup>115</sup>

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<sup>109</sup> Mugasha, A. ‘Enjoining the Beneficiary’s Claim on a Letter of Credit or Bank Guarantee’ [2004] *J.B.L.* 515 at p. 518

<sup>110</sup> Indeed, the *Olex* court found for the plaintiff on the unconscionability ground. Unconscionability as a ground for restraining letters of credit payment is discussed in chapter 5.

<sup>111</sup> (1979) 141 C.L.R. 443. Many Australian cases have pursued the approach applied in *Wood*. For example, see: *ADI Ltd v State Electricity Commission of Victoria* (1997) 13 B.C.L. 337, Sup. Ct Vic; *Barclay Mowlem Construction Ltd v Simon Engineering (Australia) Pty Ltd* (1991) 23 N.S.W.L.R. 451, Sup. Ct; *Selvas Pty Ltd v Hansen & Yunken Pty Ltd* (1987) 6 Aust. Construction L. Rep. 36, Sup. Ct SA

<sup>112</sup> (1979) 141 C.L.R. 443 at 459. In Stephen J.’s words: “Had the construction contract itself contained some qualification upon the [beneficiary’s] power to make a demand under a performance guarantee, the position might well have been different. In fact the contract is silent on the matter”.

<sup>113</sup> [2002] 1 SLR 1

<sup>114</sup> [2000] 1 S.L.R. 657. For more Singaporean cases in this regard see, e.g.,: *Eltraco International Pte Ltd v CGH Development Pte Ltd* [2000] 4 S.L.R. 290; *Chartered Electronics Industries Pte Ltd v The Development Bank of Singapore* [1999] 4 SLR 655; *GHL Pte Ltd v Unitrack Building Construction Pte*



Whilst Mugasha himself concedes that “Overall, the weight of opinion favours the liberal construction which permits the court to enjoin payment if there is fraud in the documents or in the underlying transaction”,<sup>116</sup> it is hard to reconcile this with what he described as the conventional view. If there should be a conventional view in this regard, it is submitted that such a view is that the inquiry should *not* be limited to documents.

#### 4.3.4. Arguments for and against the fraud scope expansion

The fraud scope question has vexed courts and commentators.<sup>117</sup> For example, as seen above,<sup>118</sup> Goode seemed hesitant as to whether the fraud exception should embrace fraud allegations which emanate from the underlying transaction as distinct from that pertinent to the documents.<sup>119</sup> His view of the matter had been changing over the preceding years and the last view he showed was in favour of such an expansion.<sup>120</sup> To this effect he stated that “There is no reason in principle why the fraud exception should be confined to fraud in relation to the issue of the letter of credit”.<sup>121</sup> While his last statement is appreciated, especially by those who advocate a broad view of the fraud scope, including fraud in the underlying transaction, yet unfortunately it seems that Goode did not provide reasons for pursuing such an expansive approach. Unlike Goode’s approach, this subsection seeks to examine the reasons most frequently cited

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*Ltd* [1999] 4 SLR 604; *Min Thai Holdings Pte Ltd v Sunlabel Pte Ltd* [1999] 2 SLR 368; *Bocotra Construction Pte Ltd & Ors v A-G (No 2)* [1995] 2 SLR 733

<sup>115</sup> As in the *Olex* case, the Singaporean Court of Appeal has found for the plaintiffs in both cases on the ground of unconscionability.

<sup>116</sup> Mugasha, A. “*The Law of Letters of Credit and Bank Guarantees*” (The Federation Press, Sydney 2003) at p. 145

<sup>117</sup> Horowitz, D. “*Letters of Credit and Demand Guarantees: Defences to Payment*” (Oxford University Press, 2010) at p. 24

<sup>118</sup> See subsection 4.2.2.

<sup>119</sup> Goode, R. ‘Abstract Payment Undertakings’ in Cane, P and Stapleton, J (eds), *Essays for Patrick Atiyah* (OUP, Oxford 1991) at p. 234

<sup>120</sup> It seems that with the advent of new fraud cases such as the *Themehelp* case, the lack of clarity surrounding the fraud scope question began slowly to fade away giving Goode the opportunity to answer it again this time but from a better position.

<sup>121</sup> Goode, R. “*Commercial Law*” (Butterworths, 3<sup>rd</sup> ed., London, 2004) at p. 992

by the advocates of both the narrow approach, which advocates limiting the fraud scope to fraud perpetrated in documents, and the broad approach, in order to justify their view of this particular area of letters of credit law.

Maintaining the autonomy principle has been the main reason relied on by those who advocate the narrow approach in justifying the narrowness of their approach.<sup>122</sup> In their view, the expansion of the fraud scope would undermine the autonomy principle and accordingly letters of credit would lose their prominent status as financial payment and security instruments leading the parties to search for alternative instruments that cannot be restrained by banks or courts.<sup>123</sup> From this perspective, for example, Horowitz asserted the autonomy principle's importance and the desire "to treat abstract payment undertakings as the equivalent of cash" and, thus, found that the broad approach involves "too great diminution of the autonomy principle".<sup>124</sup>

It is submitted that such an argument is untenable. The autonomy principle works on the assumption that the parties utilising letters of credit are bona fide parties whose good faith is not in doubt. However, where fraudulent parties are involved "the principle of independence of the bank's obligation under the letter of credit should not be extended to protect the unscrupulous seller".<sup>125</sup> If fraudulent beneficiaries are left to complete their fraud freely, letters of credit will lose the applicants' trust and will be abandoned by them without a return. On this assumption the fraud exception has been tailored by courts to guard defrauded applicants from the harm which they might sustain by dealing with unscrupulous beneficiaries. It is true that letters of credit would lose their attraction if the autonomy principle is undermined by repetitive

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<sup>122</sup> McMeel, G. 'Pay Now, Argue Later' [1999] *L.M.C.L.Q.* 5

<sup>123</sup> Mugasha, A. 'Enjoining the Beneficiary's Claim on a Letter of Credit or Bank Guarantee' [2004] *J.B.L.* 515 at p. 520

<sup>124</sup> Horowitz, D. "*Letters of Credit and Demand Guarantees: Defences to Payment*" (Oxford University Press, 2010) at p. 27

<sup>125</sup> *Sztejn* 177 Misc. 31 N.Y.S. 2d 631 (1941) at 634

unjustified intervention by courts and banks with its operation.<sup>126</sup> However, it should not be forgotten that letters of credit would also lose their temptation if they are viewed as instruments which are widely open to abuse and fraudulent conducts. Maintaining the autonomy principle and accordingly the utility of letters of credit as financial payments and security instruments is desirable but at the same time that should not be exaggerated. By the same token, protecting the reputation of these instruments by not punishing fraudulent beneficiaries should not be tolerated. As one American judge puts it: “There is much public interest in discouraging fraud as in encouraging the use of letters of credit”.<sup>127</sup>

Moreover, the narrow approach advocates argue that in applying the fraud in the documents exception the buyer needs only to prove that the documents are fraudulent. However, in expanding the fraud exception to comprise that fraud perpetrated in the underlying transaction “a careful assessment of the merits of the fraudulent inducement must be conducted, because there is nothing patently wrong with the documents themselves.”<sup>128</sup> In their view, in the latter situation the undermining of the autonomy principle is insufferable and accordingly should not be allowed.

Again this argument does not stand precise legal analysis. As one commentator stated “A court really cannot determine whether or not the documents are fraudulent without inquiring into whether the underlying transaction is fraudulent as well”.<sup>129</sup> Indeed, how could the court determine that the documents are fraudulent (e.g., no goods are

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<sup>126</sup> Mugasha, A. ‘Enjoining the Beneficiary’s Claim on a Letter of Credit or Bank Guarantee’ [2004] *J.B.L.* 515 at pp. 525-526; *Power Curber International Ltd v National Bank of Kuwait SAK* [1981] 3 ALL E.R. 607 (CA)

<sup>127</sup> Edenfield J., *Dynamics Corporation of America v. Citizens and Southern National Bank* 356 F. Supp. 991, 1000 (1973)

<sup>128</sup> Horowitz, D. “*Letters of Credit and Demand Guarantees: Defences to Payment*” (Oxford University Press, 2010) at p. 27

<sup>129</sup> Krimm, J. ‘U.C.C.-Letters of Credit & “Fraud in the Transaction”’ (1986) 60 *Tul. L. Rev.* 1088 at p. 1097

shipped) without an extraneous assessment? Even if the fraud is one pertinent to the documents, a court cannot determine if such a fraud is existent or not without examining the letter of credit transaction. One might ask if courts are willing to examine the goods which the documents cover to determine the fraud availability, why they should be prevented from examining the underlying contract in the same way. The arguments of the narrow approach advocates which assert that in examining the letter of credit transaction the burden upon the court would be less or that the investigations pursued would be easier does not make any sense (e.g., examining a contract might be easier for a court than getting involved in the goods' complications). As one commentator suggests:

“...the difficult question always faced by those favouring a narrow interpretation of the term ‘fraud in the transaction’ or locus of fraud: how can fraud in the documents or in the credit transaction be ascertained without looking to the underlying transaction?”<sup>130</sup>

Another argument used by those who advocate the narrow approach is that such an expansion conflicts with the role which the banks' play in the letters of credit operation. In Mugasha's view, such an expansion:

“...strays from the task of the document examiner under a letter of credit or bank guarantee, which is only to match the terms of the demand with those of the document under which the demand is made. It is not the task of the banks as document examiners or that of the courts when they decide whether or not to issue an injunction to investigate disputes as to the amounts owing or the extent of performance under the underlying contracts”.<sup>131</sup>

This argument is unacceptable. Indeed, the banks' role in a letter of credit context is documentary. If no adequate fraud proof is presented to the bank, whether acquired by its own elective investigation or by the applicant, the bank would not be prevented from being reimbursed by its applicant if it did pay. Banks in no case are required to

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<sup>130</sup> Gao, X. “*The Fraud Rule in the Law of Letters of Credit: a Comparative Study*” (London, 2002). at p. 110

<sup>131</sup> Mugasha, A. ‘Enjoining the Beneficiary's Claim on a Letter of Credit or Bank Guarantee’ [2004] *J.B.L.* 515 at p. 519

go beyond documents and to decide whether in such a situation to pay or not. As

Fellinger states, the situation:

“...is that in no case could the bank inquire beyond facially complying documents. As such, the extent of the bank’s authority is with the genuineness of the documents themselves in so far as they are not forged. Parol evidence indicating false or fraudulent statements within genuine documents is a matter outside the bank’s sphere of concern and liability”.<sup>132</sup>

However, to say that courts should not interfere in such a situation is untenable.

Courts are the most competent entities which could weigh facts and proofs which exist outside the document’s face in order to achieve justice. If courts do interfere and stop the letter of credit payment to prevent a fraudulent beneficiary from swindling either the bank or the applicant, it is hard to understand how the banks’ role would be badly affected.

Furthermore, one of the narrow approach advocates’ arguments is that in the vast majority of letters of credit cases the fraud will constitute fraud in the documents and it is only if the applicant has failed to stipulate enough documentary conditions to catch the fraud that the defence of fraud in the documents may be inoperable.<sup>133</sup>

Accordingly, in such situations the loss should fall on the applicant as he should be the one who bears the result of his mistake and negligence. Yet, such an argument is questionable. Initially, one might ask why a beneficiary fraudulently induces an applicant or a bank to open a letter of credit in his favour; why such a fraudulent seller would perpetrate fraud in the underlying transaction and what the consequences of such a fraud are. Is it expected that a fraudulent beneficiary who deceives other parties in the underlying transaction would discharge the duties entrusted to him under a

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<sup>132</sup> Fellinger, G. ‘Letters of Credit: the Autonomy Principle and the Fraud Exception’ (1990) 1 *J. Banking and Finance L. & Practice*. 4. at p. 11

<sup>133</sup> Horowitz, D. “*Letters of Credit and Demand Guarantees: Defences to Payment*” (Oxford University Press, 2010) at p. 30

letter of credit? Indeed, fraud inducing an applicant or a bank to enter a sale of contract and to open a letter of credit would ultimately lead to a fraudulent demand on the letter of credit amount. What other end can be anticipated? Fraud in the underlying transaction in order to provide letters of credit cannot be detached from the latter as both are related and connected robustly to each other and any attempt to separate them would be obviously a trail of illusion.<sup>134</sup>

Even if such an argument is correct, such an approach would encourage rather than discourage fraud. In fact, in both the underlying transaction and the letter of credit transaction the same goods or services are required from the same seller but what differs is the documents' existence or contents. However, the same fraudulent seller of the same goods would be restrained from obtaining payment if fraud is related to the documents and at the same time he would be allowed to fade away in respect of the letter of credit money if the fraud is one related to the underlying transaction. Such an approach presents fraudsters with an invaluable technique in order to deceive their victims safely. It is like saying: dear fraudster if you want to defraud the applicant and his bank securely, please try to avoid using documents and even if you have been forced to use documents try not to stipulate too much information in them so you will not be caught by the fraud exception. As Jack noted:

“It is suggested that the exception is an appropriate one which accords with the rationale that the court will not permit a beneficiary to obtain payment in reliance on his own wrongdoing. On this basis, it would be odd if the bank were obliged to pay an obviously fraudulent beneficiary only because the fraud did not manifest itself in false documents”.<sup>135</sup>

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<sup>134</sup> Gao, X. “*The Fraud Rule in the Law of Letters of Credit: a Comparative Study*” (London, 2002) at p. 113; Symons, F. ‘Letters of Credit: Fraud, Good Faith and the Basis for Injunctive Relief’ (1980) 54 *Tul. L. Rev* 338 at p. 368

<sup>135</sup> Jack, R. Malek, A. & Quest, D. “*Jack: Documentary Credits*” (Tottel Publishing, 4<sup>th</sup> ed., London, 2009) at p. 260

In addition, adopting the narrow approach view would lead to the conclusion that an independent guarantee, in the absence of documents, is an unstoppable payment method which a bank or a court can not interrupt absolutely.<sup>136</sup> While the narrow approach concerns which emanate from a fear about the letter of credit's future and marketability in international trade are respected, it seems that their approach does neglect the fact that the majority of independent guarantees do not stipulate for documents in order to release the guarantee amount. If the narrow approach view is correct in that an inquiry should be limited to documents only, then the fraud exception would not be a workable solution to protect abused applicants in an independent guarantee context.

Indeed, whilst the autonomy principle dictates keeping the different transactions involved in bringing a letter of credit to life separate, fraud is an exception to this principle. If the word exception is taken literally, why should it be limited to the letter of credit transaction? If such a conclusion is right, in order to make sense, the fraud exception should be renamed to become the fraud exception to the letter of credit transaction.

Whilst it is submitted that the fraud scope should not prevent the operation of the fraud exception, this should not be taken too broadly since the application of the fraud exception is not without its own conditions. In other words, the existence of fraud in the underlying contract or the documents does not necessarily mean that the fraud exception could be applicable always. Indeed, a sufficient fraud case should be made by the party seeking to make use of the fraud exception.<sup>137</sup> Moreover, certain requisites, which differ according to the stage at which the fraud exception are sought,

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<sup>136</sup> Gao, X. "*The Fraud Rule in the Law of Letters of Credit: a Comparative Study*" (London, 2002) at p. 113

<sup>137</sup> Chapter five examines the fraud standard.

should be provided.<sup>138</sup> The reason behind such requisites is to maintain the letter of credits' viability in the field of international commerce. As Dolan has noted:

“Prevention of fraud is legitimate commercial policy, and courts are justifiably concerned that they not fashion law contributing to fraudulent practices. At the same time, courts must understand that letters of credit and independent bank guarantees cannot function, and are lost to commerce, if parties can succeed in characterizing underlying transaction disputes as fraud in the independent obligation payment transaction. *As a general rule, commercial law commands courts to look to the underlying transaction as part of the fraud inquiry, but the command is not an open invitation to use the underlying transaction inquiry to corrode the independence of efficient commercial devices. The law must cabin that inquiry, for expansion of the inquiry has untoward commercial effect*”.<sup>139</sup>

Dolan's view does not confine the fraud exception to that where fraud is perpetrated in the documents. However, it should be noted that, whilst it is clear that Dolan is in favour of looking to the underlying transaction to find fraud, his view has been misunderstood. For example, Horowitz argues that Dolan intended to limit the fraud exception scope to fraud that had been perpetrated in the documents.<sup>140</sup> Yet a close reading of Dolan's passage suggests a different conclusion.

Firstly, Dolan stepped away from using mere contractual disputes which do not constitute fraud to obstruct the operation of letters of credit. It is true that if a letter of credit is to be interrupted repeatedly for trivial reasons which do not constitute fraud, such an instrument will lose its attraction in the international trade realm. Hence, interfering with the smooth running of such abstract payment methods should be cautiously limited to situations which are worth interfering with. Interestingly, Horowitz agrees with Dolan's view in this regard as she noted that “Only in severely egregious circumstances should that line [regarding the fraud scope] be moved [to

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<sup>138</sup> Chapter six is dedicated to examine such requisites.

<sup>139</sup> Dolan, J. ‘Tethering the Fraud Inquiry in Letter of Credit Law’ [2006] 21 *BFLR* 479 at p. 502 [Emphasis added]

<sup>140</sup> Horowitz, D. “*Letters of Credit and Demand Guarantees: Defences to Payment*” (Oxford University Press, 2010) at p. 33



include fraud in the underlying transaction] for policy reasons”.<sup>141</sup> However, one might wonder how a court could determine initially that an alleged fraud in the underlying transaction is egregious and that it is not merely a contractual dispute, and accordingly interfere with the letter of credit payment process, without firstly examining such a transaction. Can a court conclude that fraud in a certain underlying transaction is of an egregious condition by examining the documents solely? It is difficult to understand Horowitz’s approach which rejects looking to the underlying transaction to apply the fraud exception and which at the same time calls for applying such an exception where fraud in the underlying transaction is of an egregious type.

Secondly, it is suggested that Dolan’s comments in the last paragraph is pertinent to independent guarantees. Indeed, it is usually a sale of goods transaction which is covered by a documentary letter of credit and disputes in such a context would be pertinent to the goods and their condition in most of the cases. Yet, in an independent guarantee context where usually no documents are utilised and where the underlying transaction is very complicated, the reason behind the issuance of it would be difficult to understand. The use of independent guarantees is not confined to a certain kind of transactions but its use could cover a large number of different transactions. Moreover, the contracts for which an independent guarantee is used are usually manifold and contain more than one transaction (e.g., construction contracts). Accordingly, delving into the underlying transaction to apply the fraud exception in an independent guarantee context where the reason behind its issuance is unclear would bring harmless repercussions to the beneficiary. Mugasha’s view does match that of Dolan in this regard. In Mugasha’s words:

“It is suggested, however, that this seemingly broad interpretation should not be taken to permit a court to delve into the determination of the merits

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<sup>141</sup> *Ibid* at p. 35

of the underlying transaction. Rather a court should still be mindful of facilitating the letter of credit as a successful instrument of international trade”.<sup>142</sup>

Interestingly, whilst Mugasha’s last statement seems to contradict his solid opinion discussed above toward the fraud scope, it does agree with Dolan’s view in that extending the fraud exception to include fraud in the underlying transaction is an indispensable need but yet courts should be mindful in applying such an exception.

#### 4.4. Conclusion

In *Bank of Nova Scotia v Angelica-Whitewear*,<sup>143</sup> Justice Le Dain suggested that the reason explaining various judicial and academic opinions in this regard is the collision between two main policies which are: firstly, the autonomy principle and its importance in maintaining the role which letters of credit play in international commerce and, secondly, “the importance of discouraging or suppressing fraud in letter of credit transactions.”<sup>144</sup>

Indeed, the autonomy principle dictates that banks deal in documents, not goods, and that non-fraudulent beneficiaries should be assured of receiving payment if the documents comply with the letter of credit terms.<sup>145</sup> It is true that banks do not have sufficient capacity to examine the underlying transaction residing beyond documents. Even if a buyer requests a bank to do that, the latter should refuse such a request rather than putting itself in an unenviable situation.<sup>146</sup> However, unlike banks, courts are the very institutions which can assess fraud allegations. If one of the courts’ main

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<sup>142</sup> Mugasha, A. “*The Law of Letters of Credit and Bank Guarantees*” (The Federation Press, Sydney 2003) at pp. 145-146. Moreover, at 136, he stated: “a bank may not be prevented from paying an exporter on the grounds that the underlying transaction has not been satisfactorily performed”.

<sup>143</sup> (1987) 36 D.L.R. 161

<sup>144</sup> *Ibid.* at 168

<sup>145</sup> Symons, E. ‘Letters of Credit: Fraud, Good Faith and the Basis for Injunctive Relief’ (1980) 54 *Tulane Law Review* 338 at p. 343

<sup>146</sup> Fellingner, G. ‘Letters of Credit: the Autonomy Principle and the Fraud Exception’ (1990) 1 *J. Banking and Finance L. & Practice*. 4 at p. 6 [Emphasis added]

functions is to discourage fraud, why should it be confined to fraud in the documents rather than that in the underlying transaction? One might argue that the courts should not interfere because the buyer, by virtue of the autonomy principle, accepts bearing the risk of fraud in the transaction as he stipulated for conforming documents only in the letter of credit. This may be erroneous. A buyer does accept payment when presented with conforming documents to facilitate the operation of an honest sale transaction, but to say that the buyer only contracts for documents regardless of their contents does not reflect reality.

In fact, the reason for not invoking the fraud exception in most of the cases heard by the English courts (other than the *Themehelp* and *Kvaerner* cases) cannot be attributed to the fraud scope dilemma and whether fraud is existent in the documents or in the underlying transaction, but rather it can be attributed to other reasons such as the fraud standard proof, the meaning of the word fraud itself, the presence of a holder in due course and failing to satisfy an injunction's requisites.

Loosely speaking, like their common law counterparts, English courts have been successful in this regard as their focus has been on the fraud evidence rather than making unnecessary distinctions pertinent to the fraud exception scope. Nevertheless, it is suggested that it would be a better approach if English courts take this issue into consideration in future fraud cases and accordingly illustrate their view in this regard. Moreover, it is submitted that the concept of 'the underlying transaction' itself is misleading especially where the operation of letters of credit does necessitate the involvement of more than one transaction. Therefore, people involved in this regard should be cautious of using such a concept as what is meant by it would be misunderstood. Clarification of what transaction they do mean by the 'underlying transaction' should follow its use.

## Chapter Five: Fraud in the Underlying Transaction

### 5.1. Introduction

As discussed previously,<sup>1</sup> the autonomy principle is an indispensable necessity in the context of letters of credit. However, it should be noted that the autonomy principle is not essentially absolute as fraud has been recognised as an exception to this principle which dictates separating the documentary credit or guarantee from the underlying contract from which such instruments have ensued. In fact, the fraud exception works to protect applicants and banks where the beneficiary's demand is fraudulent. In this context, English courts have reiterated that fraud acts should not go unpunished and that "fraud unravels all" even the well-defined autonomy principle.<sup>2</sup>

Although fraud is a "globally well-established"<sup>3</sup> exception, yet, "one must first establish that fraud exists" in order to apply the fraud exception.<sup>4</sup> This chapter seeks to find out the answer to the following question: what constitutes fraud for the purpose of these instruments?<sup>5</sup> Whilst some commentators have suggested that the required fraud which could activate the fraud exception should be of a blatant nature, other cases and commentators have advocated intentional fraud as the proper

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<sup>1</sup> See subsection 2.4.2.1.

<sup>2</sup> White, K. 'Bankers Guarantees and the Problem of Unfair Calling' (1979) 11 *J. Mar. L. & Com.* 121 at p. 128

<sup>3</sup> Kurkela, M. "*Letters of Credit and Bank Guarantees Under International Trade Law*" (Oxford University Press, 2<sup>nd</sup> ed., 2007) at p. 173

<sup>4</sup> White, K. 'Bankers Guarantees and the Problem of Unfair Calling' (1979) 11 *J. Mar. L. & Com.* 121 at p. 128

<sup>5</sup> Kurkela, M. "*Letters of Credit and Bank Guarantees under International Trade Law*" (Oxford University Press, 2<sup>nd</sup> ed., 2007) at p. 173. As another commentator wondered "Even if documents comply in form with the credit, the question remains what circumstances will call their substance into question". See: Houten, S. 'Letters of Credit and Fraud: A Revisionist View' (1984) 62 *Can B. R.* 371 at p. 378

standard.<sup>6</sup> Nonetheless, it is suggested that “There is no concise definition of what is meant by fraud in letter of credit deals”.<sup>7</sup>

Taking this into consideration, this chapter is divided into four sections. After the introduction, the following section is intended to provide a discussion on the fraud standard related to documentary credits. This section is divided into two subsections: the first subsection addresses the existing fraud standard test which the English courts usually apply when a documentary credit fraud case appears before them; in the second subsection, taking into consideration the ineffectiveness of the former standard, a new fraud standard is proposed. The third section is dedicated to addressing the fraud standard applicable in independent guarantees cases. In its turn this section is divided into four main subsections. Similarly to the second section, the first subsection of this section addresses the existent fraud standard test which English courts usually apply when an independent guarantee case appears before them. The second subsection aims to reveal the extent of effectiveness of a similar proposed fraud test as that proposed in the last section and which addresses the fraud standard in a documentary credit context. The third subsection examines the unconscionability exception, which has originated in other commonwealth countries, and its chances of being adhered to in the English jurisdiction. The fourth and the last subsection of this section is concerned with the underlying contract exception which has lately appeared in the English courts as a means by which an applicant can restrain the payment of a fraudulent demand in an independent guarantee context. The conclusion is provided in the fourth and last section.

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<sup>6</sup> Krimm, J. ‘U.C.C. – Letters of Credit and “Fraud in the Transaction”’ (1986) 60 *Tul. L. Rev.* 1088 at p. 1099

<sup>7</sup> Rowe, M. “*Letters of Credit*” (Euromoney Books, 2<sup>nd</sup> ed., London, 1997) at p. 253

## 5.2. The fraud standard in documentary credits

A documentary credit process depends wholly on commercial documents.<sup>8</sup> The beneficiary submits documents which provide evidence that he complied with the applicant's requirements under the documentary credit. The bank in its turn pays the beneficiary once it obtains these documents without the need to look further to see whether these documents represent the truth or not. The autonomy principle, which has been injected into this context to facilitate the ease of use of both documentary credits and guarantees, exempts banks from examining different and on some occasions, complex transactions.<sup>9</sup> However, injecting the autonomy principle into these financial instruments is not without its own shortcomings.<sup>10</sup> Indeed, sometimes, the autonomy principle can put the applicants in a very "absurdly vulnerable position".<sup>11</sup> One commentator has noted that:

"It is not a difficult task to fabricate or forge these documents. Particularly with developing technology, every single person can fabricate an identical copy of a shipping document that is commonly used in trade, or they can buy one from related associations and fill it up according to their own wishes."<sup>12</sup>

English courts, as is the case with the courts in most countries, have taken the above and many similar statements into account and so have recognised the fraud exception to the autonomy principle in such cases in order to protect banks and applicants from beneficiaries' fraudulent acts. Taking this into consideration, this section is divided

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<sup>8</sup> Rowe, M. "*Letters of Credit*" (Euromoney Books, 2<sup>nd</sup> ed., London, 1997) at p. 241

<sup>9</sup> *Hamzeh Malas & Sons v. British Imex Industry Ltd* [1958] 2 Q.B. 127, [1958] 1 A11 E.R. 262 at 263-264

<sup>10</sup> Rowe, M. "*Letters of Credit*" (Euromoney Books, 2<sup>nd</sup> ed., London, 1997) at p. 241. To this he provided: "The documentary credit system works well if buyer and seller are honest. But it offers little protection against outright fraud, because banks pay against documents and are not concerned with the underlying commercial transaction".

<sup>11</sup> Megrah, M. 'Risk Aspects of the Irrevocable Documentary Credit' (1982) 24 *Ariz. L. Rev.* 255, at p. 256. In the same manner it has been noted that: "...in cases of beneficiary fraud in which an action by the [account party] on the underlying contract would be ineffectual, the rule of independent contracts would operate to unjustly enrich an unscrupulous beneficiary". See: Note: 'Letters of Credit: Injunction as a Remedy for Fraud in U.C.C Section 5-114' (1979) 63 *Minnesota Law Review* 487 at p. 490

<sup>12</sup> Yeliz, D. 'International Trade, Maritime Fraud and Documentary Credits' [2002] *Int. T.L.R.* Vol. 8(4), 128 at p. 133

into two parts. The first part discusses the existent fraud standard test which English courts require applicants to satisfy in order to benefit from the fraud exception and consequently to stop the beneficiary from fraudulently obtaining the documentary credit amount. The second part, taking the problematic nature of the existing applied test into consideration, is meant to provide a proposed fraud standard test which would suit better the special nature of these instruments and the desires of the parties who are potentially exposed to being defrauded. At this stage, it should be noted that the English law did not develop the fraud exception to any great extent in documentary credits. This is because of the fact that most of the cases which have been heard by the English courts in relation to the fraud exception were cases which concerned independent guarantees.<sup>13</sup>

#### **5.2.1. The common law fraud standard: a subjective test**

In *Hamzeh Malas & Sons v. British Imex Industry Ltd*,<sup>14</sup> Jenkins L.J. in laying stress on the importance of the autonomy principle in a documentary credit case has provided:

“We were referred to several authorities, and it seems to be plain that the opening of a confirmed letter of credit constitutes a bargain between the banker and the vendor of the goods, which imposes on the banker an absolute obligation to pay, irrespective of any dispute which there may be between the parties on the question of whether the goods are up to contract or not”<sup>15</sup>

Yet, in the *United City Merchants (Investments) Ltd v Royal Bank of Canada (The American Accord)*<sup>16</sup> case which has been described as “the leading case which sets out

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<sup>13</sup> Warne, D & Elliott, N. “*Banking Litigation*” (Sweet & Maxwell, 2<sup>nd</sup> ed., London, 2005) at p. 260

<sup>14</sup> *Hamzeh Malas & Sons v British Imex Industries Ltd* [1958] 2 Q.B. 127; [1958] 2 W.L.R. 100 (CA)

<sup>15</sup> [1958] 1 A11 E.R. 262 at 263

<sup>16</sup> [1983] 1 A.C. 168; [1982] 2 W.L.R. 1039 (House of Lords)

the standard of fraud”,<sup>17</sup> Lord Diplock found that there is an exception to the autonomy principle 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 facts *that to his knowledge are untrue*”.<sup>18</sup>

In fact, Lord Diplock’s formulation “is very close to a statement of the elements of fraudulent misrepresentation which constitute the tort of deceit”.<sup>19</sup> Following Lord Diplock’s last statement, it has been suggested that after the *United City Merchants* case “the application of the fraud exception is limited to cases where the beneficiary had knowledge of the fraud”.<sup>20</sup> Indeed, under English law “...the fraud exception has developed as part of the common law”<sup>21</sup> and thus there has been emphasis on the “beneficiary’s state of mind in the *United City Merchants*”.<sup>22</sup> Originally, the state of mind that has been required to establish fraud in the common law had been established by Lord Herschell in the *Derry v Peek* case.<sup>23</sup> To this effect, his Lordship stated:

“Fraud is proved when it is shown that a false representation has been made (i) knowingly, (ii) without belief in its truth, or (iii) recklessly, careless whether it be true or false. Although I have treated the second and third as distinct cases, I think the third is but an instance of the second, for one who makes a statement under such circumstances can have no real belief in the truth of what he states. To prevent a false statement from being fraudulent, there must, I think, always be an honest belief in its truth”.<sup>24</sup>

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<sup>17</sup> Low, H.Y. ‘Confusion and Difficulties Surrounding the Fraud Rule in Letters of Credit: An English Perspective’ [2011] *Int. J.L.M.* 17(6), 462 at p. 463

<sup>18</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada (The American Accord)* [1983] 1 A.C. 168 at 186-187 [Emphasis added]

<sup>19</sup> Malek, A & Quest, D. “*Jack: Documentary Credits*” (Tottel Publishing, 4<sup>th</sup> ed., Sussex, 2009) at p. 254

<sup>20</sup> Low, H.Y. ‘Confusion and Difficulties Surrounding the Fraud Rule in Letters of Credit: An English Perspective’ [2011] *Int. J.L.M.* 17(6), 462 at p. 463

<sup>21</sup> Enonchong, N. “*The Independence Principle of Letters of Credit and Demand Guarantees*” (Oxford University Press, Oxford, 2011) at p. 96

<sup>22</sup> Ellinger, E. ‘The Autonomy of Letters of Credit after the American Accord’ [1983] *A.B.L.R.* 118 at p. 130

<sup>23</sup> *Derry v Peek* (1889) 14 App. Cas. 337; (1889) 5 T.L.R. 625 (House of Lords)

<sup>24</sup> (1889) 14 App. Cas. 337 at 376



Accordingly, it has been frequently reiterated that fraud is “common law fraud” and that “the claimant must show deceit which involves a heavy standard of proof”<sup>25</sup> in order to activate the fraud exception in a documentary credit context.<sup>26</sup> Hence, as provided by Waller J. in the *Turkiye Is Bankasi AS v Bank of China* case:

“If the fraud exception is to apply, the bank [or buyer] must have irrefutable evidence that the claimant is dishonest so that it can establish that dishonesty if it were sued by the beneficiary”.<sup>27</sup>

While such an intentional standard of fraud has been applauded by some courts and scholars,<sup>28</sup> it has been criticised frequently by the majority.<sup>29</sup> It has been said that such a standard makes the fraud exception a narrow exception<sup>30</sup> because of the difficulty of proving it.<sup>31</sup> Indeed, “Dishonesty is hard to prove”.<sup>32</sup> Such a “rarely [to] be successfully established”<sup>33</sup> subjective test which requires an inquiry into a person’s state of mind<sup>34</sup> has led to some commentators describing the English Courts’

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<sup>25</sup> Ulph, J. “*Commercial Fraud: Civil Liability, Human Rights, and Money Laundering*” (Oxford University Press, Oxford, 2006) at p. 518

<sup>26</sup> Todd, P. “*Maritime Fraud and Piracy*” (Lloyd’s List, 2<sup>nd</sup> ed., London 2010) at p. 131, to this Todd provided: “But fraud requires more than a representation. It also requires the requisite degree of intention to fall within the definition of deceit at common law”

<sup>27</sup> *Turkiye Is Bankasi AS v Bank of China* [1996] 2 Lloyd’s Rep 611 at 618

<sup>28</sup> Fellingner, G. ‘Letters of Credit: The Autonomy Principle and the Fraud Exception’ [1990] 1 *J.B.F.L.P.* 4 at p. 24; Bulger, R. ‘Letters of Credit: A Question of Honor’ [1984] *N.Y.U.J. Int’l L. & Pol.* 799 at p. 811; Symons, E. ‘Letters of Credit: Fraud, Good Faith and the Basis for Injunctive Relief’ (1980) 54 *Tul. L. Rev.* 338

<sup>29</sup> Stoufflet, J. ‘Fraud in Documentary Credit, Letter of Credit and Demand Guaranty’ (2001) 106 *Dick. L. Rev.* 21 at p. 22

<sup>30</sup> Zohrab, P. ‘Standby Letters of Credit: Autonomy’ (1996) *N.Z.L.J.* 417 at p. 418

<sup>31</sup> Turner, C. “*Unlocking Contract Law*” (Hodder Education, 3<sup>rd</sup> ed., London, 2010) at p. 160. To this he noted: “...fraud is extremely difficult to prove”.

<sup>32</sup> Horowitz, D. “*Letters of Credit and Demand Guarantees: Defences to Payment*” (Oxford University Press, 2010) at p. 107

<sup>33</sup> Bridge, M. “*The International Sale of Goods*” (Oxford University Press, 2<sup>nd</sup> ed., Oxford, 2007) at p. 303

<sup>34</sup> Bulger, R. ‘Letters of Credit: A Question of Honor’ [1984] *N.Y.U.J. Int’l L. & Pol.* 799 at p. 811

approach, in this context, as a non-interventionist approach<sup>35</sup> and the fraud exception as “a theoretical concept rather than a practical one”.<sup>36</sup>

As late as 1893, Lord Esher in *Leivre v Gould*<sup>37</sup> had observed the rigid nature of such a standard of fraud. In his words: “A charge of fraud is such a terrible thing to bring against a man that it cannot be maintained in Court unless it is shown he had a wicked mind”.<sup>38</sup> Such a burden is very hard to satisfy by the party alleging fraud. It makes “investigators of buyers and banks”.<sup>39</sup> It would be difficult to establish that a drawing under a letter of credit involved deceit<sup>40</sup> and so “under English law there is a very limited exception to the autonomy principle in the case of fraud on the part of the seller or his agents”.<sup>41</sup> In fact, there are not many cases where this exception has been successfully applied in favour of the applicant. This could be best understood where English courts have held that they would not decide that an action of deceit exists unless the beneficiary is present in the judgement procedures so that he could have the opportunity to defend himself.<sup>42</sup>

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<sup>35</sup> Enonchong, N. ‘The Problem of Abusive Calls on Demand Guarantees’ [2007] *L.M.C.L.Q.* 1, 83 at p. 85

<sup>36</sup> Yeliz, D. ‘International Trade, Maritime Fraud and Documentary Credits’ [2002] *Int. T.L.R.* Vol. 8(4), 128 at p. 133. In the same manner Bertrams has stated: “English courts employ a very restricted notion of fraud... From these and several subsequent cases it would almost appear that English courts are inclined to treat the fraud exception as a principle of a rather theoretical nature which ought not to be put in practice”.<sup>36</sup> See Bertrams, R. “*Bank Guarantees in International Trade: The Law and Practice of Independent (First Demand) Guarantees and Standby Letters of Credit in Civil Law and Common Law Jurisdictions*” (Kluwer Law International, 3<sup>rd</sup> ed., The Hague (Netherlands), 2004) at p. 346

<sup>37</sup> [1893] 1 QB 491

<sup>38</sup> *Ibid.* at 498

<sup>39</sup> Carr, I. “*International Trade Law*” (Cavendish Publishing, 3<sup>rd</sup> ed., 2005) at pp. 503-504

<sup>40</sup> Ellinger, E. ‘Fraud in Documentary Credit Transactions’ [1981] *J.B.L.* 258 at p. 262

<sup>41</sup> Howard QC, M. Masefield, R. & Chuah, J. “*Butterworths Banking Law Guide*” (Butterworths, London, 2006) at p. 531

<sup>42</sup> Ackner L.J in *United Trading Corp SA and Murray Clayton Ltd v. Allied Arab Bank Ltd* [1985] 2 Lloyds Rep. 554. Indeed, in international transactions it is difficult to see a distant documentary credit beneficiary in allegations which are commenced by the applicant in the latter’s country.

The repercussions of the application of such a rigid standard can be clearly observed in the *Discount Record* case.<sup>43</sup> In this case not only were the goods delivered later than the agreed date which had been stated in the invoice, but there was evidence which showed that most of the goods delivered were either not as had been ordered or else were useless. Interestingly, the inspection of the goods had been made in the presence of the applicant and the issuing bank officers, but yet the English court did not recognize such an action as fraud.<sup>44</sup> In fact, the court had confined its focus to the beneficiary's state of mind rather than the situation in relation to the goods themselves.

It is submitted that, because investigating the beneficiary's mind is not an easy job and because proving such a state of mind is not an easy matter especially in preliminary hearings where it is usually only the allegations of the applicant that are heard, the English existent fraud exception is biased in favour of beneficiaries and that it does not fulfil banks' and applicants' desires as they are defenceless against fraudulent beneficiaries.<sup>45</sup> As Guest puts it:

“It is, thus, clear that the fraud rule has a narrow scope of application. It is true that there is an indication that a more liberal approach may be adopted by the courts in the future.”<sup>46</sup>

The question which would arise at this point is: “whether it is appropriate to reassess the narrow fraud exception in order to preserve trust?”<sup>47</sup> The current author's answer to this question is in the affirmative and, therefore, the next subsection is meant to

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<sup>43</sup> *Discount Records Ltd. v Barclays Bank Ltd.* [1975] 1 W.L.R. 315; 1 ALL E.R. 1071

<sup>44</sup> However, it is suggested that what has prevented the court from granting an injunction to restrain the issuing bank from paying the documentary credit amount is the existence of a confirming bank in France which had already accepted bills of exchange drawn on it by the beneficiary. For more on this point see chapter 6.

<sup>45</sup> Low, H.Y. ‘Confusion and Difficulties Surrounding the Fraud Rule in Letters of Credit: An English Perspective’ [2011] *Int. J.L.M.* 17(6), 462 at p. 465

<sup>46</sup> Guest, A. “*Benjamin's Sale of Goods*” (Sweet & Maxwell, 7<sup>th</sup> ed., London, 2006) at p. 2072

<sup>47</sup> Carr, I. “*International Trade Law*” (Cavendish Publishing, 3<sup>rd</sup> ed., 2005) at p. 503

provide a more flexible fraud standard which would make the fraud exception a practical rather than a theoretical concept.

### 5.2.2. A proposed fraud standard: an objective test

As has been seen above, “the existence of a fraud exception...is severely limited in English law”.<sup>48</sup> Thus, the question that arises at this stage is: ““Does fraud require (evidence of) deceitful or malicious conduct on the part of the beneficiary?”<sup>49</sup> The current author’s answer to this question is no. It is suggested that the question with which the courts should be concerned is not whether the beneficiary knows about the fraud but rather whether the beneficiary should have known about it. Indeed, rather than looking subjectively at the beneficiary’s state of mind to find fraud, an objective test, which would direct the inquiry into the case’s relevant circumstances in order to find fraud, will suit such a context better and will ease the application of the fraud exception. The suggested test, which previously examined this situation, and which was advocated approximately one hundred years ago in *Société Metallurgique d’Aubrives & Villerupt v. British Bank for Foreign Trade*,<sup>50</sup> states: “Did the person presenting misdescribe the goods in such a way as to be guilty of fraud. If that were so, then the bank in refusing to pay would be justified”.<sup>51</sup>

Documentary credits are usually issued in connection with sales contracts and the conditions they contain relate to the sale of goods which they have been issued for.<sup>52</sup>

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<sup>48</sup> Bridge, M. “*Benjamin’s Sale of Goods*” (Sweet & Maxwell, 8<sup>th</sup> ed., London, 2010) at 23-081

<sup>49</sup> Bertrams, R. “*Bank Guarantees in International Trade: The Law and Practice of Independent (First Demand) Guarantees and Standby Letters of Credit in Civil Law and Common Law Jurisdictions*” (Kluwer Law International, 3<sup>rd</sup> ed., The Hague (Netherlands), 2004) at p. 337

<sup>50</sup> (1922) 11 Ll. L. Rep. 168

<sup>51</sup> *Ibid.* at 170

<sup>52</sup> Finkelstein, H. “*Legal Aspects of Commercial Letters of Credit*” (Columbia University Press, New York, 1930) at p. 14

Accordingly, it is submitted that goods are “the decisive factor in finding fraud.”<sup>53</sup> Through examining the situation of the goods’ required by the documentary credit documents, the court can infer whether an evil intent is existent or not.<sup>54</sup> Fraud could be inferred in circumstances where the goods’ shipped by the seller are of a completely different nature from those which have been contracted for and determined by the documentary letter of credit. Fraud could also be inferred where the goods are defective or useless.<sup>55</sup> This would include, for example, situations where bags tendered were rags instead of paper.<sup>56</sup> In other words, “The description of old, worthless, newspapers as ‘class I typing paper’ is inconsistent with anything but a fraud”.<sup>57</sup> Such a fact would be “prima facie evidence of fraud”.<sup>58</sup> In such a case, the existence of knowledge, dishonesty, or *male fide* conduct on the part of the beneficiary “is simply derived from the established facts...”.<sup>59</sup> As it has been observed recently by one commentator:

“There are circumstances where it is obvious that the seller’s breach of contract is not one which could have occurred through mere negligence and in which a strict adherence to the autonomy principle would benefit fraudsters while denying justice to other parties”.<sup>60</sup>

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<sup>53</sup> Weisz, G. & Blackman, J. ‘Standby Letters of Credit after Iran: Remedies of the Account Party’ (1982) 1 *U. ILL. L. Rev.* 355, at p. 369

<sup>54</sup> Bulger, R. ‘Letters of Credit: A Question of Honor’ [1984] *N.Y.U.J. Int’l L. & Pol.* 799 at p. 809

<sup>55</sup> Arora, A. ‘Fraud and Forgery in Commercial Documentary Credits’ [1983] *C.L.B.* 9, 271 at p. 275

<sup>56</sup> In the same manner, another example has been provided by Ellinger: “If, for example, sea-water is shipped instead of ‘Pale Ale’ it is obvious that some fraud is involved. If, on the other hand, ‘Stout’ is shipped instead of ‘Pale Ale’ this might be due to a genuine error (or difference in terminology) and not necessarily to fraud. In such a case it might be difficult to convince a court that a fraud was committed”. See, Ellinger, E. ‘The Tender of Fraudulent Documents under Documentary Letters of Credit’ (1965) 7 *Malaya L. Rev.* 24 at p. 36

<sup>57</sup> Ellinger, E. ‘The Tender of Fraudulent Documents under Documentary Letters of Credit’ (1965) 7 *Malaya L. Rev.* 24, at p. 38

<sup>58</sup> Finkelstein, H. “*Legal Aspects of Commercial Letters of Credit*” (Columbia University Press, New York, 1930) at p. 230

<sup>59</sup> Bertrams, R. “*Bank Guarantees in International Trade: The Law and Practice of Independent (First Demand) Guarantees and Standby Letters of Credit in Civil Law and Common Law Jurisdictions*” (Kluwer Law International, 3<sup>rd</sup> ed., The Hague (Netherlands), 2004) at p. 348

<sup>60</sup> Low, H.Y. ‘Confusion and Difficulties Surrounding the Fraud Rule in Letters of Credit: An English Perspective’ [2011] *Int. J.L.M.* 17(6), 462, at pp. 462-463

Loosely speaking, the law of sales does recognize that there is a distinction between differences in kind and differences in quality and that the former may well constitute a case of fraud but the latter will rarely do.<sup>61</sup> Where it is merely a contractual breach by the beneficiary in the underlying sales transaction, it could be said that the autonomy principle is supportable on the ground that the applicant has accepted the risk of payment notwithstanding such kinds of defects in its performance.<sup>62</sup> If such a principle was not adhered to and the bank refused payment, the expectations of the parties, which they have initially bargained for, would be undermined. Furthermore, documentary credits would soon lose their commercial reputation in the eyes of sellers who would no longer trust them as a prompt and certain way of payment. However, this rationale becomes less compelling when ‘the degree and *mala fides* of the beneficiary’s breach increase to the point of fraud...’.<sup>63</sup> As has been noted by another commentator:

“Given the destruction of the underlying contract it is inconceivable that a customer without adequate legal remedy would have to pay on a letter of credit because the seller shipped empty crates through negligence rather than ‘active, intentional fraud’”.<sup>64</sup>

Whilst it is necessary to prevent the fraud exception from including cases of only small quantity shortage or deferred delivery, it would be of irreparable harmful consequences to allow fraudulent beneficiaries, who ship rubbish or totally different goods, to go unpunished. Allowing the latter situation would, as would tolerating the

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<sup>61</sup> Finkelstein, H. “*Legal Aspects of Commercial Letters of Credit*” (Columbia University Press, New York, 1930) at p. 230

<sup>62</sup> Fellinger, G. ‘Letters of Credit: The Autonomy Principle and the Fraud Exception’ [1990] 1 *J.B.F.L.P.* 4, at p. 9

<sup>63</sup> *Ibid.*

<sup>64</sup> Note. “‘Fraud in the Transaction’: Enjoining Letters of Credit during the Iranian Revolution’ (1980) 93 *Harv. L. Rev.* 992 at p. 1008

former situation, lead to the breakdown of the documentary credit mechanism.<sup>65</sup> In the latter cases, as well as the applicant, the bank's security would be affected badly. Nonetheless, banks would not always be affected in cases of intentional fraud. Where there is no great discrepancy between the actual state of the goods and their description, the bank can obtain almost the same amount which it has paid to the beneficiary if the applicant refuses to pay and as a result the bank is forced to sell the goods. However, in cases where there is a substantial discrepancy it would be very difficult for the bank to get the sum of money which it has already advanced.<sup>66</sup> Whether a deceitful intention is available or not, the banks' attention is directed into the goods and nothing else but the goods. Accordingly, it is submitted that the objective test would better serve, in addition to applicants, the banks' expectations.

