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Letters of Credit: Time for Illegality Exception and for the UCP to address Exceptions to the Principle of Autonomy

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Abstract

This article analyses when illegality is considered as an exception to the principle of autonomy in documentary letters of credit. It develops a model for illegality exception under English law based on doctrinal study, policy reasons, identified pragmatic problems and expectations of the international business community. The second part of this article argues that it is time for the UCP to nudge national laws toward appropriate outcomes for fraud and illegality exceptions and develops a model based on Cognitive Dissonance Theory, Rational Choice Theory and Nudge Theory.

INTRODUCTION

The principle of autonomy in documentary letters of credit (LC), namely, the independence of LC from the underlying transactions and goods, plays a pivotal role in enhancing confidence in an uncertain and volatile international trade environment.¹ Illegal activities have intensified recently due to the COVID pandemic and perpetrators may well hide behind the principle of autonomy to commit illegal activities.² It is therefore a thorny task to protect the principle of autonomy from being infringed by disputes in the underlying supply contract, while at the same time not allowing perpetrators to hide behind the principle of autonomy to commit illegal activities. The first part of this article proposes a model that (1) clarifies when illegality can infringe the principle of autonomy; (2) analyses policy reasons pro and against illegality exception and (3) suggests the qualifications that should be required under English law to allow illegality to infringe the principle of autonomy. The analysis will be based on doctrinal study, identified pragmatic problems and expectations of the international business community. The second part of this article argues that it is time for the Uniform Customs and Practice for Documentary Credits (UCP) to nudge national laws toward appropriate outcomes as to the fraud and illegality

¹ B Demir & B Javorcik, 'Trade finance matters: evidence from the COVID-19 crisis' [2020] *Oxford Review of Economic Policy* <https://www.ncbi.nlm.nih.gov/pmc/articles/PMC7499719/> accessed 02/12/2020: their study evidences that exports reliant upon LC as a means of payment and finance have proven to be significantly more resilient to the COVID pandemic than exports reliant upon payment by either open bank account or cash in advance.

² PwC's Global Economic Crime and Fraud Survey 2020, <https://www.pwc.com/gx/en/services/forensics/economic-crime-survey.html> accessed 02/12/2020; Europol Report, *How Criminals Profit From The Covid-19 Pandemic* (March 2020) <https://www.europol.europa.eu/newsroom/news/how-criminals-profit-covid-19-pandemic> accessed 02/12/2020; M Musumeci & F Marelli, 'How organized crime is expanding during the COVID-19 crisis' (Geneva, June 2020) <http://www.unicri.it/index.php/news/how-organized-crime-expanding-during-covid-19-crisis> accessed 02/12/2020; Experian Report, 'Fraud rate rises 33% during Covid-19 lockdown' (June 2020) <https://www.experianplc.com/media/news/2020/fraud-rate-rises-33-during-covid-19-lockdown/>

exceptions. It proposes a model on how the UCP should address illegality and fraud exceptions based on Cognitive Dissonance Theory,³ Rational Choice Theory⁴ and Nudge Theory.⁵

The principles of autonomy and strict compliance in LC provide exporters and importers with a means of security that mitigates the risk of the lack of confidence that exporters may not be paid after the shipment of goods to another country and the risk that importers may not receive conforming goods after they make payment.⁶ It is essential therefore to continue to vehemently safeguard the principle of autonomy, namely, the independence of the LC from both the underlying contract⁷ and the physical status of the goods.⁸ So banks should pay against only one condition, which is the presentation of documents by the beneficiary of the LC, that appear to be in compliance with the terms of the LC and the bank should not involve or be influenced by the actual physical status of goods and disputes between importers and exporters.⁹

But illegal trade activities have nearly doubled in the first half of 2020 in comparison to 2019,¹⁰ due to COVID 19, and the economy of the UK alone has suffered loss of £38 billion as a result of deceit for financial profit.¹¹ Supply chain is particularly vulnerable to illegal activities, because of its global reach involving different transactions (sale, custom clearance, insurance, carriage) and parties as well as various government rules under different jurisdictions. The negative impact of pandemics on the global economy¹² seemingly amplify the criminal motive of desperate traders to commit illegal activities.¹³ The recent collapse in 2020 of Hin Leong Trading (Pte) Ltd, one of the largest oil traders in East Asia, illustrates how the founder and other employees used letters of credit, based

³ L Festinger, *A Theory of Cognitive Dissonance* (Stanford University Press, 1957).

⁴ J Scott, *Rational choice theory: Understanding Contemporary Society Theories of The Present* (G Browning, A Halcli & F Webster ed, Sage Publications 2000); Rational Choice Theory is applied in criminology see R Clarke, *Situational Crime Prevention: A safer society – Strategic Approaches to Crime Prevention* (Crime and Justice homepage, The University of Chicago Press Journals Division 1995, v.19, p.91).

⁵ R Thaler & S Cass, *Nudge: Improving Decisions About Health, Wealth, and Happiness*. (2009, New York: Penguin).

⁶ F Youssef, 'Documentary Risk In Commodity Trade', consultancy paper to UNCTAD https://unctad.org/system/files/official-document/itcdcommisc31_en.pdf accessed 02/12/2020; P Elinger and D Neo, *The Law and Practice of Documentary Letters of Credit*, 1st edn (Hart, 2010) chapter 1; M Hwaidi, 'An Evaluation Of The Efficacy Of Ucp 600 Within English And Jordanian Legal Orders And Jordanian Commercial Practices', PhD thesis submitted to Nottingham Trent University <http://irep.ntu.ac.uk/id/eprint/32495/1/MHwaidi%20PhD%20final%20after%20amendments.pdf> accessed 02/12/2020.

⁷ Article 4 UCP 600; *United City Merchants (Investments) Ltd v Royal Bank of Canada* [1983] 1 AC 168.

⁸ Article 5 UCP 600; *United City Merchants (Investments) Ltd v Royal Bank of Canada* [1983] 1 AC 168, 183.

⁹ Article 14 (a) of UCP 600; *Collected Opinions 1995-2001*, R.405: banks should not investigate the authority under which a specific document was issued; *Westpac Banking Corp v South Carolina national Bank* [1986] 1 Lloyd's Rep 311, 315.

¹⁰ S Meadows, 'Covid-19 scams mean fraud cases nearly doubled in first half of year' the telegraph (16 Sep 2020) <https://www.telegraph.co.uk/news/2020/09/15/covid-19-scams-mean-fraud-cases-nearly-doubled-first-half-year/> accessed 02/12/2020.

¹¹ national Fraud Authority - annual fraud indicators January 2011; UK Government Guidance 'Crime and fraud prevention for businesses in international trade' (2020) <https://www.gov.uk/guidance/crime-and-fraud-prevention-for-businesses-in-international-trade#:~:text=It%20is%20estimated%20that%20every,sophisticated%20and%20harder%20to%20detect> accessed 02/12/2020; according to PwC Global Economic Crime and Fraud Survey 2020, 47% of respondents experienced fraud in the last two years <https://www.pwc.com/gx/en/services/forensics/economic-crime-survey.html> accessed 02/12/2020.

¹² UNCTAD, *Global Trade Update October 2020* https://unctad.org/system/files/official-document/ditcinf2020d4_en.pdf accessed 02/12/2020.

¹³ As crimes in international trade tend to be professional crime and perpetrators calculate the benefits and costs based on Rational Choice Theory: see below under the heading 'Model to The Exceptions of The Principle of Autonomy in The UCP'.

on a sham underlying sale contract, as a facility to illegally raise finance.¹⁴ It is time therefore for the UCP to recognise illegality and fraud as potential exceptions to the principle of autonomy in order to protect the integrity of LC, but in a way that will also ensure the protection of the principle of autonomy from being broadly infringed. Such an initiative is an essential part of the strategy to manage supply chain security.¹⁵

The first part in this article proposes a model of the illegality exception under English law as English law has not yet developed doctrines and rules for such an exception. The literature lacks an in-depth account of what the essential requirements should be for the illegality exception under English law.¹⁶ Whilst English law proves to be protective to the principle of autonomy, some other national laws recognise exceptions in addition to fraud and illegality, such as unconscionability and nullity regarding demand bonds and standby letters of credit. Some lawyers wrongly mingle LC with demand bonds or standby letters of credit when it comes to the exceptions of the principle of autonomy.¹⁷ That is evaluated in the second part of the article. It is another reason why the UCP should act, before it is too late, to nudge national laws to protect the principle of autonomy from being broadly infringed and to preserve the integrity of LC by addressing fraud and illegality exceptions in a time that an international instrument such as the UCP is most needed to help management of supply chain security. The second part of this article therefore proposes a model for the illegality and fraud exceptions in the UCP.

