

Fraud unravels all? A critical examination of the
fraud rules in marine insurance and documentary
credit transactions.

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This thesis is submitted in partial fulfilment of the requirements for the degree
of Doctor of Philosophy.

Declarations

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This work has not been submitted in substance for any other degree or award at this or any other university or place of learning, nor is being submitted concurrently in candidature for any degree or other award.

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Summary

This thesis considers the extent to which ‘fraud unravels all’ explains the judicial response to fraudulent marine insurance claims and fraud in documentary credit transactions. The simplicity of the maxim suggests that fraud does not unduly trouble the courts and gives the impression of a uniform and deterrent approach to fraud within the civil law. The comparison made in this thesis demonstrates this impression to be misleading; the courts have conceived of fraud differently and have employed context-specific policy concerns to justify the shape of each fraud rule. The insurance discussions are dominated by deterrence with legal sanctions placed at the heart of the model. By contrast, the trade finance courts adopt a more laissez-faire attitude which prioritises the efficiency of the credit mechanism and considers deterrence an *ex ante* issue for the parties. Accordingly, this thesis examines the respective policy justifications and considers their continued validity in light of comparative and empirical evidence. In the insurance context, it is argued that the judicial understanding of deterrence is outdated which renders the resulting legal rule ineffective. An examination of approaches to fraud in other jurisdictions then demonstrates the possibility of constructing a more nuanced remedial framework which would balance the competing policy considerations of deterrence and proportionality. The documentary credit discussion contends that the narrow English approach to fraud is not an inevitable policy decision and moreover, has resulted in detrimental consequences for the credit mechanism. It employs empirical data to develop an explanation of deterrence for the duration of credit transactions. In both contexts, these arguments have important implications for the future development of the law. In summary, this research undermines the utility of ‘fraud unravels all’ and calls instead for courts and academics to resist instinctively attractive solutions in favour of a robust, empirically-informed approach to fraud.

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Chapter One

Introduction

The phrase ‘fraud unravels all’ is a simple one. It is often espoused by the courts without further examination or explanation. The maxim is presented as sufficient to dispose of claims tainted by fraud. It hints at a singular judicial and perhaps punitive approach to fraud. It further suggests that the effect of fraud is identical – an unravelling effect on the transaction to which the fraud relates.

Indeed, this notion of simplicity is the starting point for MacDonald Eggers’ excellent monograph on deceit, in which he commences by describing rules on fraud as a singular entity, underpinned by a shared rationale and purpose,

The existence and formulation of a particular rule of law may have its genesis in utility, certainty, or fairness. The law concerning fraud and deceit, attested to by such ancient advocates as Hyperides, Aristotle and Cicero, is underpinned by our moral duty to tell the truth and the social and commercial necessity of deterring untruths drawing the innocent to their harm.¹

In *Regulating Contracts*, Professor Collins makes a similar point and highlights the commercial consequences of deceit, “rules against fraud and misrepresentation...serve to deter lying and the supply of misleading information, practices which would undermine the competitiveness of the market and reduce trust.”²

Taken together this would suggest that fraud rules are viewed as having a uniform purpose – the deterrence of fraud – which emerges from moral concerns about, and the commercial impact, of dishonesty. Furthermore, this suggests that fraud has a similar effect; to unravel the entirety of the transaction to which the fraud relates.

A closer look suggests this impression may be false. For one thing, the unravelling effect of fraud may not be solely dependent on the existence of fraud but also on the satisfaction of other criteria. Thus, the extent to which fraud unravels transactions may depend on the

¹ P MacDonald Eggers, *Deceit: The Lie of the Law* (Informa Law, 2009), [1.4].

² H Collins, *Regulating Contracts* (OUP, 1999) 75.

particular context in which the rule operates. For another, fraud rules are variously described by the courts. In certain contexts, fraud rules are characterised as serving an instrumental role for the broader societal good. In other contexts, the flexibility of the fraud rule may be constrained by the particular idiosyncrasies of the mechanism to which it relates. This will in turn constrain the rule's potential as an instrument of social utility as the court simultaneously gives effect to competing policy objectives.

The simplistic maxim may therefore not be sufficient to explain what is going on when the courts are faced with fraud. This thesis begins to address this gap by exploring the effect of fraud in two distinct but related areas; fraudulent insurance claims and fraud in transactions financed by documentary credit. A consideration of the utility of 'fraud unravels all' as an explanation of judicial action will demonstrate that the insurance and trade finance courts have conceptualised fraud in different ways. The justification for these particular characterisations depend on assertions which have been repeatedly endorsed in case law but are yet to be critically examined. This project addresses this gap by subjecting the justification for the scope of each rule and respective judicial characterisation to critique.

This thesis is not a call for all rules on fraud to be identical in all contexts. Instead, it is an attempt to understand the contextual differences which call for fraud to be thought of and treated differently. While maxims expressed in Latin may be pithy, they fail to recognise the nuance, and the reasons for that nuance, which exist in reality and against the backdrop of the piecemeal common law system. There is no conceptual difficulty with the law responding to fraud in different ways across areas of law, provided there is a minimum level of intervention on public policy grounds.³

This chapter introduces the project and undertakes several practical tasks. The discussion opens by highlighting judicial concerns about commercial fraud (I). It then provides a sketch of how fraud arises and is litigated in marine insurance (II) and within documentary credit transactions (III). Part IV justifies the comparison between these areas of law and defines the

³ See P Todd, 'Non-genuine shipping documents and nullities' [2008] LMCLQ 547, 550 where Lord Diplock's elaboration of the fraud exception for documentary credits is described as follows: "accepting, albeit with not obvious enthusiasm, that the autonomy principle must give way to the general rule of public policy, *ex turpi causa*."

research questions addressed in this project. The major argument is that policy considerations used to justify legal rules must be critically examined to assess their (continuing) validity. Part V, therefore, places the project in context by demonstrating the current absence of considered policy discussion in these areas. The remaining sections outline the methodology (VI) and the ways in which the thesis meets the requirement of originality (VII). A summary of each forthcoming chapter is provided in part VIII.

I. Judicial Concerns about Fraud

It is unsurprising that the courts have repeatedly expressed concerns about fraud in the commercial arena.⁴ These statements can be traced to the time of Lord Mansfield, the key eighteenth century architect of the commercial law, in *Pawson v Watson*.⁵ There he said that fraud, once proven, “vitiates judgments, contracts and all transactions whatsoever.”⁶ These ideas have been endorsed in modern case law by the Court of Appeal⁷ and, more recently, by the House of Lords.⁸

Judicial intervention in cases of fraud primarily responds to moral concerns about dishonesty.⁹ In some cases, intervention will consist of a refusal to become embroiled in the dispute at hand for fear of sullyng the court’s integrity.¹⁰ In the case which established the defence of illegality, *Holman v Johnson*, Lord Mansfield remarked that the court would not lend “its aid to a man who founds his cause of action upon an immoral or an illegal act.”¹¹ In other circumstances, the courts will take more overt steps to prevent the fraudster profiting from his wrongdoing. This may mean that the common law rule resembles an attempt to sanction or punish the wrongdoer. In these cases, the court will not be swayed by arguments that the claimant in some way contributed to his loss. The Court of Appeal have recently summarised this approach in the following terms, “highwaymen in commerce forfeit the right

⁴ J Dolan, *The Law of Letters of Credit Commercial and Standby Credits* (4th ed. AS Pratt & Sons, 2007) [7-66]: “Fraud has long been a source of major concern for commercial law.”

⁵ *Pawson v Watson* (1778) 2 Cowp. 785.

⁶ *Ibid* 788 per Lord Mansfield.

⁷ *Lazarus Estates Ltd v Beasley* [1956] 1 QB 702, 712 per Denning LJ.

⁸ *HIH Casualty & General Insurance v Chase Manhattan* [2003] 2 Lloyd’s Rep. 61, [15] [16] per Lord Bingham.

⁹ *Standard Chartered Bank v Pakistan National Shipping Corp. (Nos. 2 and 4)* [2003] 1 AC 959, [20] per Lord Hoffmann: “moral disapproval of fraud.”

¹⁰ *Hall v Herbert* [1993] 2 SCR 159, 169 per McLachlin J; *Birkett v Acorn Business Machines Ltd* [1999] 2 All ER Comm 429 per Colman J; Law Commission, *The Illegality Defence* (Law Com CP 189, 2009), [2.24].

¹¹ *Holman v Johnson* 1 Cowp 342 (1775), 343.

to just and equitable treatment...In this field it is all or nothing.”¹² For present purposes, the judicial response to fraud in the contexts under discussion is a clear attempt to prevent the fraudster profiting from his wrongdoing. A finding of fraud will deprive the fraudster of his entire right to indemnity or payment under the policy or credit, respectively.

By contrast, a more proactive response to fraud – designed to uphold a basic standard of commercial morality – is often evident in relation to wrongdoing in the pre-contractual phase. Courts will, for example, refuse to enforce a clause purporting to relieve one party from the consequences of his own fraud.¹³ An explicit concern about morality is also evident in the law of misrepresentation which provides remedies for innocent pre-contractual misstatements.¹⁴ Without remedies in this situation, the misrepresenter would be permitted to take advantage of a situation premised on falsity and this, as Lord Jessel MR held in *Redgrave v Hurd*, would be “a moral delinquency.”¹⁵ This same logic underpinned the law of non-disclosure in insurance.¹⁶ In *Carter v Boehm*, Lord Mansfield determined that remedies would be available even where the non-disclosure was inadvertent because “still the under-writer is deceived... because the risque run is really different from the risque understood and intended to be run, at the time of the agreement.”¹⁷ Remedies for breach of the duty of fair presentation under the Insurance Act are now tied to the nature of the breach¹⁸ or the impact that the misstatement had on the underwriter.¹⁹ The underwriter remains entitled to a remedy in the case of inadvertent non-disclosure which demonstrates the ongoing importance of upholding basic commercial morality.

There is also an economic justification for common law rules against fraud. The process of contractual negotiations enables the parties to make provision for foreseeable contingencies which may arise during their exchange. There are clearly costs associated with this process, but these can be justified on the basis that parties know their rights and liabilities with

¹² *Standard Chartered Bank v Pakistan National Shipping Corp. (No. 2)* [2000] 2 Lloyd’s Rep. 511, [126] per Ward LJ.

¹³ *S Pearson & Son Ltd v Dublin Corp* [1907] AC 351, 353-354 per Lord Loreburn LC.

¹⁴ Misrepresentation Act 1967 s.2(2).

¹⁵ *Redgrave v Hurd* (1881) 20 Ch D 1, 12-13 per Lord Jessel MR.

¹⁶ *Carter v Boehm* (1766) 3 Burrow 1905.

¹⁷ *Ibid* 1909 per Lord Mansfield.

¹⁸ Insurance Act 2015 Sched. 1 (2).

¹⁹ Insurance Act 2015 s.3; Sched 1. (3). For an important consideration of what proportionality actually means in this context, see J Davey, ‘Proportionality & the hypothetical bargain: The Law Commission’s remaking of commercial insurance law’ (2016) (Work in progress).

certainty from the outset. Fraud is a different matter. It is not an eventuality which arises due to some external event beyond the parties' control, but rather because one party intentionally deceives the other. Accordingly, the risk of dishonesty requires the design of elaborate protective clauses and this imposes considerable costs on contracting parties.²⁰ These costs cannot be justified in the same way as ordinary contractual clauses can be. Common law rules against fraud, therefore, represent an attempt to prevent the wasted expenditure that would otherwise be incurred as a result of negotiating about the fraud risk in advance. The increased costs associated with fraud also extend to litigation and this necessarily impacts upon the courts. As Lord Reed has argued extra-judicially, sanctions should be imposed on the dishonest litigant because such dishonesty "imposes an unnecessary burden on court resources."²¹

Similar concerns about fraud have been voiced by the courts in the specific contexts under discussion, marine insurance claims and documentary credit transactions. Fraud does not affect these transactions identically; it involves different parties and reaches the courts at different stages of the transaction. As a basis for the forthcoming discussion, an overview of each mechanism and the impact of fraud is now provided.

II. The Insurance Context

The nature of the insurance relationship is well known. It is designed to provide the assured with a financial safety net in the event of harm caused by an insured peril. This safety net is constructed through the transfer and spreading of risks in the market.²² A risk averse individual or entity transfers the risk of loss to a professional risk taker, the underwriter, in exchange for the payment of the premium.²³ The assured suffers a small financial loss in the short term – the premium – as a safeguard against the potential for greater loss in the future.²⁴ Risks are palatable to the underwriter because it can pool assureds with similar risk profiles and charge the same premium. Efficient underwriting depends on sufficient premium

²⁰ R Posner, *Economic Analysis of Law* (5th ed. Aspen Publishers, 1998), 123.

²¹ Lord Reed, 'Lies, damned lies: Abuse of process and the dishonest litigant' 3 (26/10/2012) available at: <https://www.supremecourt.uk/docs/speech-121026.pdf> (accessed 12/09/2017).

²² T Baker, *Insurance Law and Policy* (Aspen Publishers, 2003), 2.

²³ *Ibid* 2.

²⁴ H Beh and J Stempel, 'Misclassifying the insurance policy: The unforced errors of unilateral contract characterization' [2010] 32(1) *Card. L Rev.* 85, 105.

income within a given pool to indemnify the unlucky few who suffer a significant loss.²⁵ This enables the insurer to spread the risk of loss throughout the group of assureds.²⁶ This process of writing large numbers of risks is facilitated by the law of large numbers;²⁷ it is possible to estimate how many ships will sink in a given year, for example, but virtually impossible to identify with precision *which* ships will sink.

The premium is set by reference to the riskiness of the individual insured.²⁸ This makes pre-contractual negotiations critical; it is vital for the underwriter to gather as much relevant information about the risk as he can. This process is expensive and the underwriter will be keen to ensure that these pre-contractual expenditures do not exceed the value of the business. Accordingly, the underwriter will need to rely on the information provided by the prospective assured and this necessarily creates incentives for the assured to withhold information which would tend to increase his risk. The deliberate suppression of information at this stage would be regarded as fraud but its consideration is beyond the scope of the project.²⁹ Payment of the premium constitutes the assured's major obligation under the insurance contract. In return for this premium, the underwriter promises to hold the assured harmless against covered perils or, to pay a sum of unliquidated damages to indemnify the assured following a loss.³⁰

The claims process is the time at which the insured holds the underwriter to his bargain. This process, yet again, creates incentives for the assured to behave fraudulently and it is this kind of fraud which is the focus of this project. Fraud at the claims stage may take several forms. The insured may (i) deliberately destroy his property for the purposes of making an insurance claim or (ii) may exaggerate his losses following an insured event. Until the recent Supreme Court decision in *Versloot*,³¹ a third category of behaviour – the valid claim supported by false

²⁵ T Baker, 'Constructing the insurance relationship: Sales stories, claims stories, and insurance contract damages' (1993-1994) 72 *Tex L Rev* 1395, 1401.

²⁶ Baker, *Insurance Law* (n22) 2.

²⁷ K Abraham, *Insurance Law and Regulation* (3rd ed. Foundation Press, 2000), 2; Baker, *Insurance Law* (n22) 3.

²⁸ Abraham, *Insurance Law* (n27) 2.

²⁹ For a comprehensive account of pre-contractual fraud by the assured, readers are directed to B Soyer, *Marine Insurance Fraud* (Informa Law, 2014), 17-68. Pre-contractual duties of the commercial assured are now governed by Insurance Act 2015 s.3, sched. 1. The position for consumer assureds is contained in Consumer Insurance (Disclosure and Representations) Act 2012.

³⁰ *Firma C-Trade SA v Newcastle Protection and Indemnity Assn (The Fanti and The Padre Island)* (No 2) [1991] 2 AC 1, 35, per Lord Goff.

³¹ *Versloot Dredging BV v HDI Gerling Industrie Versicherung AG* [2016] UKSC 48 (hereafter referred to as *Versloot* (Supreme Court)).

evidence – was also treated as fraud.³² The assured may also be treated as a fraudster if he fails to disclose the existence of a defence to his underwriter. Regardless of the type of fraud, the underwriter’s liability is subject to the terms of the contract and it is not uncommon for him to attempt to identify a legitimate basis for resisting the claim. The validity of these defences must be determined before any payment will be made to the assured. It is correct then to describe the insurance relationship as ‘argue now, pay later’.³³ Where the parties are unable to agree a settlement, the insured will need to bring a claim against the insurer for the indemnity.³⁴ The fraud rule will then be deployed by the insurer as a defence to liability. The action will, save for the most exceptional of cases,³⁵ involve the allegedly fraudulent assured and the insurer. A finding of fraud at trial will cause the assured to forfeit his claim in its entirety, including any genuine loss. The nature of the insurance relationship means that allegations of fraud must be resolved before any indemnity is payable. This, from a structural perspective, is a relatively straightforward process. In this sense, the insurance fraud enquiry is much less complicated than that which occurs in transactions financed by documentary credit.

III. The Documentary Credit Context

The letter of credit is a complex method of trade financing.³⁶ It creates a network of contracts to bridge the gap between buyer and seller and assuage mutual concerns about dealing with an unknown party located abroad. The major risks of international trade concern the fundamental contractual obligations of each party; the seller’s duty to send goods conforming to the contract and the buyer’s obligation to pay. The documentary credit mechanism is designed to manage these risks by introducing banks into the contractual network. The primary payment obligation is borne by the bank and this eliminates the seller’s concerns

³² *Agapitos v Agnew (The Aegeon)* [2003] QB 556. A comprehensive account of the shifting common law definition of insurance claims fraud will be provided in Chapter Two, see later, text to fn 186 et seq.

³³ This is the reverse of the characterisation of the letter of credit contract, see G McMeel, ‘Pay now, argue later’ [1999] LMCLQ 5.

³⁴ J Feinman, ‘The regulation of insurance claims practices’ [2015] 5 UC Irvine L Rev 1319, 1416.

³⁵ The claim for indemnity may be brought by a representative of the assured such as when the assured has died following the occurrence of the loss, see *The Aegeon* (n32) 558 per Mance LJ.

³⁶ P Todd, *Maritime Fraud & Piracy* (2nd ed. Informa Law, 2010), [4.019]. However, the ICC would seem to disagree with this characterisation, see D Bischof, ‘Letters of credit (LCs): recognizing the value of simple trade instruments’ (12/07/16) available at: [http://www.iccwbo.org/News/Articles/2016/Letters-of-credit-\(LCs\)-recognizing-the-value-of-simple-trade-instruments/](http://www.iccwbo.org/News/Articles/2016/Letters-of-credit-(LCs)-recognizing-the-value-of-simple-trade-instruments/) (accessed 16/08/16) where the credit is described as “well-worn and simple”.

regarding the buyer's insolvency. Moreover, payment is contingent on the seller presenting documents indicating he has performed his obligations, which reduces the buyer's risk of paying for poor quality or non-existent goods. Effectively, the letter of credit establishes a channel through which documents representing the goods can reach the buyer in exchange for the price. The fundamental purpose of the mechanism is to ensure a swift and virtually unassailable means of payment to finance international sales.

The letter of credit does not remove the risks of international trade entirely. The documentary nature of the transaction creates incentives for the seller to commit fraud in the course of his obligations.³⁷ The first, and most deliberate, type of fraud occurs when the seller ships worthless goods or nothing at all and procures wholly false documentation to substantiate his right to payment. The second category of fraud is opportunistic in nature. This occurs when the seller has shipped the contract goods but then breaches the credit contract, and possibly also the underlying contract of sale, by shipping the goods late or from the wrong port. The fraud occurs where the seller procures fraudulent documentation, such as a backdated bill of lading, to conceal this breach.

The fraud enquiry in documentary credit transactions is particularly complex because the fraud rule can be raised both before and after payment has been made, and actions may wholly exclude the alleged fraudster. In addition, the fraud enquiry is constrained by the fact that the court's priority is to ensure that the documentary credit remains a swift payment mechanism. This limits the opportunities for fraud prevention since the investigation necessary to uncover fraud will inevitably delay payment. It is for this reason that the general organising principle of documentary credits is 'pay now, argue later.'³⁸ Aware of the fraud potential in credit transactions, the courts have developed a narrow fraud exception which can be invoked both before and after payment has been made to the credit beneficiary. From the buyer's perspective, it will be preferable to raise fraud prior to payment and this will require him to obtain an interim injunction against the seller or the paying bank. Success at this stage is very rare, though hypothetically possible, in English law. The fraud exception is more likely to operate after the seller has received payment. It is typically raised as a defence

³⁷ This is to be distinguished from fraud committed by the buyer or schemes concocted between buyer and seller to defraud the bank. These issues are briefly considered in A Malek and D Quest, *Jack: Documentary Credits* (4th ed. Tottel Publishing, 2009), [9.20].

³⁸ McMeel (n33) 5.

by the buyer in an action brought by the bank for reimbursement.³⁹ In these circumstances, the court is effectively asked to apportion loss between two innocent parties. Of course, an action to recover the money from the seller after payment is theoretically possible, but unlikely where the fraud was deliberately orchestrated by a dishonest trader.

The fraud rule in documentary credits will rarely target the fraudster directly and instead typically operates as a risk allocation device between two innocent parties. Matters are much more straightforward in the insurance context where the forfeiture rule only operates between alleged fraudster and potential victim in a final trial of the issues. These differences are explicable by reference to the different role of each mechanism. The credit is a primary payment mechanism which, to serve its purpose, must be permitted to function swiftly and with limited judicial intervention. This gives the potential victim only a very short period in which to gather sufficient evidence of fraud. By contrast, considerations of speed are far less pressing in the insurance context. Once the loss has occurred, there are few structural reasons to prevent the underwriter conducting a comprehensive investigation and presenting this evidence to a court. Provided the underwriter submits sufficient evidence, there is no reason to prevent the court reaching a conclusion on the fraud allegation. The requirements of the respective mechanisms affect the ability of the courts to intervene in a timely fashion to counter fraud. This has led the courts to conceptualise the fraud problem and the purpose of judicial intervention in different ways. The following chapters will examine these differences in greater depth but an overview is provided at this stage.

The insurance courts have recognised fraud as a serious threat to the insurance relationship. The narrative is one of dishonesty and deceit which portrays the law in instrumental terms to discourage fraud in the claims process. By contrast, the narrative of the trade finance courts largely marginalises fraud, offering an image of honest commercial dealing in which the needs of the market - a swift, certain payment mechanism - trump the security mechanisms needed to effectively detect and uncover fraud. In both contexts, these narratives are underpinned by simplistic assertions about how people respond to the threat of legal sanctions in the

³⁹ For example, *Gian Singh v Banque de l'Indochine* [1974] 1 WLR 1234; *Credit Agricole v Generale Bank* [1999] 2 All ER Comm 1009; *DCD Factors plc v Ramada Trading Ltd* [2008] Bus LR 654.

insurance case, and by reference to market need in relation to documentary credits. These assertions have not yet been the subject of considered analysis and critique.

IV. A Justification of the Comparison

The differences in the judicial narrative surrounding fraud demand further examination and consideration. While the rules under discussion – the forfeiture rule in marine insurance and the fraud exception in documentary credit – each depend, to some extent, on *ex turpi causa*, this is where the similarity ends. Indeed, the rules have been developed in different directions by the courts. This results from a different characterisation of the parties involved in the relevant transaction, constraints supposedly dictated by the particular mechanism and the intended purpose of the fraud rule. This divergence in judicial treatment makes the rules worthy comparators.

The comparison is further justified by the fact that these mechanisms converge in the practical setting. The marine insurance policy, for example, is one of the documents that the seller must present to obtain payment under a documentary credit. The potential fraudsters are commercial traders who, over the course of their careers, will be presented with opportunities to commit fraud both as seller under a documentary credit and insurance policyholder. This practical overlap often means that issues connected to marine insurance and international trade financing are examined within the same work but academic treatments tend to regard these areas as largely distinct.⁴⁰ This project continues in this tradition, but advances the discussion by comparing a crucial aspect of these commercial mechanisms; the respective fraud rules and how they have been constructed by the courts.

The mechanisms under discussion – the insurance policy and the documentary credit – serve very different purposes in international trade. This project is not then a study of comparable mechanisms and nor does it suggest that fraud rules should be identical irrespective of context. Rather, it seeks to identify the policy considerations which have shaped the fraud rule in each context and the extent to which these considerations remain valid.

⁴⁰ Examples would include Todd, *Maritime Fraud & Piracy* (n36) (chs. 3-4 concern documentary credits, ch.6 concerns marine insurance); I Carr, *International Trade Law* (5th ed. Routledge, 2014) (chapter 13 deals with these topics distinctly.)

Accordingly, the following research questions are posed:

1. How is the fraud rule constructed in doctrinal and procedural terms?⁴¹
2. What policy arguments have been used by the courts to justify the scope of and the procedural criteria required to invoke the fraud rule?⁴²
3. To what extent do these policy justifications remain valid today?⁴³

This thesis meets a gap in the literature by challenging the policy arguments used to justify the scope of the fraud rules in the law of marine insurance and documentary credits. At this stage, it is convenient to demonstrate the current absence of policy discussion in these areas.

V. The Absence of Policy Discussion

The fraud rules under discussion have developed from a similar starting point; the notion that fraud unravels all.⁴⁴ Despite this shared basis, the rules have developed differently. In each setting, the courts have relied on particular policy arguments deemed relevant to the context at hand to justify the particular scope and purpose of the rule. Considerations of deterrence have framed the discussion in the insurance cases, whereas an emphasis on commercial need has been employed in letters of credit.

There is, of course, no conceptual difficulty with using policy arguments to develop the law. Indeed, such arguments are routinely adopted by the courts in cases where “the rules of the legal system do not provide a clear resolution of a dispute.”⁴⁵ But since policy arguments are simply “value-judgements”,⁴⁶ the policy construction employed in a particular context is not fixed nor inevitable, but open to question in subsequent cases. Bell’s suggestion that courts are “too ready to assume that there is no fundamental disagreement about the values to be

⁴¹ This is addressed in Chapter Two (insurance) and Chapter Four (documentary credits).

⁴² This is addressed in Chapter Two (insurance) and Chapter Four (documentary credits).

⁴³ This is addressed in Chapter Three (insurance) and Chapter Five (documentary credits).

⁴⁴ For the insurance context see *Manifest Shipping Co Ltd v Uni-Polaris Co Ltd (The Star Sea)* [2003] 1 AC 469, [62] per Lord Hobhouse; for the documentary credit context see *United City Merchants v Royal Bank of Canada (The American Accord)* [1982] 2 Lloyd’s Rep. 1, 6 per Lord Diplock, (hereafter referred to as *United City Merchants (House of Lords)*).

⁴⁵ J Bell, *Policy Arguments in Judicial Decisions* (Clarendon Press, 1983), 22-23.

⁴⁶ *Ibid* 36.

applied”⁴⁷ is certainly applicable in the insurance and trade finance contexts. This absence of critique is particularly problematic when one appreciates that many of these arguments were developed in the nineteenth century or by analogy to much older commercial mechanisms. The nature of commerce has changed dramatically in the intervening years. It is certainly not a given that modern courts would be as influenced by these arguments if they were starting from scratch today.

Firstly, the marine insurance context. The discussion in *The Star Sea* confirms that the rule prohibiting fraudulent claims is analogous to *ex turpi causa*,

The law is that the insured who has made a fraudulent claim may not recover the claim which could have been honestly made. The principle is well established and has certainly existed since the early 19th century... Just as the law will not allow an insured to commit a crime and then use it as basis for recovering an indemnity (*Beresford v Royal Insurance Co Ltd* [1937] 2 KB 197), so it will not allow an insured who has made a fraudulent claim to recover.⁴⁸

This is not, however, a comprehensive account of the forfeiture rule. This is because the court usually refuses to engage with issues of illegality and this leaves the loss to lie where it fell.⁴⁹ The consequences of forfeiture are more severe; the assured also loses his claim for genuine loss and is required to return any sums paid prior to the discovery of the fraud.⁵⁰ This cannot be explained by reference to *ex turpi causa* but instead depends on considerations of policy,⁵¹ namely the deterrence of fraud. As Lord Hobhouse continued in *The Star Sea*,

The logic is simple. The fraudulent insured must not be allowed to think: if the fraud is successful, then I will gain; if it is unsuccessful, I will lose nothing.⁵²

⁴⁷ Ibid 36.

⁴⁸ *The Star Sea* (n44) [62] per Lord Hobhouse. See also, *Britton v Royal Insurance Co* (1866) 4 F&F 905.

⁴⁹ (Lord) J Sumption, ‘Reflexions on the law of illegality’ (Speech to Chancery Bar Association, 23 April 2012) available at: <http://www.chba.org.uk/for-members/library/annual-lectures/reflections-on-the-law-of-illegality.pdf> (accessed 18/09/2017), 3.

⁵⁰ *Axa General Insurance Ltd v Gottlieb* [2005] 1 All ER (Comm) 445, [29] per Mance LJ.

⁵¹ Ibid [29] per Mance LJ.

⁵² *The Star Sea* (n44) [62] per Lord Hobhouse.

The view that legal sanctions are required to prevent widespread claims fraud has been repeated in case law since the 1860s⁵³ and is typically endorsed in academic commentary. Professor Bennett, for example, reiterates the above excerpt from *The Star Sea* before going on to comment that “[i]f fraud carried no risk, there would be no deterrent. On the contrary, there would be a perverse incentive to be fraudulent.”⁵⁴ Professor Todd has also confirmed the overriding importance of deterrence in the construction of the forfeiture rule,

The intention is clear enough, to discourage the assured from presenting fraudulent claims, of fraudulently embellishing claims.⁵⁵

The ‘forfeiture as deterrent’ narrative remained largely unchallenged until the recent litigation in *Versloot*.⁵⁶ Earlier scepticism of the deterrent effect of the civil law appeared in Professor Clarke’s, *Law of Insurance Contracts*,⁵⁷ in which he noted that the civil law was not usually tasked with punishing offenders⁵⁸ and continued,

Moreover, the case for penal sanctions rests partly on their efficacy for social engineering for deterrence, which, in this context at least, is doubtful. The assumption is that it works.⁵⁹

Clarke repeated the argument, originally made by Mustill LJ,⁶⁰ that the civil law cannot deter if the major threat of the criminal law, imprisonment, has not dissuaded the offender.⁶¹ He continued,

Of course fraud is not murder, but to a significant degree, surely, the same can be said of cold blooded crimes such as fraud, if the fraudsters think that their chances of being

⁵³ *Britton* (n48) 909 per Willes J; *Galloway v Guardian Royal Exchange (UK) Ltd* [1999] Lloyd’s Rep. IR 209, 213 per Lord Woolf MR; *The Star Sea* (n44) 62 per Lord Hobhouse.

⁵⁴ H Bennett, *The Law of Marine Insurance* (2nd ed. OUP, 2006), 719.

⁵⁵ Todd, *Maritime Fraud & Piracy* (n36) [6.048].

⁵⁶ The case reached the Supreme Court, see *Versloot (Supreme Court)* (n31).

⁵⁷ M Clarke, *Law of Insurance Contracts* (4th ed. Service Issue 35 1 April 2016) (hereafter referred to as ‘Clarke (looseleaf)’)

⁵⁸ *Ibid* [27-2C3].

⁵⁹ *Ibid* [27-2C3]. The judgment in *Versloot Dredging BV v HDI-Gerling Industrie Versicherung AG (The DC Merwestone)* [2014] EWCA Civ 1349; [2015] 1 Lloyd’s Rep 32 (hereafter referred to as *Versloot (Court of Appeal)*) prompted further consideration of the deterrent effect of forfeiture, see P Rawlings, and J Lowry, ‘Insurance fraud: The “convoluted and confused” state of the law’ [2016] LQR 96, 98; P Rawlings and J Lowry, ‘Insurance fraud and the role of the civil law’ (2017) 80(3) MLR 525, 537 et seq.

⁶⁰ M Mustill, ‘Fault and marine losses’ [1988] LMCLQ 310, 319.

⁶¹ Clarke (looseleaf) (n57) [27-2C3].

caught are small. The courts, however, appear to have taken a different view, for the prospect of deterrence has been a significant policy factor in decisions such as *Galloway*, and more recently in *Axa v Gottlieb*.⁶²

It is correct to suggest that pre-*Versloot*, Clarke's sceptical account of the rule was unique amongst the major academic commentaries on insurance law. Indeed, his scepticism was the inspiration for the author's LLM dissertation which critiqued the Law Commission's proposals for reform from a criminological perspective.⁶³ This project continues in a similar vein by providing theoretical and empirical evidence to demonstrate the ineffectiveness of the forfeiture rule as deterrent.

The leading English account of the fraud exception in documentary credits is traced to Lord Diplock's judgment in *United City Merchants v Royal Bank of Canada*.⁶⁴ Much like its insurance comparator, the fraud rule was explained as

a clear application of the maxim *ex turpi causa non oritur actio* or, if plain English is to be preferred, fraud unravels all.⁶⁵

Policy considerations have been equally influential in this context, enabling the courts to justify the particular scope and purpose of the fraud exception. Notably, however, the policy arguments employed in relation to documentary credits are different to those deemed relevant in the insurance setting. This is not altogether surprising since the nature of the documentary credit transaction means that fraud raises different considerations and involves different parties. In particular, the major policy argument employed by the trade finance courts is the idea that commercial parties require a payment mechanism which is only subject to judicial intervention in limited circumstances. Indeed, Lord Diplock used the 'commercial need' argument to reject a broader fraud exception,

This proposition which does not call for knowledge on the part of the seller/beneficiary of the existence of any inaccuracy would embrace the fraud exception and render it superfluous. My Lords, the more closely this bold proposition

⁶² Ibid [27-2C3].

⁶³ K Richards, 'Deterring insurance fraud: A critical and criminological analysis of the English and Scottish Law Commissions' current proposals for reform' (2013) 24 ILJ 16.

⁶⁴ *United City Merchants (House of Lords)* (n44) 6-7 per Lord Diplock.

⁶⁵ Ibid 6 per Lord Diplock.

is subjected to legal analysis, the more implausible it becomes; to assent to it would, in my view, undermine the whole system of financing international trade by means of documentary credits.⁶⁶

Academic commentaries of documentary credit fraud typically repeat the salient points of Lord Diplock's judgment before identifying the procedural criteria which the claimant must satisfy.⁶⁷ There is, as far as the author can identify, no suggestion that commercial need is an inappropriate basis by which to develop the rule. The issue, however, is the nature of the reasoning which enabled the House of Lords to reach their conclusions on fraud and the related questions of forgery and nullity.⁶⁸ Professor Goode's main contention is that the judgment in *United City Merchants* misstates the contractual basis of the credit mechanism and undermines the major doctrines on which the documentary credit depends.⁶⁹ This had significant consequences for the judicial elaboration of the fraud exception in *United City Merchants*. While Goode does not suggest that the policy arguments were incorrect, his explicit critique of the judicial reasoning in the House of Lords is a notable exception to the general pattern of acceptance.

As a critique of the policy approaches adopted by the courts, this project fits within a broader tradition in private law, most notably in relation to insurance law. One of the earliest examples of such work is Harnett and Thornton's critique of the doctrine of insurable interest from a socio-economic perspective.⁷⁰ There the authors noted the value of such work; it was required "to prevent... deterioration into a set of fixed and unyielding 'principles', constant and vigilant re-evaluation of concepts is necessary to enable legal concepts to keep pace with adjustments in external variables."⁷¹ More recently, Professor Davey has employed a similar

⁶⁶ Ibid 7 per Lord Diplock.

⁶⁷ For example, Malek and Quest, *Jack* (n37) [9.8]-[9.19]; P Ellinger and D Neo, *The Law and Practice of Documentary Letters of Credit* (Hart Publishing, 2010), 138 et seq.; N Enonchong, *The Independence Principle of Letters of Credit and Demand Guarantees* (OUP, 2011), [5.10].

⁶⁸ R Goode, 'Abstract payment undertakings' in P Cane and J Stapleton (eds.), *Essays for Patrick Atiyah* (Clarendon Press, 1991) (hereafter referred to as 'Goode, 'Abstract payment undertakings'); E McKendrick, *Goode on Commercial Law* (4th ed. Penguin, 2010); D Horowitz, *Letters of Credit and Demand Guarantees: Defences to Payment* (OUP, 2010), [3.18]. See also EP Ellinger, 'Fraud in documentary credit transactions' [1981] JBL 258.

⁶⁹ Goode, 'Abstract payment undertakings' (n68) 228, 232.

⁷⁰ B Harnett and J Thornton, 'Insurable Interest in Property: A Socio-Economic Re-evaluation of a Legal Concept' (1948) 48 Col L Rev 1162.

⁷¹ Ibid 1162.

approach in a number of areas of insurance law,⁷² explicitly subjecting the judicial approach, most notably that of Lord Mance, to critique.⁷³

Having identified the academic tradition in which this project sits, it is convenient at this stage to consider the specific methodology employed here.

VI. Methodology

As a critique of common law rules on fraud, this thesis has been a desk-based project. The purpose of the project was to unpick the policy reasoning which has been used to construct fraud rules in the marine insurance and documentary credit contexts. This necessitated a close, doctrinal analysis of the relevant case law and associated academic commentary to determine the policy basis/bases underpinning the respective fraud rules.

Academic commentators and subsequent courts typically endorse the policy arguments used to justify the fraud rules without considering their validity or explanatory power. By contrast, this project critically examines these policy arguments and considers whether they remain a valid explanation of judicial intervention in fraud cases. In developing these critiques, the project drew comparisons with foreign jurisdictions and literatures beyond law. It is important to highlight, however, that as each rule is premised on context-specific policy considerations, the critiques necessarily differ both in content and the sources on which they depend. It is for this reason that a single theoretical framework is not developed in this thesis.

Both critiques adopt a comparative approach. In the insurance context, a comparison is made with the approach to fraudulent insurance claims in Australia and the English courts' approach to fraudulent claims in criminal and personal injury law. In the documentary credit chapter, the English approach is contrasted with approaches adopted in other jurisdictions, primarily the USA and Singapore. The more expansive approaches adopted in foreign

⁷² J Davey, 'Honesty & the relational commercial contract: Towards a law of post-contractual misrepresentation', (Insurance Fraud Symposium, University of Southampton Law School, 13 July 2016), 5.

⁷³ J Davey and K Richards, 'Deterrence, human rights and illegality: The forfeiture rule in insurance contract law' [2015] LMCLQ 315; J Davey, 'The reform of insurance warranties: A behavioral economics perspective' (2013) JBL 118; J Davey, 'Remedying the remedies: The shifting shape of insurance contract law' [2013] LMCLQ 476; J Davey, 'Claims notification clauses and the design of default rules in insurance contract law' (2012) 23 ILJ 245.

jurisdictions are used to reflect on the English emphasis on commercial need as a basis for the narrow fraud rule.

The project also adopts empirical work on the use of documentary credits. The data was no longer available at the time of writing⁷⁴ and so the project draws upon commentaries explaining the original survey.⁷⁵ This data fits within empirical legal scholarship which demonstrates a divergence between the law on paper and the law in action. This broader context is a useful perspective from which to consider the continued popularity of the credit mechanism and to reconceptualise fraud and deterrence in credit transactions.

Broadly speaking, the methodology adopted in this project builds on the approach taken in earlier work. In the author's LLM dissertation, criminological theories of deterrence were used to analyse the Law Commission's proposals for the reform of insurance law.⁷⁶ In this project, insights from law & economics, behavioural economics and relational contract theory are used to critique the policies said to underpin fraud rules in the insurance and documentary credit contexts. In this project, the author views theory in the same way as suggested by Professor Roger Brownsword,

the purpose of theory is to offer us a critical vantage point from which we can assess the appropriateness of the standards and values embodied in particular regimes of contract law.⁷⁷

The methodology employed in this thesis was developed with the research questions in mind. The combination of close doctrinal work and theoretical insights enabled the author to contribute to the existing literature on insurance claims fraud and fraud in transactions financed by documentary credit.

⁷⁴ In personal correspondence with Professor Mann he has confirmed that the data are no longer available, see statement by Professor Ronald Mann (Personal email correspondence, 20 May 2015) (on file with the author).

⁷⁵ R Mann, 'The role of letters of credit in payment transactions' (1999-2000) 98 Mich L Rev 2494; AW Katz, 'Informality as a bilateral assurance mechanism. Comments on Ronald Mann's 'The role of letters of credit in payment transactions' (1999-2000) 98 Mich L Rev 2554; C Gillette, 'Letters of credit as signals. Comments on Ronald Mann's 'The role of letters of credit in payment transactions'' (1999-2000) 98 Mich L Rev 2537.

⁷⁶ This was subsequently published as Richards (n63).

⁷⁷ R Brownsword, 'Maps, methodologies, and critiques: Confessions of a contract lawyer' in M van Hoecke (ed.), *Methodologies of Legal Research* (Hart Publishing, 2011) 133.

VII. Originality

A doctoral thesis must contribute to the existing body of knowledge and this project satisfies this criterion in several ways. At the outset, it is important to note the rarity of a simultaneous consideration of fraud in the marine insurance and documentary credit contexts. Although these areas of law often converge in practice, they do not typically form the basis of comparative research. Moreover, this practical inseparability highlights the fact that each area of law has developed a different response to fraud. This is striking and merits further enquiry. The suggestion made here is not that rules against fraud should be identical, but rather to highlight the importance of context in understanding the limits of a rule and of interrogating the policies which have dictated these limits.

The insurance discussion depends largely on the use of deterrence literature from the fields of criminology and psychology. These insights have now begun to permeate the policymaker and judicial debate because of submissions made in part by the author on this topic.⁷⁸ This project builds on earlier work in which these ideas were used to suggest that the forfeiture rule is an ineffective deterrent⁷⁹ in two ways. Firstly, by providing a more sophisticated account of the law & economics literature and how this accords with a consideration of insurance fraud. In addition, discussions of deterrence usually focus on the exaggerated claim whereas the discussion here extends the analysis to include the wholly fraudulent claim.

Discussions of fraud in the documentary credit context have largely concerned whether exceptions to autonomy should be extended. This project changes the focus of the debate by considering whether the policy factors underpinning the narrow conception of fraud are valid. It does this by adopting a comparative approach and by highlighting the detrimental consequences flowing from the House of Lords' reasoning in *United City Merchants*. Though

⁷⁸ Law Commission, Insurance Contract Law: Business Disclosure; Warranties; Insurers' Remedies for Fraudulent Claims; and Late Payment (Law Com No 353, 2014) 218, [23.10]; Insurance Fraud Taskforce, Insurance Fraud Taskforce Final Report (2016) available at: <https://www.gov.uk/government/publications/insurance-fraud-taskforce-final-report> (accessed 13/09/2016), 40; Insurance Fraud Taskforce, Insurance Fraud Taskforce Interim Report (2015) available at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/413146/PU1789_Insurance_Fraud_Taskforce_interim_report_-_final.pdf (accessed 13/09/2016), 16-17.

⁷⁹ The author's LLM dissertation represents the beginning of this work and was subsequently published as Richards (n63).

these are not necessarily new criticisms, the originality exists in the facts they are discussed together and to demonstrate that they undermine the very construction of the fraud rule.

One of the major areas of originality lies in the presentation of empirical work conducted in the United States. This has, as yet, not permeated the UK discussion of documentary credits.⁸⁰ The empirical work presents a radically different account of the practical use of credits and develops an analysis which explains parties' continued use of the mechanism. The particular contribution in this project is to adapt this data to the fraud context and develop a new account of fraud deterrence in overseas transactions financed by documentary credit.

VIII. Chapter Outlines

For ease of exposition, and to provide an overview of the direction of this thesis, a summary of each chapter is now provided. As a comparison of fraud rules in two contexts, the project follows a pattern; a chapter on the doctrinal limits of the relevant rule is followed by a chapter in which the policy construction is critiqued.

Following the introduction in this chapter, Chapter Two assesses the insurance forfeiture rule from a doctrinal perspective. It sketches the contours of the fraudulent claims jurisdiction and analyses the wealth of recent case law and the impact of the Insurance Act 2015. The primary policy justification in judicial discussions is fraud deterrence. The existence of information asymmetries in the insured-insurer relationship creates incentives for fraud and necessitates rules to protect the underwriter. The chapter demonstrates that the courts have adapted an expansive approach to questions of fraud; establishing relatively low materiality requirements and resisting calls to introduce elements of proportionality into the remedial framework. The recent decision in *Versloot*⁸¹ curtails the otherwise expanding approach to fraud by removing a category of conduct sufficient to invoke the rule. The relevance of the maxim 'fraud unravels all' in this context is altered by this decision. It would have been correct

⁸⁰ Several authors have cited the work in passing but have not devoted any real time to discussion in UK literature, see M Bridge, 'Documents and contractual congruence in international trade' in S Worthington (ed.), *Commercial Law and Commercial Practice* (Hart Publishing, 2003) 227 (fn 68 in original); J Ulph, 'The UCP 600: Documentary credits in the 21st century' [2007] JBL 355, 363 (fn 29 in original).

⁸¹ *Versloot (Supreme Court)* (n31).

to suggest that, prior to *Versloot*, any degree of fraud by the assured was sufficient to disentitle him to the indemnity. The current position is more nuanced; the maxim still bears weight in relation to exaggerated and fabricated claims but its reach has been circumscribed at the lower end of the culpability spectrum.

Chapter Three submits the judicial construction of the forfeiture rule to detailed critique. The major premise is that the avowed purpose of the rule – deterrence – is dependent on an outdated model of decision making. Modern deterrence theory suggests that the judicial framework to counter fraud – harsh legal sanctions – is likely to be ineffective. It is further contended that forfeiture is particularly ineffective in response to the most serious frauds – the wholly fabricated claim – since the assured does not have any genuine loss to sacrifice. The third critique suggests that modern developments in investigative and scientific techniques mean that the underwriter is no longer as susceptible to fraud as his nineteenth century counterpart. The final argument highlights that information asymmetries and the consequent risk of fraud are not unique to the insurance relationship. This means that the remedial frameworks employed in comparable settings can be used to examine the approach developed by the insurance courts. In this light, it will be suggested that considerations of proportionality are directly relevant to, and should be incorporated into, the construction of rules to counter first-party insurance fraud.

The focus then turns to fraud in documentary credit transactions. Chapter Four provides the doctrinal account of the fraud exception to autonomy in credit transactions. The trade finance courts have taken a narrow approach to questions of fraud. The operation of the rule depends on the satisfaction of onerous criteria which must be proved within a very limited timeframe. The result is a fraud exception that rarely operates to protect the innocent buyer. As such, the notion that fraud unravels all does not adequately explain the judicial approach to fraud in this setting. The construction of the fraud rule is tied to the requirements of the commercial community; in particular, a swift and unassailable payment mechanism. The courts have not regarded fraud as a particular risk and have assumed that parties limit their exposure by contracting with honest traders.

Chapter Five critiques the construction of the fraud rule in documentary credits. The courts have repeatedly advanced a narrow exception premised on commercial need. The argument, however, is that the English approach is a distinct policy choice and not the inevitable

elaboration of best commercial practice. Three distinct arguments are deployed for this purpose. The first contends that a broader approach to fraud would not have the detrimental impact on trade that courts fear. This is exemplified by the position in the United States where a broader definition of fraud is enshrined in legislation and injunctive relief is easier to obtain. Secondly, it will be argued that the leading English case on fraud made a fundamental misstep in elaborating the fraud rule. The courts have continued to apply this version of the rule notwithstanding its consequences which are detrimental to the mechanism and commercial need. The final argument adopts empirical data on the practical operation of credits collected in the United States. This is used to counter the judicial suggestion that fraud deterrence is simply an *ex ante* concern and presents a framework in which prevention is critical throughout the life of the exchange.

The fraud rules share a similar juridical underpinning but they have been developed in different directions by the courts. This project is not a call for rules to be treated in the same way or shaped by the same policy concerns; after all, the courts must be cognisant of context. The discussion in these four chapters is designed to illuminate the factors which have shaped the rules and the extent to which these factors can be justified. The project concludes in Chapter Six where the discussion summarises the findings of the project and identifies directions for future work.

IX. Conclusion

Rules on fraud are an important part of the law relating to marine insurance and documentary credits. They respond to judicial concerns about fraud in the marketplace and protect the integrity of the court. Simple phrases such as ‘fraud unravels all’ are generally used to explain judicial activity to counter fraud in these areas. These phrases, however, are far too simplistic once one appreciates the diverse circumstances in which fraud arises and the variety of competing policy arguments which courts are required to balance. This project will provide a detailed examination of the forfeiture rule in insurance contract law and the fraud exception in documentary credits. It will explore the extent to which pithy phrases adequately explain what the courts are doing, by identifying the contextual and policy considerations which have shaped each rule. These considerations are then critically examined to determine their (ongoing) validity.

This area of enquiry is highly topical in the insurance context. In recent years, the Law Commission have conducted a lengthy consultation into insurance contract law,⁸² including the law relating to fraudulent claims, and this has resulted in new legislation which elevates the remedy to statute.⁸³ The common law courts have also considered several issues relating to the scope of the fraudulent claims rule over this period.⁸⁴

The law on documentary credits has not provoked similar discussion and debate in recent years. English policymakers have preferred to leave general matters to the International Chamber of Commerce (ICC) which routinely publishes the Uniform Customs and Practice for Documentary Credits (UCP), an optional set of rules embodying international practice. Almost all credit transactions incorporate the UCP.⁸⁵ The UCP, however, makes no provision for fraud and this leaves the issue to national jurisdictions. As has been suggested, the English fraud exception is relatively restrictive and this appears to have made parties unwilling to litigate on the letter of credit contract. This necessarily limits the courts' ability to reconsider the scope and policy construction of the exception. Beyond the judicial arena, however, the mechanism remains important as a method of financing⁸⁶ and a new version of the UCP is reported to be in the pipeline.⁸⁷ Whether this new version of the rules makes provision for fraud remains to be seen but, regardless, a detailed consideration of the common law rule is important in itself, and as a mapping exercise in light of potential developments.

Having outlined the purpose and direction of the project, the substantive discussion can now begin. Chapter Two addresses the first and second research questions in the insurance context, by submitting the forfeiture rule to doctrinal analysis.

⁸² Law Com 353 (n78).

⁸³ Insurance Act 2015 s.12.

⁸⁴ *The Aegeon* (n32) (appropriate remedy for fraudulent device claims); *Gottlieb* (n50) (whether interim payments were recoverable when claim was later proven fraudulent.)

⁸⁵ F Lorenzon, 'International trade and shipping documents' in Y Baatz (ed.), *Maritime Law* (4th ed. Informa, 2017) 116.

⁸⁶ Bischof (n36).

⁸⁷ See, for example, Institute of International Banking Law and Practice, 'The community speaks: The UCP700 wish list' (26/03/2015) available at: <http://iiblp.org/the-community-speaks-the-ucp700-wish-list/> (accessed 12/09/2016).

Chapter Two

Insurance: A Doctrinal Analysis of the Forfeiture Rule

I. Introduction

Insurance contracts are characterised by information asymmetries. These arise both at formation – where the assured has greater knowledge about the insured subject matter and his loss history – and following a loss where again, the assured knows more about the cause and extent of the loss than his underwriter. These asymmetries create incentives for the assured to lie and misrepresent for private gain.¹ Following a loss – the focus of this chapter – this incentive manifests in the submission of a fraudulent claim, either because the assured invents a loss for the purpose of making a claim or seeks to exaggerate or embellish an insured loss. The data suggest that insurance claims fraud is a considerable problem² the cost of which is borne by the honest majority of policyholders.³

The legal response to fraud has developed over more than 150 years.⁴ The task has largely been undertaken by the courts although, more recently, the Law Commission⁵ and parliament have entered the arena.⁶ The result is the forfeiture rule whereby the assured loses the entire claim to which the fraud relates, including any genuine portion of loss. The rule is founded on principles analogous to illegality⁷ and policy considerations, most notably the deterrence of fraud.⁸ The following description of the forfeiture rule offered by Mance LJ, as he then was, demonstrates the utility of aligning forfeiture with the notion that ‘fraud unravels all’,

¹ J Feinman, ‘Insurance fraud, agency and opportunism: False swearing in insurance claims’ (Insurance Fraud Symposium, University of Southampton Law School, 13 July 2016), 3.

² ABI, ‘The con’s not on – Insurers thwart 2,400 fraudulent insurance claims valued at £25 million every week’ (07/07/2017) available at: <https://www.abi.org.uk/news/news-articles/2017/07/the-cons-not-on--insurers-thwart-2400-fraudulent-insurance-claims-valued-at-25-million-every-week/> (accessed 04/09/2017); ABI, ‘From Mr Whippy to giggling conmen – No let up as insurers turn up the heat on insurance cheats’ (13/09/2016) available at: <https://www.abi.org.uk/News/News-releases/2016/09/From-Mr-Whippy-to-giggling-conmen-no-let-up-as-insurers-turn-up-the-heat-on-insurance-cheats> (accessed 14/09/2016).

³ *Versloot Dredging BV v HDI Gerling Industrie Versicherung (The DC Merwestone)* (Hearing on 16/03/16, morning session), 2h 12 per Lord Mance available at: <https://www.supremecourt.uk/watch/uksc-2014-0252/160316-am.html> (accessed 31/07/16) 2h 16 per Lord Sumption, Feinman, ‘Agency and opportunism’ (n1) 4.

⁴ *Britton v Royal Insurance Co* (1866) 4 F&F 905.

⁵ Law Commission, *Insurance Contract Law: Business Disclosure; Warranties; Insurers’ Remedies for Fraudulent Claims; and Late Payment* (Law Com No 353, 2014).

⁶ Insurance Act 2015, ss.12-13.

⁷ *Manifest Shipping Co Ltd v Uni-Polaris Co Ltd (The Star Sea)* [2003] 1 AC 469, [62] per Lord Hobhouse.

⁸ *Ibid* [62] per Lord Hobhouse; *Axa General Insurance Ltd v Gottlieb* [2005] 1 All ER (Comm) 445, [29] per Mance LJ; *Galloway v Guardian Royal Exchange (UK) Ltd* [1999] Lloyd’s Rep. IR 209, 214 per Millett LJ.

more fundamentally, it is clear that the rule relating to fraudulent claims operates generally in a manner which cannot be regarded as purely prospective...an insurance indemnity is payable from the moment an insured peril causes a loss...so the effect of a fraudulent claim is to retrospectively remove or bar the insured's pre-existing cause of action.⁹

This apparent ease of characterising fraud as having an unravelling effect is complicated by a longstanding tension in insurance contract law, namely the co-existence of the forfeiture rule alongside s.17, Marine Insurance Act 1906. Famously, s.17 provided that insurance contracts were underpinned by a duty of utmost good faith to be observed by both parties. This distinguishes the insurance relationship from almost all other economic exchanges in English law and is traced to the eighteenth-century decision in *Carter v Boehm*.¹⁰ In *Carter*, Lord Mansfield justified the duty of good faith by reference to the information asymmetries present in insurance relationships,

Good faith forbids either party by concealing what he privately knows, to draw the other into a bargain, from his ignorance of that fact, and his believing the contrary.¹¹

The importance of this duty was further underlined by the remedy available to the innocent party if his counterpart failed to act in good faith; avoidance *ab initio*.¹² Avoidance would return the parties to their pre-contractual positions and would require the assured to reimburse the underwriter for valid claims paid within that policy term. Though, quite rightly, one would regard the submission of a fraudulent claim – a deliberate attempt to deceive the underwriter – as the most egregious example of a failure to observe good faith,¹³ the courts have consistently refused to recognise avoidance as an appropriate response to fraudulent claims, preferring instead the less severe remedy of forfeiture. This has been justified by

⁹ *Agapitos v Agnew (The Aegeon)* [2003] QB 556, [26] per Mance LJ.

¹⁰ *Carter v Boehm* (1766) 3 Burr 1905.

¹¹ *Ibid* 1910 per Lord Mansfield.

¹² Marine Insurance Act 1906 s.17

¹³ *The Aegeon* (n9) [2003] QB 556, [21] per Mance LJ; Sir A Longmore, 'Good faith and breach of warranty: Are we moving forwards or backwards?' [2004] LMCLQ 158, 167.

reference to the disproportionate nature of a wholly retrospective remedy.¹⁴ Clearly, the remedy of avoidance would take the notion of unravelling contractual obligations to its extreme and thereby limits the extent to which the forfeiture rule can be described in this manner.

The tension caused by the co-existence of the forfeiture rule and the statutory remedy of avoidance has now been resolved by the Insurance Act 2015.¹⁵ It is now settled that avoidance is inappropriate in this context and that forfeiture is the sole statutory sanction for insurance claims fraud.¹⁶ Viewed from this perspective, therefore, fraud does exercise an unravelling effect and *ex turpi causa* is useful shorthand for the operation of the forfeiture rule. This chapter addresses the first and second research questions, namely by identifying the construction of the forfeiture rule in doctrinal and procedural terms and then by ascertaining the policy considerations which have been used to justify this approach. Accordingly, the chapter commences in Part II by briefly explaining the nature of the insurance bargain and the information asymmetries present in the relationship. Part III then discusses the scale of the fraud problem with the use of data gathered by the insurance industry. The longstanding tension between the forfeiture rule and s.17 and its eventual resolution is the focus of Part IV. This enables the remainder of the chapter to focus solely on forfeiture and the scope of the fraudulent claims jurisdiction (V).