However, the difficulty which arises in such a context is to determine specifically what circumstances should be considered as merely breach of contract, which would not restrain a documentary credit payment, and those which would constitute fraud and so result in restraining the payment.<sup>67</sup> While some specific cases are clear, other cases are more difficult to determine. There can be no doubt that the seller is fraudulent when he submits an invoice which describes Manilla hemp while what he actually ships is cotton rags. However, a dispute could arise where the question is whether grapes are of a certain quality and whether some paper is of certain

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<sup>65</sup> Qiman, L. 'The Practice of Judicial Preservation for Documentary Credits' (eds.) in Byrne, J. "2003 Annual Survey of Letter of Credit Law & Practice" (The Institute of International Banking Law & Practice Inc., USA, 2003) 105 at pp. 108-109

<sup>66</sup> Finkelstein, H. "Legal Aspects of Commercial Letters of Credit" (Columbia University Press, New York, 1930) at p. 231. To this point Thayer provides: "It is a logical inference...that a bank which has paid under such circumstances should be allowed to recover, and that if knowledge of misrepresentation is acquired earlier, the bank should not be compelled to accept the documents or to pay. However innocently, the seller has failed as effectively as in the case of outright fraud to give the bank what the parties contemplated. That is, control over merchandise of a specific description" see: Thayer, P. 'Irrevocable Credits in International Commerce: Their Legal Effects' (1937) 37 *Colum. L. Rev.* 1326 at pp. 1336-1337

<sup>67</sup> Malek, A & Quest, D. "Jack: Documentary Credits" (Tottel Publishing, 4<sup>th</sup> ed., Sussex, 2009) at pp. 254-255

strength.<sup>68</sup> Such a difficulty has been noted by Lord Diplock in the *United City Merchants (Investments) Ltd v Royal Bank of Canada (The American Accord)*.<sup>69</sup>

Other than the required deceitful intent, his Lordship has found that fraud should be material. In citing his words again, one could note the materiality point where his Lordship provided:

“...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”.<sup>70</sup>

His Lordship’s requirement that the fraud should be material does echo the view suggested by the proposed objective test. However, what could be cited against Lord Diplock’s approach is that he connected the test of materiality to that of intent which, as seen above, is hard to prove and so ineffective in this context.<sup>71</sup> Yet the problem is to define when it could be said that a certain action does constitute a material fraud.<sup>72</sup>

To this his Lordship has provided:

“The answer to the question: ‘to what must the misstatement in the documents be material?’ should be: ‘material to the price which the goods to which the documents relate would fetch on sale if, failing reimbursement by the buyer, the bank should be driven to realise its security’.<sup>73</sup>

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<sup>68</sup> Finkelstein, H. “*Legal Aspects of Commercial Letters of Credit*” (Columbia University Press, New York, 1930) at pp. 245-246

<sup>69</sup> [1983] 1 A.C. 168; [1982] 2 W.L.R. 1039 (House of Lords)

<sup>70</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada (The American Accord)* [1983] 1 A.C. 168 at 186-187 [Emphasis added]

<sup>71</sup> Low, H.Y. ‘Confusion and Difficulties Surrounding the Fraud Rule in Letters of Credit: An English Perspective’ [2011] *Int. J.L.M.* 17(6), 462 at p. 463. In relation to this he stated: “The effect of the decision [*United City*] was a trend whereby English courts have generally avoided defining what constitutes fraud. Rather, when identifying fraud in letters of credit, the courts have always emphasised the *mens rea* – the state of mind of the beneficiary. Hence there is uncertainty as to what constitutes ‘material representation’.”

<sup>72</sup> Qiman, L. ‘The Practice of Judicial Preservation for Documentary Credits’ (eds.) in Byrne, J. “*2003 Annual Survey of Letter of Credit Law & Practice*” (The Institute of International Banking Law & Practice Inc., USA, 2003) 105 at p. 109; ‘Task Force on the Study of U.C.C. Article 5 (Letters of Credit)’ (1990) *The Business Lawyer* Vol.45, 1521 at p. 1614

<sup>73</sup> [1983] 1 AC 168 at p. 186. The same view has been suggested by Malek where he provided: “It is suggested that this must mean material to the bank’s duty to pay, so that if the document stated the truth the bank would be obliged and entitled to reject the documents. For example, if the bill of lading and the invoice in the *Sztejn* case had stated that the shipment consisted of cowhair and rubbish purporting to be bristles, they would not have conformed. And, in the *United City Merchants* case itself, if the bill



Such criterion, which has been drawn by Lord Diplock in order to determine the circumstances which would constitute a material fraud, is laudable. It depends on the actual state of the goods and takes into account the expectations of banks as well as applicants. Nonetheless, the materiality formulation which Lord Diplock has formulated has been criticized as it does not provide a detailed guidance as to what situations could specifically constitute material fraud.<sup>74</sup> While it is unanimously accepted that “the fraud in question must relate to a material aspect of the documents and shipment”<sup>75</sup> and that a distinction must be made between fraud and a mere breach of contract, it has been frequently suggested that it is a very difficult matter “to draw a line between breach of warranty and outright fraudulent practices”.<sup>76</sup> In fact, the line between mere breaches of contract and fraud is not clear<sup>77</sup> and therefore it has been suggested that this “is a matter that only the courts can properly assess”.<sup>78</sup>

However, it is submitted that such a point should not be overestimated. As has been suggested by Ellinger: “It is true that, on occasions, the facts might speak for

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of lading had had the correct date of shipment, it would have been outside the credit period”. See: Malek, A & Quest, D. “*Jack: Documentary Credits*” (Tottel Publishing, 4<sup>th</sup> ed., Sussex, 2009) at pp. 254-255

<sup>74</sup> Ellinger P. & Neo, D. “*The Law and Practice of Documentary Letters of Credit*” (Hart Publishing, Oxford, 2010) at p. 141; Enonchong, N. “*The Independence Principle of Letters of Credit and Demand Guarantees*” (Oxford University Press, Oxford, 2011) at p.105; Low, H.Y. ‘Confusion and Difficulties Surrounding the Fraud Rule in Letters of Credit: An English Perspective’ [2011] *Int. J.L.M.* 17(6), 462 at p. 463

<sup>75</sup> Qiman, L. ‘The Practice of Judicial Preservation for Documentary Credits’ (eds.) in Byrne, J. “*2003 Annual Survey of Letter of Credit Law & Practice*” (The Institute of International Banking Law & Practice Inc., USA, 2003) 105 at p. 109; Sarna, L. “*Letters of Credit: The Law and Current Practice*” (Carswell Legal Publishers, 2<sup>nd</sup> ed., Toronto, 1986) at p. 135; Leacock, S. ‘Fraud in the International Transaction: Enjoining Payment of Letters of Credit in International Transactions’ [1984] *Vand. J. Transnat’l L.* 885 at p. 914. To this Leacock has stated: “The crucial factor in determining the propriety of any judicial interference is whether or not the fraud is material enough to negate the confirming or issuing bank’s obligation to pay upon presentation of the documents”.

<sup>76</sup> Weisz, G. & Blackman, J. ‘Standby Letters of Credit after Iran: Remedies of the Account Party’ (1982) 1 *U. ILL. L. Rev.* 355, at p. 371

<sup>77</sup> Note. “‘Fraud in the Transaction’: Enjoining Letters of Credit during the Iranian Revolution’ (1980) 93 *Harv. L. Rev.* 992, at p. 1008

<sup>78</sup> Fellinger, G. ‘Letters of Credit: The Autonomy Principle and the Fraud Exception’ [1990] 1 *J.B.F.L.P.* 4, at p. 24

themselves”.<sup>79</sup> Fraudulent beneficiaries who have the intent to defraud applicants would not send the contracted for goods and they would not even send goods of equivalent price but rather they will send something valueless or even with no value at all in order to benefit from their own fraud.<sup>80</sup> Accordingly it would be easy to infer which cases are cases of fraud and which are merely breaches of contracts. The few following cases would illustrate the fact that it would not be a very difficult task to determine fraud in this context.

In *Malas (Hamzeh) & Sons v. British Imex Industries Ltd*,<sup>81</sup> Malas, a Jordanian buyer, contended that the goods, sent to him by an English seller, were defective and therefore he applied for an injunction. Jenkins L.J. held that the confirmed documentary credit constituted an absolute obligation on the bankers to pay the beneficiary “irrespective of any dispute there may be between the parties as to whether the goods are up to contract or not”.<sup>82</sup> His Lordship found that the system of international commerce facilitated by irrevocable documentary credits “would break down completely if a dispute between the vendor and the purchaser was to have the effect of freezing... the sum in respect of which the letter of credit was opened”.<sup>83</sup> In fact, Jenkins L.J.’s statement is recommendable in such circumstances. Where the iron metal which had been sent by the English sellers to the Jordanian buyers was slightly different in quality from that contracted for, it would be difficult to infer fraud from such circumstances. By the same token, sending newsprint paper of a different tensile strength rather than the contracted for strength, in the American case of *Maurice*

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<sup>79</sup> Ellinger, E. ‘The Tender of Fraudulent Documents under Documentary Letters of Credit’ (1965) 7 *Malaya L. Rev.* 24 at p. 36

<sup>80</sup> Fraud in the contract not attributable to the beneficiary is rare in letters of credit. See: Note. “‘Fraud in the Transaction’: Enjoining Letters of Credit during the Iranian Revolution’ (1980) 93 *Harv. L. Rev.* 992 at p. 1010

<sup>81</sup> [1958] 2 Q.B. 127

<sup>82</sup> *Ibid.* at 129

<sup>83</sup> *Ibid.*

*O'Meara Co. v National Park Bank*<sup>84</sup>, did not qualify for the fraud exception application.<sup>85</sup> In this case, there was no allegation of fraud and “the whole tenor of the case seemed to represent a mere honest difference of opinion”.<sup>86</sup>

However, in *Sztejn v Henry Schroder Banking Corporation*,<sup>87</sup> worthless cowhair had been sent rather than the agreed on quantity of bristles by an Indian seller. According to Justice Shientag: “In the present motion, it must be *assumed* that the seller has intentionally failed to ship any goods ordered by the buyer.”<sup>88</sup> One should note that Justice Shientag has assumed that an intention to defraud was existent from the case relevant circumstances, namely: the shipment of rubbish rather than bristles. According to Sarna: “One is therefore left with the impression that, in the reasoning of Shientag J., material fraud is sufficient justification for dishonour”.<sup>89</sup> It seems that Lord Diplock, who allegedly followed *Sztejn* in the *United City Merchant* case, may have misapplied Justice Shientag’s test. Although Justice Shientag has used the term ‘intentional’, the *Sztejn* case facts exhibit an objective test of fraud in relation to the degree of fraud necessary to warrant the application of the fraud exception.<sup>90</sup> The facts of the *Discount Record Ltd v Barclays Bank Ltd*<sup>91</sup> case resemble that of the *Sztejn* case. Yet, Megarry J. in the *Discount Record* case has concluded that:

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<sup>84</sup> 146 N.E. 636 (1925)

<sup>85</sup> For more comments on this case, see: Finkelstein, H. “*Legal Aspects of Commercial Letters of Credit*” (Columbia University Press, New York, 1930) at pp. 229-230

<sup>86</sup> Finkelstein, H. “*Legal Aspects of Commercial Letters of Credit*” (Columbia University Press, New York, 1930) at p. 230

<sup>87</sup> 177 Misc. 719, 31 N.Y.S.2d 631 (1941)

<sup>88</sup> 177 Misc. 719, 31 N.Y.S.2d 631 (1941) at 633 [Emphasis added]

<sup>89</sup> Sarna, L. “*Letters of Credit: The Law and Current Practice*” (Carswell Legal Publishers, 2<sup>nd</sup> ed., Toronto, 1986) at p. 136. For a similar approach see: Martin-Nagle, R. ‘Injunctions of Letters of Credit: Judicial Insurance against Fraud’ (1983) *J. L. & Com* 305 at p. 313

<sup>90</sup> Fellinger, G. ‘Letters of Credit: The Autonomy Principle and the Fraud Exception’ [1990] 1 *J.B.F.L.P.* 4 at p. 12. Such a fact can be derived from the subsequent case *Ashbury Park & Ocean Grove Bank v. National City Bank* 35 N.Y. Supp. 2d 985 (Sup. Ct, 1942), where Justice Shientag stated at pp. 988-989 that the fraud exception does not apply: “...unless there was such a fraud on the part of the seller that there were no goods shipped even though shipping tickets were presented.”

<sup>91</sup> [1975] 1 W.L.R. 315 at 320

“I do not think that this is a case for an injunction at all...If the first defendants have acted in breach of contract, the plaintiffs will have their claim against them...I would be slow to interfere with bankers’ irrevocable credits, and not least in the sphere of international banking, unless a sufficiently grave cause is shown; for interventions by the court that are too ready or too frequent might gravely impair the reliance which, quite properly, is placed on such credits”<sup>92</sup>

Justice Megarry has clearly suggested that in a breach of contract case the parties have to settle their disputes in normal ways of litigation and that an injunction could not be granted to restrain a documentary credit payment in such circumstances. A contrary approach would gravely impair the reliance which has been placed on these payment methods. Moreover, he has made it clear that if a sufficiently grave cause is shown the matter would be different and that courts should interfere to balance the interests of the different parties. However, it is submitted that he has applied a “rather defeatist approach”.<sup>93</sup> In *Discount* most of the goods shipped as required under the documentary credit were either rubbish or of a valueless nature. Nevertheless, Justice Megarry did not find that such facts would be considered as a sufficiently grave cause which would justify the fraud exception application. It is submitted that what made Justice Megarry refuse the injunction is the existence of a confirming bank in France which had already accepted to discount the beneficiary’s bills of exchange and so acquired the status of a holder in due course.<sup>94</sup> The inability of the applicant to provide an established proof of fraud is another reason for not granting the required injunction. In Justice Megarry’s words: “The *Sztejn* case is plainly distinguishable in relation both to established fraud and to the absence there of any possible holder in due course”. It would have been a better approach if he illustrated clearly that the

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<sup>92</sup> *Ibid.*

<sup>93</sup> Horowitz, D. “*Letters of Credit and Demand Guarantees: Defences to Payment*” (Oxford University Press, 2010) at p. 99

<sup>94</sup> For more in this point see chapter 6.

facts of *Discount* qualified the fraud exception but because of other above-mentioned reasons he found it necessary to refrain from granting the requested injunction.

The US courts have adopted a similar approach to that which requires an objective test rather than an intentional subjective test. In finding fraud, US courts look “at the factual circumstances of the case, in particular the effect and severity of the wrongdoing”.<sup>95</sup> This has been described as “a US-style wide conception of fraud”.<sup>96</sup> Article 5-109 of the United States UCC provides that for the fraud exception to apply the fraud must be material.<sup>97</sup> The official comment (Para 1) has provided that the word material in the above provision “requires that the fraudulent aspect of the document be material to the purchaser of the document or that fraudulent act be significant to the participants in the underlying transaction”.<sup>98</sup> An example of a contract to deliver one thousand barrels of salad oil has been given in the official comment. The example provides that if the seller delivers 998 barrels and, nevertheless, even knowingly, submits an invoice which shows that one thousand barrels have been shipped, the shortage of two barrels is an ordinary and immaterial breach of the underlying contract and the beneficiary’s act, even though possibly fraudulent, is not material and, accordingly, the fraud exception will not be applied.<sup>99</sup>

Obviously, the official comment has made it clear that what should be counted on is

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<sup>95</sup> Low, H.Y. ‘Confusion and Difficulties Surrounding the Fraud Rule in Letters of Credit: An English Perspective’ [2011] *Int. J.L.M.* 17(6), 462 at p. 464. Cases which he relied on include: *Dynamics Corporation of America v the Citizens and Southern National Bank*, 356 F. Supp. 991 (1973); *Harris Corporation v National Iranian Radio and Television*, 691 F.2d 1344 (1982); *Itek Corporation v First National Bank of Boston*, 556 F. Supp. 1210 (1983)

<sup>96</sup> Enonchong, N. ‘The Problem of Abusive Calls on Demand Guarantees’ [2007] *L.M.C.L.Q.* 1, 83 at p. 88

<sup>97</sup> Section 5—109 of the United States UCC under the title ‘fraud and forgery’ provides that a bank may refuse to honor a credit “(a) If a presentation is made that appears on its face strictly to comply with the terms and conditions of the letter of credit, but a required document is forged or materially fraudulent, or honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant.”

<sup>98</sup> Cited in Enonchong, N. “*The Independence Principle of Letters of Credit and Demand Guarantees*” (Oxford University Press, Oxford, 2011) at pp. 105-106

<sup>99</sup> *Ibid.*

the act itself and not the intent. A frequently cited formulation which illustrates the American courts' approach can be found in *Intraworld Industries, Inc. v Girard Trust Bank*<sup>100</sup> where it argues:

“The circumstances that will justify an injunction against honor must be narrowly limited to situations of 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*”.<sup>101</sup>

In another US case, *3Com Corp. v Banco do Brasil, S.A.*,<sup>102</sup> the objective test has again been highlighted to fit comfortably with documentary credits' fundamental mechanisms and principles. In Sotomayor J.'s words:

“The adoption of an objective test standard is consistent with the contractual nature of letters of credit. Under such contracts, a beneficiary has the right to draw on the letter of credit only if certain conditions are met. If there is a ‘bona fide claim’ that those conditions have been met – in other words, if it is clear that the beneficiary has no right to draw on the letter of credit – the beneficiary should not be permitted to draw on the line of credit merely because the beneficiary has formed a good faith but mistaken belief that conditions permitting a draw do exist”.<sup>103</sup>

Similarly, in a relatively recent documentary letter of credit case, *Levin v Meagher*,<sup>104</sup>

Margulies J has remarkably found that:

“What unifies the various standards formulated in the cases cited in the official code comment is their requirement that *fraud be determined by an objective examination of the circumstances, rather than by reference to the subjective beliefs of the beneficiary*”.<sup>105</sup>

Interestingly, Ackner LJ in the *United Trading Crop*<sup>106</sup> case has referred to some of the cases cited in the official comment of UCC 5-109 and has noted that the US

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<sup>100</sup> 461 Pa. 343, 336 A.2d 316 (1975)

<sup>101</sup> *Ibid.* at 324-325 [Emphasis added]. Citing *Dynamics Corp of America v Citizens Southern Nat'l Bank* (1973) 356 F Supp, 991, at 999. The recent case of *Mid-America Tire, Inc. v. PZT Trading Ltd.*, 95 Ohio St 3d 367 (2002) (Sup Ct, Ohio), suggests also a material fraud test in America.

<sup>102</sup> (2<sup>nd</sup> Cir. 1999) 171 F.3d 739,

<sup>103</sup> *3Com Corp. v Banco do Brasil, S.A.* (2<sup>nd</sup> Cir. 1999) 171 F.3d 739, at 747

<sup>104</sup> 2004 Cal. App Unpub LEXIS 7060

<sup>105</sup> *Ibid.* at 18 [Emphasis added]

<sup>106</sup> *United Trading Corp SA v Allied Arab Bank Ltd.* [1985] 2 Lloyd's Rep. 554 (CA)

concept of the fraud exception is far wider than that in England. He observed that such a wider concept did not result in destroying the utility of letters of credit in the international trade context but rather it gave the fraud exception a more realistic role to play.<sup>107</sup> In sum, the common law fraud and fraud under UCC Article 5 are not the same.<sup>108</sup> The difference is that the standard of the fraud which is required under Article 5 to stop a letter of credit payment is material fraud rather than intentional fraud.<sup>109</sup> The Task Force agreed that letters of credit fraud is not the same as common law fraud and that such a test “should be regarded in light of the critical importance played by the independence of the credit transaction from the underlying transaction”.<sup>110</sup> Having illustrated the fraud standard position in respect of documentary credits, the next section is concerned with the position of such a test and other applicable tests in an independent guarantee context.

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<sup>107</sup> *Ibid* at 561. To this point his Lordship stated: “It is interesting to observe that in America, where concern to avoid irreparable damage to international commerce is hardly likely to be lacking, interlocutory relief appears to be more easily obtainable. A temporary restraining order is made essentially on the basis of suspicion of fraud, followed some months later by a further hearing, during which time the applicant has an opportunity of adding to the material which he first put before the Court. Moreover, their conception of fraud is far wider than ours and would appear to include ordinary breach of contract. These cases appear to indicate that, for the purpose of obtaining relief in such cases, it is not necessary for an American plaintiff to demonstrate a cause of action against a bank, whereas it is, as previously stated, common ground that a plaintiff must in this country show a cause of action. There is no suggestion that this more liberal approach has resulted in the commercial dislocation which has, by implication at least, been suggested would result from rejecting the respondent's submissions as to the standard of proof required from the plaintiffs. Moreover, we would find it an unsatisfactory position if, having established an important exception to what had previously been thought an absolute rule, the Courts in practice were to adopt so restrictive an approach to the evidence required as to prevent themselves from intervening. Were this to be the case, impressive and high-sounding phrases such as 'fraud unravels all' would become meaningless.”

<sup>108</sup> *Rockwell International Systems Inc v Citibank NA* (1983) 719 F 2d 583, 589; *Harris Corp v National Iranian Radio and Television* (1982) 691 F 2d 1344; *Dynamics Corp of America v Citizens and Southern National Bank* (1973) 356 F Supp 991

<sup>109</sup> Wunnicke, B. Wunnicke D. & Turner P. “*Standby and Commercial Letters of Credit*” (Wiley Law Publications, 2<sup>nd</sup> ed., New York, 1996) at p. 168

<sup>110</sup> ‘Task Force on the Study of U.C.C. Article 5 (Letters of Credit)’ (1990) *The Business Lawyer* Vol.45, 1521 at p. 1615

### 5.3. The fraud standard in independent guarantees

In contrast to documentary credits, the independent guarantees' payment process does not depend on commercial documents. More often, an independent guarantee beneficiary invokes the guarantee by a simple written demand without a proof of default and without the need to submit any valued commercial documents.<sup>111</sup> The bank in its turn pays the beneficiary once the latter demands the independent guarantee amount without the need to look at the underlying transaction to see whether the demand is a result of a genuine default on the part of the applicant or not. As has been mentioned above,<sup>112</sup> the autonomy principle, which has been injected into this context to facilitate the ease of use of both documentary credits and guarantees, exempts banks from examining different and, in some circumstances, complex transactions.<sup>113</sup> Nonetheless, inserting the autonomy principle into these financial instruments has not been without its own inadequacies.<sup>114</sup> Whilst it may be said that most of the issuers do proceed on the basis that an independent guarantee will never be called upon "due to their faith in the good faith, strength and financial capability of the applicant,"<sup>115</sup> it is true, in certain circumstances, that the autonomy principle would put banks and applicants in an "absurdly vulnerable position".<sup>116</sup>

Unlike documentary credits, the autonomy principle's necessity in the independent guarantees field has been disputed. While it has been reiterated frequently that the

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<sup>111</sup> Goode, R. "Commercial Law" (Penguin Books, 3<sup>rd</sup> ed., London, 2004) at pp. 1018-1019

<sup>112</sup> See section 5.2.

<sup>113</sup> *Hamzeh Malas & Sons v. British Imex Industry Ltd* [1958] 2 Q.B. 127, [1958] 1 A11 E.R. 262 at 263-264

<sup>114</sup> Rowe, M. "Letters of Credit" (Euromoney Books, 2<sup>nd</sup> ed., London, 1997) at p. 241

<sup>115</sup> Sarna, L. "Letters of Credit: The Law and Current Practice" (Carswell Legal Publishers, 2<sup>nd</sup> ed., Toronto, 1986) at p. 151

<sup>116</sup> Megrah, M. 'Risk Aspects of the Irrevocable Documentary Credit' (1982) 24 *Ariz. L. Rev.* 255, at p. 256. In the same manner it has been noted that: "...in cases of beneficiary fraud in which an action by the [account party] on the underlying contract would be ineffectual, the rule of independent contracts would operate to unjustly enrich an unscrupulous beneficiary". See: Note: "Letters of Credit: Injunction as a Remedy for Fraud in U.C.C Section 5-114", (1979) 63 *Minnesota Law Review* 487 at p. 490.



same principles apply to independent guarantees and documentary credits,<sup>117</sup> it has been said that an analogy between the two instruments is “tenuous”.<sup>118</sup> Two interesting trends have shown up in this regard. In the first trend, Debattista argues that there should be no equation between principles of independent guarantees and that of documentary credits.<sup>119</sup> He argues that “The principle of autonomy is commercially justifiable in the [documentary credits], but totally without such foundation in [independent guarantees]”.<sup>120</sup> Accordingly, taking his view, which refuses the application of the autonomy principle in such a context,<sup>121</sup> into consideration, applicants should be free to interrupt the independent guarantee payment process whenever a dispute comes up in the underlying contract from which the guarantee has ensued. It is submitted that such a view, if followed, will undermine the utility of independent guarantees in the international trade realm.<sup>122</sup> Such a view overlooks the fact that one of the primary purposes of using independent guarantees is to guarantee the beneficiary a quick and easy payment by a reliable master without both needing to engage in protracted arguments.<sup>123</sup> In utilising such financial

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<sup>117</sup> Bridge, M. “*Benjamin’s Sale of Goods*” (Sweet & Maxwell, 8<sup>th</sup> ed., London, 2010) at 23-081; Ellinger P. & Neo, D. “*The Law and Practice of Documentary Letters of Credit*” (Hart Publishing, Oxford, 2010) at p. 139; Murray, C. Holloway, D & Timson-Hunt, D. “*Schmitthoff’s Export Trade: The Law and Practice of International Trade*” (Sweet & Maxwell, 11<sup>th</sup> ed., London, 2007) at p. 240

<sup>118</sup> Andrews, M. ‘Standby Letters of Credit: Recent Limitations on the Fraud Transaction defense’ (1988) 35 *Wayne L. Rev.* 119 at pp. 148-149

<sup>119</sup> Debattista, C. ‘Performance Bonds and Letters of Credit: A Cracked Mirror Image’. [1997] *J.B.L.* 289 at p. 304. Debattista argues that the autonomy principle has no application in independent guarantees because there are no documents used, to protect banks and applicants, and accordingly no chance for documentary fraud as established by English courts (documentary fraud is the only exception in England). Yet, taking into consideration that the fraud exception should be available in both the documents and the underlying contract, his argument does not stand valid legal analysis any more.

<sup>120</sup> Debattista, C. ‘Performance Bonds and Letters of Credit: A Cracked Mirror Image’. [1997] *J.B.L.* 289 at p. 303. He also argues that “the transplant of the principle of autonomy from letters of credit to performance bonds is misconceived”. See p. 289

<sup>121</sup> *Ibid.* at p. 304

<sup>122</sup> Horowitz, D. “*Letters of Credit and Demand Guarantees: Defences to Payment*” (Oxford University Press, 2010) at p. 92

<sup>123</sup> Ellinger P. & Neo, D. “*The Law and Practice of Documentary Letters of Credit*” (Hart Publishing, Oxford, 2010) at p. 300

instruments, it is a well-known principle that the applicant will have to pay first and argue later.<sup>124</sup> Hence, such a trend should be disallowed.

In the second trend, Bennett suggests applying the autonomy principle but with no exceptions in one way or another.<sup>125</sup> He suggests that the applicants should, from the start, inflate their contract price in order to mitigate the risk of loss caused by fraudulently demanding independent guarantees.<sup>126</sup> In his opinion, courts should not be allowed to intervene with underlying contracts to protect independent guarantees applicants because these risks, which might occur later, have been obvious to the sophisticated applicants before they have accepted to establish an independent guarantee.<sup>127</sup> According to Mugasha: “The parties agree to use these instruments well aware that each instance is a ‘pay now, talk later’ situation.”<sup>128</sup> With the same effect, Lord Denning in the *Edward Owen* case<sup>129</sup> has stated:

“As one takes instance after instance, *these performance guarantees are virtually promissory notes payable on demand...* customers make an honest demand, the banks are bound to pay: and the banks will rarely, if ever, be in a position to know whether the demand is honest or not. At any rate they will not be able to prove it to be dishonest. *So they will have to pay.*”<sup>130</sup>

It is submitted that this view should also be disallowed for the following reasons. Indeed, independent guarantees are virtually imposed on the exporters (applicants) by powerful importers (beneficiaries) who have the whip hand in negotiations.<sup>131</sup>

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<sup>124</sup> *Ibid.*; Mugasha, A. ‘Enjoining the Beneficiary’s Claim on a Letter of Credit or Bank Guarantee’ [2004] *J.B.L.* 515 at p. 533

<sup>125</sup> Bennett, H. ‘Performance Bonds and the Principle of Autonomy’ [1994] *J.B.L.* 574 at p. 581

<sup>126</sup> *Ibid.* at p. 577; to the same effect, see: Edwards, R. ‘The Role of Bank Guarantees in International Trade’ (1982) *A.L.J.* Vol. 56, 281 at p. 285

<sup>127</sup> Andrews, M. ‘Standby Letters of Credit: Recent Limitations on the Fraud Transaction defense’ (1988) 35 *Wayne L. Rev.* 119 at p. 142

<sup>128</sup> Mugasha, A. ‘Enjoining the Beneficiary’s Claim on a Letter of Credit or Bank Guarantee’ [2004] *J.B.L.* 515 at p. 533

<sup>129</sup> *Edward Owen Engineering Ltd. v Barclays Bank International Ltd.* [1978] Q.B. 159; [1977] 3 W.L.R. 764 (CA)

<sup>130</sup> [1978] 1 Lloyd’s L.R. 166, at 171 [Emphasis added]

<sup>131</sup> Edwards, R. ‘The Role of Bank Guarantees in International Trade’ (1982) *A.L.J.* Vol. 56, 281 at p. 284

Opening an independent guarantee does not necessarily mean that the applicant is a sophisticated trader or that he accepts the risk of later fraudulent calls. In addition, if the contract's price has been inflated to take into account the risks of fraudulent demands, high contract prices might lead to a situation where the applicant stays out of the tender as a whole. With higher prices and fewer participants, it is more likely that fewer contracts will be concluded and therefore international trade will decline as a result.<sup>132</sup> Furthermore, as it has been said by Bertrams: “‘paying first’ [and, hence, leaving the account party to retrieve the moneys in subsequent proceedings] would make no sense if the outcome of ‘later arguments’ is already evident”.<sup>133</sup> In some situations, the amount of the independent guarantee will equal, or even be more than, the applicant's profit on the project and thus a fraudulent demand can affect the applicant adversely.<sup>134</sup> In addition, if the applicant is a small trader, a fraudulent call might result in his bankruptcy and if a number of fraudulent calls have been made on one bank, the solvency of the bank might be at the stake.<sup>135</sup> The applicant who has obtained an independent guarantee and then such a guarantee has been acted upon, would find it difficult to obtain another independent guarantee subsequently as banks will view him as a risky customer who does not discharge his obligations. For the same reason, such an applicant will find it difficult either to obtain other contracts from parties who would ask for independent guarantees.

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<sup>132</sup> Vaart, H. ‘Standby Letters of Credit and the Problem of Bad Faith Calls’ (1981) 8 *Yale. J. World. Pub. Order.* 36, at p. 44

<sup>133</sup> Bertrams, R. “*Bank Guarantees in International Trade: The Law and Practice of Independent (First Demand) Guarantees and Standby Letters of Credit in Civil Law and Common Law Jurisdictions*” (Kluwer Law International, 3<sup>rd</sup> ed., The Hague (Netherlands), 2004) at p. 358. As observed by Cardozo J. in his dissenting opinion in the *Maurice O’Meara Co. v. Nat. Park Bank*, 146 N.E.636 (1925), “if payment might have been recovered the moment after it was made, the seller cannot coerce payment if the truth is earlier revealed.”

<sup>134</sup> Fong, P. ‘An Overview of Performance Bonds, Performance Guarantees and Bank Guarantees: Part II’ [1997] *Tr. Law* Vol. 16(3), 196 at p. 210

<sup>135</sup> Vaart, H. ‘Standby Letters of Credit and the Problem of Bad Faith Calls’ (1981) 8 *Yale. J. World. Pub. Order.* 36 at p. 37

In the words of Blair J.: “In short, the consequences of a call on an [independent guarantee]...can be harsh, draconian and abrupt”.<sup>136</sup> Therefore, and for the reasons illustrated above, it is submitted that the long term effect of fraudulent calls will insert a thick layer of uncertainty into international trade resulting in high contract prices and less trade in total.<sup>137</sup> The non-existence of documents in the independent guarantees’ field does not mean “that this is an open invitation to beneficiaries to defraud banks and applicants”.<sup>138</sup>

A conservative view in this regard can be found in Lord Denning’s words in the *Edward Owen* case<sup>139</sup> where he found that the independent guarantees and documentary letters of credit are similar but not identical and that an exception should be recognised to the autonomy principle which governs both instruments. In his words:

“All this leads to the conclusion that the performance guarantee stands on a similar footing to a letter of credit. A bank which gives a performance guarantee must honour that guarantee according to its terms. It is not concerned in the least with the relations between the supplier and the customer: nor with the question whether the supplier has performed his contracted obligation or not. The bank must pay according to its guarantee, on demand, if so stipulated, without proof or conditions. The only exception is when there is a clear fraud of which the bank has notice”.<sup>140</sup>

It is perhaps inappropriate to say that the autonomy principle is ‘misplaced’ in the context of independent guarantees. Such a principle is of an indispensable importance to facilitate the smooth running of these instruments and consequently the international trade realm. However, it is certainly true that independent guarantees are

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<sup>136</sup> *Royal Bank of Canada v Darlington* (1995) 54 ACWS (3d) 738

<sup>137</sup> Pierce, A. “*Demand Guarantees in International Trade*” (Sweet & Maxwell, London, 1993) at p. 157

<sup>138</sup> Jeffery, S. ‘Standby Letters of Credit and the Fraud exception – An Update’ [2003] 18 *B.F.L.R.* 67 at p. 81

<sup>139</sup> *Edward Owen Engineering Ltd v Barclays Bank International Ltd* [1978] Q.B. 159

<sup>140</sup> *Ibid* at 171. In the same manner Roskill L.J. in *Howe Richardson v Polimpex* [1978] 1 Lloyd’s Rep. 161 at 165, has argued: “The bank, in principle, is in a position not identical with but very similar to the position of a bank which has opened a confirmed irrevocable letter of credit”

functionally different from documentary credits, and that the fraud defence application may vary or even be exchanged by another exception in order to protect the different parties who utilise such instruments.<sup>141</sup> Yet, English courts “have regularly stated that the relevant legal principles are the same in both types of cases, and judicial authorities are used interchangeably”,<sup>142</sup> and so the fraud exception itself is the only exception to the equally well-established autonomy principle in independent guarantees. Indeed, it is the aim of the rest of this chapter to explore whether the fraud exception, either in a subjective or an objective manner, is sufficient or whether English courts should recognise other exceptions in order to protect the different parties from fraudulent demands in this context.

This following discussion is divided into four parts. The first part addresses the existent fraud standard test which English courts usually apply when an independent guarantee case appears before them. The second part aims to reveal the extent of effectiveness of an objective fraud test similar to that proposed in the last section which addresses the fraud standard in a documentary credit context. The third part examines the unconscionability exception, which has been devised in other commonwealth countries, and its chances of being adhered to in the English jurisdiction. The fourth and the last part is concerned with the underlying contract exception which has lately appeared in the English courts as a way by which an applicant can restrain the payment of a fraudulent demand in an independent guarantee context. As allegations of fraud are nearly always made in relation to

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<sup>141</sup> Horowitz, D. “*Letters of Credit and Demand Guarantees: Defences to Payment*” (Oxford University Press, 2010) at p. 92

<sup>142</sup> Ellinger P. & Neo, D. “*The Law and Practice of Documentary Letters of Credit*” (Hart Publishing, Oxford, 2010) at p. 139; Murray, C. Holloway, D & Timson-Hunt, D. “*Schmitthoff's Export Trade: The Law and Practice of International Trade*” (Sweet & Maxwell, 11<sup>th</sup> ed., London, 2007) at p. 240

independent guarantees that require only a mere demand without documents,<sup>143</sup> it is justifiable to narrow the exploration of this section to this type of guarantee.

### 5.3.1. The common law fraud standard: a subjective test

The problem of fraudulent claims afflicts independent guarantees as much as, and even more than, documentary credits.<sup>144</sup> What constitutes fraud in independent guarantees has been described as “the most significant current problem”<sup>145</sup> in this context. Indeed, for the purposes of the fraud exception, English courts have treated cases of independent guarantees as involving the same principles as those which apply in a documentary credit context.<sup>146</sup> Accordingly, the common law fraud standard (intentional fraud), as has been established in the *United City Merchants* case, has been adopted by courts in independent guarantees cases.<sup>147</sup> In relation to this, for example, Parker LJ, in *GKN Contractors v Lloyds Bank*<sup>148</sup> stated that common law fraud is the relevant test.<sup>149</sup> In explaining such a test when applied to an independent guarantee context, his Lordship provided that the required fraud:

“refers to what may be called common law fraud, that is to say, a case where the named beneficiary presents a claim which he knows at the time

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<sup>143</sup> Bertrams, R. “*Bank Guarantees in International Trade: The Law and Practice of Independent (First Demand) Guarantees and Standby Letters of Credit in Civil Law and Common Law Jurisdictions*” (Kluwer Law International, 3<sup>rd</sup> ed., The Hague (Netherlands), 2004) at p. 357

<sup>144</sup> Bridge, M. “*Benjamin’s Sale of Goods*” (Sweet & Maxwell, 8<sup>th</sup> ed., London, 2010) at 23-081

<sup>145</sup> Lock, A. ‘Standby Letters of Credit and Performance Bonds: The Lesson of the Iranian Experience’ (eds.) in Chinkin, C., Ho, P. & Chan, H. “*Current Problems of International Trade Financing*” (National University of Singapore, 2<sup>nd</sup> ed., 1990) 232 at p. 236

<sup>146</sup> Malek, A & Quest, D. “*Jack: Documentary Credits*” (Tottel Publishing, 4<sup>th</sup> ed., Sussex, 2009) at p. 247

<sup>147</sup> Debattista, C. ‘Performance Bonds and Letters of Credit: A Cracked Mirror Image’. [1997] *J.B.L.* 289 at p. 291; *Balfour Beatty Civil Engineering v Technical & General Guarantee Co Ltd* [2000] C.L.C. 252; 68 Con. L.R. 180 (CA); *Kvaerner John Brown Ltd v Midland Bank Plc & Anor* [1998] CLC 446; *Deutsche Rückversicherung AG v Walbrook Insurance Co. Ltd and Others* [1996] 1 W.L.R. 1552; [1995] C.L.C. 1532 (CA); [1994] 4 ALL E.R. 181; [1995] 1 W.L.R. 1017 (first instance). In the latter case, Phillips J. has stated, in [1994] 4 ALL E.R. 181 at pp. 196-197, that there is fraud if the beneficiary “has a bona fide claim to payment under the underlying contract” and that beneficiaries “will be acting fraudulently in that they will be claiming payment to which they know they have no entitlement”.

<sup>148</sup> (1985) 30 Build LR 53

<sup>149</sup> *Ibid.* at 63

to be an invalid claim, representing to the bank that he believes it to be a valid claim”.<sup>150</sup>

In the same manner, in *State Trading Corp of India Ltd v ED&F Man Sugar Ltd*,<sup>151</sup>

Lord Denning has noted:

“... that the buyer, when giving notice of default, must honestly believe that there has been a default on the part of the seller. Honest belief is enough. If there is no honest belief, it may be evidence of fraud. If there is sufficient evidence of fraud, the court might intervene and grant an injunction. But otherwise not. So long as the buyer honestly believes there is default on the part of the seller, that is sufficient ground for a notice of default to be given”.<sup>152</sup>

As can be seen, a claim under an independent guarantee could be described as fraudulent where “it amounts to deceit on the part of the beneficiary, namely where the beneficiary cannot honestly believe in the validity of the claim”.<sup>153</sup> The common law test in an independent guarantee context does focus on the beneficiary’s beliefs.<sup>154</sup> That is to say if the beneficiary has an honest belief he should obtain the independent guarantee amount whether his demand is justified or not.<sup>155</sup> Many *Dicta*, which have been held in recent cases, echo what both Lord Denning and Lord Parker have found previously. For instance, in *Uzinterimpex JSC v Standard Bank Plc*<sup>156</sup> the court referred to the no honest belief test in a case involving an independent guarantee. The same has been found by Arden LJ in the *Banque Saudi Fransi* case.<sup>157</sup> Moreover, in the same manner, in *Enka Insaat Ve Sanayi AS v Banca Popolare Dell’Alto Adige*

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<sup>150</sup> *Ibid.* To the same effect and in the same case, Sir John Arnold described fraud, in this context, as “requiring something in the nature of common law fraud, that is to say, established dishonesty”.

<sup>151</sup> [1981] Com. L.R. 235 (CA)

<sup>152</sup> *Ibid.* Same view has been established by Judge Thornton QC, in *TTI Team Telecom International Ltd v Hutchison 3G UK Ltd* [2003] EWHC 762 (TCC); [2003] 1 ALL ER (Comm) 914, who expressed the view that a lack of good faith by the beneficiary in demanding an independent guarantee would prevent him from claiming its amount..

<sup>153</sup> Bridge, M. “*Benjamin’s Sale of Goods*” (Sweet & Maxwell, 8<sup>th</sup> ed., London, 2010) at 24-020

<sup>154</sup> Lord Denning MR at *State Trading Corporation of India Ltd v ED & F Man (Sugar) and the State Bank of India* (The Times 22 July 1981)

<sup>155</sup> Hapgood, M. “*Paget’s Law of Banking*” (Butterworths, 13<sup>th</sup> ed., London, 2007) at p. 870

<sup>156</sup> [2007] 2 Lloyd’s Rep 187

<sup>157</sup> [2007] 1 ALL ER (Comm) 67 (CA) at 77-8

*SpA*,<sup>158</sup> Teare J. found that the fraud exception does apply where “[the beneficiary] could not honestly have believed in the validity of its demands”.<sup>159</sup>

It should be noted that the difficulty in all the cases which require a common law fraud test is to convince the courts that the beneficiary’s claim is made without his having any belief in his right to the amount he demands.<sup>160</sup> In other words this fraud test must involve dishonesty.<sup>161</sup> The absence of the required honest belief in demanding the guarantee is difficult to prove and this could pose a threat to the independent guarantee’s applicant “as he is at the mercy of the beneficiary’s judgement.”<sup>162</sup> As Bertrams has noted: “criminal law notions of malicious intent which are not suitable in relation to guarantees” should be disregarded.<sup>163</sup> It is submitted that the same criticisms which have been made of the same “difficult to prove”<sup>164</sup> test in the documentary credits context apply here and as a result it should be disallowed.

### 5.3.2. An objective test of fraud

It has been reiterated that independent guarantees are more dangerous to their applicants than documentary credits due to the absence of commercial documents which are involved in the latter’s payment mechanism.<sup>165</sup> The bank receives a mere

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<sup>158</sup> [2009] C.I.L.L. 2777 (first instance)

<sup>159</sup> *Ibid.* at p. 2778

<sup>160</sup> Guest, A. “*Benjamin’s Sale of Goods*” (Sweet & Maxwell, 7<sup>th</sup> ed., London, 2006) at p. 2072

<sup>161</sup> Jeffery, S. ‘Standby Letters of Credit and the Fraud exception – An Update’ [2003] 18 *B.F.L.R.* 67 at p. 104

<sup>162</sup> Ellinger P. & Neo, D. “*The Law and Practice of Documentary Letters of Credit*” (Hart Publishing, Oxford, 2010) at p. 318

<sup>163</sup> Bertrams, R. “*Bank Guarantees in International Trade: The Law and Practice of Independent (First Demand) Guarantees and Standby Letters of Credit in Civil Law and Common Law Jurisdictions*” (Kluwer Law International, 3<sup>rd</sup> ed., The Hague (Netherlands), 2004) at p. 356

<sup>164</sup> Jeffery, S. ‘Standby Letters of Credit and the Fraud exception – An Update’ [2003] 18 *B.F.L.R.* 67 at p. 104

<sup>165</sup> Todd, P. “*Maritime Fraud and Piracy*” (Lloyd’s List, 2<sup>nd</sup> ed., London 2010) at p. 142; Bridge, M. “*The International Sale of Goods*” (Oxford University Press, 2<sup>nd</sup>, ed., Oxford, 2007) at p. 264



demand which is usually created by the beneficiary himself<sup>166</sup> and which does not provide any value as it does not represent any specific goods.<sup>167</sup> Moreover, demanding an independent guarantee is an indication that the applicant is in difficulty and may be unable to reimburse the bank.<sup>168</sup> Hence, the banks' risk is greater than that in a documentary credit.<sup>169</sup> Moreover, due to the absence of commercial documents, independent guarantees are open to abuse<sup>170</sup> and as a result unfair or unjustified payment can occur.<sup>171</sup> Indeed, "only limited protection is available under the fraud exception of English law".<sup>172</sup> The intentional fraud exception which the English courts apply has opened the door and led the way for other acts of injustice to be perpetrated and to go unpunished in an independent guarantee context.<sup>173</sup> The applicants in independent guarantees are exposed to the risk of abusive calls which often take the issue beyond the intentional fraud test. In fact, it may well be that the applicant has breached the underlying agreement and so the beneficiary has truthfully represented that in his demand, yet, sometimes it could be that the beneficiary himself

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<sup>166</sup> Justice, J. 'Letters of Credit: Expectations and Frustrations – Part 1' (1977) *94 Banking L. J.* 424 at p. 429

<sup>167</sup> Vaart, H. 'Standby Letters of Credit and the Problem of Bad Faith Calls' (1981) 8 *Yale. J. World. Pub. Order.* 36 at p. 40; Bennett, H. 'Performance Bonds and the Principle of Autonomy' [1994] *J.B.L.* 574 at p. 576. According to Bennett: "The vast majority of performance bonds issued in practice are 'on demand', 'unconditional' or 'first demand bonds'."; Zohrab, P. 'Standby Letters of Credit: Autonomy' (1996) *N.Z.L.J.* 417 at p. 419. According to Zohrab: "The documentary letter of credit contains inbuilt checks and balances which minimise the risk of unjustified or fraudulent calls".

<sup>168</sup> Bertrams, R. "*Bank Guarantees in International Trade: The Law and Practice of Independent (First Demand) Guarantees and Standby Letters of Credit in Civil Law and Common Law Jurisdictions*" (Kluwer Law International, 3<sup>rd</sup> ed., The Hague (Netherlands), 2004) at p. 392; Justice, J. 'Letters of Credit: Expectations and Frustrations – Part 1' (1977) *94 Banking L. J.* 424 at p. 438; Sarna, L. "*Letters of Credit: The Law and Current Practice*" (Carswell Legal Publishers, 2<sup>nd</sup> ed., Toronto, 1986) at p.151. To this Sarna states: "the issuer usually makes payment under the painful realization that the money it now gives out may never be reimbursed or will so be only after years of expensive litigation against the applicant."