1: Model For Illegality Exception Under English LAW

A. Division of illegality according to where it occurs in the legal relationships in LC under national laws (part A of the model)

¹⁴ R Khasawneh & F Tan, 'UniCredit sues Hin Leong, Glencore over 'sham' oil deal' Reuters (29 Sep 2020) https://uk.sports.yahoo.com/news/unicredit-sues-hin-leong-glencore-142438097.html?guccounter=1&guce_referrer=aHR0cHM6Ly93d3cuZ29vZ2xlLmNvLnVrLw&guce_referrer_sig=AQAAALx7IStmDjtKnN_1wyC9cptVjMHg1Sm6Bf1XJT7fdj6skTksqBkI07vWGJW6MumZfbyMD5o8oECPQh0VrUJDI2j8hU4ENX6xhSyoDg5jxDoSdOH4ZE2pdKK3b0D9kouvvmj56r6ss7SnUeMLGtQFnRXsxveApYvK3uXLBFK3bafeq accessed 02/12/2020; J Jaganathan 'RPT-Founder of oil trader Hin Leong, OK Lim, charged in Singapore court in forgery case' Reuters (17 Aug 2020) <https://www.reuters.com/article/singapore-oil-hin-leong-idUSL4N2FI0RF>.

¹⁵ As a strategic response to prevent crime see J Ahokang and others, 'A conceptual model for crime prevention in Supply Chain management' (17th International Annual EurOMA Conference, Porto, Portugal Jun 2010) https://www.researchgate.net/publication/282846220_A_conceptual_model_for_crime_prevention_in_Supply_Chain_management accessed 02/11/2020.

¹⁶ E.g. Enonchong does not analyse the type of serious illegality that is required to infringe the principle of autonomy: N Enonchong, *The Independence Principle of Letters of Credits And Demand Guarantees*, 1edn (2013, OUP); Malek and Quest only addresses the United City Merchant case regarding unenforceability: A Malek and D Quest, *Jack: Documentary Credits*, 4th edn (Tottel, 2009); see also P Elinger and D Neo, *The Law and Practice of Documentary Letters of Credit*, 1st edn (Hart, 2010); J Chuah, 'Documentary credits: letter of credit - underlying transaction illegal' [2003] *Journal of International Maritime Law* 9(6), 518-521 - non of the aforementioned invaluable works distinguish that the United City Merchants is an example whereby LC is a facility furthering an illegal act so restraining payment does not infringe the principle of autonomy, see below under the heading 'Illegality in the documentary credit itself between bank and beneficiary'. Requirements for illegality exception are not analysed but they are merely criticised of being broadly flexible and demand bonds are not distinguished from LC, an example of that is the work of M Kelly-Louw 'The Comparative and international law journal of southern Africa', [2009] Vol.42 (3), p.339-386. Criminal illegality is analysed in detail and it is argued as a basis for illegality exception in USA: G McLaughlin, *Letters of credit and illegal contracts: the limits of the independence principle*, [1988] 49 Ohio St. L.J. 1197 *Banking and Finance Law Review* 479.

¹⁷ Allen & Overy, Covid-19 coronavirus update: 7 key points for making sure your standby letter of credit is still as good as cash, (19 Apr 2020 Allen & Overy) <https://www.allenoverly.com/en-gb/global/news-and-insights/publications/covid-19-coronavirus-update-making-sure-your-standby-letter-of-credit-is-still-as-good-as-cash> accessed 01/12/2020; M Kelly-Louw 'The Comparative and international law journal of southern Africa', [2009] Vol.42 (3), p.339-386.

The LC is independent from the underlying contract¹⁸ and the operating contracts (i.e. contract between banks and contract between bank and applicant in LC)¹⁹ and the bank should only examine the documents on their face and not the actual physical status of the goods.²⁰ This is the commercial and conceptual understanding of the principle of autonomy in LC. Based on that understanding, in order to determine whether the claim for illegality is a claim to breach the principle of autonomy illegality under national laws should be divided into the following categories. (1) Illegality in LC itself between bank and beneficiary. It is analysed in this section below that such a claim of illegality does not require the principle of autonomy to be set aside and, as the general principles of illegality apply, the bank is prohibited from honouring LC when there is a supervening illegality or whereby the LC is set up as a facility to further an illegal act. (2) Illegality in one of the operative contracts in LC. Under this claim of illegality the principle of autonomy should not be infringed pursuant to the principles of illegality under common law as explained below. (3) Illegality in the underlying contract of LC. It is analysed below in this section 'part A of the model' how such a claim of illegality breaches the principle of autonomy, what are the practical difficulties of allowing such a claim and what is the current position of English law. In 'part B of the model' I propose that the claim of illegality in category 3 should fulfil certain requirements that are informed by moral and rational justifications in order to be permitted to infringe the principle of autonomy under English law.

(1) Illegality in the LC itself between bank and beneficiary

For illegality in the LC contract between the issuing, or conforming, bank and the beneficiary, the general illegality principles of law apply. The principle of autonomy is not engaged and thus no real difficulty would arise. A clear example is where the issuing of the credit is prohibited as the beneficiary is from an enemy country. Another example is supervening illegality where the issuing of the credit is lawful but at the time of honouring the credit it has become illegal to honour the credit because the beneficiary is from a country that has become an enemy to the bank's country or due to a governmental order.²¹ An examination of documents and honouring the LC may be impossible to be legally performed during COVID 19 due to a government lockdown. If the LC is expired during the lockdown the bank will be discharged from its undertaking to honour the LC, based on the doctrine of frustration (i.e. unforeseen event beyond the control of parties renders the performance impossible) under common law.²² Article 36 of UCP 600 is not helpful for beneficiaries who could not, during LC period, present documents due to COVID 19 restrictions, as it excuses the bank from honouring or negotiating during the lockdown and even after resuming to business if by that time the LC is expired. Some lawyers correctly

¹⁸ Article 4 UCP 600.

¹⁹ *United City Merchants (Investments) Ltd v Royal Bank of Canada (The American Accord)* [1983] 1 AC 168, 182- 183 per Lord Diplock; *Hamzeh Malas & Sons v British Imex Industries Ltd.* [1958] 2 Q.B. 127, 129 per Jenkins LJ.

²⁰ Article 5, sub article 14 (a) and article 34 UCP 600; *GKN Contractors Ltd v Lloyd's Bank Plc* (1985) 30 B.L.R. 48, 63 Parker LJ; *Consolidated Oil Ltd v American Express Bank Ltd* [2002] C.L.C. 488, 495; *Montrod Ltd v Grundkötter Fleischvertriebs GmbH & Anor* [2002] C.L.C. 499 [59].

²¹ After the ending of Iraqi regime in 2003 the Jordanian government ordered banks in Jordan to restrain payments of letters of credit to Iraqi beneficiaries as many credits involved transactions for the previous Iraqi government.

²² Beale and others (eds), *Chitty on Contracts*, 33 edn (Sweet and Maxwell, 2020).

suggest that UCP 600 should have a provision similar to art e6e(i) and e12 of eUCP 600 that extends the period of the LC after the resumption to business.²³

The second type is where the LC is set up by the beneficiary as a facility to 'further an illegal act'. This might occur in practice where a documentary credit is a facility to achieve money laundering, disguised money exchanging, defrauding creditors, abusing tax or revenue regulations or commercial bribery. An example of that is *United City Merchants (Investments) Ltd v Royal Bank of Canada*.²⁴ The price of the underlying contract was artificially doubled to enable the buyer, Peruvian company, to exchange Peruvian currency for the artificially increased contract price and thereby avoid Peruvian exchange control regulations. The seller would receive the doubled price via LC and would keep the real price and would then transfer the artificially increased price to the branch of the buyer which is based outside Peru.

It was held by the House of Lords that the LC payment was enforceable to the extent that it represented the true price of the sale contract. Since it was not difficult to identify the monetary transaction that sought to be concealed by the actual words of both the documentary credit and the sale contract, only that part of the payment in the documentary credit that related to the monetary transaction was unenforceable.²⁵

Although the policy that *a court must not lend its aid to enforce the contract that is unenforceable by law* was applicable, and thus the court must take the point itself, there was no illegality since the statute that had been breached was a non-UK statute and the effect of such a breach, pursuant to article VIII (2) (b) of Bretton Wood Agreement, was to treat the transgressed act as unenforceable and nothing more.²⁶ Since the documentary credit was a facility to conceal the breach of the exchange control regulation the principle of autonomy was not engaged because the documentary credit contract was itself violating the legislation,²⁷ although it was not the payment of the money *per se* that was unenforceable but only the inflation of the contract price in the underlying contract.

(2) Illegality in one of the other operative contracts of the documentary credit

Illegality in one of the other operative contracts might occur in practice where the LC contract of the issuing bank with the applicant, or the indemnity contract with the confirming bank, becomes illegal if the countries of the parties issue orders or enact laws prohibiting trading with each other (supervening illegality). There is no direct authority under English law regarding this issue. Under the general illegality principles of English law the LC contract with the confirming bank would be enforced as the beneficiary would not base its claim on the illegal contract between the issuing bank and the confirming bank.²⁸

(3) Illegality in the underlying contract

²³ E LI, 'COVID-19: its impact on letters of credit' Stephenson Harwood (29 April 2020).

²⁴ [1983] AC 168.

²⁵ *United City Merchants (Investments) Ltd v Royal Bank of Canada* [1983] AC 168, 190-91 per Lord Diplock.

²⁶ *United City Merchants (Investments) Ltd v Royal Bank of Canada* [1983] AC 168, 189 per Lord Diplock.

²⁷ N Enonchong, *The autonomy principle of letters of credit: an illegality exception?* [2006] L.M.C.L.Q., 406-407.

²⁸ *Holman v Johnson* (1775) 1 Cowp. 341, 343.