II. The Insurance Relationship

Risks, broadly conceived as “event[s] ... *prima facie* adverse to the interest of the assured”,¹⁷ are an inevitable part of commercial life. The management of these risks is critical for businesses to expand and undertake new ventures.¹⁸ Insurance – the transfer of risk from the assured to a professional risk taker, the underwriter – is, as Abraham has succinctly explained,

¹⁴ *The Star Sea* (n7) [51] per Lord Hobhouse; Law Commission, ‘Reforming Insurance Contract Law Issues Paper 7: The Insured’s Post-Contract Duty of Good Faith’ (July 2010), [7.34].

¹⁵ Insurance Act 2015 s.14.

¹⁶ Insurance Act 2015 s.12.

¹⁷ *Prudential Insurance v IRC* [1904] 2 KB 658, 664 per Channell J.

¹⁸ M Clarke, *Policies and Perceptions of Insurance* (Clarendon Law, 1997), 5.

a method of managing risk by distributing it among large numbers of individuals or enterprises...By paying a relatively small sum – the insurance premium – the insured policyholder receives a promise from an insurance company to pay the insured if he or she suffers a loss. The insured avoids the risk of suffering a large loss by substituting the certainty of suffering a small one. Assuming that the risks a company covers are largely independent of each other, the insurer protects itself against suffering net losses by covering a large number of different insureds. In effect, the insurer distributes risk among all of its insureds.¹⁹

The resulting contract of insurance is contingent in nature, meaning the parties do not perform their substantive obligations simultaneously. The assured performs first by paying a premium to the underwriter. This is his consideration for the underwriter's acceptance of the risk. The underwriter calculates the premium by reference to the riskiness of the assured. This process depends on information provided by the assured²⁰ as well as the underwriter's ability to predict the likelihood of loss by reference to historical data.²¹ This task is facilitated by the law of large numbers which states that larger sample sizes should render predictions more accurate.²² While it is virtually impossible to predict whether a certain ship will sink in a given year, for example, it is far easier to determine how many ships in a group of 500 will be lost. The underwriter can then combine "fairly homogeneous risks in a common 'pool' in numbers large enough that the actual losses of the entire group can be expected to fall within statistical norms."²³

The insurer is only required to perform as understood in the colloquial sense – the payment of an indemnity to make good the loss the assured has suffered²⁴ – when an insured loss has occurred. On a formal analysis of the insurance contract, the insurer's actual primary obligation is to hold the insured harmless from the specified risks.²⁵ Notwithstanding the

¹⁹ K Abraham, *Distributing Risk: Insurance, Legal Theory and Public Policy* (Yale University Press, 1986) 1-2.

²⁰ Insurance Act 2015 ss.3-4.

²¹ Clarke, *Policies and Perceptions* (n18) 39 citing P Henry (1775) "I have but one lamp by which my feet are guided, and that is the lamp of experience. I know no way of judging of the future, but by the past."

²² P Bernstein, *Against the Gods The Remarkable Story of Risk* (Wiley & Sons, 1996) 122-123.

²³ *Commissioner of Internal Revenue v Treganowan*, 183 F 2d 288, 291 (2 Cir, 1950).

²⁴ Marine Insurance Act 1906 s.1

²⁵ *Firma C-Trade SA v Newcastle Protection and Indemnity Assn (The Fanti and The Padre Island) (No 2)* [1991] 2 AC 1, 35 per Lord Goff.

conceptual difficulties of the hold harmless doctrine,²⁶ the occurrence of an insured loss constitutes breach of contract by the insurer for which he will be liable to the assured. The contingent nature of the underwriter's liability means, therefore, that the underwriter may never substantively perform in the sense of paying an indemnity during the policy term.

The assured must prove that the loss was caused by a peril insured against to succeed in a claim for indemnity.²⁷ He must also comply with any procedural and notice requirements contained in the policy²⁸ and refrain from conduct contrary to public policy. This chapter focuses on perhaps the most egregious example of such conduct – the submission of a fraudulent claim – which will retrospectively deprive the assured of his contractual right to make a claim.²⁹

A simplistic analysis of the insurance relationship would therefore suggest that it will be straightforward for the assured to avoid losing his claim because of misconduct; he simply refrains from fraudulent conduct in the claims phase. However, both the insurance relationship and the claims process create incentives for fraudulent conduct.

As a means of transferring and distributing risk, the insurance product, as described by Beh and Stempel, provides reassurance to the assured,

Trite as it may sound, policyholders do pay premiums in order to obtain the "peace of mind" of knowing that they are protected from potential liability or loss. Insurance is defined as the incurring of a small but certain loss (the premium payment) in return for protection against a larger but contingent loss. Putting the peace of mind concept more technically, the policyholder as part of a risk management plan devotes a set

²⁶ M Clarke, *Law of Insurance Contracts* (4th ed. Service Issue 35 1 April 2016) (hereafter referred to as 'Clarke (looseleaf)') [30-2]; FD Rose, *Marine Insurance: Law & Practice* (2nd ed., Informa Law 2012) [25.1]

²⁷ Rose, *Marine Insurance* (n26) [26.1]; *Rhesa Shipping Co. S.A. v. Herbert David Edmunds Rhesa Shipping Co. S.A. v. Fenton Insurance Co. Ltd. (The Popi M)* [1985] 2 Lloyd's Rep.1, 3 per Lord Oakbrook.

²⁸ Rose, *Marine Insurance* (n26) [26.1].

²⁹ *Gottlieb* (n8) [26] per Mance LJ; P Todd, *Maritime Fraud & Piracy* (2nd ed. Informa Law, 2010), [6.049].

portion of its resources to the purchase of contractual protection against contingent risk.³⁰

On this basis, the optimum outcome of an insurance relationship would be to reach the end of a policy term without incurring a loss. It appears that some policyholders, however, do not understand this function of the insurance relationship. The Insurance Fraud Taskforce – established by the UK government in 2015 to develop mechanisms for reducing claims fraud³¹ – outlined a common misperception of the insurance relationship,

Some do not understand that insurance is designed to cover the risk of an event occurring, instead believing that they deserve a refund of premiums paid where no claim has been made.³²

This means that the policyholder may feel cheated or misled by the underwriter when he reaches the end of a policy term without any tangible benefit. This may cause the assured to attempt to recover some of his premium outlay by way of a fraudulent or exaggerated claim.³³ The structure of the claims process has also been shown to create incentives to fraudulent conduct.³⁴ These incentives largely stem from the information asymmetries which exist between underwriter and assured.³⁵ The assured will typically have far greater knowledge about the cause and extent of the loss than his insurer. This information is vital for the underwriter to determine his liability on the policy. This disparity in knowledge gives the

³⁰ H Beh and J Stempel, 'Misclassifying the insurance policy: The unforced errors of unilateral contract characterization' [2010] 32(1) Card. L Rev. 85, 105. See also Clarke, (looseleaf) (n26) [1-1]; M Clarke, *Policies and Perceptions of Insurance Law in the Twenty-first Century* (OUP, 2005), 3.

³¹ Insurance Fraud Taskforce, *Insurance Fraud Taskforce Final Report* (2016) available at: <https://www.gov.uk/government/publications/insurance-fraud-taskforce-final-report> (accessed 13/09/2016), 3.

³² *Ibid* [2.88].

³³ Clarke, *Twenty-first Century* (n30) 210; K Gill, *Insurance Fraud: Causes, Characteristics and Prevention* (unpublished PhD thesis, University of Leicester 2001) 109 available at: <https://lra.le.ac.uk/handle/2381/29106> (accessed 26/06/2017); S Tennyson, 'Economic institutions and individual ethics: A study of consumer attitudes toward insurance fraud' (1997) 32(2) *J of Ec Behavior and Organization* 247, 249-250; ABI, 'Research Brief: Deterring opportunistic general insurance fraud' (August 2010) 2-3 available at: <http://docplayer.net/39000873-Deterring-opportunistic-general-insurance-fraud.html> (accessed 26/06/2017) (Copy also on file with author).

³⁴ K Richards, 'Deterring insurance fraud: A critical and criminological analysis of the English and Scottish Law Commissions' current proposals for reform' (2013) 24 *ILJ* 16, 35-37; See generally on the concept of criminogenesis, ML Needleman and C Needleman, 'Organizational crime: Two models of criminogenesis' (1979) *The Sociological Quarterly* 517.

³⁵ S Viaene and G Dedene, 'Insurance fraud: Issues and challenges' (2004) 29(2) *Geneva Papers on Risk and Insurance* 313, 315.

assured the opportunity to behave fraudulently by, for example, exaggerating the loss or providing an explanation of the casualty which omits details which might otherwise afford the underwriter a defence. These incentives may be particularly tempting where the assured finds himself in financial difficulty.³⁶ The decision to commit fraud may, in other circumstances, predate the occurrence of loss. Such fraud occurs when the assured deliberately destroys his property or connives in its loss for the express purpose of submitting an insurance claim.

Whatever the driver for fraud in a particular case, fabricated and exaggerated claims threaten the insurance model. This is, simply put, because insurers set premiums by reference to the likelihood and extent of loss for a class of policyholders over a given period. The underwriter's solvency depends on his ability to procure premium income which exceeds his total liability to policyholders. If the underwriter makes payment on a fraudulent claim, the gap between premium income and anticipated liability will be narrowed. This will increase the cost of insurance and, over time, threaten the viability of insurance companies. As a result, several contractual mechanisms are designed to prevent the assured from succeeding in a fraudulent claim.³⁷

The first of these mechanisms is the indemnity principle. Many marine policies are indemnity contracts which, by definition, limit the assured's recovery to his actual loss.³⁸ Damages are designed to indemnify the assured i.e. to make good the loss he has sustained. The operation of this principle will, therefore, constrain the assured's ability to claim in excess of his actual loss. The indemnity principle is not, however, a comprehensive means of curtailing fraud. This is because the Marine Insurance Act 1906 expressly permits parties to contract on the basis of a valued policy where the value of the subject matter is conclusively settled in advance.³⁹ The indemnity principle has limited utility in such policies given that the contractually agreed

³⁶ Clarke, *Twenty-first Century* (n30) 210.

³⁷ This has been recognised more generally within the insurance relationship, see Abraham, *Distributing Risk* (n19) 15: "because loss predictions are imperfect and behavior cannot be monitored without cost, insurance may create incentive effects that are inefficient. To some extent these inefficiencies can be counteracted by contractual and legal devices that reduce the moral hazard of insurance."

³⁸ *Castellain v Preston* (1883) 11 QBD 380, 386 per Brett LJ; Marine Insurance Act 1906 s.1.

³⁹ Marine Insurance Act 1906 s.27(2)(3).

value of the vessel may exceed the assured's actual loss. Indeed, there may be a further incentive to fraud in valued policies.⁴⁰

The second mechanism – the principle of fortuity – reflects the fact that insurance provides cover against risks and not certainties. Where the insured peril is defined by an element of fortuity – as is the case for perils of the seas, for example – the assured will only be able to recover where he proves the fortuitous nature of the loss.⁴¹ Yet again, however, there are limits on the effectiveness of the fortuity principle as a means of preventing fraud. In particular, the mechanism is unable to limit recovery in circumstances where the peril – most notably, fire – does not contain any element of fortuity. To recover in respect of a loss caused by fire, therefore, the assured need only prove that fire was the cause of the loss.⁴²

The inability of these contractual mechanisms to constrain the assured's propensity to fraud in all circumstances necessitates the development of rules specific to fraud and fraudulent claims. Two such rules can be distinguished. Firstly, the wilful misconduct defence contained in s.55 Marine Insurance Act 1906.⁴³ This precludes recovery in circumstances where the loss has been deliberately engineered by the assured. This reflects the purpose of insurance – to guard against risks and not certainties – but also responds to public policy concerns. The statutory defence will only be available in circumstances where the assured has connived in the loss and the onus will be on the underwriter to establish the assured's wilful misconduct. This is no easy task.⁴⁴ Furthermore, the wilful misconduct defence cannot be invoked where the fraud consists of something else, such as exaggeration of genuine loss, the suppression of a defence or the use of forged evidence. Fraudulent behaviour during the claims process – as distinct from an intentionally caused loss – requires a further mechanism to prevent the assured's recovery. As was made clear by the Law Commission,

⁴⁰ B Soyer, *Marine Insurance Fraud* (Informa Law, 2014) [3-26]; Clarke, (looseleaf) (n26) [28-7] noting that a valued policy overrides the indemnity nature of marine policies. Whether a particular policy is indemnity or valued will depend on the construction of the contract.

⁴¹ Marine Insurance Act 1906 Sched 1, r.7

⁴² *Schiffshypothekenbank zu Luebeck AG v Compton (The Alexion Hope)* [1988] 1 Lloyd's Rep 311, 319 per Nourse LJ cf. the exclusion to deliberately inflicted loss within Institute Cargo Clauses B and C 2009 cl.4.7.

⁴³ Marine Insurance Act s.55(2)(a).

⁴⁴ See *Slattery v Mance* [1962] 1 QB 676, 681 per Salmon J.

It is generally accepted, however, that a policyholder who acts fraudulently should risk more than the non-payment of the fraudulent part of the claim. There should also be some element of penalty⁴⁵

The development of the appropriate legal response to fraud is the focus of discussion in this chapter. The Commission's reference to the penal nature of the response usefully summarises how the courts have approached this task. The discussion is prefaced by establishing the scale of the fraudulent claims problem in Part III.

III. Insurance Fraud Statistics

There is no shortage of publicly available data on fraudulent insurance claims, most of which emanates from the Association of British Insurers (ABI). ABI data published in 2017 demonstrated that insurers identified an average of 2,400 fraudulent claims worth £25 million per week in 2016.⁴⁶ In comparison to the data for 2015, this constituted an overall reduction in the number and value of fraudulent claims.⁴⁷ This data is then used to predict undetected fraud which is estimated to cost the industry a further £2.1 billion per year.⁴⁸ It is not possible to drill down any further into the publicly available data; the ABI statistics do not indicate the scale of fraudulent marine claims or the category of behaviour in which the assured has engaged.⁴⁹

The difficulty of obtaining accurate statistics should be mentioned at this juncture.⁵⁰ Firstly, the data is largely gathered by the insurance industry which has a vested interest in presenting an image of widespread claims fraud.⁵¹ Perhaps connected to this is the fact that the statistics we do have may not be particularly transparent. For example, in the Canadian context, fraud is typically estimated to infect between 10 and 15% of all claims but, as Ericson

⁴⁵ Law Com Issues Paper 7 (n14) [2.8].

⁴⁶ ABI, 'The con's not on' (n2)

⁴⁷ Ibid.

⁴⁸ Insurance Fraud Taskforce, *Final Report* (n31), [2.4] citing National Fraud Authority, 'Annual Fraud Indicator' (2014).

⁴⁹ See later discussion on the typology of fraudulent claims, text to fn 222 et seq.

⁵⁰ Attempts to measure the scale of claims fraud only began in the 1980s, see Viaene and Dedene (n35) 317.

⁵¹ J Feinman, *Delay Deny Defend* (Penguin, 2010), 170; R Ericson and A Doyle, 'The moral risks of private justice: The case of insurance fraud' in R Ericson and A Doyle (eds.), *Risk and Morality* (University of Toronto Press, 2003), 324.

and Doyle have made clear, “few actually know where this measurement came from or, for that matter, how accurate it is.”⁵² There is no reason to suppose that this does not translate to the English context where the ABI have suggested that fraud adds £50 to each household’s annual insurance bill.⁵³ The issue is that this figure of £50 has been used for many years but has not been revised upwards to reflect the increasing trend of fraudulent claims demonstrated by industry data.⁵⁴

Other aspects of the insurance relationship render accurate statistics elusive. For one thing, the fraudster is attempting to conceal his dishonesty from the underwriter and this creates measurement difficulties.⁵⁵ A second difficulty exists in the fact that suspect claims may be settled by the underwriter and not recorded as fraud in the official data.⁵⁶ In addition, there is some suggestion that underwriters may be prepared to overlook a degree of fraud committed by particularly lucrative policyholders on the basis that they wish to retain premium income.⁵⁷ The underwriter may also choose not to pursue fraud in circumstances where making a ‘nuisance payment’ is cheaper than investigating the loss or where adequate investigative methods do not exist.⁵⁸

In the absence of more detailed and independent data, what can be said with certainty is that the courts have accepted the scale of the problem. Indeed, it is not uncommon to see reference to the scale of claims fraud in judicial decisions.⁵⁹ This perceived problem has been used to justify the particular contours of the legal response to fraud – the forfeiture rule –

⁵² Ericson and Doyle, ‘The moral risks’ (n51) 325. See also, Feinman, *Delay, Deny, Defend* (n51) 170 – 171 for an account of a similar position in the United States.

⁵³ ABI, ‘Fraud’ available at: <https://www.abi.org.uk/Insurance-and-savings/Topics-and-issues/Fraud> (accessed 09/08/2016).

⁵⁴ Personal email with the ABI Statistics department: “This is a very high level figure based on the current amount of fraud in the UK and the total number of policy holders in the UK, please do treat this number as a rough estimate.” (08/11/2016).

⁵⁵ R Ericson and A Doyle, ‘Criminalization in private: the case of insurance fraud’ in Law Commission of Canada, *What is Crime?* (UBC Press, 2004), 103; Viaene and Dedene (n35) 319, 322.

⁵⁶ Ericson and Doyle, ‘Criminalization in private’ (n55) 105; Ericson and Doyle, ‘The moral risks’ (n51) 324.

⁵⁷ Ericson and Doyle, ‘The moral risks’ (n51) 338, 359.

⁵⁸ Ericson and Doyle, ‘The moral risks’ (n51) 323, 336; R Emerson, ‘Insurance claims fraud: Problems and remedies’ (1991-1992) 46 U Miami L Rev 907, 924.

⁵⁹ *Versloot Dredging BV v HDI Gerling Industrie Versicherung AG* [2016] UKSC 48 (hereafter referred to as *Versloot (Supreme Court)*), [56] per Lord Hughes; *Royal & Sun Alliance Insurance Co v Fahad* [2014] EWHC 4480 (QB), [24] per Spencer J; *Direct Line Insurance plc v Khan* [2002] Lloyd’s Rep. IR 364, [38]-[39] per Arden LJ; *Khan v Hussain* (16 May 2007, Huddersfield County Court) [9] per Judge Hawkesworth QC.

and recent legislation elevating the rule to statute.⁶⁰ The industry too has taken action and report annual expenditure of £200 million to counter fraud.⁶¹ Scepticism about the accuracy of the data should not be confused with disbelief; there is no doubt that fraud occurs and that fraudulent policyholders should be sanctioned.⁶² The scepticism is instead an explicit appeal for recognition of the industry's incentive to present a certain image of claims fraud.⁶³

Until the Insurance Act 2015,⁶⁴ the legal response to claims fraud was shaped entirely by the courts. This jurisprudence stretching back more than 150 years provides much material for discussion. The first issue to consider relates to the appropriate remedy for insurance claims fraud. This has been difficult for the courts to determine because of a tension between the early case law and the existence of a more severe, and *prima facie* applicable, statutory provision.

IV. Identifying the Appropriate Remedy: Forfeiture or Avoidance *ab initio*?

During consultation, the Law Commission described the jurisprudence on the fraudulent claims rule as “convoluted and confused”.⁶⁵ This was wholly attributable to the courts’ difficulty in reconciling the common law remedy of forfeiture with the subsequent statutory remedy of avoidance for breach of good faith.⁶⁶ It is important, therefore, to consider how the courts dealt with this tension and to identify the policy considerations used to justify forfeiture, and not avoidance, as appropriate in this context. This discussion also provides a useful perspective from which to consider the utility of the maxim ‘fraud unravels all’ as a description of the judicial response to insurance fraud.

⁶⁰ Insurance Act 2015 s.12(1)(a); Law Com 353 (n5) [19.1], [19.3], [21.3], [21.5].

⁶¹ ABI, ‘Insurers will do whatever it takes to protect honest customers against insurance fraud’ (18/01/2016) available at: <https://www.abi.org.uk/News/News-updates/2016/01/Insurers-will-do-whatever-it-takes-to-protect-honest-customers-against-insurance-fraud> (accessed 09/08/2016).

⁶² Feinman, *Delay, Deny, Defend* (n51) 170.

⁶³ *Ibid* 170-171 where he notes the US experience; official industry figures compiled by the Insurance Research Council were not backed up by research conducted by the quasi-governmental agency, the Massachusetts Insurance Fraud Bureau.

⁶⁴ Insurance Act 2015 s.12

⁶⁵ Law Com 353 (n5) [19.3].

⁶⁶ *Ibid* [19.3], [20.37].

Insurance fraud first arose for consideration in the context of fire policies in the mid-nineteenth century. The case of *Britton v Royal Insurance*⁶⁷ involved an assured who exaggerated his loss following a fire at his premises. The insurance policy did not contain any express provisions relating to the impact of fraud during the claims process. Willes J discussed the legal response in the following terms,

...suppose the insured made a claim for twice the amount insured and lost, thus seeking to put the office off its guard, and in the result to recover more than he is entitled to, that would be a wilful fraud, and the consequence is that he could not recover anything. This is a defence quite different from that of wilful arson. It gives the go-bye to the origin of the fire, and it amounts to this – that the assured took advantage of the fire to make a fraudulent claim. The law upon such a case is in accordance with justice, and also with sound policy. That law is, that a person who has made such a fraudulent claim could not be permitted to recover at all...And if there is wilful falsehood and fraud in the claim, the insured forfeits all claim whatever on the policy.⁶⁸

This result was further explained by reference to the nature of insurance contracts,

The contract of insurance is one of perfect good faith on both sides, and it is most important that such good faith should be maintained...such a[n] [express] condition is only in accordance with legal principle and sound policy.⁶⁹

The reason that the remedy is forfeiture – rather than the simple refusal of the claim – is explained by the contractual relationship between underwriter and assured. As discussed above, the underwriter undertakes to hold his assured harmless from the perils specified in the policy.⁷⁰ This means that the underwriter will be in breach upon the occurrence of an

⁶⁷ *Britton* (n4).

⁶⁸ *Ibid* 909 per Willes J.

⁶⁹ *Ibid* 909 per Willes J.

⁷⁰ See earlier, text to fn 25 et seq.

insured loss and will become immediately liable to the assured.⁷¹ The effect of fraud during the claims process is to bar this pre-existing right to recovery.⁷² The underwriter's liability is not contingent on the presentation of an (honest) claim⁷³ but accrues from the date of the casualty.

The response of nineteenth century courts to insurance fraud was relatively straightforward; the assured would not be permitted to recover at all in respect of the tainted claim.⁷⁴ Half a century later, however, the enactment of the Marine Insurance Act 1906 complicated matters. The Act did not make any express provision for insurance claims fraud. It did, however, contain two provisions relevant to fraud. The first, contained in s.55(2)(a), is the wilful misconduct defence, discussed above.⁷⁵ More significantly, s.17 of the 1906 Act characterised the insurance relationship as based on utmost good faith. This was a mutual duty – applicable to both assured and underwriter – breach of which would entitle the innocent party to avoid the policy *ab initio*.⁷⁶ S.17 provided an overarching characterisation of insurance contracts before ss.18-20 identified specific instances of how good faith would manifest in the pre-contractual context. The Act did not make specific provision for the operation of utmost good faith during the currency of the policy.

This existence of s.17 – and the remedy of avoidance – complicated the judicial approach to fraudulent claims. On the one hand, it is difficult to conceive of a more egregious breach of good faith than the intentional submission of a fraudulent claim⁷⁷ and yet avoidance, requiring the assured to repay any sums paid on account in respect of the fraudulent claim⁷⁸ as well as any prior valid claims submitted during that policy term, was much more severe than forfeiture. Indeed, avoidance as a response to claims fraud would have extended the

⁷¹ *Chandris v Argo Insurance Co Ltd* [1963] 2 Lloyd's Rep 65, 74 per Megaw J; *The Fanti* (n25) 35-36 per Lord Goff; *Rose, Marine Insurance* (n26) [26.1].

⁷² *Gottlieb* (n8) [26] per Mance LJ.

⁷³ *Versloot (Supreme Court)* (n59) [24] per Lord Sumption.

⁷⁴ *Britton* (n4) 909 per Willes J; *Goulstone v The Royal Insurance Co* (1858) 1 F&F 276, 280 per Pollock CB; *Loseby v Price The Express*, 17 August 1866 (Guildford Assizes), 48 per Willes J.

⁷⁵ See earlier, text to fn 43.

⁷⁶ *Carter* (n10) 1909-1910 per Lord Mansfield.

⁷⁷ *The Aegeon* (n9) [21] per Mance LJ; Longmore (n13) 167.

⁷⁸ See *Gottlieb* (n8) [27], [28], [32]; Insurance Act 2015 s.12(1)(b).

“penal effect of the law...to its ultimate.”⁷⁹ This tension continued to vex the courts in the century since the Marine Insurance Act was passed. In particular, the courts needed to determine i) whether the duty of utmost good faith extended into the post-contractual sphere and, if so, ii) the content of that duty and iii) the appropriate remedy for breach, namely would the underwriter be entitled to remedies in addition to forfeiture.⁸⁰ As the following discussion will demonstrate, the courts, in general, attempted to confine remedies for fraud to forfeiture but struggled to adequately reconcile this with the existence of a more severe, and *prima facie* applicable, statutory response.

In *The Litsion Pride*, the vessel was rendered a constructive total loss after it was hit by a missile in a restricted zone.⁸¹ The owner then fraudulently backdated a letter to advise the underwriter that the vessel had entered the zone and was thus liable for an additional premium. The judgment proceeded on the basis that utmost good faith applied in the post-contractual phase. The only dispute related to the extent and content of this duty. Hirst J held that “it must be right...to go so far as to hold that the duty in the claims sphere extends to culpable misrepresentation or non-disclosure.”⁸² This was more extensive than that contended for by the assured – a duty of honesty in the claims phase⁸³ - and would have required the assured to disclose material information in the post-contractual phase. Hirst J derived support for his position by reference to the fact that if s.17 applied both pre- and post-contractually, there was nothing in the statute to suggest that the content of the duty should differ in any way.⁸⁴ Accordingly, the submission of a fraudulent claim was to be regarded as breach of utmost good faith which would entitle the underwriter to the remedy of avoidance *ab initio*.⁸⁵ As the wording of s.17 did not compel the innocent party to avoid – the original language specified that “the contract *may* be avoided”⁸⁶ – the underwriter could simultaneously establish breach of good faith without insisting on avoidance,⁸⁷ as occurred in

⁷⁹ DR Thomas, ‘Fraudulent insurance claims: Definition, consequences and limitations’ [2006] LMCLQ 485, 513.

⁸⁰ H Bennett, *The Law of Marine Insurance* (2nd ed. OUP, 2006), [22.101].

⁸¹ *Black King Shipping Corporation and Wayang (Panama) S.A. v. Mark Ranald Massie (The Litsion Pride)* [1985] 1 Lloyd’s Rep. 437.

⁸² *Ibid* 512 per Hirst J.

⁸³ *Ibid* 509 per Hirst J.

⁸⁴ *Ibid* 511 per Hirst J.

⁸⁵ *Ibid* 515 per Hirst J.

⁸⁶ Marine Insurance Act 1906 s.17 (emphasis added).

⁸⁷ *The Litsion Pride* (n81) 515 per Hirst J arguing that there was “much commercial good sense” in this position.

The Litsion Pride. It was subsequently held in *The Star Sea* that this “should not any longer be treated as a sound statement of the law”⁸⁸ not least because it “decouples the obligation of good faith both from section 17 and the remedy of avoidance and from the contractual principles which would apply to a breach of contract.”⁸⁹ The decision is also “questionable”⁹⁰ on the facts given that the claim was for a loss caused by an insured peril during a period when a held covered clause was operating.

A more moderate approach was adopted in *Orakpo v Barclays Insurance*.⁹¹ The Court of Appeal unanimously agreed that s.17 was relevant in the context of fraudulent claims and limited the duty to one of honesty, as distinct from more expansive disclosure obligations during the claims process.⁹² Hoffmann LJ and Sir Roger Parker argued that the reasons requiring good faith continued to exist post-contractually, most notably because

just as the nature of the risk will usually be within the peculiar knowledge of the insured, so will the circumstances of the casualty; it will rarely be within the knowledge of the insurance company.⁹³

There was, however, confusion about the appropriate remedy for breach by the assured. On the one hand, Staughton and Hoffmann LJ limited the remedy to forfeiture.⁹⁴ While Sir Roger Parker began his judgment by stating that fraud would cause the claim to fall in *toto*,⁹⁵ he was in favour of avoidance *ab initio* by the end of his judgment,

it is contrary to reason to allow an insurer to avoid a policy for material nondisclosure or misrepresentation on inception, but to say that, if there is subsequently a

⁸⁸ *The Star Sea* (n7) [71] per Lord Hobhouse.

⁸⁹ *Ibid* [71] per Lord Hobhouse.

⁹⁰ *Ibid* [71] per Lord Hobhouse.

⁹¹ *Orakpo v Barclays Insurance Services* [1995] LRLR 433.

⁹² *Ibid* 451 per Hoffmann LJ, 452 per Sir Roger Parker.

⁹³ *Ibid* 451 per Hoffmann LJ. See also 452 per Sir Roger Parker: “Just as on inception the insurer has to a large extent to rely on what the assured tells him, so also is it so when a claim is made. In both cases there is therefore an incentive to honesty, if the assured knows that, if he is fraudulent, at least to a substantial extent, he will recover nothing, even if his claim is in part good.”

⁹⁴ *Ibid* 451 per Hoffmann LJ, 451 per Staughton LJ.

⁹⁵ *Ibid* 452 per Sir Roger Parker.

deliberate attempt by fraud to extract money from the insurer for alleged losses which had never been incurred, it is only the claim which is forfeit.⁹⁶

An attempt to reconcile s.17 with the forfeiture rule was next attempted by the Court of Appeal in *The Mercandian Continent*.⁹⁷ Longmore LJ took the view that as the 1906 Act specified circumstances in which avoidance was available for pre-contractual breaches of good faith,⁹⁸ similar conditions could be attached to avoidance in the post-contractual context. He argued, therefore, that avoidance would only be an appropriate response to post-contractual breaches of good faith where (i) the fraud was material in the sense that it affected the underwriter's ultimate liability and (ii) where the gravity of the fraud would enable the underwriter to terminate for breach.⁹⁹ As the lie in this case was directed to third parties in an attempt to achieve a more favourable jurisdiction for the dispute, it failed to satisfy both limbs of Longmore LJ's test.¹⁰⁰ The typical case of fraud would, however, easily satisfy both criteria¹⁰¹ and therefore the analysis did not assist in confining the operation of s.17 in any real way.

The House of Lords then considered the issue in *The Star Sea* and in so doing clarified the scope of utmost good faith in the post-contractual stage. The content of the duty will vary according to the particular situation.¹⁰² Where the underwriter is called upon to make underwriting decisions in the post-contractual stage – as will be the case for renewals and variations – the assured would be held to the same expansive disclosure obligations as at inception.¹⁰³ The position is different when the assured makes a claim under the policy. The duty at this stage is limited to one of honesty¹⁰⁴ which would prohibit the assured from

⁹⁶ Ibid 452 per Sir Roger Parker.

⁹⁷ *K/S Merc-Scandia XXXXII v Certain Lloyd's Underwriters (The Mercandian Continent)* [2001] EWCA Civ 1275, [2001] 2 Lloyd's Rep. 563.

⁹⁸ Marine Insurance Act 1906 ss.18-20; the remedy for breach in these circumstances has been amended by Insurance Act 2015, sched 1.

⁹⁹ *The Mercandian Continent* (n97) [35] per Longmore LJ.

¹⁰⁰ Ibid [42] per Longmore LJ.

¹⁰¹ Law Commission, *Insurance Contract Law: Post Contract Duties and Other Issues* (Law Com CP 201, 2011), [6.39]; *The Aegeon* (n9) [44] noting that the first criterion would be easily satisfied where the claim was wholly fraudulent or exaggerated.

¹⁰² *The Star Sea* (n7) [48] per Lord Hobhouse; *Clarke (looseleaf)* (n26) [27-1A1].

¹⁰³ *The Star Sea* (n7) [54] per Lord Hobhouse; *Lishman v Northern Maritime* (1875) LR 10 CP 179.

¹⁰⁴ *The Star Sea* (n7) [102], [111] per Lord Scott.

submitting a fraudulent claim but would not require him to disclose every material circumstance.¹⁰⁵ This difference in duty reflects the fact that the doctrine in the pre-contractual setting is designed to prevent the underwriter from being saddled with a bad bargain when material information has been withheld.¹⁰⁶ Once the risk has attached, the doctrine no longer serves this purpose but instead enables the underwriter to assess liability and quantum accurately. Lord Hobhouse referred to this distinction in his judgment,

[Avoidance] is appropriate where the cause, the want of good faith, has preceded and been material to the making of the contract. But, where the want of good faith first occurs later, it becomes anomalous and disproportionate that it should be so categorised and entitle the aggrieved party to such an outcome. But this will be the effect of accepting the defendants' argument. The result is effectively penal...This cannot be reconciled with principle.¹⁰⁷

Accordingly, Lord Hobhouse was reluctant to permit avoidance *ab initio* as a remedy for fraudulent claims. He expressed his concern in the following way,

The potential is also there for the parties, if they so choose, to provide by their contract for remedies or consequences which would act retrospectively. All this shows that the courts should be cautious before extending to contractual relations principles of law which the parties could themselves have incorporated into their contract if they had so chosen...Where the application of the proposed principle would simply serve the interests of one party and do so in a disproportionate fashion, it is right to question whether the principle has been correctly formulated or is being correctly applied and it is right to question whether the codifying statute from which the right contended for is said to be drawn is being correctly construed.¹⁰⁸

¹⁰⁵ Ibid [54], [57] per Lord Hobhouse; [95], [96], [102] per Lord Scott; H Bennett, 'Mapping the doctrine of utmost good faith in insurance contract law' [1999] LMCLQ 165, 198. The position has now been altered by the Insurance Act 2015 s.3 which requires the assured to make a fair presentation of the risk.

¹⁰⁶ Bennett, 'Mapping the doctrine' (n105) 198.

¹⁰⁷ *The Star Sea* (n7) [51] per Lord Hobhouse.

¹⁰⁸ Ibid [61].

Lord Hobhouse’s reference to the disproportionate nature of avoidance reflects the fact that although the duty of utmost good faith is mutual, it is virtually impossible to think of circumstances in which the assured would make use of this remedy.¹⁰⁹ The assured’s priority will be to maintain insurance coverage no matter the severity of the underwriter’s breach. These considerations suggest that avoidance *ab initio* may not be an appropriate remedy in the post-contractual phase. This view is strengthened by Lord Hobhouse’s insistence that the earlier fire cases were authority for the remedy of forfeiture.¹¹⁰ The House of Lords did not, however, wholly outlaw avoidance in the post-formation stage.¹¹¹ This is attributable to the fact that the issue was not determinative on the facts and their Lordships preferred to leave the matter open.¹¹² The judgment in *The Star Sea* did confirm, however, that the post-contractual duty of good faith ceased with the commencement of litigation.¹¹³ The issue of the writ engages the Civil Procedure Rules which contain, *inter alia*, remedies for dishonesty during litigation.¹¹⁴ The rules of the court are far better equipped to determine the rights and obligations of parties involved in an adversarial dispute.¹¹⁵

The first consideration of the role of s.17 in the context of fraudulent claims following *The Star Sea* occurred in *The Aegeon*.¹¹⁶ In the leading judgment, Mance LJ, as he then was, simplified the tension which had troubled previous courts. His solution was simply “to treat the common law rules governing the making of a fraudulent claim...as falling outside the scope of s.17 [with the result that] ...No question of avoidance *ab initio* would arise.”¹¹⁷ This was a clear policy choice due to the severity of avoidance *ab initio*.¹¹⁸ This analysis – the suggestion that deliberate fraud would not constitute a breach of utmost good faith – is, as the Law Commission subsequently noted,¹¹⁹ difficult to reconcile with the overarching nature

¹⁰⁹ Ibid [57] per Lord Hobhouse.

¹¹⁰ Ibid [62], [66] per Lord Hobhouse.

¹¹¹ Ibid [110] per Lord Scott: describing the issue as “more debateable”.

¹¹² Ibid [66] per Lord Hobhouse, [110] per Lord Scott.

¹¹³ Ibid [75] per Lord Hobhouse.

¹¹⁴ Ibid [75] subsequently applied in *Suez Fortune Investments Ltd v Talbot Underwriting Ltd (The Brillante Virtuoso)* [2015] EWHC 42 (Comm), [2015] Lloyd’s Rep. IR 388.

¹¹⁵ Law Com 201 (n101) [6.30] “the rules of court procedure, which set out disclosure requirements and appropriate sanctions for non-compliance.”

¹¹⁶ *The Aegeon* (n9).

¹¹⁷ Ibid [45] per Mance LJ.

¹¹⁸ Ibid [44] per Mance LJ.

¹¹⁹ Law Com 201 (n101) [6.44].

of insurance contracts. Nevertheless, Mance LJ later reiterated his position in *Axa v Gottlieb*,¹²⁰ arguing that “there is no basis or reason for giving the common law rule relating to fraudulent claims a retrospective effect on prior, separate claims which have already been settled under the same policy before any fraud occurs.”¹²¹

It was this tension – and the complex jurisprudence resulting from judicial attempts to reconcile s.17 and the forfeiture rule¹²² – that provided the backdrop to the Law Commission’s consultation on fraudulent claims. The Commission’s proposal – to limit the remedy to forfeiture¹²³ – was supported by several policy considerations. Firstly, the Commission emphasised the importance of finality in English law. It would be “unprincipled...[and]...wrong that a valid claim made under a valid policy can be undermined by subsequent events”¹²⁴ and, in addition, would risk bringing the industry into disrepute.¹²⁵ Avoidance was also regarded as impractical. This was because most assureds would be unable to satisfy a judgment perhaps some years after valid claims had been paid and the indemnity spent.¹²⁶ Legal certainty would be undermined if, in general, underwriters were unable to enforce judgments in these circumstances. Thomas has suggested that in combination, these policy arguments are “capable of supporting the exclusion of fraudulent claims from the ambit of the principle of post-contract good faith.”¹²⁷ With respect, the judicial approach is slightly more nuanced than Thomas has suggested; fraud does engage good faith in the post-contractual phase but the remedy will be limited to forfeiture of the entire claim.

The Insurance Act 2015 enacts the recommendations contained in the Law Commission’s final report.¹²⁸ The remedy for the submission of a fraudulent claim is limited to forfeiture¹²⁹ and, subject to the underwriter’s satisfaction of a notice requirement, prospective termination of the policy.¹³⁰ This entitles the underwriter to recover interim payments¹³¹ made in respect of

¹²⁰ *Gottlieb* (n8).

¹²¹ *Ibid* [23] per Mance LJ.

¹²² Law Com 201 (n101) [6.15] “convoluted reasoning and uncertainty”.

¹²³ Law Com 353 (n5) [19.4].

¹²⁴ Law Com 201 (n101) [7.10].

¹²⁵ *Ibid* [7.10] citing the view of Roy Rodger (broker).

¹²⁶ *Ibid* [7.13].

¹²⁷ Thomas (n79) 515.

¹²⁸ Law Com 353 (n5) 344 (recommendations 30-33).

¹²⁹ Insurance Act 2015 s.12(1)(a).

¹³⁰ Insurance Act 2015 s.12(1)(c).

¹³¹ Insurance Act 2015 s.12(1)(b).

claims now discovered to be fraudulent but leaves prior, valid claims untouched. The absence of avoidance *ab initio* in this context places a significant limit on the extent to which insurance claims fraud unravels all. The remainder of this chapter considers the forfeiture rule in isolation. It seeks to determine the extent to which 'fraud unravels all' provides an accurate explanation of judicial intervention in this context.

V. The Forfeiture Rule

There is no longer any doubt that the submission of a fraudulent claim will result in forfeiture.¹³² The assured will lose the entirety of the claim to which the fraud relates, including any genuine portion of loss. The discussion now assesses the extent to which 'fraud unravels all' accurately portrays the forfeiture rule. Section A first considers the juridical basis of the rule. This task is simplified following the 2015 Act and reveals a correlation between forfeiture and the general law of illegality, embodied by the maxim *ex turpi causa*. This task also enables us to appreciate the importance of policy in the development of the forfeiture rule. Accordingly, section B examines the policy rationales used to justify forfeiture. The most notable of these is fraud deterrence which has been used by the courts to legitimise the severity of forfeiture. Section C then considers the range of fraudulent conduct which will attract the remedy of forfeiture. Until recently, it would have been correct to suggest that the courts had conceived of actionable fraud in broad terms. This permitted the courts to adopt an interventionist approach which was in keeping with the expansiveness of the maxim, *ex turpi causa*. A recent Supreme Court decision has narrowed the common law meaning of fraud and thus reduces the circumstances in which forfeiture will be imposed.¹³³ The traditional impression of an active judiciary is, however, reinforced by the minimal evidential (D) and temporal constraints (E) applicable to the fraudulent claims jurisdiction.

¹³² Insurance Act 2015 s.12(1)(a).

¹³³ *Versloot (Supreme Court)* (n59).

A. The juridical basis of forfeiture

Following the enactment of the 2015 Act, the submission of a fraudulent claim will result in forfeiture¹³⁴ and require the assured to repay any interim sums paid in respect of the tainted claim.¹³⁵ As discussed above, the co-existence of the statutory remedy of avoidance¹³⁶ and the forfeiture rule had stymied judicial attempts to present a consistent account of the juridical basis of the rule.¹³⁷ Accordingly, by the commencement of the Law Commission consultation in 2006, case law indicated three distinct bases for forfeiture:¹³⁸ an aspect of the assured's post-contractual duty of utmost good faith,¹³⁹ by analogy to *ex turpi causa*¹⁴⁰ or an implied term that the assured should refrain from fraud in the claims process.¹⁴¹ The attempts to reconcile forfeiture with the s.17 were examined in the previous section.

Given that the forfeiture rule is now enshrined in statute, the search for the juridical basis of the rule becomes a largely academic exercise. Indeed, the Insurance Act not only removes the underwriter's liability for the claim¹⁴² but also entitles the underwriter to treat the contract as terminated with prospective effect.¹⁴³ It should also be noted that the assured may equally forfeit his claim as a result of an express term in the policy.¹⁴⁴ In these circumstances the courts would simply give effect to the parties' agreement.¹⁴⁵ Indeed, this doctrinal explanation¹⁴⁶ would explain forfeiture in policies which incorporate the International Hull Clauses (01/11/03).¹⁴⁷ Express terms tend to be common in non-marine policies¹⁴⁸ but less so

¹³⁴ Insurance Act 2015 s.12(1)(a).

¹³⁵ Insurance Act s.12(1)(b); *Gottlieb* (n8) [32] per Mance LJ.

¹³⁶ Marine Insurance Act 1906 s.17.

¹³⁷ Law Com 353 (n5) [20.37]: "uneasy juxtaposition of section 17 and the common law."

¹³⁸ Law Com Issues Paper 7 (n14) [4.18].

¹³⁹ For example, *Orakpo* (n91) 451 per Hoffmann LJ.

¹⁴⁰ For example, *The Star Sea* (n7) [62] per Lord Hobhouse.

¹⁴¹ For example, *Orakpo* (n91) 451 per Hoffmann LJ.

¹⁴² Insurance Act 2015 s.12(1)(a).

¹⁴³ Insurance Act 2015 s.12(1)(c).

¹⁴⁴ Law Com Issues Paper 7 (n14) [4.3]; Feinman, 'Agency and opportunism' (n1) 3.

¹⁴⁵ Feinman 'Agency and opportunism' (n1) 3.

¹⁴⁶ *Ibid* 3.

¹⁴⁷ International Hull Clauses (01/11/03) cl. 45.3. No such clause exists in Institute Time Clauses – Hulls (01/10/83).

¹⁴⁸ N Legh-Jones, J Birds and D Owen QC (eds.), *MacGillivray on Insurance Law* (11th ed. Sweet & Maxwell, 2012), [19-055].

in marine policies.¹⁴⁹ This may well explain why recent judicial discussion on the extent of the rule and meaning of fraud has occurred largely in the marine context.

Notwithstanding the partial codification of forfeiture, the juridical basis of the rule remains an important consideration for this project. Indeed, freed from the baggage of s.17, the basis for judicial intervention becomes more readily apparent. It is from this perspective that one can appreciate the significance of public policy considerations – unsurprising given the moral opprobrium that fraud inspires¹⁵⁰ – in the development of the rule. A critical starting point, therefore, is the judgment of Lord Hobhouse in *The Star Sea* where he equated the forfeiture rule with the general law of illegality,

This result is not dependent upon the inclusion in the contract of a term having that effect or the type of insurance; it is the consequence of a rule of law. Just as the law will not allow an insured to commit a crime and then use it as a basis for recovering an indemnity (*Beresford v Royal Insurance Co Ltd* [1937] 2 KB 197), so it will not allow an insured who has made a fraudulent claim to recover.¹⁵¹

This is entirely consistent with logic of *ex turpi causa*; the notion that fraud unravels all and an indication of the judicial reluctance to engage with dishonest claimants.¹⁵²

Subsequently, however, Mance LJ argued that general principles of illegality could not explain the totality of the forfeiture rule. In *Gottlieb*, Mance LJ stated,

The law of illegality...does not in my view, however, provide a complete analogy to or explanation of the common law rule relating to fraudulent claims. It applies the rule

¹⁴⁹ R Clift, 'Fraud: Does the punishment fit the crime?' International Marine Claims Conference (24 October 2007) available at: <http://www.marineclaimsconference.com/2007/docs/07RhysCliftHandout.pdf> (accessed 12/12/2016) 9.

¹⁵⁰ *The Star Sea* (n7) [72] per Lord Hobhouse: "fraud has a fundamental impact upon the parties' relationships and raises serious public policy considerations." Soyer, *Marine Insurance Fraud* (n40) [1-21] "fraud is often viewed as morally repugnant, especially in the context of insurance law, which is built upon the foundations of utmost good faith." See also Feinman, 'Agency and opportunism' (n1) 4 who refers to the "moral purpose" of forfeiture.

¹⁵¹ *The Star Sea* (n7) [62] per Lord Hobhouse.

¹⁵² J Davey and K Richards, 'Deterrence, human rights and illegality: The forfeiture rule in insurance contract law' [2015] LMCLQ 315, 318. See also Clarke, *Twenty-first Century* (n30) 207.

that a person cannot benefit from his own wrong. It does not explain either the forfeiture of the genuine part of an insurance claim - that is explained by the different considerations of policy which appear in the concluding sentences of paragraph 62 of Lord Hobhouse's speech in *The Star Sea* - or the recovery of sums paid in respect of a genuine loss after a fraud but before its discovery.¹⁵³

The "different considerations of policy"¹⁵⁴ to which Mance LJ referred in this judgment relate to fraud deterrence. As will be discussed in the following section, considerations of policy – most notably deterrence – have been critical in setting the limits, and justifying the effect, of the forfeiture rule. In *Gottlieb*, Mance LJ advocated that forfeiture should be explained as "special common law rule"¹⁵⁵ given that *ex turpi causa* could not explain the totality of the rule. A further reference to this characterisation was made in his dissenting judgment in *Versloot*¹⁵⁶ although, for the reason discussed above, the juridical basis of forfeiture is now largely confined to academic discussion.

The juridical basis of forfeiture is a useful starting point to determine the extent to which 'fraud unravels all' explains judicial intervention in cases of fraud. There is no doubt that fraud does unravel all within the confines of the tainted claim. Indeed, insurance claims fraud has effects which exceed the ordinary invocation of *ex turpi causa*; the forfeiture rule is not bound by the arbitrary timing of interim payments and, by virtue of the Insurance Act, can bring the relationship to an end.¹⁵⁷ Viewed in this light, the consequences of forfeiture are far-reaching and demonstrate the willingness of the courts to intervene in cases of fraud. These consequences, as will now be discussed, are attributable to policy considerations underpinning the rule.

B. The policy rationales of forfeiture

¹⁵³ *Gottlieb* (n8) [29] per Mance LJ.

¹⁵⁴ *Ibid* [29] per Mance LJ.

¹⁵⁵ *Ibid* [31] per Mance LJ.

¹⁵⁶ *Versloot (Supreme Court)* (n59) [119] per Lord Mance.

¹⁵⁷ Insurance Act 2015 s.12(1)(c).

The judicial approach to fraudulent insurance claims lends credence to the notion that fraud unravels all. The courts have clearly accepted the scale of the insurance fraud problem and, moreover, considered legal sanctions a critical part of combatting the problem. Accordingly, the judicial narrative involves two distinct threads (i) the need to protect the underwriter and (ii) the importance of deterrence by way of legal sanctions. Considerations of transaction cost provide a further rationale for the forfeiture rule (iii).

i. Protecting the underwriter

The risk of fraud during claims stems primarily from information asymmetries present in the insurance relationship. In particular, the assured will typically have more information about the cause and extent of the loss than the underwriter, which creates incentives for misrepresentation for private gain.¹⁵⁸ The underwriter requires this information to make an accurate assessment of the claim. The presence of these information asymmetries has traditionally been used to justify rules protecting the underwriter,

...the policy was effected through an agent, who could not be supposed to be skilled in the value of the stock in all sorts of businesses, or to know within a hundred or two the value of stock in a business different from his own.¹⁵⁹

Similar ideas are evident in more recent case law. In *Galloway v Guardian*, Lord Woolf MR held that “in the making of the claim the facts are normally wholly within the insured’s knowledge. The insurers are dependent on the insured exercising good faith in order to evaluate the claim.”¹⁶⁰ The Court of Appeal judgment in *Versloot* raised similar concerns,

The importance of honesty in the claiming process is manifest. Most insurance claims get nowhere near litigation because insurers rely on their insured...But insurers are entitled to protection from either type of fraud...¹⁶¹

¹⁵⁸ Feinman, ‘Agency and opportunism’ (n1) 3.

¹⁵⁹ *Britton* (n4) 910 per Willes J.

¹⁶⁰ *Galloway* (n8) 214 per Lord Woolf MR.

¹⁶¹ *Versloot Dredging BV v HDI Gerling Industrie Versicherung AG* [2014] EWCA Civ 1349, [2015] Lloyd’s Rep IR 115, [113] per Christopher Clarke LJ (hereafter referred to as *Versloot (Court of Appeal)*).

Lord Sumption endorsed this idea in the Supreme Court, holding that the fraudulent claims rule “reflects...the law’s traditional concern with the informational asymmetry of the contractual relationship, and the consequent vulnerability of insurers.”¹⁶² In his dissenting judgment, Lord Mance referred to the “significant protective effects”¹⁶³ of the forfeiture rule which he asserted were “entirely consistent with the underlying philosophy of insurance, mutual trust.”¹⁶⁴ The judicial characterisation of the insurance relationship is one in which the underwriter is vulnerable and merits protection. The second thread of the judicial narrative follows from this characterisation; the importance of deterring fraud through harsh legal sanctions.

ii. Fraud deterrence

The characterisation of the underwriter as in need of protection suggests that he is powerless to counter fraud. The corollary of this is that the courts have portrayed legal sanctions as an important means of overcoming this vulnerability. It is for this reason that the forfeiture rule is typically framed in instrumental terms; the deterrence of fraud. The judicial account of deterrence relies on severe legal sanctions¹⁶⁵ to discourage assureds from taking advantage of the opportunities for gain within the claims process.¹⁶⁶ The deterrent effect of the forfeiture rule is explicit in the case law. A representative example of these follows:

In *Galloway v Guardian*, Millett LJ commented on the prevalence and immorality of insurance fraud,

The making of dishonest insurance claims has become all too common. There seems to be a widespread belief that insurance companies are fair game, and that defrauding them is not morally reprehensible. The rule which we are asked to enforce today may

¹⁶² *Versloot (Supreme Court)* (n59) [26] per Lord Sumption.

¹⁶³ *Ibid* [127] per Lord Mance.

¹⁶⁴ *Ibid* [127] per Lord Mance.

¹⁶⁵ *Versloot (Court of Appeal)* (n161) [139] per Christopher Clarke LJ; *Gottlieb* (n8) [31] per Mance LJ.

¹⁶⁶ Feinman, ‘Agency and opportunism’ (n1) 3. This is the ‘economic’ rationale in Feinman’s categorisation.

appear to some to be harsh, but it is in my opinion a necessary and salutary rule which deserves to be better known by the public.¹⁶⁷

Lord Hobhouse made clear that the forfeiture rule was intended to influence the assured's behaviour and discourage the submission of fraudulent claims,

Just as the law will not allow an insured to commit a crime and then use it as a basis for recovering an indemnity, so it will not allow an insured who has made a fraudulent claim to recover. The logic is simple. The fraudulent insured must not be allowed to think: if the fraud is successful, then I will gain; if it is unsuccessful, I will lose nothing.¹⁶⁸

In the Court of Appeal judgment in *Versloot*, Christopher Clarke LJ equated effective deterrence with sanction severity,

It applies even if there is no clause in the policy incorporating it and is designedly draconian. It functions as a deterrent to the deception of insurers who...will have no, or very little, knowledge of the incident which is said to give rise to the claim. Part of the rationale is that if lying to the insurers did not attract that sanction, the dishonest insured would enjoy a one-way bet.¹⁶⁹

In Baker's characterisation of the insurance contract, he asserts that underwriters use different narratives about insurance at the sales and claims stages.¹⁷⁰ The narrative that follows a loss is designed to limit the underwriter's exposure to subsequent claims.¹⁷¹ This focus on dishonesty and deterrence in the English case law is a clear example of Baker's

¹⁶⁷ *Galloway* (n8) 214 per Millett LJ.

¹⁶⁸ *The Star Sea* (n7) [62] per Lord Hobhouse.

¹⁶⁹ *Versloot (Court of Appeal)* (n161) [75] per Christopher Clarke LJ.

¹⁷⁰ T Baker, 'Constructing the insurance relationship: Sales stories, claims stories, and insurance contract damages' (1993-1994) 72 *Tex L Rev* 1395.

¹⁷¹ *Ibid* 1405.

‘immoral insured’ narrative.¹⁷² On this basis it is easy to justify judicial intervention to counter “the depravity of those who threaten the public interest.”¹⁷³

The judicial view of deterrence is that it depends on harsh legal sanctions. Indeed, the cases are replete with references to the ‘draconian’ and ‘severe’ nature of the forfeiture rule.¹⁷⁴ Millett LJ’s reference in *Galloway* to public knowledge of forfeiture appears to suggest that decision-making about fraud, as conceptualised by the courts, involves the assured weighing up the potential penalty in the decision to offend.¹⁷⁵ Harsh sanctions, on this analysis, are required to outweigh the potential financial benefits of submitting a fraudulent claim. Characterised in this manner, his Lordship’s desire to improve public knowledge as a means of ensuring fraud deterrence can be readily understood. Academic commentary typically characterises fraud deterrence in a similar way. Bennett, for example, has argued in favour of stringent sanctions – including avoidance – to counter fraud,

...it is important not to underplay the policing function of the doctrine...if the consequence of such deliberate non-disclosure were merely loss of the fraudulent claim, the law would provide no incentive to honesty and almost encourage fraud instead of deterring it.¹⁷⁶

Legal sanctions are central to the judicial account of fraud deterrence. This absolves the underwriters’ responsibility which is consistent with the narrative of the vulnerable insurer. It further carries with it the suggestion that, absent forfeiture, insureds would routinely submit fraudulent claims. This overlooks the fact that the express requirement of good faith might have any impact on behaviour. Perhaps most interestingly, the characterisation of forfeiture as a deterrent accords the civil law an atypical instrumental purpose. The ordinary role of the civil law is not to police the parties’ relationship but to resolve disputes and award compensation for loss.¹⁷⁷

¹⁷² Ibid 1411.

¹⁷³ Ibid 1412.

¹⁷⁴ *Versloot (Court of Appeal)* (n161) [139] per Christopher Clarke LJ; *Gottlieb* (n8) [31] per Mance LJ.

¹⁷⁵ For a critique of this model of decision making, see Chapter Three text to fn 71 et seq.

¹⁷⁶ Bennett, ‘Mapping the doctrine’ (n105) 210.

¹⁷⁷ *Galloway* (n8) 214 per Millett LJ. The logic of the deterrence rationale will be considered in depth in Chapter Three.

Deterrence must also be appreciated from a broader systemic perspective¹⁷⁸ since the particular insured-insurer relationship is but one of a number of such relationships in which the underwriter engages. Just as risks are spread throughout the pool at inception, so too are the costs of fraud borne by policyholders in higher premiums.¹⁷⁹ This makes fraud deterrence all the more important. Not only will a deterrent sanction prevent the individual assured profiting from wrongdoing, but it will also safeguard the interests of honest assureds.¹⁸⁰ This has been recognised more generally by Abraham, “insurers distribute risk, and legal rules that protect insurers therefore redound to the benefit of the community of insureds.”¹⁸¹ If, as the courts presume, deterrence is dependent on harsh sanctions, this broader consideration cements the need for a severe response to fraud willingly employed by the courts.

iii. The transaction cost rationale

The judicial account of insurance fraud suggests that legal sanctions are required to protect underwriters and deter would-be fraudsters. However, issues related to transaction cost also bear examination in this context. A good deal of the information on which the underwriter relies to make decisions about the claim will emanate from his assured. Simply, if the underwriter was forced to confirm the validity of every statement made to him, the claims process would be far lengthier and more expensive as a result.¹⁸² These costs would no doubt be passed onto policyholders in increased premiums.