<sup>169</sup> Justice, J. 'Letters of Credit: Expectations and Frustrations – Part 1' (1977) *94 Banking L. J.* 424 at p. 438

<sup>170</sup> Enonchong, N. 'The Problem of Abusive Calls on Demand Guarantees' [2007] *L.M.C.L.Q.* 1, 83 at p. 83; Martin-Nagle, R. 'Injunctions of Letters of Credit: Judicial Insurance against Fraud' (1983) *J. L. & Com* 305 at pp. 308-309

<sup>171</sup> Zohrab, P. 'Standby Letters of Credit: Autonomy' (1996) *N.Z.L.J.* 417 at p. 419

<sup>172</sup> Enonchong, N. 'The Problem of Abusive Calls on Demand Guarantees' [2007] *L.M.C.L.Q.* 1, 83 at p. 88

<sup>173</sup> Hooley, R. & Sealy L. "*Commercial Law: Text, Cases, and Materials*" (Oxford University Press, 4<sup>th</sup> ed., 2009) at p. 922

was the one who caused, or at least partially induced, that breach.<sup>174</sup> In other situations, the breach could be trivial, but the guarantee is still open to the beneficiary's abuse.<sup>175</sup>

The seminal *Edward Owen* case<sup>176</sup> shows how harshly the intentional fraud test can operate against independent guarantees' applicants and how potentially they are exposed to abusive calls.<sup>177</sup> In this case, the plaintiffs were English sellers who opened an independent guarantee in favour of a Libyan buyer pursuant to a contract which through the former agreed to construct a quantity of glass fibres in Libya. It was agreed in their contract that the Libyan buyers would open an irrevocable documentary credit in favour of the English seller as a way to facilitate the payment of purchased glass fibres.<sup>178</sup> However, the Libyan buyers did not open such a documentary credit but rather they demanded the independent guarantee amount. Accordingly, the English seller sought an injunction from the English courts in order to mitigate the risk of the abusive call which the Libyan seller had made. The English Court of Appeal found that the only exception which can be applied in such a context is the conventional fraud exception. In Lord Browne's words:

“I am prepared to assume (a) that the plaintiffs are right in saying that the buyers failed to comply with their contractual obligation as to the letter of credit and (b) that as a result the plaintiffs were entitled to treat the contract as repudiated by the buyers and to cancel it...But, in my view, even if these assumptions are right, this does not come anywhere near establishing fraud on the part of the buyers”.<sup>179</sup>

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<sup>174</sup> *Edward Owen Engineering Ltd. v Barclays Bank International Ltd.* [1978] Q.B. 159; [1977] 3 W.L.R. 764 (CA); *RD Harbottle (Mercantile) Ltd v National Westminster Bank Ltd* [1978] Q.B. 146; [1977] 3 W.L.R. 752

<sup>175</sup> Horowitz, D. “*Letters of Credit and Demand Guarantees: Defences to Payment*” (Oxford University Press, 2010) at p. 87

<sup>176</sup> *Edward Owen Engineering Ltd. v Barclays Bank International Ltd.* [1978] Q.B. 159; [1977] 3 W.L.R. 764 (CA)

<sup>177</sup> Todd, P. “*Bills of Lading and Bankers' Documentary Credits*” (Informa Law, 4<sup>th</sup> ed., London, 2007) at p. 256

<sup>178</sup> *Edward Owen Engineering Ltd. v Barclays Bank International Ltd.* [1978] 1 ALL ER 976, at 976-7

<sup>179</sup> *Ibid* at 985

In the same manner, Lord Geoffrey Lane added:

“I disagree that that amounts to any proof of or evidence of fraud. It may be suspicious, it may indicate the possibility of sharp practice, but there is nothing in those facts remotely approaching true evidence of fraud or anything which makes fraud obvious or clear to the bank. Thus there is nothing, it seems to me, which casts any doubt on the bank’s prima facie obligation to fulfil its duty...”.<sup>180</sup>

The opportunity in front of the beneficiary to invoke an independent guarantee by a simple written demand without a proper proof of default rendered such an instrument open to abusive calls.<sup>181</sup> This has led to independent guarantees being referred to as ‘suicide credits’.<sup>182</sup> Abusive calls occur where the beneficiary improperly draws the independent guarantee even when it is obvious that the applicant did not breach any of his obligations under the underlying contract. It is true that such a draw leaves the applicant free to sue the beneficiary of the independent guarantee on the underlying contract but such a method would not always provide the aggrieved applicant with a definite solution.<sup>183</sup> According to Pierce:

“Payments against an unfair claim are probably lost forever. Local laws and regulations can...make it difficult to reclaim payment made against an unfair demand”<sup>184</sup>

It has been said that “the fraud rule is an inefficient means of combating unjustified demands made under [independent guarantees]”.<sup>185</sup> The subjective fraud exception of English law therefore leaves a protection gap. The question is: how should it be

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<sup>180</sup> *Ibid* at 986

<sup>181</sup> Goode, R. “*Commercial Law*” (Penguin Books, 3<sup>rd</sup> ed., London, 2004) at pp.1018-1019; Bradgate, R. White, F. & Fennell, S. “*Commercial Law*” (Oxford University Press, 9<sup>th</sup> ed., Oxford, 2002) at p. 275. To this they provide: “A demand bond is therefore particularly attractive from the points of view of the beneficiary and the bank providing the bond, but exposes the account party to the risk of an unjustified demand”; Pierce, A. “*Demand Guarantees in International Trade*” (Sweet & Maxwell, London, 1993) at p. 157

<sup>182</sup> Buckley, R. ‘Potential Pitfalls with Letters of Credit’ (1996) *A.L.J.* Vol. 70, 217 at p. 228

<sup>183</sup> Guest, A. “*Benjamin’s Sale of Goods*” (Sweet & Maxwell, 7<sup>th</sup> ed., London, 2006) at p. 2071. According to Guest: “it is important to bear in mind that this advice is of limited use where the beneficiary resides in a country which is not renowned for efficacy of its legal system”; Wunnicke, B. Wunnicke D. & Turner P. “*Standby and Commercial Letters of Credit*” (Wiley Law Publications, 2<sup>nd</sup> ed., New York, 1996) at p. 40

<sup>184</sup> Pierce, A. “*Demand Guarantees in International Trade*” (Sweet & Maxwell, London, 1993) at p. 163

<sup>185</sup> Guest, A. “*Benjamin’s Sale of Goods*” (Sweet & Maxwell, 7<sup>th</sup> ed., London, 2006) at p. 2071

filled?<sup>186</sup> While some judges have suggested that the account party should accept such a protection gap by previously building such a risk into the price of their contract, this is not a practical solution as such a move would be commercially disastrous to the independent guarantee applicant who may as a consequence price himself out of the contract biddings.<sup>187</sup> The problem of abusive calls has vexed courts in different jurisdictions for many years.<sup>188</sup> Whilst “British courts are considerably more reluctant to grant protection against unfair calling,”<sup>189</sup> a wider exception which focuses on the act (objective test) rather than the intent (subjective test) has been recognised in other jurisdictions.<sup>190</sup> Such a test has been suggested repeatedly.<sup>191</sup>

The aim of such an exception is to protect the interests of all bona fide parties concerned.<sup>192</sup> In the USA the fraud exception has been widened to fill the protection gap which independent guarantees’ applicants are suffering from.<sup>193</sup> Such a wide test dictates that the fraud exception could apply where the beneficiary demands the independent guarantee amount while his demand has no conceivable basis under the underlying contract.<sup>194</sup> This test works in the following mechanism: taking the

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<sup>186</sup> Enonchong, N. ‘The Problem of Abusive Calls on Demand Guarantees’ [2007] *L.M.C.L.Q.* 1, 83 at p. 88

<sup>187</sup> *Ibid.*

<sup>188</sup> *Ibid.* at p. 106

<sup>189</sup> Horn, N. & Wymeersch, E. “*Bank-Guarantees, Standby Letters of Credit and Performance Bonds in International Trade*” (Kluwer Law and Taxation Publishers, Deventer, 1990) at p. 32. One of the few English cases which an injunction has been granted in to prevent an abusive call is *Elian and Rabbath v Matsas and Matsas* [1966] 2 Lloyd’s Rep. 495. Such a grant has been criticised by Bennett. See: Bennett, H. ‘Performance Bonds and the Principle of Autonomy’ [1994] *J.B.L.* 574 at p. 58

<sup>190</sup> For example, abuse of right has been found to constitute fraud in Canada. see: Sarna, L. “*Letters of Credit: The Law and Current Practice*” (Carswell Legal Publishers, 2<sup>nd</sup> ed., Toronto, 1986) at p. 145; Jeffery, S. ‘Standby Letters of Credit and the Fraud exception – An Update’ [2003] 18 *B.F.L.R.* 67 at p. 104

<sup>191</sup> Enonchong, N. ‘The Problem of Abusive Calls on Demand Guarantees’ [2007] *L.M.C.L.Q.* 1, 83 at p. 88;

Buckley, R. ‘Potential Pitfalls with Letters of Credit’ (1996) *A.L.J.* Vol. 70, 217, at p. 230; Jeffery, S. ‘Standby Letters of Credit and the Fraud exception – An Update’ [2003] 18 *B.F.L.R.* 67 at p. 104

<sup>192</sup> “*Opinions of the ICC Banking Commission 1995-1996*” ICC Publication No. 565 at p. 22

<sup>193</sup> Enonchong, N. ‘The Problem of Abusive Calls on Demand Guarantees’ [2007] *L.M.C.L.Q.* 1, 83 at p. 106

<sup>194</sup> ‘Task Force on the Study of U.C.C. Article 5 (Letters of Credit)’ (1990) *The Business Lawyer* Vol.45, 1521 at p. 1615

underlying contract into consideration, if the beneficiary's claim on the independent guarantee has no conceivable basis a fraudulent intent should be imputed to him.<sup>195</sup> In Bertrams's view:

“This formula finds support in numerous decisions, as well as in legal writing, at least when one examines how the notion of fraud has been applied in concrete cases. Moreover, it has the advantage of being more specific and more comprehensible than other formulas which are marked by abstruseness. As evidence of malicious intent on the part of the beneficiary is not required, there is no need to clearly distinguish between the notion of ‘fraud’ and the notion of ‘abuse’. In this study fraud, therefore, compromises abuse”.<sup>196</sup>

A survey of relevant case law and legal writings suggests that a call would be fraudulent, a) where the applicant completes the obligations assigned to him by the underlying contract, b) where the beneficiary breaches a fundamental obligation or perpetrates a serious misconduct in relation to the contract, c) where the independent guarantee has been called for breaches that occurred in other contracts which the guarantee does not cover, d) where a judgment of a competent arbitral or judicial court has been acquired against the beneficiary's demand and e) where the beneficiary calls a tender guarantee although the contract has not been awarded to the applicant.<sup>197</sup>

In any event, the fraudulent intent does not play a part under section 5-109 of the American UCC. Section 5-109 is clear that the fraud test that should be applied is the one which depends on the materiality of the act rather than the intent of the beneficiary. Accordingly, it is not every dispute which will justify the fraud exception application but rather only material disputes which relate to the essence of the

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<sup>195</sup> Bertrams, R. “*Bank Guarantees in International Trade: The Law and Practice of Independent (First Demand) Guarantees and Standby Letters of Credit in Civil Law and Common Law Jurisdictions*” (Kluwer Law International, 3<sup>rd</sup> ed., The Hague (Netherlands), 2004) at p. 351

<sup>196</sup> *Ibid.* at p. 360

<sup>197</sup> *Ibid.* at p. 391

underlying contract.<sup>198</sup> Interestingly, the UN Convention on Independent Guarantees and Stand-by Letters of Credit has pursued a similar approach to that of the UCC section 5-109.<sup>199</sup> The UN Convention assists to ameliorate this problem by providing an internationally agreed general type of situation where an exception to the payment against a prima facie complaint demand would be justified”.<sup>200</sup> In the UN Convention the beneficiary awareness plays no part in this respect.<sup>201</sup> The solutions and rules which are found in this Convention “closely mirror the established case law”.<sup>202</sup> The UN Convention rules, in this regard, are all objective and through these objective rules fraud can be determined. The UN Convention does not view the required fraud in the light of the common law test which dictates punishment for bad faith but rather it views it as an objective reality where the demand is not a legitimate one.<sup>203</sup>

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<sup>198</sup> *Ibid.* at p. 357

<sup>199</sup> Article 19 of the UN Convention under the title “Exception to payment obligation” provides

(1) If it is manifest and clear that:

(a) Any document is not genuine or has been falsified;

(b) No payment is due on the basis asserted in the demand and the supporting documents; or

(c) Judging by the type and purpose of the undertaking, the demand has no conceivable basis, the guarantor/issuer, acting in good faith, has a right, as against the beneficiary, to withhold payment.

(2) For the purposes of subparagraph (c) of paragraph (1) of this article, the following are types of situations in which a demand has no conceivable basis:

(a) The contingency or risk against which the undertaking was designed to secure the beneficiary has undoubtedly not materialized;

(b) The underlying obligation of the principal/applicant has been declared invalid by a court or arbitral tribunal, unless the undertaking indicates that such contingency falls within the risk to be covered by the undertaking;

(c) The underlying obligation has undoubtedly been fulfilled to the satisfaction of the beneficiary;

(d) Fulfilment of the underlying obligation has clearly been prevented by wilful misconduct of the beneficiary;

(e) In the case of a demand under a counter-guarantee, the beneficiary of the counter-guarantee has made payment in bad faith as guarantor/issuer of the undertaking to which the counter guarantee relates.

(3) In the circumstances set out in subparagraphs (a), (b) and (c) of paragraph (1) of this article, the principal/applicant is entitled to provisional court measures in accordance with article 20.

<sup>200</sup> Malek, A & Quest, D. “*Jack: Documentary Credits*” (Tottel Publishing, 4<sup>th</sup> ed., Sussex, 2009) at p. 279

<sup>201</sup> Article 19 does provide that the underlying transaction could be returned to in order to determine fraud.

<sup>202</sup> Stoufflet, J. ‘Fraud in Documentary Credit, Letter of Credit and Demand Guaranty’ (2001) 106 *Dick. L. Rev.* 21 at p. 24

<sup>203</sup> *Ibid.*

While it has been said that the obligation of the banks is to honour their independent guarantees subject to the subjective fraud exception as has been explained in the discussion of documentary credits,<sup>204</sup> it has been suggested that the objective test of fraud, which could apply through examining the quality of the performance of the underlying contract in order to achieve equity where the beneficiary's breach is so egregious that an evil intent should be inferred, is the proper test.<sup>205</sup> Nevertheless, the current author suggests that the application of the suggested objective test in this regard is not without its own shortcomings as it would not be easy to always apply it and even if it is applicable it should be applied cautiously and under certain conditions.

Unlike documentary credits, which have been traditionally connected with import-export trade, it is common to witness independent guarantees in different domestic business affairs.<sup>206</sup> Independent guarantees have been used for a variety of functions and they are available for use in virtually all circumstances where an applicant owes a payment or a performance obligation to a beneficiary.<sup>207</sup> Indeed, independent guarantees "are creature of contract and as such, can take various forms and offer different protective measures depending on what the parties are agreeable to".<sup>208</sup> It is submitted that such versatility and diversity in their use are the reasons behind the difficulty of applying an objective fraud exception in independent guarantees. In applying the fraud exception in a documentary credit fraud case, all that the judge has

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<sup>204</sup> Murray, C. Holloway, D & Timson-Hunt, D. "*Schmitthoff's Export Trade: The Law and Practice of International Trade*" (Sweet & Maxwell, 11<sup>th</sup> ed., London, 2007) at p. 246

<sup>205</sup> Bulger, R. 'Letters of Credit: A Question of Honor' [1984] *N.Y.U.J. Int'l L. & Pol.* 799 at p. 809

<sup>206</sup> Sarna, L. "*Letters of Credit: The Law and Current Practice*" (Carswell Legal Publishers, 2<sup>nd</sup> ed., Toronto, 1986) at p. 2; Martin-Nagle, R. 'Injunctions of Letters of Credit: Judicial Insurance against Fraud' (1983) *J. L. & Com* 305 at p. 309

<sup>207</sup> Wunnicke, B. Wunnicke D. & Turner P. "*Standby and Commercial Letters of Credit*" (Wiley Law Publications, 2<sup>nd</sup> ed., New York, 1996) at p. 17

<sup>208</sup> Howard QC, M. Masefield, R. & Chuah, J. "*Butterworths Banking Law Guide*" (Butterworths, London, 2006) at p. 553

to do is to examine the goods' situation in order to determine whether the fraud exception applies or not.<sup>209</sup> As Hapgood puts it:

“In practice, it is easier to prove fraud in a document presented under a letter of credit than a fraudulent calling on a demand guarantee. For example, the falsity of a bill of lading can be established by one telephone call to the shipping line which purportedly issued it.”<sup>210</sup>

Yet, independent guarantees are usually used as independent collaterals which do not guarantee a specific performance under the underlying contract (like e.g., repayment of advances). In such cases, in order to determine objective fraud under them, fraud should be clear in the sense that the purpose of the collateral is abused.<sup>211</sup> Hence, the judge's task would be very difficult and may be impossible as he has to examine the different obligations and rights under the main contract which itself could be very complex, divergent and unclear as to the purpose of the independent guarantee.<sup>212</sup> It is true that independent guarantees “may seem similar enough to the [documentary credits] to justify identical legal treatment [but yet]...closer inspection, however, quickly reveals fundamental differences”.<sup>213</sup> According to Horowitz:

“The central argument will be that the application of the fraud defence to demand guarantees is very different from its application to commercial letters of credit. The principal reason for this distinction in application is that the structure and function of demand guarantees are different from those of commercial letters of credit”.<sup>214</sup>

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<sup>209</sup> Stoufflet, J. ‘Fraud in Documentary Credit, Letter of Credit and Demand Guaranty’ (2001) 106 *Dick. L. Rev.* 21, at p. 22

<sup>210</sup> Hapgood, M. “*Paget's Law of Banking*” (Butterworths, 13<sup>th</sup> ed., London, 2007) at p. 938

<sup>211</sup> Kurkela, M. “*Letters of Credit and Bank Guarantees Under International Trade Law*” (Oxford University Press, 2<sup>nd</sup> ed., 2007) at p. 180

<sup>212</sup> Pierce, A. “*Demand Guarantees in International Trade*” (Sweet & Maxwell, London, 1993) at p. 187; Wunnicke, B. Wunnicke D. & Turner P. “*Standby and Commercial Letters of Credit*” (Wiley Law Publications, 2<sup>nd</sup> ed., New York, 1996) at p. 174. According to Wunnicke: “It is not always easy to determine whether the applicant's claim is a surrogate for a contract claim or a genuine claim of fraud”.

<sup>213</sup> Vaart, H. ‘Standby Letters of Credit and the Problem of Bad Faith Calls’ (1981) 8 *Yale. J. World. Pub. Order.* 36, at p. 39

<sup>214</sup> Horowitz, D. “*Letters of Credit and Demand Guarantees: Defences to Payment*” (Oxford University Press, 2010) at p. 82



It has been said that applying blindly the same rules which govern documentary credits to independent guarantees is inappropriate.<sup>215</sup> Also it can be suggested that applying the objective fraud test which it is proposed to be applied in documentary credits is inappropriate in independent guarantees. If the same test is applied, the result will be “confusing, uncertain and frequently unfair.”<sup>216</sup> This has been noted recently by Teare J. in the English case of *Enka Insaat Ve Sanayi AS v Banca Popolare Dell’Alto Adige SpA*.<sup>217</sup> In this independent guarantee case, Teare J. found it difficult to find fraud where there is a dispute to the performance of the concerned retail and building contract.<sup>218</sup> In fact, no clear legal or factual basis for the demand is equivalent to the beneficiary’s shipment of rubbish in a sale of goods contract.<sup>219</sup> In an independent guarantee case, where there is a dispute, courts should not interfere unless “it is easy, clear and straightforward that a beneficiary has no right to payment of demand guarantee”.<sup>220</sup> Courts should not be allowed to interpret this as an invitation to explore different perspectives in relation to the underlying transaction in order to determine fraud as the consequence of such an approach would be harmful results. Indeed, by entering into a transaction which may be so easily abused, parties should note that there is a limited role which the courts can play in order to prevent such an abuse. Courts are not responsible for rewriting the bargains into which the

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<sup>215</sup> Gable, C. ‘Standby Letters of Credit: Nomenclature Has Confounded Analysis’ [1980] *Law & Pol’y Int’l Bus.* 903 at pp. 903 and 910. To this he provides at p. 910: “...the use of letters of credit has expanded into other areas totally divorced from the sale of goods. Yet, the original legal principles have remained in application without significant examination of the appropriateness of their application in a new sphere”.

<sup>216</sup> Vaart, H. ‘Standby Letters of Credit and the Problem of Bad Faith Calls’ (1981) 8 *Yale. J. World. Pub. Order.* 36 at p. 37

<sup>217</sup> [2009] C.I.L.L. 2777 (first instance)

<sup>218</sup> At p. 2778. In the same effect, see, e.g.: *Deutsche Ruckversicherung AG v Walbrook Insurance Co Ltd* [1995] 1 WLR 1017 at p. 1030 *per* Philips J.

<sup>219</sup> Weisz, G. & Blackman, J. ‘Standby Letters of Credit after Iran: Remedies of the Account Party’ (1982) 1 *U. ILL. L. Rev.* 355 at p. 371

<sup>220</sup> Mugasha, A. ‘Enjoining the Beneficiary’s Claim on a Letter of Credit or Bank Guarantee’ [2004] *J.B.L.* 515 at p. 521

parties have entered.<sup>221</sup> A court should be mindful of keeping a balanced approach between preventing the abuse of such instruments and maintaining the successful role which they play in the international trade realm which if interrupted frequently will be lost.<sup>222</sup> As Mugasha suggests:

“In reality, however, the court needs to be in a position to determine if the documents are fraudulent by reference to the underlying contract. On balance, the courts should only entertain those claims of fraud which can be expeditiously resolved without an inquiry into the state of performance on the underlying transaction”.<sup>223</sup>

Having illustrated the inefficacy which the subjective and objective tests of fraud provide in the context of independent guarantees, the following subsections discuss other potential exceptions which have evolved in England or other jurisdictions such as the unconscionability exception, which has been evolved in other common law jurisdictions in order to eliminate the problem of abusive calls, and the underlying contract exception, which originally evolved in Australia and which later has found acceptance in England.

### **5.3.3. The unconscionability exception in other common law countries**

The English approach, which has limited the exceptions to cases of intentional fraud only, has been described as the “hands off approach” in this regard.<sup>224</sup> As has been illustrated earlier, the fraud exception’s narrow scope can be seen through the existence of the abusive calls problem.<sup>225</sup> Therefore, different countries have pursued different measures. A view has emerged in these countries that independent

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<sup>221</sup> Malek, A & Quest, D. “*Jack: Documentary Credits*” (Tottel Publishing, 4<sup>th</sup> ed., Sussex, 2009) at p. 354

<sup>222</sup> Mugasha, A. “*The Law of Letters of Credit and Bank Guarantees*” (Federation Press, Sydney, 2003) at p. 146

<sup>223</sup> *Ibid.* at p. 144

<sup>224</sup> Enonchong, N. “*The Independence Principle of Letters of Credit and Demand Guarantees*” (Oxford University Press, Oxford, 2011) at p. 180

<sup>225</sup> Enonchong, N. ‘The Problem of Abusive Calls on Demand Guarantees’ [2007] *L.M.C.L.Q.* 1, 83 at p. 106

guarantees should not be treated identically to documentary credits and therefore a more liberal approach in respect of payment exceptions may be taken to restrain abusive calls.<sup>226</sup> Accordingly, in Singapore and Australia they have recognised an unconscionability exception.<sup>227</sup> The unconscionability exception notion first appeared in Singapore in the first half of the 1990s.<sup>228</sup> At the beginning there were some question marks revolving around its recognition,<sup>229</sup> but quite quickly it was expressly recognised.<sup>230</sup> Since that time numerous injunctions have been granted by Singaporean courts on the ground that a call on an independent guarantee was unconscionable.<sup>231</sup> The tenor of this exception dictates that a person should not cause hardship to others by violating their reasonable expectations. According to Mugasha:

“Insistence on rights in circumstances which make that insistence harsh or oppressive will amount to unconscionable conduct. One can engage in unconscionable conduct even if one believes, wrongly, that one is acting within one’s rights”.<sup>232</sup>

Such an exception, like the fraud objective test, focuses on the acts rather than the intent of the beneficiary in order to justify the independent guarantee payment restraint.<sup>233</sup> The main rationale of this exception is that it works to fill the protection gap which has been left by the intentional fraud test that has been conventionally developed in England. Indeed, such an exception has been developed in order to

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<sup>226</sup> Ellinger P. & Neo, D. *“The Law and Practice of Documentary Letters of Credit”* (Hart Publishing, Oxford, 2010) at p. 319

<sup>227</sup> Enonchong, N. ‘The Problem of Abusive Calls on Demand Guarantees’ [2007] *L.M.C.L.Q.* 1, 83 at p. 103

<sup>228</sup> *Bocotra Construction v Attorney-General* (No.2) [1995] 2 SLR 733

<sup>229</sup> *Ibid.*

<sup>230</sup> *GHL Pte Ltd v Unitract Building Construction Pte Ltd* [1999] 4 SLR 604

<sup>231</sup> Ellinger P. & Neo, D. *“The Law and Practice of Documentary Letters of Credit”* (Hart Publishing, Oxford, 2010) at p. 322, The following are some of the cases where an injunction has been granted on the ground of unconscionability in Singapore: *Newtech Engineering Construction Pte Ltd v BKB Engineering Constructions Pte Ltd and Others* [2003] 4 SLR 73; *GHL Pte Ltd v Unitract Building Construction Pte Ltd and Another* [1999] 4 SLR 604; *Raymond Construction Pte Ltd v Low Yang Tong & Anor*, Suit 1715/95, 11 July 1996, unreported (Lai Kew Chai J).

<sup>232</sup> Mugasha, A. ‘Enjoining the Beneficiary’s Claim on a Letter of Credit or Bank Guarantee’ [2004] *J.B.L.* 515 at p. 519

<sup>233</sup> Horowitz, D. *“Letters of Credit and Demand Guarantees: Defences to Payment”* (Oxford University Press, 2010) at p. 128. Indeed, the UN Convention on Independent Guarantees and Stand-by Letters of credit does contain provisions which in substance resemble the unconscionability exception.

mitigate the risk of the abusive calls which surrounded this context. Yet, the issue which has generated much debate in this regard is whether payment of an independent guarantee should be refused on the ground of unconscionability or not and whether English courts should recognise such an exception.<sup>234</sup>

While it has been said that Singapore is the origin of this exception, it is submitted that an English case is the foundation which led Singaporean courts to recognise this exception.<sup>235</sup> This English case is the case of *Potton Homes Ltd v Coleman Contractors*.<sup>236</sup> In this independent guarantee case, Eveleigh LJ, in his oft-quoted statement, has noted that:

“As between buyer and seller the underlying contract cannot be disregarded so readily. If the seller has lawfully avoided the contract prima facie, it seems to me he should be entitled to restrain the buyer from making use of the performance bond. *Moreover, in principle I do not think it possible to say that in no circumstances whatsoever, apart from fraud, will the court restrain the buyer.*”<sup>237</sup>

It should be noted that his Lordship’s observations have focused on the acts of the beneficiary rather than his intent and beliefs. The *Potton Homes* case has borne some fruit in Singapore where the unconscionability exception has been recognised as an independent ground to restrain independent guarantees. While the actual decision of the *Potton Homes* case has conformed to that of the received orthodoxy which calls for an intentional test of fraud, it could be said that the above act-oriented *obiter*, that his Lordship has wondered about its future applicability, has constituted the basis of

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<sup>234</sup> Enonchong, N. “*The Independence Principle of Letters of Credit and Demand Guarantees*” (Oxford University Press, Oxford, 2011) at p. 165; Goode, R. “*Commercial Law*” (Penguin Books, 3<sup>rd</sup> ed., London, 2004) at p. 991

<sup>235</sup> Ellinger P. & Neo, D. “*The Law and Practice of Documentary Letters of Credit*” (Hart Publishing, Oxford, 2010) at p. 320

<sup>236</sup> (1984) 28 Build LR 19

<sup>237</sup> At 28 [Emphasis added]

the later Singaporean recognised exception.<sup>238</sup> The unconscionability exception notion first appeared in the Court of Appeal decision in the case of *Bocotra Construction Pte Ltd v A-G (No2)*.<sup>239</sup> Soon after, such a notion was reinforced by Lai Kew Chai J. in *Raymond Construction Pte Ltd v Low Yang Tong & Anor*.<sup>240</sup> In the words of Lai Kew Chai J.:

“The concept of unconscionability to me involves unfairness, as distinct from dishonesty or fraud, or conduct of a kind so reprehensible or lacking in good faith that a court of conscience would either restrain the party or refuse to assist the party. Mere breaches of contract by the party in question would not by themselves be unconscionable”.<sup>241</sup>

Such a statement and later Singaporean statements have quoted Lord Eveleigh’s above-mentioned observations which call for a focus on the act rather than on the difficult to prove intent when deciding whether to restrain an abusive demand made on an independent guarantee. As in the objective test, in applying such an exception a commercially objectionable demand, such as the Libyan buyers’ demand in the *Edward Owen* case, ought to be enjoined.<sup>242</sup> For example, in *GHL Ltd v Unitract Building Construction Pte Ltd*<sup>243</sup> the Singapore Court of Appeal held that it was unconscionable for the beneficiary to call on the independent guarantee, which was 10% of the original contract price, when the price of the contract was later revised down. The Court of Appeal has expressly stated that it was making a deliberate departure from the conventional English approach.<sup>244</sup> To this effect the court has stated:

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<sup>238</sup> Ellinger P. & Neo, D. “*The Law and Practice of Documentary Letters of Credit*” (Hart Publishing, Oxford, 2010) at p. 320

<sup>239</sup> [1995] 2 SLR 733

<sup>240</sup> Singapore High Court Suit 1715/95, 11 July 1996, unreported case

<sup>241</sup> This passage has been quoted with approval by the Court of Appeal in later Singapore cases.

<sup>242</sup> Guest, A. “*Benjamin’s Sale of Goods*” (Sweet & Maxwell, 7<sup>th</sup> ed., London, 2006) at p. 2074

<sup>243</sup> [1999] 4 SLR 604

<sup>244</sup> At [16] and [22]. In the same manner, it was confirmed later in *Samwoh Asphalt Premix Pte Ltd v Sum Cheong Piling Pte Ltd* [2002] Build LR 459, at [11], that: “In Singapore, unconscionability on the part of the beneficiary in calling for payment on a performance guarantee is a separate and distinct ground from fraud for seeking injunctive relief”.

“We are concerned with abusive calls on the bonds. It should not be forgotten that a performance bond can operate as an oppressive instrument, and in the event that a beneficiary calls on the bond in circumstances, where there is a prima facie evidence of fraud or unconscionability, the court should step in to intervene at the interlocutory stage until the whole of the circumstances of the case has been investigated”<sup>245</sup>.

In Australia, while unconscionability is a recognised exception to the independent guarantee payment, a distinction should be drawn between unconscionability under common law and unconscionability under the statute. Indeed, unconscionability is recognised as an exception in the latter but not the former.<sup>246</sup> There is no recognised unconscionability under the common law. However, it is recognised under s 51AA of the Trade Practices Act 1974 which states that in commerce and trade a corporation should not be engaged in conduct that is unconscionable. Therefore, it applies there to unconscionable conduct in demanding an independent guarantee issued in trade and commerce.<sup>247</sup>

The echoes of the unconscionability exception have recently appeared in the English Courts. The unconscionability exception has been referred to by Judge Thornton QC in *TTI Team Telecom International Ltd v Hutchison 3G UK Ltd*.<sup>248</sup> The *TTI Team* case concerned a contract where the plaintiff TTI (the seller/ applicant) agreed to supply computer hardware and software to the defendants Hutchison (the buyer/ beneficiary). Hutchison had made an advance payment which covered part of the

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<sup>245</sup> [1999] 4 SLR 604, at [24]. Similarly in *In Eltraco International Pte Ltd v CGH Development Pte Ltd* [2000] 4 SLR 290, at [36], the Singaporean Court of Appeal stated: “It must be borne in mind that the court in restraining a beneficiary from calling on a bond on the ground of unconscionability is exercising an equitable jurisdiction. We are unable to see why in the exercise of this jurisdiction the court may not limit the restraint to only that part which was clearly excessive and allow the other part which would not be unconscionable to remain, bearing in mind that under the terms of the bond, the beneficiary is entitled to make calls from time to time and for such sums as may be appropriate.... The object of this jurisdiction is not to punish the beneficiary for making an excessive call but to achieve equity and justice.”

<sup>246</sup> Enonchong, N. ‘The Problem of Abusive Calls on Demand Guarantees’ [2007] *L.M.C.L.Q.* 1, 83 at p. 99

<sup>247</sup> *Ibid.* at 100

<sup>248</sup> [2003] EWHC 762 (TCC); [2003] 1 ALL ER (Comm) 914

contract price to TTI. TTI procured an independent guarantee in favour of Hutchison to guarantee the return of the advance payment amount in case the former did not discharge his obligation toward the latter. Later a dispute had arisen between both parties regarding some delays in TTI's performance of the contract and accordingly Hutchison gave notice of his intention to demand the independent guarantee amount. However, TTI sought an injunction to restrain Hutchison from demanding the independent guarantee. Although granting an injunction had been refused by the court because the claim was not supported by sufficient evidence,<sup>249</sup> nonetheless Thornton J.'s observations are of great importance to the unconscionability discussion and the potential availability of such an exception in England in the future. Thornton J. found that, apart from the long well-established fraud exception, an independent guarantee payment could be restrained in the case of:

“a failure by the beneficiary to provide an essential element of the underlying contract on which the bond depends; a misuse by the beneficiary of the guarantee by failing to act in accordance with the purpose for which it was given; a total failure of consideration in the underlying contract; a threatened call by the beneficiary for an unconscionable ulterior motives; or a lack of an honest or bona fide belief by the beneficiary that the circumstances, such as poor performance, against which a performance bond had been provided, actually exist”.<sup>250</sup>

It is worth noting that the *TTI Team* court has referred to some Singaporean cases in reaching the above observations. Thornton J.'s observations themselves, even *obiter*, do reflect a trend inside the English jurisdiction which welcomes the recognition of the unconscionability exception.<sup>251</sup> Moreover, it should be noted that the different

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<sup>249</sup> [2003] 1 ALL ER (Comm) 914, at [34]

<sup>250</sup> [2003] 1 ALL ER (Comm) 914, at [46]. According to Ellinger: “A few of these situations can be supported by existing authority. For instance, a lack of an honest belief that poor performance actually existed could bring the situation within the recognised fraud exception”. See: Ellinger P. & Neo, D. “*The Law and Practice of Documentary Letters of Credit*” (Hart Publishing, Oxford, 2010) at p. 324. Others situations have been supported by Eveleigh LJ in *Potton Homes*.

<sup>251</sup> Enonchong, N. “*The Independence Principle of Letters of Credit and Demand Guarantees*” (Oxford University Press, Oxford, 2011) at p. 162

situations which Judge Thornton has provided do resemble the tenor of the objective fraud test which has been applied by the American UCC Article 5 and by the UN Convention in this regard and which has been discussed above.

While it has been suggested that such an exception should be adopted,<sup>252</sup> it is submitted that the recognition of an unconscionability exception's disadvantages outweigh its advantages.<sup>253</sup> In fact, the unconscionability concept has not been fully defined. What constitutes unconscionability is not a clear-cut case but a matter of debate. This has been noted in the *Dauphin International Engineering v HRH Sheikh Sultan Bin Khalifah* case<sup>254</sup> where the Singapore Court of Appeal has stated:

“We do not think it is possible to define unconscionability other than to give some very broad indications such as lack of bona fides. What kind of situation would constitute unconscionability would have to depend on the facts of each case. This is a question which the court has to consider on each occasion where its jurisdiction is invoked. There is no predetermined categorisation”.<sup>255</sup>

Indeed, it is in one way or another the same problem which the application of an objective test of fraud suffers from in this context. While it has been said that unconscionability is a “well defined” doctrine,<sup>256</sup> it has been criticised by the majority. According to Hooley: “It is not entirely clear what constitutes

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<sup>252</sup> Guest, A. “*Benjamin’s Sale of Goods*” (Sweet & Maxwell, 7<sup>th</sup> ed., London, 2006) at p. 2075

<sup>253</sup> Enonchong, N. ‘The Problem of Abusive Calls on Demand Guarantees’ [2007] *L.M.C.L.Q.* 1, 83 at p. 85

<sup>254</sup> [2000] 1 SLR 657

<sup>255</sup> [2000] 1 SLR 657, at [42]. The court has also found at [35] that: “in every instance where there is fraud there would have been a lack of bona fides, it does not follow that in every instance where the beneficiary of a performance guarantee lacks bona fides there is necessarily fraud”. In the same manner, in *Eltraco International Pte Ltd v CGH Development Pte Ltd* [2000] 4 SLR 290, at [30], the Court of Appeal stated that: “In every instance of unconscionability there would be an element of unfairness. But the reverse is not necessarily true. It does not mean that in every instance where there is unfairness it would amount to unconscionability. That is a factor, an important factor no doubt in the consideration. It is important that the courts guard against unnecessarily interfering with contractual arrangements freely entered into by the parties. The parties must abide by the deal they have struck”. Moreover, according to Ellinger: “Unfairness in itself might not necessarily amount to unconscionability”. See: Ellinger P. & Neo, D. “*The Law and Practice of Documentary Letters of Credit*” (Hart Publishing, Oxford, 2010) at p. 322

<sup>256</sup> Guest, A. “*Benjamin’s Sale of Goods*” (Sweet & Maxwell, 7<sup>th</sup> ed., London, 2006) at p. 2075



unconscionability...The uncertainty that this creates is obvious”.<sup>257</sup> Ganotaki and Horowitz agree with Hooley that an exception of “unconscionability is uncertain”.<sup>258</sup> Similarly, Enonchong has described unconscionability as an “imprecise and vague ground for relief”.<sup>259</sup> If recognised, an unconscionability exception will inject a considerable sum of uncertainty into this area of commercial activity where clarity and certainty are clearly needed. Such uncertainty will increase litigation and will involve the courts in complicated contract disputes and as a result will deprive these instruments of the unique value and quality which they enjoy.<sup>260</sup> The unconscionability exception “process would undermine the autonomy principle”, which is well-entrenched in the independent guarantees context,<sup>261</sup> as it goes far beyond the intentional fraud test and requires more analysis of the disputed underlying contract, of different facts and of the conduct of the beneficiary.<sup>262</sup>

English courts have not shown themselves ready to embrace such an exception.<sup>263</sup> Recent cases, other than the *TTI Team* case, have not even discussed such a concept when an injunction has been sought by the independent guarantee applicants.<sup>264</sup> Such

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<sup>257</sup> Hooley, R. & Sealy L. “*Commercial Law: Text, Cases, and Materials*” (Oxford University Press, 4<sup>th</sup> ed., 2009) at p. 867

<sup>258</sup> Ganotaki, A. ‘Unconscionability and Bank Guarantees’ [2004] LMCLQ 148, at p. 152; Horowitz, D. “*Letters of Credit and Demand Guarantees: Defences to Payment*” (Oxford University Press, 2010) at p. 142

<sup>259</sup> Enonchong, N. ‘The Problem of Abusive Calls on Demand Guarantees’ [2007] *L.M.C.L.Q.* 1, 83 at p. 105

<sup>260</sup> Enonchong, N. ‘The Problem of Abusive Calls on Demand Guarantees’ [2007] *L.M.C.L.Q.* 1, 83 at p. 105

<sup>261</sup> Horowitz, D. “*Letters of Credit and Demand Guarantees: Defences to Payment*” (Oxford University Press, 2010) at p. 169

<sup>262</sup> *Ibid.* at p. 132

<sup>263</sup> Hooley, R. & Sealy L. “*Commercial Law: Text, Cases, and Materials*” (Oxford University Press, 4<sup>th</sup> ed., 2009) at p. 867

<sup>264</sup> For example: *Enka Insaat Ve Sanayi AS v Banca Popolare Dell’Alto Adige SpA* [2009] C.I.L.L. 2777 (first instance); *Simon Carves Ltd v Ensus UK Ltd* [2011] EWHC 657 (TCC); [2011] B.L.R. 340; [2011] C.I.L.L. 3009 (first instance)

an approach in this regard is recommendable. It is suggested that the English law should not adopt the unconscionability exception.<sup>265</sup>

#### 5.3.4. The underlying contract exception in England and other common law countries

The legal separation of the underlying contract from the independent guarantee undertaking should not be blindly stressed. Particularly, in a commercial context “the possibilities of the doctrine of commercial frustration are not to be ignored”.<sup>266</sup> Besides, disregarding the ordinary rules of contract would have dangerous results. Accordingly, it should be kept in mind that the underlying contract which ensues from an independent guarantee, however remote, is the base of the entire subsequent undertakings and without it such undertakings would not exist.<sup>267</sup> Taking these observations into account, an exception to the autonomy principle of independent guarantees which has been described as the underlying contract exception has evolved.<sup>268</sup> The basis of this exception dictates that if the parties view independent guarantees as being too fraud-prone then it is in their hands to change such a view.<sup>269</sup>

Such a change could be achieved by the parties through including in their underlying contract the different details of the independent guarantee which is to be procured. These details include the independent guarantee’s purpose and precise scope. Accordingly, relying on these evident details, a court could restrain a beneficiary from

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<sup>265</sup> It is not strange to find that in Malaysia such an exception has been refused. See Malaysian Court of Appeal decision in *LEC Contractors (M) Sdn Bhd v Castle Inn Sdn Bhd* [2000] 2 MLJ 339

<sup>266</sup> Thayer, P. ‘Irrevocable Credits in International Commerce: Their Legal Effects’ (1937) 37 *Colum. L. Rev.* 1326 at p. 1333

<sup>267</sup> *Ibid.*

<sup>268</sup> Enonchong, N. ‘The Problem of Abusive Calls on Demand Guarantees’ [2007] *L.M.C.L.Q.* 1, 83 at p. 88. According to Enonchong: “Such an exception is called the underlying contract exception. However such a nomenclature has been criticised as it does carry some certain risks. It could be understood that such an exception is a wide invitation to analyse and delve into the underlying contract in order to determine the rights of the parties in order to grant an injunction or not. Accordingly another name could be more appropriate”.

<sup>269</sup> Todd, P. “*Maritime Fraud and Piracy*” (Lloyd’s List, 2<sup>nd</sup> ed., London 2010) at p. 129

receiving the independent guarantee amount in a case where there is sufficient evidence that the purpose for which the guarantee has been initially procured has not materialised.<sup>270</sup> What is noble about such an exception is that it could specifically be applied where there is an explicit term in the underlying contract which restricts the situations in which a demand could be made to obtain the independent guarantee amount.<sup>271</sup> Applying such an exception does not involve banks in different disputes concerning the contracts. Since banks are not concerned with the underlying contract by virtue of the autonomy principle, it is courts that intervene to restrain a demand breaching the underlying contract's express terms.<sup>272</sup>

In such a context, there are two conflicting contractual rights in question: the beneficiary's autonomous right to demand the independent guarantee amount and the applicant's right under the underlying contract which restricts the beneficiary's right to demand. The question which arises in this context and which this section aims to answer is which contractual rights should prevail and whether such an exception to the autonomy principle should be accepted to constitute a justified ground to restrain a beneficiary from his unjustified demand?

In fact, Australia is the country where such an exception to the independent guarantee payment has been originated.<sup>273</sup> The Australian courts had many opportunities to address the above question and accordingly it is suggested that it would be beneficial

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<sup>270</sup> Bradgate, R. White, F. & Fennell, S. "*Commercial Law*" (Oxford University Press, 9<sup>th</sup> ed., Oxford, 2002) at p. 276

<sup>271</sup> Horowitz, D. "*Letters of Credit and Demand Guarantees: Defences to Payment*" (Oxford University Press, 2010) at p. 142

<sup>272</sup> Enonchong, N. 'The Problem of Abusive Calls on Demand Guarantees' [2007] *L.M.C.L.Q.* 1, 83 at p. 89

<sup>273</sup> *Ibid.* at p. 90

to examine some of the Australian authorities which have been involved in this regard before turning to the English authorities.<sup>274</sup> In Australia, courts have accepted that:

“There is an exception for the principle of autonomy where there is an underlying contract between the applicant for the guarantee and the beneficiary which restricts the beneficiary’s power to demand payment under the guarantee”.<sup>275</sup>

The high court case of *Wood Hall Ltd v The Pipeline Authority*<sup>276</sup> is the seminal Australian case in this regard. Stephen J. found that if the underlying contract, from which an independent guarantee has ensued, does contain some restrictions to the availability of the guarantee amount then “the position might well have been different”<sup>277</sup> and the court can interfere to restrain the beneficiary from demanding it in such a case. Since *Wood Hall*, Australian courts have relied heavily on Stephen J.’s approach as the foundation for judicial intervention in case it was alleged that a call had been made in breach of a term expressed in the underlying contract.<sup>278</sup>

While it has been traditionally stressed that fraud is the only exception in England,<sup>279</sup> recent English cases do show that an underlying contract exception is a new ground to restrain a beneficiary from obtaining an independent guarantee amount where he demands it in breach of the underlying contract terms. Such an exception has been

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<sup>274</sup> *Ibid.*

<sup>275</sup> *Lane-Mullins v Warrenby Pty Ltd* [2004] NSWSC 817, at [53]

<sup>276</sup> (1979) 141 CLR 443

<sup>277</sup> *Ibid.* at 459, In this case the position was not different as the underlying contract did not contain any restrictions in regard the independent guarantee.

<sup>278</sup> See, for example: *Selvas Pty Ltd v Hansen Yuncken (SA) Pty Ltd* (1987) 6 Aust Construction LR 36; *Pearson Bridge (NSW) Pty Ltd v State Rail Authority (NSW)* (1982) 1 Aust Construction LR 81; *Barclay Mowlem Construction Ltd v Simon Engineering (Australia) Pty Ltd* (1991) 23 NSWLR 451; *Transfield Pty Ltd v Fuller-FL Smith (Pacific) Pty Ltd & Deutsch Bank AG* (9 May 1997). Unreported (NSW SC: Bainton J); *Lane-Mullins v Warrenby Pty Ltd* [2004] NSWSC 817. For example, in *Pearson Bridge (NSW) Pty Ltd v State Rail Authority (NSW)*, Yeldham J. concluded that there is a clause in the underlying contract which has defined the only circumstances which in the beneficiary can call on the bond. He granted injunctions preventing the beneficiary from making the demand on the bond. The same has been held in a Malaysian court: *Daewoo Engineering & Construction Co Ltd v The Titular Roman Catholic Archbishop of Kuala Lumpur* [2004] 7 MLJ 136

<sup>279</sup> For example: *RD Harbottle (Mercantile) Ltd v National Westminster Bank Ltd* [1978] QB 146, at 156

firstly discussed in the case of *Sirius Insurance Co v FAI General Ltd.*<sup>280</sup> The court in *Sirius* held that the importance of the autonomy principle should not be exaggerated where the beneficiary has expressly agreed with the applicant in the underlying contract that he will not draw on the independent guarantee unless certain conditions were fulfilled and they yet had not been fulfilled. In the Court of Appeal, May L.J., with whose judgement Carnwath L.J., and Wall L.J. agreed, has accepted the trial judge findings in that had this case been an injunction case the court should have granted an injunction to prevent Sirius from drawing on the independent guarantee when its demand is in breach of the underlying contract terms and conditions with FAI.<sup>281</sup> To this effect the court has found:

“Whilst the principle of autonomy which applied to letters of credit was of vital importance, there was no reason why the law should not give effect to an express agreement that a party would not draw down a letter of credit unless certain conditions were met”.<sup>282</sup>

When the case reached the House of Lords, their lordships found that the underlying contract conditions had been satisfied and accordingly reversed the Court of Appeal decision.<sup>283</sup> Obviously, in the *Sirius* case different courts have accepted the new exception.<sup>284</sup> Similarly, in *TTI v Hutchison 3G UK Ltd*,<sup>285</sup> a case which concerned an application by an applicant to restrain the beneficiary from demanding or receiving an independent guarantee payment, Judge Thornton QC appeared to entertain the underlying contract exception notion. His Justice found that an injunction might be granted in a case where the demand has been made in breach of the underlying

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<sup>280</sup> [2003] EWCA Civ 470 (CA) [2004] UKHL 54; [2004] 1 WLR 3251 (House of Lords). It should be noted that this case was not an injunction case. The independent guarantee amount had already been drawn down and deposited into an escrow account.

<sup>281</sup> [2003] 1 WLR 2214, at [27]

<sup>282</sup> [2003] 1 WLR 2214, at [28]

<sup>283</sup> [2004] UKHL 54; [2004] 1 WLR 3251

<sup>284</sup> Gleghorn, S. & Simpson, J. ‘Performance Bonds: A New Exception to their Unconditional Status?’ [2011] *Bank. Law*. Vol. 4(2), 14 at p. 15

<sup>285</sup> [2003] EWHC 762 (TCC); [2003] 1 ALL ER (Comm) 914

contract.<sup>286</sup> There the underlying contract has expressly provided that the payment of the independent guarantee will only be exercised if this agreement terminated in accordance with Clause 35. Indeed, the independent guarantee itself has not restricted the beneficiary's right to demand it as the underlying contract. Later a dispute arose between the parties and the beneficiary notified the applicant about his intention to demand the independent guarantee amount alleging that the underlying contract had terminated in accordance with Clause 35. However, the applicant applied for an injunction to restrain the payment of the independent guarantee, alleging that the beneficiary was in breach of the underlying contract conditions and particularly Clause 35. In its role the court examined the applicant's allegations carefully and held that the demand was in accordance with Clause 35 and that there had been no breach of the underlying contract. Accordingly, the injunction application was refused. It is submitted that the decision would have been different had the court found that the underlying contract had not been terminated in accordance with Clause 35.<sup>287</sup> Therefore, the *TTI* case is supportive of the underlying contract exception.