The principle of autonomy implies that illegality in the underlying contract ought not to affect the LC contract between the issuing, or confirming, bank and the beneficiary. In that event, the beneficiary's payment right would be secure notwithstanding such illegality. Can this implication from the principle of autonomy be sustained even where the cause of illegality is a serious crime such as a sale of heroin²⁹ or a supply of arms to an enemy?³⁰ The answer must surely be in the negative. This is because the payment through the LC is actually the consideration (payment of the price) in the underlying illegal supply contract. This means the payment in LC assists the realisation of the underlying illegal contract (although it is not a facility to further an illegal act – unlike the situation above as in the case of *United City Merchants*³¹), and such actions have been made illegal as they have the potential to cause grave harm to society.

It is therefore essential that national laws ensure high protection for society against such harm. The need for such protection needs to overrule other norms such as the principle of autonomy (despite that this principle makes LC a secure means of payment). Conversely, should the autonomy principle always be relegated below the illegality norms whatever – and however minor – the illegality in the underlying contract? For instance should the principle of autonomy be laid aside simply because the beneficiary in the performance of the underlying C.I.F. sale contract breaches the law by sending goods on an unlicensed means of transport, or the quantity of goods to be imported exceeds the maximum amount permitted in the applicant's country, or where the applicant, unbeknown to the beneficiary, had not procured the requisite importation licence?

In order to address the inquiry, I will describe below the current position of English law. I will then propose part B of the model for the illegality exception which will be applicable to English law.

The current position of English Law and in literature

English judicial opinions support the view that illegality whether criminal or civil, that has the effect of rendering the underlying contract as being prohibited,³² is an exception to the autonomy principle where it taints LC.³³ Staughton LJ in *Group Josi Re v Walbrook Insurance Co Ltd*³⁴ provided the reliance test (i.e. the performance of letter of credit would be illegal if the beneficiary in the letter of credit would *rely*, or found its action, on the illegal contract to draw on the credit) to determine the degree of connection that permits illegality in the underlying contract to interfere with the autonomy principle.³⁵ Such a test was later challenged by Cook J in *Mahonia Ltd v JP Morgan Chase Bank (No.2)*³⁶ where he provided an alternative test for a sufficient connection in that the credit must be set up in the beginning as an integral part of the illegal scheme.³⁷

²⁹ *Mahonia Ltd v JP Morgan Chase Bank (No.1)* [2004] EWHC 1938, 2026 (Comm).

³⁰ As suggested by Staughton LJ in *Group Josi Re v Walbrook Insurance Co Ltd* [1996] 1 W.L.R. 1152, 1163.

³¹ Under the heading 'illegality in the LC contract between the bank and the beneficiary'

³² B Harris, *The EC REACH Regulation and contractual supply obligations*, [2010] J.B.L. (5), 394, 407-411.

³³ *Group Josi Re v Walbrook Insurance Co Ltd* [1996] 1 W.L.R. 1152, 1163; *Mahonia Ltd v JP Morgan Chase Bank (No.2)* [2004] EWHC 1938, 2026 (Comm).

³⁴ [1996] 1 W.L.R. 1152, 1163.

³⁵ *Group Josi Re v Walbrook Insurance Co Ltd* [1996] 1 W.L.R. 1152, 1163.

³⁶ [2004] EWHC 1938, 2026 (Comm).

³⁷ *Mahonia Ltd v JP Morgan Chase Bank (No.2)* [2004] EWHC 1938, 2026 (Comm).

Professor Enonchong has suggested, quite rightly, that the enquiry should not be to establish the degree of connection between the illegality of the underlying contract and the documentary credit but rather to establish the degree of knowledge on the part of the beneficiary.³⁸ Being the payment or the reward for an underlying contract, the documentary credit is by default an integral part to the underlying contract. Thus, the payment of the credit to the guilty beneficiary might simply be considered as a reward for his illegal act. The present article builds on that approach and proposes analysis below³⁹ as to the type of serious illegality and the degree and the time of the beneficiary's knowledge that is required to infringe the autonomy principle since those issues have not yet been analysed judicially or by literature.

Nevertheless, the dogmatic view simply rejects illegality as an exception to the principle of autonomy in LC due to the potential broad application of illegality. This is the convenient view in the USA as illegality has a broad application under both US federal and state laws with illegality extending, for example, to penalty clauses.⁴⁰ This approach interacts with the policies underpinning illegality in the sense that it is repugnant to the public conscience to enforce payment under a documentary credit for the type of illegality - in the underlying contract or operative credit contracts - that is considered as a grave crime such as a sale of heroin and the bank might be held criminally liable for the payment of a crime. McLaughlin thus argues in the USA for *criminal* illegality as being capable to infringe the autonomy principle.⁴¹

B. Moral and rational justifications informing what should be the requirements for illegality exception under English law (part B of the Model)

We need firstly to appreciate the competing policies and norms (moral and rational justifications) of illegality in the context of LC and under English law principles of illegality, and that will inform what should be the requirements for illegality exception.

Competing policies and norms

Moral justification

Three dominant policies give rise to the law of illegality under the English law, but note that the principle of autonomy in LC can be seen as an opposing policy to them. Firstly, respect for the normative effect of mandatory law expressed in the English legal system by the principle of parliamentary sovereignty (i.e. if something is forbidden it must not be

³⁸ N Enonchong, *The autonomy principle of letters of credit: an illegality exception?* [2006] L.M.C.L.Q., 408.

³⁹ Under the heading below 'proposal for illegality exception'.

⁴⁰ GT McLaughlin, *Exploring Boundaries: A Legal and Structural Analysis of the Independence Principle of Letter of Credit Law*, [2002] Banking LJ 521; GT McLaughlin, *Letters of credit and illegal contracts: the limits of the independence principle*, [1988] 49 Ohio St. L.J. 1197.

⁴¹ GT McLaughlin, *Exploring Boundaries: A Legal and Structural Analysis of the Independence Principle of Letter of Credit Law*, [2002] Banking LJ 521; GT McLaughlin, *Letters of credit and illegal contracts: the limits of the independence principle*, [1988] 49 Ohio St. L.J. 1197.

done).⁴² Secondly, the policy underlying the law of illegality is the protection of public interests and morals,⁴³ particularly where an action is criminalised.⁴⁴

The third is expressed by the maxim *ex turpi causa non oritur actio*⁴⁵ so a person should not be allowed to profit from his own wrongdoing⁴⁶ in order to serve the integrity of the law pursuant to the Supreme Court in *Patel v Mirza*⁴⁷ so the law should be consistent by refusing to give by its right hand what it takes by its left hand.⁴⁸

In consequence the policies of parliamentary sovereignty, the protection of society as a whole and *ex turpi causa* provide a moral justification for illegality to infringe the principle of autonomy in LC. But the application of those policies might, however, be unruly and be the cause of uncertainties, which could threaten the stability of transactions and undermine the security of documentary credit transactions.

Rational justification for rejecting illegality as an exception

From the perspective of guarding the principle of autonomy, the whole basis of the rational justification for the illegality exception is questionable. This is because in the context of international trade there is a lack of accessibility (i.e. both the problem of access to laws⁴⁹ and the problem of access to information concerning the underlying transaction).

Thus, unlike fraud, there are many different types of illegality and these vary greatly internationally even across the legal systems that might operate in the same documentary credit transaction. Also in illegality, the confirming bank will face the dilemma of dealing with foreign laws in many cases, particularly since illegality often relates to the violation of the regulations of the buyer's country when the confirming bank is operating in the seller's country.

Given the needs for assurance of reimbursement, manageable examination and speed banks do not enter documentary credit contracts with the expectation that they will have an extra duty to scrutinise both the laws appertaining to the underlying transaction and the underlying transaction itself. Because of the growth of statutory law under legal systems, trading parties might unintentionally violate laws and even with careful scrutiny banks may well not be able to uncover such violations.

⁴² *Pickin v British Railways Board* [1974] 2 W.L.R. 208; *Jordanian Constitution* (1952) chapter 5.

⁴³ The Law Commission (The Law Commission, *The Illegality Defence*, Consultation Paper 189, para 2.5: http://lawcommission.justice.gov.uk/docs/cp189_Illegality_Defence_Consultation.pdf) identified six rationales policy triggering illegality: (1) furthering the purpose of the rule which the claimant's illegal behaviour has infringed; (2) consistency; (3) the need to prevent the claimant profiting from his or her own wrong; (4) deterrence; (5) maintaining the integrity of the legal system; and (6) punishment. Except the first rationale the Commission did not provide decisive evidence as to the application of other rationales in the context of civil illegality.

⁴⁴ Smith and Hogan, *Criminal Law*, (13edn, OUP 2013) para 1.3.1.

⁴⁵ *United City Merchants (Investments) Ltd v Royal Bank of Canada* [1983] 1 AC 168, 183 per Lord Diplock; *Czarnikow-Rionda Sugar Trading Inc v Standard Bank London Ltd* [1999] 2 Lloyd's Rep 187, [39] per Rix J: it was considered as the authoritative source of the implied limitation of the bank's mandate.

⁴⁶ The focus should not be that the claimant is getting something out of wrongdoing but rather is the recovery for something which is illegal resulting in inconsistency in the law: *Hall v Hebert* [1993] 2 SCR 159, 175-176 per McLachlin J; cited with approval; *Patel v Mirza* [2016] 3 W.L.R. 399, [100] per Lord Toulson.