A justification premised on considerations of transaction cost is not uncommon in the insurance setting. Similar arguments were used in *Brotherton* to explain the pre-contractual disclosure duties of the assured.¹⁸³ If the assured was not required to disclose allegations of misconduct, even in circumstances where the assured knew them to be false and were in fact

¹⁷⁸ Feinman, ‘Agency and opportunism’ (n1) 4.

¹⁷⁹ *Versloot (Supreme Court hearing)* (n3) 2h 16 per Lord Sumption, Feinman, ‘Agency and opportunism’ (n1) 4.

¹⁸⁰ Baker, ‘Constructing the insurance relationship’ (n170) 1410, 1412-1413; *Chapman v Pole* (1870) 22 LT 306, 307 per Cockburn CJ.

¹⁸¹ Abraham, *Distributing Risk* (n19) 35.

¹⁸² D Harris, D Campbell and R Halson, *Remedies in Contract and Tort*, (2nd ed. Butterworths Tolley, 2001), 555.

¹⁸³ *Brotherton v Aseguradora Colseguros SA* [2003] Lloyd’s Rep. IR 746.

later disproved, the underwriter would be put “to the trouble, expense and...risk of expensive litigation...in circumstances when insurers would never have been exposed to any of this, had the insured performed its *prima facie* duty to make timely disclosure.”¹⁸⁴

This logic was repeated by Lord Hughes in *Versloot*,

Typically, insurers market their policies in part by advertising what they assert to be their prompt and uncomplicated response to claims. If such is to be the response to claims, insurers must take the claiming insured to a considerable extent on trust. Furthermore, if claims have to be investigated in detail and routinely verified by insurers, the costs of the systems necessary to do this will fall on policyholders generally.¹⁸⁵

Policy considerations have been critical in the development of the forfeiture rule. The most significant of these – fraud deterrence – has been explained by the courts as dependent on severe legal sanctions and this in turn has been used to justify the harsh consequences of forfeiture. This provides philosophical support for the notion that insurance claims fraud should unravel all. The focus now turns to the common law meaning of fraud as this is an important perspective from which to assess the utility of *ex turpi causa* in the insurance context.

C. The conception of fraud

The definition of insurance fraud is an important consideration in tracing the scope of the fraudulent claims jurisdiction. The more broadly fraud is defined, the greater scope for courts to prevent the assured receiving the indemnity. This has been a matter for the courts.¹⁸⁶ The classic definition of civil fraud is traced to the decision in *Derry v Peek*.¹⁸⁷ In that case, Lord Herschell determined that a statement would be fraudulent when it was “made (1) knowingly,

¹⁸⁴ Ibid [31] per Mance LJ.

¹⁸⁵ *Versloot (Supreme Court)* (n59) [55] per Lord Hughes.

¹⁸⁶ This remains the case following the enactment of Insurance Act 2015, see Law Com 353 (n5) [1.51].

¹⁸⁷ *Derry v Peek* (1889) 14 App Cas 337.

or (2) without belief in its truth, or (3) recklessly, careless whether it be true or false.”¹⁸⁸ Malcolm Clarke has suggested that fraud comprises three distinct elements; the fraud must be substantial, wilful and material.¹⁸⁹

The notion of substantiality requires an objective consideration of the size of the fraud. This is “not a high threshold”¹⁹⁰ and effectively enables the courts to exclude frauds which are *de minimis*¹⁹¹ from the fraudulent claims jurisdiction. As was noted at first instance in *Versloot*, a fraudulent exaggeration of £2000 in the context of a claim worth £3 million will be regarded as substantial for the purposes of forfeiture.¹⁹²

The second requirement – that the fraud is wilful and deliberate – is embodied by the definition given in *Derry*. The focus here is on the mindset of the assured. Clarke has noted that “in some degree the falsity must have been known to and, by inference intended by the claimant.”¹⁹³ This excludes, therefore, both negligence¹⁹⁴ and the ‘moral fraud’ of *Redgrave v Hurd*.¹⁹⁵ This significantly narrows the range of conduct that the courts will regard as fraudulent.

The test established in *Derry* has been accepted almost without question in the insurance context. An alternative test, however, was proposed and ultimately adopted in *Aviva v Brown*.¹⁹⁶ Counsel for the assured contended that the “combined test”¹⁹⁷ first enunciated in *Twinsectra v Yardley*¹⁹⁸ which contained an objective and subjective element was applicable.

¹⁸⁸ Ibid 374 per Lord Herschell.

¹⁸⁹ Clarke (looseleaf) (n26) 27-2B.

¹⁹⁰ *Versloot Dredging BV v HDI-Gerling Industrie Versicherung Ag (The DC Merwestone)* [2013] EWHC 1666 (Comm), [2013] Lloyd’s Rep. IR 582, [157] per Popplewell J (hereafter referred to as *Versloot (First Instance)*).

¹⁹¹ Clarke (looseleaf) (n26) [27-2B1]; Legh-Jones, Birds and Owen, *MacGillivray on Insurance Law* (n148) [19-061]. In *Lek v Mathews* [1927] LI L Rep 141, 145 per Viscount Sumner the false claims clause was interpreted to include “anything not so insubstantial as to make the maxim *de minimis* applicable.”

¹⁹² *Versloot (First Instance)* (n190) [157] per Popplewell J.

¹⁹³ Clarke, looseleaf (n26) 27-2B2.

¹⁹⁴ *Beacon Insurance Company Ltd v Maharaj Bookstore Ltd* [2014] UKPC 21, [26]: “error was a genuine one and that Mr Maharaj had not intended to deceive anyone”, [36]: “the boundary between an incompetent mistake and a lie may be a matter of impression” per Lord Hodge.

¹⁹⁵ *Redgrave v Hurd* (1881) 20 Ch D 1, see earlier discussion in Chapter One.

¹⁹⁶ *Aviva Insurance Ltd v Brown* [2012] 1 Lloyd’s Rep. IR 211, [101] but see also [61] where Eder J describes *Derry* (n187) as providing the “classic definition of fraud”

¹⁹⁷ *Twinsectra Ltd v Yardley* [2002] 2 AC 164, 172 per Lord Hutton.

¹⁹⁸ Ibid 172 per Lord Hutton.

This meant that dishonesty would only be established where i) the defendant's conduct was dishonest by the standards of reasonable men and ii) the defendant knew his conduct was dishonest on this basis.¹⁹⁹ This has not been well received in subsequent commentary or case law. Arnould has explained the result in *Aviva* as "heavily influenced by the test of dishonesty"²⁰⁰ adopted without expressing a firm view on the merits of the combined test. At first instance in *Versloot*, Popplewell J restored *Derry v Peek* as the appropriate test in cases of fraud stating that "conscious dishonesty is not a separate element of the test."²⁰¹ Moreover, Popplewell J made clear that the *Derry* standard did not constitute a lower burden for the underwriter and reiterated the difficulty of proving fraud.²⁰²

The final, and perhaps most complex, element of the common law definition is materiality. This complexity is partly explained by the fact materiality "'in the ordinary sense' has no role to play"²⁰³ here. This is because materiality usually embodies a causal connection requiring the court to determine whether the falsity impacted the representee's conduct. Indeed, the tort of deceit requires that the representee was influenced by the lie in deciding to enter the contract.²⁰⁴ By contrast, when the insurer alleges fraud, he does so precisely because he has not been induced by the lie to make payment.²⁰⁵

This has complicated the courts' approach to materiality and two distinct characterisations of this element of the test are identifiable in the case law. The first school of thought effectively marginalised the materiality requirement. In *Royal Boskalis v Mountain*, Rix J argued that there was "no additional test of materiality or, to put the same point perhaps in another way, the test of materiality is built into the concept of a fraudulent claim."²⁰⁶ This was a very limited requirement which, as Rix J contended, responded to the "disciplinary element of marine

¹⁹⁹ *Aviva v Brown* (n196) 224 per Eder J.

²⁰⁰ J Gilman (ed.), *Arnould's Law of Marine Insurance and Average* (18th ed. Sweet and Maxwell, 2013), [18-92].

²⁰¹ *Versloot (First Instance)* (n190) [154] per Popplewell J.

²⁰² *Ibid* [155] per Popplewell J.

²⁰³ *Arnould* (18th ed.) (n200) [18-62].

²⁰⁴ *Hayward v Zurich Insurance Co.* [2016] UKSC 48, [47] per Lord Clarke.

²⁰⁵ As was noted in *The Aegeon* (n9) [36] per Mance LJ.

²⁰⁶ *Royal Boskalis Westminster BV v Mountain* [1997] 1 LRLR 523, 599 per Rix J.

insurance.”²⁰⁷ This conception has been subsequently endorsed by Bennett²⁰⁸ and by Mance LJ in the following terms,

And need the fraud have any effect on insurers’ conduct? Speaking here of a claim for a loss known to be non-existent or exaggerated, the answers seem clear. Nothing further is necessary. The application of the rule flows from the fact that a fraudulent claim of this nature has been made. Whether insurers are misled or not is in this context beside the point.²⁰⁹

Understood in this way, materiality represented a very minor constraint on the courts’ ability to intervene in cases of fraud and would be easily satisfied by the underwriter.

An alternative formulation of materiality has been suggested by Malcolm Clarke. He has argued in favour of a decisive influence test such that fraud would be material when it affected the underwriter’s readiness to pay.²¹⁰ This idea encompassed “either the amount to be paid or the person to whom it is to be paid or whether to pay anyone any amount at all.”²¹¹ This test would be easily satisfied where the claim was either wholly fabricated or involved an exaggeration. The breadth of this formulation²¹² is apparent in *Wisenthal v World Auxiliary Insurance Corporation*.²¹³ In that case, Roche J determined that materiality would be satisfied if the “deceit had been used to secure easier or quicker payment of the money than would have been obtained if the truth had been told.”²¹⁴

²⁰⁷ Ibid 598 per Rix J citing *Pan Atlantic Insurance Co Ltd v Pine Top Insurance Co Ltd* [1995] 1 AC 501, 511 per Lord Mustill.

²⁰⁸ Bennett, *The Law of Marine Insurance* (n80), [22.91]: “no qualification is needed or acknowledged with respect to fraudulent claims *stricto sensu*, or alternatively is built into the concept of such a fraudulent claim.”

²⁰⁹ *The Aegeon* (n9) [36] per Mance LJ.

²¹⁰ Clarke (looseleaf) (n26) [27-2B4].

²¹¹ Ibid [27-2B4].

²¹² Law Com Issues Paper 7 (n14) [3.13].

²¹³ *Wisenthal v World Auxiliary Insurance Corporation* (1930) 38 Ll L Rep 54.

²¹⁴ Ibid 62 per Roche J.

Whether the ‘no additional requirement’ or ‘decisive impact’ conception of materiality were preferred, it was unlikely to constitute a significant hurdle for the underwriter. As the Law Commission noted, it would be a very “rare case”²¹⁵ that a lie would not be material.

The earlier reference to the complexity of materiality also reflects the fact that the applicable test was recently altered by the Supreme Court in *Versloot*.²¹⁶ At this stage, it suffices to say that the new test focuses solely on whether the lie relates to the underwriter’s liability under the policy and will be assessed retrospectively.²¹⁷ This now means that lies like those told in *Wisenthal* – to “secure easier or quicker payment of the money”²¹⁸ – will not be regarded as material. A comprehensive discussion of the new materiality threshold will be undertaken in due course.²¹⁹

Although the courts, and indeed the Insurance Act 2015, proceed on the basis that forfeiture is the only civil sanction for fraud, the common law definition of insurance fraud can be satisfied by several behaviours. It is appropriate, therefore, to speak of a spectrum of insurance fraud.²²⁰ Three behaviours are traditionally identified in the case law: (i) the wholly fraudulent claim, (ii) the exaggerated claim and (iii) the genuine claim supplemented by fraudulent means or devices. A fourth category of fraudulent claim – the assured’s suppression of a defence – will also be considered (iv) following the recent Supreme Court decision in *Versloot*.²²¹ The following discussion considers these behaviours in detail to determine the precise scope of the fraudulent claims jurisdiction.

i. The wholly fraudulent claim

A wholly fraudulent claim exists when the assured fabricates the entirety of the loss or deliberately causes the loss himself. This is the most serious type of fraudulent claim²²² and

²¹⁵ Law Com Issues Paper 7 (n14) [3.15].

²¹⁶ *Versloot (Supreme Court)* (n59) [30], [36] per Lord Sumption, [92] per Lord Clarke.

²¹⁷ *Ibid* [30], [36] per Lord Sumption, [92] per Lord Clarke.

²¹⁸ *Wisenthal* (n213) 62 per Roche J.

²¹⁹ See later, text to fn 319 et seq.

²²⁰ Richards (n34) 18.

²²¹ *Versloot (Supreme Court)* (n59).

²²² *Liverpool Victoria Insurance Co Ltd v Bashir* [2012] EWHC 895 (Admin), [9] per Sir John Thomas.

will generally require the assured to have planned his offending in advance. The paradigm marine example of the wholly fraudulent claim is the scuttle; the deliberate sinking of a vessel to claim the indemnity. Todd has suggested that scuttling is “probably quite common”²²³ although it will be difficult to prove even when there is ample suspicion about the real cause of the loss.²²⁴ This is because barratry – the destruction of the vessel by the crew to the prejudice of the owner²²⁵ – is a covered peril.²²⁶ The courts will demand considerable evidence of the assured’s complicity in the casting away of the vessel to substantiate an allegation of scuttling.²²⁷

The application of the forfeiture rule to the wholly fraudulent claim involves a difficult analysis. In the first place this is because forfeiture deprives the assured of a cause of action which arose on the occurrence of the loss.²²⁸ This does not make sense where the loss has been caused deliberately by the assured or the claim is made in the absence of any loss whatsoever. In the former case, the wilful misconduct defence establishes that the underwriter cannot be liable for loss deliberately occasioned by the assured.²²⁹ Where the claim is made in the absence of any loss, the assured could not recover simply because he would be unable to discharge the burden of proving the loss was covered by the policy.²³⁰ This makes it conceptually difficult to speak of forfeiture in the context of wholly fraudulent claims because there never was a valid claim for the assured to forfeit.

Leaving this conceptual difficulty aside, the application of forfeiture in relation to wholly fraudulent claims is also problematic because the rule is the *only* civil sanction for insurance fraud. Applying forfeiture to this type of claim is the equivalent of permitting a thief to return

²²³ Todd, *Maritime Fraud & Piracy* (n29) [6.032].

²²⁴ Cases in which scuttling has been proved include: *P Samuel & Co v Dumas* (1924) 18 Ll L Rep 211; *National Justice Compania v Prudential Assurance Co (The Ikarian Reefer)* [1995] 1 Lloyd’s Rep. 455; *The Gold Sky* (n46) [1972] 2 Lloyd’s Rep. 187.

²²⁵ Marine Insurance Act 1906 Sched. 1 (11).

²²⁶ International Hulls Clauses 2003 cl.2.2.5.

²²⁷ In *Elfie A Issaias v Marine Insurance Co Ltd* (1923) 15 Ll L Rep 186, the assured proved that the loss was barratrous; the underwriter was unable to prove that this had been done with the privity of the assured. The Court of Appeal found for the plaintiff assured.

²²⁸ *Chandris v Argo Insurance Co Ltd* [1963] 2 Lloyd’s Rep 65, 74 per Megaw J; *The Fanti* (n25) 35-36 per Lord Goff; Rose, *Marine Insurance* (n26) [26.1].

²²⁹ Marine Insurance Act 1906 s.55(2)(a).

²³⁰ Law Com Issues Paper 7 (n14) [2.7].

stolen property without imposing any further sanction. This is, simply put, an ineffective sanction because there was not, at any stage, a valid claim and therefore nothing to lose. The Law Commission recognised the absence of a penalty in the initial phase of consultation. It was noted that “the penalty may be arbitrary. An insured who presents an entirely fictitious claim loses nothing (except a claim which never existed).”²³¹ It should also be noted that the absence of a sanction in these circumstances cannot be reconciled with the judicial explanation of deterrence, namely that it is dependent on severe legal sanctions.²³²

ii. The exaggerated claim

The second category of fraudulent behaviour is the exaggerated claim. Such a claim occurs when the assured takes advantage of genuine loss to make a larger claim by, for example, inflating the value of lost items or claiming items that were never in fact owned. There is no doubt that this behaviour satisfies the common law requirement of wilfulness. The case of *Galloway v Guardian*²³³ is useful here. *Galloway* involved a domestic burglary as a result of which the assured suffered insured losses of £16,000. The assured then falsely asserted that he had also lost a computer worth a further £2,000 during the burglary. It is in these circumstances that the forfeiture rule has the greatest “bite”;²³⁴ Mr Galloway lost the entirety of his claim, including the much larger genuine portion.

Exaggeration is thought to be the most common type of insurance fraud.²³⁵ Staughton LJ commented, rather depressingly, on the prevalence of such fraud in *Orakpo v Barclays Insurance* stating that “if one examined a sample of insurance claims on household contents, I doubt if one would find many which stated the loss with absolute truth.”²³⁶ There is no reason to suggest that this portrayal is limited to domestic contents insurance.

²³¹ Ibid [7.30].

²³² See earlier, text to fn 174 et seq.

²³³ *Galloway* (n8).

²³⁴ *The Aegeon* (n9) [33] per Mance LJ.

²³⁵ MORI, ‘UK Commercial Insurance Fraud Study 2005’, available at: http://www.abi.org.uk/Publications/ABI_Publications_UK_Commercial_Insurance_Fraud_Study_2005_c6d.aspx (accessed 22 May 2012), 7.

²³⁶ *Orakpo* (n91) 450 per Staughton LJ.

The common law requirement of substantiality has been particularly problematic in the context of exaggerated claims. This is apparent in the courts' inability to express the appropriate means of measuring whether a claim is substantially fraudulent in a uniform and consistent manner.²³⁷ In *Galloway*, the question of substantiality was answered in absolute terms; an exaggeration of £2,000 was not *de minimis* and counted as fraud.²³⁸ To assess the exaggeration by reference to the value of the total claim would, as Millett LJ recognised, lead to the absurd conclusion that the greater the claim, the greater the fraud that could be practiced without fear of consequences.²³⁹ Later case law has simultaneously evaluated exaggeration in both absolute and proportional terms,²⁴⁰ meaning that a small exaggeration of a small claim could very well count as fraud.²⁴¹ Nevertheless, it seems safe to say that the approach of the first instance court in *Tonkin*, an assessment of exaggeration in relation to the overall claim,²⁴² is incorrect on the basis that it falls foul of Millett LJ's concerns about absurdity.²⁴³

Several cases towards the end of the twentieth century appeared to indicate a degree of tolerance to exaggeration. In certain circumstances, the courts would refrain from a finding of fraud on the basis that the claims process, particularly when it involved commercial assureds, often resembled a negotiation.²⁴⁴ The case of *Diggens v Sun Alliance*²⁴⁵ suggests

²³⁷ G Swaby, 'The price of a lie: Discretionary flexibility in insurance fraud' [213] JBL 77, 83.

²³⁸ *Galloway* (n8) 214 per Lord Woolf MR. See also *Direct Line Insurance v Khan* [2001] EWCA Civ 1794, [2002] Lloyd's Rep. IR 364.

²³⁹ *Galloway* (n8) 214 per Millett LJ.

²⁴⁰ *Micro Design Group Ltd v Norwich Union Insurance Ltd* [2005] EWHC 3093 (TCC), [2006] Lloyd's Rep. IR 235.

²⁴¹ R Merkin, 'Reforming insurance law: Is there a case for reverse transportation?' (Report for the English and Scottish Law Commissions, 2006) available at: http://www.lawcom.gov.uk/wp-content/uploads/2015/03/ICL_Merkin_report.pdf (accessed 24/08/2016), [6.9]; Swaby (n237) 82 - 83.

²⁴² *Tonkin v UK Insurance* [2006] EWCA 1120 (TCC), [2007] Lloyd's Rep IR 283 [178] – [179], [189]. This case involved a domestic claim exaggerated by £2000 which constituted 0.3% of the total claim. The judge, HHJ Peter Coulson QC, determined at [178] that it "would be absurd if an entirely insubstantial element of a large claim...could taint the entirety of that claim."

²⁴³ For example, J Lowry, P Rawlings and R Merkin, *Insurance Law Doctrines and Principles* (3rd ed. Hart Publishing, 2011), 312; *Arnould* (18th ed.) (n200) [18-75]; Bennett, 'Mapping the doctrine' (n105) 209: "One half of one per cent. might be regarded as *de minimis* in the abstract, but on a claim of £1,000,000 that would amount to the sum of £5,000. Relative insignificance is no reason to condone, or overlook, fraud."

²⁴⁴ *Orakpo* (n91) 451 per Hoffmann LJ; *Nsubuga v Commercial Union Assurance* [1998] 2 Lloyd's Rep. 682, 686 per Thomas J. The negotiation analysis appears to have been accepted by the Law Commission Issues Paper 7 (n14) [3.64]: "This makes it difficult to be precise about the exact boundary between fraud and, for example, exaggeration as part of the negotiation process."

²⁴⁵ *Diggens v Sun Alliance* [1994] CLC 1146.

some merit in the judicial conception of commercial claims as negotiation. In the judgment, Evans LJ referred to the following note in the insurer's file,

Put the balance of our offer 'on the table' and give the policy-holder the option of taking this and backing off, or alternatively keeping the policy-holder over the barrel to see if he [is] willing to go the route of arbitration/litigation.²⁴⁶

This suggests that the process is much more adversarial and that insurers themselves expect a degree of give and take before they would regard such conduct as fraud. However, it is only possible to regard the claims process as a negotiation where "nothing is misrepresented or concealed, and the loss adjuster is in as good a position to form a view of the validity or value of the claim as the insured."²⁴⁷ The degree of permitted exaggeration is also subject to constraint; in particular, there must be "some basis for the figure, or at least that the basis for the figure is given."²⁴⁸ These factors overcome the information imbalance which typically characterises the claims process and means that the underwriter is no longer wholly dependent on information provided by his assured.²⁴⁹

The weight of academic commentary suggests difficulties with the characterisation of the commercial claims process as a negotiation.²⁵⁰ The editors of *Arnould* have suggested that the ability of the underwriter to accurately assess the loss should not make any difference to a finding of fraud.²⁵¹ It is also difficult to accept the negotiation analysis in light of the extended

²⁴⁶ Ibid 1165 per Evans LJ.

²⁴⁷ *Orakpo* (n91) 451 per Hoffmann LJ.

²⁴⁸ J Gilman and R Merkin, (eds.), *Arnould's Law of Marine Insurance and Average* (17th ed. Sweet & Maxwell 2008), [18.76]; *Transthene Packing Co Ltd v Royal Insurance (UK) Ltd* [1996] Lloyd's Rep. LR 32, 44 per HHJ Kershaw QC holding that the claim for the full replacement cost of a machine which was seriously defective before the loss would constitute fraud. See also *Danepoint v Allied Underwriting Insurance* [2005] EWHC 2318 (TCC), [2005] All ER (D) 237 where an exaggerated claim for repair costs was not regarded as material because the final payment was subject to authorisation by a loss adjuster, [70] per Judge Peter Coulson QC the exaggeration "would...have ultimately made no difference. [because the loss adjuster] would not authorise any payments beyond those that he felt, on inspection, were justified."

²⁴⁹ D Foxton, 'The post-contractual duty of good faith in marine insurance policies: The search for elusive principles' in DR Thomas, *Marine Insurance: The Law in Transition* (Informa Law, 2006), [4.77].

²⁵⁰ But see Soyer, *Marine Insurance Fraud* (n40) [1-24], [1-26] for a view recognising the judicial tolerance to exaggeration as "realistic".

²⁵¹ *Arnould* (17th ed.) (n248) [18.72].

scope of the forfeiture rule.²⁵² As will be discussed in the following section, the rule was extended in *The Aegeon* to include claims for wholly genuine loss where the assured had lied about the cause of the loss or used forged evidence to make his case.²⁵³ It therefore seems unduly lenient to overlook exaggeration given that the forfeiture rule would operate against the claimant who told a lie merely to speed up the claims process. The case law does not reflect this critique. Notably, the decisions in *Danepoint*²⁵⁴ and *Tonkin*,²⁵⁵ heard after the extension of the rule continued to apply the negotiation analysis. A final difficulty with the negotiation analysis relates to the fact that judicial condonation of exaggeration directly contradicts the purpose of the forfeiture rule; fraud deterrence.

It is difficult to find a report of exaggeration in the marine context. Soyer has suggested several explanations for this.²⁵⁶ Firstly, he has attributed it to the existence of deductibles, such as that found in the International Hull Clauses 2003.²⁵⁷ This is not particularly convincing. Marine policies are far from unique in requiring assureds to pay an excess during the claims process. Similar terms exist in both commercial and domestic policies. Moreover, the logic justifying this feature of the contract – as a device to mitigate moral hazard²⁵⁸ – is not peculiar to the marine context.

Soyer's other explanations are more convincing. He has argued that the size of marine claims tend to justify investigation and the employment of a loss adjuster.²⁵⁹ This was also the view

²⁵² J Davey, 'Unpicking the fraudulent claims jurisdiction: Sympathy for the devil?' [2006] LMCLQ 223, 231 citing *The Aegeon* (n9) [45] per Mance LJ. See also Foxton (n251) [4.77].

²⁵³ *The Aegeon* (n9) [45] per Mance LJ.

²⁵⁴ *Danepoint* (n248) [52], [56] per HHJ Coulson QC: "It seems to me that mere exaggeration of an insurance claim will not of itself be fraud. On the other hand, exaggeration which is wilful, or which is allied to misrepresentation or concealment will, in all probability, be fraudulent. In addition, I consider that exaggeration is more likely and more excusable where the value of the particular claim or head of loss in question is unclear or a matter of opinion."

²⁵⁵ *Tonkin* (n242) [189] per HHJ Coulson QC. The court held that the claim in this case was not fraudulent but an honest and inadvertent mistake. If it had been fraudulent, "The alleged fraud appears to be worth no more than £2,000. That is, on any view, not more than about 0.3 per cent of the entirety of the claimants' claim in these proceedings. I do not consider that that is "substantial" in accordance with the authorities." The decision ignores the lesson of *Galloway* (n8) 214 per Millett LJ which cautioned against an arithmetical assessment of fraud.

²⁵⁶ Soyer, *Marine Insurance Fraud* (n40) [3-46].

²⁵⁷ *Ibid* [3-46]; International Hull Clauses 2003 (01/11/2003) cl.15. See also, Institute Time Clauses Hulls (1/10/83) cl.12.

²⁵⁸ M Pauly, 'The economics of moral hazard: Comment' (1968) 58(3)(1) *Am Ec Rev* 531, 535—536; T Baker, *Insurance Law and Policy Cases Materials and Problems* (Aspen Publishers 2003), 16; C Heimer, *Reactive Risk and Rational Action* (University of California Press, 1985), 47.

²⁵⁹ Soyer, *Marine Insurance Fraud* (n40) [3-46].

expressed by three members of the Supreme Court during argument in *Versloot*.²⁶⁰ Soyer goes on to explain why these efforts reduce exaggerated claims in the marine context; “the availability of such experts would usually have a deterrent effect because their presence would make such a deceit more risky and difficult to perpetrate.”²⁶¹ While there is an argument that investigation reduces the likelihood of fraud,²⁶² Soyer’s argument would be more compelling if it depended on evidence, rather than mere assertion.

Soyer’s final contention concerns the arrangements of the shipping industry. Marine assureds are generally required to keep accurate records of the equipment used on board.²⁶³ This would seem to make it virtually impossible for the assured to assert the loss of equipment he had never owned, as was the case in *Galloway*. Soyer also makes the argument that, in the case of a repaired vessel, a suspicious underwriter could seek corroboration in the supposed repair yard’s records.²⁶⁴ While this rationale is more convincing, it is difficult to suppose that shipping is the only such highly regulated industry. If exaggeration is more common in comparable industries, it would cast doubt on this explanation for an absence of similar marine claims.

The case of *Glencore v Alpina Insurance*²⁶⁵ provides a useful illustration of what exaggeration might look like in the marine context. Glencore was one of several companies which stored oil at a floating facility owned and operated by Metro Group. The oil was insured under an open cover and included periods of storage in the facility in Fujairah. When Metro Group collapsed in 1998, it was discovered that there was far less oil in the storage facility than anticipated. This shortfall was attributed to withdrawals made by Metro for its own (dishonest) purposes.²⁶⁶ For a short period following Metro’s collapse, Glencore took over operations at the facility. Glencore then submitted a claim to its underwriter for the difference between the amount of oil they had deposited and the amount remaining after

²⁶⁰ *Versloot (Supreme Court hearing)* (n3) 1h 34-35 per Lord Mance, 2h 15 per Lord Hughes and 2h 16 per Lord Sumption.

²⁶¹ Soyer, *Marine Insurance Fraud* (n40) [3-46].

²⁶² See later, Chapter Three on modern deterrence theory and the importance of certainty of sanctions.

²⁶³ Soyer, *Marine Insurance Fraud* (n40) [3-46].

²⁶⁴ *Ibid* [3-46].

²⁶⁵ *Glencore Ltd v Alpina Insurance* [2003] EWHC 2792 (Comm), [2004] 1 All ER (Comm) 766.

²⁶⁶ *Ibid* [25].

the collapse, less the authorised withdrawals. Prior to the first instance hearing, the insurer gave notice of its intention to run several defences, including the assertion that the claim had been fraudulently exaggerated to the knowledge of the claims manager.²⁶⁷ This was because some of the alleged shortfall related to oil which had been withdrawn during the period that Glencore was running the facility.²⁶⁸ Losses occasioned during this period could not fairly be attributed to Metro. The underwriters did not pursue a defence of fraud at trial.²⁶⁹ It is certainly correct that exaggeration is litigated less often in the marine context. It is certainly not inconceivable, however, that a marine assured might inflate his claim as illustrated by the facts of *Glencore*.

iii. Fraudulent devices and collateral lies

The third category of fraudulent claim was previously referred to as the fraudulent device claim. This claim existed when the assured suffered a loss wholly within the terms of the policy but bolstered his claim with fraudulent evidence.²⁷⁰ This would include forged receipts to substantiate the value of lost items, fabricated witness testimony or a misleading account of the loss. The rule was extended to include device claims in 2006²⁷¹ and this has prompted significant judicial and academic discussion regarding the severity of forfeiture in these circumstances. The focus of this discussion has been the appropriate materiality threshold for device claims and, to a lesser extent, issues relating to the substantial nature of the wrongdoing. The recent decision in *Versloot* changes how the law approaches these claims as well as imposing a name change; the fraudulent device is now referred to as the collateral lie.²⁷²

The starting point for discussion is the judgment in *The Aegeon*.²⁷³ The assured had undertaken that hot works would not commence until he had received authorisation from

²⁶⁷ *Ibid* [27] - [29].

²⁶⁸ *Ibid* [29].

²⁶⁹ *Ibid* [32].

²⁷⁰ *The Aegeon* (n9) [30] per Mance LJ, "A fraudulent device is used if the insured believes that he has suffered the loss claimed, but seeks to improve or embellish the facts surrounding the claim, by some lie."

²⁷¹ *Ibid* [45] per Mance LJ.

²⁷² *Versloot (Supreme Court)* (n59) [1] per Lord Sumption.

²⁷³ *The Aegeon* (n9).

the classification society. In fact, the works began before permission had been obtained and the assured misrepresented the precise start date during litigation. The question for the Court of Appeal was whether such a lie, told to strengthen an otherwise valid claim, was sufficient to attract the sanction of forfeiture. Mance LJ began by noting the absence of authority in this area²⁷⁴ and went on to conduct a review of the relevant case law. He concluded *obiter* that the jurisdiction should be extended to include device claims with the addition of a limited materiality requirement. As such, the forfeiture rule would apply to

any lie, directly related to the claim to which the fraudulent device relates, which is intended to improve the insured's prospects of obtaining a settlement or winning the case, and which would, if believed, tend, objectively, prior to any final determination at trial of the parties' rights, to yield a not insignificant improvement in the insured's prospects—whether they be prospects of obtaining a settlement, or a better settlement, or of winning at trial.²⁷⁵

Materiality was to be determined at the time the lie was told. This reflected the fact that lies were generally employed for a purpose - “because [the assured] believes that it is necessary or expedient to do so. He uses such devices, precisely because he cannot be sure that his claim is otherwise good”²⁷⁶ – and to take account of the impact the lie could have had, if believed. On this basis, the judicial enquiry was to consider whether the lie, if believed, would have placed the insured in a better position during the claims process or affected the underwriter’s handling of the claim. By way of illustration, a lie would be material if it caused the underwriter to settle earlier, more favourably or defend the claim on different grounds.²⁷⁷ In largely endorsing this version of materiality in *Versloot*, Christopher Clarke LJ held that dishonesty would be material if the underwriter was “put off relevant inquiries or...driven to irrelevant ones and he loses the opportunity to investigate the claim after an honest presentation of the facts.”²⁷⁸ This was a low threshold which caught many untruths told

²⁷⁴ Ibid [45] per Mance LJ.

²⁷⁵ Ibid [45] per Mance LJ.

²⁷⁶ Ibid [20] per Mance LJ.

²⁷⁷ Ibid [37] per Mance LJ.

²⁷⁸ *Versloot (Court of Appeal)* (n161) [132] per Christopher Clarke LJ. At [165] Christopher Clarke LJ advocated framing the materiality test in positive terms: “For my part, however, I am not quite sure why the negative

during the claims process.²⁷⁹ It is important to note, however, that this threshold would not be satisfied by lies that could not sensibly have affected the insured's prospects – such as lies told to a third party²⁸⁰ or to avoid personal embarrassment.²⁸¹ In practice, this conception of materiality did very little to prevent the forfeiture rule operating in device cases and significantly extended the scope of the fraudulent claims jurisdiction.

This conception of materiality echoed the test employed in the pre-contractual context. In *Pan Atlantic*, the House of Lords held that an underwriter would only be entitled to avoid for misrepresentation or non-disclosure where it had exerted an influence on the underwriter's decision-making process.²⁸² This would be satisfied where the misrepresentation or non-disclosure had “no more than an effect on the mind of the insurer in weighing up the risk.”²⁸³ The ‘mere influence’ test is to be distinguished from the ‘decisive impact’ test with the latter being satisfied if the non-disclosure caused the underwriter to decline the risk or charge a higher premium.²⁸⁴ This correlation between the pre- and post-contractual positions with respect to materiality has been modified by the Supreme Court decision in *Versloot*.²⁸⁵

Despite some initial uncertainty,²⁸⁶ due in part to the construction of the materiality requirement,²⁸⁷ subsequent case law, including a Privy Council judgment,²⁸⁸ endorsed the

formulation was adopted, and I would prefer the requirement to demand a significant improvement in the insured's prospects.”

²⁷⁹ *Versloot (First Instance)* (n190) [160], [176] per Popplewell J.

²⁸⁰ As was the case in *The Mercandian Continent* (n97).

²⁸¹ *Versloot (Supreme Court)* (n59) [125] per Lord Mance.

²⁸² *Pan Atlantic* (n207) 531 per Lord Mustill; confirmed in Insurance Act 2015 s.7(3).

²⁸³ *Pan Atlantic* (n207) 517 per Lord Goff.

²⁸⁴ *Ibid* 531 per Lord Mustill.

²⁸⁵ See later, text to fn 326 et seq.

²⁸⁶ *Interpart Commerciale e Gestao SA v Lexington Insurance Co* [2004] Lloyd's Rep IR 690; *Marc Rich Agriculture Trading SA v Fortis Corporate Insurance NV* [2005] Lloyd's Rep. IR 396; Clarke (looseleaf) (n26) [27-2B4].

²⁸⁷ *Interpart* (n286) [43] per HHJ Chambers QC, “The question in the present case still concerns the degree of nexus that there has to be between the fraudulent conduct and promotion of the claim against insurers. That question lies within an area where the law remains uncertain.” A Scales (Insurance Fraud Symposium, University of Southampton Law School, 13 July 2016), 1 describes Mance LJ's test as “a masterpiece in subjunctive construction.”

²⁸⁸ *Stemson v AMP General Insurance (NZ) Ltd* [2006] Lloyd's Rep. IR 852. It is difficult to assess how much weight to accord to this endorsement of the rule. On the facts, the fraudulent device point was unnecessary as the insurer was able to defend the claim on the basis that the assured had set fire to his house himself, see [25]-[26] per Lord Hope.

approach adopted in *The Aegeon*.²⁸⁹ Mance LJ's judgment on this point was "strictly speaking obiter"²⁹⁰ but subsequent courts did not question the correctness of the decision.²⁹¹ It appeared at this stage that the contours of the forfeiture rule were relatively settled. This feeling was to some extent confirmed by the fact that the Law Commission did not suggest a statutory definition for fraud nor explicitly condemn the direction in which the courts had developed the law.²⁹²

The application of the forfeiture rule to all types of insurance fraud was counterintuitive.²⁹³ It was noted above that forfeiture is not an effective sanction for the wholly fraudulent claim²⁹⁴ given the absence of any insured loss for which the underwriter would be liable. By contrast, forfeiture is penal when it operates to deprive an assured of a claim bolstered by a fraudulent device. The lopsided effect of the rule has now been reversed by the Supreme Court.²⁹⁵

The 2016 Supreme Court decision in *Versloot Dredging v HDI Gerling*²⁹⁶ fundamentally altered the legal approach to claims bolstered by a collateral lie. The case concerned a vessel which had got into difficulty on a voyage between Lithuania and Spain. The engine room began taking on water and the vessel was towed to safety. Repairs totalling €3.2 million were required. The underwriter instructed its solicitors to investigate. During this process the solicitors sought an account of the loss from the shipowners. One of the ship's managers asserted that the crew had failed to respond to a bilge alarm which was known to give false positives in heavy weather. This assertion was contained in a letter under a heading marked 'facts' and accompanied with the suggestion that the master corroborated this version of events. This was incorrect; the master was on holiday at the time of the statement and only subsequently confirmed that he was prepared to support this narrative.

²⁸⁹ *Eagle Star Insurance Co Ltd. v Games Video Co SA (The Game Boy)* [2004] EWHC 15 (Comm), [2004] 1 Lloyd's Rep. 238; *Joseph Fielding Properties (Blackpool) Ltd v Aviva Insurance Ltd* [2010] EWHC 2192 (QB), [2011] Lloyd's Rep. IR 238.

²⁹⁰ *Versloot (First Instance)* (n190) 181 per Popplewell J.

²⁹¹ See *Versloot (Supreme Court)* (n59) [20] per Lord Sumption, [85] per Lord Hughes.

²⁹² Law Com 353 (n5) [23.17].

²⁹³ See Davey and Richards (n152).

²⁹⁴ As noted earlier, see text to fn 228 et seq.

²⁹⁵ For a comprehensive critique of this consequence of the law prior to the decision in *Versloot*, see Davey and Richards (n152).

²⁹⁶ *Versloot (Supreme Court)* (n59).

The lie was borne out of frustration on the assured's part.²⁹⁷ The repair yard would not release the vessel until the repairs had been paid for and the assured was unable to do so without indemnification from his underwriter. The assured had received advice that the Inchmaree clause might afford the underwriter a defence and he was keen to assert that the loss was caused by crew failure, a covered peril subject to his satisfaction of the due diligence proviso,²⁹⁸ to divert attention away from (unfounded) suspicions about the state of the vessel.²⁹⁹

At first instance the underwriters sought to defend the claim on several substantive grounds, none of which were operative. The loss was caused by an ingress of water through an open valve. This was a covered peril, namely a loss by perils of the seas.³⁰⁰ It made no difference that the valve had been left open accidentally since negligence can supply the requisite fortuity for a loss by perils of the seas.³⁰¹ Accordingly, "the owners had a valid claim for some €3.241m whether or not the crew had failed to act on a bilge alarm activation."³⁰² Popplewell J upheld the fraudulent device defence "with regret."³⁰³ He felt bound to follow *The Aegeon* notwithstanding his serious misgivings about the disproportionate and draconian nature of forfeiture in this case.³⁰⁴ The Court of Appeal refused the subsequent appeal in terms largely similar to Mance LJ's judgment in *The Aegeon*,³⁰⁵ but suggested that the materiality threshold should be increased and expressed in positive terms,

(a) the fraudulent device must be directly related to the claim; (b) the fraudulent device must have been intended by the insured to promote his prospect of success; and (c) the fraudulent device must have tended to yield a not insignificant improvement in the insured's prospects of success prior to any final determination of the parties' rights...For my part, however, I am not quite sure why the negative

²⁹⁷ Ibid [3] per Lord Sumption.

²⁹⁸ International Hulls Clauses 2003 cl.2.2.3

²⁹⁹ *Versloot (Supreme Court)* (n59) [3] per Lord Sumption.

³⁰⁰ *Versloot (First Instance)* (n190) [40] per Popplewell J.

³⁰¹ *Baxendale v Fane (The Lapwing)* (1940) P 112, 121 per Hudson J.

³⁰² *Versloot (Supreme Court)* (n59) [4] per Lord Sumption

³⁰³ *Versloot (First Instance)* (n190) [225] per Popplewell J.

³⁰⁴ Ibid [146] per Popplewell J.

³⁰⁵ *Versloot (Court of Appeal)* (n161) [106] et seq. per Christopher Clarke LJ.

formulation was adopted, and I would prefer the requirement to demand a significant improvement in the insured's prospects.³⁰⁶

The Court of Appeal also heard argument on whether the operation of forfeiture in device cases constituted a breach of the assured's rights under the European Convention of Human Rights. Article 1, protocol 1 (A1P1) guarantees individuals the peaceful enjoyment of their possessions. Previous case law had indicated that 'possessions' extended to contractual rights.³⁰⁷ This would encompass the right to indemnity which accrues to the assured on the occurrence of loss. A1P1 is a qualified right; states can interfere with an individual's enjoyment provided intervention seeks a legitimate aim and is proportionate in nature. The Court of Appeal dismissed the assured's argument swiftly; the deterrence of fraud did constitute a legitimate aim and forfeiture was a proportionate means of achieving that aim.³⁰⁸ The court opted to look at the effect forfeiture in the round³⁰⁹ and not by reference to the individual case, as earlier cases applying A1P1 had done.³¹⁰

On appeal to the Supreme Court, a majority of 4:1 held that the newly designated collateral lie did not attract the remedy of forfeiture. This was a lie "which turns out when the facts are found to have no relevance to the insured's right to recover."³¹¹ This is a comprehensive reversal of the earlier position. The leading judgment was given by Lord Sumption. He noted that the policy of deterrence was not an appropriate explanation of sanctions where the assured sought no more than his actual entitlement under the contract.³¹² Lord Sumption started from the position that the forfeiture rule was designed to protect the underwriter from information asymmetries.³¹³ In the case of wholly fraudulent or exaggerated claims, the rule protects the underwriter from making payments which would exceed his contractual liability. The same is not true where the assured only seeks his true loss as will be the case where a collateral lie is told. If forfeiture operated in these circumstances, it would protect

³⁰⁶ Ibid [165] per Christopher Clarke LJ.

³⁰⁷ *Wilson v First County Trust Ltd (No 2)* [2003] UKHL 40; [2004] AC 816, [39].

³⁰⁸ *Versloot (Court of Appeal)* (n161) [154]-[164].

³⁰⁹ Ibid [143] relying on *James v UK* (1986) 8 EHRR 123, [36].

³¹⁰ See, for example, *Axa General Insurance Ltd v The Lord Advocate* [2011] UKSC 46; [2012] 1 AC 868, [128]; *Barnes v The Eastenders Group* [2014] UKSC 26; [2014] Lloyd's Rep FC 461; [2015] AC 1, [94].

³¹¹ *Versloot (Supreme Court)* (n59) [1] per Lord Sumption.

³¹² Ibid [26] per Lord Sumption.

³¹³ Ibid [26] per Lord Sumption.

the underwriter from having the claims process diverted or from making payment at an earlier stage. It is clear that forfeiture is not designed to provide such security to underwriters; “the underwriter loses nothing if he meets a liability that he had anyway.”³¹⁴ Even if the rule was intended to serve this purpose, Lord Sumption contended that forfeiture would be a disproportionate response to a collateral lie.³¹⁵ By way of analogy, Beh and Stempel’s discussion of remedies for the assured’s breach of claims notification provisions is useful.³¹⁶ If late notice has not prejudiced the underwriter, the denial of coverage will only give “the insurer an undeserved windfall and make[] the insurance policy fail its intended purpose.”³¹⁷ The same logic surely applies in the case of collateral lies; to deny the indemnity on the basis of a lie irrelevant to the underwriter’s ultimate liability would undermine the purpose of insurance. Having approached the matter in this way, none of their Lordships devoted any real time to the explicit proportionality analysis raised skilfully in argument; the application of A1P1 to fraudulent device claims.³¹⁸ In any event, a determination that proportionality should be assessed on a case-by-case basis would in all likelihood have constituted a higher threshold than a retrospective assessment based on the underwriter’s ultimate liability.

The decision to alter the materiality threshold in *Versloot* fundamentally changes the scope of the fraudulent claims jurisdiction. In *The Aegeon*, Mance LJ concluded that the lie should be assessed by reference to the time it was told and to the effect it had on the underwriter’s behaviour.³¹⁹ By contrast, the *Versloot* test is retrospective in nature, and considers whether the lie bore any relevance to the underwriter’s ultimate liability.³²⁰ If the court answers this in the negative, the lie will be considered ‘collateral’ and the assured will escape the sanction of forfeiture. This narrows the fraudulent claims jurisdiction – by excluding from its ambit collateral lie claims – and clarifies the appropriate standard of materiality. This should free

³¹⁴ Ibid [26] per Lord Sumption.

³¹⁵ Ibid [26] per Lord Sumption.

³¹⁶ Beh and Stempel (n30) 124.

³¹⁷ Ibid 124.

³¹⁸ *Versloot (Supreme Court)* (n59) [37] per Lord Sumption, [103] per Lord Hughes, [132] per Lord Mance. See the eloquent arguments made by Victoria Wakefield for the assured in *Versloot* hearing (n3) from 2h 31 and *Versloot Dredging BV v HDI Gerling Industrie Versicherung (The DC Merwestone)* (Hearing on 16/03/16, afternoon session) until 1h 04 available at <https://www.supremecourt.uk/watch/uksc-2014-0252/160316-pm.html> (accessed 27/09/2016). These arguments follow the acceptance of similar human rights considerations in the personal injury context, see *Summers v Fairclough Homes Ltd* [2012] UKSC 26, [2012] 4 All ER 317, [46] – [47] per Lord Clarke.

³¹⁹ *The Aegeon* (n9) [37] per Mance LJ.

³²⁰ *Versloot (Supreme Court)* (n59) [35] per Lord Sumption.

future courts from the tension between the ‘no additional requirement’ and ‘decisive influence’ standard, described earlier in this section.³²¹

There are two notable consequences flowing from the new test of materiality. Firstly, the focus on financial entitlement means that the test can be applied to all types of fraudulent claim.³²² It should follow that wholly fraudulent and exaggerated claims will always be regarded as material and thus forfeit. This is because the assured will always be seeking to recover more than his contractual entitlement. This may well make it more difficult for courts to excuse exaggeration by reference to the negotiation analysis.³²³ The new test renders the purpose of the lie irrelevant. Going forward, a lie which “affect[s] his handling of the claim, or the speed which he pays it, or the inquiries which he calls for”³²⁴ will not be material since they “can make no difference to his liability to pay.”³²⁵

Secondly, the test distinguishes the standard of materiality applicable at the claims stage from that employed in respect of non-disclosure and misrepresentation at inception. A pre-contractual lie or non-disclosure prevents the underwriter from assessing the entirety of the risk.³²⁶ Without an appreciation of the whole risk, this may cause the underwriter to accept or price risks differently than he otherwise would have.³²⁷ As such, the pre-contractual test of materiality considers the impact of the lie on the underwriter’s behaviour and awards remedies – including avoidance *ab initio* – accordingly.³²⁸ The position is different at the claims stage because the underwriter is not in the same position of choice as he was at inception.³²⁹ If the loss was caused by a covered peril, the insurer is *prima facie* liable to indemnify the assured from the time that the loss occurred.³³⁰ The appropriate test of materiality should not consider whether the lie affected the underwriter’s behaviour, but

³²¹ See earlier, text to fn 206 et seq.

³²² *Versloot (Supreme Court)* (n59) [36] per Lord Sumption.

³²³ See earlier, text to fn 244 et seq.

³²⁴ *Versloot (Supreme Court)* (n59) [91] per Lord Hughes.

³²⁵ *Ibid* [91] per Lord Hughes.

³²⁶ *Ibid* [91] per Lord Hughes.

³²⁷ *Ibid* [91] per Lord Hughes.

³²⁸ Insurance Act 2015 s.3, sched 1.

³²⁹ *Versloot (Supreme Court)* (n59) [91] per Lord Hughes.

³³⁰ *The Fanti* (n25) 35, per Lord Goff: “I accept that, at common law, a contract of indemnity gives rise to an action for unliquidated damages, arising from the failure of the indemnifier to prevent the indemnified person from suffering damage, for example, by having to pay a third party.”; Rose, *Marine Insurance* (n26) [26.1].

whether it was relevant to his ultimate liability. This was the approach taken by the Supreme Court in *Versloot*.

A strong dissent was provided by Lord Mance. He largely restated the position he adopted in *The Aegeon*, subject to the heightened materiality threshold as recommended by the Court of Appeal.³³¹ Lord Mance took particular issue with the materiality test constructed by the majority of the Supreme Court, opining that assureds tells lies for a specific purpose and reiterating the potential impact of such lies on claims handling.³³² In particular, his concern was that the retrospective nature of the test cast the claims process in the wrong light, arguing that “litigation is neither the aim nor the norm.”³³³ Lord Mance also took a firm position that deterrence was equally applicable in the context of device claims³³⁴ and, moreover, that the statutory basis of forfeiture represented parliamentary approval of this point.³³⁵ This, with respect, overlooks the fact that the Insurance Act, as recommended by the Law Commission, leaves the meaning of ‘fraudulent claim’ to the courts.³³⁶

The result in *Versloot* returns the law to the position adopted by academics prior to the decision in *The Aegeon*.³³⁷ In writings prior to the expansion of the fraudulent claims jurisdiction, Clarke had suggested that the use of fraudulent evidence to strengthen a valid claim was “dishonest but not substantial: he is not seeking to get from the insurer money to which he knows that he is not entitled.”³³⁸ It also mirrors the position taken by the Financial Ombudsman in consumer cases. The presentation of forged evidence did not automatically result in forfeiture; the Ombudsman sought to determine whether the evidence was “solely to substantiate transactions that really took place, or did the customers intend to obtain more than they were entitled to?”³³⁹ This is a logical distinction to draw since the alternative could

³³¹ *Versloot (Supreme Court)* (n59) [113] citing *Versloot (Court of Appeal)* (n161) [165] per Christopher Clarke LJ.

³³² *Versloot (Supreme Court)* (n59) [130] per Lord Mance.

³³³ *Ibid* [111] per Lord Mance.

³³⁴ *Ibid* [124]-[125] per Lord Mance.

³³⁵ *Ibid* [124] per Lord Mance.

³³⁶ Law Com 353 (n5) [23.17].

³³⁷ *The Aegeon* (n9).

³³⁸ Clarke, *Policies and Perceptions* (n18), 171.

³³⁹ Cited in Lowry, Rawlings and Merkin (n243) 309.

provide the unscrupulous underwriter with an incentive to continually question the insured in the hope of catching him in a lie.³⁴⁰

The foregoing discussion has traced the courts' difficulty in establishing an appropriate materiality threshold for device claims. Considerations of substantiality have also proved problematic in this context,³⁴¹ as illustrated by *Aviva v Brown*.³⁴² The assured claimed for the cost of remedial works and alternative accommodation following serious subsidence at his home. Mr Brown took an active role in the search for temporary accommodation and suggested several properties to his insurer. Two of the representations made in connection with this process bear particular scrutiny.³⁴³ Firstly, the assured told his insurer that he had identified a suitable property and that it was available for rent. This was false; the property was his childhood home which he now owned. Ultimately, however, the assured and his wife decided the property was unsuitable. Eder J held that this statement was "a substantial and material part of...his claim for alternative accommodation."³⁴⁴ By contrast, his statement that the landlord of the eventual temporary accommodation was chasing him for rent was not treated as substantial.³⁴⁵ This was also false given that Mr Brown was himself the landlord of the property in question. It is difficult to find any justification for treating these statements differently and certainly Eder J does not provide a rationale for his decision. It seems rather odd that if Mr Brown had only made the second false, but not fraudulent statement, he would have been entitled to recover.

Bugra and Merkin have expressed doubts as to the substantiality of the first statement since it could not have affected the insurer's handling of the claim.³⁴⁶ These doubts, as well as the result in *Brown*, demonstrate the difficulty of applying the substantiality test in relation to qualitative statements, as distinct from financial exaggeration. These difficulties may well explain why the courts have preferred to focus on materiality to determine whether such

³⁴⁰ *Longobardi v Chubb Ins Co* 560 A 2d 68, 83 (NJ, 1989) cited in Clarke (looseleaf) (n26) [27-2B4]; J Hjalmarsson, 'Exit "fraudulent means and devices"' [2016] (July) STL (published online, 25 July 2016).

³⁴¹ A Bugra and R Merkin, 'Fraud' and fraudulent claims' (2012) 125 J Brit Ins Law Association 3,5.

³⁴² *Aviva* (n196).

³⁴³ *Aviva* made 21 separate allegations of fraud – only 2 were proved at trial.

³⁴⁴ *Aviva* (n196) [96] Eder J.

³⁴⁵ *Ibid* [82] [118] per Eder J.

³⁴⁶ Bugra and Merkin (n341) 6.

conduct should count as fraud.³⁴⁷ In any event, the Supreme Court's approach to materiality in *Versloot* may well resolve the problems posed by substantiality in this context.

iv. Suppression of a defence

The final category of fraudulent claim involves the assured's deliberate suppression of information which, if disclosed, would afford the underwriter a defence under the policy. A useful illustration is provided by *Savash v CIS General Insurance*.³⁴⁸ The assured claimed on his buildings and contents insurance following an alleged burglary at his home. The underwriter successfully relied on an express clause which disclaimed liability in circumstances where the property was unoccupied, defined as "insufficiently furnished for full habitation, or not lived in by the Family, or any other person with the Family's permission, for more than 60 consecutive days."³⁴⁹ Evidence gathered by police in the immediate aftermath of the burglary lent credence to the underwriter's suggestion that the property was unoccupied.³⁵⁰ In presenting the claim, however, the assured sought to give the impression that the property had been occupied at the relevant time via the production of photographic evidence and an explanation of his personal circumstances. Akenhead J held that the underwriter was not liable for the claim as the property had been unoccupied and because the claim had been made fraudulently.³⁵¹

Writing prior to the decision in *Savash*, Bennett had argued that knowledge of a defence would trigger the assured's post-contractual duty of good faith and would, therefore, require

³⁴⁷ *Versloot (First Instance)* (n190) [223] (indicates an overlap between substantiality and materiality); Law Com 353 (n5) [22.24] "We think there is an argument that the "fraudulent device" employed in that case [Versloot] does not satisfy the common law requirements for fraud of substantiality and materiality."

³⁴⁸ *Savash v CIS General Insurance* [2014] EWHC 375 (TCC), [2014] Lloyd's Rep. IR 471.

³⁴⁹ *Ibid* [2] per Akenhead J.

³⁵⁰ *Ibid* [5] per Akenhead J: "She was surprised at the extent of the damage which had occurred and in relation to some of the things said to have been stolen in the incident (which included a large amount of heavy furniture). She was also surprised that no one had seen any vehicle parked outside the front given the size, volume and weight of items said to have been stolen, it being her view that it would have taken at least two people to carry some of the items out and frequent trips would need to have been made to and from the house. Her colleague went into the loft and told her that the pipes had been cut (from which the escaping water emanated). Her colleague did some house-to-house enquiries: the owner of No 28 had been in between 13.00 and 15.00 and had not seen anything, the owner of No 32 had seen nothing suspicious but had been out between 12.30 and 13.30, but later heard banging from No 30 which she thought might be home improvements, and the owners of Nos 21 and 36 who were in the whole time did not see anything."

³⁵¹ *Ibid* [60] per Akenhead J.

disclosure.³⁵² The removal of avoidance as the remedy for breach of s.17 Marine Insurance Act³⁵³ means it is no longer problematic to align the prohibition of fraudulent claims and the duty of good faith. There is, however, a query relating to the expansiveness of the duty suggested in Bennett's comments. This is because his comments also precede the House of Lords' judgment in *The Star Sea* in which the assured's post-contractual duty of good faith was limited to honesty.³⁵⁴ It could well be that to require the assured to voluntarily disclose information amounting to a defence would exceed this duty and resemble the wide-ranging disclosure duties imposed at inception. Mance LJ subsequently endorsed the view in *The Aegeon* that suppression of a defence would result in the loss of the claim.³⁵⁵ It would appear to be legitimate to include the suppression of a defence within the fraudulent claims jurisdiction on the basis that underwriters will typically investigate not only the scope and quantum of liability following a loss, but also whether the facts enable them to assert a defence to payment.³⁵⁶ Mance LJ then commented on the decision in *The Star Sea*, noting that "none of the speeches in the House of Lords contain any positive suggestion that the common law rule or section 17 cannot apply to a known defence."³⁵⁷ Mance LJ did not appear to identify any tension between the post-contractual duty of honesty and information pertaining to a defence known to the assured.