In the more recent case of *Simon Carves Ltd v Ensus UK Ltd*,<sup>288</sup> Ensus UK Limited (Ensus) engaged Simon Carves Limited (SCL) to complete some works related to the provision of a process plant to produce bioethanol at a site in Teesside. According to the contract's special conditions, SCL was to deliver to Ensus an independent guarantee as a security for any and all of its obligations under their contract. SCL procured the requested independent guarantee from Standard Chartered Bank.<sup>289</sup> Clause 3.7 of the contract provided that the independent guarantee would become null

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<sup>286</sup> [2003] EWHC 762 (TCC); [2003] 1 ALL ER (Comm) 914

<sup>287</sup> Enonchong, N. *"The Independence Principle of Letters of Credit and Demand Guarantees"* (Oxford University Press, Oxford, 2011) at p. 212

<sup>288</sup> [2011] EWHC 657 (TCC); [2011] B.L.R. 340; [2011] C.I.L.L. 3009 (first instance)

<sup>289</sup> [2011] C.I.L.L. 3009 at 3010

and void if an Acceptance Certificate was issued by Ensus in relation to the work of SLC. Indeed, such a Certificate was issued but, nonetheless, some disputes arose between the parties later. While Ensus intended to demand the independent guarantee amount, SLC approached the English courts requesting an injunction to stop Ensus from demanding the independent guarantee. The issue which the court had to examine was whether it should or not grant an injunction to restrain the independent guarantee where the underlying contract contained some conditions which restricted Ensus' rights to call it. At the beginning of his judgement, Akenhead J. illustrated that there is little jurisprudence regarding such cases. He found the *Sirius* case to be the most important case in England in this category.<sup>290</sup> Interestingly, an injunction was granted but this time it was not dependent on the fraud exception but on this new separate exception which had been enunciated previously by the *Sirius* Courts where the conditions that restrict the beneficiary's ability to draw on the independent guarantee have not materialised.<sup>291</sup> To that Akenhead J. courageously stated:

“In my judgement one can draw from the authorities the following: (a)...fraud is not the only ground upon which a call on the bond can be restrained by injunction...;(c) There is no legal authority which permits the beneficiary to make a call on the bond when it is expressly disentitled from doing so; (d) In principle, if the underlying contract, in relation to which the bond has been provided by way of security, clearly and expressly prevents the beneficiary party to the contract from making a demand under the bond, it can be restrained by the Court from making a demand under the bond”.<sup>292</sup>

The *Simon* case is one of the rare English cases where an injunction has been granted to restrain an independent guarantee or a documentary credit payment. Indeed, Akenhead J.'s findings in this regard correspond with the above-mentioned Australian and English authorities which indicate that “a beneficiary may be restrained by an

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<sup>290</sup> *Simon Carves Ltd v Ensus UK Ltd* [2011] C.I.L.L. 3009 at 3011

<sup>291</sup> *Ibid* at 3010

<sup>292</sup> *Ibid* at 3012

injunction from making a call in breach of a contractual promise in favour of the person seeking the injunction<sup>293</sup>

Such an exception has been criticized for several reasons. Firstly, it has been said that, under such an exception, the bank's position is unclear.<sup>294</sup> That is to say: while the autonomy principle dictates that banks should merely check upon the conformity of the documents, the underlying exception recognition would involve banks in dilemmas as they would be required to investigate underlying contracts.<sup>295</sup> Secondly, the opponents of this underlying exception argue that, if recognised, it will affect the commercial utility of independent guarantees and could cause uncertainty in this context.<sup>296</sup>

It is submitted that these criticisms are unsound as they do not stand either legal or commercial right analysis. Firstly, the position of the banks is clear. As illustrated above,<sup>297</sup> in this context, it is courts that would investigate underlying contracts and see whether the case before them is one which deserves an injunction or not. Banks should have no role in this regard and should stick to their documentary job.<sup>298</sup> Secondly, such an exception is one of the best ways that can be utilised in order to combat the abusive calls problem which independent guarantees suffer from. Combating the abusive calls problem will assist the commercial utility of independent

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<sup>293</sup> Gleghorn, S. & Simpson, J. 'Performance Bonds: A New Exception to their Unconditional Status?' [2011] *Bank. Law.* Vol. 4(2), 14, at p. 17. The Australian cases in this regard are: *Selvas Pty v. Hansen Yuncken (SA) Pty Ltd* (1987) 6 A.C.L.R. 36; *Putney Group Pty Ltd v The Royal Rehabilitation Centre Sydney* [2008] NSWSC 1424; *Clough Engineering Ltd v Oil & Natural Gas Corporation Ltd* [2008] FCAFC 136; *Olde & Ors v Primary Compass Limited* [2011] NSWSC 845; *Ceresola TLS AG v Thiess Pty Ltd v John Holland Pty Ltd* [2011] QSC 115

<sup>294</sup> Ulph, J. "Commercial Fraud: Civil Liability, Human Rights, and Money Laundering" (Oxford University Press, Oxford, 2006) at p. 508

<sup>295</sup> *Ibid.*

<sup>296</sup> Enonchong, N. 'The Problem of Abusive Calls on Demand Guarantees' [2007] *L.M.C.L.Q.* 1, 83 at pp. 94 to 96

<sup>297</sup> See section 5.1.

<sup>298</sup> Bridge, M. "Benjamin's Sale of Goods" (Sweet & Maxwell, 8<sup>th</sup> ed., London, 2010) at 23-078



guarantees and not the other way around.<sup>299</sup> The applicant should be able to protect himself from such harmful calls which would adversely affect his reputation and solvency. If the beneficiary of the independent guarantee has accepted not to demand its amount unless the conditions inserted in the underlying contract are satisfied, it is difficult to see how such an exception would affect the commercial utility of independent guarantees. Indeed, such a beneficiary should not “be allowed to hide behind the independence principle in order to break his promise in the underlying contract”.<sup>300</sup> Thirdly, in regard to the problem of uncertainty which the opponents of this exception have proposed, it has been reiterated in the *Simon* case and the other above discussed cases that the restrictions and conditions, that are inserted in the underlying contract regarding the independent guarantee payment, should be clearly and expressly stated.<sup>301</sup> As Callaway J., in the Australian case of *Fletcher Construction Australia Ltd v Varnsdorf Pty Ltd*,<sup>302</sup> has stated: “Clauses in the [underlying] contract that do not expressly inhibit the beneficiary from calling upon the security should not be too readily construed to have that effect”.<sup>303</sup>

The basis of this exception is that while the independent guarantee provides security for a valid claim in the beneficiary’s favour, the restrictions in the underlying contract are of so important nature as they reflect the way in which the parties have allocated the risk as to who should be out of the independent guarantee amount pending later

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<sup>299</sup> Enonchong, N. ‘The Problem of Abusive Calls on Demand Guarantees’ [2007] *L.M.C.L.Q.* 1, 83 at p. 94

<sup>300</sup> Enonchong, N. “*The Independence Principle of Letters of Credit and Demand Guarantees*” (Oxford University Press, Oxford, 2011) at p. 224

<sup>301</sup> *Simon Carves Ltd v Ensus UK Ltd* [2011] C.I.L.L. 3009 at 3012; Gleghorn, S. & Simpson, J. ‘Performance Bonds: A New Exception to their Unconditional Status?’ [2011] *Bank. Law.* Vol. 4(2), 14 at p. 17

<sup>302</sup> [1998] 3 VR 812

<sup>303</sup> [1998] 3 VR 812 at 827

resolution between them.<sup>304</sup> It is one thing that the beneficiary should not be prevented from demanding the independent guarantee amount where there is an underlying dispute between him and the beneficiary but a different thing to say that he should be allowed payment when he has already accepted that he will not demand payment unless certain conditions are satisfied. The question as to whether such an exception should be recognised should be answered in the affirmative. In requiring that the restriction should be clear and expressly stated, this exception has avoided the problem of uncertainty in identifying the scope and the reason behind the independent guarantee which both the fraud and the unconscionability exceptions suffer from. Rather than examining the different relations, rights and obligations in the underlying contract, all that a court has to do under this exception is to check whether a condition inserted in the underlying contract has been materialised or not.<sup>305</sup>

#### 5.4. Conclusion

The ‘material misrepresentation’ is the test used by Lord Diplock to apply the fraud exception in England. A more accurate terminology to indicate “the position as it is now is ‘intentional fraud’”.<sup>306</sup> Intentional fraud is similar to common law deceit and is narrower than the suggested objective test of material fraud.<sup>307</sup> However, since the basis of the fraud exception is the maintenance of public policy, it is suggested that

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<sup>304</sup> Gleghorn, S. & Simpson, J. ‘Performance Bonds: A New Exception to their Unconditional Status?’ [2011] *Bank. Law.* Vol. 4(2), 14 at p. 17

<sup>305</sup> Enonchong, N. “*The Independence Principle of Letters of Credit and Demand Guarantees*” (Oxford University Press, Oxford, 2011) at p. 224

<sup>306</sup> Low, H.Y. ‘Confusion and Difficulties Surrounding the Fraud Rule in Letters of Credit: An English Perspective’ [2011] *Int. J.L.M.* 17(6), 462 at p. 464

<sup>307</sup> Bulger, R. ‘Letters of Credit: A Question of Honor’ [1984] *N.Y.U.J. Int’l L. & Pol.* 799 at p. 810

there is no reason why such an exception is to be confined to situations of misrepresentations.<sup>308</sup>

In a documentary credit context, the proposed objective test is justified in order to protect innocent parties and bankers and in order to prevent fraud.<sup>309</sup> Indeed, it is not every instance of misconduct by the beneficiary that would interrupt a documentary credit payment. Ordinary contract disputes must be settled by the contract parties between themselves and totally apart from the documentary credit undertaking.<sup>310</sup> On the one hand, to allow elective or injunctive dishonour just because the goods do not conform in quality to the underlying contract of sale terms would destroy the documentary letters of credit utility. On the other hand, to allow the beneficiary to receive the documentary credit amount merely because he sent rubbish in good faith would serve no commercial purpose. As one commentator has suggested:

“A compromise between these two scenarios can be envisioned in which either the issuing bank or, ultimately, a court would balance the desirability of protecting the account party from the effects of fraud, against the benefits derived by ensuring the letter of credit is maintained as a useful commercial instrument and business device”.<sup>311</sup>

It can be suggested that such a balanced approach, which applies the objective proposed fraud test, would best suit this context.<sup>312</sup> If the beneficiary’s demand has some form of fraud other than that of a misrepresentation, why should the well-established *ex turpi causa* principle not be involved? The *United City Merchants* was a case of misrepresentation and so it is not surprising that Lord Diplock described the

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<sup>308</sup> Warne, D & Elliott, N. “*Banking Litigation*” (Sweet & Maxwell, 2<sup>nd</sup> ed., London, 2005) at p. 260

<sup>309</sup> Leacock, S. ‘Fraud in the International Transaction: Enjoining Payment of Letters of Credit in International Transactions’ [1984] *Vand. J. Transnat’l L.* 885 at p. 912

<sup>310</sup> ‘Task Force on the Study of U.C.C. Article 5 (Letters of Credit)’ (1990) *The Business Lawyer* Vol.45, 1521 at p. 1614

<sup>311</sup> Fellingner, G. ‘Letters of Credit: The Autonomy Principle and the Fraud Exception’ [1990] 1 *J.B.F.L.P.* 4 at p. 7

<sup>312</sup> Harfield, H. “*Letters of Credit*” (ALI-ABA Comm, New York, 1979) at p. 93

fraud exception as he did.<sup>313</sup> Fraud should not be considered as “an ethical matter but as a technical issue”.<sup>314</sup> In *Simon Carves Ltd v Ensus UK Ltd*.<sup>315</sup> it has been suggested, even in *obiter*, that a material fraud test should be applied.<sup>316</sup>

In an independent guarantee context, neither the fraud nor the unconscionability exceptions are efficient to mitigate the abusive calls problem. In applying both exceptions, a court will find it difficult to identify fraud or unconscionability. Recent cases show that English courts are ready now to utilise the underlying contract exception which their Australian counterparts have been using for three decades. It is submitted that such an exception is the best existing exception which could tackle the problem of abusive calls. It could be said that even with the existence of such an exception a protection gap might remain. Such an argument is right as some applicants might not insert any conditions which can restrict the independent guarantee payment and accordingly be again exposed to the same problem.<sup>317</sup> Yet, this should not prevent vigilant and smart applicants, who wish not to be exposed to abusive calls, from benefiting from such an exception. Such an examination which the court can pursue through the underlying contract exception could encourage the different parties to deal in good faith.<sup>318</sup> While it has been suggested that the best

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<sup>313</sup> Warne, D & Elliott, N. “*Banking Litigation*” (Sweet & Maxwell, 2<sup>nd</sup> ed., London, 2005) at pp. 260-261

<sup>314</sup> Stoufflet, J. ‘Fraud in Documentary Credit, Letter of Credit and Demand Guaranty’ (2001) 106 *Dick. L. Rev.* 21, at p. 25

<sup>315</sup> *Simon Carves Ltd v Ensus UK Ltd* [2011] C.I.L.L. 3009

<sup>316</sup> *Ibid.* at 3012. It should be noted that this case is an independent guarantee case. It is normal to find cases of documentary credits which apply independent guarantees *dicta* and it is also normal to find the contrary in English cases. For example, in *Tukan Timber Ltd v Barclays Bank Plc* [1987] 2 Lloyd’s Rep. 171 at 174 a documentary credit case, *dicta* has been applied from cases of performance bonds regarding the autonomy principle and the fraud exception. Similarly, in *Deutsche Ruckversicherung AG v Walbrook Insurance Co. Ltd and Others* [1994] 4 ALL E.R. 181 at 194, guidance was sought from independent guarantees’ cases for the application of the fraud exception in a documentary credit context.

<sup>317</sup> Enonchong, N. ‘The Problem of Abusive Calls on Demand Guarantees’ [2007] *L.M.C.L.Q.* 1, 83 at p. 97

<sup>318</sup> Vaart, H. ‘Standby Letters of Credit and the Problem of Bad Faith Calls’ (1981) 8 *Yale. J. World. Pub. Order.* 36, at p. 44

method is to avoid utilising independent guarantees because of the potential for abuse,<sup>319</sup> it is submitted that an “only in very limited circumstances”<sup>320</sup> underlying contract exception could protect applicants and banks from such a risk.

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<sup>319</sup> Wunnicke, B. Wunnicke D. & Turner P. “*Standby and Commercial Letters of Credit*” (Wiley Law Publications, 2<sup>nd</sup> ed., New York, 1996) at p. 41

<sup>320</sup> Enonchong, N. ‘The Problem of Abusive Calls on Demand Guarantees’ [2007] *L.M.C.L.Q.* 1, 83 at p. 93

## Chapter Six: Fraud Injunctions in Documentary Credits and Independent Guarantees

### 6.1. Introduction

This chapter examines the English courts' application of injunctions to this particular area of law. The conditions by which the English courts limit the availability of injunctions in this regard are examined. Indeed, by virtue of the autonomy principle, it is familiar that banks should not be concerned with disputes which relate to the underlying contract that leads to the issuance of a documentary credit or an independent guarantee. As previous discussions have illustrated, banks' duties should be limited to documents and nothing other than documents.<sup>1</sup> However, to intervene and refuse payment contrary to the autonomy principle, banks should be provided with an established evidence of fraud. Such evidence, which is relatively high and difficult to prove, is used by the banks which refuse payment in case the party whose right of payment was rejected raises the issue before a court of competent jurisdiction.<sup>2</sup>

Surprisingly, even provided with such compelling evidence, the bank might later discover that the fraud evidence which it holds does not constitute a sufficient evidence of fraud from the point of view of the court.<sup>3</sup> By the same token, banks who select to pay on the assumption that a provided evidence of fraud is not a sufficient ground for withholding the payment, might find themselves liable for a wrongful

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<sup>1</sup> See chapters three and four.

<sup>2</sup> Hooley, R. & Sealy, L. "*Commercial Law*" (Oxford, 2009) at pp. 877-878. To that effect Hooley stated: "If the bank refuses to pay, it must be able to prove at the subsequent trial of the action that there was fraud on the part of the seller at the time of presentation of the documents. It is not enough for the bank to refuse to pay on the ground that it had evidence from which a reasonable banker would think that there had been fraud of the seller, whether or not fraud actually existed in fact."; Rubenstein, N. 'The Issuer's Rights and Obligations Under a Letter of Credit' (1984) 17 *U.CC.L.J* 129, at p. 165

<sup>3</sup> Ellinger P. & Neo, D. "*The Law and Practice of Documentary Letters of Credit*" (Hart Publishing, Oxford, 2010) at p. 144

honour soon after.<sup>4</sup> The bank's reputation might be negatively affected in both situations.<sup>5</sup> Moreover, in order for a bank to ascertain if a certain situation is fraudulent or not, it would be necessary to examine the parties' intent and state of mind which the former are ill equipped to deal with.<sup>6</sup>

Accordingly, and in order to avoid becoming involved in the endless dilemmas arising from the abovementioned situations, the practice shows that banks ask their customers, who allege that fraud has been perpetrated in an independent guarantee or a documentary credit context, to obtain a court's injunction either to restrain the beneficiary from demanding payment (presenting documents or/and collecting payment) or to stop the bank itself from honouring the payment's demand.<sup>7</sup> In both situations and whether the court grants an injunction or not, the bank will guarantee that it remains on the safe side.<sup>8</sup> When a court injunction is made against the bank or the beneficiary, the bank itself will guarantee that it will not be held liable for a wrongful dishonour when it refuses to pay.<sup>9</sup> On the other hand, if the court refuses to grant the envisaged injunction, the bank should pay with the clear knowledge that its

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<sup>4</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada (The American Accord)* [1979] 1 Lloyd's Rep 267, at 276-277, per Mocatta J.: "It cannot often be the case that at the time of or just prior to presentation of documents under a letter of credit the bank in question can show an established fraud. Accordingly, it may well be that procedure by way of injunctions can be of little practical value as a protection against fraudulent claims. However, there seems to be nothing in the authorities to prevent a confirming bank from raising the issue of fraud as a defendant after having refused to pay on the presentation of documents, though it may well be that it would be unlikely to take this course except against an indemnity by the customer or issuing banker".

<sup>5</sup> Goode, R. "Commercial Law" (London, 2004) at pp. 989-990

<sup>6</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada (The American Accord)* [1983] 1 A.C. 168 (HL)

<sup>7</sup> See, for example; *Turkiye Is Bankasi v Bank of China* [1996] 2 Lloyd's Rep 611 per Waller J; *Groupe Josi Re v. Walbrook Insurance* [1996] 1 W.L.R. 1152; Kurkela, M. "Letters of Credit and Bank Guarantees Under International Trade Law" (Oxford University Press, 2<sup>nd</sup> ed., 2007) at p. 180; Dolan, J. "The Law of Letters of Credit: Commercial and Standby Credits" (Warren, Gorham & Lamont, Revised ed., Boston, 1996) at 7-38; Goode, R. 'Abstract Payment Undertakings' in Cane P. & Stapleton, J. (eds.), "Essays for Patrick Atiyah", (Clarendon Press, Oxford, 1991) 209, at p. 234; Leacock, S. 'Fraud in the International Transaction: Enjoining Payment of Letters of Credit in International Transactions' [1984] *Vand. J. Transnat'l L.* 885 at p. 899

<sup>8</sup> Rosenblith, R. 'What Happens When Operations Go Wrong: Enjoining the Letter-of-Credit Transaction and Other Legal Stratagems' (1985) 17 *UCCLJ* 307 at p. 326

<sup>9</sup> Malek, A & Quest, D. "Jack: Documentary Credits" (Tottel Publishing, 4<sup>th</sup> ed., Sussex, 2009) at p. 269

payment will not constitute a wrongful payment.<sup>10</sup> Nonetheless, the English courts are well known for their non-interventionist approach in this regard.<sup>11</sup> The implications of this non-interventionist approach have been reflected in applications for injunctions.<sup>12</sup> In addition to the robust fraud standard test which English courts stipulate in order to apply the fraud exception,<sup>13</sup> they have burdened the party who requests this exception protection with other requirements.<sup>14</sup>

Hence, this chapter is divided into seven parts. After the introduction, the second part provides a general overview of injunctions. The third part illustrates the limitations relating to the availability of injunctions in the letters of credit context. The following sections shed light on the requirements which English courts stipulate in order to grant an injunction in this context. The final part constitutes the conclusion of this chapter.

## 6.2. A general overview of injunctions

Interlocutory injunctions whilst varying in form share the same aim which is preserving the parties' status quo before making the request for an injunction for a short period of time until a full trial court can consider the disputed matter.<sup>15</sup> Usually,

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<sup>10</sup> Ellinger P. & Neo, D. *"The Law and Practice of Documentary Letters of Credit"* (Hart Publishing, Oxford, 2010) at p. 153; Ellinger, E. *"Documentary Letters of Credit: A Comparative Study"* (University of Singapore Press, Singapore, 1970) at p. 196

<sup>11</sup> Ellinger P. & Neo, D. *"The Law and Practice of Documentary Letters of Credit"* (Hart Publishing, Oxford, 2010) at p. 153; Demir-Araz, Y. 'International Trade, Maritime Fraud and Documentary Credits' (2002) 4 *Int. T.L.R. & R.* 128 at p. 130. To this effect Demir-Araz stated: "English courts are very reluctant in giving injunctions. They do not want to interfere with the autonomy of documentary credits. This is the reason why the requirements of fraud exception are highly demanding"; Schwank, F. 'Bank Guarantees in German and Austrian Law' (1982) *I.B.L* 7, at p. 7

<sup>12</sup> Demir-Araz, Y. 'International Trade, Maritime Fraud and Documentary Credits' [2002] *Int. T.L.R.* Vol. 8(4), 128 at p. 129; Bertrams, R. 'Counter-Guarantees in an Indirect, Independent (First Demand) Guarantee Structure' [1997] *B.J.I.B. & F.L.* Vol. 12(8), 373 at p. 379

<sup>13</sup> See chapter five for a detailed examination of the fraud standard test in both documentary credits and independent guarantees contexts.

<sup>14</sup> Howard QC, M. Masefield, R. & Chuah, J. *"Butterworths Banking Law Guide"* (Butterworths, London, 2006) at pp. 535-536

<sup>15</sup> Hanbury, H. & Martin, J. *"Modern Equity"* (London, 2005) at chapter 25; Bertrams, R. *"Bank Guarantees in International Trade: The Law and Practice of Independent (First Demand) Guarantees and Standby Letters of Credit in Civil Law and Common Law Jurisdictions"* (Kluwer Law International, 3<sup>rd</sup> ed., The Hague (Netherlands), 2004) at p. 405



a full trial court decision might not come out for a few months or even a few years by which time a claimant's right might be exposed to some risks.<sup>16</sup> Taking into consideration the urgent nature of some disputed matters, one can imagine how important an interlocutory injunction is.<sup>17</sup> For example, a defendant might become insolvent or he might simply disappear.<sup>18</sup> No more appropriate example can elucidate the important role an injunction plays better than a documentary credit or an independent guarantee fraud case. Unscrupulous beneficiaries who send worthless goods instead of the contracted for goods or who call on an independent guarantee where the terms allowing such a call have not yet materialised could vanish after perpetrating their fraud.<sup>19</sup> Chasing these beneficiaries to other jurisdictions where legal impartiality is in question would not always offer the defrauded applicant a practical solution.<sup>20</sup> An interlocutory injunction to refrain the defendant from acting on the letter of credit would insert a necessary layer of justice where an ordinary court's procedures would reveal its inability to deal with such situations.<sup>21</sup>

Originally, the English jurisdiction to grant an interlocutory injunction was found in Section 25(8) of the 1873's Judicature Act. The same section has been re-enacted after approximately fifty years. The 1925's Supreme Court of Judicature Act (Consolidation) in Section 45(1) furnished courts with the power to intervene by

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<sup>16</sup> Todd, P. "*Bills of Lading and Bankers' Documentary Credits*" (Informa Law, 4<sup>th</sup> ed., London, 2007) at p. 262

<sup>17</sup> Todd, P. "*Bills of Lading and Bankers' Documentary Credits*" (Informa Law, 4<sup>th</sup> ed., London, 2007) at p. 262

<sup>18</sup> Low, H.Y. 'Confusion and Difficulties Surrounding the Fraud Rule in Letters of Credit: An English Perspective' [2011] *Int. J.L.M.* 17(6), 462 at p. 467

<sup>19</sup> Harfield, H. "*Bank Credits and Acceptances*" (The Ronald Press Company, 5<sup>th</sup> ed., New York, 1974) at p. 80

<sup>20</sup> Jeffery, S. 'Standby Letters of Credit and the Fraud exception – An Update' [2003] 18 *B.F.L.R.* 67 at p. 105; Arora, A. 'The Legal Position of Banks in Performance Bond Cases' [1981] *L.M.C.L.Q.* 264 at p. 267; Davis, A. "*The Law Relating to Commercial Letters of credit*" (The Pitman Press, 3<sup>rd</sup> ed., London, 1963) at p. 145

<sup>21</sup> Bradgate, R. White, F. & Fennell, S. "*Commercial Law*" (Oxford University Press, 9<sup>th</sup> ed., Oxford, 2002) at pp. 273-274

means of injunctions where they find it “just or convenient” to do so.<sup>22</sup> However, the current law which deals with the courts’ jurisdiction to grant such a remedy is the Supreme Court Act 1981, specifically, s. 37(1). Unfortunately, none of the sections have drawn the “just or convenient” boundaries and, accordingly, this places a high degree of uncertainty in this particular area of law.

Guidance to the “just or convenient” concepts has been established by Lord Diplock in the seminal case of *American Cyanamid v. Ethicon Ltd.*<sup>23</sup> In that case the claimants, who were a company that manufactures medical equipment, sought an injunction to restrain the beneficiary from illegitimately using one of their medical patents. In delivering the judgement’s final verdict, Lord Diplock set up some conditions that a claimant should meet in order to guarantee the issuance of an injunction in his favour.<sup>24</sup> Lord Diplock’s first condition to grant an injunction was that such a claim should not be “...frivolous nor vexatious; in other words, that the evidence before the court discloses that there is a serious question to be tried”.<sup>25</sup> Secondly, his Lordship stipulated that what is called the balance of convenience should tip in favour of granting the injunction.<sup>26</sup> The balance of convenience depends mainly on the availability of a remedy on damages that an applicant for an injunction can recover from the person an injunction is sought against. However, it should be noted that the balance of convenience does not solely depend on damages and their availability.<sup>27</sup>

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<sup>22</sup> See, Kerr J. observations in *RD Harbottle (Mercantile) Ltd v National Westminster Bank Ltd* [1987] 1 Q.B. 146

<sup>23</sup> *American Cyanamid v. Ethicon Ltd* [1975] A.C. 396

<sup>24</sup> The same requirements have been reiterated by Lord Diplock in *Eng Mee Yong v Letchumanan* [1980] AC 331, at 337

<sup>25</sup> *American Cyanamid v. Ethicon Ltd* [1975] A.C. 396, at 407

<sup>26</sup> *Ibid.*

<sup>27</sup> *Ibid.* at 398

### 6.3. Limitations on the availability of injunctions in the context of documentary credits and independent guarantees

Before examining the requirements which English courts insist on in order to grant an injunction in this context, it should be noted that such a relief is of a limited nature due to the special characteristics which such instruments enjoy.<sup>28</sup> Firstly, the location of the party against whom an injunction is sought is an important factor which would affect the procedure to grant an injunction.<sup>29</sup> For instance, an English court would find itself powerless to interfere with a bank's right to pay the beneficiary or the latter's right to demand payment where they are both located in a foreign country.<sup>30</sup> Even if the court granted such an injunction to restrain foreign entities from acting on these instruments, the result cannot be guaranteed.<sup>31</sup> In fact, English courts have refused to implement a foreign injunction within its jurisdiction when it has been asked and, accordingly, it would be rational for these courts to expect the same treatment back.<sup>32</sup> Therefore, the English injunctions should be limited to restrain those parties who reside inside its jurisdiction.<sup>33</sup> To that effect, in a case where an English seller sought an injunction from the English courts to restrain an Iraqi bank from acting on an independent guarantee, Lord Ackner stated:

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<sup>28</sup> Malek, A & Quest, D. "*Jack: Documentary Credits*" (Tottel Publishing, 4<sup>th</sup> ed., Sussex, 2009) at pp. 280-281

<sup>29</sup> Bertrams, R. "*Bank Guarantees in International Trade: The Law and Practice of Independent (First Demand) Guarantees and Standby Letters of Credit in Civil Law and Common Law Jurisdictions*" (Kluwer Law International, 3<sup>rd</sup> ed., The Hague (Netherlands), 2004) at p. 432

<sup>30</sup> Sarna, L. "*Letters of Credit: The Law and Current Practice*" (Carswell Legal Publishers, 2<sup>nd</sup> ed., Toronto, 1986) at p. 185

<sup>31</sup> *Ibid.* at p. 187

<sup>32</sup> See: *Power Curber International Ltd v National Bank of Kuwait SAK* [1981] 1 W.L.R. 1233; [1981] 3 All E.R. 607; [1981] 2 Lloyd's Rep. 394 (CA) *per* Lord Denning. In Lord Denning words at [1981] 3 All ER 607 at 613: "If the court of any of the countries should interfere with the obligations of one of its banks, it would strike at the very heart of that country's international trade. No foreign seller would supply goods to that country on letters of credit because he could no longer be confident of being paid. No trader would accept a letter of credit issued by a bank of that country if it might be ordered by its courts not to pay".

<sup>33</sup> Bertrams, R. 'Counter-Guarantees in an Indirect, Independent (First Demand) Guarantee Structure' [1997] *B.J.I.B. & F.L.* Vol. 12(8), 373 at p. 379

“...that the Iraqi Courts will not recognize the injunction, with the result that Agromark [the beneficiary] will obtain a judgment against Rafidain [the issuing bank], must be considered as a very real one. If the positions were reversed and the sale contracts were governed by English law with an English sole jurisdiction clause, supported by performance bonds to provide security to the English buyers for the fulfilment in England of the sellers' obligations under the contract, we can readily appreciate the force of the argument that English Courts would not recognize an interim Iraqi injunction”.<sup>34</sup>

Secondly, the complex relations which documentary credits and independent guarantees might involve on the one hand, and the short time between the demand on these instruments and payment on the other hand constitute other effectual factor which limits the availability of such a relief.<sup>35</sup> An applicant who wishes to restrain a fraudulent beneficiary from demanding payment from a confirming bank abroad would find it difficult to travel to such a jurisdiction to apply for an injunction.<sup>36</sup> Even if he travelled to such a jurisdiction he would be surprised to find out that the unscrupulous beneficiary has already been paid by the confirming bank.<sup>37</sup> Moreover, the applicant himself would clash with that country's difficult producers in order to get an injunction if the country has such a remedy in its legal vocabulary.<sup>38</sup> On the other hand, the applicant will find it a “hopeless” case if he tries to restrain a

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<sup>34</sup> *Per* Ackner L.J. in *United Trading Corp SA v Allied Arab Bank Ltd* [1985] 2 Lloyd's Rep. 554, at 566

<sup>35</sup> Ellinger P. & Neo, D. “*The Law and Practice of Documentary Letters of Credit*” (Hart Publishing, Oxford, 2010) at p. 159; Todd, P. “*Maritime Fraud and Piracy*” (Lloyd's List, 2<sup>nd</sup> ed., London 2010) at p. 141; Todd, P. “*Bills of Lading and Bankers' Documentary Credits*” (Informa Law, 4<sup>th</sup> ed., London, 2007) at p. 256; Bridge, M. “*The International Sale of Goods*” (Oxford University Press, 2<sup>nd</sup>, ed., Oxford, 2007) at p. 305

<sup>36</sup> Bridge, M. “*The International Sale of Goods*” (Oxford University Press, 2<sup>nd</sup>, ed., Oxford, 2007) at p. 305; Weisz, G. & Blackman, J. ‘Standby Letters of Credit after Iran: Remedies of the Account Party’ (1982) 1 *U. ILL. L. Rev.* 355 at p. 360

<sup>37</sup> Warne, D & Elliott, N. “*Banking Litigation*” (Sweet & Maxwell, 2<sup>nd</sup> ed., London, 2005) at p. 267; Barclay, A. ‘Courts Orders Against Payment under First demand Guarantees Used In International Trade’ [1989] *J.I.B.L.* Vol. 4(3), 110 at p. 113

<sup>38</sup> Bergsten, E. ‘A New Regime for International Independent Guarantees and Stand-by Letters of Credit: The UNICITRAL Draft Convention on Guaranty Letters’ (1993) 27 *Int'l. Law.* 859 at p. 874. To that effect he stated: “Judicial procedures vary widely, including in some countries the absence of an equivalent of a preliminary injunction”.

confirming bank due to the simple fact that there is no privity contract between him and such a bank.<sup>39</sup>

Hence, an applicant will find that applying for an injunction to restrain his own bank which resides in his own country is the only efficient way to stop the fraudulent scheme.<sup>40</sup> However, obtaining such an injunction is not easy as some limitations which restrict the availability of the injunction might confront him. The existence of a holder in due course would reduce his chances of acquiring such an injunction.<sup>41</sup> For example, it is well known that a confirming bank which duly performs its duties under a documentary credit or an independent guarantee should not be prevented from being reimbursed by the issuing bank which instructed the former to open such a credit.<sup>42</sup> An English court should take into account the last factor when it is requested to grant an injunction.<sup>43</sup> Accordingly, an English court should not interfere with the banks' duties and rights unless it is provided with compelling evidence that the confirming bank has paid the beneficiary whilst it knows about such a fraud which renders it

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<sup>39</sup> *Per* Ackner L.J. in *United Trading Corp SA v Allied Arab Bank Ltd* [1985] 2 Lloyd's Rep. 554, at 560; *GKN Contractors v Lloyds Bank Plc* [1985] 30 BLR 48 at 62; Hooley, R. & Sealy L. "Commercial Law: Text, Cases, and Materials" (Oxford University Press, 4<sup>th</sup> ed., 2009) at p. 879; Todd, P. "Bills of Lading and Bankers' Documentary Credits" (Informa Law, 4<sup>th</sup> ed., London, 2007) at p. 264; Ellinger P. & Neo, D. "The Law and Practice of Documentary Letters of Credit" (Hart Publishing, Oxford, 2010) at p. 159; Hapgood, M. "Paget's Law of Banking" (Butterworths, 13<sup>th</sup> ed., London, 2007) at p. 873; Goode, R. 'Surety and On-Demand Performance Bonds' [1988] *J.B.L.* 87 at p. 91; Goode, R. 'Reflections on Letters of Credit – IV' [1981] *J.B.L.* 73 at p. 76

<sup>40</sup> Pierce, A. "Demand Guarantees in International Trade" (Sweet & Maxwell, London, 1993) at p.96

<sup>41</sup> *Credit Agricole Indosuez v Generale Bank* [1999] 2 ALL ER (Comm) 1009. In this case Rix J has provided at p. 1015: "Once the beneficiary has been paid the purpose of the fraud exception, which is to prevent a beneficiary benefiting from his fraud, is spent. That the fraud has to be both clear and clear to the knowledge of the paying bank at the time of payment is the substance of the way in which the exception was expressed in *Edward Owen*... Once an authorised payment has been made under the letter of credit it seems to me that a paying bank is entitled to the reimbursement which is promised it by the issuing bank"; *Discount Records Ltd v Barclays Bank Ltd* [1975] 1 WLR 315

<sup>42</sup> Malek, A & Quest, D. "Jack: Documentary Credits" (Tottel Publishing, 4<sup>th</sup> ed., Sussex, 2009) at p. 287; Justice, J. 'Letters of Credit: Expectations and Frustrations – Part 2' (1977) 94 *Banking L.J.* 493 at pp. 503-504; Finkelstein, H. "Legal Aspects of Commercial Letters of Credit" (Columbia University Press, New York, 1930) at p. 172

<sup>43</sup> UCP 600 Article 7(c) provides: "An issuing bank undertakes to reimburse a nominated bank that has honoured or negotiated a complying presentation and forwarded the documents to the issuing bank".

embroiled in the fraudulent scheme.<sup>44</sup> In practice, an injunction to restrain a foreign party is almost impossible.<sup>45</sup> Moreover, restraining a foreign confirming bank whose good faith is not in question would be more than impossible.<sup>46</sup> However, even though it rarely occurs, if the court is convinced that such a confirming bank is embroiled in the fraud it would restrain the issuing bank that resides in its jurisdiction from reimbursing the fraudulent confirming bank. Otherwise, an applicant will bear the ultimate loss ensuing from the fraudulent scheme the perpetrators of which he chose to deal with from the beginning.<sup>47</sup>

Nevertheless, this would not be the case where the letter of credit does not involve a holder in due course. Indeed, in such a situation the applicant's chances of acquiring an injunction would be stronger against both the fraudulent beneficiary and the bank. Having illustrated the limitations on the availability of the remedy of injunctions, which emanate from the special nature of these instruments, one can proceed to examine the merits and the drawbacks which the English courts have developed in handling this area of law.

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<sup>44</sup> Donnelly, K. 'Nothing for Nothing: A Nullity Exception in Letters of Credit?' [2008] *J.B.L.* Vol.4, 316 at p. 323

<sup>45</sup> *United Trading Corp SA v Allied Arab Bank Ltd* [1985] 2 *Lloyd's Rep.* 554; *Power Curber International Ltd v National Bank of Kuwait SAK* [1981] 1 *W.L.R.* 1233; *Discount Records Ltd v Barclays Bank Ltd* [1975] 1 *WLR* 315

<sup>46</sup> Rendell, S. 'Fraud and Injunctive Relief' (1990) 56 *Brook. L. Rev.* 111 at pp. 115-116; Rosenblith, R. 'What Happens When Operations Go Wrong: Enjoining the Letter-of-Credit Transaction and Other Legal Stratagems' (1985) 17 *UCCLJ* 307 at p. 312

<sup>47</sup> Rosenblith, R. 'What Happens When Operations Go Wrong: Enjoining the Letter-of-Credit Transaction and Other Legal Stratagems' (1985) 17 *UCCLJ* 307 at p. 312; Finkelstein, H. "*Legal Aspects of Commercial Letters of Credit*" (Columbia University Press, New York, 1930) at p. 242

## 6.4. The first requirement: an established case of fraud

### 6.4.1. The established fraud test

Formerly, the practice had been developed that a plaintiff requiring an injunction “...must establish to the satisfaction of a court a strong prima facie case”.<sup>48</sup> This means that the applicant must show that he has a real prospect of success in a full trial court if an injunction is granted. This relatively high degree of proof constituted a difficulty for applicants seeking injunctions to restrain other parties.<sup>49</sup> However, the advent of the *American Cyanamid v. Ethicon Ltd*<sup>50</sup> turned things upside down. Lord Diplock made it clear that the previous trend, requiring a prima facie case to grant injunctions, should be neglected. His Lordship presented a more flexible and obtainable requirement, namely, “...a serious question to be tried”. In such a test all that the applicant has to show is the existence of a disputed issue which deserves further litigation.

However, applications to English courts for interlocutory injunctions in documentary credits and independent guarantees have been affected by the fact that any intervention to stop payment in these contexts should be based on the fraud exception.<sup>51</sup> Indeed, if a test which can be easily obtained such as “a serious question to be tried” would work as a barrier to stop a letter of credit payment, these instruments would lose the prominent role which they play in the international trade

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<sup>48</sup> Per Atkin L.J. in *Smith v Crigg Ltd* [1924] 1 KB 655, at 659. To the same effect, e.g., see: *JT Stratford & Son Ltd v Lindley* [1964] 3 All ER 102 (HL) at 111, where Pearce L.J. (with whom other Lords concurred) questioned if the appellant have provided a prima facie case; *Cavendish House (Cheltenham) Ltd v Cavendish-Woodhouse Ltd* [1970] RPC 234, at 235 where Harman, L.J. stated that: “Therefore you start off with a prima facie case. That, of course, is the essential prelude to the granting of interlocutory relief”; *DC Thomason & Co Ltd v Deakin* (1952) Ch 646, at 660 & 671; *Fellow & Son v Fisher* [1976] 1 QB 122, at 131

<sup>49</sup> Todd, P. “*Bills of Lading and Bankers’ Documentary Credits*” (Informa Law, 4<sup>th</sup> ed., London, 2007) at p. 264

<sup>50</sup> [1975] A.C. 396, at 407

<sup>51</sup> See, for example: *United City Merchants (Investments) Ltd v Royal Bank of Canada (The American Accord)* [1983] 1 A.C. 168; *RD Harbottle (Mercantile) Ltd v National Westminster Bank Ltd* [1978] 1 QB 146, 155

realm.<sup>52</sup> Accordingly, Lord Diplock's above requirement has been discarded by later authorities and legal commentaries.<sup>53</sup> The traditional view was that a requirement to show an established or clear case of fraud should replace Lord Diplock's first requirement.<sup>54</sup> Therefore, a serious claim which does not comprise an established case of fraud would not suffice to obtain an injunction.

The requirement of an established or clear case of fraud had been firstly stipulated for in *Discount Records Ltd v Barclays Bank Ltd*.<sup>55</sup> In this case the English court refused to grant an English buyer an injunction to restrain his English bank from reimbursing a French confirming bank under a documentary letter of credit. The court in refusing to restrain the English bank from reimbursing the French bank found that "fraud must be clearly established".<sup>56</sup> Similarly, in *Harbottle (Mercantile) Ltd. v National Westminster Bank Ltd and Others*,<sup>57</sup> an English seller opened three independent guarantees in the favour of his Egyptian buyer through the National Westminster Bank. The independent guarantees were confirmed through different Egyptian banks.

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<sup>52</sup> Chong, W. 'The Abusive Calling of Performance Bonds' [1990] *J.B.L.* 414 at p. 416; Loh, Q. & Wu, T. 'Injunctions Restraining Calls on Performance Bonds – Is Fraud the Only Ground in Singapore?' [2000] *L.M.C.L.Q.* 3, 348 at p. 354

<sup>53</sup> See, e.g., *Discount Records Ltd v Barclays Bank Ltd* [1975] 1 WLR 315, 319: "Fraud must be clearly established"; *RD Harbottle (Mercantile) Ltd v National Westminster Bank Ltd* [1978] 1 QB 146, 155: "Except possibly in clear cases of fraud of which the banks have notice, the courts will [not intervene by injunction]"; *Edward Owen Engineering Ltd v Barclays Bank International Ltd* [1978] 1 Lloyd's Rep 166, 172 per Lord Denning, M.R.: Applicant must show "clear fraud of which the bank has notice"; Browne L.J.: A claim of fraud must be "very clearly established" at 173; Geoffrey Lane, L.J.: "Fraud obvious or clear to the bank" at 174; *Bolivinter Oil SA v Chase Manhattan Bank* [1984] 1 Lloyd's Rep 251, 257 per Sir John Donaldson, M.R.: "The evidence of fraud must be clear, both as to the fact of fraud and as to the bank's knowledge"; *IE Contractors Ltd v Lloyds Bank Plc* [1990] 2 Lloyd's Rep 496; *Group Josi Re v Walbrook Insurance Co Ltd* [1996] 1 W.L.R. 1152 at p.1161; *United Trading Corp SA v Allied Arab Bank Ltd* [1985] 2 Lloyd's Rep. 554 at 565, per Ackner L.J.; Johnson, A. & Paterson, S. 'Fraud and Documentary Credits' [2001] *J.I.B.L.* Vol. 16(2), 37 at p. 37; Demir-Araz, Y. 'International Trade, Maritime Fraud and Documentary Credits' [2002] *Int. T.L.R.* Vol. 8(4), 128 at p. 131; Wehling, A. 'Fraud and Forgery in Documentary Credits – A Comparison.' [1995] *Tr. Law* Vol. 15(5), 378 at p. 380; Malek, A & Quest, D. "*Jack: Documentary Credits*" (Tottel Publishing, 4<sup>th</sup> ed., Sussex, 2009) at p. 255; Barclay, A. 'Courts Orders Against Payment under First demand Guarantees Used In International Trade' [1989] *J.I.B.L.* Vol. 4(3), 110 at p. 120; Bridge, M. "*The International Sale of Goods*" (Oxford University Press, 2<sup>nd</sup> ed., Oxford, 2007) at p. 305

<sup>54</sup> *Ibid.*

<sup>55</sup> [1975] 1 WLR 315

<sup>56</sup> *Discount Records Ltd v Barclays Bank Ltd* [1975] 1 WLR 315, 319

<sup>57</sup> [1977] 3 W.L.R. 752



The three guarantees were provided by the English seller to the Egyptian buyer to guarantee the former's fulfilment of his obligations under the underlying sale contract.

Unfortunately, disputes about the performance of the sale contract have arisen and as a result the Egyptian's side called on the independent guarantees. At the beginning, the English seller had been successful in his application for an injunction to restrain the bank from paying the Egyptians. However, before long, the bank had applied to discharge the previously granted injunction. Kerr J. who found that the case is "...not of an established fraud at all"<sup>58</sup> decided to discharge the granted injunction and gave the judgment for the claimant bank.

The well-known case in this regard, *Edward Owen Engineering Ltd. v Barclays Bank International Ltd.*<sup>59</sup> supports the same conclusions as above. In this case, the plaintiff, an English seller, contracted to sell Libyan buyers some particular goods. The sellers, and in exchange for the issuance of a documentary letter of credit in their favour, were required to provide the Libyan buyers with an independent guarantee for ten per cent of the sale contract's price to assure that they duly performed their obligations under the latter. However, the Libyan buyers did not provide the contracted for documentary letter of credit.<sup>60</sup> Nevertheless, the latter, who appeared to be in default,<sup>61</sup> approached the bank and demanded the independent guarantee amount. Therefore, the English sellers resorted to the courts asking for an injunction to restrain the bank from paying the Libyan buyers.

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<sup>58</sup> [1977] 3 W.L.R. 752, at 761

<sup>59</sup> [1978] 1 ALL ER 976

<sup>60</sup> The Libyan sellers opened an unconfirmed documentary letter of credit in favour of the English supplier while the sale contract stipulated for a confirmed letter of credit. In Denning L.J. words at 978: "The letter of credit expressly provided that payment was only to be made when the Libyan customers authorised it. So the letter of credit was plainly not a confirmed letter of credit".

<sup>61</sup> [1978] 1 ALL ER 976 at 976

While an injunction was accepted by one judge and refused by another one subsequently in the lower courts, the Court of Appeal, (consisting of Lord Denning, Lord Browne and Lord Geoffrey Lane) tipped the balance towards the latter judge's end and refused to grant an injunction. In justifying the reason for the court's refraining from interfering by means of injunctions, Lord Denning stated that it is only in cases of "established or obvious fraud"<sup>62</sup> that a court would interfere to grant an injunction contrary to the autonomy principle. To the same effect Lord Browne has found that "it is certainly not enough to allege fraud; it must be 'established', and in such circumstances I should say very clearly established".<sup>63</sup> Nonetheless, the learned court in considering the particular facts of the case had not found the Libyan sellers' call on the independent guarantee fraudulent and, accordingly, it was impossible to satisfy the established fraud proof test which they stipulated for.

Illustrating the matter in the same manner pursued above without taking into consideration the special facts of each single case, led many authors to advocate that the "established fraud" is the only test English courts apply when a documentary credit's or an independent guarantee's applicant seeks an injunction to restrain a bank or a beneficiary from acting on these instruments.<sup>64</sup> While they have repeatedly criticised such a test and described it as difficult to obtain and high to reach, none

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<sup>62</sup> [1978] 1 ALL ER 976 at 981

<sup>63</sup> [1978] 1 ALL ER 976 at 984. To that same effect Geoffrey Lane, L.J. stated: "Fraud obvious or clear to the bank".

<sup>64</sup> Malek, A & Quest, D. "*Jack: Documentary Credits*" (Tottel Publishing, 4<sup>th</sup> ed., Sussex, 2009) at p. 255; Enonchong, N. 'The Problem of Abusive Calls on Demand Guarantees' [2007] *LM.C.L.Q.* 83 at p. 85; Bridge, M. "*The International Sale of Goods*" (Oxford University Press, 2<sup>nd</sup> ed., Oxford, 2007) at p. 305; Grotenthaler, M. 'Letters of Credit as Credit Support – The Canadian Position' [2005] *J.I.B.L.R.* Vol. 20(3), 129 at p. 131; Demir-Araz, Y. 'International Trade, Maritime Fraud and Documentary Credits' [2002] *Int. T.L.R.* Vol. 8(4), 128 at p. 131; Johnson, A. & Paterson, S. 'Fraud and Documentary Credits' [2001] *J.I.B.L.* Vol. 16(2), 37 at p. 37; Wehling, A. 'Fraud and Forgery in Documentary Credits – A Comparison' [1995] *Tr. Law* Vol. 15(5), 378 at p. 380; Fellingner, G. 'Letters of Credit: the Autonomy Principle and the Fraud Exception' (1990) 1 *J. Banking & Finance L. & Practice*. 4; Barclay, A. 'Courts Orders Against Payment under First demand Guarantees Used In International Trade' [1989] *J.I.B.L.* Vol. 4(3), 110 at p. 120; Elland-Goldsmith, M. 'Performance Bonds in the English Courts' [1978] 4 *DPCI* 151

have offered a convincing rational explanation as to why English courts have developed such a test and in what circumstances it should be applied.<sup>65</sup> However, contrary to the majority view, it is suggested that such a test is sound if the special facts that lead to its issuance are taken into consideration.

In *Edward Owen Engineering Ltd v Barclays International Ltd*,<sup>66</sup> Lord Denning upheld Kerr J.'s discharging of the injunction previously granted. To this his Lordship found that:

“This is a new case on a performance bond or guarantee which must be decided on the principles applicable to it. *Seeing that the bank must pay, and will probably come down on the English suppliers on their counter-guarantee, it follows that the only remedy of the English suppliers is to sue the Libyan customers for damages*”.<sup>67</sup>

In fact, pursuant to the instructions of the English sellers, the independent guarantee issued by Barclays Bank was confirmed through a second bank in the buyer's country. The situation there was similar to a confirmed letter of credit.<sup>68</sup> The English sellers promised the instructing bank, Barclays Bank, to pay once the request for the independent guarantee amount had been made; Barclays Bank itself promised the Umma Bank (the Libyan issuing bank) to pay once it had requested the independent guarantee amount and the Umma Bank in its turn promised the Libyan buyers to affect the independent guarantee payment on demand. All promises to pay were to be

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<sup>65</sup> See, for example: Enonchong, N. *The Independence Principle of Letters of Credit and Demand Guarantees* (Oxford University Press, Oxford, 2011) at p. 121; Ellinger P. & Neo, D. *The Law and Practice of Documentary Letters of Credit* (Hart Publishing, Oxford, 2010) at p. 157; Donnelly, K. ‘Nothing for Nothing: A Nullity Exception in Letters of Credit?’ [2008] *J.B.L.* Vol.4, 316 at p. 223; Hapgood, M. *Paget's Law of Banking* (Butterworths, 13<sup>th</sup> ed., London, 2007) at p. 873

<sup>66</sup> [1978] 1 ALL ER 976

<sup>67</sup> [1978] 1 ALL ER 976 [Emphasis added]. Moreover, it should be noted that: “The contract contains a clause giving exclusive jurisdiction to the courts of Libya”. In the same manner, for example, see: *R.D. Harbottle v National Westminster Bank Ltd* [1978] QB 146 at 151, where Kerr J. said that “the bank had given its own guarantee, and in effect pledged its own credit, to the Egyptian banks to pay on demand, its reputation depends on strict compliance with its obligations. This has always been an essential feature of banking practice.”; *Turkan Timber Ltd v Barclays Bank Plc* [1987] 1 Lloyd's rep. 171 at 217

<sup>68</sup> [1978] 1 ALL ER 976, at 976

affected without the need for any proof which shows the discharging of any certain obligations.