⁴⁷ [2016] 3 W.L.R. 399, [99-101] per Lord Toulson.

⁴⁸ *Patel v Mirza* [2016] 3 W.L.R. 399, [99] per Lord Toulson.

⁴⁹ Access to law is regarded as one of the eight principles of the rule of law identified by Lord Bingham extra judicially: Bingham, *The Rule of Law*, [2007] *The Cambridge Law Journal* (66), 76.

Indeed the problem of the lack of accessibility as to underlying performance and to foreign laws generates uncertainties that open the door for unnecessary litigation, and serves to encourage traders (acting without good faith, who simply aim to escape from their contractual obligations) to raise illegality as a defence to their payment obligation.

The scope of illegality is broad under some jurisdictions (e.g. in the USA penalty clauses render the contract illegal) to the effect that permitting any type of illegality to interfere with the principle of autonomy might capture many LC and thus undermine the reputation of LC as being a secure method of payment. Hence, the focal issue is not whether an infringement or exception to the autonomy principle is right or wrong in itself, rather the issue is the containment of the effects of the exception on the security of LC.

Accordingly, to allow illegality to infringe the principle of autonomy, an illegality exception needs to be designed in a way that is responsive to the need of legal systems to safe guard society and the competing needs of the banks and traders as to the maintenance of the security of LC taking into account the problem of the lack of accessibility.

Rational justification for accepting illegality as an exception

From the perspective of supply chain security management, the illegality exception to the principle of autonomy is rationally justified, in order to improve the standard of 'conveyance security' (checking authenticity of the materials presented by the parties).⁵⁰ So the law which recognises the illegality exception makes the efficacy of 'conveyance security' standard concrete as the perpetrator will face imminent penalty (i.e. being denied the right of payment). Also since the motive of illegal activities, being financial crimes in international trade usually committed by sophisticated individuals or groups,⁵¹ is to enhance the wealth of the capitalist mind and hence it is naturalised in the mind of the criminal,⁵² the element of calculating costs and benefits in the Rational Choice Theory⁵³ is the deterministic factor to commit the illegal activity in the mind of the perpetrator. This means it is very important that the law makes clear to the perpetrator that he will not easily benefit from his illegal activity by hiding behind the principle of autonomy.

Therefore, I am of the opinion that illegality should be accepted to infringe the principle of autonomy but in a way that is justifiably narrowed by taking into account the challenges identified in the previous heading, particularly in the context of the lack of accessibility and the unruly potential broadness of illegality. I propose below the qualifications to justify the illegality exception, particularly under the principles of English law.

A proposal for the requirements (qualifications) of illegality exception

⁵⁰ J Ahokas and others, 'A conceptual model for crime prevention in Supply Chain management' (17th International Annual EurOMA Conference, Porto, Portugal Jun 2010) https://www.researchgate.net/publication/282846220_A_conceptual_model_for_crime_prevention_in_Supply_Chain_management accessed 02/11/2020.

⁵¹ 'What is financial crime?' International Compliance Association (2020) <https://www.int-comp.org/careers/your-career-in-financial-crime-prevention/what-is-financial-crime/> accessed 02/12/2020.

⁵² Based on Bogner theory of crime: A Stichman, 'Bonger, Willem: Capitalism and Crime: Encyclopedia of Criminological Theory' FT Cullen & P Wilcox ed (2010 SAGE Publications, Inc).

⁵³ J Scott, Rational choice theory: Understanding Contemporary Society Theories of The Present (G Browning, A Halcli & F Webster ed, Sage Publications 2000); Rational Choice Theory is applied in criminology see R Clarke, Situational Crime Prevention: A safer society – Strategic Approaches to Crime Prevention (Crime and Justice homepage, The University of Chicago Press Journals Division 1995, v.19, p.91).

To ensure a justified narrowness application of illegality exception it is submitted that five qualifications must be fulfilled:

- (a) The seriousness of illegality ought to denote either criminal illegality that has the effect of prohibiting the contract or civil illegality that has both the effect of prohibiting the underlying contract and the element of deceitful wrongdoing;⁵⁴
- (b) The knowledge of the beneficiary, but, unlike fraud, the degree and time of such knowledge vary;
- (c) The actual knowledge of the bank to the effect that the lack of such knowledge protects the right of banks to reimbursement;
- (d) Strong and corroborative evidence at the pre-trial stage, as under fraud, of illegality with the knowledge of both the bank⁵⁵ and the beneficiary.
- (e) Balance of convenience at pre-trial stage.

Types of illegality that should infringe the principle of autonomy in LC

It is submitted that criminal illegality, with the knowledge of the beneficiary and with the actual knowledge of the bank as explained below, in the underlying contract which renders the consideration, or the promise, of that contract unenforceable or void is the first type of illegality that should be permitted to infringe the principle of autonomy.

Of course, an action is criminalised under a legal system for the protection of the whole society and for the safeguarding of a state, and the level of the engagement of such policy varies according to the severity of the crime as perceived by the state. Clearly punishment and deterrence are viable policies for criminal illegality, but ostensibly they have no application to civil illegality.⁵⁶ Also the maxim *ex turpi causa* emanates from the criminal context under English law,⁵⁷ and it is not generally applicable to civil illegality.⁵⁸ Being the policy triggering the fraud exception under English law the *ex turpi causa*⁵⁹ has an application in the context of criminal illegality where the beneficiary is guilty of such illegality.⁶⁰

⁵⁴ The element of deliberate wrongdoing being an important factor to apprehend serious illegality as was implied in *Mahonia Ltd v JP Morgan Chase Bank (No.2)* [2004] EWHC 1938, 2026 (Comm).

⁵⁵ *Group Josi Re v Walbrook Insurance Co Ltd* [1996] 1 W.L.R. 1152, 1163 obiter per Staughton LJ.

⁵⁶ *Tribe v Tribe* [1996] Ch 107, 133-134 per Millett LJ; *Tinsley v Milligan* [1992] Ch 310, 334 per Ralph Gibson LJ; although it was argued by the Law Commission (The Law Commission, *The Illegality Defence*, Consultation Paper 189, par 2.5: http://lawcommission.justice.govuk/docs/cp189_Illegality_Defence_Consultation.pdf) that deterrence and punishment were policies underpinning the civil illegality doctrine under English law, the empirical findings in their Consultation indicated that just over half of the respondents believed that deterrence is a rational policy behind civil illegality and the majority thought that punishment is not a rational policy underlying civil illegality.

⁵⁷ *Beresford v Royal Insurance Company Limited* [1938] AC 586, 599 per Lord Atkin.

⁵⁸ Except in tort where there is dishonesty: Beale and others (eds), *Chitty on Contracts*, (31st edn, Sweet and Maxwell 2012), para 16.165; under Jordanian law the maxim may operate in dishonesty in the formation of a contract: Hadith Narrated by Abul-Hussain Muslim son of Habaj son of al Nishapuri, *Sahih Muslim Book 10 Business Transactions*.

⁵⁹ *United City Merchants (Investments) Ltd v Royal Bank of Canada* [1983] AC 168, 183.

⁶⁰ See above under the heading 'moral justification'.

Criminal illegality that renders the contract void or unenforceable involves any criminal illegality known by the parties,⁶¹ or ought to be known,⁶² at the formation of the contract under English law. Or a criminal illegality in the performance that renders - under the applicable law - the underlying contract void or unenforceable (e.g. lawful sale of coffee but the seller in the performance of the contract uses slave workers to produce the coffee).

Where the committed crime in the performance of the underlying contract does not affect the validity or the enforceability of the promise, or the consideration, of the contract under the applicable law, it entails that the enforceability of the contract does not affect the public conscience under that legal regime. Therefore, such criminal illegality should not affect the payment obligations in LC. This has the effect of narrowing the scope of criminal illegality in a justified pragmatic way that associates public protection to the manifested measures by a state.

However, civil illegality in the underlying contract which renders the consideration, or the promise, of that contract unenforceable or void so as to prohibit the contract pursuant to a statute triggers the principle of parliamentary sovereignty which is a dominant principle under English law, and that might explain why English judges in *Group Josi* and *Mahonia* are of the opinion to accept such illegality to infringe the principle of autonomy. But if such civil illegality was truly severe in the sense of affecting the whole society, and thus being a supervening norm ousting other norms such as the principle of autonomy in LC, it would be criminalised by the parliament.

Hence, deceitful wrongdoing (i.e. the underlying transaction is set up to deceive third parties and the letter of credit is used to secure such transaction) is a further qualification that should be required, as it was opined per Cook J in *Mahonia*,⁶³ to civil illegality to give effect to the illegality exception, since the *ex turpi causa* maxim operates under such illegality though, unlike fraud exception, is used to prevent deceiving a party privy from the LC.