The assured's suppression of a defence has not yet generated significant academic comment as a distinct category of fraudulent claim. Clarke, for example, includes it as a type of fraudulent claim but provides no further detail on the matter.³⁵⁸ It is likely, however, that this type of conduct will gain new prominence following the decision in *Versloot*.³⁵⁹ This is because the suppression of a defence would presumably meet the new standard of materiality

³⁵² Bennett, 'Mapping the doctrine' (n105) 210.

³⁵³ Insurance Act 2015 s.14(1)(3).

³⁵⁴ *The Star Sea* (n7) [102], [111] per Lord Scott.

³⁵⁵ *The Aegeon* (n9) [18] per Mance LJ.

³⁵⁶ *Gan Insurance Co Ltd v Tai Ping Insurance Co Ltd* [2002] EWCA Civ 248, [2002] CLC 870, [37] per Mance LJ.

³⁵⁷ *The Aegeon* (n9) [18] per Mance LJ.

³⁵⁸ Clarke, (looseleaf) (n26) [27-2B4]: notes the existence of this type of conduct as fraudulent but provides no further discussion.

³⁵⁹ Hjalmarrsson, 'Exit "fraudulent means and devices"' (n340).

because it affects the underwriter's ultimate liability. The issue will need to be considered at length by an appropriately senior court.³⁶⁰

The decision in *Versloot* limits the circumstances in which fraud will unravel all in the context of insurance claims. This does not mean, however, that the common law definition of fraud is settled. For one thing, subsequent courts will need to ascertain the precise limits of the 'collateral lie'³⁶¹ and the strength of the materiality threshold. The courts also retain the freedom to develop the meaning of fraudulent claim in future cases. Notwithstanding this recent development, procedural matters – most notably, the standard of proof (D) and temporal limits of forfeiture (E) – do not unduly constrain the courts' ability to intervene in fraud cases.

D. The standard of proof

The standard of proof is an important consideration in assessing the scope of the fraudulent claims jurisdiction. The higher the burden, the more difficult it will be to explain the jurisdiction by reference to the maxim, fraud unravels all.

As a civil matter, the ordinary burden of proof – the balance of probabilities – should apply in insurance fraud cases. This would simply require the underwriter to demonstrate that fraud was more likely than not.³⁶² Given the concealed nature of fraud, the underwriter will be permitted to rely on "circumstantial evidence and inference to demonstrate [the assured's] knowledge and intent"³⁶³ to satisfy this burden.

A closer examination of the case law, however, gives the impression that an intermediate standard – somewhere between the ordinary civil standard and the more onerous criminal

³⁶⁰ See the discussion in *The Mercandian Continent* (n97) [28] per Longmore LJ: "the conduct of the assured which is relied on by underwriters must be causally relevant to underwriters' ultimate liability, or at least, to some defence of the underwriters before it can be permitted to avoid the policy. This is, I think, the same concept as that underwriters must be seriously prejudiced by the fraud complained of before the policy can be avoided."

³⁶¹ Hjalmarsson, 'Exit "fraudulent means and devices"' (n340).

³⁶² *Arnould* (18th ed.) (n200) [18-101].

³⁶³ P MacDonald Eggers and P Foss, *Good Faith and Insurance Contracts* (LLP, 1998), [11.11]; *Arnould* (18th ed.) (n200) [18-102]. *Stemson* (n288) [7], [9] per Lord Hope in which the Privy Council noted the first instance court's reliance on circumstantial evidence and inferences it had drawn relating to the credibility of witnesses.

standard – applies in the fraud context. In *Hornal v Neuberger*, a case on fraudulent misrepresentation, the Court of Appeal characterised the burden as follows,

The more serious the allegation the higher the degree of probability that is required: but it need not, in a civil case, reach the very high standard required by the criminal law.³⁶⁴

More recently, in *Re H (Minors)*, Lord Nicholls repeated this idea in the context of a child protection case,

The balance of probability standard means that a court is satisfied an event occurred if the court considers that, on the evidence, the occurrence of the event was more likely than not. When assessing the probabilities the court will have in mind as a factor, to whatever extent is appropriate in the particular case, that the more serious the allegation the less likely it is that the event occurred and, hence, the stronger should be the evidence before the court concludes that the allegation is established on the balance of probability. Fraud is usually less likely than negligence...Built into the preponderance of probability standard is a generous degree of flexibility in respect of the seriousness of the allegation.³⁶⁵

The existence of an intermediate standard of proof would present a greater challenge to the underwriter than would be posed by the ordinary civil standard.³⁶⁶ More recent case law, however, has suggested that *Re H* increases the evidential burden facing underwriters but does not displace the ordinary civil standard of proof.³⁶⁷ This means, in practice, that the courts demand cogent evidence in cases involving serious allegations and will examine that

³⁶⁴ *Hornal v Neuberger Products Ltd* [1957] 1 QB 247, 258 per Denning LJ.

³⁶⁵ *Re H (Minors)* [1996] AC 563, 586-587. This standard is endorsed by a range of cases and academic commentators, see Clarke, looseleaf (n26) [27-2A1]; *Arnould* (18th ed.) (n200) [18-101]. Recent cases endorsing the *Re H* approach include *Beachview Aviation Ltd v Axa Insurance Ltd* [2015] NIQB 106, [32] per Stephens J; *Mandalia v Beaufort Dedicated No.2 Ltd* [2014] EWHC 4039 (QB), [75] per Gerard McDermott QC.

³⁶⁶ J Hjalmarsson, 'The standard of proof in civil cases: An insurance fraud perspective' (2013) 17 E&P 47, 50.

³⁶⁷ *Secretary of State for the Home Department v Rehman* [2003] 1 AC 153, [55] per Lord Hoffmann (confd. *In Re B*); *R (N) v Mental Health Review Tribunal (Northern Region)* [2006] QB 468, [62] per Richards LJ (endorsed in *Re D* [2008] UKHL 33; 1 WLR 1499, [27] per Lord Carswell).

evidence “in a more critical fashion.”³⁶⁸ This is typically justified by reference to the adverse consequences that a finding of fraud will have for the individual.³⁶⁹

Importantly, the Law Commission did not regard *Re H* or *Hornal* as establishing an intermediate standard of proof for insurance cases. They derived support from *Re B* in which Lord Hoffmann held that there was “only one civil standard of proof and that is proof that the fact in issue more probably occurred than not.”³⁷⁰ The Law Commission clarified that “although the courts may start thinking that an innocent explanation is more likely than fraud, this does not affect the legal standard of proof.”³⁷¹ The suggestion that fraud was less likely than negligence was “simply something to be taken into account, where relevant, in deciding where the truth lies.”³⁷² There is, however, no empirical basis for the courts to conclude that fraud is less likely than negligence.³⁷³ Without such data, it is right to question the alleged frequency of these offences as the basis for an increased evidential burden on underwriters.

Even if the cases had created an intermediate standard of proof, there are strong arguments that the ordinary civil standard – the balance of probabilities – should apply in insurance cases.³⁷⁴ Hjalmarsson has argued that the child protection and matrimonial cases deserve special protection due to the human rights issues that arise in those contexts.³⁷⁵ Indeed, the later child protection cases can be viewed as only applying to cases which arise under the Children Act.³⁷⁶ More importantly for this project, an intermediate standard of proof limits the extent to which the forfeiture rule can serve its deterrent purpose. As Hjalmarsson has argued,

³⁶⁸ Soyer, *Marine Insurance Fraud* (n40) [1-18].

³⁶⁹ *Britton* (n4) 910 per Willes J; *Hornal* (n364) 266-267 per Morris LJ; *Beachview Aviation* (n365) [32] per Stephens J; M Clarke, ‘Lies, damned lies, and insurance claims: The elements and effects of fraud’ [2000] NZ L Rev 233, 237.

³⁷⁰ *Re B (Children) (Sexual abuse: Standard of proof)* [2009] 1 AC 11, [13] per Lord Hoffmann.

³⁷¹ Law Commission Issues Paper 7 (n14) [3.54].

³⁷² *Re B* (n370) [70] per Lady Hale.

³⁷³ E McBride, ‘Is the civil ‘higher standard of proof’ a coherent concept?’ (2009) 8 Law, Probability and Risk 323, 334.

³⁷⁴ Hjalmarsson, ‘The standard of proof’ (n366) 61, 73.

³⁷⁵ *Ibid* 63, 71.

³⁷⁶ *Re B* (n370) [69] cited by Hjalmarsson, ‘The standard of proof’ (n366) 62.

A common argument is that a heightened standard of proof should be employed where the consequences of the case are very serious, particularly in fraud cases...In insurance cases, in particular, there is a clear opposing social or policy interest which is just as valid as the protection of an individual person and his or her reputation. The opposing interest is the legitimate social need to limit the number and combined size of fraudulent insurance claims and to prevent guilty individuals getting away with fraud.³⁷⁷

The preferable view, as endorsed by the Law Commission,³⁷⁸ is that the balance of probabilities standard should apply in insurance fraud cases. It is notable that issues of proof were not included in the final proposals for reform which suggests that matters are relatively settled.³⁷⁹ If correct, this means that procedural issues do not unduly increase the burden facing the underwriter. This is also reflected in the number of cases in which fraud has been successfully established. Even in cases where the underwriter has failed to prove fraud, this is more usually attributed to an absence of “direct evidence”³⁸⁰ than the constraints of the evidential burden. The discussion now turns to the temporal limits of forfeiture and considers whether these hinder the unravelling effect of fraud.

E. The temporal limit

The courts approached the tension between the forfeiture rule and the statutory remedy of avoidance by consistently limiting the remedy for fraudulent claims to forfeiture.³⁸¹ In so doing, the House of Lords in *The Star Sea* imposed a temporal limit on the post-contractual duty of good faith,

Once the parties are in litigation it is the procedural rules which govern the extent of the disclosure which should be given in the litigation, not section 17³⁸²

³⁷⁷ Hjalmarsson, ‘The standard of proof’ (n366) 70-71.

³⁷⁸ Law Com Issues Paper 7 (n14) [3.52]-[3.54].

³⁷⁹ But see the call for a re-examination of the relevant standard of proof: Hjalmarsson, ‘Standard of proof’ (n366) 72-73.

³⁸⁰ *Yeganeh v Zurich Plc.* [2011] EWCA Civ 398, [2011] Lloyd’s Rep. IR 540, [14] per Ward LJ.

³⁸¹ This was discussed earlier in this chapter, see Part IV.

³⁸² *The Star Sea* (n7) [77] per Lord Hobhouse. See the more recent discussion of the moment at which the parties’ relationship is crystallised in the context of a writ agreement issued under a notice of abandonment in *Atlasnavios-*

This dictum was later endorsed by the Court of Appeal in *The Aegeon*.⁴⁷⁰ Mance LJ considered that it would be “inappropriate to introduce a distinction between the duration of the impact of the fraudulent claims rule...and of the s.17 duty.”⁴⁷¹ The same policy argument – the altered character of the parties’ relationship during litigation – dictated that the threat of forfeiture should cease on the commencement of litigation.⁴⁷²

The Civil Procedure Rules (CPR) govern the situation in which a claimant lies during litigation.⁴⁷³ When faced with a dishonest litigant, the Court may either dismiss the claim for abuse of process⁴⁷⁴ or adjudicate the issue in the normal way, provided the dishonesty has not made this impossible.⁴⁷⁵ Strike out enables the court to “protect [the] legitimacy of...[its] own processes”⁴⁷⁶ and is, therefore, the procedural equivalent of *ex turpi causa*.⁴⁷⁷ The major difference, however, is that strike out is to be used proportionately in line with the overriding principle of the CPR.⁴⁷⁸ Proportionality in this context requires the court to use their discretion reasonably, such that the judicial response represents the minimum necessary to protect the judicial process from abuse.⁴⁷⁹ By contrast, the operation of the forfeiture rule does not depend on an explicit consideration of proportionality. In essence, therefore, this means that the assured who lies in the period before litigation risks a far greater penalty – the forfeiture of his entire claim – than if he lies during the trial.⁴⁸⁰ This is counterintuitive; lies told during

Navegação LDA v Navigators Insurance Co Ltd (The B Atlantic) (No 2) [2014] EWHC 4133 (Comm), [2015] 1 Lloyd’s Rep. IR 151, [343] per Flaux J.

⁴⁷⁰ *The Aegeon* (n9) [52] per Mance LJ.

⁴⁷¹ *Ibid* [53] per Mance LJ.

⁴⁷² *Ibid* [52] per Mance LJ; See also Thomas ‘Fraudulent insurance claims’ (n79) 488.

⁴⁷³ *Versloot (Court of Appeal)* (n161) [78] per Christopher Clarke LJ.

⁴⁷⁴ Civil Procedure Rules r.3.4.(2)(b); confirmed in *Zahoor v Masood* [2009] EWCA Civ 650, [2010] 1 WLR 746, [71] per Mummery LJ.

⁴⁷⁵ A Zuckerman, ‘Must a fraudulent litigant be allowed to think: if the fraud is successful, I will gain much; if it is not, I will still recover my legitimate claim?’ (2011) 30(1) CQJ 1, 2.

⁴⁷⁶ A Zuckerman, ‘Court protection from abuse of process – the means are there but not the will’ (2012) 31(4) CQJ 377, 378.

⁴⁷⁷ *Ibid* 378.

⁴⁷⁸ Civil Procedure Rules r.1.1; Bugra and Merkin (n341) 8.

⁴⁷⁹ Zuckerman, ‘Court protection’ (n389) 380.

⁴⁸⁰ This risk is not replicated in other areas of the civil law. See Zuckerman, ‘Must a fraudulent litigant’ (n388) 5: recognising the difficulty of responding to fraud with substantive law as it would “encourage a diversity of solutions to a common problem, create waste and confusion. Further, it would bring the law into disrepute if the outcome of deceit were different depending on the right invoked.” See later discussion of the tort context in Chapter Three, text to fn 312 et seq.

litigation are designed with a more reprehensible purpose – to mislead both the underwriter and the court – whereas the lie told earlier intends only to deceive the insurer. Park J hinted at this inconsistency in *The Aegeon*,

Suppose that at the trial his lies are exposed, but the judge takes the view that he would have won anyway without them. Does he lose the case because he lied? The answer is: no. If his case is a good one anyway, he wins. It is deplorable that he lied but he is not deprived of his victory in consequence.⁴⁸¹

Lies told before and during litigation will be treated differently by the courts. In the former situation, fraud deterrence preoccupies the courts and is used to justify the potentially harsh consequences of forfeiture. By contrast, the issue of the claim form triggers the operation of the CPR meaning that considerations of proportionality will colour the court's assessment of the appropriate remedy. This more punitive response to pre-litigation dishonesty demonstrates the utility of 'fraud unravels all' to explain the effect of insurance claims fraud.

VI. Conclusion

This chapter has examined the civil response to insurance claims fraud from a doctrinal perspective and identified the policy factors which have been critical in shaping this response. The earlier tension between the forfeiture rule and the statutory remedy of avoidance⁴⁸² has now been resolved by the Insurance Act 2015. The 2015 Act confirms that forfeiture is the appropriate response to insurance claims fraud.⁴⁸³ Viewed in isolation, therefore, the notion that 'fraud unravels all' is a useful explanation of the operation of the forfeiture rule. This is because the rule acts to retrospectively bar the assured's right to succeed in a claim.

Writing in advance of the Supreme Court decision in *Versloot*, Soyer suggested that the development of forfeiture was characterised by a tension between the need to penalise dishonest assureds and concerns about treating all frauds alike.⁴⁸⁴ This is essentially the

⁴⁸¹ *The Aegeon* (n9) [58] per Park J.

⁴⁸² Marine Insurance Act 1906 s.17.

⁴⁸³ Insurance Act 2015 s.12(1)(a).

⁴⁸⁴ Soyer, *Marine Insurance Fraud* (n40) [1.24]-[1.26].

suggestion that proportionality had been a critical factor in judicial decision making. While this tension was certainly evident in the attempt to marginalise avoidance in the fraudulent claims context,⁴⁸⁵ there is no evidence that it played any part in the judicial approach to the forfeiture rule. Indeed, prior to *Versloot*, the fraudulent claims jurisdiction had been widened to include device claims⁴⁸⁶ and the courts had paid no attention⁴⁸⁶ to the nuances of fraudulent claims which a truly proportionate enquiry would demand.

The absence of an explicit proportionality enquiry within the confines of the forfeiture rule is due to the overriding importance of fraud deterrence. The courts have accepted both the scale of the fraud problem and the role of legal sanctions in combatting fraud. As conceptualised by the courts, deterrence is dependent on harsh sanctions. Indeed, this is no doubt the result when forfeiture is imposed in respect of an exaggerated claim and, formerly in relation to claims bolstered by fraudulent devices. A further narrative in the case law concerns the vulnerability of underwriters to fraud. This solidifies both the importance of deterrence and legal sanctions – as distinct from industry initiatives – to respond to the fraud problem.

The fraudulent claims jurisdiction is no doubt more settled following the passage of the Insurance Act and the decision in *Versloot*.⁴⁸⁷ Further developments are still likely, however, not least because the precise contours of the collateral lie and the new materiality test will need further consideration. In addition, the Supreme Court emphasised that lying during litigation was not without risk.⁴⁸⁸ Any lie, whether collateral or otherwise, would entitle the court to make use of procedural sanctions during litigation.⁴⁸⁹ It remains to be seen how subsequent courts will make use of these tools. It will also be interesting to see how underwriters contend with suspicious claims given that the new statutory regime makes it far more difficult for underwriters to raise a technical defence as a proxy for fraud.⁴⁹⁰

⁴⁸⁵ *The Star Sea* (n7) [51] per Lord Hobhouse.

⁴⁸⁶ *The Aegeon* (n9) [45] per Mance LJ.

⁴⁸⁷ *Versloot (Supreme Court)* (n59).

⁴⁸⁸ *Ibid* [98] per Lord Hughes, [108] per Lord Toulson.

⁴⁸⁹ *Ibid* [36] per Lord Sumption, [98] per Lord Hughes.

⁴⁹⁰ *Macaura v Northern Assurance Co Ltd* [1925] AC 619.

This chapter has addressed the limits of the fraudulent claims jurisdiction and considered the policy arguments that have influenced the development of the rule. The following chapter focusses on the third research question by submitting these policy considerations to critique. It will contend, primarily, that the judicial conception of deterrence depends on an outdated model of decision making and this means that forfeiture is an ineffective deterrent. Research in related disciplines suggests that legal sanctions are a minor factor in decisions about crime and this weakens the centrality of forfeiture in the insurance law model. The remaining discussion challenges the characterisation of the underwriter as vulnerable. Furthermore, the absence of proportionality in the insurance framework is compared to other fraud-prone systems which have adopted nuanced remedial frameworks. The suggestion is that while deterrence is a laudable and important policy objective, there is no reason for it to override everything else and thereby prevent the establishment of proportionate sanctions for insurance fraud.

Chapter Three

Insurance: A Critique of the Judicial Response to Fraud

The notion that 'fraud unravels all' makes sense in the insurance context. The courts have fashioned an expansive jurisdiction to deal with fraud. This is a result of their characterisation of the insurance relationship as distinctive in which the insurer merits protection from fraudulent assureds. The courts view themselves as deterring fraud through the imposition of harsh penalties.

There is something superficially attractive about these propositions and the idea that individuals modify their behaviour in response to the threat of legal punishment. A closer look suggests the consequentialist effects of forfeiture are not guaranteed nor is the characterisation of the insurer-insured relationship a given. This chapter addresses the third research question in the insurance context and considers the extent to which the suggested policy justifications are valid. The importance of sanctions to counter insurance fraud is not contested but it is far from clear that the policy reasons said to justify harsh sanctions are sufficiently compelling.

For ease of exposition, the arguments challenging these propositions are summarised here:

- A. The assumption that the forfeiture rule deters is premised on an outdated model of decision making. Modern research casts doubt on the centrality of legal sanctions in deterrence.
- B. The forfeiture rule is not an effective legal sanction for the wholly fraudulent claim.
- C. Underwriters' vulnerability and consequent need for protection from fraud is no longer as compelling given technological and investigative developments.
- D. Fraud deterrence and proportionality can be reconciled within a remedial framework. The Australian approach to insurance fraud and the English response to fraudulent personal injury claims and in the criminal law reflect a more balanced approach. This casts doubt on the supposed necessity of harsh sanctions.

I. The Deterrence Critique

The notion that civil law rules play, or have the potential to play, a significant role in deterring socially harmful conduct is likely to be counterintuitive to those inculcated in the traditional distinction between the criminal and civil spheres. And yet, this is exactly the rationale underpinning the draconian consequences of forfeiture in insurance contract law. Notions of deterrence have traditionally been used to justify fraud rules in the insurance context notwithstanding the absence of empirical evidence.¹ Without such evidence, it becomes virtually impossible to determine whether the law has met its aim or assess the appropriateness of the chosen approach.² And yet, simple assumptions about the deterrent effect of legal sanctions have not troubled the insurance courts. This approach mirrors Shand's comment that "once, moreover, the courts are prepared to talk in terms of deterrence, they do so irrespective of any reality the deterrent may have."³

The judicial account of deterrence is fairly simplistic; harsh sanctions deter. This is not unique to the insurance context. In *Smith v Citibank*, a case on fraudulent misrepresentation, Lord Steyn held that,

a policy of imposing more stringent remedies on an intentional wrongdoer serves...a deterrent purpose in discouraging fraud...And in the battle against fraud civil remedies can play a useful and beneficial role.⁴

This would seem to mirror the equally simplistic assertions of a rational choice conception of crime. This section will argue that the reality of deterrence is far more complex. Put simply, the law cannot have such a decisive influence on individuals' decisions largely because they are unaware of the law and in any event, are influenced by different factors.

¹ This point is also made by P Rawlings and J Lowry, 'Insurance fraud: The "convoluted and confused" state of the law' [2016] LQR 96, 115: "there is no empirical data to show that the fraudulent claim rule does deter, and a growing literature throws serious doubts on the effectiveness of non-criminal (and even criminal) sanctions in deterring behaviour."

² J Smits, *The Mind and Method of the Legal Academic* (Edward Elgar, 2012), 67.

³ J Shand, 'Unblinkering the unruly horse: Public policy in the law of contract' (1972) 30 Cambridge LJ 144, 155.

⁴ *Smith New Court Securities Ltd v Citibank NA* [1997] AC 254, 279-280 per Lord Steyn.

Modern frameworks of decision making about crime undermine the traditional deterrence model in several ways. Firstly, the decision-making process is affected by a broad range of considerations, of which the threat of legal sanctions is one (relatively minor) factor. Secondly, humans lack the ability to conduct a wholly rational analysis and instead rely on techniques to simplify the decision-making process. These cognitive shortcuts commonly skew the decision in favour of offending. Lastly, the objective realities of detection and punishment are irrelevant; instead the individual's perception of these costs is decisive.

The discussion proceeds as follows. First, the discussion will address the major arguments of rational choice theory and the assumptions on which it relies (A). The argument made here uses analysis rooted in the criminal law to evaluate sanctions in the private sphere. Economic analysis is not unique to the criminal law and so it is important to justify the use of this framework (B). The discussion will then turn to the modern research which has undermined rational choice theory (C). The major argument is that if the insurance courts' insistence on harsh sanctions depends on an outdated model of decision making, the forfeiture rule is likely to be ineffective in practice.

A. Economic analysis of crime: Rational choice theory

An economic analysis of law seeks to answer two questions; firstly, what are the effects of law on behaviour, and secondly, are those effects desirable?⁵ It answers those questions by applying tools of economic theory to legal issues.⁶ In relation to the first question, it is important to understand the assumed characteristics of the actor whose behaviour is analysed. Gary Becker's sketch of the actor is as follows,

[A]ll human behavior can be viewed as involving participants who [1] maximize their utility [2] from a stable set of preferences and [3] accumulate an optimal amount of information and other inputs in a variety of markets.⁷

⁵ L Kaplow and S Shavell, 'Economic analysis of law' (1999) available at: http://www.law.harvard.edu/programs/olin_center/papers/pdf/251.pdf (accessed 01/08/16), 3.

⁶ Ibid 3.

⁷ G Becker, *An Economic Approach to Human Behavior* (University of Chicago Press, 1976) 14.

This characterisation assumes rationality, namely that actors consistently make decisions which maximise their expected utility or self-interest.⁸ Through this process of maximising, the actor ranks alternatives and chooses the course of action that most increases his utility.⁹

The actor is also presumed to be immune from the manner in which choices are presented.¹⁰ This means that the actor will always respond to the consequences of a course of action whether they are characterised in terms of a loss or a gain.¹¹ When the actor is faced with alternate courses of action, he is presumed to have sufficient ability to gather and assess information to determine which alternative conforms to his preferences. The actor adopts a cost-benefit analysis to make this decision. On this basis, law is regarded as a set of incentives (benefits) and sanctions (costs) which shapes behaviour. The second question for law & economics scholars is answered by reference to considerations of welfare economics; does the consequent behaviour accord with ideas of economic efficiency and equity.¹²

It is possible to trace this type of analysis to Jeremy Bentham's eighteenth century work on criminal law and deterrence.¹³ The modern version of the analysis, primarily associated with the Chicago School of the 1950s, was initially applied to the law of competition and monopolies.¹⁴ The analysis gradually became more expansive and was used to assess the efficiency of almost every area of law.¹⁵

⁸ R Posner, *Economic Analysis of Law* (5th ed. Aspen Law, 1998), 4.

⁹ R Cooter and T Ulen, *Law & Economics* (3rd ed, Addison-Wesley, 2000), 11.

¹⁰ M Eisenberg, 'Behavioral economics and contract law' in E Zamir and D Teichman (eds.), *The Oxford Handbook of Behavioral Economics and the Law* (OUP, 2014) 446, 447.

¹¹ Eisenberg (n10) 447 citing A Tversky and D Kahneman, 'The framing of decisions and the psychology of choice' (1981) 211(4481) *Science* 453, 457.

¹² Kaplow and Shavell, 'Economic analysis' (n5) 3.

¹³ JH Burns, HLA Hart and F Rosen (eds), *The Collected Works of Jeremy Bentham An Introduction to the Principles of Morals and Legislation* (Clarendon Press, Oxford 2005); Kaplow and Shavell, 'Economic analysis' (n5) 3.

¹⁴ Kaplow and Shavell, 'Economic analysis' (n5) 3; E Posner 'Values and consequences: An introduction to economic analysis of law' in E Posner, *Chicago Lectures in Law and Economics* (Foundation Press, 2000), 189.

¹⁵ Posner, 'Values and consequences' (n14) 189-190; Papers which are attributed with expanding the law & economics analysis included R Coase, 'The problem of social cost' (1960) 3 *J of L and Econ* 1 and G Calabresi, 'Some thoughts on risk distribution and the law of torts' (1961) 70 *Yale LJ* 499.

The publication of Becker's seminal paper, 'Crime and punishment: An economic approach', in 1968 extended this analysis to the criminal law.¹⁶ He contended that the decision to commit crime was the same as any other decision to which the same analytical framework was applicable.¹⁷ This was an assertion of considerable magnitude given the prevailing theories about crime. The positive school of criminology had dominated the crime discourse since the early 1900s which held that crime was a product of economic, social and biological factors.¹⁸ This resulted in policies which sought to incapacitate harmful offenders¹⁹ and to correct the inequalities that caused crime.²⁰

Becker restored the view that the decision to commit crime depended on weighing "the costs of apprehension and conviction"²¹ against the benefits of commission. This was a return to the utilitarian ideas of classical criminology which had dominated discussions of crime and criminal justice from the renaissance until the early twentieth century. The classical school, particularly Jeremy Bentham and Cesare Beccaria, conceptualised crime as "a rational calculation of the risk of a pain versus potential pleasure derived from an act".²² Understood in this way, the appropriate purpose of punishment was deterrence.²³

The major premise of law & economics as it relates to ideas of deterrence is the law of demand.²⁴ This suggests that if the price of any good increases, there will be reduced

¹⁶ G Becker, 'Crime and punishment An economic approach' (1968) 76 J of Pol Econ 169, 170 intending that the framework was applicable to the entire range of criminal offences, including white collar crimes and more trivial offences such as parking violations.

¹⁷ Ibid 170, 201; N Mazar and D Ariely, 'Dishonesty in everyday life and its policy implications' (2006) 25(1) J of Pub Pol & Mark. 117, 118.

¹⁸ A comprehensive account of the positive school of criminology is beyond the scope of this work. The following provide a representative sample of the causes of crime. R Merton, 'Social structure and anomie' (1938) 3(5) Am. Soc. Rev. 672, 672, 678; A Quetelet, 'Of the development of the propensity to crime' originally published in A Quetelet, *A Treatise on Man* (Chambers, 1842) and reprinted in E McLaughlin, J Muncie and G Hughes (eds), *Criminological Perspectives* (2nd ed. SAGE Publications, 2003), 41; E Ferri, 'Causes of criminal behaviour' originally published in E Ferri, *The Positive School of Criminology; Three Lectures by Enrico Ferri* (Charles H Kerr & Co., 1908) and partially reprinted in E McLaughlin, J Muncie and G Hughes (n18) 54.

¹⁹ J Lilly, F Cullen and R Ball, *Criminological Theory Context and Consequences* (5th ed. SAGE Publications, 2011), 34.

²⁰ Ibid 83.

²¹ Becker, 'Crime and punishment' (n16) 205.

²² R Akers, *Criminological Theories Introduction, Evaluation and Application* (3rd edn, Roxbury Publishing Company 2000), 16.

²³ Burns, Hart and Rosen (n13) 34, 158; R Bellamy (ed) and R Davies (tr), *Beccaria: 'On Crimes and Punishments' and Other Writings* (Cambridge University Press, 1995) 31.

²⁴ Posner, *Economic Analysis* (n8) 4.

consumer demand for that good in proportion to the size of the initial increase. This will prompt the rational, self-interested actor to investigate alternatives which he preferred less when the good was at its previous, lower price.²⁵ This hypothesis is equally applicable to the commission of crime, as Richard Posner has argued,

people act as rational maximizers of their satisfactions in making such nonmarket decisions as whether to...commit or refrain from committing crimes...Rules of law operate to impose prices on...these nonmarket activities, thereby altering the amount or character of the activity...The first two premises lead to such predictions as that...increasing the severity as well as certainty of criminal punishment will reduce the crime rate.²⁶

The theory of the criminal sanction propounded by the law & economics movement rests on deterrence on the basis that “the state reduces the demand for crime by setting a “price” for it in the form of an expected cost of having to pay a fine or go to prison.”²⁷ The rational criminal is assumed to conduct a cost-benefit analysis in which he weighs the expected costs against the benefits. A person refrains from crime when the costs outweigh the benefits.²⁸ In this equation, the costs of crime are traditionally regarded as the certainty and severity of punishment. More peripheral costs, which are not a major part of the conventional analysis, include the criminal’s opportunity costs and the expenses required to commit the offence.²⁹ The criminal weighs these costs against the expected benefits of punishment which, in the case of fraud, are largely financial.

This idea leads to very simple policy prescriptions: increasing the costs of crime will result in fewer offences.³⁰ This is no doubt intuitively attractive. A question remains, however, how should policymakers increase the costs of crime? The answer for law & economics scholars was rooted in the idea that these costs were interchangeable and in notions of efficiency.

²⁵ Ibid 5.

²⁶ R Posner, ‘The law and economics movement’ (1987) 77 (2) *American Economic Review* 1, 5.

²⁷ Posner, *Economic Analysis* (n8) 250.

²⁸ Ibid 242.

²⁹ Ibid 242.

³⁰ G Stigler, ‘The optimum enforcement of laws’ in G Becker and W Landes (eds.), *Essays in the Economics of Crime and Punishment* (NBER, 1974), 56.

A traditional economic analysis of law views the certainty and severity of legal sanctions as representing a cumulative cost to the offender.³¹ For example, a fine of \$10,000 with a 0.1 chance of detection has the same expected cost to the offender as a fine of \$1million where the chance of detection is 0.001.³² In both cases the rational offender calculates the expected cost of crime as \$1000.³³ Where the cumulative cost of these variables exceeds the benefits of offending, the model predicts that the individual refrains from crime. This suggests that the role played by each variable matters little for deterrence as long as the combination reaches a given cost value in the mind of the offender. This notion of interchangeability has been recently confirmed by Kaplow and Shavell.³⁴ The major lesson of this analysis is that a severe sanction which is unlikely to be imposed can have an identical deterrent effect as a more trivial sanction where the offender is very likely to be apprehended and convicted.³⁵

This presents a choice to policymakers; which combination of sanctions should be chosen to reduce crime? The answer to this question depended on efficiency;³⁶ policymakers should determine the most efficient combination of certainty and severity for each offence and operationalise sanctions on that basis. The most efficient combination would typically be high severity/low certainty sanctions. This is because increasing the likelihood of detection is not costless, but requires significant state investment in the machinery of the criminal justice system.³⁷ Becker and Posner argued, on the basis of theoretical models, that this was the appropriate combination in relation to prison sentences and fines.³⁸

³¹ Ibid 56; A Harel, 'Behavioral analysis of criminal law: A survey' in E Zamir and D Teichman, *The Oxford Handbook of Behavioral Economics and The Law* (OUP, Oxford 2014), 575.

³² Posner, *Economic Analysis* (n8) 244.

³³ Ibid 244.

³⁴ L Kaplow and S Shavell, *Fairness Versus Welfare* (Harvard University Press, 2002), 362 Where an offence has a low probability of detection, it may be "desirable to employ higher punishments than those called for under the proportionality principle."

³⁵ A Harel, 'Economic analysis of criminal law: A survey' in A Harel and K Hylton (eds.), *Research Handbook on the Economics of Criminal Law* (Edward Elgar, 2012), 575.

³⁶ Becker, 'Crime and punishment' (n16) 183-184; R Posner, 'An economic theory of the criminal law' (1985) 85 *Colum L Rev* 1193, 1206.

³⁷ Posner, 'An economic theory' (n36) 1207.

³⁸ Becker, 'Crime and punishment' (n16) 184; Posner, 'An economic theory' (n36) 1206, 1213; Kaplow and Shavell, 'Economic analysis' (n5) [6.2.2].

This single metric could result in very harsh policy recommendations. Efficiency could dictate, for example, that trivial offences which were difficult or expensive to detect were punished very severely.³⁹ Some of Becker's contemporaries had noted these potential consequences of his analysis and sought to develop arguments to counter his insistence on severity.⁴⁰ This is not to say, however, that Becker was wholly immune from broader considerations. In his 1968 paper he had suggested that if deterrence was society's only concern, offences could be reduced "at will" by rendering detection virtually certain and ensuring that punishment exceeded the offender's gain.⁴¹ While this would not meet his efficiency criterion, Becker had a further issue with prescriptions made on this basis: it "ignore[d] the social costs of increases" in certainty and severity.⁴² Social costs were the product of the cost of punishment to the offender and the impact that this punishment had on society.⁴³ Note that this impact could be negative, as when society is forced to invest resources in prisons, or could be positive, as when the sanction is a fine which the offender pays to society.⁴⁴ Accordingly, Becker suggested that fines should be used in preference to imprisonment as these would generally result in lower social costs.⁴⁵ Imprisonment should be used to sanction offenders unable to pay a fine.⁴⁶ This analysis is not without criticism – it assumes that the collection of fines is costless⁴⁷ and aggregates the offender's cost into the overall determination of social cost⁴⁸ – but it is important to address the totality of prescriptions that Becker made.

Rational choice theory provides a superficially attractive model of criminal decision making. If crime is the result of a rational balancing of costs and benefits, the key to crime reduction lies in increasing the costs of offending.⁴⁹ Moreover, these costs can be increased in a manner which is economically efficient for society without compromising on deterrence.

³⁹ Becker, 'Crime and punishment' (n16) 183-184; see also Kaplow and Shavell, *Fairness Versus Welfare* (n34) 362.

⁴⁰ Harel, 'Economic analysis' (n35) 576: "horrified even the most orthodox advocates of law and economics who tried hard to provide counterarguments"; K Dau-Schmidt, 'An economic analysis of the criminal law as a preference-shaping policy' (1990) 1 *Duke LJ* 1, 21.

⁴¹ Becker, 'Crime and punishment' (n16) 180.

⁴² *Ibid* 181.

⁴³ *Ibid* 180.

⁴⁴ *Ibid* 180.

⁴⁵ *Ibid* 193.

⁴⁶ *Ibid* 193.

⁴⁷ Posner, 'An economic theory' (n36) 1206-1207; A Harel, 'Economic analysis' (n35) 15.

⁴⁸ Dau-Schmidt (n40) 11-12.

⁴⁹ Becker, 'Crime and punishment' (n16) 177.

There is a certain symmetry between rational choice theory and the approach of the insurance courts. The judges have consistently argued that harsh penalties deter and that communication of these penalties will reduce fraud. True, the insurance courts do not speak explicitly in economic terms, but this does not preclude the explanatory power of economic theory.⁵⁰ While intuitively attractive, these models are far too simplistic. They fail to recognise the complex realities of decision making and the importance of social context for the potential offender. Accordingly, sanctions premised on rational choice theory, including the insurance forfeiture rule, are likely to be ineffective in deterring offenders. It will be argued that modern deterrence theory better reflects these complexities and can be used to underpin sanctions which are more likely to deter.

B. The applicability of the framework

The forgoing discussion has centred on the economic approach to criminal law. However, the focus of discussion here – the forfeiture rule – is a civil law sanction. Given that economic analysis is not unique to the criminal law, the applicability of the criminal framework within this thesis merits explanation.⁵¹ An explanation is all the more necessary given the similarity between the insurance approach and the economic analysis of intentional torts which also equates deterrence with harsh sanctions.⁵² The relative size and maturity of the criminal literature means, however, that it provides a more comprehensive basis for comparison and is preferred in this project.

The critical difference between the criminal and civil settings is the purpose of the punishment or sanction, respectively. The criminal law imposes punishments “for doing what is forbidden”⁵³ and is designed to “dissuade the actor from engaging in [the] activity at all.”⁵⁴ This is because conduct punishable by the criminal law lacks any social utility whatsoever.⁵⁵

⁵⁰ Posner, ‘An economic theory’ (n36) 1230 where a similar point is made in relation to the criminal law.

⁵¹ I am grateful to Dr Johanna Hjalmarsson for encouraging me to think about the suitability of this framework in greater depth and to Professor Rick Swedloff for assisting me in reaching the final conclusion on this point.

⁵² R Cooter, ‘Economic analysis of punitive damages’ [1982] 56 S Cal L Rev 79, 89-90.

⁵³ R Cooter, ‘Prices and sanctions’ (1984) 84 Colum L Rev 1523, 1524.

⁵⁴ J Coffee, ‘Paradigms lost. The blurring of the criminal and civil law models’ (1991-1992) 101 Yale LJ 1875, 1876.

⁵⁵ *Ibid* 1876.

The level of punishment is typically affected by two variables; the harm caused and the offender's state of mind.⁵⁶

By contrast, the civil law, generally concerns conduct which creates social utility but, in so doing, imposes externalities on others. Many examples are cited in the literature⁵⁷ but the most useful for our purposes is a contract which is breached by one party. As a socially useful activity, the practice of contracting is to be encouraged, but the law must make provision for the possibility that one party fails to perform as agreed. The task for the courts, therefore, is to develop appropriate sanctions in these circumstances. One option would be to punish the contract breaker but this could also have the unwelcome effect of making contracting less desirable. A more appropriate response is to 'price' the behaviour so that the sanction equals the harm caused.⁵⁸ This forces the actor to internalise any externalities he imposes on others,⁵⁹ which in the context of breach of contract, requires the breaching party to pay compensatory damages to his counterpart.⁶⁰ This is an appropriate response since the majority of contract breaches are not opportunistic but either involuntary, as would be the case where frustration operates, or voluntary but characterised as efficient.⁶¹ This enables the individual to determine whether to engage in the particular conduct⁶² and to undertake an efficient level of precautions.⁶³

There is an occasional reference in the economic literature on contract law to large damages awards which are designed to deter inefficient, opportunistic breaches.⁶⁴ This is how we would characterise the submission of a fraudulent insurance claim. These references, however, are not sufficiently developed to enable a comprehensive analysis of the forfeiture rule.

⁵⁶ Cooter, 'Prices and sanctions' (n53) 1552.

⁵⁷ Posner, 'An economic theory' (n36) 1206 (the example of driving which causes an accident); Coffee (n54) 1884 (the example of a manufacturer who causes environmental pollution).

⁵⁸ Cooter, 'Prices and sanctions' (n53) 1554.

⁵⁹ Coffee (n54) 1876; Cooter, 'Prices and sanctions' (n53) 1525.

⁶⁰ *Robinson v Harman* 154 ER 363 (1848), 365 per Parke B. But see H Collins, *Regulating Contracts* (OUP, 1999) 121 where he argues that "we should be cautious in assuming that it is the legal sanction or a payment equivalent to the measure of legal damages that supplies this incentive towards performance of undertakings."

⁶¹ Posner, *Economic Analysis* (n8) 131.

⁶² Cooter, 'Prices and sanctions' (n53) 1552.

⁶³ Cooter and Ulen (n9) 290.

⁶⁴ Posner, *Economic Analysis* (n8) 130-131, 142.

Where the civil law 'pricing' method works well, the non-breaching party will be indifferent to performance or breach plus damages.⁶⁵ This is because a damages award calculated by reference to expectation interest will mean that the non-breaching party is in the same position as though the contract was fully performed.⁶⁶ The critical point is that the 'price' equals the harm caused.⁶⁷ To impose prices which exceeded the harm would discourage the actor from engaging in socially beneficial activities, namely contracting.⁶⁸

Insurance fraud does not produce any social utility. In fact, as a deliberate attempt by the assured to extract more than his entitlement at the expense of the underwriter and the pool of policyholders, fraud creates disutility. This disutility increases premiums for honest policyholders and forces the underwriter to expend unnecessary costs in determining the validity of the claim.⁶⁹ This resembles the type of conduct proscribed by the criminal law and, therefore, by analogy, the appropriate legal response is to outlaw fraud. A framework premised on 'prices' would give the impression that fraud was a legitimate activity provided the assured was willing to pay the relevant price. This is clearly not the message that the legal system is attempting to send, as evidenced by the fact that insurance fraud is also punishable as a crime.⁷⁰ Accordingly, the economic analysis of the criminal law and its associated literature is a suitable framework in which to discuss the forfeiture rule.

C. An alternative account of legal sanctions: Modern deterrence theory

Modern deterrence theory is the result of research undertaken to test the assertions of rational choice theory⁷¹ and developments in decision theory from the behavioural and

⁶⁵ Ibid 133; E Zamir and B Medina, *Law, Economics, and Morality* (OUP, 2010) 294.

⁶⁶ *Robinson* (n60) 365 per Parke B. A similar analysis is employed to explain damages awards in tort law, see Cooter and Ulen (n9) 345-346.

⁶⁷ Cooter, 'Prices and sanctions' (n53) 1554. This supposes that monetary damages are capable of fully compensating the accident victim or non-breaching party in a contract, for this point in relation to tort see Cooter and Ulen (n9) 345.

⁶⁸ M Bedi, 'Contract breaches and the criminal/civil divide: An inter-common law analysis' (2011-2012) 28 *Ga St U L Rev* 559, 583-584, 588-589. This is the fear of 'over-deterrence', see generally Posner, 'An economic theory' (n36) 1206.

⁶⁹ Cooter and Ulen (n9) 276 make this point in discussing why fraudulent misrepresentation during negotiations will render a contract void.

⁷⁰ Fraud Act 2006 s.2; see later discussion in part V (ii).

⁷¹ R Paternoster, 'How much do we really know about criminal deterrence?' (2010) 100(3) *J of Crim L & Criminol.* 765, 779.

cognitive sciences. It presents a much more complex framework for understanding decisions about crime than the law & economics approach. The framework adopts a more realistic actor who is distinguishable from his rational forbear. The decision-making process too is fundamentally different; the actor takes a broader range of factors into account when choosing between alternatives and the process itself is far from the methodical approach suggested by law & economics.

Before considering the ways in which modern theory diverges from the rational choice account of crime and deterrence, it is important to provide a sketch of the actor in the behavioural analysis. The model of man used in behavioural economics differs considerably from the rational actor. The actor's preferences are not constant; decisions do not always reflect self-interest but demonstrate concern for others.⁷² Empirical evidence demonstrates that the actor values fairness both in how he is treated and how he treats others.⁷³ There is considerable evidence of altruistic and reciprocal behaviour in one-time interactions between anonymous parties,⁷⁴ the paradigm case in which one would expect 'rational', selfish behaviour.⁷⁵ Perceptions of unfairness can also cause behaviours more spiteful than the traditional framework would predict.⁷⁶ In economic exchange, behaviour is not driven solely by financial concerns but in some circumstances considerations of "comfort, or power, or pleasure"⁷⁷ may dominate decision making. Decision making, therefore, is not simply a balance of the relative economic costs and benefits.

Modern theory recognises that preferences are not solely shaped by exogenous factors⁷⁸ but also develop through social interaction.⁷⁹ The actor's existence within a particular society explains a good deal of his behaviour. The actor, for example, is characterised as having a

⁷² C Jolls, C Sunstein and R Thaler, 'A behavioral approach to law and economics' [1998] 50 Stan LR 1471, 1479.

⁷³ Ibid 1479.

⁷⁴ Mazar and Ariely, 'Dishonesty in everyday life' (n17) 119 citing U Gneezy, 'Deception: The role of consequences' (2005) 95(1) Am Ec Rev 384; J Andreoni and J Miller, 'Analyzing choice with revealed preference: Is altruism rational?' in C Plott and V Smith (eds.), *Handbook of Experimental Economics Vol 1* (Elsevier Science, 2008); J Abeler, D Nosenzo and C Raymond, 'Preferences for truth-telling' (IZA Discussion Paper No. 10188, September 2016) available at: <http://ftp.iza.org/dp10188.pdf> (accessed 15/09/2016), 7, 38.

⁷⁵ E Posner, 'Law, economics, and inefficient norms' [1996] 144 U Penn L Rev 1697, 1714.

⁷⁶ Jolls, Sunstein and Thaler (n72) 1479.

⁷⁷ J Kidwell, 'A caveat' (1985) Wis L Rev 615, 617.

⁷⁸ This is a major premise of rational choice, see Dau-Schmidt (n40) 5; Cooter and Ulen (n9) 18.

⁷⁹ Mazar and Ariely, 'Dishonesty in everyday life' (n17) 119; Kidwell (n77) 617.

“desire to achieve a positive image of self by winning acceptance or status in the eyes of others.”⁸⁰ He achieves this social approbation by behaving in accordance with the norms of his society. Behaving in accordance with these codes of conduct also benefits the actor intrinsically. Evidence of this comes from the field of neuroscience which demonstrates that the brain responds in the same way to behaviour which accords with social norms as it does to stimuli which offer the actor external rewards.⁸¹ This suggests the existence of an internal mechanism to control behaviour. This internal mechanism sanctions misconduct, behaviour which contravenes this set of values, and rewards compatible behaviour.⁸² Put simply, we feel good when we behave in ways we consider good even if this means we sacrifice external benefits associated with a different course of action.⁸³ The recognition that behaviour is shaped by a combination of internal and external influences undermines the predictive ability of a model based solely on external considerations.

The actor in this modern framework also differs from his rational forbear in his ability to gather and assess relevant information. The complexity of decision making means that the actor is no longer regarded as a super computer.⁸⁴ Instead, the actor employs mental shortcuts to assist with decision making.⁸⁵ These shortcuts are prone to mislead and divert the actor from ‘rational’ decisions. This again should lead us to question the predictive accuracy of the rational choice framework. The complexities of the actor in the behavioural model render him much more akin to actual humans than *homo economicus*. The following discussion of behaviour and decision making should be viewed in this light.

⁸⁰ H Grasmick and D Green, ‘Legal punishment, social disapproval and internalization as inhibitors of illegal behavior’ (1980) 71 J of Crim L and Criminol 325, 328 citing D Wrong, ‘The oversocialized conception of man in modern sociology’ (1961) 26 Am Soc Rev 183, 185; Abeler, Nosenzo and Raymond (n74) 19.

⁸¹ Mazar and Ariely, ‘Dishonesty in everyday life’ (n17) 119 citing J Rilling et al., ‘A neural basis for social cooperation’ (2002) 35(2) Neuron 395; D de Quervain et al., ‘The neural basis of altruistic punishment’ (2004) 305 (5688) Science 1254.

⁸² N Mazar, O Amir and D Ariely, ‘The dishonesty of honest people: A theory of self-concept maintenance’ (2008) 45(6) J of Mark. R 633, 633.

⁸³ Ibid 634.

⁸⁴ Jolls, Sunstein and Thaler (n72) 1477.

⁸⁵ Ibid 1477.

i. *Certainty and severity not interchangeable*

A major premise of the rational choice conception of crime was the idea that the legal costs, sanction certainty and severity, were interchangeable. The contribution of each cost did not matter provided that the overall cost value exceeded the benefits of crime. Much of the early work following Becker's paper set about subjecting these assertions to empirical testing. A variety of methods established that certainty of detection was a far greater indicator of deterrence than sanction severity.⁸⁶ This resurrected the view previously held by renaissance theorists, Bentham and Beccaria.⁸⁷ The relationship between certainty and severity was also subjected to critique. The modern research undermined the idea of a cumulative relationship in which the variables were interchangeable and instead posited a model in which both variables must represent a real cost. If either cost is perceived to be negligible, the threat of legal sanctions will not inhibit crime.⁸⁸

The empirical evidence makes clear that the "issues are more complex than standard deterrence analysis assumes."⁸⁹ A notable absence from standard theory is the time at which punishment is levied in relation to the offence;⁹⁰ the celerity of punishment. Beccaria had insisted that speed was a vital component of deterrence on the basis the offender would associate swift punishment with the offence in question.⁹¹ Modern theorists have recognised the importance of speed⁹² which further demonstrates the simplistic account offered by rational choice. In the insurance context, punishments are unlikely to be administered swiftly. The underwriter's assessment of a claim as fraudulent will occur after the claims process and

⁸⁶ E Blais and J Bacher, 'Situational deterrence and claim padding: Results from a randomized field experiment' (2007) 3 J Exp Criminol 337, 338; S Klepper and D Nagin, 'The deterrent effect of perceived certainty and severity of punishment revisited' (1989) 27 Criminology 721, 741. Much of this work focussed on the death penalty, see: A von Hirsch et al, *Criminal Deterrence and Sentence Severity An Analysis of Recent Research* (Hart Publishing 1999), 11; H Grasmick and R Bursik, 'Conscience, significant others and rational choice: Extending the deterrence model' (1990) 24 L & Soc Rev 837, 837. The research into the death penalty demonstrated no clear difference in the rate of capital offences between states which prescribed the death penalty and those which prescribed life imprisonment.

⁸⁷ Burns, Hart and Rosen (n13) 31.

⁸⁸ Grasmick and Green (n86) 327.

⁸⁹ P Robinson and J Darley, 'Does criminal law deter? A behavioral science investigation' (2004) 24(2) Oxford J of Leg Stud 173, 182, 186.

⁹⁰ T Loughran, R Paternoster and D Weiss, 'Hyperbolic time discounting, offender time preferences and deterrence' (2012) 28 J Quant Criminol 607, 611, 624.

⁹¹ Bellamy and Davies (n23) 49.

⁹² Robinson and Darley (n89) 193; a preliminary study on the impact of celerity and hyperbolic discounting was conducted by Loughran, Paternoster and Weiss (n90).

some form of investigation. The process may be further delayed by a trial. The loss of a claim is therefore likely to occur a considerable time after the fraud was committed. As a result, the assured may not necessarily associate the sanction with the offence.

The empirical evidence undermines the deterrent effect of sanction severity. As such, it follows that sanctions premised on this framework, such as the insurance forfeiture rule, will be relatively ineffective in deterrence terms. The construction of adequate deterrents, therefore, depends on other factors, including ones which trigger the actor's internal behaviour mechanism. This is the focus of the following discussion.

ii. Informal sanction threats and perception

Rational man takes account of the objective legal costs of punishment in his decision to offend. The actor in the modern framework, by contrast, considers a broader range of costs and thinks about those costs in different ways.

We consider first the additional variables that affect the decision to offend. These are generally referred to as social or informal sanctions because they are not imposed by the state.⁹³ Social sanctions include feelings of shame and embarrassment levied on the individual by himself as a result of behaving in a way which contravenes his moral code.⁹⁴ Sanctions are also imposed by the offender's community – he may feel shame or be shunned socially – because his behaviour breaks agreed codes of conduct. If wrongdoing affects the individual's commercial reputation, market costs will also be suffered, such as a fall in demand for products or a reduction in parties willing to trade with the fraudulent individual.⁹⁵ It is important to distinguish a separate category of sanctions which follow a formal sanction but are not imposed by the state.⁹⁶ These would include, the difficulty of obtaining professional employment⁹⁷ and future insurance cover as a result of a civil finding of fraud.

⁹³ Paternoster (n71) 781.

⁹⁴ Mazar, Amir and Ariely, 'The dishonesty of honest people' (n82) 633-634.

⁹⁵ A Ogus, *Costs and Cautionary Tales* (Hart Publishing, 2006), 130.

⁹⁶ The author is grateful to Professor Rick Swedloff for highlighting this distinction in discussions at the Insurance Fraud Symposium (University of Southampton Law School, 13 July 2016).

⁹⁷ J Waldfoegel, 'The effect of criminal conviction on income and the trust "reposed in the workmen"' (1994) *J Hum Resour* 62, 63, 66, 72.

Informal sanction threats exercise a stronger deterrent effect than traditional legal sanctions.⁹⁸ The modern framework recognises that the precise impact of social sanctions varies by offender and, in particular, the extent to which his social circle is engaged in criminality. If his acquaintances themselves engage in deviant behaviour, the weight of informal sanctions will be considerably lower than those social sanctions levied by a law-abiding group.⁹⁹ The significance of social sanctions confirm the modern characterisation of decision makers as rooted in their community. Not only is the informal sanction a more effective deterrent than the legal sanction, but it is also far cheaper to administer.¹⁰⁰ In rational choice theorists' drive for efficiency, the utility of stigma and other informal sanctions appears to have been overlooked.

The importance of informal sanctions is not to say that legal penalties are irrelevant. Formal sanctions imposed by the state will typically provide a foundation for the imposition of informal sanctions.¹⁰¹ The legal penalty signals to the wider community that the individual has contravened accepted standards of behaviour.¹⁰² There are, of course, some circumstances in which social sanctions will be levied irrespective of formal sanctions. Most notably, the individual's own feelings of guilt are triggered by behaviour which challenges his perception of himself as morally good. Formal sanctions will also be less relevant in markets where the individual's misconduct is visible to, and can be sanctioned independently by, other market participants.

Formal sanctions imposed by the state also have an important moralising effect.¹⁰³ The fact that a particular act is prohibited and sanctioned by the legal system validates social norms about the particular offence. This can serve to strengthen society's feelings about certain types of behaviour. Alignment between social values and the law renders the law credible in

⁹⁸ Klepper and Nagin (n86) 721; D Kahan 'Social influence, social meaning, and deterrence' (1997) 83(2) Va L Rev 349, 354, 357.

⁹⁹ Grasmick and Green (n86) 329.

¹⁰⁰ Dau-Schmidt (n40) 30.

¹⁰¹ Klepper and Nagin (n86) 741; Ogus (n95) 130.

¹⁰² Collins (n60) 124.

¹⁰³ R Paternoster and S Simpson, 'Sanction threats and appeals to morality: Testing a rational choice model of corporate crime' (1996) 30 L & Soc Rev 549, 577; Kidwell (n77) 618.

the eyes of the populace.¹⁰⁴ The evidence suggests a higher rate of compliance with ‘credible’ laws than those laws which diverge from widespread social attitudes,¹⁰⁵ particularly where these sanctions are imposed by a lawmaker regarded as legitimate.¹⁰⁶

There is no doubt that there is a complex interrelationship between formal and informal sanctions.¹⁰⁷ The evidence suggests that social sanctions have the capacity to exercise a stronger deterrent effect but any model must account for both types of sanction. The general premise of modern theory continues to rely on a cost-benefit analysis; the actor will be deterred from crime when the combination of formal and informal costs outweighs the benefits. Mazar and Ariely present a more complex model of this interaction and suggest that it exists as a step function.¹⁰⁸ It suggests that when the actor engages in low-level or negligible dishonesty, the internal mechanisms of control are not activated.¹⁰⁹ Decisions depend solely on a consideration of external costs and benefits. When the dishonesty contemplated activates the internal mechanism, the actor’s reward system exerts considerable dissuasive force against misconduct.¹¹⁰ The actor forgoes the opportunity for dishonesty but this decision is unconnected from the external sources of reward and punishment.¹¹¹ In cases where the external benefits of dishonesty are particularly large, Mazar and Ariely contend that the internal mechanism no longer plays a role; it is overridden by the promise of these material benefits.¹¹² Decisions again are made solely by reference to external factors. This latter aspect of the model has not been well tested; if correct, however, it would suggest a residual role for the rational cost-benefit analysis.¹¹³ This highlights the nuances of the relationship between informal and formal sanction threats and that this may vary according

¹⁰⁴ D Kahan, ‘Between economics and sociology: The new path of deterrence’ (1996-1997) 95 Mich L Rev 2477, 2481; T Tyler, *Why People Obey The Law* (Yale University Press, 1990) 64; Zamir and Medina (n65) 77.

¹⁰⁵ Kahan, ‘Between economics and sociology’ (n104) 2481; P Robinson, ‘The criminal-civil distinction and the utility of desert’ (1996) 76 Boston Uni. L Rev. 201, 213; Zamir and Medina (n65) 77-78.