The Libyan buyers, in accordance with the terms of the independent guarantee, had approached the Umma Bank and called on the independent guarantee. The Umma Bank in its turn had duly honoured the demand pursuant to the independent guarantee terms and, accordingly, returned to the English bank asking for reimbursement. The English sellers when they knew that such a call had taken place approached the English courts to restrain Barclays Bank from paying the Umma Bank. When an injunction had been initially issued by the English courts, Barclays Bank had contacted the Libyan bank asking about the possibility of stopping the independent guarantee payment. However, the reply was disappointing as the bank there in Libya had already honoured the call. The Umma Bank response was as follows:

“We are not in a position to comply with its [the injunction] contents. Subject matter must be settled between concerned [parties]...Please authorise us urgently...regret [we] hold you responsible for any consequences resulting from non-execution”.<sup>69</sup>

In such a case restraining Barclays Bank from reimbursing the Umma Bank would be inconsistent with the assumption upon which the latter entered into a contract with the former. Banks in independent guarantees, as is the case with documentary credits, are not concerned with the actual performance of the underlying contract which leads to the issuance of such instruments.<sup>70</sup> Moreover, it is an inherited particularity of the law of letters of credit that if a bank “...does as it is told, it is safe; if it declines to do anything else, it is safe; if it departs from the conditions laid down, it acts at its own risk”.<sup>71</sup> The English court while admitting that the Libyan buyers were in default,

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<sup>69</sup> [1978] 1 ALL ER 976, at 980-981

<sup>70</sup> See Lord Jenkins observations in *Malas v British Imex Industries Ltd* [1958] 2 QB 127, at 129

<sup>71</sup> *Per* Lord Sumner in *Equitable Trust Co of New York v Dawson Partners Ltd.* (1927) 27 Lloyd’s L. Rep. 49

found it a difficult situation in which to intervene, especially between parties (banks) whose good faith is not under question.<sup>72</sup> Barclays Bank promised the Umma bank to repay the independent guarantee amount once the Libyan buyers called on the guarantee and in view of that it should fulfil its promise. As Lord Denning puts it:

“So there it is. Barclays Bank International has given its...promise to pay, to Umma Bank on demand...the demand was made. The bank must honour it. This court cannot interfere with the obligations of the bank.”<sup>73</sup>

With a lack of established or obvious fraud on their part, nothing should deprive the Umma bank from being reimbursed. This elucidates why Barclays Bank itself had applied for the injunction to be discharged. As Hooley states:

“Where the fraudulent conduct of the beneficiary or other person presenting the documents is clear and obvious to the bank, then the bank should not pay against the documents and it will not be entitled to reimbursement from the applicant or other instructing party”.<sup>74</sup>

But to say that the Umma Bank is not entitled to be reimbursed where fraud has not been clear or established to its knowledge conflicts with documentary credits and independent guarantees law and practice. While not all of the *Edward Owen* judgment aspects impress the current author,<sup>75</sup> it is advocated that the fraud proof test applied in this case is the consistent test which suits well the special nature of such a case. The presence of the Umma Bank, which has honoured its obligation in good faith as an issuing bank, has prevented the English court from interfering by means of

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<sup>72</sup> *Per* Lord Denning in *Edward Owen* at 981: “The long and short of it is that although prima facie the Libyan customers were in default in not providing the letter of credit, nevertheless they appear to have claimed against the Umma Bank on the performance bond issued by them; in turn the Umma Bank claimed on Barclays Bank, who claimed on the English suppliers.”

<sup>73</sup> *Per* Lord Denning in *Edward Owen* [1978] 1 ALL ER 976, at 983

<sup>74</sup> Hooley, R. & Sealy, S. “*Commercial Law*” (Oxford, 2009) at p. 877

<sup>75</sup> In *Edward Owen*, in the current author’s view, the fraud standard test and the explanation of the nature of the independent guarantees and their relationship with the autonomy principle was unsatisfactory.

injunction.<sup>76</sup> Indeed, as elucidated above,<sup>77</sup> the case was one where an applicant's right to apply for an injunction is of a limited nature.<sup>78</sup>

In the same manner and for the same reasons, the court refused to impede the payment process by means of injunctions in *Discount Records Ltd v Barclays Bank*.<sup>79</sup> The existence of a French bona fide confirming bank, which has honoured the seller's draft in a documentary credit context without any slightest suspicion that to their knowledge fraud had been perpetrated, prevented the issuance of such an injunction. The court found that the English bank (Barclays Bank) had to reimburse the French bank which has duly honoured the French sellers' drafts even though the latter was fraudulent. Taking into consideration the special facts of the case, the court had limited the situations in which it can intervene against an innocent bank to that where fraud can be "clearly established" in the bank's side.<sup>80</sup> As Fellingner puts it "Fraud is a legal matter and, as such, [banks] should not be permitted to make judgments on the evidence".<sup>81</sup> Unless banks are provided with an established proof of fraud, they should not be held liable for its perpetration. To the same effect, Bridge stated:

"...the onus lies on the applicant to provide the bank with the appropriate compelling evidence. That evidence must speak for itself: the applicant 'must not simply make allegations and expect the bank to check whether those allegations are founded or not'. A bank is not a detective agency and cannot be expected to investigate whether there is substance behind an inconclusive case presented by the applicant."<sup>82</sup>

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<sup>76</sup> Gao, X. 'Presenters Immune From the Fraud Rule in the Law of Letters of Credit' [2002] *L.M.C.L.Q.* 1, 10 at pp. 18-19

<sup>77</sup> See section 6.3.

<sup>78</sup> See, e.g., *Turkiye IS Bankasi AS v Bank of China* [1998] 1 Lloyd's Rep. 250; [1998] C.L.C. 182 (CA); *Howe Richardson Scale Co Ltd v Polimex-Cekop* [1977] Court of Appeal Transcript 27

<sup>79</sup> [1975] 1 WLR 315, at 319

<sup>80</sup> *Discount Records Ltd v Barclays Bank Ltd* [1975] 1 WLR 315, 319; the same course of action has been pursued in the *Harbottle* case.

<sup>81</sup> Fellingner, G. 'Letters of Credit: the Autonomy Principle and the Fraud Exception' (1990) 1 *J. Banking & Finance L. & Practice*. 4, at p. 22

<sup>82</sup> Bridge, M. "*Benjamin's Sale of Goods*" (London, 2010) at Part 7 - Overseas Sales, Chapter 24 - Autonomous Guarantees, Section 5 - Two Fundamental Principles: Irrevocability and Autonomy, Sub-section (b) - Autonomy, 24-022; to the same effect, see: *Turkiye Is Bankasi AS v Bank of China* [1996] 2 Lloyd's Rep. 611 at 617 *per* Waller J.; *United Trading Corp SA v Allied Arab Bank Ltd* [1985] 2

It is submitted that the approach advocated by English courts above should be maintained because it imitates banks' assumptions and the protection they envisage in such a context.<sup>83</sup> It should be noted that English courts have stipulated for the same fraud proof test in cases where a letter of credit applicant refuses to reimburse an issuing bank that has paid the beneficiary or a confirming bank in accordance with the payment undertaking terms.<sup>84</sup> In such cases, English courts have ruled in favour of the bank unless the applicant can show an established case of fraud which the issuing bank had knowledge of.

Those who allege that an established, obvious or clear proof of fraud should be constantly presented before courts in order to restrain a letter of credit, erect their allegations on a misunderstanding emanating from the celebrated case of *Sztejn v J Henry Schroder Banking Corp.*<sup>85</sup> In this case, Shientag J., for the purpose of the motion therein found that "the allegations of the complaint must be deemed established and 'every intendment and fair inference is in favour of the pleading'".<sup>86</sup> However, the author argues that even though Justice Shientag deemed the allegations of the complaint established, nothing in the case itself suggests that the court was not prepared to interfere unless a proof of established fraud was brought to its attention. Indeed, his Justice deemed such allegations to be established in order to satisfy a New

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Lloyd's Rep. 554 at 560; Fellingner, G. 'Letters of Credit: the Autonomy Principle and the Fraud Exception' (1990) 1 *J. Banking & Finance L. & Practice*. 4, at p. 12. To that effect Fellingner stated: "it would be a most unfortunate interference with business transactions if banks were obliged or permitted to become involved in disputes between the parties".

<sup>83</sup> Rowe, M. "Letters of Credit" (Euromoney Books, 2<sup>nd</sup> ed., London, 1997) at p. 254

<sup>84</sup> *Fortis Bank SA/NV v Indian Overseas Bank* [2009] EWHC 2303; *Gian Singh & Co Ltd v Banque de l'Indochine* [1974] 2 Lloyd's Rep. 1; *Societe Generale SA v Saad Trading* [2011] EWHC 2424 (Comm) (first instance); Zhang, J. 'Reimbursement under Letters of Credit' [2011] *S.T.L.* Vol. 11(9) 1 at 2

<sup>85</sup> 177 Misc 719, 31 NYS 2d 631 (1941); see for example: *Discount Records Ltd. v Barclays Bank* [1975] 1 ALL E.R. 1071 at 1074-5; Sarna, L. "Letters of Credit: The Law and Current Practice" (Carswell Legal Publishers, 2<sup>nd</sup> ed., Toronto, 1986) at p. 140

<sup>86</sup> 177 Misc 719, 31 NYS 2d 631 (1941) at 721

York rule of procedure.<sup>87</sup> Moreover, there were no suggestions that the plaintiff buyer had provided the court with any evidence other than a mere complaint alleging fraud on the side of the seller. Hence, it is difficult to infer from the *Sztejn* facts that Justice Shientag had set up a high proof test. Had a confirming bank been involved in the *Sztejn* and an injunction been sought where this bank had already honoured its obligations in good faith, an established proof of fraud would be an unavoidable necessity in such a context.<sup>88</sup>

#### 6.4.2. The only realistic inference test

Acknowledging that an established proof of fraud can be brought up to serve the above particular situations,<sup>89</sup> English courts have developed other more obtainable fraud proof tests which might apply more efficiently to other situations.<sup>90</sup> This can be seen in the *United Trading Corp S.A v. Allied Arab Bank* case.<sup>91</sup> There, the sellers, United Trading Corporation S.A., had entered into numerous sale contracts with Agromark (a State Establishment for Agricultural Products Trading which was controlled by the Iraqi Ministry of Agriculture) to sell the latter foodstuffs. All the sale contracts were financed through documentary letters of credit. However, an independent guarantee, to be issued and confirmed by the Rafidain Bank (a state bank of Iraq) in favour of Agromark in order to secure United's performance of their obligations under the contract of sale, was one of the sale contracts' clauses. United Trading had not approached the Rafidain Bank directly and rather they had instructed their own bankers to carry out such a task and to issue the independent guarantees.

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<sup>87</sup> See, e.g., *Madole v Gavin*, 215 App Div 299, 300 (Sup Ct, NY ) (1926); *McClare v Massachusetts Bonding & Insurance Co*, 266 NY 371, 373 (Ct App) (1935). The previous cases were referred to in the *Sztejn* case at 721

<sup>88</sup> *Sztejn v J Henry Schroder Banking Corp*, 177 Misc 719, 31 NYS 2d 631 (1941) at 723

<sup>89</sup> See subsection 6.4.1.

<sup>90</sup> *Kvaerner John Brown Ltd v Midland Bank Plc* [1998] C.L.C. 447; *Themehelp Ltd v West* [1995] 3 W.L.R. 751; *United Trading Corp SA v Allied Arab Bank Ltd* [1985] 2 Lloyd's Rep. 554; Bennett, H. 'Performance Bonds and the Principle of Autonomy' [1994] *J.B.L.* 574 at p. 582

<sup>91</sup> *United Trading Corp SA v Allied Arab Bank Ltd* [1985] 2 Lloyd's Rep. 554



Disputes had arisen between the sellers and the buyers about the rights and obligations of both parties under the sale contracts and, accordingly, Agromark approached its bank, the Rafidain, and called on the independent guarantees. When United heard about the calls incident it rushed to the court and sought interlocutory injunctions to restrain its bankers, the Rafidain Bank and Agromark from acting on the independent guarantees.

In the court of first instance, Mr Justice Neill granted the plaintiffs' sellers the injunctions they sought to obtain. However, and less than 10 days after an inter partes hearing, his Justice discharged the ex parte injunctions which had been granted earlier by him even though he had directed that the pre-granted orders should not be drawn up until a longer period of time had elapsed.<sup>92</sup> The reason behind his later judgment discharging the injunctions is to be found in the subsequent sentences:

“ . . . The evidence is not so plain and cogent as to establish that the demand by [Agromark] is fraudulent. It may be suspicious. It may require investigation. But the authorities, as I see it, show I should only act where the evidence is quite clear. In my judgment, it does not reach the high standard of proof required.”<sup>93</sup>

However, the sellers appealed and the matter reached the Court of Appeal where Ackner LJ, taking into account the special facts of the case, announced a new flexible test of proof.<sup>94</sup> His Lordship found that it would be sufficient for a court to apply a more accessible test of fraud rather than blindly applying the high established fraud test. It seems that his Lordship found it easier to grant an injunction where the party for which restraint is being sought does not enjoy the protection available to a holder in due course which has been illustrated above in the *Edward Owen* case.<sup>95</sup> Indeed,

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<sup>92</sup> *United Trading Corp SA v Allied Arab Bank Ltd* [1985] 2 Lloyd's Rep. 554 at 557

<sup>93</sup> *Ibid.*

<sup>94</sup> The bench consisted of Lord Justice Ackner, Lord Justice Slade and Sir John Megaw.

<sup>95</sup> Ellinger, E. 'The Autonomy of Letters of Credit after the American Accord' [1983] *A.B.L.R.* 118 at p. 125

Agromark had called on the independent guarantee but the Rafidain Bank had not paid them by the time of the hearing of this case. His Lordship refused to accept the defendants' allegations claiming that a higher test of fraud is the proper test to be applied and that a court would not interfere unless "every possibility of an innocent explanation is excluded".<sup>96</sup> His Lordship found that applying a high proof test of fraud in this case would be pointless and that "the respondents are over-stating the standard of proof" required to apply the fraud exception. His Lordship to that effect stated that:

"...we would find it an unsatisfactory position if, having established an important exception to what had previously been thought an absolute rule, the Courts in practice were to adopt so restrictive an approach to the evidence required as to prevent themselves from intervening. Were this to be the case, impressive and high-sounding phrases such as 'fraud unravels all' would become meaningless".<sup>97</sup>

Therefore, his Lordship advocated a new test following the principles laid down in the *American Cyanamid* case.<sup>98</sup> To that effect he found that "If the Court considers that on the material before it the only realistic inference to draw is that of fraud, then the seller would have made out a sufficient case of fraud".<sup>99</sup> His Lordship recognised that an important phrase like "fraud unravels all" would be a theoretical elusion if an established proof of fraud was required in order to grant an injunction in such cases.<sup>100</sup> After all, the court had refused to re-grant the previous dismissed injunctions. Lord Ackner, to that effect, stated:

"...although the plaintiffs have provided, on the available material, a seriously arguable case that there is good reason to suspect, certainly in regard to some of these contracts, that the demands on the performance bonds have not been honestly made, they have not established a good arguable case that the only realistic inference is that the demands were fraudulent".<sup>101</sup>

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<sup>96</sup> *United Trading Corp SA v Allied Arab Bank Ltd* [1985] 2 Lloyd's Rep. 554, at 561

<sup>97</sup> *Ibid.*

<sup>98</sup> [1975] A.C. 396

<sup>99</sup> *United Trading Corp SA v Allied Arab Bank Ltd* [1985] 2 Lloyd's Rep. 554 at 561

<sup>100</sup> Bailey, J. 'Unconditional Bank Guarantees' [2003] *I.C.L. Rev.* Vol. 20(2), 240 at p. 262

<sup>101</sup> *United Trading Corp SA v Allied Arab Bank Ltd* [1985] 2 Lloyd's Rep. 554 at 565

However, while his Lordship has advocated a new test which would facilitate granting injunctions where fraud is perpetrated in such a context, he failed to draw a distinction between cases where “the only realistic interference is that the demands were fraudulent” should be applied and other cases where the test of an established fraud should be applied. It is unclear whether his Lordship intended the realistic inference test to apply equally and exclusively to all cases where an injunction is sought to stop fraud in a letter of credit context, or if it is limited to cases where no bona fide parties (e.g., the Libyan bank in the *Edward Owen* case) are involved. It would have been a better approach if he had wiped out the ambiguity surrounding such an area of law.

In fact, it can be said that English courts have gone beyond the test applied in the *United Trading Corp S.A v. Allied Arab Bank* and proposed another fraud proof test so as to allow the issuance for injunctions in a more supple manner. Such a new test can be found in the often critiqued case *Themehelp Ltd v West*.<sup>102</sup> In *Themehelp* the parties entered a sale contract according to the terms of which the seller agreed to sell a particular business. It was agreed that the buyer would disburse the procured business’s price all the way through instalments at some particular arranged dates. The seller stipulated for the opening of an independent guarantee by the buyer in his favour, in order to guarantee that the latter will properly carry out his obligations under the sale contract and most importantly to guarantee that he pays the agreed instalments punctually. The buyer duly opened such an independent guarantee.

However, whilst things had been moving normally, the buyer discovered that the seller had misrepresented some facts in the underlying contract which rendered the contract fraudulent. The buyer approached courts alleging that such a contract was

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<sup>102</sup> [1995] 3 W.L.R. 751

fraudulent and therefore it should be rendered void and null. The buyer, furthermore, claimed damages for being placed in such a position. While the seller refuted such fraud claims, the buyer continued with his allegations and eventually requested the court to issue an injunction to restrain the seller from calling on the beforehand given independent guarantee.

An injunction had been granted by Kay J. at the first instance court. Similarly, the Court of Appeal maintained the injunction except Evans LJ who dissented. The court found that an injunction could be granted where the applicant can show a “seriously arguable” case of fraud.<sup>103</sup> While the case is one of the infrequent cases where an English court has granted an injunction pursuant to the fraud exception, nonetheless, the basis which upon the court granted the injunction is to some extent questionable.<sup>104</sup> The court justified the approach it pursued by alleging that the proof test of fraud and its stringency should depend on the party against which an injunction is sought. To that effect Balcombe L.J stated:

“The same considerations of policy do not apply where...[an] injunctive relief is sought to stop the beneficiary from making such a demand pending the trial of the action in which the issue of his fraud will be determined. In such a case I see no reason why the ordinary principles for the grant of interlocutory relief should not apply”.<sup>105</sup>

His Lordship found that the proof test should not be applied differently from that laid down by the *American Cyanamid* guidelines where the party sought to be restrained is the beneficiary.<sup>106</sup> While their Lordships’ broad suggestion, in that the test of proof should be different depending on the party sought to be restrained, is consistent to some extent with the approach illustrated above in *Edward Owen* and *United Trading*

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<sup>103</sup> [1995] 3 W.L.R. 751, at 770

<sup>104</sup> More about this point can be found in subsection 4.3.2.

<sup>105</sup> [1995] 3 W.L.R. 751, at 771

<sup>106</sup> Todd, for example, supports the same conclusion. Todd, P. “*Bills of Lading and Bankers’ Documentary Credits*” (Informa Law, 4<sup>th</sup> ed., London, 2007) at p. 268. See, as well: Martin-Nagle, R. “Injunctions of Letters of Credit: Judicial Insurance against Fraud” (1983) *J. L. & Com* 305 at p. 319

cases, the current author disagrees with their Lordships. It is submitted that the test of fraud in documentary credits and independent guarantees should be different from that applied in the *American Cyanamid*, taking into account the special characteristics of these instruments and the role they play in the international trade realm.<sup>107</sup> On the one hand, if the fraud proof test is too easy to fulfil and so injunctions are too easy to obtain, letters of credit will lose the prominent role which they have played.<sup>108</sup> On the other hand, if the fraud proof test is so difficult to fulfil, fraud will undermine the trust which upon these instruments are based. Accordingly, a practical test such as the only realistic inference would suit better the particular nature of such instruments where no third innocent parties are involved. Moreover, the line of thought which advocates that an injunction would be less destructive to the autonomy principle where it is sought against a beneficiary rather than a bank must be refuted. Whether the injunction is sought against a bank or a beneficiary, do the results differ? Without a doubt, the results will be the same: depriving the beneficiary of the payment until a full trial court can adjudicate the disputed matter. It would have been a better approach if their Lordships had distinguished between injunctions against normal parties who are not innocent third parties and who did not acquire the holder in due course status and those who, on the contrary, enjoy such protection.<sup>109</sup> Indeed, the distinction between injunctions against banks and beneficiaries was the essence of Lord Evans' dissent.

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<sup>107</sup> Malek, A & Quest, D. "*Jack: Documentary Credits*" (Tottel Publishing, 4<sup>th</sup> ed., Sussex, 2009) at pp. 280-281; Murray, C. Holloway, D & Timson-Hunt, D. "*Schmitthoff's Export Trade: The Law and Practice of International Trade*" (Sweet & Maxwell, 11<sup>th</sup> ed., London, 2007) at p. 252

<sup>108</sup> "This is the critical point. Autonomous bank undertakings are considered vital to the financing of international trade. A widely available exception would *ex hypothesi* undermine the autonomy principle, causing "thrombosis" in the "life blood of commerce". An exception must be made for fraud, but the importance of autonomy requires it to be confined to cases of truly compelling evidence of fraud. That restriction cannot in turn be undermined by a virulent interim strain of thrombosis in the form of readily available interim injunctions", by Bridge, M. "*Benjamin's Sale of Goods*" (London, 2010), at 24-026; Bailey, J. 'Unconditional Bank Guarantees' [2003] *I.C.L. Rev.* Vol. 20(2), 240 at p. 262; Harfield, H. "*Letters of Credit*" (ALI-ABA Comm, New York, 1979) at p. 75

<sup>109</sup> Chuah, J. 'Performance Guarantees and the Fraud Exception' [1999] *S.L. Rev.* 26, 49 at p. 50

Accordingly, the approach pursued in the *Themehelp* case should be disregarded.<sup>110</sup> The fraud proof test developed there, if applied by later authorities, will undoubtedly undermine the important role which letters of credit are playing in the trade realm.<sup>111</sup> In such a case, English courts should follow *Czarnikow-Rionda v. Standard Bank*<sup>112</sup> where the court therein returned to the *United Trading* test which reflects the special characteristics of these instruments.<sup>113</sup> It is suggested that the *United Trading* test should be always applied where no innocent third parties are involved; the court in such an instance should ask: has the plaintiff provided sufficient evidence that fraud is the only realistic inference? On the other hand, the *Edward Owen* test which requires an established proof of fraud should be maintained as well. This test should be applied where injunctions are sought against innocent third parties whose good faith is not in question; the court in such an instance should ask: has the plaintiff provided sufficient evidence that fraud has been established, clear and obvious?

In *Turkiye Is Bankasi AS v Bank of China*<sup>114</sup> the plaintiffs alleged that a bona fide issuing bank should not be entitled to reimbursement from the instructing bank where the call on the independent guarantee was fraudulent. The plaintiffs contended that the proper test to apply is Lord Ackner's test, but the court there found that such a test is

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<sup>110</sup> Bailey, J. 'Unconditional Bank Guarantees' [2003] *I.C.L. Rev.* Vol. 20(2), 240 at p. 262

<sup>111</sup> Bertrams, R. "*Banks Guarantees in International Trade*" (London, 2004) at p. 407. Article 20 of the UNICITRAL Convention supports the above suggestions as it does not distinguish between injunctions against banks or beneficiaries. See, for example, Staughton L.J. observations in *Groupe Josi Re v. Walbrook Insurance* [1996] 1 Lloyd's Rep. 345, at 361, where he found that: "the effect on the life blood of commerce will be the same whether the bank is restrained from paying or the beneficiary is restrained from asking payment."; Phillips J. in *Deutsche Ruckversicherung AG v Walbrook Insurance Co* [1994] 4 ALL ER 181, at 196-197; Rix J. in *Czarnikow-Rionda v Standard Bank London* [1999] 2 Lloyd's Rep 187, at 202; *Kvaerner John Brown v Midland Bank* [1998] CLC 446

<sup>112</sup> [1999] 2 Lloyd's Rep. 187; Staughton L.J. in *Groupe Josi v. Walbrook Insurance* [1996] 1 Lloyd's Rep. 345, at 361

<sup>113</sup> Rix J., in *Czarnikow-Rionda Sugar Trading Inc v Standard Bank London Ltd* [1999] 2 Lloyd's Rep. 187 at 202, stated that: "... the fact that the claimant gets the benefit of a lower standard of proof for the purposes of a pre-trial hearing, places on the Court ... an additional requirement to be careful in its discretion not to upset what is in effect a strong presumption in favour of the fulfilment of the independent banking commitments". Yet it should be noted that in this case the only realistic inference test has been applied in the wrong context which has involved holders in due course. In such a situation it is suggested that the established fraud proof test is the one which should have been applied.

<sup>114</sup> [1998] 1 Lloyd's Rep. 250

inappropriate due to the special facts of the case in consideration.<sup>115</sup> The Court of Appeal applied the *Edward Owen* test which stipulates for the fraud proof to be “firmly established as the proper criterion”.<sup>116</sup>

While it has been repeatedly said that the established fraud test is one of the main reasons why English courts refuse to interfere by means of injunctions to prevent fraud from occurring in a letters of credit context,<sup>117</sup> the above discussion reveals that this line of allegation is misleading. English courts’ dual proof test of fraud fulfils the expectations of the different parties utilising such instruments.<sup>118</sup> An English court will look on the legal status of the party whom the plaintiff is seeking to restrain and based on that it will apply the appropriate test according to the situation. Accordingly, it is suggested that the English approach to this area of law is consistent. Yet it is suggested that English courts should clarify such a difference in future cases in order to prevent unexpected misapplications. Having illustrated the first requirement of the *American Cyanamid* guidelines and its application in letters of credit contexts, the following sections will proceed to examine the other requirements usually requested by English courts to grant an injunction.

## 6.5. The second requirement: a cause of action

In many of the cases where fraud was alleged to restrain a letter of credit, it has been argued by the defendants (banks and beneficiaries) that a cause of action against them

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<sup>115</sup> Teng, C. ‘Bank Guarantees – Counter Guarantees’ [1998] *J.I.B.L.* Vol. 13(5), N56 at N57

<sup>116</sup> *Turkiye Is Bankasi AS v Bank of China* [1998] 1 Lloyd’s Rep. 250 at 253, per Hirst L.J

<sup>117</sup> Goode, R & McKendrick E. “*Goode on Commercial Law*” (Penguin Books, 4<sup>th</sup> ed., London, 2010) at p. 1100; Bertrams, R. “*Bank Guarantees in International Trade: The Law and Practice of Independent (First Demand) Guarantees and Standby Letters of Credit in Civil Law and Common Law Jurisdictions*” (Kluwer Law International, 3<sup>rd</sup> ed., The Hague (Netherlands), 2004) at p. 358; Mugasha, A. “*The Law of Letters of Credit and Bank Guarantees*” (Federation Press, Sydney, 2003) at p. 148

<sup>118</sup> Interestingly, a dual proof of fraud has been applied by le Dain J. in the Canadian case of *Bank of Nova Scotia v Angelica-Whitewear Ltd* [1987] 1 Supreme Court Reports, 59, 84

has not been presented and as a result an injunction should not be granted.<sup>119</sup> On the other hand, applicants for injunctions appeared worried about providing a cause of action in order to guarantee the issuance of the requested injunction.<sup>120</sup> This section examines this requirement and the extent to which English courts have stipulated for its existence in order to grant an injunction. Is such a requirement necessary to obtain an injunction in a documentary credit or an independent guarantee context? Should the presence of this requirement depend on the legal position of the party an injunction is sought against? The answer to these questions can be found below.

### 6.5.1. Letters of credit which involve holders in due course

Undeniably, even though it has not been stipulated for in the *American Cyanamid*,<sup>121</sup> in order to obtain an injunction from an English court a cause of action has been frequently demanded.<sup>122</sup> However, this requisite has not been adhered to always and some exceptions to it have been recognised.<sup>123</sup> At this early stage, it can be said that injunctions based on a fraud case in documentary credits and independent guarantees contexts are one of these exceptions but yet the matter is not without its own problems.<sup>124</sup> In a letter of credit context, it has been said that the bank's knowledge of

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<sup>119</sup> *Sztejn v J Henry Schroder Banking Corp*, 177 Misc 719, 31 NYS 2d 631 (1941)

<sup>120</sup> *United Trading Corp SA v Allied Arab Bank Ltd* [1985] 2 Lloyd's Rep. 554

<sup>121</sup> [1975] A.C. 396

<sup>122</sup> *Owners of Cargo Lately Laden on Board the Siskina v Distos Compania Naviera SA* [1979] A.C. 210, at 256 where Lord Diplock said: "The right to obtain an interlocutory injunction is merely ancillary and incidental to the pre-existing cause of action"; *The Chief Constable of Kent & Others* [1983] 1 Q.B. 34, at 45 & 49

<sup>123</sup> For example, *Channel Tunnel Group Ltd. v Balfour Beatty Construction Ltd.* [1993] A.C. 334

<sup>124</sup> Ellinger P. & Neo, D. "*The Law and Practice of Documentary Letters of Credit*" (Hart Publishing, Oxford, 2010) at p. 158; *United Trading Corp SA v Allied Arab Bank Ltd* [1985] 2 Lloyd's Rep. 554, at 560; *Group Josi* (Staughton LJ) [1996] 1 WLR 1152 at 1159. However, in *Czarnikow-Rionda v Standard Bank* [1999] 2 Lloyd's Rep 187 at 203 Rix J upheld this requirement. Todd agrees with Rix J. approach. See: Todd, P. "*Bills of Lading and Bankers' Documentary Credits*" (Informa Law, 4<sup>th</sup> ed., London, 2007) at p. 262. It is interesting to note that in America "In respect of applications for restraining orders against the bank, the question of whether the bank is aware of the beneficiary's fraud has never been regarded as relevant issue". This is the case also under the UN Convention. See: Bertrams, R. "*Bank Guarantees in International Trade: The Law and Practice of Independent (First Demand) Guarantees and Standby Letters of Credit in Civil Law and Common Law Jurisdictions*" (Kluwer Law International, 3<sup>rd</sup> ed., The Hague (Netherlands), 2004) at p. 416



the fraud is the cause of action and a court will not grant an injunction without its existence.<sup>125</sup> Interestingly, this requirement can be traced back to the same line of authorities which stipulated for an established test of fraud as the test of proof sufficient to invoke the fraud exception. In *RD Harbottle (Mercantile) Ltd v National Westminster Bank Ltd*<sup>126</sup> the court therein found that it would not interfere with the flow of letters of credit “except possibly in clear cases of fraud of which the banks have notice”.<sup>127</sup> In the same way, in *Edward Owen Engineering Ltd v Barclays Bank International Ltd*, Lord Denning embraced the same view that the applicant in order to obtain an injunction has to show a “clear fraud of which the bank has notice”.<sup>128</sup> Geoffrey Lane L.J adopted the same approach where he stipulated for “fraud obvious or clear to the bank” in order to grant an injunction.<sup>129</sup> Furthermore, in *Bolivinter Oil SA v Chase Manhattan Bank*, Sir John Donaldson M.R. supported the above authorities stating that “The evidence of fraud must be clear, both as to the fact of fraud and as to the bank’s knowledge”.<sup>130</sup>

However, as two banks or even more were involved in the above cases, it is difficult to distinguish which bank’s knowledge was intended to constitute the required cause of action. While all of the above authorities have stipulated for fraud where “the bank has notice” or instances where it is “clear to the bank’s knowledge”, one might ask which bank is meant to have such knowledge. Is it the issuing bank or the confirming

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<sup>125</sup> *Bolivinter Oil SA v Chase Manhattan Bank NA* [1984] 1 W.L.R. 392 at 393; Bertrams, R. “*Bank Guarantees in International Trade: The Law and Practice of Independent (First Demand) Guarantees and Standby Letters of Credit in Civil Law and Common Law Jurisdictions*” (Kluwer Law International, 3<sup>rd</sup> ed., The Hague (Netherlands), 2004) at p. 408; Leacock, S. ‘Fraud in the International Transaction: Enjoining Payment of Letters of Credit in International Transactions’ [1984] *Vand. J. Transnat’l L.* 885 at p. 911; Harfield, H. “*Letters of Credit*” (ALI-ABA Comm, New York, 1979) at p. 75; Cresswell, P. ‘The Fraud Exception and Other Legal Problems in relation to Contract Bonds and guarantees and Standby Letters of Credit’ [1987] *B.B. & F.L.R.*, 269 at p. 270

<sup>126</sup> *RD Harbottle (Mercantile) Ltd v National Westminster Bank Ltd* [1978] 1 QB 146

<sup>127</sup> *Ibid.* at 155

<sup>128</sup> *Edward Owen Engineering Ltd v Barclays Bank International Ltd* [1978] 1 Lloyd’s Rep 166 at 172

<sup>129</sup> *Ibid.* at 174

<sup>130</sup> *Bolivinter Oil SA v Chase Manhattan Bank* [1984] 1 Lloyd’s Rep 251, at 257

bank and does that make any difference? The author argues that the existence of this element of fact surrounds this particular area of law with a significant amount of uncertainty.

The approach which calls for the necessity of a cause of action in a letter of credit context can find further support in the *Czarnikow-Rionda v Standard Bank* case.<sup>131</sup>

There the plaintiffs had instructed their own bank (the defendant) to open a number of documentary credits in favour of their sellers. Pursuant to the credit terms, Standard Bank had instructed two Swiss banks to confirm the documentary credits. In their turn, the Swiss banks had confirmed the credit and duly advised the sellers of its existence. After a period of time, the sellers sought to discount the documentary credits.<sup>132</sup> Accordingly, the Swiss banks discounted their drafts. However, alleging that fraud was existent in the underlying transaction, Czarnikow-Rionda sought to obtain an injunction to stop Standard Bank from reimbursing the Swiss banks. The injunction request was rejected by Rix J. for a number of reasons, amongst them being the fact that the applicant had not provided the bank with knowledge of the cause of action. He found that such a requirement:

“...was implicit in the argument before the court and in Lord Diplock’s [in the *American Accord* case] citation with approval of the *Sztejn* and *Edward Owen* cases. When, therefore, Lord Diplock stated that the fraud exception was an application of the doctrine that ‘fraud unravels all’, he was not, in my respectful opinion, speaking as broadly as might be thought. It would be less pithy but more accurate to fill out the dictum by saying that fraud unravels the bank’s obligation to act on the appearance of documents to be in accordance with a credit’s requirement provided that the bank knows in time of the beneficiary’s fraud”.<sup>133</sup>

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<sup>131</sup> [1999] 2 Lloyd’s Rep. 187

<sup>132</sup> This point is not without its own problems. In fact, the applicants argued that the documentary credit was a deferred one and accordingly the Swiss banks should bear the implications of the unauthorised discounting of it. However, the court found that the terms of the credit itself, although titled as a deferred documentary credit, make it a negotiated credit.

<sup>133</sup> [1999] 2 Lloyd’s Rep. 187, at 199

While Rix J. insisted on the necessity of a cause of action in such a confirmed documentary credit context, in order to grant an injunction to restrain the issuing bank from reimbursing the confirming bank, yet as can be noticed, again it is not clear from his statement which bank is meant to know about the fraud. It is not apparent whether his Justice intended to confine such a requirement to confirming banks merely or whether it includes issuing banks as well. A clarification to this matter can be found in the *United Trading* case. In this case, Lord Ackner found that:

“...the Court has the jurisdiction to grant a *quia timet* injunction if the plaintiffs can establish that Rafidain [the issuing bank of an independent guarantee] is threatening to commit a breach of a duty owed to the plaintiffs”.<sup>134</sup>

As has been discussed in the previous section, where an independent guarantee or a documentary credit comprises a second bank which confirms such an instrument, the latter's relation with the first issuing bank resembles that of the issuing bank with its applicant.<sup>135</sup> Hence, a confirming bank which pays a beneficiary without the existence of an established proof of fraud should not be prevented from being reimbursed.<sup>136</sup> However, if the confirming bank pays after it has been provided with an established proof of fraud, it will not be eligible to be reimbursed.<sup>137</sup> In other words, a confirming bank that pays, although fraud is established to the knowledge of other parties apart from this bank, where it does not know about the fraud and where such established fraud is not clear to its knowledge, would not be held liable for the fraud and should be entitled to reimbursement. Conversely, if the bank knew about the established fraud and yet selected to pay, it would find itself unable to ask for reimbursement.

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<sup>134</sup> *United Trading Corp SA v Allied Arab Bank Ltd* [1985] 2 Lloyd's Rep. 554, at 560

<sup>135</sup> Gao, X. 'Presenters Immune From the Fraud Rule in the Law of Letters of Credit' [2002] *L.M.C.L.Q.* 1, 10 at pp. 26 to 29

<sup>136</sup> Ellinger P. & Neo, D. "*The Law and Practice of Documentary Letters of Credit*" (Hart Publishing, Oxford, 2010) at p. 156

<sup>137</sup> Harfield, H. "*Bank Credits and Acceptances*" (The Ronald Press Company, 5<sup>th</sup> ed., New York, 1974) at p. 81

Accordingly, if the confirming bank's knowledge of the fraud constitutes what is meant to be a cause of action, then a cause of action would be an imperative necessity in order to prevent it from seeking reimbursement from the issuing bank.

Such a requirement is important to protect these confirming banks' expectations which they envisage when they accept to confirm a letter of credit. A cause of action in such cases is an essential requirement which an applicant has to discharge in order to obtain his desired injunction to restrain the issuing bank from reimbursing the confirming bank. The relevant day for establishing such knowledge on the bank's part identically resembles that required to be provided in a full trial case by an applicant who refuses to reimburse his bank and claims that the latter's payment was fraudulent. As Lord Ackner suggests "We doubt that this is really open to contest".<sup>138</sup> Indeed, the applicant has to prove that the confirming bank's knowledge of the alleged fraud existed prior to the time at which the latter has paid the ultimate fraudulent beneficiary.<sup>139</sup> If the applicant can simply prove that the confirming bank acquired the knowledge of the fraud after the latter had already affected payment, then the former's allegations would not suffice to form a cause of action against the bank. Indeed, "The bank would not have been in breach of any duty in making the payment without the requisite knowledge".<sup>140</sup> Hence, the approach pursued above by the English authorities in requiring an established fraud which the confirming bank has knowledge of, is recommended when an applicant seeks an injunction in a confirmed

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<sup>138</sup> *United Trading Corp SA v Allied Arab Bank Ltd* [1985] 2 Lloyd's Rep. 554, at 560

<sup>139</sup> See, e.g., *European Asian Bank AG v Punjab & Sind Bank (No.2)* [1983] 1 W.L.R. 642 at 658; *United Trading Corp SA v Allied Arab Bank Ltd* [1985] 2 Lloyd's Rep. 554 at 560; *Groupe Josi Re v Walbrook Insurance Co* [1996] 1 W.L.R. 1152 at 1161; *Credit Agricole Indosuez v Generale Bank* [1999] 2 All E.R. (Comm) 1009 at 1015; *DCD Factors Plc v Ramada Trading Ltd* [2007] EWHC 2820 (QB); [2008] Bus. L.R. 654; *Gian Singh & Co Ltd v Banque de l'Indochine* [1974] 1 W.L.R. 1234 at 1238; To the same effect see: UCP 600 art.34; URDG 758 art.27; ISP98 r.1.08(b)

<sup>140</sup> *United Trading Corp SA v Allied Arab Bank Ltd* [1985] 2 Lloyd's Rep. 554, at 560

letter of credit context. However, in the *Edward Owen* case, Lord Browne, who refused to grant the English sellers an injunction, said:

“...it is quite impossible to say that fraud on the part of the buyers or the Umma Bank [the issuing bank of the independent guarantee] has been established, still less that Barclays bank [the instructing bank of the independent guarantee] had knowledge of it”.<sup>141</sup>

Whilst Lord Ackner has confined the requirement of the bank’s knowledge to that of an independent guarantee’s issuing bank (the same as a documentary credit’s confirming bank), it seems that Lord Browne has expanded the boundaries of such a requirement to include the knowledge of the instructing bank (the same as a documentary credit’s issuing bank). Hence, taking into consideration the statement of the court, as given above, in the *Edward Owen* case, an injunction would not be granted unless both banks have knowledge of the fraud.<sup>142</sup>

With respect, it is suggested that such an approach is untenable. An issuing bank’s (in a documentary credit context/ an instructing bank in an independent guarantee context) knowledge of the fraud should not constitute a barrier in front of other bona fide confirming/issuing banks which pay beneficiaries without acquiring such knowledge. The autonomy principle supports this conclusion.<sup>143</sup> Whether issuing/instructing banks have knowledge or not that should not work to harm confirming/issuing banks which confirm these undertakings on the assumption that as long as they do what they are told to do they will inevitably be reimbursed. What counts in a confirmed credit as a cause of action is the confirming bank’s knowledge and not that of the issuing bank. An issuing bank’s knowledge should not affect the reimbursement operation. Unless an applicant can show that the confirming bank has

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<sup>141</sup> [1978] 1 ALL ER 976 at 984

<sup>142</sup> Bertrams, R. “*Banks Guarantees in International Trade*” (London, 2004) at p. 409.

<sup>143</sup> Bradgate, R. White, F. & Fennell, S. “*Commercial Law*” (Oxford University Press, 9<sup>th</sup> ed., Oxford, 2002) at p. 273-4

paid a fraudulent beneficiary though the fraud is established to its knowledge, the former would not succeed in his interlocutory injunction application.

### 6.5.2. Letters of credit which do not involve holders in due course

Requiring a cause of action in confirmed documentary credits and independent guarantees contexts has strongly affected the operation of granting injunctions where no holders in due course parties are involved.<sup>144</sup> Questions as to whether a cause of action against an issuing bank, where no bona fide holders are involved, is needed to obtain an interlocutory injunction have been indistinctly raised.<sup>145</sup> Does the knowledge of the fraud by the issuing bank constitute an inescapable condition which the applicant has to provide in order to guarantee the issuance of an injunction? The remaining part of this section is dedicated to answer such a question.

It should be said that the existence of questionable statements such as that delivered by Lord Browne above have greatly influenced the operation of granting injunctions in such situations. The general English view has been that a cause of action is needed whenever an injunction is requested to restrain a bank from paying a letter of credit.<sup>146</sup> Yet, this work suggests that a cause of action should not be stipulated for in order to restrain an issuing bank from paying a fraudulent beneficiary where no holders in due course are involved.

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<sup>144</sup> Ellinger P. & Neo, D. “*The Law and Practice of Documentary Letters of Credit*” (Hart Publishing, Oxford, 2010) at p. 155

<sup>145</sup> Bertrams, R. ‘Counter-Guarantees in an Indirect, Independent (First Demand) Guarantee Structure’ [1997] *B.J.I.B. & F.L.* Vol. 12(8), 373 at p. 377; Hardenberg, L. ‘First Demand Guarantees: Abuses and Remedies under Dutch Law’ (1991) 19 *Int’l Bus. Law.* 241 at p. 242; Chong, W. ‘The Abusive Calling of Performance Bonds’ [1990] *J.B.L.* 414 at p. 418; Harfield, H. “*Bank Credits and Acceptances*” (The Ronald Press Company, 5<sup>th</sup> ed., New York, 1974) at p. 81

<sup>146</sup> Bertrams, R. “*Bank Guarantees in International Trade: The Law and Practice of Independent (First Demand) Guarantees and Standby Letters of Credit in Civil Law and Common Law Jurisdictions*” (Kluwer Law International, 3<sup>rd</sup> ed., The Hague (Netherlands), 2004) at p. 424

As Kerr J., in *R. D. Harbottle (Mercantile) Ltd. v. National Westminster Bank Ltd. and Others*, puts it: “The courts have discretion to grant interlocutory injunctions whenever it is just or convenient to do so”.<sup>147</sup> Where the issuing bank has yet not paid the fraudulent beneficiary and there are no other concerned banks or holders in due course who paid in good faith, the requirement of the former’s knowledge of the fraud should not work as an obstruction to allow fraudulent beneficiaries to benefit from their own fraud.<sup>148</sup> Such a requirement seems absurd and escaping with the money obtained through fraudulent schemes would be the ultimate result if the issuing bank does not know about the fraud. Stipulating for such a requirement means that courts will interfere to stop fraud if banks know about it. However, the courts will allow the utilization of letters of credit as fraud instruments as long as the banks do not know about such a fraud. Such an approach turns a blind eye to the fact that in asking for a court’s interlocutory injunction the applicant seeks to protect himself and the non-aware bank, who would be interested in the actual performance of the underlying contract, at the same time from the beneficiary’s concealed fraud.

In addition, the applicant requests such a stop-payment method to protect the bank from interfering with legal issues which the latter is ill-equipped to deal with and which it is protected from by virtue of the autonomy principle. Indeed, if the bank knows about the fraud and welcomes to interfere with the operation of such instruments, requiring an injunction will be senseless. One would expect that a court will interfere to prevent fraud by means of injunctions where banks do not know about the fraud and not the other way around.<sup>149</sup> Accordingly, fraud prevention should

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<sup>147</sup> [1987] 1 Q.B. 146, at 158

<sup>148</sup> Bertrams, R. “*Bank Guarantees in International Trade: The Law and Practice of Independent (First Demand) Guarantees and Standby Letters of Credit in Civil Law and Common Law Jurisdictions*” (Kluwer Law International, 3<sup>rd</sup> ed., The Hague (Netherlands), 2004) at p. 425

<sup>149</sup> *Ibid.* at p. 429

suppress the requirement that an injunction's applicant has to provide a cause of action against the bank. However, where holders in due course are involved, a cause of action in a confirmed letter of credit context has what justifies its request, namely: protection for bona fide confirmers and holders in due course whose good faith is not in question.

Support for this approach can be found in *Bolivinter Oil S.A. v Chase Manhattan Bank*.<sup>150</sup> Therein, the plaintiffs' Counsel argued, where it is arguable to say that the court seemed convinced with such an argument, that a cause of action requirement should not be a barrier to prevent granting injunctions where the result of a declining approach would ultimately lead to the swindler seller profiting from his own fraud.

The Counsel argued that:

“The basis of the jurisdiction is not the power of the court to grant an injunction restraining a breach of contract. The plaintiff does not have to establish that the payment enjoined would constitute a breach of contractual duty owed to the plaintiff by the bank. The basis of the jurisdiction is wider; the power of the court to intervene where necessary to prevent fraud. The plaintiff has to show that his legal rights are threatened by the fraud of the beneficiary.”<sup>151</sup>

Ironically, if ‘fraud unravels all’<sup>152</sup> is the essence of the fraud exception's existence, it is hard to justify emphasising insignificant requirements which could negatively affect granting injunctions.<sup>153</sup> Such requirements, which initially have been developed outside the letters of credit context, should be neglected if their insertion would not properly serve the special nature of these instruments and the expectations of their

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<sup>150</sup> [1984] 1 Lloyd's Rep. 251

<sup>151</sup> [1984] 1 Lloyd's Rep. 251, at 254

<sup>152</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada (The American Accord)* [1983] 1 A.C. 168, at 176

<sup>153</sup> *Per* Sir Donaldson in *Bolivinter Oil* [1984] Lloyd's Rep 251. To this he provided at 256: “If, as Lord Diplock said, the principle is that ‘fraud unravels all’ and if the issue is whether payment should now be made, it is nothing to the point that at an earlier stage the fraud was unknown to the payer and so could not begin its unravelling, if fraud is now known to him and has now unravelled his obligations”.



users.<sup>154</sup> While stipulating for such a requirement is justified where a holder in due course is involved, this should not be the case where no bona fide holders are existent.