Accordingly, it is submitted that such civil illegality is the second type of illegality that is qualified to infringe the principle of autonomy in LC because: (1) having the effect of prohibiting the underlying contract clearly indicates the seriousness of illegality, though it is not as severe as criminal illegality, and the intention of the legislation to safeguard the state;⁶⁴ (2) having the element of deceitful wrongdoing triggers the maxim *ex turpi causa*;

⁶¹ The contractual parties *intend* to enter into the contract for an unlawful purpose (e.g. the contract appears to be a sale of goods but in reality it aims to defeat the enforcement of exchange control regulation: As claimed by the confirming in *United City Merchants (Investments) Ltd v Royal Bank of Canada* [1983] AC 168; or an insolvent debtor undertakes payment obligations so as to defraud creditors *Begbie v Phosphate Sewage Co Ltd* (1875) L.R. 10 Q.B. 491; *Cockshott v Bennett* (1788) 2 T.R. 763) or to perform the contract illegally (*Apthorp v Neville* (1907) 23 T.L.R. 575; cf; *Stoneleigh Finance Ltd v Phillips* [1965] 2 Q.B. 537, 572, 580) or use the lawful subject matter of the contract for an upcoming unlawful purpose (e.g. the sale of juices to illegally flavour beer: *Langton v Hughes* (1813) 1 M. & S. 593; cf; *Gas Light & Cake Co v Turner* (1839) 6 Bing. N.C. 324; Peel, *Treitel The Law of Contract*, (12th edn, Sweet and Maxwell 2007) para 11.19.)

⁶² Criminal illegality occurs where the term of the contract necessarily involves committing an offence under common law (*Fores v Johnes* (1802) 4 Esp 97), under statute (e.g. infringing food and drug legislation: *Langton v Hughes* (1813) 1 M. & S. 593; *Askey v Golden Wine Co* [1948] 2 All E.R. 35 or exchange control legislation: *Bigos v Boustead* [1951] 1 All E.R. 92 or the making of a bribe pursuant to the Bribery Act 2000) or contrary to public policy (e.g. trading with an enemy: *Ertel Bieber & Co v Rio Tinto Co* [1918] AC 260, 273, 289 or deceiving public authority: *Miller v Karlinski* (1945) 62 T.L.R. 85; *Napier v national Business Agency* [1951] 2 All E.R. 264; *Beauvale Furnishings Ltd v Chapman* [2000] All E.R. (D) 2038).

⁶³ *Mahonia Ltd v JP Morgan Chase Bank (No.2)* [2004] EWHC 1938, 2026 (Comm).

⁶⁴ For instance REACH Regulation prohibits substances requiring registration to be placed in the market of EEA for the objectives of protecting human health, environment and the free movement of goods in a single market: B Harris, *The EC REACH Regulation and contractual supply obligations*, [2010] J.B.L. (5), 394-419.

(3) the problem of the lack of accessibility can be overcome by requiring the actual knowledge of the bank in order to protect the bank from unexpected liability as explained below.

Knowledge of the beneficiary and its degree

The knowledge of the beneficiary as to the relevant illegality should be essential under English law and it must also be the case under any rational legal system for the following reasons.

To infringe the principle of autonomy in LC for illegality committed in the underlying contract without the knowledge of the beneficiary, where the payment of the credit does not itself perform an illegal act, is neither morally nor rationally justified.⁶⁵ The maxim *ex turpi causa* is not applicable in the absence of criminality or dishonesty on the part of the beneficiary.

A recognition of such illegality whether or not the documents are nullity, which is unbeknown to the beneficiary, as an exception to the autonomy principle would give the opportunity to guilty parties to use LC as means to avoid the consequences of their wrongdoing. For instance, the buyer who purchases goods knowing they are to be shipped illegally without the knowledge of the seller, might then be granted an injunctive relief restraining the bank from payment on the basis of illegality. Furthermore, such recognition would substantially devastate the security underpinning LC given the potential breadth of illegality.

Yet, both the degree of the beneficiary's knowledge and the level of proof are contingent on different types of illegality.

So, under English law, where the underlying contract is ostensibly illegal in the place of the beneficiary's performance, then the knowledge of the beneficiary is presumed.⁶⁶ If, however, such underlying contract does not necessarily involve the commission of an offence to the effect that the contract may be performed lawfully, then if it is performed illegally by a party other than the beneficiary the actual knowledge (i.e. including a wilful of shutting eyes) of the beneficiary of the fact of such illegal performance must be proved.⁶⁷

Where illegality in the formation of the underlying contract is not apparent (i.e. the parties entered into an ostensibly lawful contract to achieve an unlawful purpose or to perform the contract illegally, for example a lawful sale of medical thermometers for the unlawful purpose of the use of heroin), then the beneficiary's complicity under English law must include participation (e.g. producing unusual thermometers that are fit for heroin).⁶⁸ Illegality in the performance on the part of the beneficiary requires the knowledge of the

⁶⁵ See above under the heading 'competing policies and norms'.

⁶⁶ *Waugh v Morris* (1873) L.R. 8 Q.B. 202, 208 per Blackburn J.

The sale of goods that are not legally saleable in the buyer's country with the knowledge of the seller is a valid contract for the seller as long as the seller is not obliged to deliver the goods to the buyer's warehouse: *Sumner Permain and Company v Webb and Company* [1922] 1 K.B. 55.

⁶⁷ As under fraud exception: M Hwaidi, 'Four Uncertainties around the Fraud Exception in Documentary Letters of Credit under English Law' [2018] *Journal of International Maritime Law* 24, 1, p. 39-56.

⁶⁸ Beale and others (eds), *Chitty on Contracts* (31st edn, Sweet and Maxwell 2012), para 16.011.

beneficiary as explained above, but if that illegality related to the performance of the part of the applicant then the participation of the beneficiary is required.⁶⁹

For illegality in the formation of the contract that is capable of being performed legally on the part of the beneficiary, it is submitted that it must be proved that the beneficiary has knowledge as to the non-apparent illegality before or at the time when the contractual term for the payment by LC in the underlying contract is concluded as it is a proof of the beneficiary's illegal intent at the time of forming the contract. It should not thus be sufficient to prove that the beneficiary has knowledge as to the illegality at the time of documents presented.

For the issue of illegality in the performance which renders the contract void or unenforceable, I suggest the knowledge of the beneficiary must be proved prior to the time of honouring the credit (i.e. once the documents or the draft are accepted for negotiation under deferral and acceptance documentary credit). This is because the ultimate risk – where all the parties are innocent prior the honour of the credit - must rest on the applicant and as such the beneficiary might enter into new contracts creating obligations upon himself on the confidence that the payment of the honoured credit would be realised.

Actual knowledge of the bank, the time of knowledge and no duty to investigate

Given the problem of the lack of accessibility of illegality as to the underlying contract and the represented facts by documents in LC, as analysed above, the main problem in the recognition of an illegality exception is the potential exposure of banks to the risk of being innocently caught by illegality.

The factual matrix that the bank is not a contracting party to the underlying contract, it is not usually an expert in the underlying trade and it needs to determine the conformity of documents on their face⁷⁰ within a short period of five banking days⁷¹ justify that the bank should not be under a duty to investigate the illegality of the presented documents, or of the underlying contract.⁷² As the bank is not obliged to investigate the fraud in LC under English law,⁷³ it is *fortiori* that it is not obliged to do so for illegality and that in turn reflects the need for speed and manageable examination. Therefore, for illegality to be recognised as an exception to the autonomy principle, the "actual knowledge" of the bank is required.

Here it must be proved, by the entity seeking to restrain the paying bank from payment on the ground of illegality,⁷⁴ that there is a wilful shutting of eyes by the bank to credible evidence as to illegality and its "effects" under the relevant law. The bank's knowledge in this respect should not include a constructive knowledge based on what a reasonable bank should have known and must be established taking into account that the bank is not under a duty to make inquiries as to illegality. Only where there is credible evidence presented

⁶⁹ For analogy: *Ashmore, Benson, Pease & Co Ltd v A.V Dawson Ltd* [1973] 1 W.L.R. 828.

⁷⁰ Principle of appearance: article 4 and 14 UCP 600; there is an assumption that the documents are lawful and genuine: article 37 UCP 600.

⁷¹ Sub-article 14 (d) UCP 600.

⁷² To draw an analogy regarding the lack of accessibility of illegality in a context other than documentary credits: *Bank für Gemeinwirtschaft Aktiengesellschaft v City of London Garages Ltd* [1971] 1 W.L.R. 149.

⁷³ *Türkiye İs Bankası AS v Bank of China* [1996] 2 Lloyd's Rep 611, 617; *United Trading Corp SA v Allied Arab Bank Ltd* [1985] 2 Lloyd's Rep 554, 560; *Gian Singh & Co. Ltd. v Banque de l'Indochine* [1974] 1 W.L.R. 1234.

⁷⁴ By analogy to fraud: *Deutsche Rückversicherung AG v Walbrook Insurance Co Ltd* [1995] 1 W.L.R. 1017, 1030.

to the bank as to illegality and its general effects under the applicable law, should the bank proceed in making inquiries to ensure the reliability of the evidence and the actual effects of illegality and the extent of that obligation should be responsive to the individual circumstances of the bank.⁷⁵

The time of the bank's actual knowledge must be prior to the payment of the credit.⁷⁶ The requirement of actual knowledge should operate as a protective to the bank's right of reimbursement. Therefore where the bank refuses to pay the credit on the basis of mere allegation of illegality, without having strong evidence and actual knowledge as to the illegality, and it turns out in the judgment that the underlying contract is actually prohibited due to illegality with the knowledge of the beneficiary the bank would not be liable for refusal of payment. One exception to the actual knowledge is crimes against humanity as defined by the Rome Statute of International Criminal Court,⁷⁷ the constructive knowledge of the bank should be sufficient as to the effects of such illegality under the applicable law, but not as to the factual occurrence of such illegality in the underlying contract.