¹⁰⁶ Tyler (n104) 64-65.

¹⁰⁷ Grasmick and Green (n80) 334. See also P Cane, ‘The anatomy of private law theory: A 25th anniversary essay’ (2005) 25(2) OJLS 203, 217 “Private law is not only a system of norms but also a set of social practices around these norms and institutions. More theoretical work needs to be done on the interaction of these elements.”

¹⁰⁸ Mazar and Ariely, ‘Dishonesty in everyday life’ (n17) 120.

¹⁰⁹ Ibid 120.

¹¹⁰ Ibid 120.

¹¹¹ Ibid 120.

¹¹² Ibid 120.

¹¹³ See later discussion, text to fn 222 et seq. But see Abeler, Nosenzo and Raymond (n74) 8 who suggest that increases in incentives have little impact on behaviour.

to the nature of the dishonesty. It is not the goal of this project to sketch the precise contours of this relationship but to suggest that accounts of deterrence which exclude a whole category of sanction threats are necessarily incomplete. It also suggests that sanctions must be tailored to the degree of dishonesty and to the way in which decisions are made.

The rational actor is presumed to balance the objective likelihood of detection and the actual punishment rate in his decision to offend. The empirical evidence suggests a much different view. Firstly, it is highly unlikely that potential offenders know or obtain such information as part of their decision-making process.¹¹⁴ This is what Robinson and Darley have called the “legal knowledge hurdle”.¹¹⁵ Knowledge of legal penalties is low even among groups for whom accurate statistics would seem to be useful; those involved in a life of crime.¹¹⁶ This does not mean that society is totally ignorant of legal rules¹¹⁷ nor that the overarching threat of the law has no effect; of course it must do to some extent. The point is that the individual will struggle to determine how the law will deal with him. Issues to do with burdens of proof, factors influencing sentencing and judicial discretion combine to obscure the actual threat value of the law.¹¹⁸

If we look at the specific insurance fraud statistics, these ideas would seem to hold. Data from 2010 suggests that policyholders are generally aware of the severity of the fraud rule, and in some cases identified consequences more severe than forfeiture,¹¹⁹ but more than half considered that fraud was ‘unlikely’ or ‘very unlikely’ to be detected.¹²⁰ This goes against industry-wide messages to counter the perception that offenders are unlikely to be caught¹²¹ and reduces the impact of punishment in the decision process.

¹¹⁴ T Brooks, *Punishment* (Routledge Cavendish, Oxford 2012), 47; Mazar and Ariely, ‘Dishonesty in everyday life’ (n17) 120.

¹¹⁵ Robinson and Darley (n89) 175.

¹¹⁶ *Ibid* 176.

¹¹⁷ *Ibid* 177.

¹¹⁸ *Ibid* 177.

¹¹⁹ ABI, Research Brief: Detering Opportunistic General Insurance Fraud (2010) available at: <http://www.betterregulation.com/external/Research%20Brief%20Detering%20Opportunistic%20general%20insurance%20fraud.pdf> (accessed 30/07/16) 5: almost 70% of participants thought the whole claim would be denied, 64% considered that the policy would be avoided and 55% thought the individual would go to court.

¹²⁰ *Ibid* 6: 51% thought it was ‘unlikely’ or ‘very unlikely’ that insurance frauds would be detected.

¹²¹ ABI, ‘Insurers will do whatever it takes to protect honest customers against insurance fraud’ (18/01/16) available at: <https://www.abi.org.uk/News/News-updates/2016/01/Insurers-will-do-whatever-it-takes-to-protect-honest-customers-against-insurance-fraud> (accessed 13/08/16).

On the basis that potential offenders do not know the actual likelihood of being caught and punished, it follows that decisions can only be made on the basis of perception.¹²² This is critical. The development of perception is strongly tied to the actor's experience of the system and those of his acquaintances.¹²³ As such, a prior offence which went undetected or was treated leniently will cause the offender to perceive a lower likelihood of detection and sanction severity than the reality. The same logic is applicable to the severity of informal sanctions. Punishment will be perceived as a lesser threat by those offenders for whom crime "may lead to very little if any loss of status and respect in the communities within which they function."¹²⁴ Decisions about crime, like many other decisions, are not made in a vacuum;¹²⁵ there is a "strong correlation between a person's obedience and her perceptions of others' behaviour and attitude toward the law."¹²⁶ This suggests that attempts to shape society's perceptions about punishment should be just as important to policymakers and courts as changing the law. It is not enough to enact harsher penalties without working to communicate that those sanctions exist and will apply to particular groups. Indeed, as Kahan has argued, it is "obvious that a policy that attends only to price and not to social influence may be ineffective in reducing crime."¹²⁷

iii. Limits on rationality and the use of heuristics and biases

A rational choice model of crime conceptualises man as able to access and accurately compute all the information needed to make an optimal decision. This is implicit in the assumption that the actor knows the objective likelihood of detection and punishment. Developments in cognitive psychology and behavioural science during the 1970s demonstrated the simplicity of this assumption.¹²⁸ Humans do not have perfect memories nor infinite cognitive capacity.¹²⁹

¹²² Paternoster (n71) 780; Robinson and Darley (n89) 184.

¹²³ Robinson and Darley (n89) 177, 178.

¹²⁴ Ibid 192. See also, Kahan 'Social influence' (n98) 357.

¹²⁵ Kahan, 'Social influence' (n98) 354; Kahan, 'Between economics and sociology' (n104) 2486.

¹²⁶ Kahan, 'Social influence' (n98) 354.

¹²⁷ Ibid 361.

¹²⁸ D Teichman, 'The optimism bias of the behavioral analysis of crime control' (2011) U Ill. L Rev 1697, 1698.

¹²⁹ Jolls, Sunstein and Thaler (n72) 1477.

The complexity of many decisions will mean that it is impossible for decision makers to weigh all possible alternatives.¹³⁰ As such, there are bounds to human rationality; individuals will tend to demonstrate a consistent preference for particular outcomes¹³¹ but their decisions will not always coincide with the predictions of rational choice theory. There is, for example, empirical evidence of 'satisficing'¹³² where an individual makes decisions which meet "a specified aspiration level"¹³³ but does not fully maximise his utility. The decision is good enough, but not the best it could be. In the real world, satisficing is common; individuals could not shop around for the best deal *ad infinitum*, considerations of time and need overriding those of optimality. Of course, this behaviour could be described as rational; it would be inefficient, and in some cases, impossible, to 'waste' time amassing and considering all possible alternatives.¹³⁴

This bounded rationality is overcome by the use of mental shortcuts, known as heuristics, and biases, which simplify the decision-making process. As such, the use of heuristics is rational, provided that the heuristics are themselves rational.¹³⁵ The focus in this discussion is on those biases which are most relevant to decision making about crime; the availability heuristic, hyperbolic discounting and the optimism bias.

The rational choice model relies on potential offenders having access to information about the objective likelihood of detection and the likely punishment. This is unrealistic particularly when one considers the variables affecting detection and judicial discretion in sentencing.¹³⁶ The problems of bounded rationality are particularly acute when decision makers need to assess the probability of a given outcome,¹³⁷ such as the likelihood of punishment. Evidence suggests that the availability heuristic is adopted in these circumstances. Availability is a

¹³⁰ R Korobkin and T Ulen, 'Law and behavioral science: Removing the rationality assumption from law and economics' [2000] 88(4) Cal L Rev. 1051, 1077.

¹³¹ H Simon, 'Altruism and economics' (1993) 83 The Am Econ Rev 156, 156.

¹³² The idea of satisficing is first identified by H Simon, 'Rational choice and the structure of the environment' (1956) 63(2) Psych. Rev 129, 129.

¹³³ Korobkin and Ulen (n130) 1075.

¹³⁴ *Ibid* 1076; Posner, *Economic Analysis* (n8) 19 suggests however that decisions made on the basis of incomplete information are rational and in line with a rational choice theory of law when the costs of acquiring complete information would exceed the likely benefits stemming from a wholly informed decision.

¹³⁵ Eisenberg (n10) 446.

¹³⁶ Robinson and Darley (n89) 177.

¹³⁷ Jolls, Sunstein and Thaler (n72) 1480.

measure of the likelihood of a given event calculated by reference to the ease with which the actor can call to mind similar examples.¹³⁸ This will depend on the personal experience of the potential offender and his immediate community as well as relevant media coverage.¹³⁹ The actor asked to judge the probability of event for whom “retrieval is easy and fluent”¹⁴⁰ will assume a high likelihood of the given event. In general terms, the availability heuristic is prone to error since “actors are...systematically insensitive to sample size and therefore erroneously take small samples as representative.”¹⁴¹ In relation to crime, the prior experience of committing similar offences without being detected is likely to cause the individual to underestimate the likelihood of apprehension. It follows that the availability heuristic may cause individuals to make decisions which the rational choice framework would not predict.¹⁴²

A second way in which recent research has undermined rational choice theory is related to how decision makers balance the costs and benefits of a given decision. The traditional cost-benefit analysis presumes that individuals give equal weight to each factor.¹⁴³ The behavioural research demonstrates that this is not the case.¹⁴⁴ Instead, the more immediate the event, the more heavily it is weighed in the decision to act in a particular way. The likelihood of future events is heavily discounted.¹⁴⁵ This is the heuristic of hyperbolic discounting. Its existence explains why individuals make decisions which conflict with their long-term goals¹⁴⁶ such as the employee’s inability to save for retirement or the dieter who succumbs to a tempting dessert.

¹³⁸ A Tversky and D Kahneman, 'Availability: A heuristic for judging frequency and probability' (1973) 5 *Cognitive Psychology* 207, 208 “Life-long experience has taught us that instances of large classes are recalled better and faster than instances of less frequent classes, that likely occurrences are easier to imagine than unlikely ones, and that associative connections are strengthened when two events frequently co-occur. Thus, a person could estimate the numerosity of a class, the likelihood of an event, or the frequency of co-occurrences by assessing the ease with which the relevant mental operation of retrieval, construction, or association can be carried out.”

¹³⁹ Robinson and Darley (n89) 177-178. There is a considerable overlap here with issues of perception, discussed above.

¹⁴⁰ D Kahneman, *Thinking, Fast and Slow* (Penguin, 2012) 129.

¹⁴¹ Eisenberg (n10) 447.

¹⁴² Korobkin and Ulen (n130) 1069, 1075; Jolls, Sunstein and Thaler (n72) 1477.

¹⁴³ See Zamir and Medina (n65) 86 who suggest that certain factors necessarily have ‘lexical priority’ over others but that these different weightings are ignored by a conventional cost-benefit analysis.

¹⁴⁴ T Ulen and R McAdams, ‘Behavioral criminal law and economics’ (2008) University of Chicago Public Law and Legal Theory Working Paper No. 244, 23; Robinson and Darley (n89) 194.

¹⁴⁵ Jolls, Sunstein and Thaler (n72) 1539.

¹⁴⁶ *Ibid* 1479.

This heuristic is particularly relevant to decisions about crime. In the typical case, benefits are likely to be enjoyed immediately after commission¹⁴⁷ with any punishment to be suffered later on.¹⁴⁸ In the cost-benefit analysis, therefore, the immediate benefits of crime are accorded much more importance than the possible costs. The lag between commission and costs is particularly acute in relation to offences of fraud which are characterised by lengthy investigations.¹⁴⁹ Hyperbolic discounting is likely to affect many decisions about crime and will be particularly emphasised in circumstances where the offence is committed due to emotional¹⁵⁰ or financial pressure. This would account for some of the cases of exaggeration in the insurance context. It is for this reason that the celerity of punishment is an important factor in modern deterrence theory.

The optimism bias is also relevant to questions of deterrence. The human propensity to optimism¹⁵¹ means that decision makers are likely to assume that negative consequences, such as having one's crime detected and sanctioned severely, are more likely to happen to someone else.¹⁵² This allows the decision maker to further discount the potential costs of crime. If the decision maker discounts the formal costs of crime in this way, it may also have a knock-on effect for his perception of social sanctions given that these are to a large extent dependent on the imposition of sanctions by the state. At the same time, the optimism bias may cause individuals to overestimate the benefits of crime. For those individuals not suitably deterred by the threat of sanctions, the combined effect of the optimism bias is likely to tip the decision in favour of offending.

¹⁴⁷ Robinson and Darley (n89) 195.

¹⁴⁸ Loughran, Paternoster and Weiss (n90) 608.

¹⁴⁹ R Ogren, 'The ineffectiveness of the criminal sanction in fraud and corruption cases: Losing the battle against white collar crime' (1972-1973) 11 Am Crim L Rev 959, 969. Recent investments in the criminal process, most notably the creation of the Insurance Fraud Enforcement Department (IFED), seeks to expedite the process, see <https://www.cityoflondon.police.uk/advice-and-support/fraud-and-economic-crime/ifed/pages/default.aspx> (accessed 15/09/2017).

¹⁵⁰ Robinson and Darley (n89) 179.

¹⁵¹ Ulen and McAdams (n144) 5, 17.

¹⁵² Jolls, Sunstein and Thaler (n72) 1524; C Jolls, 'Behavioral economics analysis of redistributive legal rules' (1998) 51 Vand L Rev 1653, 1659.

As McAdams and Ulen have argued, it is also important to account for the beneficial ways in which behavioural biases interact with decision making.¹⁵³ The optimism bias is a prime candidate for such treatment. The optimistic offender who underestimates the likelihood of detection is likely to take fewer precautions in committing his crime,¹⁵⁴ as from an economic standpoint, these precautions would represent wasted costs. This, they argue, “would bolster the true probability of detection, which partially offsets the dilution of deterrence excess optimism causes.”¹⁵⁵ It is easy to envisage fewer precautions in the context of street crime but less so in relation to commercial fraud. This further indicates the complexity of decision making and the need for further empirical work on the influence of these biases.¹⁵⁶

Modern deterrence theory represents a significant departure from the traditional understanding of deterrence and rational choice theory. It recognises that the decision to offend is taken by boundedly rational, optimistic actors who use rules of thumb, such as availability and hyperbolic discounting, to simplify the process. Under this analysis, there is a much broader range of costs and benefits which form part of the decision. In particular, decision makers accord greater weight to social sanctions levied by themselves and their social circle than the threat of legal sanctions. The law serves to provide a foundation for the imposition of informal sanctions and legitimises moral views about certain behaviours.

The combined impact of these factors has been usefully highlighted by Robinson and Darley,

Potential offenders commonly do not know the legal rules ...Even if they know the rules, the cost-benefit analysis potential offenders perceive ... commonly leads to ... violation rather than compliance, either because the perceived likelihood of punishment is so small, or because it is so distant as to be highly discounted ... And, even if they know the legal rules and perceive a cost-benefit analysis that urges compliance, potential offenders commonly cannot or will not bring such knowledge to bear [because of] a variety of social, situational or chemical influences. Even if no

¹⁵³ Ulen and McAdams (n144) 17.

¹⁵⁴ Ibid 17.

¹⁵⁵ Ibid 17 citing N Garoupa, ‘Behavioral economic analysis of crime: A critical review’ (2003) 15 *European J of Law and Economics* 5, 9.

¹⁵⁶ Ulen and McAdams (n144) 17-18; Korobkin and Ulen (n130) 1092.

one of these three hurdles is fatal to the law's behavioural influence, their cumulative effect typically is.¹⁵⁷

The argument made here is that this empirical research should change the nature of the debate for academics, policymakers and the judiciary. Policies which rely on the severity of sanctions – such as the forfeiture rule – are out of step with modern thinking about deterrence and, therefore, are likely to be ineffective in preventing crime. The Supreme Court was recently invited to reconsider the scope of the forfeiture rule in light of the lessons from modern deterrence theory. Accordingly, the discussion now considers the judicial response to the evidence and provides some illustrations of deterrents aligned with modern theory.

D. Modern deterrence theory and the Supreme Court

In the course of argument in *Versloot*, counsel for the assured referred their Lordships to modern deterrence theory, in the form of an article co-written by the author and Professor James Davey.¹⁵⁸ During the hearing itself, Lord Mance noted that set against empirical evidence were “theories of judicial activity [which] invite us to operate on the basis of rational choice theory which assume that people behave logically and that we have knowledge of the law.”¹⁵⁹ This statement from Lord Mance encapsulates the entire debate contained in this section.

The arguments received little attention in the final judgment. The comments are worth citing in full. Firstly, the comments made by Lord Toulson which indicate tacit acceptance of the importance of internal moral codes in preventing wrongdoing,

I am not a psychologist, but I am sceptical about the idea that knowledge of this judgment will incentivise people with valid insurance claims to lie in support of their claims. Those who are honest will not do so because it would not be in their nature,

¹⁵⁷ Robinson and Darley (n89) 174.

¹⁵⁸ J Davey and K Richards, ‘Deterrence, human rights and illegality: The forfeiture rule in insurance contract law’ [2015] LMCLQ 315. Note that the authors were in contact with counsel for the assured soon after the first instance judgment.

¹⁵⁹ *Versloot Dredging BV v HDI Gerling Industrie Versicherung (The DC Merwestone)* (Hearing on 16/03/16, morning session), 2h 12 per Lord Mance available at: <https://www.supremecourt.uk/watch/uksc-2014-0252/160316-am.html> (accessed 31/07/16).

while some who are dishonest may do so if they think that they will get away with it, despite the risk of it having a boomerang effect on whether the court believes anything that they say.¹⁶⁰

More generally, however, the Supreme Court was sceptical of the empirical evidence on deterrence and did not use modern theory to ground the new approach to collateral lies told in support of an insurance claim. Lord Sumption, in giving the opinion of the majority, commented

There was, it was said, little empirical evidence that the common law rule was an effective deterrent to fraud, and no reason to think that the problem was peculiar to claims on insurers as opposed to, say, claims in tort for personal injuries, the cost of which also falls ultimately on insurers and policy-holders without there being any equivalent common law rule. Informational asymmetry is not a peculiarity of insurance, and in modern conditions may not even be as true of insurance as it once was. These points have some force. But I doubt whether they are relevant. Courts are rarely in a position to assess empirically the wider behavioural consequences of legal rules. The formation of legal policy in this as in other areas depends mainly on the vindication of collective moral values and on judicial instincts about the motivation of rational beings, not on the scientific anthropology of fraud or underwriting.¹⁶¹

During argument in *Versloot*, Lord Mance had commented that scepticism about the deterrent effect of the rule was “understandable.”¹⁶² However, he too dismissed the empirical arguments in the following terms,

We were referred to academic criticism of theories of deterrence in this context, but, as Lord Sumption observes, many legal rules are framed on a basis which assumes that they are capable of having and shaping legal, social or economic behaviour, and here is a classic example of Parliament endorsing this approach.¹⁶³

¹⁶⁰ *Versloot Dredging BV v HDI Gerling Industrie Versicherung AG (The DC Merwestone)* [2016] UKSC 48, [108] per Lord Toulson (hereafter referred to as *Versloot (Supreme Court)*).

¹⁶¹ *Ibid* [10] per Lord Sumption.

¹⁶² *Versloot (Supreme Court hearing)* (n159) 2h 11 per Lord Mance.

¹⁶³ *Versloot (Supreme Court)* (n160) [124] per Lord Mance, referring to the Insurance Act 2015 s.12.

This retrenches the rational choice analysis. It is unsurprising that the Supreme Court – a judiciary inculcated in a rational choice approach to law-making – responded in this way to empirical and behavioural evidence. It would have required the Supreme Court to look at the bigger picture, which as Lord Sumption noted, courts are generally unable to do.¹⁶⁴ Writing extra-judicially, however, Lord Mance has been receptive to modern evidence about decision making and recognised that it forces a reassessment of judicial assumptions in the context of illegality.

The brocard [of *ex turpi causa*] ... is of course an invitation to fast-thinking of the type that the Nobel prize-winner Daniel Kahnemann has in his book *Thinking Fast and Slow* so tellingly - and, for decision-makers like myself, alarmingly - described. It suggests easy answers, but is entirely fallacious in so doing.¹⁶⁵

He continued,

I doubt whether it is realistic to try to justify it on a deterrent basis...But I doubt whether it really can have here. Have persons engaging in illegal transactions ever heard of *ex turpi causa*? Would it deter them? Gamblers might even relish the chances of uncovenanted benefit which it offers.¹⁶⁶

Lord Mance's acceptance of these arguments in the context of an academic article makes his dismissal of them in the Supreme Court disappointing. Of course, this may well be explained by the different nature of a journal article and a judicial speech. The typical journal article takes as its focus "an ideal situation rather than an actual situation",¹⁶⁷ as noted by Lord Sumption during the hearing in *Versloot*. This gives the author much greater freedom to examine the topic without feeling constrained by practical considerations, even if that author is ordinarily a Supreme Court judge. In relation to this specific case, Lord Mance's comments also appear to have been influenced by Parliament's acceptance of the forfeiture rule as deterrent in the Insurance Act.¹⁶⁸ To be clear, however, modern deterrence theory does not

¹⁶⁴ *Versloot (Supreme Court)* (n160) bid [10] per Lord Sumption.

¹⁶⁵ (Lord) J Mance, 'Ex turpi causa—When Latin avoids liability' (2014) 18 *Edin L Rev* 175, 176.

¹⁶⁶ *Ibid* 182-183.

¹⁶⁷ *Versloot (Supreme Court hearing)* (n159) 2h 26 per Lord Sumption.

¹⁶⁸ Insurance Act 2015 s.12; *Versloot (Supreme Court)* (n160) [124] per Lord Mance.

entirely relegate legal sanctions but instead views them as part of the decision-making process about dishonesty. It would not be incompatible, therefore, to simultaneously endorse the forfeiture rule as deterrent and modern deterrence theory.

Notwithstanding the effective rejection of these ideas in the Supreme Court, the role of behavioural science in deterrence has been recognised extra-judicially. The following discussion charts some of these recent developments and considers what deterrents aligned with the lessons of modern deterrence theory might look like.

E. Aligning deterrents with modern deterrence theory

A small body of empirical work relating to the insurance claims process confirms the potential of deterrents aligned with modern theory and provides inspiration for this part of the discussion. In addition, a recent meta-analysis of 72 studies drawn from economics, psychology and sociology attributed honest behaviour to the personal costs associated with lying and concerns about reputation.¹⁶⁹ This provides further support for social sanctions and mechanisms which seek to trigger these ‘costs’ in the development of deterrents.¹⁷⁰

The claim form is a critical tool in fraud deterrence as this is the moment at which the opportunity for fraud arises. A Canadian study on exaggerated claims trialled the impact of incorporating social norms into the claims process across four insurance companies.¹⁷¹ In half of the claims, the policyholder received a letter in addition to the standard claim form. The letter reminded recipients of the penalties for fraud and continued,

[a]nd we know, as a recent poll has revealed, that a very large majority of people feel that boosting insurance claims is morally wrong...we very well know that the large majority of insurance holders share our beliefs. And this is why we take this opportunity to ask for your help and your cooperation in completing carefully the enclosed forms.¹⁷²

¹⁶⁹ Abeler, Nosenzo and Raymond (n74) 38-39.

¹⁷⁰ Ibid 38-39.

¹⁷¹ Blais and Bacher (n86).

¹⁷² Ibid 350.

On average, policyholders in receipt of the experimental letter submitted claims worth \$300 less than claimants who were subject to the company's standard procedure.¹⁷³ This intervention can be viewed as an attempt to overcome some of the biases that result in the decision to commit fraud. Firstly, the reminder of legal penalties is perhaps an attempt to overcome the effect of hyperbolic discounting by bringing sanctions into the forefront of the decision maker's mind. In addition, the appeal to morality can be explained as an attempt to make salient the individual's own set of values to trigger the internal behaviour mechanism at the relevant time.

The placement of the honesty declaration on claim forms is also critical. Assureds are typically required to sign at the bottom of the claim form to confirm that the information provided is true to the best of their knowledge. This declaration may also require the policyholder to acknowledge the possible sanctions of insurance fraud. Research by Shu *et al.* suggests that this declaration comes too late; by the time the assured signs the form, the exaggeration has already occurred.¹⁷⁴ The researchers tested the impact of moving the declaration to the top of the form in both laboratory and real-world settings. The real-world settings included a policy review form used by an American insurance company.¹⁷⁵ The assured was required to state their current mileage which was to be compared for the purposes of the experiment to their actual mileage. This presented an opportunity for dishonesty; it was in the participants' self-interest to understate mileage to attract a lower premium. Policyholders who had declared their honesty in advance of their mileage recorded higher figures which was associated with lower dishonesty.¹⁷⁶ This mirrored the findings of the other experiments undertaken by Shu *et al.*¹⁷⁷ The effect of relocating the honesty declaration was equated to the process of swearing an oath in court.¹⁷⁸ In Ariely's parlance, the honesty declaration primes the assured with his own morality as the opportunity for dishonesty is presented.¹⁷⁹

¹⁷³ Ibid 344, 347.

¹⁷⁴ L Shu *et al.*, 'Signing at the beginning makes ethics salient and decreases dishonest self-reports in comparison to signing at the end.' (2012) 109(38) PNAS 15197, 15198.

¹⁷⁵ Ibid 15198.

¹⁷⁶ Ibid 15198.

¹⁷⁷ Ibid 15197-15198.

¹⁷⁸ Ibid 15197.

¹⁷⁹ Ibid 15198. See also N Mazar, O Amir and D Ariely, '(Dis)Honesty: A combination of internal and external rewards' (Working Paper, Sloan School of Management (MIT)) cited in D Ariely, *The (Honest) Truth About Dishonesty* (Harper, 2012), 50-51.

These suggestions for the redesign of the claim form focus prevention efforts at the moment that the opportunity for fraud is presented. They are likely to be cost-effective¹⁸⁰ not least because insurers will already need to make other changes to their documentation following the 2015 Act.

The industry has also been taking steps to counter fraud outside of the courts. These efforts can be analysed from the perspective of modern deterrence theory, even if this was not the basis for intervention by insurers. The Insurance Fraud Enforcement Department (IFED) was established in 2012 and is funded by insurers.¹⁸¹ It centralised police investigation into insurance fraud within the City of London Police. Previous difficulty in detecting fraud stemmed from a lack of expertise in financial crime¹⁸² and the central unit overcomes this difficulty. IFED has had considerable success since its inception having seized or confiscated £1.3million from fraudsters and achieving 200 convictions totalling more than 100 years in prison sentences.¹⁸³

Continued effort and investment should, in time, increase the detection of insurance fraud. An increase in the objective likelihood of detection is not, as previously discussed, a significant indicator of compliance with the law. What is important about this, however, is the potential for greater investigation and prosecution to affect perception of detection and social norms about the immorality of insurance fraud. The greater the social costs associated with opportunistic fraud, the less likely it is that an assured will take advantage of the incentives to fraud during the claims process.

The reality of insurance fraud has also been publicised through the work of IFED. A BBC 1 daytime television show, 'Claimed and Shamed', is now in its sixth series and follows IFED investigators as they uncover and prosecute insurance fraud.¹⁸⁴ The Insurance Fraud

¹⁸⁰ Shu et al (n174) 15198.

¹⁸¹ IFED, 'About IFED' available at: <https://www.cityoflondon.police.uk/advice-and-support/fraud-and-economic-crime/ifed/Pages/About-IFED.aspx> (accessed 12/09/2017).

¹⁸² R Emerson, 'Insurance claims fraud: Problems and remedies' (1991-1992) 46 U Miami L Rev 907, 950.

¹⁸³ IFED, 'IFED News' (22/01/16) available at: <https://www.cityoflondon.police.uk/advice-and-support/fraud-and-economic-crime/ifed/ifed-news/Pages/Insurance-Fraud-Enforcement-Department-announce-new-head.aspx> (accessed 31/07/16).

¹⁸⁴ BBC, 'Claimed and Shamed' available at: <http://www.bbc.co.uk/programmes/b071hmq0> (accessed 01/08/16).

Taskforce, discussed further below,¹⁸⁵ has credited the programme with “raising the profile of insurance fraud and acting as a deterrent.”¹⁸⁶ From the perspective of modern deterrence theory, media coverage should increase the ease with which decision makers can call to mind instances of detection and punishment. This taps into the availability heuristic by which individuals would tend to underestimate the likelihood of detection. Research by the ABI demonstrates that many policyholders do not consider insurance fraud a crime or otherwise consider it victimless.¹⁸⁷ The television programme may help to overcome these misconceptions by equating fraud with traditional street crimes and providing concrete examples of detection and punishment.

Following the conclusion of the Law Commission consultation into insurance contract law, the government established the Insurance Fraud Taskforce (IFT).¹⁸⁸ The IFT was charged with

investigat[ing] the causes of fraudulent behaviour and recommend[ing] solutions to reduce the level of insurance fraud in order to ultimately lower costs and protect the interests of honest consumers.¹⁸⁹

The Taskforce was receptive to the role that behavioural economics could play in combatting insurance fraud. One of their key recommendations was for the ABI to commission research into the use of behavioural economics and adopt useful conclusions as best practice within the industry.¹⁹⁰ The IFT also emphasised the importance of structural mechanisms to overcome incentives to fraud,

...good research has been published about consumers and behavioural economics and considers it would be worthwhile for insurers to review their documentation, sales and claims processes with consumer behaviour in mind.¹⁹¹

¹⁸⁵ See later, text to fn 188.

¹⁸⁶ Insurance Fraud Taskforce, *Insurance Fraud Taskforce Final Report* (2016) available at: <https://www.gov.uk/government/publications/insurance-fraud-taskforce-final-report> (accessed 13/09/2016), [4.12]

¹⁸⁷ S Viaene and G Dedene, ‘Insurance fraud: Issues and challenges’ (2004) 29(2) *The Geneva Papers on Risk and Insurance*, 321.

¹⁸⁸ Insurance Fraud Taskforce, *Final Report* (n186) [3.47].

¹⁸⁹ *Ibid* 75.

¹⁹⁰ *Ibid* 8-9, 53-54, 57.

¹⁹¹ *Ibid* [5.17].

This is promising largely because it demonstrates a willingness to look beyond law as a means of combatting insurance fraud. Notwithstanding the rejection of modern deterrence theory by the courts, the recommendation that insights drawn from behavioural science should be established as best practice for the insurance industry is a welcome move.

The major critique of the insurance forfeiture rule is that it is premised on outdated models of decision-making which focus attention on the severity of legal punishment. Modern theory, by contrast, accords legal sanctions a more modest role in deterrence and instead emphasises the preventive power of social sanctions. The remainder of the chapter develops further critiques of the judicial response to insurance claims fraud. The first of these highlights the absence of an effective legal sanction for the most serious fraud; the wholly fabricated claim.

II. The Absence of an Effective Legal Remedy for Wholly Fraudulent Claims

The forfeiture rule was designed to deter the exaggerated claim,¹⁹² and, in this sense, one can readily appreciate the model of deterrence which inspired the nineteenth-century judges. A rule which operates to deprive the assured of genuine loss (in addition to the fraudulent portion), however, works much less well in relation to wholly fraudulent and fraudulent device claims. Indeed, the argument made in this section is that forfeiture is an ineffective deterrent to the most serious fraud; the wholly fabricated claim.¹⁹³ Applying forfeiture to this type of claim is akin to allowing the thief to return stolen goods to the store without receiving any additional sanction. The rule has minimal impact on the wholly fraudulent claimant because there is not, and never was, any genuine claim to be forfeited.¹⁹⁴

The Law Commission was aware of this, noting in its 2012 consultation paper that the forfeiture rule had “little practical effect”¹⁹⁵ in relation to wholly fraudulent claims.¹⁹⁶ The Commission further stated, however, that ordinary common law remedies – most notably, an

¹⁹² *Britton v Royal Insurance Co* (186) 4 F&F 905, 909 per Willes J.

¹⁹³ See earlier, Chapter Two.

¹⁹⁴ P MacDonald Eggers, ‘Utmost good faith and the presentation and handling of claims’ in B Soyer (ed.), *Reforming Marine and Commercial Insurance Law* (Informa, 2008), 245.

¹⁹⁵ Law Commission, ‘Insurance Contract Law: Post Contract Duties and Other Issues’ (Law Com CP 201) [7.29], [8.20].

¹⁹⁶ *Ibid* [7.29], [8.20].

action in the tort of deceit¹⁹⁷ – were available to underwriters. Two cases in which the underwriter sought remedies in addition to forfeiture merit discussion at this stage. First, *London Assurance v Clare*¹⁹⁸ in which the underwriter claimed damages for the investigation of an alleged arson in addition to recovering the indemnity from the assured. The argument was made that the assured was under an implied duty to put forward honest claims and fraud, therefore, entitled the underwriter to damages for breach of contract.¹⁹⁹ Goddard J held that such damages “were far too remote”²⁰⁰ and cited the fact that all claims would need to be investigated to determine liability and quantum. It is difficult to find subsequent mention of damages until the 2012 case of *Parker v NFU Mutual Insurance Society*.²⁰¹ It “was not disputed”²⁰² that the underwriter was entitled to damages and interest for the costs of investigating an alleged arson but there was not any discussion of the basis of the cause of action nor the method of assessment. *Parker* has been subsequently cited in case law²⁰³ and by the Law Commission²⁰⁴ although in neither circumstance has the availability of damages been mentioned.

Despite the recent discussion of damages in *Parker*, it is clear that underwriters do not routinely seek additional remedies.²⁰⁵ To some extent, this is understandable since a claim in deceit would require the underwriter to satisfy an additional procedural hurdle, namely that it had been influenced by the misrepresentation.²⁰⁶ Cognisant of this remedial gap, the Law Commission initially advocated the creation of a statutory right to damages to meet the costs of investigating fraudulent claims.²⁰⁷ This remedy was designed as a deterrent to wholly

¹⁹⁷ Law Commission, *Insurance Contract Law: Business Disclosure; Warranties; Insurers’ Remedies for Fraudulent Claims; and Late Payment* (Law Com No 353, 2014), [22.30]; *Insurance Corporation of the Channel Islands v McHugh* [1997] 1 LRLR 94, 135 per Mance J: “would not in itself appear in legal theory to preclude the making of a claim – if the facts otherwise justified it – based on any positive deceitful misrepresentation.”

¹⁹⁸ *London Assurance v Clare* [1937] 57 Ll L Rep 254.

¹⁹⁹ *Ibid* 270 per Goddard J.

²⁰⁰ *Ibid* 270 per Goddard J.

²⁰¹ *Parker v NFU Mutual Insurance Society* [2012] EWHC 2156 (Comm), [2013] Lloyd’s Rep. IR 253.

²⁰² *Ibid* [205] per Teare J.

²⁰³ *Bates v Aviva* [2013] EWHC 1687 (Comm), [2013] Lloyd’s Rep. IR 492.

²⁰⁴ Law Com 353 (n197) [22.43] discussion of *Parker* (n201) in the context of fraudulent co-insureds.

²⁰⁵ Law Com 353 (n197) [22.30].

²⁰⁶ *Hayward v Zurich Insurance Co.* [2016] UKSC 48, [67], [71] per Lord Toulson.

²⁰⁷ Law Com 201 (n195) [8.19].

fraudulent claims and would have capped damages at costs which were foreseeable and reasonable in the circumstances.²⁰⁸

By the time of the final report, the Law Commission had abandoned this proposal, stating that “we do not consider that the recoverability of investigation costs will significantly disincentivise policyholder fraud.”²⁰⁹ This was justified on the basis that insurers did not commonly bring actions in deceit nor attempt to include express terms reserving their right to damages,²¹⁰ though this may well be due to the complexity of actions in deceit.²¹¹ A statutory cause of action would have considerably simplified matters for underwriters. The Commission also suggested the difficulty of recovering investigative costs from fraudulent policyholders²¹² though this is not particularly convincing in relation to commercial assureds.

Uniting both the Commission’s initial preference for a financial penalty and its eventual rejection is assertion, and not evidence, about deterrence. This is a classic example of Bell’s account of (judicial) policymaking which takes place,

on the basis of unsupported assertions of social fact and projection of future benefits or disasters which would follow the adoption of a new rule, which rest on the judges’ appreciation of human nature.²¹³

To some extent, judicial reliance on such material can be excused since the court will be limited by the material before it.²¹⁴ This explanation does not assist the Law Commission which could have trialled the potential impact of costs during consultation.²¹⁵ This leads the

²⁰⁸ Ibid [8.20].

²⁰⁹ Law Com 353 (n197) [22.30].

²¹⁰ Ibid [22.30].

²¹¹ See earlier, text to fn 206.

²¹² Law Com 353 (n197) [22.30].

²¹³ J Bell, *Policy Arguments in Judicial Decisions* (Clarendon Press, 1983) 67.

²¹⁴ Ibid 68.

²¹⁵ The Law Commission has a history of undertaking, and drawing on, empirical work, see Law Commission, ‘The Law Commission for England and Wales and its use of empirical research’ (09/06/2010) available at: http://www.lawcom.gov.uk/wp-content/uploads/2015/06/empirical_research_090610.pdf (accessed 22/09/16), [1.4] but noted at [1.5] that financial implications limit more widespread empirical work. See also, M Partington, ‘Empirical legal research and policy-making’ in P Cane and H Kritzer (eds.), *The Oxford Handbook of Empirical Legal Research* (OUP, 2010), 1012.

author to speculate that the real reason for abandonment was really an “apparent lack of demand,”²¹⁶ particularly given that Goriely has recently characterised the Commission as developing “piecemeal solutions for demonstrated problems where there was consensus for reform.”²¹⁷ If this explanation is correct, this should cause us to question whether underwriters remain as vulnerable to fraud – and therefore as necessitous of judicial protection – as they were when the forfeiture rule emerged. This will be discussed in the following section.²¹⁸ The abandonment of proposals could also be due to concern that the provisions would not satisfy the non-controversial procedure for Law Commission bills.²¹⁹

It is important to recognise that there is nothing in the Law Commission’s final report to suggest that underwriters cannot still make use of common law remedies in fraud cases following the enactment of the 2015 Act.²²⁰ By only enshrining the forfeiture rule in statute, however, the Act gives the impression that this is the sole civil sanction for fraud. The position taken in this thesis is that the failure to enact a statutory remedy for the most serious frauds is problematic both in conceptual and practical terms.

To appreciate the conceptual difficulty, it is important to return to the judicial understanding of deterrence, namely that it is contingent on harsh legal sanctions.²²¹ It is wholly inconsistent that this same logic has not been used to develop a suitable sanction for wholly fraudulent claims. Indeed, the absence of a statutory response is also disappointing in light of Mazar and Ariely’s work on decision making around dishonesty. This research, discussed earlier in this chapter,²²² demonstrated that a traditional cost-benefit analysis has some traction in cases where the external benefits of dishonesty are particularly large.²²³ The wholly fraudulent claim – the scuttle in the marine context – falls neatly within this description because the successful assured stands to make considerable financial gain. In such cases, the existence of

²¹⁶ Law Com 353 (n197) [22.31].

²¹⁷ T Goriely, ‘Good faith: The residual impact of s.17 Marine Insurance Act 1906’ (Good Faith in Contract Law, Exeter University, July 2017).

²¹⁸ See later, Part III.

²¹⁹ A Horne and R Kelly, ‘The Law Commission and Law Commission Bill Procedures’ (27 March 2015) available at: <http://researchbriefings.files.parliament.uk/documents/SN07156/SN07156.pdf> (accessed 13/09/2017).

²²⁰ Law Com 353 (n197) [20.6], [22.30].

²²¹ See earlier, Chapter Two, text to fn 174 et seq.

²²² See earlier, text to fn 113 et seq.

²²³ Mazar and Ariely, ‘Dishonesty in everyday life’ (n17) 120.

material benefits overrides internal mechanisms for behaviour control. Mazar and Ariely have argued, therefore, that decisions in these circumstances more typically reflect the rational choice model,²²⁴ although presumably this would have to be modified to take account of the cognitive limitations of the decision maker.²²⁵ Accordingly, effective legal deterrence would require the construction of sufficiently certain and severe sanctions which exceeded the benefits of offending. The fact that forfeiture “provides no deterrent against complete fabrication”²²⁶ is problematic on this basis. Had the Law Commission’s proposal to create a statutory basis for recovering investigation costs been taken forward, it would have been a much better fit with the model suggested by Mazar and Ariely’s research. As designed by the Law Commission, the damages would have compensated the underwriter and so cannot be characterised as a punitive response to the wholly fraudulent claim. However, the introduction of damages would have provided a tangible external sanction for the fraudulent assured. This would have gone some way to addressing the absence of an effective sanction for the most serious frauds.

The Law Commission’s abandonment of this proposal is also difficult to reconcile with other areas of the civil justice system where financial penalties are considered a deterrent to dishonesty. Recent civil justice reforms, designed to “control costs and promote access to justice,”²²⁷ introduced Qualified One-way Costs Shifting (QOCS).²²⁸ This protects litigants from adverse costs orders by providing that any order cannot exceed the amount the claimant has been awarded in damages.²²⁹ This means that if the claimant is unsuccessful, he will not become liable in damages to the defendant. This protection from costs is not absolute; in particular, a full costs order can be made where the claimant has been fundamentally

²²⁴ Ibid 120.

²²⁵ Such as those discussed above, text to fn 128 et seq.

²²⁶ Law Com 201 (n195) [7.29] (n195).

²²⁷ R Jackson, *Review of Civil Litigation Costs: Final Report* (December 2009) (hereafter referred to as ‘Jackson Report’), [i].

²²⁸ Ibid ch.19. Civil Procedure Rules r.44.13 limits QOCS to (1)(a) personal injury cases, (b) claims under the Fatal Accidents Act 1976, and (c) claims which arise out of death or personal injury and survive for the benefit of an estate by virtue of section 1(1) of the Law Reform (Miscellaneous Provisions) Act 1934. See commentary of this in P Rawlings and J Lowry, ‘Insurance fraud and the role of the civil law’ (2017) 80(3) MLR 525, 534-536.

²²⁹ Civil Procedure Rules r.44.14.

dishonest.²³⁰ This is designed to deter frivolous and fraudulent claims.²³¹ This is a fundamentally different approach to that taken by the Law Commission. Of course, neither approach has been justified empirically but it is notable that opposing views about the deterrent effect of monetary sanctions have been adopted in similar areas of law within a short space of time.

It is disappointing that the Law Commission did not make use of the opportunity to consider a remedy for wholly fraudulent claims in more depth. It means that the criticism of the forfeiture rule as counterintuitive remains unresolved. Goriely's suggestion that there was insufficient demand for reform²³² causes us to reflect on the judicial narrative surrounding insurance fraud: the vulnerable underwriter and deceitful assured. It contends, in the first place, that modern underwriters are not as susceptible to fraud as their eighteenth-century counterparts and further, that this prompts reconsideration of the centrality of deterrence as a policy consideration.

III. The Vulnerability of Modern Underwriters?

One of the traditional hallmarks of the insurance relationship is the existence of information asymmetries between assured and underwriter. These asymmetries are particularly critical pre-contractually and at the claims stage. This is because the key underwriting decisions – whether to accept the risk and on what terms – depend on access to information. This information is generally held by the prospective assured. As Lord Mansfield made clear in *Carter v Boehm*, the law developed obligations of disclosure so that the insurer could assess the risk properly,

The special facts, upon which the contingent chance is to be computed, lie most commonly in the knowledge of the insured only; the underwriter trusts to his

²³⁰ Civil Procedure Rules r.44.16.

²³¹ Jackson Report (n227) ch.19 [4.5], [4.8]; M Porter-Bryant, 'Fundamental dishonesty' available at: <http://www.guildhallchambers.co.uk/uploadedFiles/FundamentalDisMPB.pdf> (accessed 30/07/16) 1. See also, A Higgins, 'A defence of qualified one way costs shifting' [2013] Civ J Q 198, 203: "These are sensible limitations on one way cost shifting, and will go a long way to preventing any increase in hopeless or fraudulent claims."

²³² Goriely (n217).

representation, and proceeds upon confidence that he does not keep back any circumstance in his knowledge...The keeping back such circumstance is a fraud, and therefore the policy is void. Although the suppression should happen through mistake, without any fraudulent intention; yet still the under-writer is deceived, and the policy is void; because the risque run is really different from the risque understood and intended to be run, at the time of the agreement.²³³

This was indisputable at the time the Marine Insurance Act was drafted.²³⁴ Underwriters would have found it very difficult to assess the accuracy of pre-contractual representations without information-forcing obligations imposed on assureds. The development of rules to protect the underwriter at that stage was wholly reasonable.²³⁵

Information asymmetries in the claims stage also warranted rules to protect the underwriter following a loss. In *Britton*, Willes J commented that the assured had lied to “put the office off its guard, and in the result to recover more than he is entitled to”.²³⁶ He continued, “it is of the utmost moment that insurances should be enforced fairly and protected from fraud.”²³⁷ The contemporary state of scientific and investigative methods²³⁸ would have made it problematic for the underwriter to obtain independent information about the loss and, in any event, the marine context of the loss would have made information asymmetries particularly acute.²³⁹

These rules, in Lord Mansfield’s words, designed “to prevent fraud and to encourage good faith”²⁴⁰, were secured with harsh sanctions. The 1906 Act prescribed avoidance *ab initio* as the remedy for non-disclosure²⁴¹ and the prevalent use of basis clauses transformed all pre-

²³³ *Carter v Boehm* (1766) 97 Eng Rep 1162, 1164 per Lord Mansfield.

²³⁴ J Lowry, P Rawlings and R Merkin, *Insurance Law Doctrines and Principles* (3rd ed. Hart 2011) 84: “Duties... have their origins in a time when there was a clear lack of symmetry in the information available to the insured and to the insurer.”

²³⁵ M Clarke, *Policies and Perceptions of Insurance* (Clarendon Law, 1997), 83; Law Com 353 (n197), [5.2].

²³⁶ *Britton* (n192) 909 per Willes J.

²³⁷ *Ibid* 911 per Willes J.

²³⁸ R Clift, ‘Fraud: Does the punishment fit the crime?’, International Marine Claims Conference (24 October 2007), 11.

²³⁹ B Conway, *Maritime Fraud*, (LLP, 1990) 19, 73; *Versloot (Supreme Court)* (n160) [55] per Lord Hughes: insured loss “may occur anywhere in the world and with or without witnesses.”

²⁴⁰ *Carter* (n233) 1165 per Lord Mansfield.

²⁴¹ Marine Insurance Act 1906 s.18.

contractual statements into warranties, breach of which automatically discharged the underwriter's liability.²⁴² At the claims stage, the 1906 Act contained provisions on wilful misconduct²⁴³ and the forfeiture rule had been in use for 50 years by the time of codification.²⁴⁴

Similar arguments, connected to ideas of good faith, are evident in modern case law,

I do not see why the duty of good faith on the part of the assured should expire when the contact has been made. The reasons for requiring good faith continue to exist. Just as the nature of the risk will usually be within the peculiar knowledge of the insured, so will the circumstances of the casualty: it will rarely be within the knowledge of the insurance company. I think that the insurance company should be able to trust the assured to put forward a claim in good faith.²⁴⁵

In *Versloot*, Lord Hughes commented,

At the later stage when the claim is made, the policyholder will also typically know a good deal more about the facts which give rise to the claim than the insurers possibly can...Insured loss is generally adventitious.²⁴⁶

Despite these recent references to ideas of protection, modern case law has restricted the scope of the post-contractual duty of good faith. The assured is not required to disclose all material matters during claims but is subject to a lesser duty to refrain from misrepresentations.²⁴⁷ MacDonald Eggers and Foss have suggested that this is the correct approach due to the adversarial nature of the claims process.²⁴⁸ It is also doubtful whether arguments relating to protection are today as persuasive as they were in the nineteenth

²⁴² M Clarke, *Law of Insurance Contracts* (4th ed. Service Issue 35 1 April 2016), [20-2A1] (hereafter referred to as Clarke (looseleaf)), but now see Insurance Act 2015 s.9(2).

²⁴³ Marine Insurance Act 1906 s.55.

²⁴⁴ *Britton* (n192).

²⁴⁵ *Orakpo v Barclays Insurance Services* [1999] Lloyd's Rep. LR 443, 451 per Hoffmann LJ.

²⁴⁶ *Versloot (Supreme Court)* (n160) [55] per Lord Hughes.

²⁴⁷ *Manifest Shipping Co Ltd v Uni-Polaris Co Ltd (The Star Sea)* [2003] 1 AC 469, [102], [111] per Lord Scott. See earlier discussion, Chapter Two, text to fn 104 et seq.

²⁴⁸ P MacDonald Eggers and P Foss, *Good Faith and Insurance Contracts* (LLP, 1998), [11.173], [11.175].

century. The insurer is no longer an individual waiting for news in a coffee house,²⁴⁹ but commonly a large and sophisticated organisation which attracts custom because of its expertise in risk and claims settlement.²⁵⁰ In a modern age of information technology,²⁵¹ not only have “the means of collating, collecting, and recalling information...improved greatly”,²⁵² but insurers have dedicated anti-fraud teams comprised of forensic investigators, loss adjusters and other specialists.²⁵³ These are all tools to which the early twentieth century underwriter did not have access. It is now distinctly possible that insurers could despatch investigators to the scene of a casualty in real time to determine whether the loss is covered and to assess the credibility of the assured’s account.²⁵⁴ Indeed, Soyer has suggested that the size of marine claims would tend to justify the expense of specialist investigation.²⁵⁵ Provided the insurer has “has equal access to witnesses, technical reports and the like”,²⁵⁶ he should be well placed to investigate the loss without relying on his assured. This same logic enabled the Court of Appeal in *Orakpo* to determine that exaggeration was not necessarily fraudulent but a bargaining position taken by the assured.²⁵⁷

It is doubtful, therefore, that the modern underwriter requires the same protection as their earlier counterparts. Indeed, the notion of underwriter protection was an important theme in the *Versloot* litigation. The Supreme Court rejected the suggestion that the underwriter should be protected from lies which would cause it to be “put off relevant inquiries or...driven

²⁴⁹ J Herschaft, ‘Not your average coffee shop: Lloyd’s of London – A twenty-first-century primer on the history, structure, and future of the backbone of marine insurance’ [2004-2005] 29(2) Tul. Mar. LJ 169, 171 by virtue of Lloyd’s network of correspondents located in ports across the globe.

²⁵⁰ *Versloot (Supreme Court)* (n160) [55] per Lord Hughes.

²⁵¹ See J Feinman, *Delay Deny Defend* (Penguin, 2010), 121 where he compares the modern and eighteenth century underwriter; “Lloyd, anticipating Starbuck’s provision of free Wi-Fi by more than two centuries, made available paper, pens, and shipping news to his customers.”

²⁵² Clarke, *Policies and Perceptions* (n235), 89. See also Law Com 353 (n197) [5.3].

²⁵³ Similar arguments have been made in the US context, see E Anderson, R Tuttle and S Crego, ‘Draconian forfeitures of insurance: Commonplace, indefensible, and unnecessary’ (1996) 65(3) Ford LR 825, 842: “The notion that insurance companies need special assistance with respect to claims investigation is specious. Insurance companies tout their special expertise in claims handling and loss investigation. Nearly every insurance company has a special unit to ferret out false claims and the insurance industry has a plethora of industry-wide organizations to combat insurance fraud.”

²⁵⁴ Cf. *Versloot (Supreme Court)* (n160) [55] per Lord Hughes: “Only sometimes will thorough investigation of the circumstances of the claimed loss be a realistic option for insurers.”

²⁵⁵ B Soyer, *Marine Insurance Fraud* (Informa Law, 2014) [3-46].

²⁵⁶ Davey and Richards (n158) 318.

²⁵⁷ *Orakpo* (n245) 451 per Hoffmann LJ.

to irrelevant ones.”²⁵⁸ This was simply because “wasted effort of this kind is no part of the mischief against which the fraudulent claims rule is directed, and even if it were the avoidance of the claim would be a wholly disproportionate response.”²⁵⁹ This can be readily understood; after all, the underwriter will need to investigate for the purposes of determining validity and quantum, whether or not the claim subsequently turns out to be fraudulent.²⁶⁰ Accordingly, the discussion of underwriter protection in *Versloot* was more nuanced; deterrent sanctions remain important because of the information asymmetries inherent in the claims process²⁶¹ but there are limits to the protection the law is willing to offer. As Lord Sumption noted,

It is therefore right to ask in a case of collateral lies uttered in support of a valid claim, against what should the underwriter be protected by the application of the fraudulent claims rule? It would, as it seems to me, serve only to protect him from the obligation to pay, or to pay earlier, an indemnity for which he has been liable in law ever since the loss was suffered.²⁶²

The decision in *Versloot* limited the protection available to underwriters during the claims process; the law will only offer protection against (presumably) non-collateral lies,²⁶³ exaggerations and wholly fraudulent claims. This is an important limit on the forfeiture rule and provides some support for the argument that ideas of protection are no longer so compelling in the modern era.

Fraud deterrence is not only relevant at claims but also at the underwriting stage; as they say, ‘prevention is better than cure’. In recent years, the industry has made concerted efforts to facilitate information sharing between underwriters through the creation of databases, such

²⁵⁸ *Versloot Dredging BV v HDI-Gerling Industrie Versicherung AG (The DC Merwestone)* [2014] EWCA Civ 1349; [2015] 1 Lloyd’s Rep 32, [132] per Christopher Clarke LJ (hereafter referred to as *Versloot (Court of Appeal)*); *Versloot (Supreme Court)* (n160) [26] per Lord Sumption.

²⁵⁹ *Versloot (Supreme Court)* (n160) [26] per Lord Sumption.

²⁶⁰ Law Commission 353 (n197) [22.29]: “Some argued that investigation of claims should be considered an inherent cost of the insurer’s business.”; *Versloot (Supreme Court hearing)* (n159) 2h 02 per Richard Lord QC available at: <https://www.supremecourt.uk/watch/uksc-2014-0252/160316-am.html> (accessed 31/07/16); MacDonald Eggers and Foss (n248), [11.173]; *Clare* (n198) 270 per Goddard J.

²⁶¹ *Versloot (Supreme Court)* (n160) [26] per Lord Sumption, [114] per Lord Mance.

²⁶² *Ibid* [26] per Lord Sumption.

²⁶³ The precise definition and application of the ‘collateral lie’ remains a matter for future litigation.

as the Claims and Underwriting Exchange (CUE)²⁶⁴ and the Insurance Fraud Register.²⁶⁵ This enables underwriters to decline cover, or else charge a very high premium, to those with a history of fraud. Clarke has poetically referred to the forfeiture rule as operating “once the horse has bolted.”²⁶⁶ The use of databases means that “more attention is now being paid to information at an earlier stage, in particular information about the ‘stable’. The key to underwriting profitability, whether it be private or commercial, is often the moral and other standards of the insured.”²⁶⁷ The existence of these databases is the means by which Lord Hughes’ prediction that fraudulent assureds will struggle to obtain cover in the future²⁶⁸ becomes a reality. Fraud prevention does not just rely on underwriters identifying fraud-prone assureds at the outset, but also in educating assureds as to the appropriate behaviour during claims.²⁶⁹

It is interesting that the judicial discussions of insurance fraud have continued to focus on the horse; the courts do not accord any role to insurers to prevent fraud pre-contractually. In some ways, this is not surprising; the courts can only respond to the case before them and have no authority to direct the actions of insurance companies, or the industry more broadly. However, in other areas of the law, the courts have not hesitated to allocate pre-contractual responsibility for fraud prevention to the parties. In the context of documentary credits, to be discussed in detail later,²⁷⁰ the courts have assumed that traders take sufficient preventative measures before contracting.²⁷¹ This divergence is particularly interesting if we consider that entities within the insurance industry, such as the ABI, Lloyd’s and the International Group of Protection & Indemnity Clubs, will typically be in a better position and have greater resources to take these steps in comparison to the buyer in an international sale. This serves to cement the characterisation of insurers as needing judicial protection which, for the reasons outlined above, is less convincing in the modern era.

²⁶⁴ M Clarke, *Policies and Perceptions of Insurance Law in the Twenty-first Century* (OUP, 2005) 212.

²⁶⁵ Insurance Fraud Bureau, ‘About the IFR’ available at: <http://www.theifr.org.uk/en/about/> (accessed 29/07/2016).

²⁶⁶ Clarke, *Policies and Perceptions* (n235) 179.

²⁶⁷ *Ibid* 179.

²⁶⁸ *Versloot (Supreme Court)* (n160) [98] per Lord Hughes.

²⁶⁹ W Lesch and J Brinkmann, ‘Consumer insurance fraud/abuse as co-creation and co-responsibility: A new paradigm’ (2011) 103(1) *J of Bus Ethics* 17, 18.

²⁷⁰ See later, Chapter Four.

²⁷¹ For example, *Sanders v Maclean* (1883) 11 QBD 327, 343 per Bowen LJ. See later discussion, Chapter Four.

Interestingly, the Law Commission recognised the modernisation of underwriters and the changing nature of the insurance industry in respect of the assured's pre-contractual duty of disclosure. The Commission noted that,

The 1906 Act codifies principles developed in the eighteenth and nineteenth centuries, when communications were slow and access to information was difficult. It was drafted on the principle that the proposer knows everything about the risk and the underwriter knows nothing. It therefore sought to protect insurers.²⁷²

Under the 1906 Act, the underwriter was entitled to the remedy of avoidance *ab initio* if the assured failed to make a full disclosure. The Law Commission considered that this went too far,

[it] over-protects the insurer against the loss it might have suffered had the claim been paid, and provides no incentive for insurers to ask appropriate questions. Even where avoidance is not actually invoked, the threat of it puts the insurer in a very strong position to negotiate a low settlement.²⁷³

The Insurance Act 2015 reflects the contemporary insurance market with respect to pre-contractual duties of disclosure. The underwriter is given a more proactive role during negotiations and the new remedies correspond to the impact of breach.²⁷⁴ It is notable then that these same ideas were not deemed relevant in the context of fraudulent claims. Indeed, the Law Commission preferred to characterise the forfeiture rule as "appropriate".²⁷⁵

There is no doubt that technological and investigative developments have reduced insurers' vulnerability to fraud at both the underwriting and claims stages. While it is not suggested that rules against fraud are unnecessary, these developments undermine the continued

²⁷² Law Com 353 (n197) [5.2].