In what the author describes as a misconception, English courts rely on the American *Sztejn* case as an authority which stipulates for a cause of action whenever an injunction is requested.<sup>155</sup> Rix J., as seen above, argues in the same manner that the *Sztejn* supports this view. The misconception has emanated from reciting the following statement delivered by Justice Shientag:

“...On the present motion, it must be assumed that the seller has intentionally failed to ship any goods ordered by the buyer. In such a situation, where the seller’s fraud has been called to the bank’s attention before the drafts and documents have been presented for payment, the principle of the independence of the bank’s obligation under the letter of credit should not be extended to protect the unscrupulous seller”.<sup>156</sup>

While the general view developed has been that *Sztejn* supports the cause of action requirement where no holders in due course are involved, it can be said that this view is erroneous. Indeed, while Shientag J. has pointed up the banks’ obligations in cases where they have been provided with a sufficient proof of fraud, nothing suggests that a court will not interfere unless this sufficient proof is brought to the bank’s attention.<sup>157</sup> In this case there was also nothing which suggests that the issuing bank has acquired the knowledge required to constitute a cause of action. The absence of the cause of action did not prevent the court from interfering by means of injunctions. Besides, the defendants’ claim, that a cause of action against them was not presented, did not affect the court’s steadiness not to discharge the granted injunction. Accordingly, the *Sztejn* case itself, where the defendants were an advising bank whose

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<sup>154</sup> Goode, R & McKendrick E. “*Goode on Commercial Law*” (Penguin Books, 4<sup>th</sup> ed., London, 2010) at p. 1101; Battaile, J. ‘Guaranty Letters of Credit: Problems and Possibilities’ (1974) 16 *Ariz. L. Rev.* 822 at p. 855

<sup>155</sup> Uzzelle, G. ‘Letters of Credit’ (1985) 10 *Mar. Law.* 47 at p. 63

<sup>156</sup> *Sztejn v J Henry Schroder Banking Corp*, 177 Misc 719, 31 NYS 2d 631 (1941) at 721

<sup>157</sup> Uzzelle, G. ‘Letters of Credit’ (1985) 10 *Mar. Law.* 47 at p. 63

task was confined to merely collecting documents on behalf of the issuing bank, does not support the need of a cause of action requirement. Had a bona fide confirming bank been involved in the case, it would not be a surprise that a cause of action against such a bank had been required.

Bridge, amongst others,<sup>158</sup> suggests that: “The question of the bank’s knowledge of the fraud does, however, become academic in the context of interim relief”.<sup>159</sup> To that effect he cited a piece of Phillips J. judgement in *Deutsche Ruckversicherung AG v Walbrook Insurance Co Ltd*.<sup>160</sup> (a letter of credit where no holders in due course were involved) where the latter said:

“...the requirement that there must be clear evidence of the bank’s knowledge of fraud is academic once the proceedings have reached the inter partes stage. At this point, the evidence of fraud will be placed simultaneously before the court and before the bank which is party to the proceedings. If the court concludes that there is clear evidence of fraud, it will necessarily conclude that the bank has acquired knowledge of the fraud”.<sup>161</sup>

Indeed, Philips J. observations have, to a great extent, been embraced by later authorities. In *Kvaerner John Brown Ltd v Midland Bank Plc*<sup>162</sup> (a no holders in due course case) the court went beyond Phillips J. statement and neglected such a requirement to the extent that it did not even discuss it.<sup>163</sup> The defendants had asked the plaintiffs to open an independent guarantee and so it had been duly opened. One of the independent guarantee terms required the defendants to notify the plaintiffs that they would call on the guarantee fourteen days before the actual call. Yet, the

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<sup>158</sup> Bertrams, R. “*Banks Guarantees in International Trade*” (London, 2004) at p. 409

<sup>159</sup> Bridge, M. “*Benjamin’s Sale of Goods*” (London, 2010) at 24-027; In the same manner, see: Hedley, W. & Hedley, R. “*Bills of Exchange and Bankers’ Documentary Credits*” (LLP Professional Publishing, 4<sup>th</sup> ed., London, 2001) at p. 328

<sup>160</sup> [1995] 1 W.L.R. 1017

<sup>161</sup> [1995] 1 W.L.R. 1017 at 1030

<sup>162</sup> [1998] C.L.C. 447

<sup>163</sup> The *Themehelp* case did neglect such a requirement as well. Singapore cases have stated categorically that the balance of convenience test has no application in cases concerning performance bonds. See for example: *Bocotra Construction Pte Ltd v Attorney General* (No 2) (1995) 2 SLR 733.

defendants called on the independent guarantee without notifying the applicants as required by the guarantee terms. In view of that, the applicants applied for an injunction to stop the bank from paying the fraudulent beneficiaries. Interestingly, Cresswell J. therein solely examined the fraud proof and on the light of it he granted the requested injunction.<sup>164</sup>

It is suggested that the approach which Bridge, Phillips J. and Cresswell J. have pursued is recommendable. Where a court finds that fraud is existent, an issuing bank will acquire the knowledge of this fraud inevitably.<sup>165</sup> Accordingly, an injunction's applicant should not be required to provide such already evidential existing fact. Bridge suggests that the court's question should be "whether the applicant has adduced sufficient evidence in the court proceedings" and if the applicant does so by adducing the required fraud evidence, nothing should deprive him from obtaining the injunction which he is seeking.<sup>166</sup>

While such an approach is welcomed, it would have been a better approach if they had distinguished between cases where no holders in due course are involved, and that where the latter are present. Distinguishing between these two situations is an important issue which both courts and legal commentators have overlooked during the past years. The dual approach pursued in the previous section in regard to the fraud proof test should be applied when a court asks whether a cause of action is needed to grant an injunction. On the one hand, in seeking an injunction to restrain an issuing bank from reimbursing a confirming bank, the applicant has to show an established

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<sup>164</sup> [1998] C.L.C. 447, at 450. Interestingly, the fraud proof test applied by Cresswell J. was that: "clearly arguable...that the only realistic inference is that the demand was made fraudulently".

<sup>165</sup> Enonchong, N. *"The Independence Principle of Letters of Credit and Demand Guarantees"* (Oxford University Press, Oxford, 2011) at p. 119

<sup>166</sup> Bridge, M. *"Benjamin's Sale of Goods"* (London, 2010) at 24-027. To that Bridge stated: "Knowledge of the bank, as such, is unnecessary. The basis for the bank's declining to pay, should the injunction be issued, will be the injunction, not the bank's knowledge of certain conduct of the beneficiary".

fraud with a cause of action namely the confirming bank's knowledge of such a fraud. This justifies the reason why the cases which stipulated for an established proof of fraud had always attached this requirement, that the fraud should be known to the bank itself. It is the knowledge of the confirming bank and not that of the issuing bank which counts as a cause of action. On the other hand, where an applicant seeks to restrain an issuing bank or a beneficiary in the absence of other confirming banks or holders in due course, the situation should be different.<sup>167</sup> In such a case, an applicant merely has to show the more adequate test that "the only realistic inference is fraud" with no cause of action. Providing an already present knowledge to the issuing bank in such cases would be a superfluous illusion.

It is not surprising, in the light of failure to distinguish between both the above situations, to see contradictory statements as to whether a cause of action is required to grant an injunction or not. The above examined list of authorities shows that while in some cases a cause of action has not been adhered to as a requirement to invoke the fraud exception, judges in the other cases have found themselves unable to grant an injunction unless a cause of action is provided. In light of the above confusion and contradictory attitudes to this particular area of law it would not be a surprise to find statements which blindly stipulate for a cause of action in order to grant an injunction regardless of the different contexts within which it is sought, like the following one where Rix J., in the *Czarnikow-Rionda* case, stated:

"I accept that in *Deutsche v Walbrook* Mr Justice Phillips raised the question whether it is necessary for the claimant to have any cause of action, and sought to answer it in the negative by reference to the acceptance of his proposition in *Bolivinter*; but I have already ventured to

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<sup>167</sup> Bertrams, R. "Bank Guarantees in International Trade: The Law and Practice of Independent (First Demand) Guarantees and Standby Letters of Credit in Civil Law and Common Law Jurisdictions" (Kluwer Law International, 3<sup>rd</sup> ed., The Hague (Netherlands), 2004) at p. 417

suggest that Sir John Donaldson's judgement in *Bolivinter* does not support that view of the matter".<sup>168</sup>

Indeed, where an injunction has been sought to restrain an issuing bank from reimbursing a confirming bank, his Justice was unable to find any other way except to stipulate for a cause of action in order to grant an injunction. Unfortunately, inability to distinguish between situations where confirming banks are involved from that where only issuing banks are involved, led Rix J. to wrongfully criticise other judgements in order to justify the route he has taken. Once the problematic cause of action requirement to grant an injunction in a letter of credit context has been illustrated, one can continue to examine the last requirement, namely, the balance of convenience.

## **6.6. The third requirement: the balance of convenience**

### **6.6.1. A background**

Having provided the court with a serious issue to be tried in addition to a cause of action which justifies his claim, an injunction's applicant in order to obtain the required interlocutory relief has to satisfy the last requirement pursuant to the *American Cyanamid* guidelines which is, namely, that the balance of convenience is in favour of granting the injunction.<sup>169</sup> In fact, in determining where the balance of convenience lies and whether it is in favour of granting the injunction or not, the adequacy of damages test constitutes the crucial test which a court will apply. Accordingly, even if an applicant for an injunction successfully satisfies the first two requirements discussed above, if the court finds that the defendant (the bank or the beneficiary in our case) would be able to compensate the applicant for losses which

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<sup>168</sup> *Czarnikow-Rionda v Standard Bank* [1999] 2 Lloyd's Rep. 187, at 203

<sup>169</sup> Bailey, J. 'Unconditional Bank Guarantees' [2003] *I.C.L. Rev.* Vol. 20(2), 240 at p. 258

might afflict him in the case that an injunction is not granted, the court will not grant the requested injunction.<sup>170</sup>

Nevertheless, if the court concludes that the defendant would not be able to compensate the applicant for an injunction later in a full trial court, granting an injunction would after that be dependent on the applicant's solvency.<sup>171</sup> In other words, a court will not grant the applicant an injunction unless it is satisfied that he would be able to compensate the defendant for any losses which he might sustain in case the latter succeeds afterwards at a full trial court. In sum, in order to obtain the interlocutory relief, the applicant for an injunction has to show the defendant's inability to compensate him if an injunction is not granted and, at the same time, his ability to compensate the defendant if he fails later to support his preliminary claims before a full trial court. If the applicant satisfies this dual adequacy of damages test, then an injunction will be granted in his favour.<sup>172</sup>

In addition to the adequacy of damages which constitutes the main test, it should be said that other factors might play an influential role in whether a court determines to grant an injunction or not. The availability of a freezing injunction (*Mareva* order)<sup>173</sup> might affect negatively the process of granting an interlocutory injunction.<sup>174</sup> The

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<sup>170</sup> Bertrams, R. "Bank Guarantees in International Trade: The Law and Practice of Independent (First Demand) Guarantees and Standby Letters of Credit in Civil Law and Common Law Jurisdictions" (Kluwer Law International, 3<sup>rd</sup> ed., The Hague (Netherlands), 2004) at p. 410

<sup>171</sup> Bridge, M. "The International Sale of Goods" (Oxford University Press, 2<sup>nd</sup>, ed., Oxford, 2007) at p. 305

<sup>172</sup> Hapgood, M. "Paget's Law of Banking" (Butterworths, 13<sup>th</sup> ed., London, 2007) at p. 873

<sup>173</sup> It has been called a *Mareva* order after it was initially applied in *Mareva Compania Naviera SA v International Bulk Carriers SA* [1975] 2 Lloyd's Rep 509. This remedy has since been refined. Such a remedy has been put on a statutory basis and also widened. The Supreme Court Act 1981 s. 37 (2) provided for such a remedy. Now it is called a freezing injunction under the Civil Procedure Rules 1998. Rule 25.1 (1) The court may grant the following interim remedies –

(f) an order (referred to as a 'freezing injunction') –

(i) restraining a party from removing from the jurisdiction assets located there; or

(ii) restraining a party from dealing with any assets whether located within the jurisdiction or not

<sup>174</sup> Hooley, R. & Sealy L. "Commercial Law: Text, Cases, and Materials" (Oxford University Press, 4<sup>th</sup> ed., 2009) at p. 922

banks' reputation and whether granting an injunction would affect it forms another factor which a court might take into consideration whilst weighing the balance of convenience. Taking this into consideration, the following subsections are meant to examine such requirements and the extent to which English courts have stipulated for its existence in order to grant an injunction in a letter of credit context.

### 6.6.2. The adequacy of damages test

In what can be described as a succinct summary of the current English law position in respect of the operation of interlocutory reliefs and their availability in a letter of credit context, Bertrams has noted that:

“The conclusion with respect to English law should be that even if the account party were to succeed in clearly establishing fraud by the beneficiary, thus bringing him within the fraud exception, and even if such fraud were known to the bank, applications for a stop-payment order [injunctions] against the bank would fail on the balance of convenience test”.<sup>175</sup>

The dominant view which English courts have developed, concerning the inability to distinguish between circumstances which necessitate the existence of a cause of action and those which do not, has left the impression that an interlocutory injunction is of little application if not altogether non-existent. This is mainly due to the fact that such an approach has shifted the main reason behind the requested injunctions which is, namely, fraud prevention to that other questionable reason, which has been sometimes poorly applied in the wrong place, namely, the knowledge of the bank. Based on such an erroneous conception, the short line of cases, where English courts have enjoyed the rare (because usually an injunction's applicant will fail to satisfy the first two requirements and accordingly there will be no need to discuss such an undue

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<sup>175</sup> Bertrams, R. “*Bank Guarantees in International Trade: The Law and Practice of Independent (First Demand) Guarantees and Standby Letters of Credit in Civil Law and Common Law Jurisdictions*” (Kluwer Law International, 3<sup>rd</sup> ed., The Hague (Netherlands), 2004) at p. 410

requirement) opportunity to discuss the balance of convenience requirement,<sup>176</sup> show that the courts have been mistaken in determining the identity of the person who should correspond to the injunction's applicant as a defendant whilst weighing the balance of convenience.<sup>177</sup> Although a distinguishing approach between instances which include a holder in due course and those which do not will be drawn in order to illustrate the different aspects of the balance of convenience and the repercussions which might ensue from adhering or not to such a requirement, it will be concluded that, when a fraud case is present, the better approach which English courts should apply in both instances is to neglect such a requirement which originally has been developed outside the unique context of the letter of credit.

The approach calling for the balance of convenience, as the third requirement which the applicant must satisfy in order for the court to grant an injunction, can be seen in the oft-cited statement of Kerr J., in the *Harbottle Mercantile Ltd v National Westminster bank Ltd*, where he provided:

“The plaintiffs then still face what seems to me to be an insuperable difficulty. They are seeking to prevent the bank from paying and debiting their account. It must then follow that if the bank pays and debits the plaintiffs' account, it is either entitled to do so or not entitled to do so. To do so would either be in accordance with the bank's contract with the plaintiffs or a breach of it. If it is in accordance with the contract, then the plaintiffs have no cause of action against the bank and, as it seems to me, no possible basis for an injunction against it. Alternatively, if the threatened payment is in breach of contract...then the plaintiffs would have good claims for damages against the bank”.<sup>178</sup>

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<sup>176</sup> Ellinger P. & Neo, D. “*The Law and Practice of Documentary Letters of Credit*” (Hart Publishing, Oxford, 2010) at p. 159

<sup>177</sup> Martin-Nagle, R. ‘Injunctions of Letters of Credit: Judicial Insurance against Fraud’ (1983) *J. L. & Com* 305 at p. 317

<sup>178</sup> *Harbottle Mercantile Ltd v National Westminster bank Ltd* [1977] 3 W.L.R. 752, at 760-761. In the same manner: *GKN Contractors v Lloyds Bank* (1985) 30 BLR 48 at 64, 65



In fact, the same approach was followed a few years ago in *Czarnikow-Rionda v Standard Bank*,<sup>179</sup> where Rix J. was adamant that the balance of convenience in such cases would militate against granting the required injunctions on the assumption that the bank always would be a solvent party whose ability to compensate the injunction's applicant is not in any doubt. In both the above cases the question was whether an injunction should be granted to restrain the issuing bank from reimbursing the confirming bank. Both courts found that even if the confirming bank had acquired the knowledge of the established, clear and obvious fraud required to grant the injunction, the matter should be left to the issuing bank to determine whether it is going to reimburse the confirming bank or not. Undoubtedly, an issuing bank in such a circumstance will be able to compensate the applicant for the damages that the latter might sustain from such a fraudulent payment.<sup>180</sup> Similarly, the confirming bank also will be able to compensate the issuing bank if the former breached the underlying contract concluded between them. The solvency of banks is well known and as a result an injunction would not be granted once it reached the balance of convenience stage.<sup>181</sup> This approach in both respectful Judges' view is necessary to maintain the integrity and the autonomy of the banks' commitments in this context.<sup>182</sup>

### **6.6.3. Looking at the adequacy of damages test from another angle**

Yet, it is suggested that, instead of maintaining integrity, such an approach will ultimately leave banks in an unenviable situation.<sup>183</sup> Indeed, in a confirmed letter of

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<sup>179</sup> [1999] 2 Lloyd's Rep. 187

<sup>180</sup> Fellingner, G. 'Letters of Credit: The Autonomy Principle and the Fraud Exception' [1990] 1 *J.B.F.L.P.* 4 at p. 16

<sup>181</sup> Ellinger P. & Neo, D. "*The Law and Practice of Documentary Letters of Credit*" (Hart Publishing, Oxford, 2010) at pp. 144-145

<sup>182</sup> However, for example, Malek does support this conclusion. See: Malek, A & Quest, D. "*Jack: Documentary Credits*" (Tottel Publishing, 4<sup>th</sup> ed., Sussex, 2009) at p. 289

<sup>183</sup> In *Itek Corp. v First National Bank of Boston* 730 F.2d. 19 (1<sup>st</sup>. Cir. 1984) it was said that "...the failure to issue an injunction where otherwise appropriate would send a clear signal to those inclined to

credit, an issuing bank instructs a confirming bank to do some works, which the former cannot do for one reason or another, in return for an amount of commission.<sup>184</sup> On the one hand, the issuing bank will reimburse the confirming bank for any money which the latter pays in accordance with the contract between both banks as long as the latter acted in a good faith.<sup>185</sup> On the other hand, an issuing bank can return to the confirming bank to recover any amount of money which the former has paid to the latter where it is found that the latter has performed its duties contrary to the contract terms concluded between the two banks.<sup>186</sup> However, this should not be the case anymore if an applicant can show that the confirming bank itself is embroiled in a fraud scheme in any form (e.g., fraud happened under its knowledge). The fact that a confirming bank would usually be a solvent party should not work to harm issuing banks where a clear and sufficient case of fraud to the knowledge of the former bank has been adduced by the applicant to the court. Indeed, granting an injunction in such cases would save time and efforts which an issuing bank would waste in prosecuting the confirming bank. The result of further litigation in a foreign country would not always provide the issuing bank with a practical solution especially where other parties are fraudsters.<sup>187</sup>

Moreover, in applying the balance of convenience requirement stated by their Justices above, it seems that the only concern of English courts is to protect letters of credit applicants. Their approach suggests that as long as applicants can recover fraudulent

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engage in fraudulent activities that they are likely to be rewarded. Such a result would have an even greater adverse impact upon issuing banks and ultimately discourage the use of letters of credit”

<sup>184</sup> Ellinger, E. ‘The Tender of Fraudulent Documents under Documentary Letters of Credit’ (1965) 7 *Malaya L. Rev.* 24 at p. 41

<sup>185</sup> Ryder, F. ‘The Guarantee on Demand’ [1978] *British Business Law* 58 at p. 58; Ellinger, E. ‘The Tender of Fraudulent Documents under Documentary Letters of Credit’ (1965) 7 *Malaya L. Rev.* 24 at p. 41

<sup>186</sup> Bennett, H. ‘Performance Bonds and the Principle of Autonomy’ [1994] *J.B.L.* 574 at p. 579

<sup>187</sup> Neil J., in *United Trading v Allied Arab Bank* [1985] 2 Lloyd’s Rep. 554, has stated: “It cannot be in the interest of international commerce or of the banking community as a whole that this important machinery...should be misused for the purposes of fraud”.

payment, protecting issuing banks is unimportant. Such an approach which protects the applicants' interests and overlooks that of other bona fide parties such as issuing banks is absurd. Issuing banks like applicants should be protected from fraud and fraudsters, and courts should recognise such a fact. Indeed, if the essence of the fraud exception illustrated by Lord Diplock in the *American Accord* is:

“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 preferred ‘fraud unravels all’. *The court will not allow their process to be used by a dishonest person to carry out fraud*”.<sup>188</sup>

it is difficult to justify the approach pursued by Rix J. and Kerr J. above. While the confirming bank is not the beneficiary referred to by Lord Diplock's above statement, it is arguable that such a complicit bank's position, where it facilitates the beneficiary's fraud scheme which certainly would not transpire without the bank benefiting from it, is equal to the fraudulent beneficiary position. The last argument can find a conclusive support in his Lordship's last sentence where he stressed the courts' role in not allowing the carrying out of fraud by a dishonest person whoever he is. After all, it should not be forgotten that in such a case the beneficiary himself is fraudulent and accordingly, the court should prevent him from benefiting from his own fraud rather than developing approaches which help the spreading of this injurious phenomenon.

It has been said that: “a bank is not a detective agency and cannot be expected to investigate whether there is substance behind an inconclusive case presented by the applicant”.<sup>189</sup> A bank usually would not take the initiative in assessing the strength or truthfulness of the allegation of the applicant. Indeed, a bank, whose abilities do not

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<sup>188</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada (The American Accord)* [1983] 1 A.C. 168, at 176-177

<sup>189</sup> Bridge, M. “*Benjamin's Sale of Goods*” (London, 2010) at 24-027

qualify it for such work, is not the institution capable of verifying such claims and there must be doubt whether it would suffice to stop the reimbursement process or not.<sup>190</sup> As Lord Ackner has observed in the *United Trading* case:

“The grant of an injunction would not be upon the basis that they had established fraud, but only on the basis that on the available evidence it was seriously arguable that fraud had occurred. *Such a finding does not indicate success in the final action, nor does the failure to obtain an interim injunction predicate failure when the case is ultimately heard*”.<sup>191</sup>

Notably, even what courts find as a sufficient proof of fraud in an interlocutory stage would vary from what a full trial court would recognise as a sufficient evidence of fraud later on.<sup>192</sup> If this is the case with the very institution established and well equipped to investigate such instances, one can imagine to what extent a bank decision would be fragile. Relying on the English approach, an issuing bank which from the beginning advises its applicant to obtain a court’s injunction in order to avoid becoming embroiled with assessments which it is ill-equipped to deal with, will shockingly find itself facing the very same position it tried to keep away from. Accordingly, if the bank accepted its applicant’s allegations and refused to reimburse the confirming bank it would find itself bound to compensate the latter for the damages it sustained as a result of the previous refusal to reimburse it in addition to the letter of credit due amount.

On the other hand, if the same bank refused to take seriously its customer allegations it would find itself defrauded by the confirming bank. In such a situation the issuing bank will find itself bound to return the letter of credit amount to its applicant should it have breached the contract concluded between them. Even if it has paid the

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<sup>190</sup> *Turkiye Is Bankasi AS v Bank of China* [1996] 2 Lloyd's Rep. 611 at.617 per Waller J

<sup>191</sup> *United Trading Corp SA v Allied Arab Bank Ltd* [1985] 2 Lloyd's Rep. 554, at 565. [Emphasis added].

<sup>192</sup> Ellinger, E. “*Documentary Letters of Credit: A Comparative Study*” (University of Singapore Press, Singapore, 1970) at pp. 196-197

untrustworthy confirming bank in good faith, the issuing bank will be held liable for the letter of credit amount, which it has already paid for its applicant who previously warned it of such a payment's implications. With such an approach consequences would be harmful in both ways to issuing banks.<sup>193</sup>

Furthermore, the autonomy principle does support this line of argument. In fact, banks should not investigate extraneous matters as their work is documentary in nature.<sup>194</sup>

Whilst maintaining the integrity and autonomy of the banks' commitments is one of the reasons upon which Kerr J. and Rix J. have based their approach, it is suggested that such an approach necessitates banks' interference with matters beyond documents in order to protect their own interests. In pursuing such an approach, a bank will find itself compelled to undermine the very base which English courts have taken into account whilst stipulating for the balance of convenience requirement.

Implementing such an approach can be seen where a court might from the very preliminary stages refuse to interfere to stop payment by means of injunctions relying on the balance of convenience requirement. Relying on such an approach, courts might not test out the fraud allegations and whether they are sufficient to invoke an injunction or not.<sup>195</sup> Rather, as long as the defendant is a solvent party (a bank) who can fully compensate the applicant for the damages that might afflict him, the court will deprive banks from benefiting from any assisting preliminary findings it usually reaches about the alleged fraud and its strength which might be of good use to banks in determining whether to pay or not.<sup>196</sup> Such an approach has been pursued by Rix J.

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<sup>193</sup> *Ibid.*

<sup>194</sup> Bertrams, R. "Bank Guarantees in International Trade: The Law and Practice of Independent (First Demand) Guarantees and Standby Letters of Credit in Civil Law and Common Law Jurisdictions" (Kluwer Law International, 3<sup>rd</sup> ed., The Hague (Netherlands), 2004) at p. 408

<sup>195</sup> *Ibid.* at p. 435

<sup>196</sup> Ellinger P. & Neo, D. "The Law and Practice of Documentary Letters of Credit" (Hart Publishing, Oxford, 2010) at pp. 144-145

in the *Czarnikow-Rionda* case.<sup>197</sup> Rix J. was of the view that as long as the defendant is a bank, whose solvency is beyond any doubt, fraud allegations should not be considered. The balance of convenience would solely on its own suffice in refusing to grant the injunction. Unfortunately, pursuing Rix's approach, an issuing bank, rather than limiting its duties to check documents on their face, would find itself carrying out its own external investigations, which might not always be successful, in order to protect its own interests.<sup>198</sup> Such an approach is subject to the same criticism which the general approach above, calling for the balance of convenience requirement, suffers from. Hence, while such a requirement does protect applicants, it is commended that in a confirmed letter of credit the balance of convenience requirement should be neglected as it does not provide banks with the security which these institutions require.<sup>199</sup>

The same questions arise where an injunction is sought against an issuing bank where no holders in due course parties are involved. While the balance of convenience is to some extent justified in the above context, where it does protect the applicants but not issuing banks from fraud, it is arguable to say that stipulating for such a requirement where no holders in due course are involved would not provide the envisaged protection which the applicants look for either.

As has been illustrated above, in such a context, a cause of action against neither the non-existent confirming bank nor the issuing bank should constitute an obstacle before the applicant who seeks to restrain a fraudulent beneficiary. It is true that if the issuing bank knows about the fraud it should not pay and if it pays it would be a

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<sup>197</sup> [1999] 2 Lloyd's Rep. 187

<sup>198</sup> Barclay, A. 'Courts Orders Against Payment under First demand Guarantees Used In International Trade' [1989] *J.I.B.L.* Vol. 4(3), 110 at p. 121

<sup>199</sup> Low, H.Y. 'Confusion and Difficulties Surrounding the Fraud Rule in Letters of Credit: An English Perspective' [2011] *Int. J.L.M.* 17(6), 462 at p. 467

solvent party who would be able to compensate the defrauded applicant for the damages inflicted on him. However, the problem arises when the issuing bank does not acquire sufficient knowledge which might make it liable for damages after paying the fraudulent beneficiary.<sup>200</sup>

In what can be described as a *vicious circle*, if courts insist on not granting an injunction because of applying the balance of convenience against the issuing bank, the beneficiary will ultimately run away with the money he obtains through fraud limiting remedies for the applicant to pursue the former into foreign jurisdictions.<sup>201</sup>

Common sense suggests that even following such an unscrupulous beneficiary into foreign jurisdictions would not be a practical solution because in the same manner that this beneficiary vanished from the English jurisdiction it would vanish again similarly from other jurisdictions.<sup>202</sup> An issuing bank which does not know about the fraud would not be held liable for such a fraud. Blindly weighting the balance of convenience against the issuing bank in such cases would ultimately lead to a refusal to grant the required injunction and thus open the doors wide for the fraudulent beneficiaries to benefit from their own fraud with all the ease that they need.<sup>203</sup>

The approach English courts have pursued in *Kvaerner John Brown Ltd v. Midland Bank Plc*<sup>204</sup> is worth noting in this regard. Creswell J. granted an injunction where the “only realistic inference is that the demand was made fraudulently”. It should be

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<sup>200</sup> Bertrams, R. “*Bank Guarantees in International Trade: The Law and Practice of Independent (First Demand) Guarantees and Standby Letters of Credit in Civil Law and Common Law Jurisdictions*” (Kluwer Law International, 3<sup>rd</sup> ed., The Hague (Netherlands), 2004) at p. 418

<sup>201</sup> Enonchong, N. ‘The Problem of Abusive Calls on Demand Guarantees’ [2007] *L.M.C.L.Q.* 1, 83 at pp. 86-87; Harfield, H. “*Bank Credits and Acceptances*” (The Ronald Press Company, 5<sup>th</sup> ed., New York, 1974) at p. 80

<sup>202</sup> Davis, A. “*The Law Relating to Commercial Letters of credit*” (The Pitman Press, 3<sup>rd</sup> ed., London, 1963) at p. 145

<sup>203</sup> Low, H.Y. ‘Confusion and Difficulties Surrounding the Fraud Rule in Letters of Credit: An English Perspective’ [2011] *Int. J.L.M.* 17(6), 462 at p. 467; Bridge, M. “*The International Sale of Goods*” (Oxford University Press, 2<sup>nd</sup> ed., Oxford, 2007) at p. 305

<sup>204</sup> [1998] C.L.C. 447

noted that neither the cause of action nor the balance of convenience (which his Justice did not even consider) constituted a barrier in front of the court to restrain the bank from paying the fraudulent beneficiary. Had his Justice applied the balance of convenience and weighted it against the bank, an injunction would not have been the outcome of the case. Moreover, *Lorne Stewart Plc v. Hermes Kreditversicherungs AG, Amey Asset Services Ltd*<sup>205</sup> supports this trend where an interlocutory injunction is sought against a beneficiary. To this effect, Garland J. found that simply the: “balance of convenience is in favour of preserving the status quo rather than provoking further litigation between [beneficiaries] and [applicants], or [banks] and [beneficiaries]”.<sup>206</sup> In the same manner in *Simon Carves Ltd v Ensus UK Ltd* it has been provided:

“Broadly, they are that the calling of the bond as in this case gives rise to a very real risk of damage to the commercial reputation, standing and worthiness of [the applicant] which would be very difficult to quantify; there would be a very real risk that [the applicant] would not pre-qualify for tenders because often tenderers have to disclose whether there have been recent calls on the bonds and if so on what grounds”.<sup>207</sup>

Interestingly, in the *Simon* case it has been found that the balance of convenience favours granting the injunction especially where the applicant is a solvent person who could compensate any damages which would later affect the beneficiary or the bank. Having illustrated the adequacy of damages test implications, the next subsection is meant to examine other factors which English courts take into consideration in this context in order to decide where the balance of convenience should tip.

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<sup>205</sup> [2001] WL 1251939 (available only through Westlaw). Indeed, the case considered an invalid demand made out of the independent guarantee time. However, even though this case was not a fraud case this should not prevent applying the *dicta* which the court delivered relating to the balance of convenience requirement.

<sup>206</sup> [2001] WL 1251939 at Para 32 (available only through Westlaw)

<sup>207</sup> [2011] C.I.L.L. 3009 at 3013



#### 6.6.4. Banks' reputation and the availability of freezing injunctions

English courts have repeatedly said that a balance of convenience is required in order to obtain an injunction to stop the payment of a letter of credit as it protects the banks' reputation.<sup>208</sup> In their view banks should be left free to discharge their obligations and commitments which they acquire in a letter of credit context. To that effect, Lord Ackner stated:

“The plaintiffs' position must be contrasted with that of the banks... If this Court were to grant an injunction which was recognized by the Iraqi Courts, then, if the plaintiffs subsequently failed in the action, the damage would consist of the loss of interest which [the bank] would have to pay to [the beneficiary] and injury to its reputation as a bank. The loss of interest on its own could amount to a very large figure -- several million dollars -- and the damage to its reputation would be very difficult to quantify”.<sup>209</sup>

Lord Ackner's view was that by granting an injunction which would restrain the bank from paying the beneficiary the former's reputation would be affected.<sup>210</sup> In his view, the bank therein would be seen as a bank which does not fulfil its commitments and accordingly would not be trusted by further traders who wish to use its services in similar transactions. Moreover, he warned that, in a case where an injunction is granted, if the plaintiffs failed to prove fraud in subsequent litigations (a full trial court), the damages which the bank might sustain would amount to a very large sum of money which the plaintiffs' ability to compensate is questionable. With respect, Lord Ackner's view in this respect is arguable. Indeed, the bank's reputation argument is a double-edged sword. While it is arguable that a bank's reputation would

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<sup>208</sup> Howard QC, M. Masefield, R. & Chuah, J. “*Butterworths Banking Law Guide*” (Butterworths, London, 2006) at p. 536; Bertrams, R. “*Bank Guarantees in International Trade: The Law and Practice of Independent (First Demand) Guarantees and Standby Letters of Credit in Civil Law and Common Law Jurisdictions*” (Kluwer Law International, 3<sup>rd</sup> ed., The Hague (Netherlands), 2004) at p. 434

<sup>209</sup> *United Trading Corp SA v Allied Arab Bank Ltd* [1985] 2 Lloyd's Rep. 554, at 565-566

<sup>210</sup> See, for example: *Bolivinter v Chase* [1984] 1 Lloyd's Rep 251, at 257

be affected by not paying the beneficiary,<sup>211</sup> it would be affected in the same manner if it pays the beneficiary.<sup>212</sup> In other words, a bank's reputation where it does not pay would be negatively affected from the beneficiaries' point of view. Similarly, if the bank pays its reputation would be affected negatively from the applicant's point of view. In neither case the bank's reputation would go unaffected.

However, it is suggested that the bank's reputation would not be affected where it obeys a court order.<sup>213</sup> A court order, firstly, protects the bank itself from beneficiaries' fraud where the former is interested in the actual performance of the underlying contract which such payment undertakings are serving. Secondly, such an order, which is issued by the very institution created to investigate whether fraud is existent or not, protects the bank from investigating external facts which might not justify the bank's refusal or acceptance to pay later on when the matter reaches a full trial court.<sup>214</sup> Thirdly, a bank would be seen as an institution which makes bad financial decisions and its reputation would be affected more harshly where it facilitates fraud rather than being seen as a bank which does not pay the beneficiary because it obeys a court order which suggests that the beneficiary is a fraudulent person who does not deserve payment.<sup>215</sup> Finally, banks enter such contracts as the applicants' agents to perform a certain job and once they have performed it they are

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<sup>211</sup> Hooley, R. & Sealy L. "*Commercial Law: Text, Cases, and Materials*" (Oxford University Press, 4<sup>th</sup> ed., 2009) at p. 879

<sup>212</sup> Qiman, L. 'The Practice of Judicial Preservation for Documentary Credits' (eds.) in Byrne, J. "*2003 Annual Survey of Letter of Credit Law & Practice*" (The Institute of International Banking Law & Practice Inc., USA, 2003) at 105 at p. 107

<sup>213</sup> Hardenberg, L. 'First Demand Guarantees: Abuses and Remedies under Dutch Law' (1991) 19 *Int'l Bus. Law*. 241 at p. 242; Horn, N. & Wymeersch, E. "*Bank-Guarantees, Standby Letters of Credit and Performance Bonds in International Trade*" (Kluwer Law and Taxation Publishers, Deventer, 1990) at p. 26; Fong, P. 'An Overview of Performance Bonds, Performance Guarantees and Bank Guarantees: Part II' [1997] *Tr. Law* Vol. 16(3), 196 at p. 202

<sup>214</sup> Ellinger, E. 'Fraud in Documentary Credit Transactions' [1981] *J.B.L.* 258 at p. 266

<sup>215</sup> Horn, N. & Wymeersch, E. "*Bank-Guarantees, Standby Letters of Credit and Performance Bonds in International Trade*" (Kluwer Law and Taxation Publishers, Deventer, 1990) at p. 26; Warne, D & Elliott, N. "*Banking Litigation*" (Sweet & Maxwell, 2<sup>nd</sup> ed., London, 2005) at p. 268

paid an amount of commission which is commensurate with this job.<sup>216</sup> Accordingly, banks should take into account while pricing their services that a court order might be an available remedy which an applicant might activate once fraud has suddenly appeared.

It has been argued that the availability of freezing injunctions (formerly known as *Mareva* injunctions) which a court might grant, should in appropriate situations limit the availability of interlocutory injunctions.<sup>217</sup> Indeed, this was the main argument of Evans L.J. for not granting an interlocutory injunction in *Themehelp Ltd v. West*.<sup>218</sup> In this case, he said that “The present case cries out for *Mareva* relief”. However, his brethren Lordships in this case, Balcombe and Waite L.J.J., were of the view that a freezing order would not suffice to protect the applicant’s interests in such a case and, accordingly, it should not work to destruct granting an interlocutory injunction.<sup>219</sup> It is submitted that the approach pursued by Balcombe and Waite L.J.J. is a rational one for two reasons.<sup>220</sup> Firstly, if a freezing order has been granted, that would not guarantee the applicant that what he paid would be returned in full where the beneficiary owes money to other creditors.<sup>221</sup> Indeed, the amount of money restrained by means of freezing injunctions would be distributed equally between different and numerous creditors and the letter of credit applicant will not acquire a priority right

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<sup>216</sup> Guest, A. “*Benjamin’s Sale of Goods*” (Sweet & Maxwell, 7<sup>th</sup> ed., London, 2006) at p. 2027

<sup>217</sup> *Czarnikow-Rionda Sugar Trading Inc v. Standard Bank London Limited* [1999] 2 Lloyd’s Rep. 187; Hooley, R. & Sealy L. “*Commercial Law: Text, Cases, and Materials*” (Oxford University Press, 4<sup>th</sup> ed., 2009) at p. 922; King, R. “*Gutteridge & Megrah’s Law of Bankers’ Commercial Credits*” (Europa Publications Limited, 8<sup>th</sup> ed., London, 2001) at p. 72; Chong, W. ‘The Abusive Calling of Performance Bonds’ [1990] *J.B.L.* 414 at p. 418; Bailey, J. ‘Unconditional Bank Guarantees’ [2003] *I.C.L. Rev.* Vol. 20(2), 240 at p. 275; Gleghorn, S. & Simpson, J. ‘Performance Bonds: A New Exception to their Unconditional Status?’ [2011] *Bank. Law.* Vol. 4(2), 14 at p. 17; Goode, R. ‘Reflections on Letters of Credit – II’ [1980] *J.B.L.* 378 at p. 380

<sup>218</sup> *Themehelp Ltd v. West* [1995] 3 W.L.R. 751

<sup>219</sup> The same approach has been pursued by Rix J. in *Czarnikow-Rionda Sugar Trading Inc v Standard Bank London Ltd* [1999] 2 Lloyd’s Rep. 187, at 203-204

<sup>220</sup> Malek, A & Quest, D. “*Jack: Documentary Credits*” (Tottel Publishing, 4<sup>th</sup> ed., Sussex, 2009) at p. 294

<sup>221</sup> Wilson, F. “*Carriage of Goods by Sea*” (Pearson Education Limited, 6<sup>th</sup> ed., Essex, 2008) at p. 326; Warne, D & Elliott, N. “*Banking Litigation*” (Sweet & Maxwell, 2<sup>nd</sup> ed., London, 2005) at p. 270

amongst these creditors to recover his money.<sup>222</sup> The other reason is that such a remedy would be inefficient where the beneficiary has no assets in the jurisdiction in which a freezing order is sought within.<sup>223</sup> Accordingly, such an approach which does not fully protect the applicant should not be recognised.<sup>224</sup> Indeed, if courts are willing to interfere why should they not interfere in a way which provides the applicants with the full protection which they envisage when knocking at the courts' doors asking for justice?

## 6.7. Conclusion

The autonomy principle dictates that banks should not interfere with the underlying contract concluded between the parties from which a letter of credit ensues.<sup>225</sup> As long as the required documents do conform to the terms of the letter of credit the bank must pay. However, when a fraud case is alleged and a bank cannot infer the validity of these allegations, the best place to hear such allegations is courts.<sup>226</sup> Where the interval between the demand and the actual payment is short, an applicant can ask for the courts' temporary services to restrain the beneficiary from demanding payment or the bank from paying. This service comes in the form of interlocutory injunctions and who seek it has to satisfy some requirements in order to obtain it.

While the applicant has the right to seek an injunction against the beneficiary or the issuing bank, the more realistic way is to try to restrain involved parties who reside in his country. This emanates from the fact that other parties are usually resident in

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<sup>222</sup> Pugh-Thomas, A. 'Can a Buyer Bypass the Guarantor and Stop the Seller from Demanding Payment from the Guarantor?' [1996] *I.C.C.L.R.* Vol. 7(4), 149 at p. 152

<sup>223</sup> Rowe, M. "*Letters of Credit*" (Euromoney Books, 2<sup>nd</sup> ed., London, 1997) at 258; Justice, J. 'Letters of Credit: Expectations and Frustrations – Part 2' (1977) 94 *Banking L.J.* 493 at p. 495

<sup>224</sup> Penn, G. 'Performance Bonds: Are Bankers Free From the Underlying Contract?' [1985] *L.M.C.L.Q.* 132 at p. 135

<sup>225</sup> Guest, A. "*Benjamin's Sale of Goods*" (Sweet & Maxwell, 7<sup>th</sup> ed., London, 2006) at p. 2027

<sup>226</sup> Malek, A & Quest, D. "*Jack: Documentary Credits*" (Tottel Publishing, 4<sup>th</sup> ed., Sussex, 2009) at p. 300

foreign jurisdictions' whose legal and political orientation cannot be predicted. Moreover, due to the speedy operation of such undertakings, an applicant arriving in such a foreign jurisdiction would probably find that the confirming bank has already paid.

In granting an injunction against an issuing bank, a court should distinguish between two situations: cases where holders in due course are involved and cases where they are not. Where a holder in due course is involved he acquires special rights and as long as he does not know about the fraud he should not be held liable for it. However, this is not the case where no holders in due course are involved. In both cases it is true that where banks have already paid despite the existent fraud which is unknown to them, the applicant will ultimately bear the losses because he is the person who chose to deal with the fraudulent beneficiary. Nonetheless, the situation should be different if the applicant can show that a holder in due course is embroiled in the fraud where the issuing bank has not yet paid. Indeed, the requirements to enjoin the issuing bank in the two situations are different and courts should take this into account when hearing an injunction case.

A dual approach which suits both situations can be found in the English judgements in this regard. English courts have developed satisfactory approaches to the first requirement established by the *American Cyanamid* case which they have in an appropriate manner turned to meet the special nature of the fraud exception. Both, as discussed above, the "established case of fraud" and "the only realistic inference is fraud" proof standards are required depending on the context in which an injunction is required. However, lower proof standards such as that of "arguable case of fraud" presented by the *Themehelp* court should be rejected as it neither suits the nature of these instruments nor satisfies the expectations of the different parties utilising it.

While attacked by judiciary and legal commentators, a cause of action in a confirmed letter of credit is required to deprive the latter bank from being reimbursed. This should not be the case where no holders in due course are involved. In the latter case fraud prevention should suppress other superfluous requirements attaching to it, which will be unnecessary. This justifies the contradictory views which English courts have developed as to this requirement in order to grant an injunction.

The last requirement as to the balance of convenience should be neglected or at least courts should recognise that in weighing it the applicant's litigant should be the fraudulent party who always will not be a solvent party and whose willingness to reimburse the applicant or the issuing bank for losses they may sustain is in doubt. Weighing the balance of convenience against banks leads to refusal to grant the injunction and accordingly a failure to protect either issuing banks or applicants. The approach pursued in *Kvaerner John Brown* and *Lorne Stewart* cases where both courts have neglected assessing such a requirement is recommended. This approach protects issuing banks from playing the role of courts in investigating fraud allegations and their strength in order to protect itself in future litigations. Indeed, if applying the *American Cyanamid* general guidelines would not properly fit the special nature of these letters of credit, developing these guidelines to suit these instruments' particular nature should not constitute a barrier in front of courts to achieve envisaged justice.

While the three requirements have been applied by the English courts differently from one case to another, mistaken views, such as that made by Rix J. in the *Czarnikow-Rionda* case with respect to the cause of action requirement, may be seen over and over in this particular area of law. It would not be surprising that this will be the case if English courts continue this approach which does not clearly make a distinction

between requirements needed in the different contexts. Unless the English judiciary illustrates the differences in the requirements needed in each case, a letter of credit applicant will remain uncertain as to the requirements he should provide a court with in order to obtain an injunction and so be protected from fraudsters.

## Chapter Seven: Letters of Credit Fraud: A Jordanian Perspective

### Introduction

This chapter examines the way in which the Jordanian law has tackled the problem of fraud in the letters of credit context. While the discussion in this chapter will begin with looking at the position in a number of Arabian Middle Eastern countries, later discussion will focus on Jordan in particular. Such limitation of focus in this chapter is attributed to the fact that the Jordanian judiciary, in contrast to other Arabian Middle Eastern countries, has heard some fraud cases in the last few years.

This chapter is divided into four main sections. Following the introduction, the second section of this chapter provides a general background about the way in which the Arabian Middle Eastern jurisdictions have dealt with letters of credit. As is well known, the Islamic law serves as one of the law sources in most of the Arabian Middle Eastern countries and, therefore, this section will also provide an overview of the Islamic law position in this regard. The third section is concerned with the Jordanian jurisdiction in particular. In this section, an overview of the manner this jurisdiction has dealt with letters of credit is provided. Taking into consideration the legislative vacuum and the shortage of supplementary law sources, a primary research by means of interviews with some Jordanian judges was conducted.<sup>1</sup> This section critically analyses the existing secondary data available and the new primary data collected through the interviews. Accordingly, the first subsection provides general analysis of the legislation available in this respect in both the Jordanian Commercial and Civil Acts. The next subsection is concerned with other available data whether

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<sup>1</sup> The interviews' different aspects and mechanism could be found in Appendix 1



primary or secondary. The provided analyses in this section take the form and the order which has been pursued in the previous chapters and therefore fraud in the documents, the scope of fraud, the standard of the fraud required in order to apply the fraud exception and the injunctions in such a context comprise the main subsections focused on in this part. The conclusion is to be found in the fourth section.<sup>2</sup>

## **7.1. Letters of credit in the Arabian Middle Eastern region: a general background**

### **7.1.1. Introduction**

The use of letters of credit does not stop at some specific geographic boundaries and is not restricted to some countries. By virtue of its unique location, the Middle East has played a vital role in international trade in various fields. Like developed countries, Middle Eastern countries perform a leading role in the use of letters of credit.<sup>3</sup> This has been observed by Kerr J., in the English case of *RD Harbottle (Mercantile) Ltd v National Westminster Bank Ltd*, where he found that: “Performance guarantees in such unqualified terms seem astonishing, but I am told that they are by no means unusual, particularly in transactions with customers in the Middle East”.<sup>4</sup>

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<sup>2</sup> It should be noted that this work is meant to study the Arabian countries which are located in what has been known as the Traditional Middle East and is not intended to study other Arabian countries which are located in what has been known as the Greater Middle East. Accordingly, Arabian countries, which are located in the Traditional Arabian Middle Eastern region and which this study is concerned comprises of: Egypt, Iraq, Saudi Arabia, Yemen, Syria, United Arab Emirates, Jordan, Lebanon, Palestinian Territories, Oman, Qatar, Bahrain and Kuwait.

<sup>3</sup> Loh, Q. & Wu, T. ‘Injunctions Restraining Calls on Performance Bonds – Is Fraud the Only Ground in Singapore?’ [2000] *L.M.C.L.Q.* 3, 348, at p. 349; Lock, A. ‘Standby Letters of Credit and Performance Bonds: The Lesson of the Iranian Experience’ (eds.) in Chinkin, C., Ho, P. & Chan, H. ‘*Current Problems of International Trade Financing*’ (National University of Singapore, 2<sup>nd</sup> ed., 1990) 232, at p. 233; Penn, G. ‘Performance Bonds: Are Bankers Free From the Underlying Contract?’ [1985] *L.M.C.L.Q.* 132, at p. 135; Williams, K. ‘On Demand and Conditional Performance Bonds’ [1981] *J.B.L.* 8, at p. 9

<sup>4</sup> [1978] Q.B. 146 at 150

Arabian Middle Eastern countries relied on foreign contracts financed by means of letters of credit for the advancement of various fields.<sup>5</sup> Indeed, the petroleum industry, which the region is well known for, leads to the issuance of hundreds of letters of credit daily in order to facilitate the different contracts ensuing from this industry.<sup>6</sup> Letters of credit in their different forms and types became an imperative instrument without these countries would find it difficult to run their affairs.<sup>7</sup>

### 7.1.2. The legal position of letters of credit in the Arabian Middle Eastern region

Arabian Middle Eastern countries, which are civil law countries, can be divided into two categories in relation to the way they have dealt with letters of credit.<sup>8</sup> The first category countries have neglected letters of credit and did not regulate them neither by special legislation nor by inserting some articles into their commercial acts.<sup>9</sup> This category includes: Jordan, Syria, Lebanon, Saudi Arabia and the Palestinian territories. On the other hand, the second category countries have regulated letters of credit by inserting some articles addressing the operation of these instruments specifically into their commercial acts.<sup>10</sup> This category includes: Egypt, Iraq, Kuwait, United Arab Emirates, Qatar, Oman, Yemen and Bahrain.