Strong evidence at pre-trial: Alternative Power Solution Ltd v Central Electricity

The evidence of illegality must be strong at the pre-trial as it can only be fully examined at the full trial.⁷⁸ By parallel the test would be the one that is laid down in *Alternative Power Solution Ltd v Central Electricity Board and another*⁷⁹ so that on the material available the only realistic inference to draw is the illegal intent of the beneficiary and the actual knowledge of the bank as to such illegality. It would be very difficult to prove the illegal intent of the beneficiary where illegality is not ostensible in the underlying contract. Also, it must be proved that credible evidence is presented to the bank as to illegality in the underlying contract and facts and its effects.

Balance of convenience

The balance of convenience⁸⁰ in granting a protective relief (an interlocutory injunction and a freezing injunction) pending a full trial of the issues would mainly involve: the seriousness of illegality against the stabilisation of the security of payment facilitated by LC in international trade and the consequences as to both the breach of the bank's obligations and the negative reputation of the bank as a trusty provider of payments in international trade.

⁷⁵ In a different context (trusts) it was said that a wilfully or recklessly failing to make inquiries which an honest person would have made constitutes part of actual knowledge: *Bank of Credit and Commerce International (Overseas) Ltd v Akindele* [2001] Ch 437, CA.

⁷⁶ By analogy to fraud exception: *European Asian Bank AG v Punjab & Sind Bank* (No.2) [1983] 1 W.L.R. 642, 658; *United Trading Corp SA v Allied Arab Bank Ltd* [1985] 2 Lloyd's Rep 554, 560; *Credit Agricole Indosuez v Generale Bank* [1999] 2 All E.R. (Comm) 1009, 1015; *DCD Factors Plc v Ramada Trading Ltd* [2007] EWHC 2820 (Q.B.), [2008] Bus L.R. 654; *Group Josi Re v Walbrook Insurance Co* [1996] 1 W.L.R. 1152, 1161.

⁷⁷ Article 7 Rome Statute for International Criminal Court (2011) <https://www.icc-cpi.int/resource-library/documents/rs-eng.pdf>.

⁷⁸ *Czarnikow-Rionda Sugar Trading Inc v Standard Bank London Ltd* [1999] 2 Lloyd's Rep 187, 202 per Rix J; *cited with approval; Alternative Power Solution Ltd v Central Electricity Board and another* [2015] 1 W.L.R. 697, [57].

⁷⁹ [2015] 1 W.L.R. 697, [59].

⁸⁰ Section 37 (1) Senior Courts Act 1981; *American Cyanamid Co v Ethicon Ltd* [1975] AC 396.

The qualifications that are proposed above would justify in a convenient way an interlocutory injunction prohibiting the payment under the documentary credit because of illegality. Still, such qualifications ensure a restricted application as to illegality exception.

2: Model to The Exceptions of The Principle of Autonomy in The UCP

The UCP and its revisions are issued by the International Chamber of Commerce (ICC).⁸¹ Most of LC around the world apply, by the choice of parties, the UCP. National laws have been heavily influenced by the UCP as to the rules governing LC.⁸² There is no revision in the UCP and their interpretative aids⁸³ that address the issue of whether illegality and fraud can set aside the principle of autonomy in LC. Surely, I argue, this is one area that requires the UCP to exercise its power of seduction by nudging national laws towards appropriate outcomes.

A. Justifications for the UCP to address illegality and fraud exceptions

As a justification to the UCP's current position, it is the ICC's view that the issue of fraud, alike with illegality and enforcement, is the product of the applicable national laws.⁸⁴ On the one hand, it is prudent to appreciate that fraud and illegality have the effects of being overriding mandatory doctrines (i.e. they override other legal doctrines and trade usages in that the parties cannot contract out of them) and thus an agreement or trade practice by the international banking community opposing illegality and fraud exceptions would be futile. On the other hand, the UCP can address the exceptions to the principle of autonomy in general terms highlighting the practical difficulties and needs of parties to enlighten national laws of LC's peculiar context for illegality and fraud. It will be in an advisory form to national laws. So applicable national laws decide whether or not to accept the exceptions and also decide detailed rules for the exceptions. Such an approach will not be repugnant to mandatory law under the applicable national laws.

Also, it is not prudent to leave the matter open without being addressed at all, given COVID 19 illegal activities have increased as explained in the introduction of the article. Some traders in international trade barely survive in the market due to substantial decrease of global trade,⁸⁵ and there has been a lack of workforce to inspect logistic

⁸¹ <https://iccwbo.org> accessed 02/12/2020.

⁸² For example, English courts recognise a particular way of interpreting the UCP according to ICC's way to achieve international uniformity *Fortis Bank S.A./N.V, Stemcor UK Limited v Indian Overseas Bank* [2011] EWCA (Civ) 58, [29]; Commercial Code of many countries refer to the application of the UCP see for example article 341 of Egyptian Commercial Code number 17 year 1999, article 399 of Qatar Commercial Code number 27 year 2006.

⁸³ For UCP 600: ICC, International Standard Banking Practice for the Examination of Documents under Documentary Credits (ISBP), (ICC Publication No. 745, 2013); ICC Opinions.

⁸⁴ *Opinions 2009-2011*, R.744.

⁸⁵ Indeed global trade is substantially reduced to 7% according to United Nations International Trade and Commodities (UNCTAD) https://unctad.org/system/files/official-document/ditcinf2020d4_en.pdf.

procedures thoroughly.⁸⁶ These circumstances heighten the motive to commit financial crime as the motive is no longer merely to increase wealth but it is to avoid harsh consequences such as insolvency.

It could be argued as a justification to the current UCP's position that mentioning exceptions to the principle of autonomy in UCP, or its interpretative aids, may raise awareness of importers (applicants in LC) to insert such exceptions merely to escape a bad bargain rather than being due to a genuine concern. However, unlike the 20th century, this no longer applies as those exceptions are now broadly known to traders and banks.⁸⁷ Also deceitful traders and their employees should not take advantage of the principle of autonomy by using it as a veil to protect their fraud or illegal activities. The UCP should therefore address the possibility of lifting the veil (the principle of autonomy) in order to protect the reputation of LC as an honest method of payment and a confident means to raise finance.

The last justification to address illegality and fraud exceptions in the UCP is to protect the principle of autonomy in LC from being broadly infringed under national laws. For the following reasons.

English law has proven to be a protective legal system as to the expectation of international traders of having secure means of payment, since there are only two cases of fraud where an injunction was granted by English courts and those were in respect of demand bonds.⁸⁸ Of course fraud exception, and the above proposed illegality exception, under English law is not illusory as there is a potential to grant injunctive relief.⁸⁹ However, in Canada, Singapore and Malaysia the application of fraud exception is broader than that under English law, mainly because the standard of evidence in granting injunctions can be less strict than that under English law.⁹⁰

Jordan is a good example of a developing country under which the fraud exception can be functionally applied broadly, although in principle or paper it intends to be narrowly applied. In a striking similarity and contrast, Jordanian law (based on Sharia and Civil law) and English law share the same policy underlying fraud exception and the rule that the beneficiary should have knowledge of the fraud to be restrained from payment in documentary credit.⁹¹ But, by applying functional comparative study, the outcomes between English law and Jordanian law differ.

The Court of Distinction (the highest court in Jordan which interprets the law) in the case 1215 year 2005 (civil case) stated that fraud with the knowledge of the beneficiary is a well-recognised exception to the principle of autonomy in LC. The applicant had requested the bank to restrain payment and presented an official report from the port of the arrival

⁸⁶ A Geschonneck, 'The Supply chain fraud pandemic', May [2020] <https://home.kpmg/xx/en/blogs/home/posts/2020/05/supply-chain-fraud-pandemic.html> accessed 02/12/2020.

⁸⁷ A Stichman, 'Bonger, Willem: Capitalism and Crime: Encyclopedia of Criminological Theory' FT Cullen & P Wilcox ed (2010 SAGE Publications, Inc).

⁸⁸ *Themehelp Ltd v West* [1996] Q.B. 84; *Kvaerner John Brown Ltd v Midland Bank Plc* [1998] C.L.C. 446: in the latter case the issue of balance of convenience was not addressed before the court and therefore the case is not to be regarded as an authority as to the availability of injunctions in the light of the balance of convenience.

⁸⁹ M Hwaidi, 'Four Uncertainties around the Fraud Exception in Documentary Letters of Credit under English Law' [2018] *Journal of International Maritime Law* 24, 1, p. 39-56.

⁹⁰ C Amafule, 'The Exceptions To The Principle of Autonomy', PhD thesis submitted to the University of Birmingham; accessed 02/12/2020 < etheses.bham.ac.uk/3831/1/Amaefule12PhD.pdf >.