²⁷³ *Ibid* [5.42].

²⁷⁴ Insurance Act 2015 sched 1, part 1, ss.2, 4, 5.

²⁷⁵ Law Com 353 (n197) [20.6].

characterisation of the insurer as vulnerable and in need of judicial protection. The argument developed in this section – that we should re-examine this rationale of forfeiture – is further supported by the more nuanced discussion of underwriter protection in *Versloot*. Proceeding on the basis that the requirement for protection is no longer as compelling today, we can assess the overriding significance of deterrence in the construction of fraud remedies. To this end, the final argument in this chapter examines the approach to insurance fraud in Australia and related areas of English law to suggest that it is possible to develop a remedial framework which balances the deterrence of fraud and proportionality.

IV. A Proportionate Approach to Deterrence

The insurance courts have traditionally focussed on deterrence in the construction of remedies for fraud. The recent decision in *Versloot*, by contrast, highlighted the opposing consideration of proportionality.²⁷⁶ There is insufficient space in this thesis to consider the philosophical arguments in favour of proportionate sanctions or to make explicit recommendations for a proportionate framework in English law.²⁷⁷ Accordingly, this part of the chapter attempts a more manageable task; namely, to identify approaches in comparable jurisdictions and areas of law where considerations of proportionality have enabled the construction of a nuanced response to fraud without compromising fraud deterrence.

It is important to preface this discussion by addressing the suggestion that considerations of proportionality are not appropriate in the construction of rules against fraud. In the economic literature, for example, Posner has argued that issues of fairness should be irrelevant in the criminal law.²⁷⁸ He has argued that participation in “the criminal justice system is voluntary: you keep out of it by not committing crimes.”²⁷⁹ Christopher Clarke LJ’s argument in *Versloot* about the scope of the forfeiture rule has echoes of this rationale. He noted that “the rule is

²⁷⁶ *Versloot (Supreme Court)* (n160) [36] per Lord Sumption.

²⁷⁷ Readers are directed to the following for a consideration of this area: J Andenaes, ‘The morality of deterrence’ (1970) 37(4) U Chicago L Rev 649; K Carlsmith, J Darley and P Robinson, ‘Why do we punish? Deterrence and just deserts as motives for punishment’ (2002) 83(2) J of Personality & Social Psychology 284; P Robinson, ‘Hybrid principles for the distribution of criminal sanctions (1987-1988) 82 Nw U L Rev 19; L Weinreb, ‘Desert, punishment, and criminal responsibility’ (1986) 49 Law & Contemp. Problems 47; F Zimring, ‘Principles of sentencing, plain and fancy’ (1988) 82(1) Nw U L Rev 73.

²⁷⁸ See also Kaplow and Shavell, *Fairness Versus Welfare* (n34) 352.

²⁷⁹ Posner, ‘An economic theory’ (n36) 1213.

only applicable in the case of fraud, from which no insured should have any difficulty in abstaining.”²⁸⁰ There is, however, evidence of these values beginning to permeate other areas of private law. The Supreme Court has recognised proportionality as relevant to the law on contractual penalties²⁸¹ and a similar argument has been made in the American context.²⁸² The similarity between forfeiture and penalty clauses is that they are not ordinary contractual terms, but rather contain a disciplinary element. As such, these clauses “implicate values other than economic efficiency and the parties’ autonomy”²⁸³ and justify consideration of the broader public interest. As such, the call for proportionality in insurance fraud is timely and would also correspond with the introduction of like remedies elsewhere in insurance contract law.²⁸⁴

In the context of legal sanctions, proportionality implies some relationship between wrongdoing and punishment.²⁸⁵ It is not enough to speak of proportionality in abstract terms²⁸⁶ and we must, therefore, consider whether a given punishment corresponds to the crime in any real sense.²⁸⁷ As Lacey and Picard have suggested, the practical reflection of proportionality can only depend on “fair and appropriate penalties which are meaningful to, and regarded as legitimate by, the populace in whose name they are imposed.”²⁸⁸ This appeal for proportionality thus depends on two factors; i) an acceptance by the courts or legislature that some relationship between fraud and sanction is appropriate and ii) a substantive discussion about what this would mean in practice. This is evidently no easy task.²⁸⁹ In this regard, the English insurance courts could draw inspiration from more nuanced statutory responses to fraud, namely the Australian approach to insurance fraud and the English attitude towards personal injury fraud (A). The English criminal response to insurance fraud

²⁸⁰ *Versloot (Court of Appeal)* (n258) [155] per Christopher Clarke LJ.

²⁸¹ *Cavendish Square Holdings BV v Talal El Makdessi; Parking Eye Limited v Beavis* [2015] UKSC 67, [32] per Lord Neuberger and Lord Sumption.

²⁸² S Shiffrin, ‘Remedial clauses: The overprivatization of private law’ (2015-2016) 67 *Hastings LJ* 407, 423.

²⁸³ *Ibid* 413.

²⁸⁴ Insurance Act 2015 sched. 1.

²⁸⁵ N Lacey, ‘The metaphor of proportionality’ [2016] 43(1) *J Law & Soc* 27, 30.

²⁸⁶ *Ibid* 28, 41.

²⁸⁷ N Lacey and H Picard, ‘The chimera of proportionality: Institutionalising limits on punishment in contemporary social and political systems’ (2015) 78 *MLR* 216, 219.

²⁸⁸ *Ibid* 219.

²⁸⁹ Kaplow and Shavell, *Fairness Versus Welfare* (n34) 306-308 where the authors note that there is “no natural metric for translating the wrong into punishment” and that questions of proportionality receive different answers between societies and over time.

provides a further model for reconciling deterrence and proportionality (B). A final argument, in Part C, suggests that nuanced sanctions are also required for economic reasons.

A. Balancing deterrence and proportionality in statute: The Australian Insurance Contracts Act 1984 and the English Criminal Justice and Courts Act 2015

The first examples of a proportionate approach to fraud are statutory in nature; involving a default remedy enshrined in legislation coupled with a judicial discretion to mitigate the harshness of the remedy in appropriate cases. The discussion commences by considering the Australian response to insurance fraud.

i. The Australian Insurance Contracts Act 1984

The Australian Insurance Contracts Act (ICA) 1984 establishes a proportionate framework to deal with fraudulent claims in all lines, excluding marine.²⁹⁰ Forfeiture remains the primary sanction for fraud²⁹¹ but the Act provides the following judicial discretion;

In any proceedings in relation to such a claim, the court may, if only a minimal or insignificant part of the claim is made fraudulently and non-payment of the remainder of the claim would be harsh and unfair, order the insurer to pay, in relation to the claim, such amount (if any) as is just and equitable in the circumstances.²⁹²

This requires courts to balance fraud deterrence, explicitly listed as a relevant policy factor in s.56,²⁹³ and the impact of forfeiture for the assured. The Australian Law Reform Commission (ALRC) recognised the importance of deterrence but determined that it did not require the “insured to suffer loss far in excess of the damage his fraud has caused to the insurer.”²⁹⁴ The legislation was explicitly designed to “strike a fair balance between the interests of the insurer and the insured.”²⁹⁵

²⁹⁰ Insurance Contracts Act 1984 s.9(1)(d).

²⁹¹ Insurance Contracts Act 1984 s.56(1).

²⁹² Insurance Contracts Act 1984 s.56(2).

²⁹³ Insurance Contracts Act 1984 s.56(3).

²⁹⁴ Assistant Treasurer (Australia), ‘Insurance Contracts Bill 1984 Explanatory Memorandum’ (13161/84, 1983 - 1984), [187] (hereafter referred to as ‘Insurance Contracts Bill’).

²⁹⁵ *Ibid* [187].

If the Australian experience is to provide a meaningful example for English law, we need to consider how this discretion operates in practice. The meaning of ‘minimal or insignificant’ was not immediately obvious to those drafting the legislation nor the courts called upon to apply it. The ALRC contended in consultation that the discretion envisaged a \$200 exaggeration in a claim worth \$3000.²⁹⁶ By the time that the Bill reached the legislature, the Explanatory Memorandum had “downplayed”²⁹⁷ the extent of permissible exaggeration, suggesting instead that an exaggeration of \$50 in a \$100,000 claim would be allowed.²⁹⁸ The case law demonstrates that the judicial approach has also become less lenient over time. The first reported case to exercise the discretion was *Entwells v National & General Insurance*.²⁹⁹ There the court recognised an exaggeration of \$27,000 as ‘relatively small’ in the context of a claim worth \$520,000.³⁰⁰ This decision has not been well received by commentators.³⁰¹ The Queensland Court of Appeal took a much firmer approach in *Ricciardi v Sunway Metcorp Insurance*, recognising that an exaggeration of \$10,000 could never be regarded as ‘minimal or insignificant’, no matter the size of the claim.³⁰² This approach is to be preferred as it reflects the necessary balance between deterrence and the interests of the assured.

The statutory discretion is not as well-suited to dealing with fraudulent devices or collateral lies. This is because s.56 explicitly refers to fraud affecting a minor part of the claim rather than falsity which goes to the root of the entire claim.³⁰³ The issue did not arise for decision

²⁹⁶ Australian Law Reform Commission, *Insurance Contracts* (ALRC 20, 1982), [243].

²⁹⁷ M Kirby, ‘Australian insurance contract law: Out of the chaos – A modern, just and proportionate reforming statute’, Speech at Australian Insurance Law Association National Conference 2010 (28 October 2010) available at: http://www.michaelkirby.com.au/images/stories/speeches/2000s/2010_Speeches/2499-SPEECH-HUGH-ROWELL-LECTURE-OCTOBER-2010.pdf (accessed 24/08/2016), (fn 44 in original).

²⁹⁸ *Insurance Contracts Bill* (n294) [187].

²⁹⁹ *Entwells Pty Ltd v National and General Insurance Co Ltd* (1991) 6 WAR 68.

³⁰⁰ *Ibid.*

³⁰¹ G Swaby, ‘The price of a lie: Discretionary flexibility in insurance fraud’ [213] JBL 77, 98; R Merkin, ‘Reforming insurance law: Is there a case for reverse transportation?’ (Report for the English and Scottish Law Commissions, 2006) available at: http://www.lawcom.gov.uk/wp-content/uploads/2015/03/ICL_Merkin_report.pdf (accessed 24/08/2016), [6.11].

³⁰² *Ricciardi v Suncorp Metway Insurance* [2001] QCA 190, [36] – [37] per Chesterman J.

³⁰³ *Tiep Thi Tho v Australian Associated Motor Insurers Ltd* [2001] VSCA 48, [25] per Buchanan J. The decision in this case diverged from the position which had existed at common law prior to the 1984 Act. In *GRE Insurance v Ormsby* (1982) 29 SASR 498, the assured suffered a burglary and increased the damage to the door through which the thieves had gained access. At 502-503 per Mitchell J, the court held that the assured was entitled to recover on the basis that a valid claim would not be regarded as fraudulent even if “it were proved that there was an attempt to support the valid claim by evidence which was intentionally false.”

under the 1984 Act until the case of *Tho v Australian Associated Motor Insurers*³⁰⁴ in 2001. In *Tho*, the assured's son had taken the insured car without consent and crashed it. The assured, unaware that the policy covered these circumstances, concocted a story that the vehicle had been stolen and subsequently damaged by the thief. Without the lie, the underwriter would have been liable for the loss and the question for the court, therefore, was whether this falsity was within the statutory discretion. The court held that the meaning of fraud "encompasses a lie which could not prejudice the insurer even if it were believed as well as a lie which does not prejudice the insurer because the insurer is not deceived."³⁰⁵ The assured's attempt to bring the lie within the discretion in s.56 was rejected by the court in the following terms, "where, as here, the fraud relates to the entire sum or benefit claimed, the division contemplated by the subsection cannot be achieved."³⁰⁶ The assured forfeited the entirety of her claim.

Although the statutory discretion will not operate in the case of a collateral lie, it does appear to be working well in relation to exaggerated claims. Recent amendments to the 1984 Act did not make any changes to the framework for fraud³⁰⁷ and Michael Kirby has remarked that,

most Australian lawyers, expert in this field, would not now want to go back to the old absolute law. And the Australian insurance industry appears to be of the same view, taking into account the actual operation of the proportionate operation of the ICA in practice.³⁰⁸

The Australian approach to insurance fraud differs from the English model in both its treatment of exaggerated and collateral lie claims. The more balanced approach to exaggeration could serve as useful guidance should the English courts wish to develop a more

³⁰⁴ *Tho* (n303).

³⁰⁵ *Ibid* 286 per Buchanan JA. This definition was recently confirmed in *Sgro v Australian Associated Motor Insurers* [2015] NSWCA 262, [46] per Beazley P.

³⁰⁶ *Tho* (n303) 287 per Buchanan J.

³⁰⁷ Insurance Contracts Amendment Act 2013. See generally, Australian Law Reform Commission, Review of the Marine Insurance Act 1909 (ALRC 91, 2001) available at <http://www.alrc.gov.au/inquiries/marine-insurance-act-1909> (accessed 27/09/2017).

³⁰⁸ The Hon M Kirby, 'Insurance contract law reform—30 years on' (2014) 26 *ILJ* 1, 17. This suggests that the concerns of "serious conceptual and practical difficulties with this provision" expressed in JA Tarr, 'Dishonest insurance claims' (1988) 1 *Ins LJ* 42, 52 are overrated.

nuanced response to claims fraud in the future.³⁰⁹ This would, as Gerald Swaby has opined, meet the “need for the courts to have some equitable discretion in borderline cases.”³¹⁰ In searching for analogues for the future development of English insurance law, we are not limited to comparable jurisdictions. Indeed, the prevalence of personal injury claims fraud³¹¹ means that we can legitimately consider how the English courts have responded to fraud in this context.

ii. *The English Criminal Justice and Courts Act 2015*

Fraudulent personal injury claims arise for similar reasons as opportunistic insurance fraud; information asymmetries which exist between victim and defendant³¹² and additionally, the subjective nature of pain and suffering.³¹³ Interestingly, however, a more nuanced remedial response to personal injury claims fraud has been developed in contrast to the rigidity of forfeiture in first-party insurance claims. In addition to providing a further example of a proportionate approach to deterrence, the argument made here is that there is not a compelling reason to treat these two areas as distinct.

The law applicable to personal injury fraud is contained in the Criminal Justice and Courts Act 2015 (CJCA). The default remedy for the “fundamentally dishonest”³¹⁴ litigant is the dismissal of the entire claim, including any genuine part.³¹⁵ This is the procedural equivalent of the forfeiture rule. However, the Act also creates a judicial discretion exercisable in cases where

³⁰⁹ Law Com 353 (n197) [23.7] noting the existence of the statutory discretion in Australia but choosing not to recommend it on the basis that it could signal a lenient attitude to fraud.

³¹⁰ Swaby (n301) 78.

³¹¹ *Fairclough Homes v Summers* [2012] UKSC 26, [32] per Lord Clarke; *Ul-haq v Shah* [2010] 1 WLR 616, [51] per Toulson LJ; A Zuckerman, ‘Must a fraudulent litigant be allowed to think: if the fraud is successful, I will gain much; if it is not, I will still recover my legitimate claim?’ (2011) 30(1) CQJ 1, 1.

³¹² W Norris QC, ‘Look out: I’ve got a power...but I am not going to use it’ (2012) 3 JPI Law 169, 171.

³¹³ R Ericson and A Doyle, ‘The moral risks of private justice: The case of insurance fraud’ in R Ericson and A Doyle, *Risk and Morality* (University of Toronto Press, 2003), 336.

³¹⁴ Criminal Justice and Courts Act 2015 s.57(2). The meaning of ‘fundamentally dishonest’ is a matter for the courts. In an unreported case, *Hanif v Patel* [2016] (County Court (Manchester) 11 May 2016), HHJ Main QC dismissed the claim in its entirety, satisfied that the claimant had been fundamentally dishonest. As the judgment was not reported it is impossible to know how the judge defined this standard. In future, it is likely that courts will have regard to the related litigation concerning ‘Qualified One-way Costs Shifting’ (QOCS), see earlier discussion, where courts began to define this notion under the Civil Procedure Rules. See generally, B Dixon, ‘Fundamental dishonesty and the Criminal Justice and Courts Act 2015’ (2015) 2 J P I Law 108.

³¹⁵ Criminal Justice and Courts Act 2015 s.57(2)(3).

the claimant would suffer “substantial injustice if the claim was dismissed.”³¹⁶ This preserves the possibility that the fraudulent claimant will receive a measure of damages, notwithstanding his fraudulent exaggeration. Importantly, and contrary to forfeiture,³¹⁷ the framework established by the CJA covers the entirety of proceedings; the prospect of dismissal does not cease when the writ is issued.³¹⁸

The trigger for legislation was the Supreme Court decision in *Summers v Fairclough Homes*.³¹⁹ Following an accident at work, Summers claimed £880,000 in damages but it later transpired that he had exaggerated the extent of his injuries to a very considerable extent.³²⁰ When the fraud was discovered, the underwriter applied to have the claim struck out. The Supreme Court held that while strike out was possible, it would only be suitable in “very exceptional circumstances”³²¹ and when it constituted a “just and proportionate”³²² response to the fraud. The Court did not provide any concrete examples in which strike out would be proportionate.³²³ Lord Clarke speculated, however, that dismissal might be appropriate where the litigant had engaged in “a massive attempt to deceive the court”³²⁴ where the actual loss was “very small”.³²⁵ Summers’ sizeable exaggeration – some 90% of the total claim – did not meet this test³²⁶ and he was awarded damages of £88,000, to reflect the gravity of his actual injuries.³²⁷ Indeed, it is notable that the Supreme Court did not regard deterrence as solely dependent on harsh legal sanctions and highlighted a multitude of procedural

³¹⁶ Criminal Justice and Courts Act 2015 s.57(2).

³¹⁷ See earlier, Chapter Two, text to fn 381 et seq.

³¹⁸ Criminal Justice and Courts Act 2015 s.57(1).

³¹⁹ *Summers* (n311).

³²⁰ *Ibid* [3]. This was a considerable exaggeration; the damages claim was in the region of £838,000, his actual loss was later assessed to be in the region of £88,000.

³²¹ *Ibid* [33] per Lord Clarke.

³²² *Ibid* [61] per Lord Clarke.

³²³ *Ibid* [49] per Lord Clarke. Strike out has since been employed in several cases *Fari v Homes for Haringey* (County Court (Central London) 9 October 2012); *Scullion v Royal Bank of Scotland* (County Court (Exeter) 24 May 2013) and *Plana v First Capital East* (County Court (London) 15 August 2013).

³²⁴ *Summers* (n311) [49] per Lord Clarke

³²⁵ *Ibid* [49] per Lord Clarke

³²⁶ But see Norris, ‘Look out’ (n312) 176: arguing that it is “difficult to imagine a more clear cut case” that would fit Lord Clarke’s hypothetical situation in which strike out would be appropriate.

³²⁷ *Summers* (n311) [63] per Lord Clarke.

weapons which could contribute to deterrence,³²⁸ including adverse costs orders,³²⁹ a reduction in interest or proceedings in contempt.³³⁰

Although the Criminal Justice and Courts Act makes dismissal more likely in comparison to the position post-*Summers*,³³¹ the legislation clearly continues the balance between fraud deterrence and the impact on the individual. This balance is initially evident in the judicial discretion contained in s.57(2) which entitles the court to award damages even though the claimant has behaved fraudulently. In addition, the overriding character of the legislation does not appear to be penal; the Act requires criminal courts to have regard to the fact of dismissal when dealing with related proceedings in contempt or dishonesty.³³² This was explicitly incorporated to ensure that punishments were proportionate.³³³ This is a commendable attempt to prevent double punishment and reflects the ideas of balance inherent in the legislation. Notably, a similar caution against double punishment has not been sounded by the insurance courts nor in the Insurance Act.

A further distinction between the personal injury and insurance response to fraudulent claims is temporal in nature. The threat of the forfeiture rule ceases with the issue of the writ³³⁴ whereas the remedy of strike out is directed at dishonesty during litigation.³³⁵ This is interesting. If the personal injury claimant lies at trial, he is attempting to deceive both the defendant and the court. This is surely far more serious than the lie which only deceives the underwriter, as will be the case where the lie is told before litigation begins, and yet the forfeiture rule prescribes a much harsher remedy than the statutory response in the CJCA.

³²⁸ Ibid [50] - [56], [61] per Lord Clarke.

³²⁹ *Jackson v Ministry of Defence* [2006] EWCA Civ 46, [16] per Tuckey LJ: "must act as a considerable disincentive to claimants and their advisers against making exaggerated claims."

³³⁰ *Summers* (n311) [50] - [56], [61] per Lord Clarke. Incidentally, these are the same tools which Lords Hughes and Toulson suggested could attach to fraudulent claims, including collateral lies, in the first-party context in *Versloot (Supreme Court)* (n160) [98] [99] per Lord Hughes, [108] per Lord Toulson. Note that proceedings in contempt must be proportionate, see *Royal & Sun Alliance Insurance Co v Fahad* [2014] EWHC 4480 (QB), [25], [29] per Spencer J.

³³¹ Criminal Law and Legal Policy Unit (Ministry of Justice), 'Criminal Justice and Courts Act 2015 Circular 2015/01' (23 March 2015) available at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/428204/cjc-act-circular.pdf (accessed 26/08/16) [175].

³³² Criminal Justice and Courts Act 2015 s.57(7).

³³³ Criminal Law and Legal Policy Unit (n331) [178].

³³⁴ *The Star Sea* (n247) [75] per Lord Hobhouse; *Agapitos v Agnew (The Aegeon)* [2003] QB 556, [52] per Mance LJ.

³³⁵ Criminal Justice and Courts Act 2015 s.57(9): "This section does not apply to proceedings started by the issue of a claim form before the day on which this section comes into force."

This means that the relative severity of the remedies is counterintuitive since one would expect the litigant who threatens judicial integrity to be sanctioned more severely than the assured who merely attempts to deceive his counterpart.

These different approaches to fraud should prompt us to consider whether there are policy considerations militating in favour of different treatment. The difference between these areas is typically explained by the direct relationship of good faith in the first-party context.³³⁶ While there is no doubt that a requirement of good faith is not imposed in the personal injury context, this explanation is less convincing when one considers the practical consequences of personal injury fraud. As was noted in *Hayward v Zurich*, “personal injury claims usually fall to be met by insurers and the ultimate cost is borne by other policyholders through increased premiums.”³³⁷ The Law Commission noted the inconsistency created by the different approaches to fraud in their final report,

The reported decisions have shown no inclination to move away from the well-established forfeiture rule and, although it is arguably anomalous, we do not have a mandate to recommend more substantial change.³³⁸

Instead of comprehensively engaging with the anomaly, the Law Commission simply reiterated the absence of good faith in the personal injury context and suggested that first-party insurance was particularly vulnerable to fraud.³³⁹ With respect, moral hazard is a similar threat in the personal injury context and it is disappointing, therefore, that the Law Commission chose to sidestep the issue. In the author’s view, the requirement of good faith in first-party claims can only partially explain the difference in approach.

A notable theme in the personal injury discussions is the importance of holding the party who has caused damage to the fraudster to account.³⁴⁰ In *Summers*, the Supreme Court held that

³³⁶ *Summers* (n311) [29] per Lord Clarke; *Ul-haq* (n311) [37] per Toulson LJ; Law Com 353 (n197) [21.19].

³³⁷ *Hayward* (n206) [51] per Lord Toulson.

³³⁸ Law Com 353 (n197) [21.20].

³³⁹ *Ibid* [21.21]-[21.22].

³⁴⁰ *Summers* (n311) [61] per Lord Clarke: “more appropriate to penalise such a claimant as a contemnor than to relieve the defendant of what the court has held to be a substantive liability.”

it was “more appropriate to penalise such a claimant as a contemnor than to relieve the defendant of what the court has held to be a substantive liability.”³⁴¹ By contrast, the insurance courts have wholly disregarded the underwriter’s substantive liability. This makes little sense when we recall that the underwriter’s obligation is to hold his assured harmless against covered perils. Liability is established as from the date of loss³⁴² and is not contingent on the bringing of an honest claim.³⁴³

It is also likely that the physical nature of loss³⁴⁴ has contributed to the more lenient approach in the personal injury cases, though this is not explicitly mentioned in the judicial or legislative discussions. In any event, the author doubts whether physical injury can adequately explain the different approaches to fraudulent claims in these contexts. The notion of holding the breaching party to account is surprisingly absent in the insurance debates and, as was argued above, the presence of good faith is an insufficient explanation of the divergence between personal injury and insurance law. The discretion in the CJCA encourages courts to balance deterrence and the rights of the fraudulent litigant. A similar balancing exercise does not take place in the pure insurance cases, despite Soyer’s contention to the contrary.³⁴⁵ Instead, the myopic focus of the insurance courts on deterrence causes important public values, such as proportionality and fairness, to be excluded from the debate.

Both the Australian approach to insurance fraud and the discretion contained within the CJCA enable the court to respond proportionately to exaggerated claims. An alternative means of balancing fraud deterrence and proportionality is evident in the English criminal law response to insurance fraud. This is an important comparison because the approach to sentencing demonstrates a means of responding to a spectrum of wrongdoing.

³⁴¹ Ibid [61] per Lord Clarke.

³⁴² *Firma C-Trade SA v Newcastle Protection and Indemnity Association (The Fanti)* [1991] 2 AC 1, 35-36 per Lord Goff.

³⁴³ *Versloot (Supreme Court)* (n160) [24] per Lord Sumption.

³⁴⁴ Ibid [63] per Lord Clarke.

³⁴⁵ Soyer, *Marine Insurance Fraud* (n255) [1.23]-[1.24]. See also *Diggens v Sun Alliance* [1994] CLC 1146, 1165 per Evans LJ where it is noted that the case law had not determined whether the remedy should be in some way proportionate to the fraud.

B. Balancing deterrence and proportionality in mandatory guidelines: English criminal law

Insurance fraud is a crime under the Fraud Act 2006.³⁴⁶ A comparison with the criminal law approach to fraud is warranted for two reasons. Firstly, the Law Commission justified the atypical deterrent function of the forfeiture rule by reference to the historically low likelihood of criminal punishment.³⁴⁷ In addition, the insurance law narrative of sanctions is one of severity and punishment and, as such, resonates with the premise of criminal law.

Insurance fraudsters are sentenced in the same way as other offenders by the criminal courts. Sentencing is designed to fulfil a number of functions including punishment, rehabilitation and deterrence³⁴⁸ and is subject to the Sentencing Council Guidelines.³⁴⁹ A court must determine the offender's culpability and the harmfulness of the offence before taking account of aggravating and mitigating factors.³⁵⁰ Relevant considerations include the actual or intended financial harm and whether the offence was sophisticated or opportunistic in nature.³⁵¹ Note that the vulnerability of the underwriter, a significant concern in the civil law context, is irrelevant in the criminal setting. The Guidelines' reference to vulnerability contemplates a wholly different category of victims where their age, financial circumstances or mental capacity render them particularly susceptible to deception.³⁵²

The Guidelines enable the court to rank each offence on a scale of severity and, unlike the forfeiture rule, respond to the entire spectrum of wrongdoing. The corresponding framework of sentences is large, comprising, at its most lenient, a fine based on the offender's income and, at its most severe, a custodial sentence of seven years.³⁵³ The guiding principle of totality

³⁴⁶ Fraud Act 2006 s.2.

³⁴⁷ Law Com 353 (n197) [19.3].

³⁴⁸ Sentencing Council, 'Sentencing basics' available at: <https://www.sentencingcouncil.org.uk/about-sentencing/sentencing-basics/> (accessed 22/08/16).

³⁴⁹ Sentencing Council, *Fraud, Bribery and Money Laundering Offences: Definitive Guideline* (October 2014) available at: https://www.sentencingcouncil.org.uk/wp-content/uploads/Fraud_bribery_and_money_laundering_offences_-_Definitive_guideline.pdf (accessed 22/08/2016). (Hereafter referred to as 'Sentencing Guidelines') See also Lacey (n285) 32 where she argues that proportionality in the criminal law is achieved through the use of sentencing guidelines.

³⁵⁰ Sentencing Council, *Fraud, Bribery and Money Laundering* (n349) 6-7, 10.

³⁵¹ *Ibid* 6-7.

³⁵² *Ibid* 7.

³⁵³ *Ibid* 10.

instructs the court to consider whether the “total sentence is just and proportionate to the overall offending behaviour.”³⁵⁴ On this basis, the court sentencing an insurance fraudster would be required to weigh the circumstances of the wrongdoing and, in particular, take account of the degree of planning and intended financial gain. Accordingly, the assured in *Tonkin*,³⁵⁵ who exaggerated his claim by 0.3%, would receive a dramatically different sentence under the Fraud Act than the assured in *The Ikarian Reefer*,³⁵⁶ who deliberately scuttled his vessel.

The criminal response to fraud provides a practical example of how considerations of deterrence and proportionality can be combined within a single framework. Notably, considerations of fairness are not thought to detract from the preventive effect of the criminal law, as appears to be the basis for the insurance courts’ resistance to a more nuanced approach in the civil setting. Moreover, the current absence of proportionality in the civil context means that forfeiture will constitute a much greater sanction for low-level frauds than the equivalent sentence under the Fraud Act. This is concerning since the civil courts do not extend the evidential and procedural safeguards to the alleged fraudster that he would enjoy in criminal litigation.³⁵⁷ The final argument in favour of proportionality is made from an economic perspective; a nuanced legal response is required to reflect the differences in fraud offences.

C. The economic argument in favour of proportionality

Rational choice theory generally understands deterrence as being contingent on harsh penalties. The first argument in this chapter suggested the fallacy of this contention based on modern decision-making theory. Suppose for the moment, however, that deterrence was in fact contingent on harsh penalties, it would not automatically follow that one sanction was capable of deterring a range of criminal or civil offences. Fraudulent insurance claims, for example, vary considerably and have been characterised in earlier work as constituting a

³⁵⁴ *Ibid* 11.

³⁵⁵ *Tonkin v UK Insurance* [2006] EWCA 1120 (TCC), [2007] Lloyd’s Rep IR 283.

³⁵⁶ *National Justice Compania v Prudential Assurance Co (The Ikarian Reefer)* [1995] 1 Lloyd’s Rep. 455.

³⁵⁷ *Broome v Cassell* [1972] AC 1027, 1127-1128 discussed in Clarke, *Twenty-first Century* (n264) 276. See also, Rawlings and Lowry, ‘Insurance fraud and the role of the civil law’ (n1) 538.

spectrum of wrongdoing.³⁵⁸ Although the Sentencing Council Guidelines make these differences relevant in criminal sentencing; as it stands, the forfeiture rule treats all frauds in the same way.

An economic analysis suggests that these variations between offences are important and should matter in the construction of civil remedies. To make this argument, it is necessary to assume that the cost-benefit analysis of rational choice theory is correct. Accordingly, if the costs of offending are held constant, there is a clear incentive for the actor to choose the offence which offers him the greatest benefits.³⁵⁹ As Stigler has argued, “if the thief has his hand cut off for taking five dollars, he had just as well take \$5,000.”³⁶⁰ But this course of action does not just benefit the actor to a greater extent, it has a correspondingly harmful impact on society. Stigler has expressed this as an “increasing marginal disutility of offenses, so a theft of \$1000 is more than twice as harmful as a theft of \$500.”³⁶¹ A single penalty to deter a range of offences ignores these consequences. The risk then is that a single penalty deters the least serious offences but creates additional incentives for the actor to commit more serious crimes.³⁶² In Stigler’s example, the prospect of losing a hand deters the thief from stealing a small sum of money but fails to deter him from stealing a larger sum. By contrast, a range of sanctions which correspond to the severity of different offences creates, on an economic analysis, an adequate deterrent for each offence. This is known in the economic literature as marginal deterrence.³⁶³ As Posner has suggested, “if it were not for considerations of marginal deterrence, more serious crimes might not always be punishable by more severe penalties than less serious ones.”³⁶⁴ The forfeiture rule takes no account of these concerns. The criminal framework, outlined above, does conform to the requirements of marginal deterrence and therefore, on this analysis, would be regarded as a more effective deterrent.

³⁵⁸ K Richards, ‘Deterring insurance fraud: A critical and criminological analysis of the English and Scottish Law Commissions’ current proposals for reform’ (2013) 24 *ILJ* 16, 18-19.

³⁵⁹ Stigler (n30) 57.

³⁶⁰ *Ibid* 57.

³⁶¹ *Ibid* 58.

³⁶² See the example of bike and car theft suggested by Posner, *Economic Analysis* (n8) 246.

³⁶³ Stigler (n30) 57.

³⁶⁴ Posner, ‘An economic theory’ (n36) 1207. But see Posner at 1208 where he suggests, without detailed elaboration, that marginal deterrence is not a particularly useful consideration.

On the assumption that rational choice theory holds, the forfeiture rule creates an adequate deterrent to exaggeration. This echoes the conclusion reached by the Law Commission.³⁶⁵ However, once an individual has decided to commit fraud, the marginal deterrence analysis suggests that the forfeiture rule serves to incentivise the more serious frauds, like the scuttle. This should be concerning both to the industry and the general public who absorb the cost of these frauds. The argument then is not just that the forfeiture rule is an ineffective deterrent to the wholly fraudulent claim, as argued in Part II,³⁶⁶ but also that the existence of a single sanction actually incentivises the commission of these more serious offences. This economic argument for proportionality exists alongside the evidence of remedial frameworks in tort and criminal law which combine considerations of deterrence and proportionality. It is my contention that these arguments provide strong support for the development of nuanced civil response to fraud to replace the universal rule of forfeiture.³⁶⁷

V. Conclusion

The scale of the fraudulent claims problem across all lines of insurance is said to justify the imposition of deterrent civil sanctions. Recent legislative activity has confirmed the appropriateness of deterrence as a policy justification in this context.³⁶⁸ This expansive approach to fraud has demonstrated the extent to which the assured's fraud can and does unravel all. The particular contours of the fraudulent claims rule are typically explained by reference to underwriters' vulnerability to information asymmetries and ideas of utmost good faith. The chapter has argued that, although civil sanctions for fraud are necessary, these justifications are open to critique.

Deterrence is generally not an aim of the civil law, which instead attempts to resolve disputes between private parties and award compensation for harm. But even if we can accept the need for deterrence in this context, it does not mandate acceptance of draconian sanctions.

³⁶⁵ Law Com 201 (n195) [7.28] - [7.29].

³⁶⁶ See earlier, Part II.

³⁶⁷ There is insufficient space to consider a nuanced civil regime in more detail here and the author intends to undertake such a task in future work.

³⁶⁸ Insurance Act 2015 s.12; *Versloot (Supreme Court)* (n160) [124] per Lord Mance.

The fundamental argument of this chapter was that modern theories of deterrence and decision making undermine notions of sanction severity and instead prioritise social sanctions and cognitive limitations. The forfeiture rule is an ineffective deterrent in light of this recent empirical and theoretical research. Instead, the research calls for the recognition of the complexity and nuance of decision making, and the development of deterrents which correspond to these processes. While the Supreme Court was not receptive to these arguments in *Versloot*,³⁶⁹ it was contended that these interdisciplinary insights remain critical to the fight against fraud. The Insurance Fraud Taskforce recommendations³⁷⁰ and recent industry initiatives would tend to confirm this.

The absence of an effective sanction for the wholly fraudulent claim is a notable shortcoming of the civil response to fraud. If the insurance courts truly believe that deterrence is secured by draconian penalties, it is difficult to understand why a similar approach is not adopted to counter all types of fraud in the claims stage. Following the Law Commission's abandonment of these issues, future development is now a matter for the courts. Until such time as this mantle is taken up, the lack of equivalent penalties leaves the forfeiture rule on shaky ground and undermines the judicial conception of deterrence.

The underwriter's vulnerability to fraud is a common theme in judicial accounts of fraud. The development of modern investigative tools and resources which enable underwriters to gather information independently suggest that these arguments are no longer as compelling as they were when the forfeiture rule emerged in the mid-nineteenth century. These developments tend to reduce the information asymmetries which create the opportunity for dishonesty in the claims process.

Different approaches to fraudulent (insurance) claims in other jurisdictions and related areas of law prompt further questioning of the English civil response to insurance fraud. In particular, the Australian approach to non-marine fraud, the English approach to personal injury fraud and the criminal response to insurance fraud demonstrate how deterrence can

³⁶⁹ See earlier, text to fn 158 et seq.

³⁷⁰ Insurance Fraud Taskforce, *Final Report* (n186) 8-9, 53-54.

be reconciled within a more nuanced remedial framework. A range of penalties which correspond to the severity of the offender's conduct responds to notions of fairness as well as economic arguments related to marginal deterrence. It was argued that the first-party insurance context was not sufficiently unique to merit such a distinct response to claims fraud.

In combination, these critiques highlight the weakness of the policy justifications said to underpin the forfeiture rule. It has the capacity to operate in a draconian fashion on the one hand, but fails to provide any effective deterrent for the most serious fraudulent claims. This is illogical and not supported by evidence. There is no doubt that the deterrence of fraud remains important but efforts to deter should reflect empirical research and the decision-making processes involved in dishonesty. A sophisticated remedial regime informed by these insights would, in the very least, contain an effective penalty for wholly fraudulent claims and could adopt a more nuanced approach to exaggerations. This is effectively a demand for the courts to balance fraud deterrence with considerations of proportionality. The demand for such proportionality is timely; public values are beginning to permeate judicial debates in private law and recommendations of the Insurance Fraud Taskforce are likely to result in some movement in this direction.

The focus now moves from insurance claims fraud to fraud committed in transactions financed by documentary credit. The maxim *ex turpi causa* has been central in the judicial elaboration of the fraud exception but in practice, the simplicity of this phrase belies the complexity of the fraud enquiry. This is because the documentary credit raises competing policy considerations – the deterrence of fraud and the autonomy of the credit mechanism – and the courts have consistently prioritised the efficiency of the credit. The resulting exception is narrow in scope which demands the satisfaction of onerous procedural requirements. Accordingly, while *ex turpi causa* may underpin the fraud exception, Chapter Four will argue that fraud rarely unravels all in the context of transactions financed by documentary credit.

Chapter Four

Documentary Credits: A Doctrinal Analysis of the Fraud Exception

I. Introduction

The effectiveness of international sales depends on the availability of devices to strengthen and secure economic exchange. This is because overseas transactions are risky and involve a greater number of risks than a typical domestic exchange.¹ The discussion focuses on one of the most significant mechanisms developed for this purpose; the documentary credit. The credit overcomes risks associated with payment and defective performance by the seller by substituting the buyer's promise to pay for that of a bank and only releasing payment when evidence of contractual compliance is tendered.

A major risk remains unresolved by the credit mechanism, however, and that is the risk that the seller will behave fraudulently. This causes two significant policy considerations to collide; the need to facilitate international trade and the importance of discouraging fraud in commercial transactions.² The conflict between these policies is particularly evident in the documentary credit context as the hallmarks of a system capable of identifying and sanctioning fraud – detailed investigations and significant expense – are in stark contrast to the commercial demand for an efficient method of payment.³ This balance is critical in understanding the judicial approach to documentary credits and in appreciating how the law relating to fraud has developed.

The precise balance that has been drawn by the English courts is the subject of discussion in this chapter. It is evident that the courts have prioritised the promotion of international trade at the expense of a more robust anti-fraud mechanism. A rule against fraud does exist but it has been framed in narrow terms and its use is constrained by procedural issues and the rules

¹ M Bridge (ed.), *Benjamin's Sale of Goods* (9th ed. Sweet & Maxwell, 2015), [18-001].

² *Bank of Nova Scotia v Angelica-Whitewear* [1987] 1 RCS 59, 72 per Le Dain J: "differences of view or emphasis with respect to these issues, reflect the tension between the two principal policy considerations: the importance to international commerce of maintaining the principle of the autonomy of documentary credits and the...importance of discouraging or suppressing fraud in letter of credit transactions"; N Enonchong, *The Independence Principle of Letters of Credit and Demand Guarantees* (OUP, 2011), [1.03]-[1.04]

³ P Todd, *Maritime Fraud & Piracy* (2nd ed. Informa, 2010), [2.022]-[2.023].

governing letters of credit. Nevertheless, the phrase ‘fraud unravels all’ does appear routinely in the case law; the maxim *ex turpi causa* forming a significant part of the judicial reasoning in the elaboration of the fraud exception.⁴ To simply state the maxim, however, is to ignore these broader issues which have dictated the precise boundaries of the exception.

The chapter explores the first and second research questions; firstly, how has the fraud rule been constructed in the law of documentary credits and, secondly, what policy arguments have been employed by the courts to justify this particular construction? By way of introduction, the discussion commences with an account of the risks involved in international trade and the range of financing mechanisms available to parties. Part II then focuses on the contractual framework created by the documentary credit and examines the underlying principles which ensure its utility as a financing mechanism.⁵ Attention then turns to fraud in Part III. The discussion will first consider how the courts have conceptualised the fraud problem and their role in prevention. The focus will then shift to the limited circumstances in which the English courts are willing to permit fraud by the beneficiary to disrupt payment under a documentary credit.

A. The risks of international trade

Risks in international trade arise because the contracting parties do not perform their obligations simultaneously, but sequentially.⁶ Unlike the position in insurance, both parties to an international contract of sale are expected to perform substantively and performance is not contingent on the occurrence of a specified event. Performance is sequential simply because the great distances involved make simultaneous performance impossible. The security of economic exchange depends on overcoming these risks. From the seller’s perspective, these risks relate primarily to payment; both the creditworthiness and the insolvency risk of the buyer are at issue. In addition, there is a risk that the buyer will behave opportunistically when he receives the goods by rejecting them due to minor discrepancies

⁴ For example, *United City Merchants v Royal Bank of Canada (The American Accord)* [1982] 2 Lloyd’s Rep. 1, 6 per Lord Diplock (hereafter referred to as *United City Merchants (House of Lords)*).

⁵ A consideration of the doctrinal account of the mechanism is also warranted at this stage as discussion in Chapter Five will discuss empirical evidence which challenges the traditional account of how the mechanism operates, see Chapter Five, Part III.

⁶ G Gundlach, ‘Exchange governance: The role of legal and nonlegal approaches across the exchange process’ (1994) 13(2) J Pub Pol & Mark. 246, 247; R Posner, *Economic Analysis of Law* (5th ed. Aspen Publishers, 1998), 101.

in quality. If the buyer refused to pay or rejected the goods, the seller would have to find a replacement buyer preferably located in the same place as the goods, arrange for his goods to be returned or to bring an action for the price against the buyer. Trading parties will seek to avoid litigation overseas for reasons of time, expense and uncertainty due to differences in legal systems.⁷

The risk for the buyer lies in his limited ability to assess the probity of the seller in advance. His concern relates to whether the quality and quantity of the goods shipped accords with the parties' contractual agreement. If the seller fails to meet these obligations, the buyer faces the difficult prospect of bringing an action for breach of contract against his seller.

Exchanges can be strengthened, and these risks alleviated, by the adoption of mechanisms to support the transaction. Several payment mechanisms exist for this purpose. The first, pre-payment, requires the buyer to pay before the goods are shipped. This reduces the risks associated with insolvency and opportunism and also means that the seller is not without working capital during shipment.⁸ The reverse of this mechanism, shipment on open account, requires the seller to ship the goods and extend credit to his buyer.⁹ This is the ideal solution for the buyer as it enables him to withhold payment until he has examined the goods for contractual conformity.¹⁰ The similarity between these mechanisms is that they only assuage one party's concerns about the transaction. A mechanism that simultaneously provides reassurance to both parties will often be required, particularly where the parties are strangers¹¹ and are trading across borders.

⁷ D Bischof, 'Letters of credit (LCs): recognizing the value of simple trade instruments' (12/07/16) available at: [http://www.iccwbo.org/News/Articles/2016/Letters-of-credit-\(LCs\)-recognizing-the-value-of-simple-trade-instruments/](http://www.iccwbo.org/News/Articles/2016/Letters-of-credit-(LCs)-recognizing-the-value-of-simple-trade-instruments/) (accessed 15/08/16).

⁸ R Mann, 'The role of letters of credit in payment transactions' (1999-2000) 98 Mich L Rev 2494, 2516-2517; AW Katz, 'Informality as a bilateral assurance mechanism. Comments on Ronald Mann's 'The role of letters of credit in payment transactions' (1999-2000) 98 Mich L Rev 2554, 2556.

⁹ Mann (n8) 2517; Katz (n8) 2556.

¹⁰ Katz (n8) 2556.

¹¹ Todd, *Maritime Fraud & Piracy* (n3) [4.003] "Documentary credits remain well-adapted to transactions where unfamiliar parties deal with each other at a distance, where the security of a document of title is required, and where re-sales at sea are envisaged."

The most significant intermediate financing mechanism is the letter of credit. It is designed to allay both parties' concerns about dealing overseas by expanding the contractual network to include banks and reallocates many of the risks inherent in international trade. Payment is arranged, and made, through an intermediary bank which has no interest in the underlying transaction, in exchange for documentation which evidences that the seller has performed in accordance with the parties' agreement. The credit enables the seller to shift the risk of non-payment and insolvency to the bank and reduces the buyer's ability to reject the goods opportunistically.¹² The seller retains the marginal risk that the paying bank will fail before he has received payment.

In a standard sale, the risk that the seller will fail to perform or perform inadequately are borne by the buyer. The fact that payment is contingent on certain documentation should reduce these concerns in transactions financed by documentary credit. However, risks relating to the quality and quantity of contract goods will remain with the buyer as such matters are irrelevant to the payment decision made by the bank. In such circumstances, and subject to the difficulties and expense of foreign litigation,¹³ the buyer will need to bring an action for breach on the underlying contract to obtain relief.

In comparison to other intermediate financing mechanisms, such as documentary collection,¹⁴ the documentary credit is expensive. As an indication, the price is usually fixed by reference to a quarter of one percent of the invoice price¹⁵ though considerations of the buyer's standing with his bank are also relevant.¹⁶ Why then are parties willing to adopt the credit if other, cheaper mechanisms are available in the market? The answer would seem to lie in the irrevocable nature of credit, that is to say, that the bank's undertaking to pay cannot be revoked without the express agreement of the seller-beneficiary.¹⁷ This makes payment

¹² This is subject to the possibility of opportunistic behaviour during waiver, see later text to fn 76.

¹³ Todd, *Maritime Fraud & Piracy* (n3) [4.045].

¹⁴ In a documentary collection arrangement, a bank agrees to act as the middleman between the parties; collecting payment from the buyer in exchange for the documents presented by the seller. This is a cheaper mechanism since the bank makes no obligation to make payment to the seller but instead acts simply as an intermediary between the parties. A consideration of the collection mechanism is beyond the scope of this thesis.

¹⁵ Mann (n8) 2499; Katz (n8) 2559.

¹⁶ Mann (n8) 2499.

¹⁷ International Chamber of Commerce, 'The Uniform Customs and Practice for Documentary Credits' (2007 Revision, ICC Publication no. 600) (hereafter referred to as UCP 600), art. 3: "A credit is irrevocable even if there is

virtually certain for the seller, subject to the provision of correct documentation, and explains the popularity of the mechanism.¹⁸ At one time the documentary credit was thought to account for the majority of international trade financing,¹⁹ and although such widespread use is no longer the case,²⁰ the mechanism has regained a degree of popularity in recent years, particularly in Asia.²¹ This resurgence has been attributed to uncertainty in global financial markets.²² The most recent data, provided by the 2015 ICC Global Trade and Finance Survey, suggests that credits fund 40% of worldwide import and export trade.²³ This represents some US\$2 trillion per year.²⁴

Although the credit solves many of the parties' concerns, it does not remove all of the risks associated with international trade. A major risk, and the focus of this thesis, is that the seller-beneficiary will commit fraud in the performance of his contractual obligations. Indeed, two particular aspects of the system provide opportunities for the dishonest seller to exploit his buyer; the ease of forging documents due to high quality reproduction methods²⁵ and the use of containers.²⁶ Containerisation enables dishonest sellers to conceal the true quality of goods from the master and obtain clean shipping documents. This risk is usefully illustrated by the facts of *Discount Records v Barclays* where the seller concealed rubbish among a fraction of the contract goods in cartons but tendered clean documents.²⁷ The risk of bank failure also remains unmitigated by the decision to use a documentary credit, although admittedly this is

no indication to that effect." This constitutes a departure from the previous version of the UCP in which art. 5 recognised the possibility that the credit could be revocable or irrevocable in nature.

¹⁸ The low failure of letters of credit would tend to confirm the unassailable nature of payment, see Bischof (n7).

¹⁹ United Nations Conference on Trade And Development (UNCTAD), 'Documentary risk in commodity trade' (1998), 1: letters of credit supported trade worth US\$100 billion/year and accounted for 60% of commodity sales.

²⁰ Todd, *Maritime Fraud & Piracy* (n3) [4.003]; J Ulph, 'The UCP 600: Documentary credits in the 21st century' [2007] JBL 355, 356; H Beale (ed.) *Chitty on Contracts* (32nd ed. Sweet & Maxwell, 2015), [34-446].

²¹ *Chitty* (32nd ed.) (n20) [34-446].

²² J Mora and W Powers, 'Global perspectives in the decline of trade finance' in JP Chauffour and M Malouche (eds.), *Trade Finance during the Great Trade Collapse* (The World Bank, 2011) 128.

²³ International Chamber of Commerce, 'ICC Global Trade and Finance Survey 2015' (2015), 40-41 available at: <http://www.iccwbo.org/about-icc/policy-commissions/banking/> (accessed 26/07/2016).

²⁴ International Chamber of Commerce, 'About ICC Banking' available at: <http://www.iccwbo.org/about-icc/policy-commissions/banking/> (accessed 15/08/2016).

²⁵ EP Ellinger, 'Fraud in documentary credit transactions' [1981] JBL 258, 258; Todd, *Maritime Fraud & Piracy* (n3) [3.022].

²⁶ Todd, *Maritime Fraud & Piracy* (n3) [2.047].

²⁷ *Discount Records v Barclays Bank* [1975] 1 WLR 315, 317 as cited in Todd, *Maritime Fraud & Piracy* (n3) [4.058].

a small risk.²⁸ The risk of bank failure would be borne by the seller in the first instance who would then seek payment under the contract of sale from the buyer.²⁹

B. Independent guarantees: Performance bonds and standby letters of credit
As an intermediate method of financing, the documentary credit will typically be used in transactions where parties are unknown to each other and where the absence of trust justifies the expense of the credit.³⁰ At this stage, however, reference should be made to two other mechanisms, referred to broadly as ‘independent guarantees’ which share characteristics with the letter of credit. Although these mechanisms serve different purposes, the law relating to these instruments, and particularly its response to fraud, have developed in tandem.³¹ As such, a brief explanation is required.

The most significant of these independent guarantees are the performance bond (used primarily in the United Kingdom) and the standby letter of credit. The standby credit was originally developed and used primarily in the United States³² but today the standby is being used more broadly to facilitate international transactions.³³ The similarity between these mechanisms and the letter of credit is the agreement of a third-party bank to pay one of the contractual parties in pre-determined situations. The difference is the intended purpose and amount of this payment. The letter of credit is the primary source of payment for the seller³⁴ and is designed to furnish him with an assured right of payment when he presents conforming

²⁸ I Carr, *International Trade Law* (5th ed. Routledge, 2014) 476.

²⁹ M Brindle and R Cox, *Law of Bank Payments* (3rd ed. Sweet and Maxwell, 2004), [8.032]; R Goode, ‘Abstract payment undertakings’ in P Cane and J Stapleton (eds.), *Essays for Patrick Atiyah* (Clarendon Press, 1991), 212 (hereafter referred to as ‘Goode, ‘Abstract payment undertakings’); *WJ Alan & Co Ltd v El Nasr Export and Import Co* [1972] 2 QB 189, 212 per Denning LJ who described the credit as a conditional payment. Recourse to the buyer following the failure of the bank resurrects the risks of buyer insolvency and opportunism.

³⁰ Mann (n8) 2498; Todd, *Maritime Fraud & Piracy* (n3) [4.003].

³¹ *RD Harbottle (Mercantile) Ltd v Nat West Bank Ltd* [1978] QB 146, 156 per Kerr J; *Howe Richardson Scale Co Ltd v Polimex-Cekop* [1978] 1 Lloyd’s Rep. 161, 163 per Roskill LJ; Todd, *Maritime Fraud & Piracy* (n3) [4.009]. It is not unusual to see performance bond cases cited in letter of credit disputes, for example, *Edward Owen Engineering v Barclays Bank International Ltd*. [1978] QB 159, a case on performance bonds, is routinely cited in letter of credit cases such as *United City Merchants (House of Lords)* (n4), *Tukan Timber v Barclays Bank plc* [1987] 1 Lloyd’s Rep. 171, *Montrod Ltd v Grundkötter Fleischvertreibe GmbH* [2002] 1 WLR 1975.

³² A Malek and D Quest, *Jack: Documentary Credits* (4th ed. Tottel Publishing, 2009) [12.14]. The standby mechanism was developed to enable federal chartered banks in the USA to circumvent a law which prohibited the issue of guarantees on behalf of third parties. The standby credit is used widely in domestic transactions in the United States. See generally, A Mugasha, *The Law of Letters of Credit and Bank Guarantees* (The Federation Press, 2003) 44.

³³ *Chitty* (32nd ed.) (n20) [34-486].

³⁴ Goode, ‘Abstract payment undertakings’ (n29) 213.

documentation. The payment made under a documentary credit is the full invoice value of the transaction. By contrast, the performance bond or standby credit is designed to create a financial incentive for the seller to perform his substantive obligations.³⁵ The performance bond constitutes a secondary obligation which may never be drawn upon when the contract is performed without incident.³⁶ In the event of the seller's poor performance, such as short delivery or the delivery of defective goods, the buyer is able to call on the bond and receives the sum of money stipulated by the parties.³⁷ This is typically 5-10%³⁸ of the contract price. An important difference is the trigger to payment under these mechanisms. As the documentary credit is the substantive means of payment, the bank requires documentary evidence that the seller has performed his contractual obligations. These documents will evidence shipment of the requisite goods in the manner agreed by the parties.³⁹ The performance bond, by contrast, may only require a simple written assertion of the seller's breach of contract, though the bond may specify additional, but minimal, documentary conditions.

The comparative ease of seeking payment under a performance bond means that this device is particularly vulnerable to fraud.⁴⁰ Arguably, performance bonds could have formed the basis of comparison within this project. The letter of credit, however, has been chosen as the second example of fraud rules in commercial law. This is because the bulk of the policy discussion and recent developments in the law occur in the context of documentary credits. The law relating to fraud in documentary credits and performance bonds has developed in tandem and, therefore, occasional reference will be made to bonds throughout the discussion. For now, the discussion focuses solely on the documentary credit and examines the mechanism from a doctrinal perspective.

³⁵ P Ellinger and D Neo, *The Law and Practice of Documentary Letters of Credit* (Hart Publishing, 2010), 308.

³⁶ *Harbottle* (n31) 149 per Kerr J, "These were in effect to be performance bonds...their purpose was to provide security to the buyer for the fulfilment by the plaintiffs of their obligations under the contracts."; *Bachmann Pty Ltd v BHP Power New Zealand Ltd* [1999] 1 VR 420, 436-437 per Brooking JA.

³⁷ Ellinger and Neo (n35) 306.

³⁸ Malek and Quest, *Jack* (n32) [12.48] (in relation to performance bonds); H Getz, 'Enjoining the international standby letter of credit: The Iranian letter of credit cases' (1980) 21 Harv Int. LJ 189, 193-194 (in relation to standby letters of credit). But see Malek and Quest, *Jack* (n32) [12.15] where it is said that the standby credit is replacing the documentary credit in some international sales. In these cases, the standby credit would pay the entire contract price.

³⁹ This is discussed further, see later text to fn 99.

⁴⁰ Malek and Quest, *Jack* (n32) [12.44].

II. The Documentary Credit Mechanism: A Network of Contracts

An agreement to finance a contract of sale by letter of credit creates a network of autonomous but interconnected contracts. The object of the contract, like any other contract of sale, is for the seller to pass control and ownership of the goods to the buyer in exchange for the price. The network of contracts created under the credit creates a mechanism to facilitate this exchange. The diagram below provides a representation of the network.