What is interesting in this regard is that, while there are some differences in the wording between some articles of these different commercial laws, in general the

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<sup>5</sup> Loh, Q. & Wu, T. ‘Injunctions Restraining Calls on Performance Bonds – Is Fraud the Only Ground in Singapore?’ [2000] *L.M.C.L.Q.* 3, 348, at p. 349

<sup>6</sup> For example, Saudi Arabia and other gulf countries are considered as an important market for international trade and as a result independent guarantees are used frequently by their banks. The main user of independent guarantees in these countries is the governments’ entities. See: Nassar, N. & Nassar, S. “*Al-Damanat Al-bankieh fi Al-Tijarah Al-Dwalieh fi Ktabien*” (Al-Ihram, Cairo, 1997) at p. 183

<sup>7</sup> Bertrams, R. “*Bank Guarantees in International Trade: The Law and Practice of Independent (First Demand) Guarantees and Standby Letters of Credit in Civil Law and Common Law Jurisdictions*” (Kluwer Law International, 3<sup>rd</sup> ed., The Hague (Netherlands), 2004) at p. 1

<sup>8</sup> Affaki, B. ‘Demand Guarantees in the Arab Middle East’ [1997] *J.I.B.L.* 12 (7), 271 at p. 272

<sup>9</sup> *Ibid.*

<sup>10</sup> *Ibid.*

same principles have been adopted by these different countries.<sup>11</sup> For example, the commercial laws of all of these countries have defined independent guarantees and documentary credits in the same way and all of these laws have stressed the importance of the autonomy principle in these contexts.<sup>12</sup> On the one hand, for example, the Kuwaiti Commercial Law, Number 68 of the year 1980, under Article 382 has defined an independent guarantee as:

“A promise which a bank issues pursuant to its customer’s instructions which dictates paying an amount of money to the beneficiary without condition or restrictions if the latter asked for it during a certain time which the independent guarantee does provide...”

Article 385 of the same Kuwaiti Law stresses the importance of the autonomy principle by providing: “A bank does not have the right to refuse paying the beneficiary for some reason which is due to the bank – applicant or the beneficiary – applicant relationships”. On the other hand, for example, a documentary credit has been defined under Egyptian Commercial law, Number 17 of the year 1999, in Article 341/1 as: “A contract which through a bank promises to open a credit pursuant to one of its customers’ instructions in favour of another person who is called the

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<sup>11</sup> For instance, Articles 382 to 387 of the Kuwaiti Commercial Law cover the subject of independent guarantees. In the United Arab Emirates, the Commercial Transactions Law Number 18 of the year 1993 in Articles 414 to 419 has regulated some of the independent guarantees’ operation aspects. In Bahrain, the Commercial law Number 7 of the year 1987 covers the subject of independent guarantees under Articles 331 to 336. Iraqi Commercial Law Number 30 of the year 1984 governs independent guarantees under Articles 287 to 293. The Egyptian Commercial law Number 17 of the year 1999 does the same under Articles 355 to 360. By the same token, the Qatari Commercial Law Number 27 of the year 2006, the Yemeni Commercial Law Number 32 of the year 1991 and the Omani Commercial Law Number 55 of the year 1990 have pursued the same approach. Articles 406 to 413 of the Qatari Commercial Law, Articles 408 to 414 of the Yemeni Commercial law and Articles 392 to 397 of the Omani Commercial Law govern some aspects of independent guarantees operations. Similarly, Articles 367 to 377 of the Kuwaiti Commercial Law cover the subject of documentary credits. In the same token, Articles 341 to 350 of the same Egyptian Law, Articles 400 to 407 of the Yemeni law, Articles 317 to 326 of the Bahraini law, Articles 273 to 284 of the Iraqi law, Articles 386 to 399 of the Qatari Law, Articles 377 to 387 of the Omani Law and Articles 428 to 438 of the Emirati Law regulate some aspects of the documentary credits operation.

<sup>12</sup> To this Ellinger provides: “Other laws exist in South America, in the Middle East and amongst the Gulf countries. The models used in the latter are the Lebanese Law and the Law of Kuwait”. See: Ellinger P. & Neo, D. “*The Law and Practice of Documentary Letters of Credit*” (Hart Publishing, Oxford, 2010) at p. 58

beneficiary”. Moreover, the second section of the same Article has stressed the importance of the autonomy principle in a documentary credit context.

However, what we are mainly concerned about here is the absence of provisions which tackle the problem of fraud in these laws. It has been argued that the absence of provisions regulating fraud in these contexts could be attributed to the fact that such a fraud has not been presented before these countries’ courts prior to the enunciation of these laws.<sup>13</sup> Case law outcomes in these countries do not differ from what has been drawn from their different commercial laws. Different cases have stressed the general principles of the documentary credits and independent guarantees operations. For example, in the Egyptian Court of First Instance decisions num. 1189/49 on 13-02-1984 and 2084/58 on 29-05-1989 the courts illustrated the importance of the autonomy principle in the independent guarantees context by stating that:<sup>14</sup>

“The bank should not refuse to pay the beneficiary the amount of the independent guarantee because of a reason which is related to the relationship between the bank and the applicant or the relationship between the beneficiary and the applicant”.<sup>15</sup>

Moreover, in Saudi Arabia, decision num. 422/1420, issued by the Saudi Dispute Settlement Committee on 25-01-2000, noted the importance of the autonomy principle which facilitates the smooth functioning of international trade.<sup>16</sup> Similarly, The Emirati Court of First Instance of Abu Dhabi in its decision num. 894/79, issued on 16-03-1981, noted the importance of the autonomy principle.<sup>17</sup> Yet, while most of these countries’ courts have had the chance to comment on many different aspects of

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<sup>13</sup> Al-Kilani, M. “*Amaliat Al-Bonok*” (Dar Al-Thakafa, Amman, 2009) at pp. 325-326

<sup>14</sup> Referred to in Nassar, N. & Nassar, S. “*Al-Damanat Al-bankieh fi Al-Tijarah Al-Dwalieh fi Ktabien*” (Al-Ihram, Cairo, 1997) at pp. 170-172

<sup>15</sup> The same has been found in decisions number 249/35 on 27-05-1969, number 106/37 on 04-03-1973 and number 648/48 on 12-04-1984. Same as well in the Court of Appeal decision num. 785 on 19-02-1963. See Nassar, N. & Nassar, S. “*Al-Damanat Al-bankieh fi Al-Tijarah Al-Dwalieh fi Ktabien*” (Al-Ihram, Cairo, 1997) at pp. 170-172

<sup>16</sup> Cited in Nassar, N. & Nassar, S. “*Al-Damanat Al-bankieh fi Al-Tijarah Al-Dwalieh fi Ktabien*” (Al-Ihram, Cairo, 1997) at p. 174

<sup>17</sup> Available in Majalet Al-Adaleh number 33 of the ninth year, 1982, at p. 86

documentary credits and independent guarantees law, such courts have not addressed the problem of fraud within such a context.<sup>18</sup>

The jurisprudence in these countries has played a notable role in shaping the law of documentary credits and independent guarantees.<sup>19</sup> For instance, AL-Kilani suggests that legal scholars have played the main role in shaping the law of independent guarantees in Egypt and other Arabian Middle Eastern countries.<sup>20</sup> In addition, the Egyptian Institution of Banking Studies has played a great role in shedding light on the legal characteristics of both documentary credits and independent guarantees.<sup>21</sup> However, it is surprising to know, after efforts which have been spent in researching the different books and articles written by scholars in these different countries, that most of the jurisprudence in this regard does not offer a discussion of the fraud problem. The remaining small part of this jurisprudence, which offered some discussion on the fraud problem, did so by copying other foreign countries' legal position (notably England) in this regard.<sup>22</sup>

Notably, countries of both categories have paid huge attention to the international initiatives in this regard.<sup>23</sup> The International Chamber of Commerce (ICC) sets of rules, such as the UCP and the URDG,<sup>24</sup> have been referred to frequently by these countries' courts whenever a case comprising a letter of credit is pleaded before

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<sup>18</sup> Except the Courts of Jordan which will constitute the main focus of the following discussion. See: Awad, A. "*Khitabat Al-Daman Al-Masrefieh*" (Dar Al-Nahda Al-Arabieh, Cairo, 2007) at p. 355

<sup>19</sup> For example Nassar does provide a good summary of independent guarantees' different principles. at pp.170-172

<sup>20</sup> Al-Kilani, M. "*Amaliat Al-Bonok*" (Dar Al-Thakafa, Amman, 2009) at p. 331

<sup>21</sup> *Ibid.*

<sup>22</sup> See, for example: Al-Kilani, M. "*Amaliat Al-Bonok*" (Dar Al-Thakafa, Amman, 2009); Awad, A. "*Khitabat Al-Daman Al-Masrefieh*" (Dar Al-Nahda Al-Arabieh, Cairo, 2007); Nassar, N. & Nassar, S. "*Al-Damanat Al-bankieh fi Al-Tijarah Al-Dwalieh fi Ktabien*" (Al-Ihram, Cairo, 1997)

<sup>23</sup> Most of the banks in this region apply the UCP rules to the documentary letters of credit which they issue. Cases heard before the different countries' courts assure this fact. For example, the UCP rules have been applied to the letters of credit disputed in the Jordanian cases which have been analysed in this chapter.

<sup>24</sup> Such sets of rules have been discussed thoroughly in chapter two.

them.<sup>25</sup> In fact, some of the second category countries which have regulated letters of credit with special provisions in their laws did not promulgate enough provisions to cover all aspects of the operations of the letters of credit. These aspects include, for example, the strict compliance principle and the fraud exception. However, to address the legislative vacuum, these countries have referred to the ICC rules (UCP and URDG) in their legislations and stated that these rules are given the force of national laws and should be applied to offset the shortfall of legislation in relation to unaddressed matters. To this effect, for example, Article 341/3 of the Egyptian Commercial Law, Number 17 of the year 1999, has provided: “In the absence of a specific provision in this regard, the UCP rules which have been issued by the International Chamber of Commerce are to be implemented”.<sup>26</sup>

Yet, a criticism that could be made of the application of these ICC different rules is that none of them have inserted special rules to tackle the fraud problem which occurs in this context.<sup>27</sup> Besides, it should be noted that in some of these countries, such as Saudi Arabia, a judge would not usually apply a law or a set of rules which the parties agree to govern their contract. A judge in such a country would apply general rules of law with their main source being the Islamic Law (*Sharia*). Taking this into consideration, the next part of this section is dedicated to exploring the Islamic Law position in this regard.

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<sup>25</sup> See, for example: The Jordanian Court of Cassation, Case num. 152/75, *Journal of Jordanian Bar Association* (1976) at p. 173

<sup>26</sup> For example, the same has been provided by the Syrian Commercial Law no. 33/2007 under Article 241 and the Qatari Commercial Law no. 27 of the year 2006 under Article 399 in regard to documentary credits and Article 423 in regard to independent guarantees.

<sup>27</sup> See chapter 2.

### 7.1.3. The Islamic Law (*Sharia*) position

The most acceptable sources of the Islamic law are: the Holy *Quran*, *Sunna* and *Ijma'*. On the one hand, the Holy *Quran* is the first source and the most important source of Islamic Law. In Islam it is believed that the Holy *Quran* is the direct words of God which have been revealed to his Prophet Muhammad (peace upon him) through the Angel Gabriel. The Holy *Quran* comprises the social, political, moral, philosophical and economic basis which Muslim society is built on. On the other hand, the *Sunna* is the other main primary source of the Islamic Law. *Sunna* comprises the religious speech and actions of Prophet Muhammad (peace upon him) which have been narrated through his Companions and Islamic Imams. Moreover, *Ijma'* is the agreement of the Muslim community on religious issues.<sup>28</sup>

For example, when a Saudi judge hears a dispute concerning an independent guarantee, in the course of applying or interpreting a certain rule or principle, his point of view would be affected by the basic principles which the Islamic Law provides.<sup>29</sup> In Saudi Arabia the main source of law is Islamic Law. While the Islamic Law does not stand as the main source of law in most of the Arabian Middle Eastern countries, this piece of law is recognised as one of the effective sources of law in these countries.<sup>30</sup> The Islamic Law in these countries stands as a source for civil and criminal law hence it has an important part to play in personal status law and commercial law.<sup>31</sup> While the Islamic law is full of principles and rules which arrange the different rights and responsibilities of the different parties, this subsection is

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<sup>28</sup> Zweigert, K. & Kotz, H. “*Introduction to Comparative Law*” (Clarendon Press, 3<sup>rd</sup> ed., Oxford, 1998) at p. 304

<sup>29</sup> Nassar, N. & Nassar, S. “*Al-Damanat Al-bankieh fi Al-Tijarah Al-Dwalieh fi Ktabien*” (Al-Ihram, Cairo, 1997) at p. 177

<sup>30</sup> Zweigert, K. & Kotz, H. “*Introduction to Comparative Law*” (Clarendon Press, 3<sup>rd</sup> ed., Oxford, 1998) at p. 304

<sup>31</sup> Nassar, N. & Nassar, S. “*Al-Damanat Al-bankieh fi Al-Tijarah Al-Dwalieh fi Ktabien*” (Al-Ihram, Cairo, 1997) at p. 177

concerned with the following question: what is the Islamic law's position in relation to letters of credit and their fraud problem?

Documentary credits and independent guarantees have been defined by Islamic scholars in a similar manner to that of other scholars and different laws.<sup>32</sup> Yet, Islamic jurisprudence has construed the legal relationship between the bank and the applicant which arises from documentary credits and independent guarantees as an agency relationship.<sup>33</sup> As a result, under Islamic Law, dealing with such instruments is permitted as long as the bank is getting a commission in return for its work and the applicant does not pay the bank unless the latter is duly discharged from its obligations according to the contract.<sup>34</sup>

In the Holy *Quran*, God has prohibited fraud by referring to it in various places. One of these places is Surat AL-Mutaffifin (the chapter of defrauders). In this Surat, verses one to six, God has said:

“Woe to those who give short weight, who, when they take by measure from others, take it fully, and when they measure or weigh for them, they give them less than what is due. Do they not think that they will be raised up again on a Great Day? The Day when all mankind shall stand before the Lord of the worlds”.

In Medina (one of the Saudi Arabian cities), in the time of Prophet Muhammad, fraud by means of giving short weight and measure was prevalent among the people. Hence, God has sent down *this Surat* and as a result people started to give full weight and measure. Another example, which highlights the prohibition of fraud in Islam, could

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<sup>32</sup> Al-Saraj, M. “*AL-Nizam Al-Masrefi Al-Islami*” (Dar AL-Thakafa, Cairo, 1989) at p. 112; Al-Jondi, M. “*Fekah Al-Ta’amol AL-Mali wa Al-Masrefi Al-Hadith*” (Dar Al-Nahda Al-Arabieh, Cairo, 1989) at p. 160

<sup>33</sup> Al-Saraj, M. “*AL-Nizam Al-Masrefi Al-Islami*” (Dar AL-Thakafa, Cairo, 1989) at p. 118; Abd Al-Azeem, H. “*Khitab Al-Daman Fi Al-Bonok Al-Islamieh*” (Al-Ma’had Al-Alami Le Al-Fekr Al-Islami, Cairo, 1996) at p. 57

<sup>34</sup> *Ibid.*



be found in Surat Al-Shu'ara' (the chapter of poets), in verses 181 to 183, where God has ordered people to:

“Measure in full, and do not be of those who reduce. And weigh with a proper balance. And do not give the people their goods diminished, and do not roam the earth causing turmoil.”

Fraud is also condemned under the *Sunna*. This can be seen in the following Hadith (speech of Prophet Muhammad) where Prophet Muhammad (peace upon him) has stressed the prohibition of fraud. In his words, while reproaching a dishonest seller, he (peace upon him) said: “Whosoever deceives us is not one of us”.<sup>35</sup>

These verses and Hadith obviously do demand that people discharge appropriately their commercial commitments and do not defraud other people. The above mentioned verses in their tenor implied a fortiori prohibition of different fraud acts. The Hadith takes a similar approach. As can be seen, Islam is keen to prevent such acts which include different deceitful and illegal dealings. While there are no verses or hadith which have directly addressed the fraud problem in a letter of credit context, it could be safely said that, in view of the verses and Hadith mentioned above, fraud is generally prohibited under Islamic law and that this includes fraud perpetrated in documentary credits and independent guarantees.

## **7.2. The Jordanian position**

### **7.2.1. Introduction**

The situation in Jordan is different from the other above mentioned countries in this respect. Whilst no Jordanian legislation is dedicated to cover this area, the Jordanian

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<sup>35</sup> Abo Horaira narrated this in Sahih Al-Bokhari and Muslim. These two books, Sahih Al-Bokhari and Sahih Muslim, are the main books where many different Hadith have been written and saved.

judiciary,<sup>36</sup> unlike its neighbours, has recently heard some letters of credit fraud disputes. It must be noted that the relatively few cases, regarding fraud in the letters of credit context, heard by the Jordanian courts did not tackle all the different aspects of fraud exception which have been illustrated thoroughly in the previous chapters. For this reason, the author found that an empirical element of research by means of interviews had to be conducted with Jordanian judges in order to make tackling different aspects of the Jordanian fraud exception a possibility.<sup>37</sup>

In the following subsection the relevant legislation provided by the Jordanian Commercial and Civil Acts is highlighted. Taking into consideration the failure of these Acts to address the fraud problem in the letters of credit context, other relevant supplementary sources of law, such as case law, are examined in the succeeding subsections. The outcomes of the conducted interviews will be analysed thoroughly in these subsections.

### **7.2.2. The Jordanian Commercial and Civil Acts**

Before the issuance of the Jordanian Civil Act, Number 43 of the year 1976, civil rights and responsibilities in Jordan were governed by the Ottoman Majalet AL-Ahkam AL-Adlieh which was issued in 1876.<sup>38</sup> This can be attributed to the fact that Jordan had been part of the Ottoman Empire before the latter's collapse and the emergence of Jordan as an independent country. After the Ottoman's collapse, while different Arabian countries have chosen to adopt different foreign civil laws, the Jordanian legal community has refused to follow these countries and it rather chose to

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<sup>36</sup> Jordanian courts are divided into two main divisions; civil and criminal. They are also generally divided into three stages of litigation namely: Courts of first instance, Courts of Appeal and the Courts of Cassation. Indeed, there are specialised courts which deal with specific matters such as the labour and the customs courts. State security matters are also heard by a special court.

<sup>37</sup> More about the interviews' different aspects and mechanism can be found in Appendix 1.

<sup>38</sup> AL-Fakahani, H. "*Al-Waseet fe Shareh AL-Kanoon AL-Madani Al-Ordoni Rakam 43 Sanat 1976*" (AL-Dar AL-Arabieh lel Mawsoa'at, Cairo, 1978)

establish a new contemporary civil law which accords with Islamic principles.<sup>39</sup> Although Jordan as a country acquired its independence in 1946, the issuance of such a civil law was delayed until 1976. Such a delay can be attributed to the political and economic instability which the region has been surrounded by in that time.<sup>40</sup> The Jordanian Civil Act saw the light on 01-08-1976 after it had been approved by the Jordanian Parliament.

Similarly, the Ottoman Commercial Law remained in effect until the time when the Jordanian legislator issued the current Commercial Act Number 12 in 1966. In this respect, the Jordanian legislator has followed the Syrian and Lebanese steps which they embodied in the previous Syrian Commercial Law of the year 1949 and the current Lebanese Commercial Law of the year 1942.<sup>41</sup> Moreover, the Jordanian legislator issued other different legislations which can be considered as complementary to the Jordanian Commercial Act. These complementary legislative pieces covered the areas of industrial and commercial property, commercial agencies, transportation and e-commerce in general. The reason behind such complementary laws is to face the evolution of international trade in the various different fields.<sup>42</sup>

Jordanian legislators did not address the letters of credit operations in the Commercial Act Number 12 of the year 1966. This could be attributed to the absence of such instruments in Jordan at the time of preparing this Act which was issued in 1966.<sup>43</sup> However, interestingly, a general reference to financial credits (as they have been described) has been provided as follows:

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<sup>39</sup> Such as Egypt which has adopted the French approach in this regard.

<sup>40</sup> Melhem, M. 'Al-Tatawor AL-Tareki lel Kanoon AL-Madani AL-Ordoni', an Article published on 01-12-2011 at Alrai Newspaper. Available at <http://alrai.com/article/6286.html> Last accessed on 25-03-2013

<sup>41</sup> Al-Tarawneh B. & Melhem, B. "*Mabade' AL-Kanoon Al-Tijari*" (Dar AL-Masirah, Amman, 2012) at p. 3

<sup>42</sup> *Ibid.* at p. 4

<sup>43</sup> Al-Kilani, M. "*Amaliat Al-Bonok*" (Dar Al-Thakafa, Amman, 2009) at p. 332

“If a financial credit has been issued to guarantee a second party's rights and the bank in its role authorized such a credit, withdrawal or amendment to this credit is no longer legal without authorization from the second party in question. In such a credit, the bank is obligated to execute the credit once the documents are submitted”.<sup>44</sup>

Even though no mention of letters of credit has been provided by the Jordanian legislator, one can notice that the autonomy principle is in some way referred to by the above mentioned Article. While the term financial credits is surrounded by ambiguity as it is not clear what such a concept stands for and what financial instruments it covers, it is still noteworthy that the legislature has introduced the notion of the autonomy principle even if it was intended to be applied in a different context. Article 2 of this Commercial Act has provided some solutions where such an Act does not regulate the commercial matter in question. This Article reads as follows:

“(1) If no explicit text is available in this act, then the Civil Act rules should be applied to commercial issues; (2) However, Civil Act rules should only be applied in accordance with the special principles of the commercial law”.

As can be seen, by virtue of the above quoted Article, the Civil Act rules can be used in order to replace the legislative vacuum in the Commercial Act. However, it should be noted that such a use should not contradict the special principles that govern Commercial Law. Article 122 of the Commercial Act leads to the same conclusion where it provides: “The financial transactions which are not regulated or mentioned by this Act are subject to the Civil Act rules which address many different sorts of contracts”. Yet, no rules related to letters of credit can be found in the Civil Act rules. However, some rules which do address different fraud practices in general can be found. Article 145 of the Jordanian Civil Act states: “If a contracting party deceives

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<sup>44</sup> Article 121/1 (Act no. 12/1966)

the other party the latter can terminate the contract if it has been proved that such a deceit is material". Furthermore, Article 148 provides:

“If deceit emanates from a third party other than the contracting parties and the deceived party can prove that such a deceit has been perpetrated under the knowledge of the other contracting party, the deceived party can rescind the contract”.

Interestingly, the tenor of Articles 145 and 148 resembles that of the fraud test (the common law fraud) which was implemented by Lord Diplock in the *United Merchants* case<sup>45</sup> and which thereafter has been adhered to by succeeding English courts. Like the *dictum* delivered by Lord Diplock, knowledge and materiality have constituted the pillars and by their existence an act can be considered as deceitful and fraudulent.

Taking into consideration section 2 of Article 2 of the Commercial Act which deprives the application of the Civil Act rules if applying them would contradict the principles of the commercial law, a question arises as to whether the Jordanian courts have adhered to the Civil Act's above-mentioned rules when a letter of credit fraud dispute has been brought before them? In other words, have Jordanian courts applied this fraud test which resembles that of the common law in the letters of credit context? Moreover, have the Jordanian courts pursued an approach which is similar to that of their English counterpart in this regard?

### **7.2.3. Letters of credit fraud in the Jordanian law**

Although, the Jordanian Commercial Act has not encompassed documentary credits and independent guarantees in its numerous folds, Jordanian case law has addressed several aspects of these financial instruments. For example, the Jordanian Court of

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<sup>45</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada (The American Accord)* [1983] 1 A.C. 168

Cassation has defined documentary credits in its decision number 152/75 of the year 1976.<sup>46</sup> To this the Court of Cassation provided that:

“A documentary credit is a promise ensuing from a bank upon the request of the applicant (buyer) and by which the bank is obliged to pay the goods’ price to the beneficiary (seller) under some conditions”.

Like other Arabian Middle Eastern countries, the autonomy principle, which dictates that the letter of credit is independent from the contract in association with which it has been issued, has been expressly stressed in the many different cases heard by the Jordanian courts. For instance, the Court of Cassation decision number 1554/1999, of the year 1999, provided that: “The obligation of the bank under the letter of credit is independent from the sale of goods contract on which it was based.”<sup>47</sup>

Yet, what is distinct about the Jordanian judiciary in this regard is that it has dealt with the fraud problem. This section is not meant to discuss the different relationships and principles which ensue from a letter of credit, but it is meant to highlight the way the Jordanian courts have dealt with the fraud problem. Hence, letters of credit documentary fraud, the scope of the fraud, the standard of the fraud and the injunctions’ relief are analysed in this section.

### ***7.2.3.1. Letters of credit documentary fraud***

So far as the author is aware, this particular issue, fraud in the documents, has not been tested before the Jordanian courts. This could be attributed to the fact that no case disputing such a matter has come before the Jordanian courts. Where neither legislation nor case law offer a solution before the Arabian Middle Eastern courts, these courts have frequently referred to the jurisprudence in order to decide a dispute

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<sup>46</sup> The Jordanian Court of Cassation, Case num. 152/75, *Journal of Jordanian Bar Association* (1976) at p. 173

<sup>47</sup> See, also, Court of Cassation decisions number: 2077/1998, 511/1995 and 1776/1998. Available at Adaleh Centre for Legal Information Publications (the 11<sup>th</sup> issue, 2009), can be accessed through [www.Adaleh.info](http://www.Adaleh.info). (Subject to subscription)

which has been pleaded before them. Hence, it would be useful to find out what the Arabian Middle Eastern jurisprudence holds for such a matter. It is interesting to know that only one Arabian Middle Eastern letters of credit book has been relied on extensively by the Jordanian courts in deciding issues which arise in this regard.<sup>48</sup> In this book Awad states that:

“The submission of false documents is considered as fraud. Such kind of fraud should prevent accepting the documents and executing the letter of credit. And if the beneficiary has a solid right in triggering the letter of credit payment by the submission of the required documents, such a fact is conditioned to situations where the beneficiary submits *genuine and truthful* documents in the appropriate time specified in the letter of credit”<sup>49</sup>.

It is noteworthy to see that Awad has found that to make a conforming presentation the beneficiary has to submit genuine and truthful documents and nothing less. Notably, Awad has criticised the English House of Lords decision in the *United City Merchants* case.<sup>50</sup> The learned author has found that the formulation which the House of Lords has pursued is problematic.<sup>51</sup> Awad found that this formulation, which would not allow banks to refuse false documents unless the bank can ascertain that the beneficiary himself has intentionally participated in falsifying the documents or at least that such falsification has been done under his knowledge, works to the detriment of banks and the autonomy principle.<sup>52</sup> Moreover, while he has acknowledged that the UCP exempts and protects banks from any responsibility regarding the documents’ genuineness or falsification in situations where such falsity

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<sup>48</sup> Awad, A. “*Al-Itimadat Al-Mostanadih: Derasah le Al-kada’a wa Alfekeh Almokaran wa Kawa’ed Sanat 1983 Al-Dwalieh*” (Dar Al-Nahda Al-Arabieh, Cairo, 1989)

<sup>49</sup> *Ibid.* at p. 310 [Emphasis added]

<sup>50</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada (The American Accord)* [1983] 1 A.C. 168

<sup>51</sup> Awad, A. “*Al-Itimadat Al-Mostanadih: Derasah le Al-kada’a wa Alfekeh Almokaran wa Kawa’ed Sanat 1983 Al-Dwalieh*” (Dar Al-Nahda Al-Arabieh, Cairo, 1989) at pp. 311-312. It is noteworthy that, as in many other Arabian Middle Eastern books in this regard, the *United City Merchants* case and other English cases have been referred to by this author when he discussed the fraud issue.

<sup>52</sup> *Ibid.*

is difficult to discover, he assured that this should not be the case where such falsity is apparent to the banks.<sup>53</sup> In contrast to the English conventional view in this regard, in Awad's view the fact that the document is false in any respect, whether fraudulent or not, would give the bank the right to refuse the beneficiary's submitted documents. Remarkably, Awad's view accords with the current author's findings which call for a genuinity pre-requisite in this respect as illustrated in chapter three.

The outcomes of the interviews, which have been conducted with the Jordanian judges, correspond with Awad's and the current author's view in this regard. All of the interviewed judges were of the view that the beneficiary's intent, whether fraudulent or not, should not constitute a barrier in order to refuse non-genuine and false documents. Al-Shraideh, Al-Kharabsheh, Al-Smadi, Al-Akhras and other judges, who preferred to stay anonymous, were of the view that the non-genuinity of any of the documents would be a sufficient ground for the banks to refuse accepting the documents presented by the beneficiary. They all noted that the banks' position and the importance of the documents necessitate the application of a non-genuinity defence in this regard. For example, Judge Al-Smadi provided that:

“Irrespective of who was the reason behind the non-genuinity of the presented documents, the bank has to refuse accepting such documents when it knew that they are non-genuine. It is not the task of banks to investigate neither who is responsible for such non-genuinity nor why it has been committed”.<sup>54</sup>

Markedly, Judge Al-Smadi has given some examples which make him believe that a bank could easily know whether a document is a genuine one or not. He gave the example of a ship which does not sail from Jordan. In this manner, he found that a bill

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<sup>53</sup> *Ibid.*

<sup>54</sup> An interview with Judge Hazem Al-Smadi, of the Palace of Justice Court of Appeal, on 19-09-2011



of lading which evidences the shipment of some particular goods from Jordan by the latter ship would apparently constitute a non-genuine document.<sup>55</sup>

In view of these reasons mentioned-above, the author believes that if a case which resembles the English *United City Merchants* case was heard by the Jordanian courts the result would be contrary to Lord Diplock's views and in accordance with what has been reached in England by the Court of Appeal. Whether one of the documents presented is nullity or not and whether there is fraud perpetrated therein or not, it is submitted that a non-genuinity defence would be applied rather than a fraud exception in this respect.

### ***7.2.3.2. The fraud scope: documents, underlying transaction or both?***

Through examining the Jordanian jurisdiction it has been found that the international prolonged debate regarding the place of fraud, which would justify the execution of the fraud exception, has not found a place in Jordanian case law. In its decision number 835/2004,<sup>56</sup> the Jordanian Court of Cassation found that fraud in the underlying transaction should interrupt the autonomy principle and, accordingly, banks should refuse to pay beneficiaries when evidence to such a fraud is available in their possession before the payment has occurred.<sup>57</sup>

In this case a Jordanian buyer entered into a contract with a Canadian seller to supply the former with equipment and furniture for his hospital. Accordingly, pursuant to the Jordanian buyer's instructions, a Jordanian bank (The Housing Bank) opened a documentary letter of credit which was confirmed through a bank in Canada in favour of the Canadian seller. The contract between the parties included the shipment of nine

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<sup>55</sup> *Ibid.*

<sup>56</sup> Issued on 2004, available at Adaleh Centre for Legal Information Publications (the 11<sup>th</sup> issue, 2009)

<sup>57</sup> Interestingly one of the Jordanian authors recommends such an approach. See: Al-Kilani, M. "Amaliat Al-Bonok" (Dar Al-Thakafa, Amman, 2009) at p. 332

new equipment and furniture containers. However, when the shipment arrived, the customs declaration showed that it was only five containers which had been shipped and that they contained used and damaged furniture and medical equipment. As a result, the Jordanian buyer approached the Jordanian courts and sought to restrain the Jordanian bank from paying the documentary letter of credit amount. The Court of First Instance<sup>58</sup> granted the injunction sought by the Jordanian buyer to stop the bank's payment and likewise the Court of Appeal<sup>59</sup> did. When the matter reached the Court of Cassation it did not hesitate to confirm what had been concluded by the lower courts.

The Court of Cassation's decision number 1215/2005<sup>60</sup> illustrates the Jordanian situation in this regard with further clarity. In this case, a Jordanian buyer entered into a contract with an English seller in order to supply the former with some certain oil materials. Consequently, a documentary letter of credit was issued by a Jordanian bank (The Export and Finance Bank) and confirmed through an English bank. The documentary letter of credit required the seller to submit a bill of lading and some other documents in order to acquire the letter of credit amount. What is distinctive about such a requirement is that neither the bill of lading nor any of the other documents required by the buyer demonstrated the nature of the goods. The buyer simply requested a bill of lading and other usually demanded documents, which buyers ask for in a letter of credit context, without identifying any special conditions or specifications. When the goods arrived in Jordan, it was discovered by the Royal

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<sup>58</sup> Decision Number 2419/89. Not published.

<sup>59</sup> Decision Number 1586/2003. Not published.

<sup>60</sup> Issued on 2005, Adaleh Centre for Legal Information Publications (the 11<sup>th</sup> issue, 2009). Available also at the *Journal of Jordanian Bar Association* (2005) at p. 189

Scientific Society<sup>61</sup> that what had arrived was not the required goods according to the sale contract, but rather unusable used oil mixed with water and other pollutants. Therefore, the Jordanian buyer sought the courts' relief by means of an injunction. Indeed, the injunction was granted and when the matter was disputed before the Court of First Instance<sup>62</sup>, the Court of Appeal<sup>63</sup> and the Court of Cassation, they all concluded in the Jordanian buyer's favour. According to the Court of Cassation:

“While the documents required by the letter of credit are intact in both facial and technical aspects, they are forged because they included unreal information about the contracted for oil material. If the documentary letter of credit and the underlying sale contract are two autonomous contracts this would not be the case anymore where there is fraud. Fraud invalidates the sale contract and this would extend to the bank's relationship with the seller”.<sup>64</sup>

Interestingly, the Jordanian Court of Cassation did not find any problem in examining the underlying sale contract in order to decide whether fraud had been perpetrated in such a contract or not. Although the documents had been duly submitted by the English seller pursuant to the Jordanian buyer's instructions, this did not preclude the Jordanian courts from intervening and examining the underlying contract in order to investigate the presence of fraudulent actions.

Have the Jordanian courts limited the application of the fraud exception to what has been described as fraud in the documents or does mere fraud in the transaction suffice in order to trigger the fraud exception? While some of the interviewees, Al-Kharabsheh, Al-Akhras and Judge A, were of the opinion that fraud wherever perpetrated in a letter of credit context should disrupt the payment process, other

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<sup>61</sup> An independent, non-profit organization conducting scientific and technological research and developmental work related to the development process in Jordan.

<sup>62</sup> Decision number 2622/2001. Not published.

<sup>63</sup> Decision number 1130/2004. Not published

<sup>64</sup> Court of Cassation decision number 1215/2005. Issued on 2005, Adaleh Centre for Legal Information Publications (the 11<sup>th</sup> issue, 2009). Available also at the *Journal of Jordanian Bar Association* (2005) at p. 189

interviewed judges, Al-Shraideh, Al-Smadi, Judge B, Judge C and Judge D, were adamant that the boundaries of fraud should be limited to merely fraud that is perpetrated in the documents. Thus, it seems that the scope of the fraud exception is still a vexing matter that has not been settled amongst the Jordanian judges.

Judge A assured that he has granted an injunction in a letter of credit case where fraud has been perpetrated in the underlying transaction.<sup>65</sup> The scenario of this case, as it was articulated by this judge, is interesting and worth highlighting. In this case a Jordanian buyer had contracted with a Chinese seller for the supplying of some mobile phones. The contract stipulated that the Chinese company should not enter into the same contract for the supply of mobile phones with any other Jordanian buyers. Accordingly, a documentary letter of credit was opened to finance the sale contract. However, the Jordanian buyer found that another Jordanian company was selling the same mobile phones under the auspices of the same Chinese sellers. The Jordanian buyer sought an injunction in order to prevent his bank from paying the fraudulent Chinese sellers. While both the documents and the goods were intact, the Jordanian judge found that the Chinese seller was fraudulent when he sold the same kind of mobile phones to another Jordanian buyer contrary to the contract terms provided between them and the first Jordanian buyer. Neither examining the underlying contract nor calling the second Jordanian buyers to hear their testimony constituted a barrier before the court in order to apply the fraud exception. In deciding whether to stop the letter of credit payment or not the judge found that the Chinese seller was guilty of fraud and accordingly he granted the sought injunction.

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<sup>65</sup> Injunctions orders and the hearings which they include are not published by the Jordanian courts and accordingly they are not accessible and cannot be referred to unless the injunction itself is disputed again in higher courts.

However, other Jordanian judges have demonstrated an unwillingness to expand the fraud scope as they claimed that such an expansion would disrupt the autonomy principle.<sup>66</sup> The reasons by which they justified their unwillingness to expand the fraud scope are the same as those much often-cited and mentioned by English judges and legal writers who oppose such an expansion.<sup>67</sup> Maintaining the letters of credit utility and marketability and the importance of the autonomy principle were the reasons that for example, Al-Shraideh and al-Smadi gave to justify their adherence to limiting the fraud scope. To this effect Al-Shraideh provided:

“It should not be looked to the underlying contracts in order to stop a fraud process in a letter of credit context. The court discretion should be limited to that fraud which accompanies documents and nothing more. The reason behind this limitation is the fact that any intervention with underlying contracts in this regard would undermine the letters of credit boundaries”.<sup>68</sup>

The approach taken by the Jordanian courts corresponds with the international conventional view in this regard.<sup>69</sup> From the author’s personal point of view, such an approach is successful and should be welcomed because what is supposed to be fought against is fraud irrespective of the place in which it is perpetrated. Limiting the application of the fraud exception to documents means that some buyers will continue to suffer from the sellers’ fraud merely because it has been carried out in the transaction rather than in documents.<sup>70</sup> Conversely, some of the judges seem to have neglected the fact that adhering to such limitation would affect the letters of credit and the autonomy principle which governs it in a negative way. They neglect the fact that

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<sup>66</sup> Judge Al-Shraideh, Judge Al-Smadi, Judge B, Judge C and Judge D

<sup>67</sup> For example see: Horowitz, D. “*Letters of Credit and Demand Guarantees: Defences to Payment*” (Oxford University Press, 2010) at p. 24

<sup>68</sup> An interview with Judge Amjad Al-Shraideh, of the North Amman Court of first instance, on 21-09-2011

<sup>69</sup> For a detailed discussion about the conventional view see subsection 4.3.3.

<sup>70</sup> Jack, R. Malek, A. & Quest, D. “*Jack: Documentary Credits*” (Tottel Publishing, 4<sup>th</sup> ed., London, 2009) at p. 260

by becoming financial instruments susceptible to fraud, letters of credit would be abandoned by traders.<sup>71</sup>

### *7.2.3.3. The fraud standard*

In its decision num. 835/2004, the Jordanian Court of Cassation has stated that:

“...the documentary letter of credit...has stipulated that the imported goods have to be new and conforming to the credit. Hence, shipping goods incompatible with such a stipulation prevents the bank from paying the money referred to in the documentary letter of credit as long as the seller has not complied with the credit stipulations and any argument to the contrary is in contrary with reality and law”.<sup>72</sup>

In this case, the Court of Cassation found that shipping the goods in a condition different from the one stipulated for in the documentary credit should not go unpunished. The Jordanian court has focused on the condition of the goods themselves merely in determining whether to stop the documentary letter of credit payment. The intention of the seller has not constituted a main factor in determining the fraud existence. It should be noted that fraud has been inferred by examining the goods' condition itself and not the intent or the state of the seller's mind. In other words, the case facts were sufficient for the Jordanian court to trigger the fraud exception. The court found that shipping five containers filled with damaged or used medical equipment instead of nine filled with brand-new equipment does constitute fraud. In the court's view such an act could not be considered anything but fraud and fraud only.

In such a case, it is suggested that carriers would not jeopardize their reputation by perpetrating fraud as suing them would not constitute a difficulty as long as their place of residence and work are well known. It is submitted that in most of the cases it

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<sup>71</sup> Gao, X. “*The Fraud Rule in the Law of Letters of Credit: a Comparative Study*” (London, 2002) at p. 113

<sup>72</sup> Issued on 2004, available at Adaleh Centre for Legal Information Publications (the 11<sup>th</sup> issue, 2009)

is sellers who have the interest to defraud buyers. If an injunction is not granted, it is sellers who would vanish and suing them later would constitute an illusory relief.<sup>73</sup> Although if it is not the seller but a third person, with whom the seller has contracted to provide the goods, who has perpetrated the fraud, as between the seller and the buyer the former should bear the consequences of such fraud. It would be easier for the seller, who has chosen such a fraudulent person to deal with, to sue this person and to bear the consequences of such an unsuccessful choice.<sup>74</sup> The buyer in such an instance contracts with the seller on the assumption that he will receive the goods regardless of the source from which the later would obtain the goods and of any relations which he may enter into. Hence, whether such a fraud is perpetrated by the seller or other third parties, it is the former who should be responsible for it and it is he who would be in a better position to be sued.<sup>75</sup>

The same findings have been established by the Court of Cassation in its decision number 1215/2005.<sup>76</sup> In the same manner as that pursued in the above mentioned case, the Jordanian court found that the shipment of goods which do not conform to the letter of credit terms would impede the payment process. To this the court has provided:

“...for a documentary letter of credit to be considered as a strong guarantee in the seller’s favour, things contracted for should move into the correct direction as envisaged by the credit parties. The letter of credit should be a settlement of an honest business transaction and the seller’s behaviour should not involve fraud.”

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<sup>73</sup> Todd, P. “*Bills of Lading and Bankers’ Documentary Credits*” (Informa Law, 4<sup>th</sup> ed., London, 2007) at p. 273

<sup>74</sup> Busto, C. ‘Are Standby Letters of Credit A Viable Alternative to Documentary credits’ (1991) *J.I.B.L.* Vol. 6(2), 72 at p. 72

<sup>75</sup> Sarna, L. “*Letters of Credit: The Law and Current Practice*” (Carswell Legal Publishers, 2<sup>nd</sup> ed., Toronto, 1986) at pp. 184-185

<sup>76</sup> Issued on 2005, Adaleh Centre for Legal Information Publications, (the 11<sup>th</sup> issue, 2009)

It should be noted that the learned court did not neglect the fraudulent intention importance, but, as had been held in case number 835/2004, this court pursued the approach calling for detecting the required intent from the case particular facts. To this point the court provided that “If documents are facially conforming but in fact they are not because of the seller acts or his knowledge, the bank has to refuse the presented documents”. While the court did express its concerns toward the intent requirement, this did not constitute a barrier before the applicants to stop the credit payment as is the case in England.

In England, the courts in order to grant an injunction focus their attention mainly on the presence of intent before looking into the case particular facts.<sup>77</sup> As seen in many cases, such as the *Edward Owen*<sup>78</sup> and the *Discount Records*,<sup>79</sup> the English courts found that a fraudulent intent should be proved even when the case particular facts cannot be explained by a word other than fraud. However, it is interesting to notice how the Jordanian Court of Cassation in this case has ruled that fraud has been perpetrated from the case particular facts. In the words of the court:

“...the technical inspection certificate shows that the goods are not the oil material contracted for but unusable used oil which has been filled in coated barrels that avers the perpetration of fraud by the seller”.

The Jordanian Civil Act rules which address fraud in general, and which to a great extent resemble that adhered to by the English courts, have not been applied by the Jordanian judges in this context. It seems that the Jordanian judges have found it difficult to apply such rules in a commercial context where they would work to the detriment of the documentary credits’ applicants and contrary to the letters of credit envisaged mechanism. Interestingly, the interviewees’ responses in this regard are

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<sup>77</sup> For more about the English requirement of intent see section 5.2.1.

<sup>78</sup> *Edward Owen Engineering Ltd. v Barclays Bank International Ltd.* [1978] Q.B. 159; [1977] 3 W.L.R. 764 (CA)

<sup>79</sup> *Discount Records Ltd. v Barclays Bank Ltd.* [1975] 1 W.L.R. 315; 1 ALL E.R. 1071



compatible with the current author's view expressed in chapter five and with that reached by the Court of Cassation in the above mentioned cases.<sup>80</sup>

The judges, who have been interviewed, frequently expressed their rejection of applying civil rules in a commercial context where the former would not fit or work properly in the latter. These judges have found that, by virtue of Article 2/ 2 of the Jordanian Commercial Act, applying the civil rules which address fraud in general would contradict the principles of the commercial law. The judges have noted that letters of credit enjoy special characteristics and hence it needs a special fraud standard. In Judge Al-Kharabsheh's words:

“The fraud standard which the court will be looking for is that which could be inferred from the case facts and not from the parties' intents. Applying the latter in the letter of credit context would deprive applicants from the protection they seek”.<sup>81</sup>

One of the questions discussed with the judges is whether any breach related to the underlying contract would be considered as fraud and whether there should be a line drawn between what can be considered as fraud and what cannot be. In this regard the judges have illustrated that not any breach of the contract would suffice to be considered as fraud. They noted that it is the facts of the case itself through which fraud can be determined and be distinguished from a mere breach of contract which does not suffice to stop the payment process. To this, for instance, Judge Al-Smadi has noted that: “Only egregious fraud is the one which unravels everything”.<sup>82</sup> In addition, their Justices have provided that such a line would vary from one case to another case taking into consideration the nature of the goods, the time of the

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<sup>80</sup> See section 5.5.2.

<sup>81</sup> An interview with Judge Israa Al-Kharabsheh, of the North Amman Court of first instance, on 16-09-2011

<sup>82</sup> An interview with Judge Hazem Al-Smadi, of the Palace of Justice Court of Appeal, on 19-09-2011

shipment, the parties' expectations and many other variables which cannot be confined in one category.<sup>83</sup>

The Jordanian case law and the judges' views in this regard are remarkable. It is submitted that the Jordanian approach that has been pursued towards the fraud standard is easier to obtain than that of its English counterpart. Focusing on the intent rather than the perpetrated act is one of the main reasons which caused the English fraud exception to be viewed as a theoretical relief rather than a practical one.<sup>84</sup> The short time between the presentment of the required documents and the actual payment of the letter of credit makes providing a proof of the seller's intent a very difficult task in front of the buyers who look to stop the payment process. Nevertheless, the Jordanian approach does not place barriers in front of the buyers who seek to stop a letter of credit payment on the basis of fraud. The fraudulent intention can be inferred from the case particular facts. Moreover, similar to the approach pursued in the American *Sztejn* case,<sup>85</sup> the Jordanian judiciary seems to be aware of the fact that not every trivial breach of contract would stop the payment but that it is limited to cases that warrant the court's intervention because of the ferocity of such a breach.

Yet, while the Jordanian approach to the fraud standard is to a great extent clear in the case of documentary letters of credit, the same cannot be said about independent guarantees. It is true that many of the independent guarantee law's aspects, such as the autonomy and the strict compliance principles, have been considered by the Jordanian

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<sup>83</sup> For example, an interview with Judge Amjad Al-Shraideh, of the North Amman Court of first instance, on 21-09-2011

<sup>84</sup> Yeliz, D. 'International Trade, Maritime Fraud and Documentary Credits' [2002] *Int. T.L.R.* Vol. 8(4), 128 at p. 133; Bertrams, R. "*Bank Guarantees in International Trade: The Law and Practice of Independent (First Demand) Guarantees and Standby Letters of Credit in Civil Law and Common Law Jurisdictions*" (Kluwer Law International, 3<sup>rd</sup> ed., The Hague (Netherlands), 2004) at p. 346

<sup>85</sup> See section 3.2 for more about the *Sztejn* case.

courts in many different cases.<sup>86</sup> However, nothing regarding the fraud problem can be found in these cases. Nothing can be found in the jurisprudence and no fraud cases in this context have been before the courts yet. Interestingly, all the interviewed judges have refused to discuss independent guarantees' fraud because, as they demonstrated, they do not have as yet sufficient background to enter into such a discussion. Therefore, it is suggested that the vacuum related to independent guarantees in this regard is not merely a legislative one, but it is a vacuum at all levels which also includes case law and jurisprudence. While a blind eye can be turned on the documentary letters of credit position because of the other supplementary legal sources or the judges' presented knowledge available in this regard, the situation is different in the context of independent guarantees.