⁹¹ Court of Distinction (Civil), 1215/2005, Alkurtas programme.

of the goods confirming that the goods were crude waste oil instead of Ethel Lead. The bank rejected this request and paid the beneficiary against the presentation of documents appeared to be in conformity with the credit. The applicant sued the bank for wrongful payment. Neither the Court of Distinction nor the court of appeal investigated whether the beneficiary had knowledge of the fraud at or before the time of the presentation of documents (that the goods were waste). The Court of Distinction held that the bank was not entitled to pay as there was fraud with the knowledge of the beneficiary. Hence the court assumed the knowledge of the beneficiary of the fraud. Had this case decided under English law, the bank would be entitled to pay unless the evidence presented to it by the applicant clearly shows that the beneficiary had knowledge of the fraud.⁹²

The author conducted semi-structured interviews with three Jordanian judges,⁹³ to whom usually most LC cases are referred to (i.e. they are to be regarded as representative cases).⁹⁴ It was transpired that many *ex parte* injunctions restraining payment in LC were granted by Jordanian *ex part* judges.⁹⁵

The problem under Jordanian law is that the respondent does not have the right to reply to the application for an injunction; the respondent only has the right to appeal against the injunction after it has been implemented.⁹⁶ This right to appeal allows the respondent to challenge the strength of evidence submitted by the petitioner and the merits in order to be taken into account by the court when exercising the discretion upon which it decides whether to grant or refuse the requested injunction. The risk that arises where the discretion is exercised without the input of the respondent is that a door is thereby opened for traders – who wish to restrain payment under LC – to act in bad faith. Traders may advance allegations of fraud or ostensible illegality on the part of the respondent that have no foundation in fact, in the knowledge that a court will accept those allegations at face value. This is a particular issue in the context of allegations of illegality, because of the breadth of the illegality concept, and the very significant risk of illegality arising without the respondent being party to it, or having any knowledge of it -particularly if it was a bank - at the material time. This would threaten the stability of LC as a reliable payment mechanism, since genuine payment obligations would be undermined by spurious injunctions.

Some authors argue that as unconscionability, which is a very flexible concept under common law, is an exception to the autonomy principle in the law of demand bonds in Singapore and Australia, it would also be an applicable exception for LC as they stand on the same legal principles.⁹⁷ Similarly, it is opined that since the abuse of rights, which is a

⁹² *United City Merchants (Investments) Ltd v Royal Bank of Canada* [1983] 1 AC 168; but some may argue that such an example refers to the issue of nullity as the goods were waste and the presented documents were accordingly null by being worthless and this should be subject to nullity exception whereby the law should not require the knowledge of the beneficiary if he presents null documents as it was held in Singapore: *Beam Technologies v Standard Chartered Bank* [2003] 1 SLR 597.

⁹³ Identity is concealed as required by the interviewees: the interviews were conducted according to Nottingham Trent University (NTU) ethical policy and their structures had been accepted by the ethical committee of NTU.

⁹⁴ For the selection of typical cases: Henn, Weinstein and Foard, *a Critical Introduction to Social Research*, (2 edn, Sage 2009).

⁹⁵ Interviews were conducted in Jordan in 2013 see M Hwaidi, 'An Evaluation Of The Efficacy Of UCP 600 Within English And Jordanian Legal Orders And Jordanian Commercial Practices', PhD thesis submitted to Nottingham Trent University <http://irep.ntu.ac.uk/id/eprint/32495/1/MHwaidi%20PhD%20final%20after%20amendments.pdf> accessed 02/12/2020.

⁹⁶ Article 170 Jordanian Civil Procedures Rules (1988).

⁹⁷ C Amafule, 'The Exceptions To The Principle of Autonomy', PhD thesis submitted to the University of Birmingham; accessed 02/12/2020 <etheses.bham.ac.uk/3831/1/Amaefule12PhD.pdf>.

flexible legal concept based on acting on good faith under Civil law, is an exception to the autonomy principle in demand bonds it would also be permitted to restrain the autonomous payment in LC.⁹⁸ Of course the role of documents in demand bonds (pay when I notify) is different *per se*, and far less important than that in LC and this ought to draw a fundamental dichotomy between these two facilities.⁹⁹ The security of payment by LC would become vulnerable, if the elastic concepts of unconscionability or the abuse of rights would be allowed to impeach the principle of autonomy.

Still, nullity (worthless documents that have no legal effects) is an exception to the autonomy principle in Singapore¹⁰⁰ and a literal interpretation, without evaluating the merits of LC, as to article 5-109 of the Uniform Commercial Code in the USA might lead to the same result. In Egyptian law the fraud exception extends to nullity as the knowledge of the beneficiary of the fraud is not required.¹⁰¹ Laying the risk of null documents on innocent beneficiaries rather than innocent applicants or banks opposes the very nature of LC that is an assurance of payment conditional on the conformity of documents on their face. LC being an assurance of payment on the conformity of the appearance of documents facilitates documentary sales (e.g. C.I.F.) amongst traders and business communities in international trade, and laying the risk of null documents on innocent beneficiaries rather than innocent applicants or banks would devastate such facility.

According to the above paragraphs, the ICC should take the strategic decision of addressing illegality and fraud exceptions in the UCP in order to manage the security of LC internationally whilst preserving the integrity of LC and its autonomy. This constitutes the first part of the model for the UCP.

B. The theoretical approach for the UCP to address illegality and fraud exceptions

This section proposes the second part of the model for the UCP which suggests approaches based on Cognitive Dissonance Theory and Rational Choice Theory to prevent illegal activities and also on Nudge Theory to influence national laws to choose appropriate outcomes.

By applying the theory of Cognitive Dissonance by Festinger¹⁰² the revealing of illegality and fraud exceptions in the UCP will cause cognitive dissonance to perpetrators. It will increase their stress, so they will not be confident to hide behind the principle of autonomy to execute their intended illegal act. However, fraud and illegal activities in international trade tend to be sophisticated crimes for financial gains, and the motive is to increase wealth so is justified as a natural thing to do in the capitalist mind of the criminal.¹⁰³ Therefore criminals will try to make their behaviour consistent with the law, so they will try to play it well in a way they will calculate the costs and benefits, particularly the likelihood of being realistically caught by the current legal rules to decide whether to take the risk. The solution for this dilemma is to put criminals in an ambiguous position so they

⁹⁸ B Kozolchyk: Bank Guarantees and Letters of Credit: Time for a return to the fold, accessed 02/12/2020 <[https://www.law.upenn.edu/journals/jil/articles/volume11/issue1/Kozolchyk11U.Pa.J.Int'lBus.L.1\(1989\).pdf](https://www.law.upenn.edu/journals/jil/articles/volume11/issue1/Kozolchyk11U.Pa.J.Int'lBus.L.1(1989).pdf)>

⁹⁹ M Hwaidi, 'Four Uncertainties around the Fraud Exception in Documentary Letters of Credit under English Law' [2018] *Journal of International Maritime Law* 24, 1, p. 39-56; P Elinger and D Neo, *The Law and Practice of Documentary Letters of Credit*, 1st edn (Hart, 2010), 143.

¹⁰⁰ *Beam Technologies v Standard Chartered Bank* [2003] 1 SLR 597.

¹⁰¹ Court of Cassation (Civil) number 621 year 79.

¹⁰² L Festinger, *A Theory of Cognitive Dissonance* (Stanford University Press, 1957).

¹⁰³ A Stichman, 'Bonger, Willem: Capitalism and Crime: Encyclopedia of Criminological Theory' FT Cullen & P Wilcox ed (2010 SAGE Publications, Inc).

will be dealing with incomplete information to make it more difficult for them to calculate the rationality of their decision.¹⁰⁴ The UCP should address illegality and fraud exceptions without mentioning rules or requirements as to when clearly those exceptions apply. This has the potential to prevent illegal activities and enhance, as it will reduce the confidence of perpetrators to hide behind the principle of autonomy and it will increase perceived risk, complexity and time invested while reducing awards.¹⁰⁵ It will therefore assist the prevention of illegal activities in letters of credit by making the situation of committing the crime more costly. That will in turn enhance the integrity of LC as a method of payment and means of finance.

Ahokas Juha and others have developed a conceptual model to prevent crime in supply chain which is based on both the theory of total quality management and the theory of crime to enhance the management of supply chain security standards such as APEC 2005.¹⁰⁶ In their developed model under the element of Response there should be a strategic response to "crime reward decreasing product and process planning" based on Rational Choice Theory.¹⁰⁷ The initiative of having a UCP provision for the exceptions of illegality and fraud is a strategic response as it is based on Rational Choice Theory and Cognitive Dissonance Theory to prevent crime and to protect the integrity of LC globally for reasons explained in the previous paragraph. Such a strategic response by the UCP is essential to assist the management of supply chain security, because the proposed position of the UCP in the above paragraph is capable to nudge national laws.¹⁰⁸

By applying Nudge Theory,¹⁰⁹ this initiative in the UCP should not appear, or intend, to enforce national laws to a particular legal position or to achieve uniform outcomes. It should only intend to influence and change the choice architecture of national laws by being clothed in an advisory form and the means of flexibility, but yet sufficiently stress perpetrators, to suit various national laws. It should though be certain (i.e. by providing some details) regarding the commercial context of the main pragmatic needs and difficulties of illegality and fraud in LC as expected by the international business community. This is because a rational national law needs a good reputation in international trade in order to be chosen as the applicable law by traders, and it will therefore reflect the expectation of the international business community. Due to the proven influence of the UCP on national laws,¹¹⁰ addressing illegality and fraud exceptions will encourage

¹⁰⁴ Known in situational crime theory as incomplete information to make the situation of committing the crime more difficult by limiting rationality of choosing to commit crime regardless of the motive of the criminal: M Felson & RV Clarke, 'Opportunity makes the thief: practical theory for crime prevention' [1998] Police Research Series, London https://popcenter.asu.edu/sites/default/files/opportunity_makes_the_thief.pdf accessed 02/12/2020.