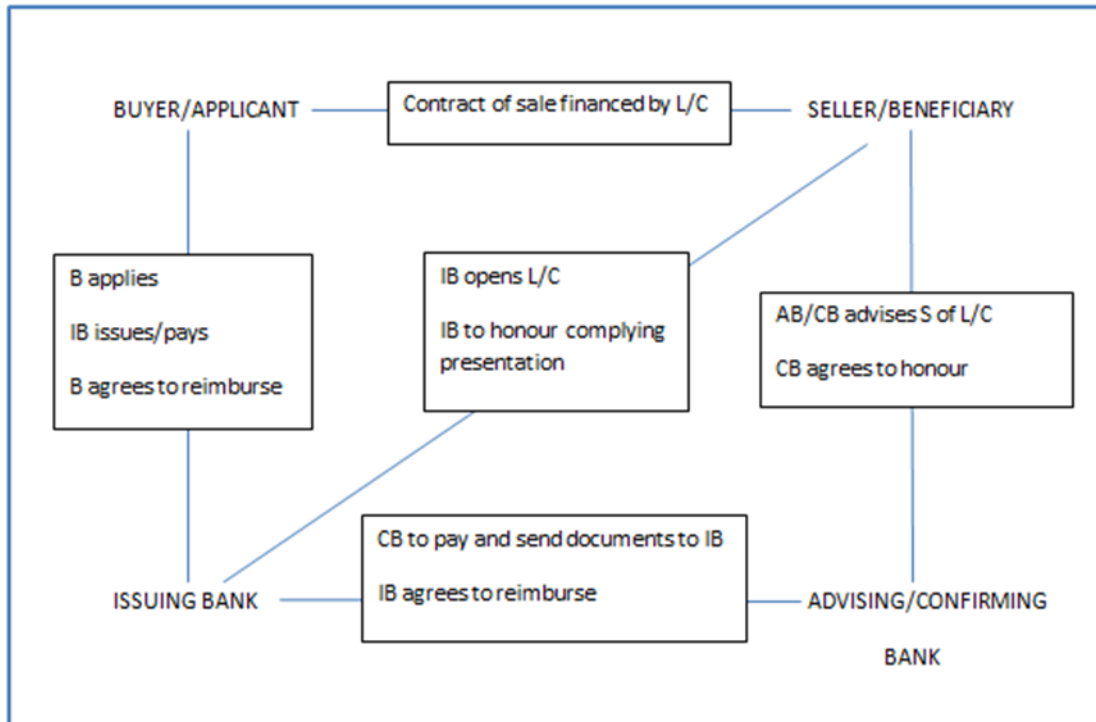


Figure 1: A typical letter of credit transaction

The starting point is the contract of sale in which the parties agree that the transaction will be financed by letter of credit. The parties must also nominate the banks through which payment is available and agree the final date on which payment can be sought. The documentary conditions that the seller will need to satisfy will also be agreed at this stage. The required documents usually include a clean bill of lading, an insurance policy and quality certificates issued by a third party. A brief point on terminology. In the credit context, the buyer is referred to as the applicant and the seller as the beneficiary. These terms will be used interchangeably throughout.

The applicant approaches his bank to issue a documentary credit in favour of the beneficiary. The issuing bank undertakes to pay the beneficiary when the necessary documents are presented. From a contractual perspective, the opening of the credit will generally constitute a condition precedent to the seller's duty to arrange shipment.⁴¹

The particular value of the credit for the seller is his ability to seek payment from a bank located in his own country.⁴² This is facilitated by the confirming bank, an institution local to the seller, who gives an independent undertaking to pay when complying documents are presented. A less advantageous arrangement is also possible where the bank merely advises the seller-beneficiary that the credit has been opened. Once the opening of the credit has been communicated to the beneficiary, the obligations created by the credit are irrevocable;⁴³ it will be impossible to amend the terms of payment without the beneficiary's assent.

The bank must examine the documents to ensure compliance with the terms of the credit within five banking days.⁴⁴ If the documents do so comply, the confirming bank must make payment to the beneficiary.⁴⁵ The confirming bank then presents the documents to the issuing institution. If the issuing bank deems that the documents comply, it will reimburse the confirming bank and then debit the applicant's account in exchange for the documents.

Where the documents do not conform, the bank "may refuse to honour or negotiate."⁴⁶ The factors which inform this decision will depend upon whether the bank is the confirming or issuing institution. In line with the doctrine of autonomy, discussed below, the confirming bank's decision depends solely on an examination of the documents.⁴⁷ By contrast, the issuing bank may approach the applicant for permission to waive the discrepancies in the

⁴¹ *Trans Trust SPRL v Danubia Trading Co* [1952] 2 QB 297, 304 per Lord Denning; Brindle and Cox (n29) [8-035]. Recently confirmed in *Mena Energy DMCC v Hascal Petroleum Ltd* [2017] EWHC 262 (Comm); [2017] 1 Lloyd's Rep. 607, [161] per Males J.

⁴² *Hamzeh Malas & Sons v British Imex Industries* [1958] 2 QB 127, 129 per Jenkins LJ.

⁴³ UCP 600 art.2.

⁴⁴ UCP 600 art. 14(b).

⁴⁵ UCP 600 art.8. The precise time of payment will depend on the type of credit chosen by the parties, see UCP 600 art.2.

⁴⁶ UCP 600 art. 16(a).

⁴⁷ UCP 600 art. 14(a).

documents.⁴⁸ If the bank decides to reject the presentation, it must do so within five banking days and provide a list of discrepancies for the beneficiary.⁴⁹ Provided that the credit has not yet expired, the beneficiary may remedy the defects and make a further presentation for payment. Finally, where the bank and beneficiary disagree about the existence of discrepancies, the bank may agree to make payment under reserve or subject to a letter of indemnity from the beneficiary.⁵⁰

A. The law governing documentary credits

At its heart, the documentary credit is a device of commercial origin and, as such, does not readily conform to a strict contractual analysis.⁵¹ Notwithstanding these analytical issues, the courts have recognised that the credit creates the network of contracts, discussed above. Given that the credit mechanism is used by parties across jurisdictions, a degree of uniformity in how these contracts are interpreted is desirable. Beginning in 1933, the International Chamber of Commerce set about a task which has resulted in significant harmonisation in the use of documentary credits.⁵² The Uniform Customs and Practices for Documentary Credits (UCP) is a voluntary set of rules which gain the force of law through inclusion in the parties' contract.⁵³ Almost all transactions financed by documentary credit expressly incorporate the UCP.⁵⁴

The current version of the UCP, the UCP 600, entered into force in July 2007. The English courts interpret the UCP purposively⁵⁵ given that it embodies "international practice and the

⁴⁸ UCP 600 art. 16(b).

⁴⁹ UCP 600 art. 14(b), 16(c).

⁵⁰ C Schmitthoff, 'Discrepancies of documents in letter of credit transactions' (1987) JBL 94, 104-108. A comprehensive account of these methods of payment is beyond the scope of this thesis.

⁵¹ Goode, 'Abstract payment undertakings' (n29) 209, 235; Malek and Quest, *Jack* (n32) [1.16]; *Angelica-Whitewear* (n2) 82 per Le Dain J, "...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."

⁵² UCP 600 art. 1, "The Uniform Customs and Practice for Documentary Credits, 2007 Revision, ICC Publication no. 600 ("UCP") are rules that apply to any documentary credit...when the text of the credit expressly indicates that it is subject to these rules. They are binding on all parties thereto unless expressly modified or excluded by the credit." See UCP 600 (Foreword): "The objective, since attained, was to create a set of contractual rules that would establish uniformity in that practice, so that practitioners would not have to cope with a plethora of often conflicting national regulations."

⁵³ Ulph (n20) 355.

⁵⁴ F Lorenzon, 'International trade and shipping documents' in Y Baatz (ed.), *Maritime Law* (4th ed. Informa, 2017) 116.

⁵⁵ *Fortis Bank SA/NV v Indian Overseas Bank* [2011] EWCA Civ 58, [2011] 2 Lloyd's Rep. 33, [29] per Thomas LJ.

expectations of international bankers and international traders so that it underpins the operation of letters of credit in international trade.”⁵⁶ The parties are free to vary these terms by agreement.⁵⁷

The UCP does not, however, provide a comprehensive guide on matters relating to letters of credit.⁵⁸ In areas where the UCP is silent, and in the absence of an express choice of law clause,⁵⁹ the Rome Convention determines that the contract will be governed by the law of the country with which the contract has the closest connection.⁶⁰ The most significant factors for this purpose will be the location of the bank first checking the documents for compliance and the place at which payment is made to the beneficiary.⁶¹ This will typically be the country in which the confirming bank and beneficiary are based, the seller-beneficiary’s home country.⁶² The residual role for national law undermines the significant degree of harmonisation which has been achieved in many aspects of documentary credit use. This is most notable in relation to the effect of fraud on the letter of credit transaction,⁶³ to be discussed in Part III.

The provisions of the UCP and their purposive interpretation by national courts ensures that the credit meets the needs of the commercial community. In particular, traders desire a payment mechanism which is “as good as cash,”⁶⁴ by which I mean a device under which payment is virtually unassailable and enables documents to be transferred between parties without onerous notice requirements.⁶⁵ These characteristics are highly desirable in the commercial world and particularly useful in transactions where multiple re-sales are

⁵⁶ Ibid [29] per Thomas LJ. See also, *Glencore International AG v Bank of China* [1996] 1 Lloyd’s Rep. 135, 148 per Sir Thomas Bingham MR: In construing the UCP, courts “seek to give effect to the international consequences underlying the UCP.”

⁵⁷ UCP 600 art. 1.

⁵⁸ Malek and Quest, *Jack* (n32) [1.23].

⁵⁹ Ibid [13.47]: “It is unusual for a letter of credit to specify a governing law, though there is no reason why it should not do so.”

⁶⁰ Rome Convention on the Law applicable to Contractual Obligations 1980, art.4.1

⁶¹ *Marconi Communications International v PT Pan Indonesia Bank* [2007] 2 Lloyd’s Rep. 72, [63] per Potter LJ.

⁶² Malek and Quest, *Jack* (n32) [13.49].

⁶³ Carr (n28) 438. For a comparative discussion of the American approach to fraud in credit transactions, see Chapter Five, Part I.

⁶⁴ *Power Curber v Bank of Kuwait* [1981] 2 Lloyd’s Rep. 394, 398 per Denning LJ; *Safa v Banque du Caire* [2000] 2 Lloyd’s Rep. 600, 605 per Waller LJ.

⁶⁵ *Chitty* (32nd ed.) (n20) [34-001].

envisaged.⁶⁶ The importance of a commercially desirable mechanism are particularly apparent in the development of the twin doctrines of autonomy and strict compliance.

B. Autonomy and strict compliance

i. The principle of autonomy

An efficient system of trade financing is said to depend on the autonomous nature of the contracts created by the letter of credit.⁶⁷ The principle itself is enshrined in the following two provisions of the UCP,

Article 4a

A credit by its nature is a separate transaction from the sale or other contract on which it may be based. Banks are in no way concerned with or bound by such contract, even if any reference whatsoever to it is included in the credit. Consequently, the undertaking of a bank to honour, to negotiate or to fulfil any other obligation under the credit is not subject to claims or defences by the applicant resulting from its relationships with the issuing bank or the beneficiary. A beneficiary can in no case avail itself of the contractual relationships existing between banks or between the applicant and the issuing bank.⁶⁸

Article 5

Banks deal with documents and not with goods, services or performance to which the documents may relate.⁶⁹

Put simply, the doctrine of autonomy treats as distinct each of the contracts created by the letter of credit. This means that each contract is to be enforced by reference to its own terms without reference to other contracts in the network.⁷⁰ Autonomy is most visible in the bank's decision to make payment since only considerations of documentary compliance are relevant.

⁶⁶ Todd, *Maritime Fraud & Piracy* (n3) [2.040]-[2.041].

⁶⁷ *Angelica-Whitewear* (n2) 70 per Le Dain J "international commercial utility".

⁶⁸ UCP 600 art. 4(a).

⁶⁹ UCP 600 art. 5.

⁷⁰ Todd, *Maritime Fraud & Piracy* (n3) [4-021].

The bank must ignore the buyer's assertions that the seller has shipped poor quality goods or breached the contract in some other way.⁷¹ The operation of the credit contract is therefore independent from the operation of the underlying contract of sale.

The effect of autonomy is to cast the bank's role in purely clerical terms. This can be justified for two distinct reasons. Firstly, to require banks to assess the commercial materiality of discrepancies would require expertise in the particular transaction. This is unrealistic.⁷² The UCP confirms that a determination of conformity is not to be equated with evidence of the genuineness or accuracy of the documents.⁷³ A second justification relates to the speed of payment. Documentary compliance can be gauged relatively quickly, facilitating the commercial desire for swift payment.

The contractual nature of the documentary credit provides a further perspective from which we can appreciate the doctrine of autonomy. Goode has commented that there is "no good reason why the issuing bank should be entitled to invoke the protection of the sales contract, to which it is a stranger."⁷⁴ This reiterates the fact that the bank cannot have regard to contractual disputes between buyer and seller in determining whether payment is due under the credit. The contractual explanation of autonomy remains valid notwithstanding the enactment of the Contract (Rights of Third Parties) Act 1999 which limits third party enforceability to circumstances where the contract expressly so provides or confers a benefit on a third party.⁷⁵ Given that the bank's role is to facilitate the transaction, the underlying contract of sale will not confer a benefit on a bank for the purposes of the 1999 Act.

If the doctrine of autonomy was absolute, by which I mean that in no circumstances could payment be disrupted by extraneous considerations, the mechanism would offer virtual certainty and security of payment. The standard, both that enunciated by the courts and contained within the UCP, is not absolute, but rather recognises the risk of beneficiary fraud and the reality that documents may not be wholly compliant in all presentations.

⁷¹ *Turkiye Is Bankasi v Bank of China* [1998] 1 Lloyd's Rep 250, 253, 255 per Hirst LJ.

⁷² *Equitable Trust Co of New York v Dawson Partners Ltd* (1926) 27 Ll L Rep 49, 52 per Viscount Cave.

⁷³ UCP 600 art. 34.

⁷⁴ Goode, 'Abstract payment undertakings' (n29) 219.

⁷⁵ Contracts (Rights of Third Parties) Act 1999 s.1(1)

Where the presented documents contain discrepancies, the UCP entitles the issuing bank to reject the presentation or to seek a waiver from its customer, the credit applicant, to make payment.⁷⁶ This evidently is designed to facilitate payment in the real world of technical discrepancies and so forth. The evidence suggests that banks frequently take advantage of this entitlement in practice.⁷⁷ The re-introduction of the buyer into the payment process resurrects the risk of buyer opportunism and, more importantly, the risk that factors other than documentary compliance will determine payment.⁷⁸ As such, although waiver undoubtedly enables payments to be made in cases of document discrepancy, the process itself undermines the doctrine of autonomy.

The creation of specific exceptions to the doctrine of autonomy is a matter for the common law and, there is no doubt that the English courts have been cautious in this regard. The effect of any exception to autonomy is to make payment less certain since factors unrelated to the credit contract itself may operate to disrupt or prevent payment. This has been expressed in colourful language by the courts, most notably in the concern that exceptions would cause “thrombosis” to occur in the “life blood of commerce.”⁷⁹

The resulting exceptions to autonomy have been cast in narrow terms and to the extent that public policy would demand. The most significant of these, and the focus of the project, is the fraud exception. The conflict between the commercial utility of the mechanism and the need to prevent fraud, identified in the opening remarks of this chapter, is particularly apparent in the development of the fraud exception to autonomy.

ii. The principle of strict compliance

The doctrine of strict compliance refers to the standard against which demands for payment and reimbursement are judged. Presentations which fail to attain this standard, due to

⁷⁶ UCP 600 art. 16(b).

⁷⁷ Mann (n8) 2513.

⁷⁸ Todd, *Maritime Fraud & Piracy* (n3) [4.015].

⁷⁹ *Intraco Ltd v Notis Shipping Corporation of Liberia (The Bhoja Trader)* [1981] 2 Lloyd’s Rep. 256, 257 per Donaldson LJ.

missing documents or documents which indicate the wrong shipment date for example, entitle the bank to refuse payment. The precise standard of compliance has been formulated in different terms under the UCP and by case law and so a degree of precision is required. It is conventional to begin with a consideration of the position at common law and to chart the evolving approach to the question of compliance. The early cases favoured a strict approach to compliance. The leading exposition is found in *Equitable Trust of New York v Dawson Partners*,

It is both common ground and common sense that in such a transaction the accepting bank can only claim indemnity if the conditions on which it is authorised to accept are in the matter of the accompanying documents strictly observed, there is no room for documents which are almost the same, or which will do just as well. Business could not proceed securely on any other lines.⁸⁰

This approach was endorsed in subsequent case law.⁸¹ The facts of *JH Rayner v Hambro's Bank*⁸² provide a useful illustration of strict compliance in practice. The exchange involved the sale of Coromandel groundnuts. The bill of lading, however, listed 'machine-shelled groundnut kernels' though it was common ground that these were identical to the specified groundnuts. The bank refused to pay. The Court of Appeal held that the rejection was legitimate as the bank had a limited contractual mandate to pay and as such "acts at its peril if it departs from the precise terms of the mandate."⁸³

More recent case law has questioned the level of stringency that documents must attain.⁸⁴ In particular, the courts will block attempts by banks to reject documents on the basis of technical discrepancies. This was made clear by the Court of Appeal in *Kredietbank Antwerp v Midland Bank*:

The requirement of strict compliance is not equivalent to a test of exact literal compliance in all circumstances and as regards all documents, to some extent,

⁸⁰ *Equitable Trust* (n72) 52 per Viscount Cave.

⁸¹ For example, *Gian Singh v Banque de l'Indochine* [1974] 1 WLR 1234, 1240 per Lord Diplock "this oft-cited passage has never been questioned or improved on."

⁸² *JH Rayner v Hambro's Bank* [1943] KB 37, 37.

⁸³ *Ibid* 37 per MacKinnon LJ, 42-43 per Goddard LJ.

⁸⁴ Malek and Quest, *Jack* (n32) [8.31].

therefore, the banker must exercise his own judgment whether the requirement is satisfied by the documents presented to him.⁸⁵

This suggests that the bank does not occupy a purely administrative role but must in certain circumstances exercise some discretion. This counters the impression of autonomy discussed in the preceding section. In *Kredietbank*, the credit required a report issued by ‘Griffith Inspectorate’. The beneficiary tendered a document issued by ‘Daniel C Griffith (Holland) BV...member of the worldwide inspectorate’ which the Court of Appeal determined was compliant and ordered payment to be made.⁸⁶ The authors of *Jack* have criticised this approach. They have opined that the documents may need to be exactly compliant for certain parties in a string sale who will never physically receive the goods.⁸⁷ Their preference would be for banks to reject documents containing discrepancies like those in *Kredietbank* unless “it is unmistakably typographical [or] the document could not reasonably be referring to a person or organisation different from the one specified in the credit.”⁸⁸ There is clearly a balance to be struck here to ensure that payments are not unreasonably withheld. The reality, however, is that this balance will need to be determined on a case-by-case basis.

The phrase ‘strict compliance’ does not appear in the UCP; the obligation to make payment instead arises against a ‘complying presentation’ judged against “the terms and conditions of the credit, the applicable provisions of these rules and international standard banking practice (ISBP)”.⁸⁹ There is no longer a qualification that this duty is carried out with reasonable care⁹⁰ since it was considered that this made little practical difference to the process of examination.⁹¹

⁸⁵ *Kredietbank Antwerp v Midland Bank* [1999] CLC 1108, [12] per Evans LJ.

⁸⁶ *Ibid* [57] The court commented further that “[i]f there is a literal requirement that the name ‘Griffith Inspectorate’ shall appear in the documents, then it does so, assuming only that there is a world-wide Inspectorate group and that the company bearing the name Daniel C. Griffith (Holland) is a member of it. That is an assumption which, as the judge held, an experienced banker can be expected to make”

⁸⁷ Malek and Quest, *Jack* (n32) [8.37].

⁸⁸ *Ibid* [8.38].

⁸⁹ UCP 600 art. 2. The duties of the issuing and confirming banks to pay against a complying presentation are contained in art. 7(a) and art. 15(a), and art. 8(a) and art. 15(b), respectively. See also, ICC, International Standard Banking Practice 681 (2007 Revision, ICC Publication no. 681), a set of best practices for document examination and a guide as to how credits should be operated on a day-to-day basis.

⁹⁰ See, for example, UCP 500 art. 13(a).

⁹¹ Malek and Quest, *Jack* (n32) [8.3].

The ISBP confirms the direction of travel in case law as to the meaning of ‘complying presentation’. It provides that “a misspelling or typing error that does not affect the meaning of a word or the sentence in which it occurs, does not make a document discrepant.”⁹² Abbreviations in general use will also not affect a determination of compliance.⁹³ This approach to questions of compliance is appropriate; it should ensure that the presented documents serve their commercial purposes without insisting on an unrealistic standard which could unduly frustrate transactions.

The process of document examination is a complex undertaking for the banks. As banks cannot look beyond the face of the documents to determine compliance, it is possible that payment is made against documents which appear to conform but are later discovered to contain defects. This would be the case where documents had been falsified to conceal late shipment or had been authorised by a forged signature. The subsequent discovery of defects is problematic since payment will have already been made to the seller. In light of this possibility, the UCP establishes the rule of apparent compliance which guarantees the paying bank’s right to reimbursement in circumstances where the documents appeared to comply with the terms of the credit at the time of payment.⁹⁴ Without such protection, banks may well become unwilling to finance international transactions by documentary credit and, therefore, the rule of apparent compliance is to be welcomed.

A potential risk associated with the principle of strict compliance is that it could open the door to opportunistic behaviour by the issuing bank. Opportunism in this sense would contemplate the identification of *any* discrepancy to refuse payment,⁹⁵ particularly if this was accompanied by pressure from its customer or the suspicion of fraud. Of course, this would not be an illegitimate response to discrepancies on an isolated reading of the terms of the credit and UCP. This is unlikely to be a significant risk in practice, however, since banks have a vested

⁹² ISBP 681 (n89) [25].

⁹³ Ibid [6].

⁹⁴ UCP 600 art. 14(a); Brindle and Cox (n29) [8-088]-[8.089].

⁹⁵ Todd, *Maritime Fraud & Piracy* (n3) [4.019]; See also *Guaranty Trust Co of New York v Van den Berghs* (1925) 22 Ll L Rep 112, 114 per Roche J that a bank could reject documents on the basis of minor discrepancies if the market had fallen. This is of course subject to the bank’s knowledge and interest that the market had fallen. This would seem to contradict the modern view that banks are not to assess the materiality of discrepancies but simply to determine whether documents comply.

interest in payments succeeding for reputational reasons.⁹⁶ Empirical research gives credence to this assertion. The evidence demonstrates that payments are routinely made against discrepant presentations notwithstanding the existence of defects which would justify rejection.⁹⁷ Detailed discussion of this empirical work is postponed until Chapter Five but, for now, it suffices to say that this evidence undermines the possibility that strict compliance might operate as a proxy for suspicions of fraud.

Much like the doctrine of autonomy, the principle of strict compliance ensures the credit fulfils its function as an efficient method of trade financing. Firstly, the determination of whether the documents comply with the terms of the credit is much more straightforward than a process which demanded an assessment of the materiality of any documentary defects. This enables the bank to examine documents within the five days permitted by the UCP⁹⁸ which contributes to the commercial demand for a swift payment mechanism.

Strict compliance should also provide a degree of reassurance for the buyer. Firstly, this is because compliant documents should only be capable of production when the seller has performed his substantive obligations.⁹⁹ In addition, the bank's ability to reject documents containing minor discrepancies should provide some protection against fraud¹⁰⁰ since such defects may indicate wrongdoing by the credit beneficiary.¹⁰¹ This should minimise the risk for the buyer of making payment in advance of receiving the goods.

The legal framework which has developed to support documentary credit transactions reflects the commercial desire for an efficient system of financing which cannot be undermined by disputes relating to the underlying contract of sale. This makes sense in an environment of honesty. A risk that remains unmitigated by the credit mechanism and a legal framework which privileges autonomy is the risk that the beneficiary will commit fraud.

⁹⁶ *Harbottle* (n31) 151 per Kerr J; *Bolivinter Oil SA v Chase Manhattan Bank* [1984] 1 Lloyd's Rep. 251, 257 per Sir John Donaldson MR: the injunction undermines "the bank's greatest asset...namely its reputation for financial and contractual probity. Furthermore, if this happens at all frequently, the value of all irrevocable letters of credit and performance bonds and guarantees will be undermined."

⁹⁷ Mann (n8) 2502 – 2504.

⁹⁸ UCP 600 art. 14(b).

⁹⁹ Mann (n8) 2505; M Moses, 'Letters of credit and the insolvent applicant: A recipe for bad faith dishonor' (2005-2006) 57 Ala L Rev 31, 47.

¹⁰⁰ D Horowitz, *Letters of Credit and Demand Guarantees: Defences to Payment* (OUP, 2010), [3.19]; Ellinger, 'Fraud in documentary credit transactions' (n25) 260; W Chew, 'Strict compliance in letters of credit: The bankers protection or bane?' (1990) 2 S Ac LJ 70, 71.

¹⁰¹ Horowitz (n100) [3.19].

Cognisant of this gap, the English courts have crafted a fraud exception to autonomy to respond to wrongdoing by the beneficiary. This is the focus for the remainder of the chapter.

III. The Fraud Exception

The development of the fraud exception causes the competing policy considerations of the autonomy of the credit mechanism and fraud deterrence to collide.¹⁰² This is because the demand for an efficient and unassailable payment mechanism, facilitated by the doctrine of autonomy, is wholly opposed to the characteristics of a system designed to uncover and sanction fraud.

The risk of fraud – heightened by containerisation and high-quality reproduction methods – means that a wholly autonomous mechanism would be problematic. If the credit applicant could never adduce evidence extraneous to the documents, this would give the green light to the fraudulent beneficiary whose wrongdoing would be concealed by documents which appeared to conform. It follows that an exception to the doctrine of autonomy in cases of fraud is required for reasons of public policy. As an exception to autonomy, this enables the claimant to look beyond the documents to furnish the necessary evidence¹⁰³ by, for example, introducing documentary evidence relating to the underlying contract, evidence from third parties and evidence of the quality of the goods.

The impact of fraud by the beneficiary is not established in the UCP. Instead, the ICC have taken the view that fraud is a controversial issue which is best left to national courts to fashion rules in line with local attitudes.¹⁰⁴ In balancing the competing policy considerations, the English courts have consistently emphasised the autonomy of the mechanism over a more robust anti-fraud rule. The resulting exception is narrow in scope, requiring the claimant to prove fraud by the beneficiary as well as several other onerous criteria. This means that the English courts will only intervene to disrupt payments under the credit mechanism in the most

¹⁰² This is the balancing exercise referred to in the opening paragraphs of this chapter, see text to fn 2.

¹⁰³ Malek and Quest, *Jack* (n32) [9.2].

¹⁰⁴ ICC Banking Commission, 'Latest queries answered by the ICC Banking Commission' (1997) 3(2) *Documentary Credits Insight* 6 cited in A Davidson, 'Fraud, the Prime Exception to the Autonomy Principle in Letters of Credit' (2003) 8 *Intl. Trade & Bus L Ann* 23, 26.

exceptional of circumstances. The limited circumstances in which the exception can be invoked in practice calls into question the explanatory power of the notion that fraud unravels all. It also brings into focus other documentary defects unconnected to the beneficiary, notably documents which have been forged or are nullities, and whether these can be used to delay payment under a documentary credit.

The following discussion charts the restrictive approach to fraud in English law. It commences with a consideration of how the courts have conceived of the fraud problem and their role in combatting fraud (A). It then discusses the circumstances in which the fraud exception can be employed (B). Much like the insurance forfeiture rule, the fraud exception in documentary credits depends in part on *ex turpi causa*. A considered analysis of the juridical basis of the rule is undertaken in part C. The procedural aspects of the fraud exception – the criteria the claimant will need to satisfy (D), the standard of proof (E) and issues relating to the interim injunction (F) are then considered in turn.

A. Setting the scene: Judicial conceptions of fraud

There are few statistics with which to gauge the extent of the fraud problem in documentary credits. An absence of fraud cases in England¹⁰⁵ has contributed to this obscurity but this is more likely due to the chilling effect of the judicial construction of fraud, than an actual absence of fraud. As such, there are only very limited indications as to the extent of the problem. One such indication appears from Langley J's judgment in *Banco Santander v Bayfern* in which he commented that, "it was comforting to hear from both experts that the incidence of fraud in these situations is very rare indeed...whilst when it arises [is] no doubt capable of involving very large sums."¹⁰⁶ Reference should also be made to the most recent

¹⁰⁵ M Bridge, *The International Sale of Goods Law & Practice* (2nd ed. OUP, 2007), [6.84], "failure of fraud cases to go to trial gives rise to some difficulty in defining fraud and giving instructive examples." See also E Symons, 'Letters of credit: Fraud, good faith and the basis for injunctive relief' (1979-1980) 54 Tul L Rev 338, 344 which suggests that patterns of litigation mirror economic cycles in business.

¹⁰⁶ *Banco Santander SA v Bayfern Ltd* [1999] CLC 1321, 1332. In this case the confirming bank had discounted the letter of credit to the beneficiary. The beneficiary's fraud was discovered after discounting but before maturity. The question for the court was whether the risk of fraud should be borne by the confirming bank or the issuing bank (and applicant) under the UCP 500. The risk was determined to lie with the confirming bank because the bank had taken an assignment of the beneficiary's rights. The position has now been changed under the UCP 600 art. 7(c) and art. 12(b).

Trade Finance Survey conducted by the ICC which recorded the “troublesome trend[s]” of increasing allegations of fraud and applications for injunctions.¹⁰⁷ Of course, this does not mean that fraud is happening with any greater regularity than previously.

An efficient system of trade depends on the ability to sell goods on the basis of documents and for those documents to transfer ownership to the buyer.¹⁰⁸ The bill of lading was developed for this purpose. It was common practice that bills of lading were issued in three sets as a safeguard for the buyer against lost documents.¹⁰⁹ This, however, creates the possibility for fraud¹¹⁰ as the seller could theoretically sell the same cargo to multiple buyers and issue each a bill of lading. Bills of lading continue to be issued in three sets¹¹¹ even though the conditions justifying this practice no longer exist.¹¹² Of course, the parties are free to stipulate that the buyer should receive a full set of bills of lading¹¹³ and this would provide some protection against fraud. Modern developments also create opportunities for fraud in a system where the accuracy of documents is critical. The availability of high quality methods of reproduction and the use of containers¹¹⁴ assist unscrupulous traders.

Perhaps surprisingly, the fraud risk does not appear to have affected the popularity of the mechanism. Indeed, neither does fraud appear to be perceived as a major concern for the contracting parties.¹¹⁵ As Todd has argued,

¹⁰⁷ ICC, ‘Global Trade and Finance Survey’ (n23) 37, 45-46. (18.5% of respondents reported an increase in the allegations of fraud.)

¹⁰⁸ Bridge, *Benjamin's Sale of Goods* (9th ed) (n1) [18-007]; McKendrick, *Goode on Commercial Law* (4th ed. Penguin, 2010) 960.

¹⁰⁹ Todd, *Maritime Fraud & Piracy* (n3) [3.037].

¹¹⁰ *Sanders v Maclean* (1883) 11 QBD 327, 342 per Bowen LJ, “The possibility of its separation is intentionally devised for the purpose not of fraud, but of protecting honest dealing. The separation may conceivably afford opportunities of fraud, if the holders chose to be dishonest, but on the whole the commercial world is satisfied to run the risk of this contingency for the sake of the compensating advantages and conveniences which merchants rightly or wrongly have ... believed to be afforded by the system of triplicates or quadruplicates.” See also UNCTAD, ‘Documentary risk’ (n19) 63: “the set of documents provided with a letter of credit is a passport to fraud.”

¹¹¹ Todd, *Maritime Fraud & Piracy* (n3) [2.052]; P Todd, *Bills of Lading and Bankers Documentary Credits* (4th ed. Informa, 2007), [3.26] “one of which being accomplished, the others stand void.”

¹¹² *Glyn Mills Currie & Co v East and West India Dock Co* (1882) 7 App Cas 591, 599 per Earl Cairns.

¹¹³ D Backus and H Harfield, ‘Customs and letters of credit: The Dixon, Irmaos case’ (1952) 52 Colum L Rev 589, 593 suggesting that credits commonly require all three bills to be presented.

¹¹⁴ Todd, *Maritime Fraud & Piracy* (n2) [2.047].

¹¹⁵ *Ibid* [2.050], [4.127].

...maritime fraud is facilitated by a trading system, deliberately developed over decades by commercial parties, where security against fraud has been sacrificed, apparently deliberately, to commercial expediency. The courts also take the view that this is what the commercial parties want. There are costs to security, in terms of convenience and speed as well as financial, and the parties are assumed not to want to pay those costs.¹¹⁶

The courts then have conceptualised their role as giving effect to the needs of the commercial community. In the documentary credit context, this is reflected in the importance of swift and certain payment over the construction of a broader fraud exception. More generally, the discussion in *Sanders v Maclean* is useful in this regard,

The object of mercantile usages is to prevent the risk of insolvency, not of fraud; and anyone who attempts to follow and understand the law merchant will soon find himself lost if he begins by assuming that merchants conduct their business on the basis of attempting to insure themselves against fraudulent dealing. The contrary is the case.¹¹⁷

More recently, Lloyd LJ endorsed this proposition in *The Future Express* holding that “that celebrated observation is as true today as it was a hundred years ago.”¹¹⁸ This view that the law merchant has no instrumental purpose in fraud deterrence should not be confused with a liberal attitude to wrongdoing by traders.¹¹⁹ The converse is true. Indeed, rules on fraud have developed to protect the integrity of the court and to prevent the fraudster from benefitting from his own wrongdoing. Where these rules operate against the beneficiary directly, he will lose his entire right to payment without any consideration of proportionality or contributory negligence.¹²⁰ In addition, a claim in the tort of deceit will enable the defrauded party to recover the entirety of its payment and damages for all direct loss from

¹¹⁶ Ibid [2.003].

¹¹⁷ *Sanders* (n110) 343 per Bowen LJ.

¹¹⁸ *The Future Express* [1993] 2 Lloyd’s Rep. 542, 544.

¹¹⁹ Todd, ‘Outlawing dishonest international traders’ [2000] LMCLQ 394, 394.

¹²⁰ *Standard Chartered Bank v Pakistan National Shipping Corp. (Nos. 2 and 4)* [2003] 1 AC 959, [16] per Lord Hoffmann drawing support at [14]-[17] from *Edgington v Fitzmaurice* (1888) 29 Ch Div 459.

the beneficiary.¹²¹ In direct actions against the beneficiary, the courts will not hesitate to enforce the highest standards of commercial morality.¹²²

Fraud deterrence is viewed as a matter for the parties to resolve pre-contractually. As Bowen LJ commented in *Sanders*,

Credit, not distrust, is the basis of commercial dealings; mercantile genius consists principally in knowing whom to trust and with whom to deal, and commercial intercourse and communication is no more based on the supposition of fraud than it is on the supposition of forgery.¹²³

This assumption that traders will only deal with honest counterparts is also apparent in modern case law. In *HIH v Chase Manhattan*, Lord Bingham commented that commercial parties will assume the “honesty and good faith of the other; absent such an assumption they would not deal.”¹²⁴ The same sentiments are evident in a report issued by the United Nations Conference on Trade and Development (UNCTAD). For buyers, suggested UNCTAD, “the best protection...is to make adequate inquiries to be able to satisfy themselves as to the reliability of the parties they deal with.”¹²⁵ The Report further attributed fraud in documentary credits to insufficient safeguards to ensure that the contractual goods had actually been shipped.¹²⁶ The courts evidently view commercial traders as able to protect themselves and, moreover, consider that this is appropriate; the courts’ role is not to rewrite the contract *ex post*.

The suggestion that fraud should be a matter for the parties does have some force.¹²⁷ A number of American commentators have characterised credit transactions as involving

¹²¹ *Doyle v Olby (Ironmongers) Ltd* [1969] 2 QB 158, 167 per Lord Denning MR.

¹²² See, for example, *Standard Chartered Bank v Pakistan National Shipping Corp. (No. 2)* [2000] 2 Lloyd’s Rep. 511, [2] per Evans LJ.

¹²³ *Sanders* (n110) 343 per Bowen LJ.

¹²⁴ *HIH Casualty & General Insurance v Chase Manhattan* [2003] 2 Lloyd’s Rep. 61, 68. See also *Yam Seng Pte Ltd v International Trade Corporation Ltd* [2013] EWHC 111 (QB), [2013] 1 Lloyd’s Rep. 526, [135] per Leggatt J: “A paradigm example of a general norm which underlies almost all contractual relationships is an expectation of honesty. That expectation is essential to commerce, which depends critically on trust.”

¹²⁵ UNCTAD, ‘Documentary risk’ (n19) 74.

¹²⁶ *Ibid* 62. See also Ulph (n20) 368 which she suggests that the UCP 600 contains a “subtle message” that the requirement of a certificate from an independent expert is the best protection against fraud.

¹²⁷ Todd, *Maritime Fraud & Piracy* (n3) [2.051].

experienced, commercial parties who do not require judicial protection.¹²⁸ On this basis, the court's role is simply to interpret the contractual agreement. In *Gill & Duffus v Berger*, for example, the contract term providing that the expert's certificate would be determinative of the quality of the goods was "freely negotiated and included in the contract between the parties in the interests of speed, certainty and economy."¹²⁹ If the buyer is concerned that a single expert's certificate does not provide adequate safeguards,¹³⁰ he should negotiate for greater protection. Moreover, as Todd has argued, if the contract does not require delivery against a full set of bills of lading,¹³¹ the onus is on the buyer to ensure his counterpart is honest and not for the courts to remake the deal *ex post*.¹³²

Judicial pronouncements in general do not contemplate the risk of fraud in international trade.¹³³ This is not to say that the courts will permit a fraudster to get away with wrongdoing, but rather evidence judicial assumptions about the parties involved in overseas trade. The courts clearly regard traders as sophisticated commercial parties who do not require their protection, in the form of a more rigorous fraud enquiry. In any event, a more proactive approach to fraud would diminish the speed and efficiency of payment. The following discussion will demonstrate the prominence of these considerations in shaping the availability of relief. It would seem that in the context of documentary credits, prevention is regarded as better than cure.

B. Circumstances in which the fraud exception is relevant

It is conventional to begin any discussion of the fraud exception with the American case giving rise to the rule on both sides of the Atlantic, *Sztejn v Schroder Banking Corp*.¹³⁴ The case

¹²⁸ J Dolan, *The Law of Letters of Credit Commercial and Standby Credits* (4th ed. AS Pratt & Sons, 2007) [7-80] "the law should not reward novice or unknowledgeable parties at the expense of a credit device fashioned by experienced merchants...Rather than accommodating those who misunderstand and thus destroy the credit, courts should enforce credits vigorously and hasten the learning process."; X Gao, *The Fraud Rule in the Law of Letters of Credit: A Comparative Survey* (Kluwer Law International, 2002) 77: "a commercial transaction between sophisticated parties who can and should look after their own interests."

¹²⁹ *Gill & Duffus v Berger* [1984] AC 382, 388 per Lord Diplock.

¹³⁰ UNCTAD, 'Documentary risk' (n19) 62.

¹³¹ Todd, *Maritime Fraud & Piracy* (n3) [3.038].

¹³² *Ibid* [2.051].

¹³³ See, for example, *Meyerstein v Barber* (1866-67) LR 2 CP 38, 51 per Willes J: "all arguments founded upon the notion that the Court is to pronounce a judgment in this case which will protect those who deal with fraudulent people, are altogether beside the facts of this case, and foreign from transactions of this nature."

¹³⁴ *Sztejn v Schroder Banking Corp* 177 Misc. 719 (NY Misc 1941).

involved a contract for the sale of bristles which was to be financed by documentary credit. The buyer alleged that the seller had sent boxes of rubbish instead of the contract goods and sought an injunction against the issuing bank and beneficiary. The issuing bank argued that as it was only concerned with the documents, a presentation which appeared to conform should entitle it to pay the beneficiary.

Shientag J began his judgment by emphasising the importance of the doctrine of autonomy,

It is well established that a letter of credit is independent of the primary contract of sale between the buyer and the seller. The issuing bank agrees to pay upon presentation of documents, not goods. This rule is necessary to preserve the efficiency of the letter of credit as an instrument for the financing of trade...It would be...most unfortunate...if a bank was obliged or even allowed to go behind the documents, at the request of the buyer, and enter into controversies between the buyer and the seller regarding the quality of the merchandise shipped.¹³⁵

This confirms that ordinary breaches of the underlying contract will not be sufficient for the courts to interfere with payment under a documentary credit.¹³⁶ He continued, however, that the autonomy principle “presupposes that the documents accompanying the draft are genuine and conform in terms to the requirements of the letter of credit.”¹³⁷ Accordingly, where the seller has acted fraudulently – by, for example, intentionally failing to ship any of the contract goods¹³⁸ – and this is known to the bank, the bank is entitled to resist payment.¹³⁹ The protection afforded to beneficiaries by the doctrine of autonomy “should not be extended to protect the unscrupulous seller.”¹⁴⁰

¹³⁵ Ibid 721 per Shientag J.

¹³⁶ Ibid 721-722 per Shientag J.

¹³⁷ Ibid 721 per Shientag J.

¹³⁸ Ibid 722 per Shientag J.

¹³⁹ Ibid 722 per Shientag J.

¹⁴⁰ Ibid 722 per Shientag J.

Although the focus of the thesis is fraud committed by the beneficiary,¹⁴¹ the fraud exception can be employed within several of the contracts created by the documentary credit. It is convenient to outline these fact patterns before considering the relevant criteria and issues of proof.

- (1) The beneficiary brings a suit following the bank's refusal to pay due to fraud. The fraud exception is invoked by the bank as a defence to non-payment.
- (2) The applicant resists a claim for reimbursement from the issuing bank on the basis that the bank should not have paid due to fraud.
- (3) The paying bank seeks to recover payment directly from the beneficiary. This action occurs either as a claim for damages in the tort of deceit¹⁴² or an action in restitution to reclaim money paid under a mistake of fact.¹⁴³
- (4) (a) The applicant seeks an interlocutory injunction against the bank to prevent payment due to fraud.
(b) The applicant seeks an interlocutory injunction against the beneficiary to prevent the presentation of documents on the basis of fraud.

The consequences of the fraud exception depend upon the circumstances in which it is employed. Used against the beneficiary, the exception will prevent him receiving payment (situation 1), require him to pay damages to the bank (situation 3) or preclude the presentation of documents (situation 4b). Where the exception is employed against the issuing bank, it will operate to bar the bank's claim for reimbursement from the applicant (situation 2) or will prevent the bank from honouring the credit (situation 4a).

A successful direct action against the fraudulent beneficiary – situations 3 and 4b – is relatively unlikely. This is because the fraudster may well have disappeared with the proceeds of the credit¹⁴⁴ and/or the claimant will struggle to satisfy the procedural hurdles to succeed

¹⁴¹ As opposed to fraud committed by the applicant, see Malek and Quest, *Jack* (n32) [9.20]; X Gao, 'The identity of the fraudulent party under the fraud rule in law of letters of credit' (2001) 24 UNSWL 119, 125-128.

¹⁴² *Standard Chartered Bank (Nos. 2 and 4)* (n120) [4] per Lord Hoffmann.

¹⁴³ *Edward Owen* (n31) 171 per Lord Denning MR citing *Bank Russo-Iran v. Gordon Woodroffe & Co. Ltd.* (3 October 1972, QBD) per Browne J (noted by LN Williams (1972) 116 Sol Jo 921).

¹⁴⁴ Todd, *Maritime Fraud & Piracy* (n3) [2.004], [4.041]

at the interim stage. By contrast, judicial intervention in situation 2 requires the court to allocate the loss between two innocent parties; the issuing bank and the buyer. Bridge has characterised the losses to these parties as follows,

The loss to the buyer may be the market loss that comes with paying for July goods when in fact August goods were shipped, or it may be the loss arising on the receipt of goods that bear little relation to goods of the contractual description. The loss incurred by an issuing bank, for example, may be the reduced value of its security if it is taking a pledge of the documents as security for an advance to the buyer.¹⁴⁵

Although the focus in this thesis is fraud committed by the credit beneficiary, the varied circumstances in which the exception may be employed requires careful consideration of the legal basis for judicial intervention. It is appropriate to examine the juridical basis of the fraud exception at this stage.

C. The juridical basis of the exception

The leading case on fraud in English law is *United City Merchants v Royal Bank of Canada*¹⁴⁶ in which the confirming bank employed the exception to refuse payment to the credit beneficiary (situation 1).¹⁴⁷ The House of Lords recognised a narrow fraud exception in this case which was premised on *ex turpi causa*.¹⁴⁸ This proved, however, to be an inadequate explanation for intervention in all the circumstances in which the fraud exception may be relevant. Accordingly, subsequent case law has developed a supplementary basis for intervention; the implied term analysis. The discussion in this section tests these explanations against each of the situations 1-4 where the exception is relevant. The argument made here is that both analyses are required to understand judicial intervention in cases of fraud.

The juridical basis of the fraud exception does not, in general, garner significant academic or judicial attention. The leading academic treatment of documentary credits, *Jack:*

¹⁴⁵ M Bridge, 'Documents and contractual congruence in international trade' in S Worthington, (ed.), *Commercial Law and Commercial Practice* (Hart, 2003), 228-229.

¹⁴⁶ *United City Merchants (House of Lords)* (n4).

¹⁴⁷ A comprehensive discussion of the facts of this case and the criteria required to trigger the fraud exception are postponed until Part D.

¹⁴⁸ *United City Merchants (House of Lords)* (n4) 6 per Lord Diplock.

Documentary Credits, confines its discussion of the juridical basis of the exception to a mere two paragraphs.¹⁴⁹ The absence of detailed consideration in *Goode on Commercial Law*¹⁵⁰ is somewhat surprising given that Goode has devoted significant attention to other aspects of the fraud exception.¹⁵¹ The rationale of the exception is afforded a matter of sentences by Ellinger and Neo in which they simply reiterate the position advocated by the House of Lords.¹⁵² Enonchong's treatment of the exception is longer – running to seven paragraphs¹⁵³ – but focuses substantially on the implied term analysis¹⁵⁴ with limited attention paid to the explanation provided in *United City Merchants*.¹⁵⁵ Judicial discussions of the rationale of the rule are also similarly lacking.¹⁵⁶ Taken together, this lack of focus is surprising given that the juridical basis of the fraud exception is not comprehensively settled.

i. The ex turpi causa analysis

In *United City Merchants*, Lord Diplock explained the exception as “a clear application of the maxim *ex turpi causa non oritur actio* or, if plain English is to be preferred, fraud unravels all.”¹⁵⁷ This immediately presents a problem.¹⁵⁸ The usual translation of *ex turpi causa*, or illegality, is the following, derived from the case of *Holman v Johnson*,

No Court will lend its aid to a man who founds his cause of action upon an immoral or an illegal act. If, from the plaintiff's own stating or otherwise, the cause of action appears to arise *ex turpi causa*, or the transgression of a positive law of this country, there the Court says he has no right to be assisted.¹⁵⁹

¹⁴⁹ Malek and Quest, *Jack* (n32) [9.13]-[9.14].

¹⁵⁰ McKendrick, *Goode on Commercial Law* (n108) 1101, a single paragraph is devoted to the juridical basis.

¹⁵¹ For example, Goode, 'Abstract payment undertakings' (n29) 228-234.

¹⁵² Ellinger and Neo (n35) 141.

¹⁵³ Enonchong, *The Independence Principle* (n2) [5.03]-[5.009].

¹⁵⁴ *Ibid* [5.06]-[5.09]. The discussion of the alternative basis of the exception does not just run to a greater number of paragraphs but also a significantly higher word count.

¹⁵⁵ *Ibid* [5.04]-[5.05].

¹⁵⁶ For example, the recent Privy Council decision in *Alternative Power Solution Ltd v Central Electricity Board* [2014] UKPC 31, did not consider the precise juridical basis of the exception.

¹⁵⁷ *United City Merchants (House of Lords)* (n4) 6 per Lord Diplock.

¹⁵⁸ See, for example, Malek and Quest, *Jack* (n32) 253 (fn 5 in original) where the authors comment that 'fraud unravels all' is traditionally translated from the maxim, *fraus omnia corrumpit*. Bridge, 'Documents and contractual congruence' (n145) 229 is also in favour of this alternative translation although he noted that "blanket statements of this kind, however, envelope better than they explain."

¹⁵⁹ *Holman v Johnson* 1 Cowp 342 (1775), 343 per Lord Mansfield.

This rule is designed to maintain the integrity of the court and to prevent the plaintiff profiting from his own wrongdoing.¹⁶⁰ Indeed, this is how Lord Diplock went on to explain the fraud exception in *United City Merchants* stating, “the Courts will not allow their process to be used by a dishonest person to carry out a fraud.”¹⁶¹ Given that the fraud exception will not always involve the beneficiary directly, it is questionable whether *ex turpi causa* can adequately explain judicial intervention in these cases.

To determine the validity of the *ex turpi causa* analysis, it is necessary to consider each of the circumstances in which the exception is employed.

In situation 1, a claim for payment under a letter of credit by the beneficiary who has submitted fraudulent documents would certainly arise *ex turpi causa* and would furnish the paying bank with a defence. In situation 3, the beneficiary’s fraud would entitle the paying bank to bring a direct claim for reimbursement. This rationale would also account for the case in which the applicant sought an injunction against the fraudulent beneficiary to prevent him presenting documents for payment (situation 4b). It is the personal fraud of the beneficiary in these cases which would justify intervention on the basis of *ex turpi causa*. The courts’ refusal to assist a dishonest litigant is evident when the fraud exception operates in these circumstances and deprives the beneficiary of contractual rights.

By contrast, in a claim for reimbursement by the issuing bank (situation 2) or where the applicant seeks an injunction against his bank (situation 4a), the fraudulent beneficiary is not a party to the action. The court in these situations is not being asked to aid a fraudulent claimant but rather to allocate losses between innocent parties (situation 2) or to effectively create a cause of action where the applicant seeks an injunction against the issuing bank (situation 4a). This is the opposite of a judicial refusal to become embroiled in a network of contracts tainted with fraud. As such, *ex turpi causa* provides a much less convincing

¹⁶⁰ Brindle and Cox (n29) 724.

¹⁶¹ *United City Merchants (House of Lords)* (n4) 7 per Lord Diplock.

explanation of intervention in these circumstances.¹⁶² For ease of exposition, the following table demonstrates those cases in which *ex turpi causa* provides a valid juridical basis for the operation of the fraud exception.

Situation	Ex turpi causa?
(1) Bank refuses to pay beneficiary	Yes
(2) Applicant refuses reimbursement	No
(3) Bank seeks reimbursement from beneficiary	Yes
(4a) Applicant seeks injunction against IB	No
(4b) Applicant seeks injunction against beneficiary	Yes

Table 1: Ex turpi causa as juridical basis

Given the inability of *ex turpi causa* to explain judicial intervention in all circumstances in which the exception may operate, it becomes relevant to consider whether broader principles from the law of illegality may assist in this respect. In particular, the question is whether the notion of taint – whereby a *prima facie* lawful contract is declared unenforceable because it is collateral to an illegal transaction¹⁶³ – could be used to explain intervention in cases not directly involving the fraudulent beneficiary (situations 2 and 4a). The author’s view is that this analysis does not underpin judicial activity in these situations. In the first place, the author has not found any cases in which such an argument has been made and, moreover, the courts do not speak in terms of ‘unenforceability’ when the fraud exception operates in these circumstances. Interestingly, and by way of contrast, these ideas have been explicitly used in the more recent development of an illegality exception to payment in credit transactions.¹⁶⁴

¹⁶² Todd has made this argument in relation to the claim for reimbursement, see P Todd, ‘Non-genuine shipping documents and nullities’ [2008] LMCLQ 547, 556.

¹⁶³ A comprehensive account of the law of illegality is beyond the scope of this project. Readers are directed to R Buckley, *Illegality and Public Policy* (3rd ed. Sweet & Maxwell, 2013).

¹⁶⁴ *Group Josi Re v Walbrook Insurance Co Ltd* [1996] 1 Lloyd’s Rep 345, 354 per Staughton LJ; *Mahonia Ltd v JP Morgan Chase Bank (No 1)* [2003] 2 Lloyd’s Rep. 911, [66], [68] per Colman J; *Mahonia Ltd v JP Morgan Chase Bank*

This suggests to the author that the courts regard the fraud and illegality exceptions as distinct. Finally, intervention in situation 4a requires the court to create a cause of action for the applicant against the issuing bank. This willingness of the courts to involve themselves in this situation is to be contrasted with the typical judicial refusal to become embroiled in contracts tainted with fraud.

The foregoing discussion has demonstrated that *ex turpi causa* cannot explain judicial intervention in all circumstances in which the fraud exception is employed. A supplementary basis for the exception has been suggested in case law¹⁶⁵ to which attention now turns.

ii. *The implied term analysis*

More recent case law has explained the fraud exception on the basis of an implied term.¹⁶⁶ This responds to the fact that, in certain situations, the operation of the exception depends on the bank's knowledge of fraud.¹⁶⁷ If, for example, the court's desire was simply to prevent its processes being used to facilitate a fraud, the bank's knowledge of fraud prior to payment would be unnecessary.¹⁶⁸ This, however, remains an important criterion which must be satisfied in situations 2 and 4a.¹⁶⁹ In *Czarnikow-Rionda v Standard Bank*, Rix J discussed the fraud exception in light of the contractual relationships created by the letter of credit. Drawing on previous cases which interpreted the source of the exception as contractual,¹⁷⁰ he argued that "payment in the face of fraud can[not] be a mere matter of discretion by a bank: it must be either within its mandate or not, and either a matter of obligation or not."¹⁷¹ Rix J further described the decision in *United City Merchants* as "an authoritative expression

and West LB [2004] All ER (D) 10, [428], [432]-[433] per Cooke J. A lengthier discussion of the impact of illegality in credit transactions is omitted from this thesis for reasons of space. Readers are directed to Horowitz (n100) Ch 7 for a comprehensive treatment of illegality in this context.

¹⁶⁵ *Czarnikow-Rionda v Standard Bank* [1999] 2 Lloyd's Rep. 187.

¹⁶⁶ Malek and Quest, *Jack* (n32) [9.14]. For a comprehensive account of implied terms under English law see, *Chitty* (32nd ed.) (n20) chapter 14.

¹⁶⁷ The criteria which must be satisfied to trigger the fraud exception will be considered shortly, see Part C of this chapter.

¹⁶⁸ *Czarnikow-Rionda* (n165) 203 per Rix J.

¹⁶⁹ *Ibid* 205; *Gian Singh* (n81) 9 per Lord Diplock; Malek and Quest, *Jack* (n32) [9.41]. See later discussion, Part C(iv).

¹⁷⁰ *Czarnikow-Rionda* (n165) 203 per Rix J citing inter alia *Harbottle* (n31); *Tukan Timber* (n31); *Discount Records* (n27).

¹⁷¹ *Czarnikow-Rionda* (n165) 203 per Rix J.

of the source in law of the implied limitation on a bank's mandate."¹⁷² In English contract law, the purpose of implying terms was recently considered by the Supreme Court in *Marks & Spencer v BNP Paribas Securities*.¹⁷³ The Court held that the purpose of implication was to "discover what the parties have agreed"¹⁷⁴ and only authorised the insertion of terms if "without the term, the contract would lack commercial or practical coherence."¹⁷⁵ For an implied term to operate in the letter of credit context, it would need to conform to this test. As with the task above, the discussion will now consider in which of the situations the implied term analysis can explain judicial intervention. Due to the autonomous nature of the contracts created by the credit, this supplementary analysis has the greatest potential in situations where there is a direct relationship involving the paying bank. It is for this reason that the implied term analysis cannot explain the position as between applicant and beneficiary (situation 4b).¹⁷⁶

It is convenient to begin by considering the contract between the bank and beneficiary as this is the focus of the implied term analysis in *Jack*¹⁷⁷ and adopted by *Bridge*.¹⁷⁸ On this basis, the term would be relevant as a defence to non-payment by the bank (situation 1) and as a cause of action to recover payment from the fraudulent beneficiary (situation 3). Any cause of action provided by the implied term in situation 3 would operate alongside an action in deceit or restitution.

The authors of *Jack* suggest that the term would amount to a representation by the beneficiary that the documents did not to his knowledge contain material misrepresentations nor were part of an attempt to defraud the bank or its customer.¹⁷⁹ It is not impossible that such a term could conform to the test enunciated in the *Marks & Spencer's* case. The

¹⁷² Ibid 203 per Rix J.

¹⁷³ *Marks & Spencer plc v BNP Paribas Securities Service Trust Co (Jersey) Ltd* [2015] UKSC 72, [22]-[32] per Lord Neuberger clarifying the approach in *Attorney General of Belize v Belize Telecom* [2009] 1 WLR 1988.

¹⁷⁴ *Marks & Spencer* (n173) [69] per Lord Carnwarth.

¹⁷⁵ Ibid [21] per Lord Neuberger.

¹⁷⁶ *Bridge*, 'Documents and contractual congruence' (n145) 229.

¹⁷⁷ *Malek and Quest*, *Jack* (n32) [9.14].

¹⁷⁸ This is the focus of the discussion in *Malek and Quest*, *Jack* (n32) [9.14] and *Bridge*, 'Documents and contractual congruence' (n145) 229.

¹⁷⁹ *Malek and Quest*, *Jack* (n32) [9.14].

reference to the bank's customer does not raise any conflict with the doctrine of autonomy since the latter gives way when the fraud exception operates.