A judge hearing a fraudulent case in this regard would be surprised to know that he can be guided by nothing in order to give good reasons for his judgement. It is submitted that this would result in harmful results to the disputed parties.<sup>87</sup> A party who is involved in an independent guarantee which is governed by the Jordanian law would be surprised to know that this law does not provide any help in relation to his rights or duties in the case of a fraudulent demand. This could lead these parties to avoid the application of the Jordanian law in this regard. In some cases it would lead

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<sup>86</sup> It is interesting to note that it took a long time for Jordanian courts to recognise the differences between normal surety guarantees and independent guarantees. It is also interesting to note, that even though such a difference is well appreciated, in the latest cases the Jordanian courts still use the word guarantee interchangeably to refer to both surety and independent guarantees. For example: Court of Cassation decisions number: 650/69, *Journal of Jordanian Bar Association* (1970) at p. 95; 12/75, *Journal of Jordanian Bar Association* (1975) at p. 1214; 170/1986, *Journal of Jordanian Bar Association* (1988) at p. 1345; 350/1996, *Journal of Jordanian Bar Association* (1998) at p. 1063; 2462/1999, *Journal of Jordanian Bar Association* (2002) at p. 1713. This has been noted by Bertrams where he provided: "For instance, the Arab language has only one term which refers to both the accessory and the independent guarantee". See: Bertrams, R. "*Bank Guarantees in International Trade: The Law and Practice of Independent (First Demand) Guarantees and Standby Letters of Credit in Civil Law and Common Law Jurisdictions*" (Kluwer Law International, 3<sup>rd</sup> ed., The Hague (Netherlands), 2004) at p. 201. See as well: Al-Kilani, M. "*Amaliat Al-Bonok*" (Dar Al-Thakafa, Amman, 2009) at p. 326

<sup>87</sup> An interview with Judge D, of the Court of Cassation, on 19-09-2011

to avoiding dealing with Jordanian parties who would insist on implementing such a law which is ambiguous in this regard. This can be clearly understood in such an international context where each of the parties would prefer to resort to its own country's legal system. Thus, in order to avoid such complications, it is submitted that a reform to this area of law is urgently needed in order to protect different Jordanian and international traders, who apply the Jordanian law in their various contracts, and to facilitate Jordan's trade transactions in general.

It should be noted that the case facts which have been narrated by judge A above,<sup>88</sup> where he accepted to scrutinise the contract terms in order to find whether the Chinese sellers had sold mobile phones to other Jordanian buyers where the contract prevents them from doing so, support the chance of recognising an underlying contract exception such as that which has been proposed and applied recently by the English courts in Jordan.<sup>89</sup>

#### *7.2.3.4. Letters of credit fraud Injunctions*

The Jordanian Civil Procedure Act, Number 24 of the year 1988,<sup>90</sup> has allocated some provisions to deal with injunctions. Article 32 of this Act provides:

“...the judge of urgent matters, without permanently prejudicing the parties' rights, may grant a temporary injunction until a full hearing court can adjudicate the disputed matter if requested to grant an injunction in a case where: 1- the matter is urgent and the right of the party seeking an injunction would be lost if no judiciary relief is granted in that time...”<sup>91</sup>

Notably, this Article has stipulated that for granting an injunction an element of urgency should exist. Although the determination of the urgency of the disputed

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<sup>88</sup> See subsection 7.3.3.2.

<sup>89</sup> See subsection 5.3.4.

<sup>90</sup> Amended by the law Number 16 of the year 2006.

<sup>91</sup> The judge of urgent matters is the judge who is responsible for adjudicating requests for injunctions. This judge is usually the head of the Court of first instance or another judge which the former may appoint.

matter is under the discretion of the judge of urgent matters, injunctions sought to stop a letter of credit on the fraud basis have been usually considered as urgent.<sup>92</sup> The potential loss of the letter of credit amount makes such a matter an urgent one which merits an injunction.<sup>93</sup> By the virtue of Article 32, the judge who grants an injunction grants it temporarily, without adjudicating the rights of the different parties, until a full court can hear the matter disputed.<sup>94</sup> Accordingly, in the absence of a special provision that regulates the injunctions' procedure in a letter of credit context, a letter of credit applicant can ask for this judiciary relief in order to stop the fraudulent beneficiary from collecting the fruits of his dishonesty.

Unlike the English approach,<sup>95</sup> the fraud proof standard does not constitute an obstacle in front of an applicant who seeks the Jordanian courts' relief to restrain the bank from paying the fraudulent beneficiary. On the one hand, the banks' need for acquiring an established standard of fraud in order to refuse to pay on its own the fraudulent beneficiary has been frequently illustrated by the Jordanian courts.<sup>96</sup> The importance of this requirement is well understood as it protects the bank and justifies its refusal to pay in later potential litigation.<sup>97</sup> On the other hand, the requirement of an established fraud standard has not been adhered to by the Jordanian courts in the

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<sup>92</sup> Zu'bi, A. "*Iltizamat AL-Bonok Al-Mosderah fe Al-Itimadat AL-Mostanadieh: Dirasah Mokaraneh*" (Dar Wa'el le Al-Nasher, Amman, 2000) at p. 105

<sup>93</sup> Al-Kharabsheh, I. "*Al-Ghosh fe Al-A'ked Al-Asasi Ka Estesna' ala Mabda' Al-Istiklal fe AL-Itimadat AL-Mostanadieh*" at p. 94. A Master's dissertation submitted to the University of Jordan in 2010. Available at the University of Jordan library

<sup>94</sup> AL-Qudah, M. "*Kanoon Osol Al-Mohakamat AL-Madanieh wal Tanzeen AL-Gada'ai fel Ordon*" (Dar Althakafah, 1<sup>st</sup> ed., Amman, 1992) at p. 75

<sup>95</sup> Ellinger, E. 'Documentary Credits and Fraudulent Documents' (eds.) in Chinkin, C., Ho, P. & Chan, H. "*Current Problems of International Trade Financing*" (National University of Singapore, 2<sup>nd</sup> ed., 1990) 139, at p. 163

<sup>96</sup> See, for example: Decision number 2622/2001 & Decision number 1130/2004. Both decisions are not published.

<sup>97</sup> Harfield, H. "*Bank Credits and Acceptances*" (The Ronald Press Company, 5<sup>th</sup> ed., New York, 1974) at p. 81

case of injunctions.<sup>98</sup> None of the Jordanian cases discussed above, where injunctions have been granted, showed the need for such a difficult test of proof in order to grant the requested injunctions. The Jordanian courts have applied a test which is to a great extent identical with the “only realistic inference” test applied in some of the English cases.<sup>99</sup> The applicant under such a test is not required to prove that fraud has been perpetrated beyond any doubt as in the established test, but what he has to do is to show from the facts and the documents presented that the only reasonable explanation is that there is fraud in the transaction.

Whilst it is submitted that applying such a test is a successful step counted in favour of the Jordanian approach as it provides practical rather than theoretical means to obtain an injunction, the Jordanian application to this standard is not without its own problems. In fact, the Jordanian courts do not distinguish between the two main categories which injunctions in a letter of credit context may be divided into as illustrated in Chapter Six.<sup>100</sup> Jordanian courts have applied the test that resembles the “only realistic inference” in both categories. This includes cases where a holder in due course is involved and cases where no holder in due course is involved in the letter of credit transaction. It is submitted that, although such an approach is applauded in the latter category, this would work to the detriment of banks in particular and the letters of credit mechanism in general if applied to the first category.

In case num. 1215/2005,<sup>101</sup> it seems that the Jordanian Court of Cassation has neglected the fact that, when the injunction was sought before it to stop the Jordanian bank from reimbursing the English confirming bank, the English bank had already

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<sup>98</sup> For example: Court of Cassation case number 1215/2005. Issued on 2005, Adaleh Centre for Legal Information Publications (the 11<sup>th</sup> issue, 2009)

<sup>99</sup> For example: *Themehelp Ltd v West* [1996] Q.B. 84; [1995] 3 W.L.R. 751 (CA); *United Trading Corp SA v Allied Arab Bank Ltd.* [1985] 2 Lloyd’s Rep. 554 (CA)

<sup>100</sup> See section 6.4.

<sup>101</sup> Issued on 2005, Adaleh Centre for Legal Information Publications (the 11<sup>th</sup> issue, 2009)

discharged its documentary duties and paid the letter of credit amount. The Jordanian court neglected such a fact and granted an injunction to stop the Jordanian issuing bank from reimbursing its English counterpart which had duly fulfilled the obligation entrusted to it. The same course has been pursued in the Court of Cassation case number 835/2004.<sup>102</sup> The Jordanian issuing bank has been prevented from reimbursing the Canadian confirming bank because of the test applied in this case. Although the issuing bank has frequently, before the three different level of courts, reminded the court of the special role which the confirming bank plays in confirmed credits, this has not been given any particular attention by these courts. Interestingly, the same approach has been pursued where no confirming bank has existed. This can be seen in the Court of First Instance decision num. 407/2009<sup>103</sup> where an injunction<sup>104</sup> has been granted on a similar basis as that of “the only realistic” test applied occasionally by English courts.

As previously pointed out in Chapter Six, a moment’s reflection would reveal that the established fraud test is the one which suits the category of injunctions where a holder in due course, such as confirming and negotiating banks, is involved. This test would serve better both the banks’ expectations and the autonomy principle which maintains the smooth running of such instruments in the world trade realm. Furthermore, applying the “only realistic inference” test is recommended in the second category which does not involve a holder in due course. Accordingly, in the absence of a confirming bank and where the issuing bank has not paid yet there would be no problems if the later test is applied. In such a case, the autonomy principle which

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<sup>102</sup> Issued on 2004, available at Adaleh Centre for Legal Information Publications ( the 11<sup>th</sup> issue, 2009)

<sup>103</sup> Issued on 2009, not published

<sup>104</sup> Injunction number 233/2009, not published

protects the banks' and parties 'expectations would not work against granting the requested injunction.

While English courts have been usually inclined to apply the strict established test in both categories,<sup>105</sup> the Jordanian courts seem to apply the “only realistic inference” test in both categories. Neither the English nor the Jordanian courts have noticed that each test has to be applied to the category which suits it. On the one hand, it is submitted that applying the English approach in this regard would mean that no injunctions would be available in a letter of credit context. On the other hand, applying the Jordanian approach would destroy the autonomy principle application in the letters of credit context. Hence, it is suggested that it would be a better approach if both jurisdictions learn from each other's experience, and so apply both tests each in its category, in order to enhance their approach to this particular area of law.

Providing a cause of action, which has been frequently required by the English courts in order to grant an injunction,<sup>106</sup> is not required by the Jordanian courts in this respect. It seems that the fact that there is fraud somewhere in the letter of credit transaction is itself sufficient to overlook such a requirement. However, it should be noted that while such an approach is recommended in cases where there are no holders in due course, this should be avoided in cases where a holder in due course is involved.<sup>107</sup> The confirming bank's knowledge of the perpetrated fraud should be proved in order to acquire the requested injunction against the issuing bank. Banks issue and confirm letters of credit on the assumption that as long as they discharge

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<sup>105</sup> See subsection 6.4.1.

<sup>106</sup> See, for example: *RD Harbottle (Mercantile) Ltd v National Westminster Bank Ltd* [1978] 1 QB 146

<sup>107</sup> See subsection 6.5.2.



their documentary duties in good faith they will be reimbursed.<sup>108</sup> Therefore, if these banks are prevented from collecting the money which they have already paid through issuing and confirming letters of credit, such instruments will lose their marketability and reputation.<sup>109</sup> Letters of credit would be abandoned because of the potential risks that they would involve and that might harm the moral and physical interests of these banks.

The cause of action point has been discussed with the interviewed judges. At the beginning of the discussion in this regard, most of the judges were adamant that the approach pursued by the Jordanian courts is a correct one. Nevertheless, they have rejected the views about which they have previously been adamant and changed their mind after thinking about such matters from different perspectives. When the learned judges looked at the matter from the banks' perspective they realised how dangerous it would be to grant an injunction in a confirmed letter of credit context where the foreign confirming bank has already paid in good faith the letter of credit amount. The judges have realised that in such a case the maintenance of the autonomy principle should prevail against fraud unless there has been an established case of fraud which the confirming bank knows about before the time it paid. According to Judge Al-Shraideh: "A holder in due course should be sheltered from later defences where he does not know about it".<sup>110</sup> Al-Smadi, Al-Kharabsheh, Al-Akhras, Judge A and other judges have all expressed views which agree with Judge Al-Shraideh's view. While the Jordanian courts' approach to the first category, which includes holders in due course, is unfortunate, it is submitted that their approach concerning the second

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<sup>108</sup> Ellinger, E. "*Documentary Letters of Credit: A Comparative Study*" (University of Singapore Press, Singapore, 1970) at pp. 196-197

<sup>109</sup> *Ibid.* at p. 197

<sup>110</sup> An interview with Judge Amjad Al-Shraideh, of the North Amman Court of first instance, on 21-09-2011

category, where no holders in due course are involved, is recommended in this regard and that judges have expressed views which accord with such a fact.

Unlike English law, the balance of convenience also has not comprised a requirement by the Jordanian courts when an injunction to stop a letter of credit is sought. Instead of applying legal principles which have been developed outside the letters of credit context, such as the balance of convenience requirement, the Jordanian courts in the different cases brought before them have required the applicant to present a guarantee in order to grant the required injunction.<sup>111</sup> The reason behind such a guarantee is to assure the court that the applicant's claims are genuine and not just a device through which he can delay the letter of credit payment.<sup>112</sup> Such a guarantee may be used later to compensate other parties (the banks and the beneficiary) from losses which they may sustain from delaying the payment in case it turns out that the applicant's claims were false.

All of the interviewed judges assured the soundness of such an approach. They were of the view that the balance of convenience requirement is redundant and that providing a guarantee instead would constitute a more useful requirement because of what it provides in terms of practical and effectual implications in this regard.<sup>113</sup> The judges found that rather than looking to the issuing banks in weighing such a balance it should be the fraudulent beneficiary that the court should weigh the balance against. Accordingly, they were of the view that where fraud has been proven the balance of convenience will always tilt in favour of granting the required injunction and therefore there is no point in considering such a requirement. In judge A's view:

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<sup>111</sup> For example, injunction number 233/2009. Not published.

<sup>112</sup> An interview with Judge A, of the South Amman Court of first instance, on 20-09-2011

<sup>113</sup> An interview with Judge C, of the West Amman Court of Appeal, on 19-09-2011

“The balance of convenience does not constitute a requirement which Jordanian courts ask for in order to grant an injunction in a letter of credit fraud case. I cannot see the benefit from stipulating for such a requirement... Asking the injunction’s applicant to provide a guarantee is more useful in this regard”.<sup>114</sup>

It is noteworthy that the English debate regarding whether an injunction is sought against the bank or the beneficiary himself has not been controversial in Jordan.<sup>115</sup>

The reason behind the absence of this debate may be attributed to the absence of the balance of convenience requirement itself. The interviewed judges have frequently assured such a conclusion.

### 7.3. Conclusion

While it is only case law which addresses the fraud problem in the letters of credit context in Jordan, the Jordanian judge, as provided by Article 3 of the Jordanian Commercial Act, has the discretion to apply the case law if he wishes to.<sup>116</sup> Although such precedents have been usually applied in most of the cases, the Jordanian judge is not obligated to do so. This also applies to other Arabian Middle Eastern countries which this work considers.<sup>117</sup> Jordanian judges seem to be affected by the international views in this regard. This can be clearly seen where it is suggested that the judge’s view depends on what he reads from international texts and cases.<sup>118</sup> Accordingly, under the current Jordanian position, an applicant’s success in his application to restrain a letter of credit payment will ultimately depend on the judge’s personal view to this area of law. For example, an applicant would be surprised to

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<sup>114</sup> An interview with Judge A, of the South Amman Court of first instance, on 20-09-2011

<sup>115</sup> See subsection 4.3.2

<sup>116</sup> Article 3 of the Jordanian Commercial Act provides: “If there is no legal provision that can be applied, the judge may be guided by case law, the jurisprudence and the requirements of fairness and commercial practice”.

<sup>117</sup> For example, Article 3 of the Syrian Commercial Act, Number 33 of the year 2007, provides the same as to that of its Jordanian counterpart.

<sup>118</sup> For instance, all of the Jordanian cases in this regard have referred to different English and American cases and texts in order to justify the approaches which they have pursued. An interview with Judge A, of the South Amman Court of first instance, on 20-09-2011

know that the same facts that qualified him for an injunction in a previous case would not qualify him in another case because it is heard by another judge whose views are different from his preceding fellow. In Goode's words:

“There is a divergence of views not only between different law systems, but even within the same law system both on what constitutes a defence to a claim on a credit and on the approach to be taken by the court on an application for interim injunctive relief.”<sup>119</sup>

While most of the analysed cases and conducted interviews show that Jordan has developed, to some extent, a recommended approach in this regard, it is submitted that this would not guarantee the decisions or directions of future litigation. In fact, misapplications have been seen in some of the analysed cases. These include, for example, the fraud proof standard and the cause of action requirement. This also could be expected where there are no rules in the different law sources which regulate the fraud exception application in the context of independent guarantees. Similarly, it is also submitted that such misapplications might occur at an Arabian Middle Eastern level where there are no rules in the different law sources which regulate the fraud exception application.

The draftsmen of the ICC rules have, since the promulgation of the first edition of the UCP in 1933, brought up many reasons to justify their deliberate neglect to introduce rules that regulate fraud in this context. The main reason stated by these draftsmen is that it would be a better approach to leave such an issue to national laws and judges who can determine the best ways to tackle such a problem as it better suits them.<sup>120</sup> It is suggested that the ICC draftsmen should take into consideration that their approach has, at least from an Arabian Middle Eastern perspective, proved to be ineffective

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<sup>119</sup> Goode R, *Transnational Commercial Law, Texts, Cases and Materials*, (Oxford Press, Oxford, 2007) at pp. 353-354

<sup>120</sup> For example Article 1.05(c) of the ISP98 expressly states: “These rules do not define or otherwise provide for defences to honour based on fraud, abuse, or similar matters. These matters are left to applicable law”.

and, accordingly, introduce some provisions to regulate the fraud problem in their next publications and revisions. Similarly, it is also suggested that Arabian Middle Eastern legislators should take such a matter into consideration and accordingly promulgate rules that tackle such a thorny matter.

In the meantime, Arabian Middle Eastern countries are invited to adopt the UN Convention on Independent Guarantees and Stand-by Letters of Credit to tackle the shortage of law which they suffer from regarding fraud perpetrated in the independent guarantees context.<sup>121</sup> Nevertheless, taking into consideration the legislative vacuum concerning documentary letters of credit fraud at the national and international level, it is suggested that the only aid is expected to come from the ICC draftsmen.

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<sup>121</sup> It is noteworthy that out of the few countries which have ratified the Convention there are two Arabian Middle Eastern Countries, namely; Kuwait and Tunisia. Indeed, it is recommended that the other Arabian Middle Eastern Countries take the same initiative and ratify this Convention.

## Chapter Eight: Conclusion

### 8.1. Findings and recommendations

This work has critically examined the fraud exception application to the autonomy principle of documentary credits and independent guarantees under the English and Jordanian law. This examination has been pursued in order to explore the problems associated with this exception application in both jurisdictions and consequently to propose some legal reforms which would solve such problems and so prevent or at least mitigate fraud occurrence. The importance of such an examination lies in the fact that independent guarantees and documentary credits are prolific in international trade realm and that fraud could badly affect these instruments' viability, parties which use them and commerce in general.<sup>1</sup>

In this work it has been argued that, whilst the autonomy principle plays a vital role in international trade, the courts should facilitate the fraud exception application and recognise other exceptions, such as the non-genuinity and the underlying contract exception, where the former exception would be unable to prevent fraud occurrence. The current author suggests that the current English fraud exception is narrow and problematic for four reasons; firstly, the fraud exception has been applied where banks receive documents and have to decide from their face whether to pay or not. Hence, under English law, banks, whose work is of a documentary nature, are required to establish fraud in order to stop an independent guarantee or a documentary credit payment. Yet, in this work, the current author suggests that such an application would place banks in an unenviable position. Secondly, a general view has been

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<sup>1</sup> Schulze, WG. 'The UCP 600: A New Law Applicable to Documentary Letters of Credit' [2009] 21 *SA Merc LJ*. 228 at p. 228

established that the fraud exception application is limited to fraud that is perpetrated in the documents rather than fraud which might be perpetrated in the underlying contract which has evolved through these instruments. However, it has been suggested in this work that this distinction is an illusory one and would serve to increase fraudulent conducts rather than to decrease such conducts.

Thirdly, under English law, a fraudulent intent has to be proved in order to apply the fraud exception. Yet, this work argues that such a proof is hard to obtain if the short time between the fraudulent beneficiary's call on the instrument and the time at which the bank would pay and the difficult nature of the intent proof are taken into consideration. Fourthly, English courts have burdened the party seeking their protection, by means of injunctions in order to restrain the fraudsters from obtaining the letter of credit amount, with very difficult requirements. These requirements comprise: an established proof of fraud, a cause of action and a balance of convenience which requires the applicant for an injunction to show the defendant's inability to compensate him if an injunction is not granted and, at the same time, his ability to compensate the defendant if he fails later to support his preliminary claims before a full trial court. The current author argues that while stipulating for some of these requirements has been exaggerated, other requirements have been misplaced and misapplied frequently by English courts.

Taking the above observations into consideration, it is recommended that the English courts should reform their approach to this area of law in the following manner: firstly, it is suggested that banks should not become embroiled in disputes pertaining to underlying contracts' but that they should merely scrutinize to ascertain whether documents' submitted are genuine or not. The application of the fraud exception at this stage should be replaced by a pre-requisite of genuinity and, accordingly, a bank's

attention should be directed to the documents' themselves rather than the intent behind them. In this regard, the current author urges the English courts to reconsider the *United City Merchants* case.<sup>2</sup> In the same manner, because its uncertainty compromises its acceptability, the current author suggests that the nullity exception has no application in this context.<sup>3</sup> Secondly, this work advocates that the theoretical distinction between fraud in the documents and fraud in the underlying transaction should be refuted and ignored. Thus, it is suggested that English courts should develop practical techniques to mitigate fraud rather than finding theoretical justifications in order to escape adjudicating such matters. Their aim should be to prevent fraud irrespective of the point at which it occurs.

Thirdly, instead of the common law fraud standard which has proved difficult and unattainable, the author proposes that an objective test of fraud which focuses on the state of the goods rather than the beneficiary's intent should be embraced by English courts in documentary credit cases. Such a proposed test would make the fraud exception an obtainable relief before a defrauded applicant who seeks a court's protection. In contrast, due to the special features and characteristics which an independent guarantee enjoys, this work suggests that the fraud exception would not mitigate fraudulent conducts which might occur in such a context. These special characteristics encompass the lack of utilised documents in independent guarantees and the fact that, unlike documentary credits which usually facilitate a sale of goods, the purpose of such guarantees would be difficult to ascertain. Moreover, it is submitted that the Singaporean unconscionability exception should be refuted as

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<sup>2</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada (The American Accord)* [1983] 1 A.C. 168; [1982] 2 W.L.R. 1039 (House of Lords)

<sup>3</sup> The nullity exception has been discussed in chapter 3.



well.<sup>4</sup> Such a refusal could be attributed to the uncertainty intrinsic in such a concept. In this work, it is suggested that English courts should adopt the underlying contract exception in this context.<sup>5</sup> Indeed, through utilising such an exception, an applicant can restrain the beneficiary from acquiring the independent guarantee amount where the latter is breaching the underlying contract terms which condition the independent guarantee's payment. Interestingly, recent English cases do show a trend which calls for the adoption of this exception which reflects the parties' expectations.<sup>6</sup>

Finally, the current author recommends that English courts should review their application to injunctions in this area of law. In view of that, English courts should keep in mind that the conditions which an injunction requires differ where a bona fide holder in due course is involved from cases where there are no such parties. A proof of an established fraud in the former case is well-understood where such a condition works to protect bona fide parties who have duly fulfilled their commitments. However, requiring such a concrete proof where no holders in due course are existent serves neither legal nor commercial purposes. By the same token, the requirement of a cause of action, which dictates that the bank's knowledge about the alleged fraud should be proved, is well appreciated in cases which involve a holder in due course. For instance, unless a confirming bank knows about the fraud before it has paid, an issuing bank should not be restrained from reimbursing the former in a documentary credit context. However, to require such knowledge in cases which do not involve bona fide parties does not stand accurate legal or commercial analysis.

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<sup>4</sup> The unconscionability exception has been discussed in chapter 5.

<sup>5</sup> The underlying contract exception has been discussed in chapter 5.

<sup>6</sup> *Simon Carves Ltd v Ensus UK Ltd* [2011] EWHC 657 (TCC); [2011] B.L.R. 340; [2011] C.I.L.L. 3009 (first instance); *Sirius Insurance Co v FAI General Ltd* [2003] EWCA Civ 470 (CA) [2004] UKHL 54; [2004] 1 WLR 3251 (House of Lords); *TTI v Hutchison 3G UK Ltd* [2003] EWHC 762 (TCC); [2003] 1 ALL ER (Comm) 914

Moreover, it is suggested that a balance of convenience has no application in the injunctions context of this area of law. Under English law, a balance of convenience weighted against a bank would interrupt the injunction's application and as a result will let the fraudulent beneficiary escape with the money he obtains through fraud. Hence, it is submitted that whilst banks should not get embroiled in underlying contracts and with the question of whether fraud has been perpetrated there or not, the balance of convenience should be always implicitly weighted against the fraudulent beneficiary and not banks. English courts should take this into consideration in order to make an injunction a practical weapon in the hands of aggrieved applicants who seek their help.

On the other hand, it is suggested in this work that such misapplications might occur at an Arabian Middle Eastern level where there are no rules in the different law sources which regulate the fraud exception application. Due to such lack of rules, this work submits that this would not guarantee the outcome or direction of future litigation in this regard. In fact, misapplications have been seen in some of the analysed cases. This included, for example, the fraud proof standard and the cause of action requirement.<sup>7</sup>

In the meantime, the current author suggests that Arabian Middle Eastern countries should adopt the UN Convention on Independent Guarantees and Stand-by Letters of Credit in order to address the shortage of law which they suffer from regarding fraud perpetrated in the independent guarantees context.<sup>8</sup> Nevertheless, taking into consideration the legislative vacuum concerning documentary letters of credit fraud at

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<sup>7</sup> See chapter 7 for more in this regard.

<sup>8</sup> It is noteworthy that out of the few countries which have ratified the Convention there are two Arabian Middle Eastern Countries, namely Kuwait and Tunisia. Indeed, it is recommended that the other Arabian Middle Eastern Countries take the same initiative and ratify this Convention.

the national and the international levels, it is suggested that the only aid is expected to come from the International Chamber of Commerce (ICC) draftsmen.

Whilst the autonomy principle does play an important role in the independent guarantees and documentary credits practice, this work has argued that courts of these countries should keep in mind that such a principle is not of an absolute nature. Such a principle should not be blindly applied and should not automatically prevail over other equitable or contractual doctrines. Whenever a court hears a case in such a context, it should weigh the different and, sometimes, contradicting considerations against each other in order to decide this case. The courts should keep in mind the expectations of the different involved parties, the purpose of the utilised instrument and the maintenance of the international utility of these instruments.

Fraud is a major concern for banks that handle documentary credits and independent guarantees and any attempt to mitigate its occurrence should be applauded. Therefore, the fraud exception boundaries should be understood. The court when looking to this area of law should distinguish between different dictums and criteria which have been developed in such a context. Blindly applying these dictums and criteria without appreciating their applicability and validity in respect of the facts of each different case would have harmful consequences. While some of these dictums can be applied in many cases, this should not be unconditional. Hence, courts are invited to test whether a certain statement, which has been made by earlier courts, applies to the case which they might have before them. Documentary credits and independent guarantees are international financial instruments which involve many different parties and many different kinds of contracts and which, accordingly, open the door for many different and varying disputes to occur. Hence, what is a good law in a certain case might not

be the same in another case and therefore the facts of each case should be considered cautiously.

It is true that it was previously thought that the autonomy principle was of an absolute nature and that there was no exception to such a principle.<sup>9</sup> Yet, sooner rather than later it has been recognised that an exception to this principle is needed where blatant cases of abuse and fraud start to show up and as a result a fraud exception has been established. Similarly, the fraud exception had been considered as the only and unique exception. Nevertheless, soon demands arose to recognise other exceptions and in virtually all jurisdictions exceptions have been recognised. Therefore, it is common to witness the widening of the conventional common law English fraud exception and to see other exceptions recognised where the former does not provide the parties with the protection that they envisage. Indeed, what was the consensus view in this area of law 10 years ago would not go unchallenged nowadays.<sup>10</sup> It should not be forgotten that “The documentary credit is a creature of the early twentieth century, somewhat later but nonetheless from an era when trading conditions were different from today”<sup>11</sup> and hence it is a corollary to see this area of law developing from time to time. However, it is true that “in order for points of law to be established we have to wait for the right facts to present themselves and for the right arguments to be run”.<sup>12</sup>

In an independent guarantee context, whilst there are no protections offered under the fraud exception umbrella in cases where the beneficiary demands payment in an abusive manner, it would be normal to see other exceptions like the unconscionability

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<sup>9</sup> *United Trading Corporation SA v Allied Arab Bank* [1985] 2 Lloyd’s Rep. 554, 561

<sup>10</sup> Mugasha, A. ‘Enjoining the Beneficiary’s Claim on a Letter of Credit or Bank Guarantee’ [2004] *J.B.L.* 515 at p. 537

<sup>11</sup> Todd, P. “*Bills of Lading and Bankers’ Documentary Credits*” (Informa Law, 4<sup>th</sup> ed., London, 2007) at p. 283

<sup>12</sup> Hughes, M. ‘Standby Letters of Credit and Demand Guarantees’ [2005] *B.J.I.B. & F.L.* Vol. 20(5), 174 at p. 174

and the underlying contract exceptions evolving in order to fill the existent protection gap. By the same token, in a documentary credit context, where the common law fraud standard is not efficient to combat fraud practices and to offer the applicants the desired protection, it would be normal to see propositions which call to widen the fraud standard limits or to embrace other exceptions occasionally. In this regard, suggestions which call for accepting the risk of such fraudulent and abusive demands and considering them as a risk which the parties have accepted to take are ingenuous.<sup>13</sup> If fraud is left as a gap in order to maintain the attraction of documentary credits and independent guarantees as a result of their autonomous character, the rise in fraud will remain and losses will become substantial. Ultimately, the risk of fraud will diminish the attractiveness of these instruments.

## **8.2. Limitations and further possible research**

The fraud exception of the autonomy principle is a large area which would provide an unlimited amount of discussion and analysis. However, the limited scope of this work does not allow for an extensive treatment of the different issues in this regard. Whilst this work has examined other exceptions, such as the nullity exception, the unconscionability exception and the underlying contract exception, because of their overlap with the fraud exception, this work is not intended to examine other potential exceptions to the autonomy principle of such instruments.<sup>14</sup> Hence, it is suggested that future work, if pursued in this area of law, should take these potential exceptions into consideration.

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<sup>13</sup> *Edward Owen Engineering Ltd v Barclays Bank International Ltd* [1978] QB 159, 170 & 176

<sup>14</sup> The illegality exception is one of these well-established exceptions nowadays. For a good discussion on the illegality exception, for example, see: Enonchong, N. 'The Autonomy Principle of Letters of Credit: An Illegality Exception?' [2006] *L.M.C.L.Q.* Vol. 3, 404; Enonchong, N. "*The Independence Principle of Letters of Credit and Demand Guarantees*" (Oxford University Press, Oxford, 2011); Horowitz, D. "*Letters of Credit and Demand Guarantees: Defences to Payment*" (Oxford University Press, 2010)

This work is also not intended to cover the subject of conflicts of law which might occur in such an area of law.<sup>15</sup> If time is sufficient, taking into account the existence of different parties who are located in different countries in this context, this study would have explored the subject of conflicts of law in this regard. Besides, this work does not cover issues of assignments, transfers and other different relationships which might arise between the different parties involved in this context.<sup>16</sup> Appreciating these different relationships is so important in this context. For example, as has been seen in chapter six, being a holder in due course rather than a normal beneficiary has affected the fraud exception application in this regard. Had this study given more time, an examination to these different relationships would have been completed.

Moreover, electronic means which have recently been introduced in this context are not discussed in this work.<sup>17</sup> While it was noted a few years ago that the: “Letters of credit practice is still grounded in a paper mentality”<sup>18</sup> and that it is not expected that the electronic medium will make significant changes to the paper based letters of credit market for another couple of years,<sup>19</sup> it is submitted that it might be the proper time now to examine the viability and implications of such electronic medium. Such an examination is well-appreciated where the Supplement to the Uniform Customs and Practice for Documentary Credits for Electronic Presentation (well-known as the

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<sup>15</sup> For a good discussion in this regard, see: Malek, A & Quest, D. “*Jack: Documentary Credits*” (Tottel Publishing, 4<sup>th</sup> ed., Sussex, 2009); Ellinger P. & Neo, D. “*The Law and Practice of Documentary Letters of Credit*” (Hart Publishing, Oxford, 2010); King, R. “*Gutteridge & Megrah’s Law of Bankers’ Commercial Credits*” (Europa Publications Limited, 8<sup>th</sup> ed., London, 2001)

<sup>16</sup> The following provide good working examples in this regard: Ellinger P. & Neo, D. “*The Law and Practice of Documentary Letters of Credit*” (Hart Publishing, Oxford, 2010); Bertrams, R. “*Bank Guarantees in International Trade: The Law and Practice of Independent (First Demand) Guarantees and Standby Letters of Credit in Civil Law and Common Law Jurisdictions*” (Kluwer Law International, 3<sup>rd</sup> ed., The Hague (Netherlands), 2004); Mugasha, A. “*The Law of Letters of Credit and Bank Guarantees*” (Federation Press, Sydney, 2003)

<sup>17</sup> For more regarding this point, see: Malek, A & Quest, D. “*Jack: Documentary Credits*” (Tottel Publishing, 4<sup>th</sup> ed., Sussex, 2009)

<sup>18</sup> Barnes, J. ‘E-Commerce and Letter of Credit Law and Practice’ [2003] *Documentary Letter of Credit World* Vol. 5(7), 30, at pp. 32-33

<sup>19</sup> Christensen, K. ‘Will the UCP Help Electronic Trade Grow Up?’ [2003] *DCInsight* Vol. 9(1), 16, at pp. 16-17

eUCP) has come into force recently in order to accommodate presentation of electronic records alone or in combination with paper documents in this context.<sup>20</sup>

As seen in chapter seven, while the work has examined the current position in other Arabian Middle Eastern countries, the focus of the discussion was the Jordanian jurisdiction in particular. Taking into consideration the current legislative vacuum, such a limitation was due to the fact that, unlike the Jordanian courts, other Arabian Middle Eastern courts did not witness fraud disputes. It is suggested that if these courts have the opportunity to hear similar cases in the future, a more comprehensive study of this region could be pursued. Such a possible study could be pursued as well if any of these countries enunciate some provisions to tackle the fraud exception application to this area of law.

Finally, it should be remembered that, where the documentary credits and independent guarantees law is still developing, it will be customary to see the fraud exception developing from time to time. Bearing this in mind it will be necessary to examine this exception every once in a while in order to evaluate further developments to this area of law.

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<sup>20</sup> The eUCP supplements the Uniform Customs and Practice for Documentary Credits (2007 Revision ICC Publication No. 600)

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## Appendix

### The Interviews' Mechanism

Empirical research is important where secondary data sources prove insufficient to test the researcher's hypothesis. Empirical research may be divided into two main approaches; qualitative and quantitative research.<sup>1</sup> On the one hand, for quantitative research in this area the foremost method is the social survey which through the researcher will be able to generate quantifiable data relating to a large number of people who are selected in order to test hypotheses, and this is why it has been so widely used.<sup>2</sup> Surveys can be made through distributing questionnaires to a group of people who are experienced in the area to be researched and whose views are worth ascertaining. All that the researcher has to do is to plan, design and distribute the questionnaires to the group to be researched. After the group has responded to the questionnaire, the researcher will be able to analyse the new collected data.

The use of questionnaires can save time and effort where the group of people to be researched is large.<sup>3</sup> Moreover, using this method produces speedy results, can be completed at the respondent's convenience and has the merit of confidentiality. However, many disadvantages can attach to the use of this method. For example, this method does not allow for the probing or clarification of the responses collected if this is needed, especially where responses are vague or do not deal with the point expected by the researcher.<sup>4</sup> Moreover, because of the nature of their work, in the course of which potential respondents may be asked frequently to fill in surveys, surveys do not

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<sup>1</sup> Salter, M. & Mason, J. "*Writing Law Dissertations: An Introduction and Guide to the Conduct of Legal Research*" (Pearson Education Limited, Essex, 2007) at p. 166; Dawson, C. "*Practical Research Methods*" (How To Books Ltd, Oxford, 2002) at p. 15

<sup>2</sup> Denscombe, M. "*The Good Research Guide*" (Open University Press, 3<sup>rd</sup> ed., England, 2007) at p. 154

<sup>3</sup> Dawson, C. "*Practical Research Methods*" (How To Books Ltd, Oxford, 2002) at p. 14

<sup>4</sup> Drever, E. "*Using Semi-Structured Interviews in Small-Scale Research*" (Scottish Council for Research in Education, Glasgow, 1995) at p. 2

always motivate the respondents to participate in the research.<sup>5</sup> Additionally, whether or not it is most appropriate to use questionnaires may depend largely on the nature of the research which is to be conducted.<sup>6</sup>

On the other hand, qualitative research is concerned with the quality of the information collected rather than its quantity.<sup>7</sup> In other words, the researcher, rather than concentrating on large groups of people, will concentrate on small groups related to the area to be researched. For qualitative research in this area the foremost method for collection of data is the interviews which through the researcher will be able to generate data relating to a small number of people who are selected in order to test or generate the hypotheses drawn by his research.<sup>8</sup> Interviews can be made through meeting those authoritative people who are related to the area to be researched.

It could be said that the use of interviews needs more time than is the case if a questionnaire is used.<sup>9</sup> However, the fact that the group of people interviewed will be smaller than that used for a questionnaire would lead to a contrary conclusion.<sup>10</sup> Indeed, the number of people will be fewer and accordingly the data collected, while might be of a greater value, will also be less.<sup>11</sup> The questions used in an interview can

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<sup>5</sup> Denscombe, M. *"The Good Research Guide"* (Open University Press, 3<sup>rd</sup> ed., England, 2007) at p. 170

<sup>6</sup> Drever, E. *"Using Semi-Structured Interviews in Small-Scale Research"* (Scottish Council for Research in Education, Glasgow, 1995) at p. 5

<sup>7</sup> Denscombe, M. *"The Good Research Guide"* (Open University Press, 3<sup>rd</sup> ed., England, 2007) at p. 202

<sup>8</sup> Drever, E. *"Using Semi-Structured Interviews in Small-Scale Research"* (Scottish Council for Research in Education, Glasgow, 1995) at p. 1

<sup>9</sup> Denscombe, M. *"The Good Research Guide"* (Open University Press, 3<sup>rd</sup> ed., England, 2007) at p. 203; Drever, E. *"Using Semi-Structured Interviews in Small-Scale Research"* (Scottish Council for Research in Education, Glasgow, 1995) at p. 3

<sup>10</sup> Dawson, C. *"Practical Research Methods"* (How To Books Ltd, Oxford, 2002) at p. 49; Brenner, M. Brown, J. & Canter, D. *"The Research Interview: Uses and Approaches"* (Academic Press, London, 1985) at p. 4

<sup>11</sup> Dawson, C. *"Practical Research Methods"* (How To Books Ltd, Oxford, 2002) at p. 15



be divided into two categories: structured questions and semi-structured questions.<sup>12</sup> In the first category the questions used are planned in advance by the researcher and when he conducts his interview he will not be able to deviate from these questions.<sup>13</sup> Accordingly, as is the case with questionnaires, the researcher will not be able to probe or clarify his interviewees' responses when he needs to do that. However, in the category of semi-structured interviews the researcher will prepare some general questions to be discussed with his interviewees, but, unlike the structured interviews, he will be able to deviate from the general questions in the way that he thinks it will provide more value for his research.<sup>14</sup>

In this work, the author has chosen to conduct semi-structured interviews in order to collect the data needed to fill the secondary data gap related to the fraud exception application in the Jordanian law. The reasons for such a choice can be attributed to, firstly, the small number of people who are aware of and have the knowledge needed regarding the researched area. Secondly, the probing or clarification of the responses which the use of interviews provides is well appreciated if the difficulty and complexity of the topic researched is taken into consideration.<sup>15</sup> As has been mentioned above, interviews allow the researcher to probe more deeply into the interviewees' views and hence collect more in-depth details than is possible by a survey method.<sup>16</sup> Thirdly, taking into consideration the nature of the research, the

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<sup>12</sup> Salter, M. & Mason, J. "*Writing Law Dissertations: An Introduction and Guide to the Conduct of Legal Research*" (Pearson Education Limited, Essex, 2007) at p. 167

<sup>13</sup> Dawson, C. "*Practical Research Methods*" (How To Books Ltd, Oxford, 2002) at p. 29

<sup>14</sup> Salter, M. & Mason, J. "*Writing Law Dissertations: An Introduction and Guide to the Conduct of Legal Research*" (Pearson Education Limited, Essex, 2007) at p. 167; Drever, E. "*Using Semi-Structured Interviews in Small-Scale Research*" (Scottish Council for Research in Education, Glasgow, 1995) at p. 1; Brenner, M. Brown, J. & Canter, D. "*The Research Interview: Uses and Approaches*" (Academic Press, London, 1985) at p. 3

<sup>15</sup> Denscombe, M. "*The Good Research Guide*" (Open University Press, 3<sup>rd</sup> ed., England, 2007) at p. 176; Brenner, M. Brown, J. & Canter, D. "*The Research Interview: Uses and Approaches*" (Academic Press, London, 1985) at p. 3

<sup>16</sup> Drever, E. "*Using Semi-Structured Interviews in Small-Scale Research*" (Scottish Council for Research in Education, Glasgow, 1995) at p. 3

researcher found that conducting interviews would be more helpful than surveys. For example, by using interviews the researcher can determine whether the person interviewed has a sufficient background in order to duly answer the planned questions. However, in a survey it would be difficult to ascertain whether the respondent has the knowledge required or whether he just claims to have.<sup>17</sup>

The choice of the group of people to be interviewed was considered very important because it would affect the research.<sup>18</sup> The researcher initially found that four groups of people, which deal with issues regarding documentary credits and guarantees, might be interviewed. These four groups of people are, notably, judges, lawyers, bankers and legal scholars. However, the researcher has decided to confine the interviews to judges. Jordanian scholars have been excluded because the author, after a long search and investigations, has not found even a single jurist expert in the field of the fraud problem in this context. For the same reason lawyers have been excluded. Bankers, while they largely deal with these instruments, look at these instruments from a business perspective rather than a legal one and accordingly have been excluded. Indeed, bankers are concerned, in the first place, with the documents' facial conformity as they are ill-equipped to deal with issues which do not appear upon a document's face.<sup>19</sup> As seen in many cases, banks when faced by a fraud issue request, either themselves or by instructing the credit's applicant, the courts' help by means of injunctions to stop the payment of the credit.<sup>20</sup>

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<sup>17</sup> *Ibid.* at pp. 2-3

<sup>18</sup> King, N. & Harrocks C. "*Interviews in Qualitative Research*" (Sage Publications Ltd, London, 2010) at p. 29; Drever, E. "*Using Semi-Structured Interviews in Small-Scale Research*" (Scottish Council for Research in Education, Glasgow, 1995) at p. 33

<sup>19</sup> Bertrams, R. "*Bank Guarantees in International Trade: The Law and Practice of Independent (First Demand) Guarantees and Standby Letters of Credit in Civil Law and Common Law Jurisdictions*" (Kluwer Law International, 3<sup>rd</sup> ed., The Hague (Netherlands), 2004) at p. 408

<sup>20</sup> See, for example; *Turkiye Is Bankasi v Bank of China* [1996] 2 Lloyd's Rep 611 *per* Waller J; *Groupe Josi Re v. Walbrook Insurance* [1996] 1 W.L.R. 1152; Kurkela, M. "*Letters of Credit and Bank*

Yet, in a country like Jordan, where a legislative vacuum exists, it is judges, who represent the foremost institution which interprets and applies laws, who would usually substitute such a vacuum by borrowing from and implementing other law supplementary sources. To this effect, in a letter of credit fraud dispute, while they are controlled to some extent by general law principles and rules, the first and last decision will be for these judges. For example, in deciding whether fraud that can stop the payment of an independent guarantee should be confined to documents or whether it should be extended to include fraud in the transaction, the last view and that which will decide the dispute will be the judges' view.

It is a fact that most of the Jordanian judges are not familiar with the fraud problem in this context.<sup>21</sup> Hence, the study is limited to those judges who have the relevant backgrounds for this study.<sup>22</sup> Those judges have been selected through a snowball sampling.<sup>23</sup> Indeed, in a snowball collection the researcher has to:

“...identify a few key informants: the main people involved in the activity [which he] is studying. When he approaches them or interviews them, [he] ask[s] them to suggest other people to whom [he] should speak to gain a full and balanced picture...The snowballing can continue until [he] finds [that he] is not getting any new names. In which case [he] can feel confident that [he] interviewed the people most central to [his research].”<sup>24</sup>

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*Guarantees Under International Trade Law*” (Oxford University Press, 2<sup>nd</sup> ed., 2007) at p. 180; Dolan, J. “*The Law of Letters of Credit: Commercial and Standby Credits*” (Warren, Gorham & Lamont, Revised ed., Boston, 1996) at 7-38; Goode, R. ‘Abstract Payment Undertakings’ in Cane P. & Stapleton, J. (eds.), “*Essays for Patrick Atiyah*”, (Clarendon Press, Oxford, 1991) 209, at p. 234; Leacock, S. ‘Fraud in the International Transaction: Enjoining Payment of Letters of Credit in International Transactions’ [1984] *Vand. J. Transnat’l L.* 885 at p. 899

<sup>21</sup> An interview with Judge D, of the Court of Cassation, on 19-09-2011

<sup>22</sup> Drever, E. “*Using Semi-Structured Interviews in Small-Scale Research*” (Scottish Council for Research in Education, Glasgow, 1995) at p. 34

<sup>23</sup> King, N. & Harrocks C. “*Interviews in Qualitative Research*” (Sage Publications Ltd, London, 2010) at p. 34; Drever, E. “*Using Semi-Structured Interviews in Small-Scale Research*” (Scottish Council for Research in Education, Glasgow, 1995) at p. 37

<sup>24</sup> Drever, E. “*Using Semi-Structured Interviews in Small-Scale Research*” (Scottish Council for Research in Education, Glasgow, 1995) at pp. 36-37

It should be noted that some of the judges who were interviewed have been involved in such fraud disputes.<sup>25</sup> Other judges have a background relevant to this issue; for example, it is noteworthy that many of these judges have contributed to the field of the study through their own postgraduate Masters dissertations, PhD theses or other various kinds of publications.<sup>26</sup> While many of these judges welcomed publishing their interviews' contents and attaching their names to this work, some others have shown a desire to remain anonymous and accordingly the information acquired from the latter group will be referred to, quoted and analysed anonymously. Nevertheless, it should be noted that some judges have refused to become involved in the interviews.

Interviews have been conducted during September 2011. Eight Jordanian judges have been interviewed. These judges were from the different levels of courts, some being from the Court of First Instance, while others are judges from the Court of Appeal and the Court of Cassation. The judges who welcomed publication of their interviews and attaching their names to this work are: Judge Hazem Al-Smadi, of the Palace of Justice Court of Appeal, Judge Israa Al-Kharabsheh, of the North Amman Court of First Instance, Judge Amjad Al-Shraideh, of the North Amman Court of First Instance and Judge Nash'at Al-Akhras of the Palace of Justice Court of Appeal. The Judges who have shown a desire to remain anonymous have been given pseudonyms and therefore are referred to as Judge A, Judge B, Judge C and Judge D. A thank you goes to these judges who gave the researcher lengthy periods of time out of their busy days in order to help this work reach completion.

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<sup>25</sup> For example: Judge A, of the South Amman Court of first instance.

<sup>26</sup> For example, Judge Israa Al-kharabsheh, who sits as a judge in the Court of first instance, has contributed to this field by her Master's dissertation under the title "*Fraud in the Underlying Contract as an Exception to the Independence Rule of Documentary Credits*" submitted to the University of Jordan on 2010. This dissertation is available at the University of Jordan's Library.

Is fraud a recognised exception to the autonomy principle in Jordan? If yes, in which situations can a bank that issued a letter of credit refuse the beneficiary's demand on the basis of fraud? Does the bank have to establish fraud in order to refuse a non-genuine document or does the fact that a document presented contains some falsity allow the bank to refuse the beneficiary's presentment? Does proving the beneficiary's fraudulent intent constitutes a compulsory condition in order to stop payment? Have the Jordanian courts limited the application of the fraud exception to what has been described as fraud in the documents or does what has been described as fraud in the transaction suffices in order to trigger the fraud exception? Has this jurisdiction allowed the use of injunctions in this respect and, if yes, in what circumstances and under what conditions is such a relief granted? Should the ICC carry on its approach which neglects the fraud problem in such a context or is it going to be a better approach if such a problem is given more attention and so as a result has a place in its next new publications? These questions were the questions discussed mainly in the interviews and they are the same questions which have been discussed in chapters three, four, five, and six in order to illustrate the fraud meaning, scope and implications in this context. The above-mentioned questions were answered through both the secondary research data provided by the cases heard by the Jordanian courts in conjunction with the data collected through the interviews which have been conducted with these learned judges.