¹⁰⁵ E Kleemans, M Soudijn and A Weenink, 'Situational Crime Prevention and Cross-Border Crime: Situational Prevention of Organised Crimes (K Bullock, R Clarke & N Tilley 2010 Willan Publishing).

¹⁰⁶ J Ahokas and others, 'A conceptual model for crime prevention in Supply Chain management' (17th International Annual EurOMA Conference, Porto, Portugal Jun 2010) https://www.researchgate.net/publication/282846220_A_conceptual_model_for_crime_prevention_in_Supply_Chain_management accessed 02/11/2020.

¹⁰⁷ J Ahokas and others, 'A conceptual model for crime prevention in Supply Chain management' (17th International Annual EurOMA Conference, Porto, Portugal Jun 2010) see table 2 in the paper https://www.researchgate.net/publication/282846220_A_conceptual_model_for_crime_prevention_in_Supply_Chain_management accessed 02/11/2020.

¹⁰⁸ R Thaler & S Cass, *Nudge: Improving Decisions About Health, Wealth, and Happiness*. (2009, New York: Penguin).

¹⁰⁹ R Thaler & S Cass, *Nudge: Improving Decisions About Health, Wealth, and Happiness*. (2009, New York: Penguin).

¹¹⁰ For example, English courts recognise a particular way of interpreting the UCP according to ICC's way to achieve international uniformity *Fortis Bank S.A./N.V., Stencor UK Limited v Indian Overseas Bank* [2011] EWCA (Civ) 58, [29]; Commercial Code of many countries refer to the application of the UCP see for example

national laws to prevent illegality and fraud and to only infringe the principle of autonomy in a narrow way that is based on the commercial context and the reality of challenges encountered by the LC parties. Empirical study indicates that judges in Jordan are keen to deepen their understanding as to the concerns of the actors to LC in relation to illegality.¹¹¹ That may also be the position in many developing countries and the UCP should help in informing them of such a context.

C. Proposed Provision for the UCP

According to the justifications and theoretical approach advised above, it is submitted that there is a need to buttress the needs of the LC parties, in the context of fraud and illegality exceptions, in the UCP. This is not to say that the purpose is to regulate by the means of certainty how illegality and fraud may be operated as exceptions to the principle of autonomy. Because such an attempt would be repugnant to most if not all legal systems due to the overriding nature of illegality and fraud norms, and it would also make it easier for criminals to calculate costs and rewards of crime. Rather, it must be the task of the UCP to provide guidance highlighting the policies underpinning LC and the prominent needs of the actors of LC in the context of illegality and fraud. Here, flexibility should be the reflective means of the documentary credit policies and needs in order to both ensure the adaptability of such UCP guidance across the different range of legal systems and factual circumstances and be opaque enough to stress the mind of criminals and make the situation of illegal activities in LC more costly. However, as I argued above, the means of certainty (providing some details) is necessary to convey the commercial context and pragmatic needs and difficulties to reflect the expectation of international business community. These tools facilitate the application of the theoretical approaches to address the illegality and fraud exceptions constitute the third part in the model for the exceptions to the principle of autonomy in the UCP.

It is hoped that an upcoming iteration of the UCP would contain a provision that is similar to the following proposed texts:

"The principle of autonomy of documentary credits is fundamental in international finance and trade and it must be highly guarded in order to facilitate a secure method of payment to beneficiaries and to protect banks reputation and their right to reimbursement. Fraud and illegality are idiosyncratic issues that are associated to national laws and are outside the scope of the UCP. It is, however, the expectation of international banking community that the national laws that recognise fraud and illegality as exceptions to the principle of autonomy will take into consideration the following.

- (i). Knowledge of the beneficiary and the bank of the fraud and illegality, and the bank should not be under an obligation to investigate whether there is fraud or not.*

article 341 of Egyptian Commercial Code number 17 year 1999, article 399 of Qatar Commercial Code number 27 year 2006.

¹¹¹ The generated data from interviews conducted with three Jordanian judges: M Hwaidi, 'An Evaluation Of The Efficacy Of UCP 600 Within English And Jordanian Legal Orders And Jordanian Commercial Practices', PhD thesis submitted to Nottingham Trent University <http://irep.ntu.ac.uk/id/eprint/32495/1/MHwaidi%20PhD%20final%20after%20amendments.pdf> accessed 02/12/2020.

- (ii). *The type of illegality must be confined to grave crimes, or to an illegal action that is regarded as being against the fundamental principles of safeguarding the state.*
- (iii). *Banks do not have access to foreign laws and to the facts in the underlying contracts, they need to examine the documents within a short period of time, they need to preserve their reputation and thus they are not obliged to investigate whether there is illegality or not.*
- (iv). *Evidence as to illegality, in the underlying contract, with the knowledge of the beneficiary and the actual knowledge of the bank prior to the payment.*

CONCLUSION

It is hoped the developed model in this article for illegality exception under English law will assist courts to recognise illegality exception in letters of credit (LC) in a systematic way that ensures both the security of payment and finance via LC and the integrity of LC. It is also hoped that the UCP will adopt the model proposed in this article for illegality and fraud exceptions to assist the international management of supply chain security by nudging national laws towards appropriate outcomes.

Part A of the model clarifies when the principle of autonomy is engaged for an illegality claim in LC. To avoid confusion, a distinction must be drawn between (1) illegality in the formation or performance of the LC contract itself between the bank and the beneficiary; (2) illegality in one of the operating contracts in documentary credits and; (3) illegality in the underlying contract. The principle of autonomy is not engaged in the first two categories, so the general principles of the law of illegality apply. It is argued that illegality in the underlying contract whereby the LC is used as a facility to further an illegal act by the beneficiary or with his knowledge, as in the *United City Merchants* case, belongs to the first category so it does not affect the principle of autonomy. It is the claim of illegality in the third category that can be said to be a claim for illegality exception, to set aside the principle of autonomy.

The bank faces thorny challenges in deciding whether or not it is obliged to honour the LC where there is an alleged illegality in the underlying contract. This is because illegality is an unruly area that is much more complex than fraud partly since it often involves the violation of laws which are foreign to the confirming bank. There is a lack of accessibility as banks lack an access to the law and to the facts of the underlying contract. However, the moral and rational justification for the illegality exception is even stronger than that of the fraud exception. Part B of the model identifies the policy reasons pro to illegality exception (i.e. *ex turpi causa* and integrity of law, parliament sovereignty, protection of society, public conscious, integrity of LC, supply chain security) and against illegality exception (i.e. security of payment and finance, reputation of banks as guarantors of payment, lack of accessibility, broad application of illegality, speed in checking documents and manageable presentation, evidence is not examined fully prior full trial). It then argues that illegality exception is justified subject to qualifications that are triggered and informed in a balanced way by policy reasons (including pragmatic needs and difficulties in LC context) of both pro and against illegality exception.

These qualifications are: (1) illegality must be confined to criminal and civil illegality in the formation of the underlying contract or in the performance of such contract if that illegality

renders the whole underlying contract unenforceable by the beneficiary, in addition that there must be a deceitful wrongdoing by the beneficiary in civil illegality; (2) the knowledge of the beneficiary as to the illegality and the degree of such knowledge which varies from participation to a presumed knowledge as it is contingent on the form of illegality; (3) the actual knowledge of the bank, subject to some preservations, and that the bank is not obliged to investigate as to whether there is illegality or not; (4) strong evidence as to illegality at pre-trial and (5) balance of convenience in granting an injunctive relief at pre-trial by focusing on the seriousness of illegality and consequences on parties.

Finally, in light of COVID 19 and for other justifications the article argues that the UCP should address illegality and fraud exceptions. The developed model for the UCP for illegality and fraud exceptions consists of three parts. (1) The aim is to take a strategic decision to internationally manage the security of LC by safeguarding the principle of autonomy and the integrity of LC. Justifications for the aim are analysed in the article, for example the recent increase of illegal activities and functional differences between national laws, the need of developing legal systems to be further enlightened with the commercial context of LC. (2) Approaches to achieve the aim are based on Cognitive Dissonance Theory and Rational Choice Theory to prevent illegal activities and also on Nudge Theory to influence national laws to choose appropriate outcomes. (3) The means to apply the approaches. The means for Cognitive Dissonance Theory and Rational Choice Theory are: stressing the mind of potential perpetrators and making committing illegal activities more costly. This would be achieved by addressing illegality and fraud exceptions in the UCP whilst providing incomplete information to potential perpetrators as to when the exceptions apply. For Nudge Theory these means are: (a) UCP provisions should be in an advisory form, (b) they should be flexible by avoiding certainty (i.e. no detailed rules) so the UCP will not be repugnant to national laws and (c) they should provide certainty in conveying the commercial context and pragmatic needs of traders, so the choice architect of a national law will understand that context in order to then meet the expectations of the international business community and hence that national law will become a preferred choice as the applicable law by international traders.