The question is whether the implied term – as formulated in *Jack* – can explain judicial intervention in situations 1 and 3. In the absence of definitive judicial comment on the matter, a couple of brief comments will be offered. It would be relatively straightforward to recognise an implied term in situation 3 as it would augment the existing post-contractual causes of action available to the bank. The implied term involves a more complicated analysis in respect of situation 1 because the term would need to function as a defence to non-payment by the bank. There is nothing to prevent the development of such an analysis but it would require senior judicial consideration. Indeed, until such time as the courts have examined the implied term analysis in more detail, the precise content and utility of any term remains a matter for academic speculation.

By contrast, the implied term analysis is particularly promising as between the issuing bank and the applicant. The term would provide a defence where the applicant refuses reimbursement (situation 2) and create a cause of action when an injunction is sought against the bank (situation 4a). The content of the term would relate to the bank's contractual mandate to make payment to the beneficiary. As discussed above, the rule of apparent compliance contained in the UCP 600 entitles the banks to pay when the presented documents appear to comply. The bank, however, will not be entitled to reimbursement if it knew at the time of payment that the documents were fraudulent notwithstanding their apparent compliance.¹⁸⁰ The implied term, therefore, would provide a concrete basis for this qualification to the bank's entitlement to pay.

Support for this analysis is provided by Enonchong¹⁸¹ and by analogy to some case law discussion. In *Tukan Timber*, Hirst J argued that an applicant would have a "cast-iron claim for damages"¹⁸² against a bank which paid against apparently compliant documents in circumstances when it had knowledge of fraud. It is reasonable to assume that what Hirst J

¹⁸⁰ Brindle and Cox (n29) [8-088]-[8-089].

¹⁸¹ Enonchong, *The Independence Principle* (n2) [5.06].

¹⁸² *Tukan Timber* (n31) 177 per Hirst J cited in *Czarnikow-Rionda* (n165) 203 per Rix J.

had in mind was an implied contractual term to underpin this claim since there is nothing to suggest that the parties had expressly contracted on this basis.

The implied term analysis is yet to be tested by a senior English court.¹⁸³ In *Alternative Power*, a case where the credit applicant sought an injunction against the issuing bank (situation 4a), the Privy Council did not discuss the juridical basis of the fraud exception.¹⁸⁴ The references to *ex turpi causa* throughout the judgment¹⁸⁵ are disappointing given the inability of the maxim to explain the fraud exception in these circumstances. Indeed, the implied term analysis would be particularly useful in contracts involving the credit applicant and issuing bank, as is the case in situations 2 and 4a. An implied term in the contract between issuing bank and beneficiary would provide a further defence in situation 1 and an additional claim for reimbursement in situation 3.

The foregoing analysis should make clear that *ex turpi causa* cannot convincingly explain the variety of contexts in which the fraud exception can be utilised. This difficulty could be rectified either by recognising *fraus omnia corrumpit* as the appropriate maxim or by admitting that the contracts are more interconnected than doctrine would suggest. It is submitted that this latter solution is unlikely given the primacy accorded to autonomy by the courts. In addition, the contractual analysis would strengthen the operation of the fraud exception and would provide an additional basis for judicial intervention in certain circumstances. The validity of the contractual analysis remains to be settled by subsequent case law. Assuming this analysis is valid, the following table sets out the juridical basis or bases applicable in each of the situations in which the fraud exception might be invoked.

¹⁸³ It has gained academic support, however, see Malek and Quest, *Jack* (n32) [9.26]; K Donnelly, 'Nothing for nothing: A nullity exception in letters of credit?' [2008] JBL 316, 322 who describes it as "more principled"; the majority of textbooks cite the implied term analysis as an alternative or additional basis for intervention in cases of fraud, see Malek and Quest, *Jack* (n32) [9.14]; McKendrick, *Goode on Commercial Law* (n108) 1101; Brindle and Cox (n29) [8-087].

¹⁸⁴ *Alternative Power* (n156).

¹⁸⁵ *Ibid* [37] [46] [78] per Lord Clarke.

Situation	Juridical Basis/Bases
(1) Bank refuses to pay beneficiary	Ex turpi causa Implied term: IB and Beneficiary
(2) Applicant refuses reimbursement	Implied term: IB and Applicant
(3) Bank seeks reimbursement from beneficiary	Ex turpi causa Implied term: IB and Beneficiary
(4a) Applicant seeks injunction against IB	Implied term: IB and Applicant
(4b) Applicant seeks injunction against beneficiary	Ex turpi causa

Table 2: Ex turpi causa and implied term analysis

As it stands, judicial intervention is largely premised on the notion that ‘fraud unravels all’. The phrase itself suggests a fairly expansive jurisdiction. Broader contextual considerations related to the documentary credit as a financing device have militated against liberal intervention by the courts. This is particularly evident when one considers the way in which the criteria pertaining to the fraud exception have been framed. The following discussion establishes the criteria necessary to invoke the fraud exception at trial, relevant in situations 1-3, discussed above. This is followed by the additional criteria which must be satisfied for relief at the interlocutory stage, as will be required in situation 4a and b.

D. Criteria

The leading case on the fraud exception in English law is *United City Merchants*.¹⁸⁶ The case involved the sale of a fibre glass plant between English sellers and Peruvian buyers which was financed by documentary credit. The sellers had assigned their rights and obligations under the credit to United City Merchants. The credit required shipment to be made by 15/12/1976 from London to Callao. The first presentation of documents was rejected. A second presentation stated that shipment had been made from London on 15/12/1976. The documents therefore appeared to conform to the terms of the credit. The second

¹⁸⁶ *United City Merchants (House of Lords)* (n4). This is also the leading English case on illegality in a letter of credit.

presentation was also rejected. The bank contended that it had information which demonstrated that shipment had not been effected on the specified date and, moreover, that this was known to the beneficiary before the second presentation. The specific allegation was that the documents had been fraudulently backdated by the loading broker to meet the requirements of the credit. The beneficiary and its assignee brought an action against the negotiating bank demanding payment (situation 1).

At first instance, Mocatta J held that the beneficiary was entitled to payment as the fraud had been committed by an independent third party without the beneficiary's knowledge or authorisation.¹⁸⁷ The Court of Appeal disagreed, holding that the fraudulent backdating of the bill barred the beneficiary's right to payment, irrespective of the author of the false shipment date. The focus was on the nature and quality of the documents rather than the identity of their creator.¹⁸⁸ Accordingly, the Court of Appeal unanimously allowed the appeal because the bank's obligation to pay was only triggered by the presentation of genuine documents which conformed to the terms of the credit.¹⁸⁹ If the bank knew, therefore, that forged documents were presented, it had no obligation to pay; the identity of the forger was "immaterial."¹⁹⁰

The House of Lords restored the decision of the first instance judge. Lord Diplock commenced his judgment by reinforcing the doctrine of autonomy,

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 that does not permit of any dispute with the buyer as to the performance of the contract of sale being used as a ground for non-payment or reduction or deferment of payment.¹⁹¹

¹⁸⁷ *United City Merchants v Royal Bank of Canada (The American Accord)* [1979] 1 Lloyd's Rep. 267, 278 per Mocatta J (hereafter referred to as *United City Merchants (First Instance)*).

¹⁸⁸ *United City Merchants v Royal Bank of Canada (The American Accord)* [1981] 1 Lloyd's Rep. 604, 623 per Stephenson LJ, 628 per Ackner LJ, 632 per Griffiths LJ (hereafter referred to as *United City Merchants (Court of Appeal)*).

¹⁸⁹ *Ibid* 628 per Ackner LJ, 632 per Griffiths LJ.

¹⁹⁰ *Ibid* 632 per Griffiths LJ.

¹⁹¹ *United City Merchants (House of Lords)* (n4) 6 per Lord Diplock.

He continued,

To this general statement of principle...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 [the seller's] knowledge are untrue.¹⁹²

As the bill of lading had been backdated by a third party, without the beneficiary's knowledge,¹⁹³ the fraud exception did not operate to deprive the assured of payment.¹⁹⁴

More generally, a party seeking to invoke the fraud exception will need to satisfy each of the criteria established in *United City Merchants*. For clarity, these are summarised here:

- i. A material misrepresentation of fact in the documents
- ii. Fraud known to the beneficiary
- iii. The representee relies on the fraud
- iv. Fraud known to the bank (relevant in situations 1, 2 and 4a)

i. Material misrepresentation of fact in the documents

The fraud must involve a material misrepresentation of fact, express or implied, within the documents. By way of example, the documents would contain misrepresentations of fact when apparently compliant documents were presented but the beneficiary had shipped rubbish, as in *Discount Records v Barclays*.¹⁹⁵ Equally, the presentation of apparently compliant documents where nothing had been shipped, as demonstrated by the facts of *Etablissement Esefka*,¹⁹⁶ would satisfy this criterion. As a final example, documents which had been altered to conceal a breach of the credit contract – the date or place of shipment, for

¹⁹² Ibid 6 per Lord Diplock.

¹⁹³ Ibid 7 per Lord Diplock.

¹⁹⁴ Ibid 11 per Lord Diplock. This was subject to the decision on the illegality point. The House of Lords held that the beneficiary was entitled to payment for sums which did not constitute a money transaction in disguise.

¹⁹⁵ *Discount Records* (n27); *Sztejn* (n134) 721.

¹⁹⁶ *Etablissement Esefka International Anstalt v Central Bank of Nigeria* [1979] 1 Lloyd's Rep. 445.

example – would also meet this test.¹⁹⁷ It should be noted, for clarity, that the fraud exception did not operate in any of these cases because of difficulties in establishing the other criteria. These examples are included to illustrate ‘misrepresentation of fact’ in this context.

A difficulty arises in relation to the standard of ‘materiality’. This was not conclusively resolved in *United City Merchants* in which Lord Diplock rejected two conceptions of materiality without providing a definitive standard.¹⁹⁸

The authors of *Jack* suggest that materiality should be assessed by reference to the bank’s obligation to pay.¹⁹⁹ Applied to the facts of *United City Merchants*, had the documents in fact shown the actual (late) shipment date, the bank would have had no liability to pay and could have rejected the documents for non-compliance. This must be the correct approach. Notably, this standard of materiality would not embrace all documentary defects. It is suggested in *Jack*, for example, that a bill of lading which had been falsely dated to conceal the real date of shipment but where shipment had nonetheless occurred within the permitted period would be a false, but immaterial, representation.²⁰⁰ This suggests that some lies, though false, would fall short of the materiality standard to be actionable for the purposes of the exception. This has echoes of the recent insurance decision in *Versloot* in which the collateral lie was excluded from the fraudulent claims jurisdiction.²⁰¹ The false but immaterial standard is yet to be tested by the trade finance courts.

An alternative standard of materiality was suggested by counsel for the plaintiff beneficiaries in *Rafsanjan Pistachio Producers v Bank Leumi*.²⁰² It was contended that a statement would only be material if it reduced the value of the bank’s security on resale.²⁰³ This, presumably,

¹⁹⁷ *United City Merchants (House of Lords)* (n4).

¹⁹⁸ Enonchong, *The Independence Principle* (n2) [5.23] - [5.25]; *United City Merchants (House of Lords)* (n4) 7 per Lord Diplock rejected a materiality standard that would have entitled the bank to refuse payment if the documents accurately reflected the condition of the goods and information about shipment but that these statements demonstrated that there had been a breach of the credit contract, 8 per Lord Diplock also rejected a standard by which materiality would be assessed according to the resale value of the goods were the bank required to realise its security.

¹⁹⁹ Malek and Quest, *Jack* (n32) [9.17].

²⁰⁰ *Ibid* [9.17].

²⁰¹ See earlier discussion, Chapter Two, text to fn 296 et seq.

²⁰² *Rafsanjan Pistachio Producers Cooperative v Bank Leumi* [1992] 1 Lloyd’s Rep. 513, 541.

²⁰³ *Ibid* 541.

was designed to confine the materiality enquiry since an assessment would only be required when the bank needed to realise its security following the applicant's insolvency. This suggestion was not accepted in *Rafsanjan*. Indeed, Hirst J commented that such an analysis "misse[d] the point" because the fraud rule was designed to prevent dishonest litigants using the courts' processes to perpetrate a fraud.²⁰⁴ It would be contrary to principle, therefore, if the operation of the fraud exception depended on the bank's ability to sell the documents at a later date.

Fraud in the transaction

The requirement that the fraud appears in the documents is a significant restriction on the scope of the exception and calls into question the explanatory power of 'fraud unravels all'. The question is whether fraud by the beneficiary – either misrepresentation in relation to the underlying contract or an intentional failure to ship any of the contract goods²⁰⁵ – is sufficient to prevent payment under the credit.

As a starting point, there is nothing in *United City Merchants* which overtly precludes an extension to fraud in the transaction.²⁰⁶ Caution is required, however, given that Lord Diplock's intention was to make judicial intervention possible only in the most exceptional of cases.²⁰⁷ This is apparent in his concern to safeguard the viability of the credit mechanism, stating that a broader fraud exception would "undermine the whole system of financing international trade by means of documentary credits."²⁰⁸

Nevertheless, there are powerful policy arguments supporting such an extension. In the first place, if the rationale of the exception is that fraud unravels all, it should not matter where the beneficiary's wrongdoing is located.²⁰⁹ To confine actionable fraud to that located in the documents would, as Enonchong has argued, further hinder the courts' ability to discourage

²⁰⁴ *Ibid* 541-542 per Hirst J. The logical conclusion of this analysis would suggest that the purpose of the fraud rule is to secure the full value of the documents to the bank.

²⁰⁵ *Sztejn* (n134) 721 per Shientag J.

²⁰⁶ Horowitz (n100) [2.15].

²⁰⁷ *Ibid* [2.15].

²⁰⁸ *United City Merchants (House of Lords)* (n4) 7 per Lord Diplock.

²⁰⁹ Malek and Quest, *Jack* (n32) [9.26]; Enonchong, *The Independence Principle* (n2) [5.18]; Ellinger and Neo (n35) 143. This echoes the arguments used to support the nascent development of an illegality exception in English law: *Mahonia Ltd (2003)* (n164) [68] per Colman J; *Mahonia Ltd (2004)* (n164) [431] per Cooke J.

fraud in international transactions.²¹⁰ Fraud in the transaction has also been recognised as sufficient in performance bond cases.²¹¹ This, admittedly, is a weaker basis for extending the exception given the very few documentary requirements in bond transactions.²¹²

Recent case law does suggest that English courts would now be prepared to recognise fraud in the transaction. In *Group Josi Re*, the credit applicant sought to disrupt payment on the basis that the underlying contract of reinsurance had been induced by fraudulent misrepresentation and/or non-disclosure.²¹³ Although the injunction was ultimately refused,²¹⁴ the fact that the alleged wrongdoing related to the underlying transaction did not concern the court. The applicant in *Czarnikow-Rionda* also sought to invoke the exception on the basis of fraudulent misrepresentation.²¹⁵ The injunction was refused at the balance of convenience stage, but again the court had no objection that the fraud was not documentary in nature.²¹⁶

The express recognition of fraud in the transaction would require consideration from a senior court. In particular, the court would need to determine the necessary degree of proximity between the fraud and the credit contract.²¹⁷ This would overcome Horowitz's concern that any extension to fraud in the transaction would unduly complicate matters for the banks.²¹⁸ At present, there appears to be weak judicial support for an expanded conception of fraud to include wrongdoing by the beneficiary in relation to the underlying sale. Until such time as the extension is confirmed, the restriction of actionable fraud to that apparent in the documents constitutes a significant limitation on the extent to which fraud unravels all in documentary credit transactions.

²¹⁰ Enonchong, *The Independence Principle* (n2) [5.18].

²¹¹ McKendrick, *Goode on Commercial Law* (n108) 1101; *Themehelp Ltd v West* [1996] QB 84, 98-99 per Waite LJ.

²¹² Todd, *Bills of Lading and Bankers Documentary Credits* (n111) [9.79].

²¹³ *Group Josi Re (Court of Appeal)* (n164) 358.

²¹⁴ *Ibid* 364 per Staughton LJ, 369 per Saville LJ.

²¹⁵ *Czarnikow-Rionda* (n165).

²¹⁶ Malek and Quest, *Jack* (n32) [9.25]; Ellinger and Neo (n35) 143.

²¹⁷ Commentators in favour of a connection between the fraud and the documentary credit include Malek and Quest, *Jack* (n32) [9.26] and Horowitz (n100) [2.28].

²¹⁸ Horowitz (n100) [2.28].

ii. *The beneficiary knows the misrepresentation to be untrue*

The beneficiary must know at the time of presentation that the documents contain material misrepresentations.²¹⁹ This will be satisfied either where the beneficiary has himself committed the fraud or where he adopts the fraud of another.²²⁰ Enonchong has argued that the position in English law with respect to agents is not yet clear.²²¹ On normal principles, however, one would expect that the beneficiary would be responsible for the fraudulent acts of his authorised agent²²² provided these were not designed to deceive the beneficiary himself.²²³

The level of knowledge mirrors that found in the tort of deceit. As such, fraud will be proven when the beneficiary presents documents which contain “a false representation made (i) knowingly (ii) without belief in its truth or (iii) recklessly, careless of whether it be true or false.”²²⁴ The authors of *Jack* have suggested the possibility of a broader standard, namely that liability would be imposed when the beneficiary had suspicions about the document(s) but failed to examine them properly.²²⁵ This would increase the types of behaviour sufficient to invoke the fraud exception as well as creating evidential difficulties.²²⁶ This has yet to be argued before a court but, given the restrictive approach to fraud, the author suggests that it would be unlikely if the exception was widened in this way.

²¹⁹ *Group Josi Re (Court of Appeal)* (n164) 360 per Staughton LJ.

²²⁰ W Blair, ‘Commentary on ‘Documents and contractual congruence in international trade’ in Worthington, S. (ed.), *Commercial Law and Commercial Practice* (Hart, 2003), 245 (the exception extends to the position where the beneficiary takes documents honestly but later learns of fraud.)

²²¹ Enonchong, *The Independence Principle* (n2) [5.34] citing *Re Hampshire Land* [1896] 2 Ch 743 and *Lloyd v Grace Smith* [1912] AC 715. But see Goode, ‘Abstract payment undertakings’ (n29) 232, 234 where the fraud exception includes the fraud of the beneficiary’s agent.

²²² *Kwei Tek Chao v British Traders & Shippers Ltd* [1954] 2 QB 459, 470 per Devlin J, “if Sloomakers had made fraudulent representations to Wilhelmson, the agent of the shipping company, in order to procure the bills of lading, the defendants would have been liable although they had not expressly authorized it, because Sloomakers would have been doing improperly the very act which they had been authorized to do; but that is not the question which I have to consider.”

²²³ F Reynolds (ed.), *Bowstead & Reynolds on Agency* (18th ed. Sweet & Maxwell, 2006), [8-064] – [8-065]; Enonchong, *The Independence Principle* (n2) [5.35] citing *Kwei Tek Chao* (n222) 471 per Devlin J.

²²⁴ *Derry v Peek* (1889) 14 App Cas 337, 376 per Lord Herschell.

²²⁵ Malek and Quest, *Jack* (n32) [9.18]. This standard of knowledge is relevant in the marine insurance context in relation to the defence of unseaworthiness under s.39(5) MIA 1906, see *Compania Maritima San Basilio SA v Oceanus Mutual Underwriting Association (Bermuda) Ltd (The Eurysthenes)* [1977] QB 49, 68 per Lord Denning MR.

²²⁶ Malek and Quest, *Jack* (n32) [9.18]. See also Ellinger and Neo (n35) 142.

The decision to confine actionable fraud to that committed by the beneficiary or with his knowledge places two important limits on the scope of the fraud exception. First, it means that moral fraud – innocent misrepresentations of which the representor was wholly unaware²²⁷ – will not be actionable. The court must content itself that the beneficiary has knowingly committed fraud. The second consequence is that wrongdoing committed by other parties in the chain is irrelevant for the purposes of the fraud exception, even though this wrongdoing may result in forged and null documents being presented to the bank. The courts have once again relied on the commercial demand for an unassailable payment mechanism to justify their approach.²²⁸ A more compelling explanation, in the author's view, relates to the fact that *ex turpi causa* is explicitly designed to prevent a fraudster profiting from his own wrongdoing. Accordingly, it is entirely logical that only fraud by the beneficiary triggers the exception.

The decision to restrict actionable fraud to that carried out by the beneficiary has forced the courts to consider whether forgery and nullity unconnected to the beneficiary constitute independent bases for refusing payment under a credit.²²⁹

Forgery

The leading discussion of forgery appears in the Court of Appeal judgment in *United City Merchants*. Stephenson LJ described a forged document in the following terms,

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: Forgery Act, 1913, s.1(2)...Or the document may tell a lie about its contents. Then it is no forgery...²³⁰

²²⁷ *Redgrave v Hurd* (1881) 20 Ch D 1, see earlier discussion in Chapter One, text to fn 15.

²²⁸ *United City Merchants (House of Lords)* (n4) 7 per Lord Diplock.

²²⁹ Bridge, 'Documents and contractual congruence' (n145) 235.

²³⁰ *United City Merchants (Court of Appeal)* (n188) 618 per Stephenson LJ. See also Ackner LJ's judgment at 628.

The bill of lading produced in *United City Merchants* told two lies about itself, namely the date and place of its creation.²³¹ It was properly regarded as a forgery. The question, therefore, was whether forgery of a third party – the loading broker – was sufficient to prevent payment under the credit. The Court of Appeal answered in the affirmative, citing the fact that a forged document, even if the beneficiary was unaware of the defects, was not a complying document.²³² Ackner LJ continued,

A banker cannot be compelled to honour a credit unless all the conditions precedent have been performed, and he ought not to be under an obligation to accept or pay against documents which he knows to be waste paper... The buyer's instructions to the banker must be construed as requiring the acceptance of valid documents only, and the banker's promise to the seller must be similarly construed.²³³

Lord Diplock firmly disapproved of this position on appeal noting that additional exceptions to autonomy would have a detrimental impact on international trade.

This proposition which does not call for knowledge on the part of the seller/beneficiary of the existence of any inaccuracy would embrace the fraud exception and render it superfluous...[T]he more closely this bold proposition is subjected to legal analysis, the more implausible it becomes; to assent to it would, in my view, undermine the whole system of financing international trade by means of documentary credits.²³⁴

The conclusive position with respect to forgery, therefore, is that it does not constitute an additional basis for refusing payment under the credit. Lord Diplock's analysis makes clear that the bank will be obliged to honour the presentation unless the forgery can be connected to the beneficiary at the time of presentation.²³⁵

²³¹ Ibid 618 per Stephenson LJ.

²³² Ibid 623 per Stephenson LJ, 628 per Ackner LJ.

²³³ Ibid 628 per Ackner LJ.

²³⁴ *United City Merchants (House of Lords)* (n4) 7 per Lord Diplock.

²³⁵ Ibid 7 per Lord Diplock.

Nullity

Wrongdoing by a party other than the credit beneficiary may render the document a nullity. A null document has no legal value and is essentially a worthless piece of paper.²³⁶ In *Kwei Tek Chao*, Devlin J considered that the relevant test was whether the alteration related “to the whole or to the essence of the instrument or not.”²³⁷ The focus, therefore, is whether the document is capable of serving its intended commercial function. The bill of lading in *United City Merchants*, despite the misstatements relating to the time and place of shipment, 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.”²³⁸ The document was thus not a nullity.

There are numerous examples of nullity in the case law. A document purporting to be issued by a company which does not exist would count as a nullity²³⁹, for example, as would a document signed by a person who honestly, but wrongly, believed he was entitled to do so.²⁴⁰ A bill of lading either covering non-existent cargo on a non-existent ship²⁴¹ or a forged bill covering existing cargo would equally count as nullities.²⁴² In certain circumstances, a forgery may additionally render a document a nullity, such as when the bill of lading was not issued by the company purporting to be the issuer²⁴³ and where a certificate of insurance is tendered without a valid policy.²⁴⁴

Nullities cause problems for parties taking the documents as security; the credit applicant and the issuing bank. The documents enable the ultimate buyer to take delivery and maintain subsequent actions in respect of damage.²⁴⁵ The documents also enable the paying bank to

²³⁶ *Montrod* (n31) [43] “worthless in the sense that it is not genuine and has no commercial value, whether as security for the goods or otherwise”

²³⁷ *Kwei Tek* (n222) 476 per Devlin J.

²³⁸ *United City Merchants (House of Lords)* (n4) 9 per Lord Diplock.

²³⁹ *Beam Technology (Mfg) Pte Ltd v Standard Chartered Bank* [2002] SGCA 53; D Neo, ‘A nullity exception in letter of credit transactions’ [2004] Sing JLS 46, 68.

²⁴⁰ *Montrod* (n31) [56].

²⁴¹ Todd, ‘Non genuine shipping documents’ (n162) 562; Todd, *Bills of Lading and Bankers Documentary Credits* (n111) [9.152], [9.156].

²⁴² As was the case in *Motis Exports Ltd v Dampskibsselskabet AF 1912 Aktieselskab and Aktieselskabet Dampskibsselskabet Svendborg* [2000] 1 Lloyd’s Rep. 211, 217 per Mance LJ.

²⁴³ Goode, ‘Abstract payment undertakings’ (n29) 231.

²⁴⁴ *Ibid* 231.

²⁴⁵ Bridge, *Benjamin* (9th ed.) (n1) [18-008], [18-018]; Todd, *Bills of Lading and Bankers Documentary Credits* (n111) [5.5].

recoup its losses in the event of the applicant's insolvency prior to reimbursement.²⁴⁶ These actions are impossible where the documents are nullities. Whether nullities constitute a further basis for denying payment is, therefore, critical.

Lord Diplock did not conclusively resolve the nullity question in *United City Merchants*.²⁴⁷ The issue subsequently came before the Court of Appeal in *Montrod v Grundkötter*.²⁴⁸ The credit stipulated that an inspection certificate should be signed by the credit applicant. During the transaction, however, the beneficiary was mistakenly led to believe that it could sign the certificate on behalf of the applicant. It duly did so. The credit applicant argued for a nullity exception which would enable presentations to be rejected which contained documents which were "not genuine and ha[d] no commercial value."²⁴⁹ This was unanimously rejected by the Court of Appeal,

The creation of a general nullity exception, the formulation of which does not seem to me susceptible of precision, involves making undesirable inroads into the principles of autonomy and negotiability universally recognised in relation to letter of credit transactions...Further such an exception would be likely to act unfairly upon beneficiaries participating in a chain of contracts in cases where their good faith is not in question. Such a development would thus undermine the system of financing international trade by means of documentary credits.²⁵⁰

As it stands, therefore, a document which is a nullity or has been forged must be accepted as good currency unless the defect can be connected to the beneficiary in time.²⁵¹ This undermines the doctrine of strict compliance since it is difficult to see how forged or null documents could ever be regarded as those required by the credit. Nevertheless, the courts have justified their refusal to create further exceptions to autonomy by the need to ensure

²⁴⁶ As recognised in *Beam Technology* (n239) [33]; *Lorenzon* (n54) 116.

²⁴⁷ *United City Merchants (House of Lords)* (n4) 9 per Lord Diplock.

²⁴⁸ *Montrod* (n31).

²⁴⁹ *Ibid* [43].

²⁵⁰ *Ibid* [58] per Potter LJ.

²⁵¹ *United City Merchants (House of Lords)* (n4) 7 per Lord Diplock.

that the credit remains an unassailable payment mechanism.²⁵² The difficulties created by this analysis and an alternative approach to nullities will be considered in Chapter Five.

The discussion now reverts to the criteria the claimant will need to establish to invoke the fraud exception. The third of these – reliance and loss – considers the impact of the fraud on the claimant’s behaviour. This is not a particularly difficult hurdle to meet in English law.

iii. Reliance and loss

An ordinary claim in the tort of deceit will require the claimant to prove that they relied on the misrepresentation and subsequently suffered loss.²⁵³ This has to some extent been modified by the recent decision in *Hayward v Zurich*.²⁵⁴ The Supreme Court held that this element of the test would be satisfied where the claimant had been influenced by the misrepresentation.²⁵⁵ The application of these requirements in the context of the fraud exception depends on whether the bank has made payment.

Where payment is outstanding, the claimant – either the beneficiary (situation 1) or the applicant (situations 4a and b) - need show only the potential loss that would have occurred had the bank made payment. This was considered in *Rafsanjan Pistachio* where the bank had refused payment due to fraud (situation 1). The beneficiary contended that the reliance requirement would only be satisfied where the bank had actually made payment.²⁵⁶ Hirst J swiftly disposed of this argument stating that it “demonstrate[d] a complete misconception of the relevant principle.”²⁵⁷ He further held that the bank had established potential reliance on the basis of “unanimous evidence of all the bank’s witnesses”²⁵⁸ and an objective appreciation of the circumstances. This must be the correct approach. If actual reliance had

²⁵² Ibid 7 per Lord Diplock (forgery); *Montrod* (n31) [58] per Potter LJ (nullity). See later, Chapter Five, where it will be argued that the judicial approach to forgery and nullity undermine the rationale for a narrow fraud exception.

²⁵³ *Standard Chartered Bank v Pakistan National Shipping Corp. (No. 2)* [1998] 1 Lloyd’s Rep. 684, 704 per Cresswell J; M Jones, A Dugdale and M Simpson (eds.), *Clerk and Lindsell on Torts* (21st ed. Sweet & Maxwell, 2015) [18-01].

²⁵⁴ *Hayward v Zurich Insurance Co.* [2016] UKSC 48.

²⁵⁵ Ibid [67], [71] per Lord Toulson.

²⁵⁶ *Rafsanjan* (n202) 542.

²⁵⁷ Ibid 542 per Hirst J.

²⁵⁸ Ibid 542 per Hirst J.

to be established prior to payment, it would be impossible for an interim injunction to be issued in any circumstances.²⁵⁹

The position is necessarily different when the bank has made payment. Where the bank attempts to recover from the beneficiary in the tort of deceit (situation 3), it will need to demonstrate actual reliance and loss. This is not a difficult burden to satisfy.²⁶⁰ Indeed, it was held in *Komerčni Banka v Stone & Rolls* that acceptance of the documents by the bank constituted reliance on the beneficiary's fraudulent statements.²⁶¹ The issue of reliance will be similarly straightforward where the bank seeks reimbursement from his customer (situation 2).

A fourth criterion – that the fraud be patent to the bank – is required in certain circumstances. This requirement must be demonstrated if the applicant wishes to resist reimbursement (situation 2). It is also relevant in two cases where payment is outstanding; where the bank defends non-payment on the basis of fraud (situation 1) and where the applicant seeks an injunction against the issuing bank (situation 4a).

iv. Fraud known to the bank

In the earlier discussion, the fraud exception was said to depend on two juridical bases; *ex turpi causa* and an implied term. The supplementary analysis – the implied term – was required to account for the fact that in certain circumstances, the fraud exception requires proof of the bank's knowledge of fraud at the time it made payment.²⁶² If, for example, the judicial desire was simply to prevent its processes being used by dishonest litigants, the knowledge requirement would be unnecessary.²⁶³ It appears therefore, that this requirement serves only to increase the already considerable burden on the claimant and correspondingly reduce the likelihood of judicial intervention. Accordingly, Rix J proposed an amendment to *ex turpi causa* in *Czarnikow-Rionda*,

²⁵⁹ Ibid 542 per Hirst J; Enonchong, *The Independence Principle* (n2) [5.47].

²⁶⁰ Enonchong, *The Independence Principle* (n2) [5.48].

²⁶¹ *Komerčni Banka v Stone & Rolls* [2003] 1 Lloyd's Rep. 383, 400 per Toulson J.

²⁶² *Czarnikow-Rionda* (n165) 203 per Rix J.

²⁶³ Ibid 203 per Rix J.

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 requirements provided that the bank knows in time of the beneficiary's fraud.²⁶⁴

The critical question in relation to this criterion is one of timing; when must the bank have knowledge of the fraud? The answer depends on the circumstances in which fraud is pleaded. The issuing bank is only entitled to reimbursement where it has paid without notice of the fraud. Accordingly, to resist a claim for reimbursement in situation (2), the applicant must prove that the bank knew of the fraud before it made payment. This was established in *United Trading v Allied Arab Bank*,²⁶⁵

where payment has in fact been made, the bank's knowledge that the demand made by the beneficiary on the performance bond was fraudulent must exist prior to the actual payment to the beneficiary and that its knowledge at that date must be proved. Accordingly, if all a plaintiff can establish is such knowledge *after* payment, then he has failed to establish his cause of action. The bank would not have been in breach of any duty in making the payment without the requisite knowledge. We doubt that this is really open to contest.²⁶⁶

The timing issue has proved more difficult in circumstances where payment is yet to be made, as in situations 1 and 4a. In general terms, *Edward Owen Engineering v Barclays* is authority for the proposition that the bank can only refuse payment where it had knowledge at the time of the demand.²⁶⁷ A problem arises, however, where a bank suspects fraud but can only justify rejection of documents with evidence gathered between the time of presentation and trial. The courts have struggled to determine whether subsequently acquired evidence should be admissible for the purposes of the fraud exception.

²⁶⁴ Ibid 199 per Rix J.

²⁶⁵ *United Trading Corporation v Allied Arab Bank Ltd* [1985] 2 Lloyd's Rep 554.

²⁶⁶ Ibid 560 per Ackner LJ.

²⁶⁷ *Edward Owen* (n31) 172 per Lord Denning MR, 173 per Browne LJ.

In *Bolivinter v Chase Manhattan*, it was suggested obiter that evidence acquired after the bank's refusal to pay should be sufficient to invoke the fraud exception,²⁶⁸

...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.²⁶⁹

When the issue was subsequently considered in *Balfour Beatty v Technical & General*,²⁷⁰ Waller LJ felt constrained by the general proposition established in *Edward Owen*.²⁷¹ He did concede, however, that it would be absurd if the bank could not rely on evidence unearthed after the refusal to pay as this would effectively require the court to assist the fraudster.²⁷² To resolve this difficulty, Waller LJ suggested that if the bank was able to prove fraud by the time of the hearing, it would have a cause of action for fraudulent misrepresentation against the beneficiary.²⁷³ If the bank then obtained summary judgment in respect of the misrepresentation, this would cancel out any liability which it otherwise owed to the beneficiary.²⁷⁴

The circuitry of Waller LJ's solution²⁷⁵ prompted Mance LJ to search for a more straightforward alternative in *Solo Bank v Canara*.²⁷⁶ He suggested that the court should simply use its general power to protect its processes from fraud in these circumstances. To do otherwise "would affront good sense, and probably general principles relating to illegality, if Courts were obliged to give judgment in favour of a beneficiary now shown to be acting fraudulently."²⁷⁷

²⁶⁸ *Bolivinter* (n96) 256 per Sir John Donaldson MR.

²⁶⁹ *Ibid* 256 per Sir John Donaldson MR.

²⁷⁰ *Balfour Beatty Civil Engineering v Technical & General Guarantee Co Ltd* [2000] CLC 252.

²⁷¹ *Ibid* 259 per Waller LJ.

²⁷² *Ibid* 259 per Waller LJ.

²⁷³ *Ibid* 259 per Waller LJ.

²⁷⁴ *Ibid* 260 per Waller LJ.

²⁷⁵ See the critiques of this analysis in N Enonchong, 'The autonomy principle of letters of credit: An illegality exception?' [2006] LMCLQ 404, 415-416; Todd, *Maritime Fraud & Piracy* (n3) [4.075].

²⁷⁶ *Solo Industries Ltd v Canara Bank* [2001] 2 Lloyd's Rep. 578.

²⁷⁷ *Ibid* [21] per Mance LJ.

This was subsequently endorsed in *Mahonia v JP Morgan Chase Bank*.²⁷⁸ The simplicity of this approach is, as Enonchong has argued, “preferable”²⁷⁹ to the solution advanced in *Balfour Beatty*, not least because it accords with the overarching basis of the fraud exception.

E. Standards of proof

A discussion of the standard of proof requires us to distinguish what must be proved at trial and at the interlocutory stage. Regardless of the stage at which the exception is invoked, the standard of proof places a considerable burden on the claimant.²⁸⁰ It is convenient to discuss standards of proof together before going on, in Part F, to consider the additional procedural requirements for injunctive relief.

As a civil issue, the normal standard of proof applies at trial; the balance of probabilities. This is subject to jurisprudence suggesting that the standard is heightened in cases involving more serious allegations. The leading case is *Hornal v Neuberger* in which fraudulent misrepresentation was alleged.²⁸¹ Following a review of the authorities, the Court of Appeal concluded that an intermediate standard of proof was appropriate,

The more serious the allegation the higher the degree of probability that is required: but it need not, in a civil case, reach the very high standard required by the criminal law.²⁸²

As noted in the insurance discussion, the standard of proof was subsequently considered in *Re H (Minors)*.²⁸³ The House of Lords determined that the ordinary civil standard remained applicable in serious cases, but that more “cogent evidence”²⁸⁴ would be required to convince a court that the alleged event had occurred.²⁸⁵ This has been universally accepted as applicable in documentary credit cases.²⁸⁶ Interestingly, and unlike the position in insurance,

²⁷⁸ *Mahonia Ltd (2003)* (n164) [46] per Colman J.

²⁷⁹ Enonchong, ‘The autonomy principle – illegality’ (n275) 415; Enonchong, *The Independence Principle* (n2) [5.61].

²⁸⁰ Enonchong, ‘The autonomy principle – illegality’ (n275) 413.

²⁸¹ *Hornal v Neuberger* [1957] 1 QB 247

²⁸² *Ibid* 258 per Denning LJ.

²⁸³ *Re H (Minors)* [1996] AC 563, 586-587 per Lord Nicholls.

²⁸⁴ *Ibid* 586 per Lord Nicholls citing *In re Dellow’s Will Trusts* [1964] 1 WLR 451, 455 per Ungood-Thomas J.

²⁸⁵ *Re H* (n283) 586 per Lord Nicholls.

²⁸⁶ Malek and Quest, *Jack* (n32) [9.32]; McKendrick, *Goode on Commercial Law* (n108) 1102.

the appropriateness of an intermediate standard has not been questioned in the trade finance context. This is probably because few fraud cases come before the courts. There is no reason, however, that Hjalmarsson's arguments made in the insurance context would not be equally relevant in respect of documentary credits.²⁸⁷ Allegations of fraud by the beneficiary do not raise any human rights issues that would make the defendant worthy of the protection afforded by a higher standard of proof.²⁸⁸

The position is more complicated when an injunction is sought to prevent the bank from making payment (situation 4a) or to prevent the beneficiary presenting documents for payment (situation 4b). The courts have struggled to enunciate the appropriate standard of proof in these circumstances. Various expressions appear in the case law including that there must be proof of "established or obvious fraud"²⁸⁹, a "real prospect"²⁹⁰ of establishing fraud and "a good arguable case that on the material available the only realistic inference" is that the beneficiary was fraudulent.²⁹¹ However expressed, the burden will not be discharged by an "uncorroborated statement of the customer."²⁹² This is a high threshold which is indicative of the tension between the autonomy principle and an attainable standard of proof.²⁹³

There has also been some discussion about whether there should be a lower standard of proof when an injunction is sought to prevent the beneficiary tendering documents (situation 4b). Waite LJ favoured a lower standard in these circumstances in *Themehelp*, arguing that where the beneficiary was yet to seek payment, an injunction would not pose the "slightest threat...to autonomy".²⁹⁴ The Court of Appeal in *Group Josi Re* criticised this approach, however, holding that "the effect on the lifeblood of commerce will be precisely the same whether the bank is restrained from paying or the beneficiary is restrained from asking for

²⁸⁷ J Hjalmarsson, 'The standard of proof in civil cases: An insurance fraud perspective' (2013) 17 Int J E&P 47. See earlier discussion, Chapter Two, text to fn 374 et seq.

²⁸⁸ Ibid 63, 71.

²⁸⁹ *Edward Owen* (n31) 169 per Denning LJ.

²⁹⁰ *Solo Industries* (n276) 1815-1816 per Mance LJ.

²⁹¹ *United Trading* (n265) 561 per Ackner LJ.

²⁹² *Bolivinter* (n96) 257 per Sir John Donaldson MR.

²⁹³ McKendrick, *Goode on Commercial Law* (n108) 1102.

²⁹⁴ *Themehelp* (n211) 99 per Waite LJ. This approach was endorsed in *Czarnikow-Rionda* (n165) 202 per Rix J.

payment.”²⁹⁵ Academic commentary also appears to favour a single test.²⁹⁶ The approach in *Themehelp* is perhaps best regarded as an aberration given that the doctrine of autonomy demands that payment is only disrupted in the most exceptional of circumstances.²⁹⁷

In *Alternative Power Supply*, the Privy Council reviewed the authorities and proposed the following test,

it must be clearly established at the interlocutory stage that the only realistic inference is (a) that the beneficiary could not honestly have believed in the validity of its demands under the letter of credit and (b) that the bank was aware of the fraud.²⁹⁸

The “only realistic inference”²⁹⁹ standard is necessarily lower than the burden the applicant would need to discharge at trial.³⁰⁰ This does not mean, however, that the applicant is more likely to succeed at the interim stage. This is because the UCP requires banks to determine documentary compliance within five banking days³⁰¹ which significantly increases the practical burden of proof for the applicant.³⁰² In any event, the applicant will also need to satisfy the court of additional matters, discussed in Part F, to obtain an interim injunction.

The Privy Council’s insistence on the bank’s knowledge is also interesting since this would be an unnecessary criterion if the purpose of the fraud exception was simply to prevent fraud.³⁰³

The knowledge requirement perhaps further confirms the judicial preference for the

²⁹⁵ *Group Josi Re (Court of Appeal)* (n160) 361 per Staughton LJ. See also the judgment at first instance, *Group Josi Re v Walbrook* [1995] 1 WLR 1017, 1030 per Phillips J stating that to establish different tests would “rob the beneficiary of much of the benefit which a letter of credit is intended to bestow.”

²⁹⁶ Favourable views are found in Brindle and Cox (n29) 732. But for the opposing view see McKendrick, *Goode on Commercial Law* (n108) 1099; Todd, *Maritime Fraud & Piracy* (n3) [4.083]; Malek and Quest, *Jack* (n32) [9.77].

²⁹⁷ *Group Josi Re (Court of Appeal)* (n160) 361 per Staughton LJ; *Group Josi Re (First Instance)* (n295) 1030 per Phillips J. See also *Sirius Insurance Co v FAI General Insurance Ltd* [2003] EWCA Civ 470; [2003] 1 WLR 2214, [31] per May LJ, [34] per Carnwarth LJ. This was not discussed by the Privy Council in *Alternative Power* (n156).

²⁹⁸ *Alternative Power* (n156) [59] per Lord Clarke. The decision was referred to in *National Infrastructure Development Company Ltd v Banco Santander SA* [2016] EWHC 2990 (Comm) but the Court did not express any opinion about the correctness of the Privy Council’s discussion of fraud.

²⁹⁹ *Alternative Power* (n156) [59] per Lord Clarke.

³⁰⁰ *Czarnikow-Rionda* (n165) 202 per Rix J.

³⁰¹ UCP 600 art. 14(b).

³⁰² Todd, *Maritime Fraud & Piracy* (n3) [4.008]; G McMeel, ‘Letters of credit and the fraud exception – the threshold test for injunctive relief’ [2015] LMCLQ 19, 22.

³⁰³ This underlines the importance of the implied term analysis as an additional explanation of judicial intervention in cases of fraud. See earlier discussion, text to fn 166.

autonomy of the mechanism, expressed as the “integrity of banking contracts”³⁰⁴ in *Czarnikow-Rionda*. From a practical perspective, this additional requirement increases the burden on the party wishing to invoke the fraud exception and makes it less likely that he will overcome the “strong presumption in favour of the fulfilment of the independent banking commitments.”³⁰⁵

F. The injunction

In situation 4, the applicant seeks an injunction against either the paying bank or the beneficiary. Where the injunction targets the beneficiary, the conclusion of these proceedings will also be of interest to the issuing bank.³⁰⁶ This is because the outcome will enable the bank to act confidently in its decision to honour the credit or to refuse payment.³⁰⁷ Further criteria, derived from the House of Lords’ decision in *American Cynamid v Ethicon*,³⁰⁸ are relevant at the interim stage. Claimants will be subjected to a three-stage test; i) the merits of the evidence, ii) the adequacy of damages as a remedy and iii) the overall balance of convenience. This is a difficult test and many applicants fall at the first hurdle, failing to prove fraud to the requisite standard.

i. *The merits of the evidence*

A claim of fraud at the interim stage must be proved according to the test established in *Alternative Power Supply*, discussed above.³⁰⁹ In relation to the quality of evidence required, the following comments made by Ackner LJ in *United Trading* are useful,

...strong corroborative evidence of the allegation, usually in the form of contemporary documents, particularly those emanating from the buyer [the beneficiary of the performance bond]...For the evidence of fraud to be clear, we would also expect the buyer to have been given the opportunity to answer the allegation and to have failed

³⁰⁴ *Czarnikow-Rionda* (n165) 202 Rix J.

³⁰⁵ *Ibid* 202 Rix J.

³⁰⁶ *Malek and Quest, Jack* (n32) [9.40].

³⁰⁷ *Ibid* [9.40].

³⁰⁸ *American Cynamid Co v Ethicon* [1975] AC 396.

³⁰⁹ *Alternative Power* (n156) [59] per Lord Clarke; see earlier discussion, text to fn 298.

to provide any, or any adequate answer in circumstances where one could properly be expected.³¹⁰

The notion that the alleged fraudster should be given “a fair and proper opportunity”³¹¹ to rebut the allegations has been endorsed by academic commentators.³¹²

This places a considerable burden on the claimant, not least because the evidence must be gathered within the five banking days allowed for document examination.³¹³ It is unsurprising, therefore, that there are “vanishingly rare”³¹⁴ examples of claimants satisfying this first criterion for injunctive relief. Indeed, the author is aware of only one case involving a traditional letter of credit where the claimant adduced sufficient evidence in time. In that case – *Tukan Timber*³¹⁵ - the credit required that receipts were signed by one of the buyer’s two directors and it was successfully established that signatures in respect of two presentations were forged. The second presentation was “manifestly...crude and plainly dishonest.”³¹⁶ The Court held that the seller-beneficiary could only have inferred that these documents – which he then went on to present for payment – were not what they appeared to be.³¹⁷ Although the injunction was not ultimately granted,³¹⁸ *Tukan Timber* is a useful example of “one of those very, very rare cases wherein the strict burden of proof was satisfied”.³¹⁹

³¹⁰ *United Trading* (n265) 561 per Ackner LJ; It should be noted that *United Trading* concerned a performance bond and not a letter of credit and so it was the seller seeking to prevent banks making payment under the bond. The jurisprudence relating to the fraud exception has developed in tandem in relation to these autonomous bank undertakings. See *United City Merchants (House of Lords)* (n4) 6 per Lord Diplock.

³¹¹ *United Trading* (n265) 561 per Ackner LJ.

³¹² Horowitz (n100) [5.43] describing the approach as “commendable”; McMeel (n302) 21.

³¹³ UCP 600 art. 14(b).

³¹⁴ McMeel (n302) 21.

³¹⁵ *Tukan Timber* (n31).

³¹⁶ *Ibid* 176 per Hirst J. One of the documents was purportedly signed in 1983 but bore the new name of the company which had not been registered until December 1984. The document also bore the same date as an earlier rejected document.

³¹⁷ *Ibid* 176 per Hirst J.

³¹⁸ *Ibid* 177 per Hirst J noting that the applicant had failed to prove that the beneficiary would have made a third presentation under the credit and “I should, in the exercise of my discretion, have refused the order sought, applying the *American Cynamid Co. v. Ethicon* principles.”

³¹⁹ *Ibid* 176 per Hirst J. Although the beneficiary met the necessary standard of proof, he was unable to satisfy the remaining criteria for the grant of an injunction. Cases in which the first criterion has been satisfied in relation to a performance bond include *Themehelp* (n211) 91-93, 100 per Waite LJ and in relation to a standby letter of credit in *Kvaerner John Brown Ltd v Midland Bank plc [1998] CLC 446*, 450 per Cresswell J.

ii. *The adequacy of damages as a remedy*

Where sufficient evidence of fraud has been established, the court will consider the second limb of *American Cyanamid*; whether damages would be an adequate remedy in lieu of an injunction.³²⁰ If damages would be an adequate remedy for the applicant, the injunction will be refused no matter how strong his *prima facie* case may be.³²¹ Damages will very often be considered adequate, particularly where the party to be enjoined has the capacity to compensate the applicant.³²² This will almost certainly be the case in actions against the bank as evidenced by the decisions in *Discount Records*³²³ and *GKN Contractors*.³²⁴

If a remedy in damages would not be adequate for the credit applicant, the court must then consider the defendant's position. The courts will need to determine whether damages would adequately compensate the defendant bank or beneficiary if it subsequently won at trial. This aspect of the test makes it "highly unlikely"³²⁵ that an injunction will be issued. This is because reputational damage caused to the bank as a result of non-payment will be difficult to remedy by way of a payment in damages.³²⁶ Indeed, this was the reason the injunction was refused in *Tukan Timber*; any damage to the bank was not compensable by the plaintiff's cross-undertaking in damages.³²⁷

iii. *The overall balance of convenience*

The final element of the *American Cyanamid* test is the overall balance of convenience. It requires courts to consider whether the grant or refusal of an injunction is least likely to result in injustice.³²⁸ This is a considerable hurdle for the applicant to overcome. Reference is

³²⁰ *American Cyanamid* (n308) 408.

³²¹ *Ibid* 408.

³²² Enonchong, *The Independence Principle* (n2) [10.26].

³²³ *Discount Records* (n27) 320.

³²⁴ *GKN Contractors v Lloyd's Bank* (1985) 30 BLR 48, 51.

³²⁵ Bridge, *Benjamin* (9th ed.) (n1) [24-31]; *Alternative Power* (n156) [79] per Lord Clarke.

³²⁶ M Bridge, *Benjamin's Sale of Goods* (8th ed. Sweet & Maxwell, 2010) [24-028].

³²⁷ *Tukan Timber* (n31) 176.

³²⁸ Bridge, *Benjamin* (8th ed.) (n326) 24-028; Malek and Quest, *Jack* (n32) [9.74] "it will be considered whether more harm will be done by granting or refusing the injunction."

commonly made to Kerr J's speech in *Harbottle* in which he described this task as constituting an "insuperable difficulty...[in which]...The balance of convenience would...be hopelessly weighted against the plaintiffs."³²⁹

In documentary credit disputes, one would expect to see the same factors being weighed by the courts.³³⁰ These include the autonomy of the payment mechanism and potential damage to the bank's reputation.³³¹ Subsequent difficulty for the applicant-buyer to recover under the contract of sale if fraud is substantiated at trial will also be relevant, although the courts have generally been unpersuaded that such difficulty justifies an injunction. In *Harbottle*, Kerr J commented that "these are risks which the merchants take...This is unfortunate for the plaintiffs, but it is what they have agreed."³³² Two further factors are likely to reduce the applicant's chance of success, namely if the credit will expire during the currency of the injunction³³³ and the availability of a freezing injunction over the beneficiary's assets.³³⁴ The latter course of action is particularly advantageous since it will provide some protection to the applicant and, as the case law suggests, does not threaten the autonomy of the credit mechanism.³³⁵

The balance of these factors is not a neutral exercise, but starts from "a strong presumption in favour of the fulfilment of the independent banking commitments."³³⁶ Indeed, a consideration of these factors led Rix J to comment on the difficulty of achieving interim relief,

I do not know that it can be affirmatively stated that a Court would never, as a matter of balance of convenience, injunct a bank from making payment under its letter of

³²⁹ *Harbottle* (n31) 155 per Kerr J.

³³⁰ *Malek and Quest, Jack* (n32) [9.75].

³³¹ *Ibid* [9.75].

³³² *Harbottle* (n31) 155-156 per Kerr J.

³³³ *Enonchong, The Independence Principle* (n2) [10.27]. See, *Permasteelisa Japan KK v Bougesstroi Banca Intesa SpA* [2007] EWHC 3508 (QB); *Themehelp* (n211) 106 per Balcombe LJ.

³³⁴ Senior Courts Act 1981 s.37; *Malek and Quest, Jack* (n32) [9.82]; *Czarnikow-Rionda* (n165) 203 per Rix J (noting that the availability of Mareva relief was "a highly important consideration and goes very far to undermine his [the claimant's] complaint about the difficulties of his position.")

³³⁵ *Z Ltd v A-Z* [1982] QB 558, 574 per Lord Denning MR; *Bolivinter* (n96) 257 per Sir John Donaldson MR; *Themehelp* (n211) 103 per Evans LJ; *Czarnikow-Rionda* (n165) 203-204 per Rix J. But see the majority reasoning in *Themehelp* (n211) 100-101 per Waite LJ and 107 per Balcombe LJ.

³³⁶ *Czarnikow-Rionda* (n165) 202 per Rix J. Confirmed in *Alternative Power* (n156) [59] per Lord Clarke.

credit...All that can be said is that the circumstances in which it should be done have not so far presented themselves, and that it would of necessity take extraordinary facts to surmount this difficulty.³³⁷

Even where the claimant has successfully established fraud to the requisite standard, itself not an easy task, these concerns will generally extinguish the claim.³³⁸ The courts have expressed concern that if interim injunctions were more readily attainable, it “would risk endangering confidence in the integrity of the system of financing international trade”³³⁹ based on autonomous undertakings. There is also concern that banks would suffer in reputational terms if injunctions were more readily available,³⁴⁰ though it is difficult to imagine any reputational damage if non-payment resulted from a court order.³⁴¹ The broader contractual context of the credit further complicates a claim for injunctive relief. In *Discount Records*,³⁴² the alleged fraud was uncovered in front of a representative of the issuing bank but it was likely that the beneficiary had already received payment by discounting the credit before the maturity date. An injunction in these circumstances would not have affected the fraudster but only have prevented reimbursement of the confirming bank. Undoubtedly, banks would become less willing to finance transactions by documentary credit if the losses flowing from fraud were borne by the confirming institution.

Applicants have only been successful in obtaining an injunction in cases involving a standby credit.³⁴³ It is submitted that although the claimant will need to satisfy the same procedural requirements irrespective of the type of credit, the judicial appreciation of the remaining criteria will differ. Ellinger and Neo have argued convincingly that the critical point is the

³³⁷ *Czarnikow-Rionda* (n165) 204 per Rix J.

³³⁸ *Alternative Power* (n156) [79] per Lord Clarke: “the reasons why reported cases of injunctions being granted (or continued) under the fraud exception are so rare are (a) because it is almost never possible to establish the test for fraud as opposed to a mere possibility of fraud, but also (b) because the balance of convenience will almost always militate against the grant of an injunction.”

³³⁹ *Bridge, Benjamin* (8th ed.) (n326) 24-028 citing *Discount Records* (n27) 320, *Bolivinter* (n96) 257 per Sir John Donaldson MR and *Czarnikow-Rionda* (n165) 204 per Rix J.

³⁴⁰ *Bolivinter* (n96) 257 per Sir John Donaldson MR. See also *McMeel* (n302) 23.

³⁴¹ *Malek and Quest, Jack* (n32) [9.75].

³⁴² *Discount Records* (n27). See also *Czarnikow-Rionda* (n165) in which the beneficiary had already received payment via the negotiating or confirming banks. Rix J noted at 204-205 that the injunction would only serve to prevent the reimbursement of those banks and would not hamper the alleged fraudster.

³⁴³ See *Kvaerner John Brown* (n319); *Themehelp* (n211).

relative importance of payment to the beneficiary.³⁴⁴ In a documentary credit, the beneficiary will expect payment on the presentation of conforming documents and delay may impact his ongoing ability to trade.³⁴⁵ By contrast, prompt payment is less critical for the beneficiary of a standby credit. This is because the standby beneficiary cannot know at the outset whether his counterpart will fail to perform and consequently whether he will need to draw on the credit. Accordingly, non-payment of the credit in these circumstances would have a much lesser impact for the standby beneficiary than his counterpart under a traditional credit.³⁴⁶

IV. Conclusion

The documentary credit provides parties trading overseas with a reliable payment mechanism and mitigates many of the risks involved in international trade. The credit can serve the purposes of the commercial community due to the principles of autonomy and strict compliance which facilitate a mechanism built on speed and certainty. The credit is, however, unable to solve all the risks inherent in international trade. A major unresolved risk relates to the possibility that the credit beneficiary will engage in fraud. This risk is borne by the buyer which the courts suggest is mitigated through careful *ex ante* screening.

The UCP is silent as to the impact fraud by a beneficiary will have on the credit transaction. The English courts have recognised a fraud exception to autonomy which can be invoked in interim proceedings and at trial. This responds to public policy concerns to ensure that fraudulent litigants are not able to profit from their dishonesty. It is evident that in balancing the need to promote international trade and the deterrence of fraud, the English courts have had the interests of the commercial community at the forefront. The result is a narrow exception coupled with onerous procedural requirements.³⁴⁷ There is no doubt that the courts have prioritised “considerations of speed and convenience, [which] override[] those of security.”³⁴⁸ The result, as Todd has argued, may well be that “many claims which are in fact

³⁴⁴ Ellinger and Neo (n35) 163.

³⁴⁵ Ibid 163.

³⁴⁶ Ibid 163.

³⁴⁷ Todd, *Maritime Fraud & Piracy* (n3) [4.008].

³⁴⁸ Ibid [4.008].

fraudulent [will] succeed.”³⁴⁹ The credit applicant remains entitled to bring an action for breach on the underlying contract of sale, although the success of this action will depend on the availability and honesty of the credit beneficiary.³⁵⁰

The narrow parameters of the fraud exception were justified by reference to the commercial importance of a swift, unassailable payment mechanism. The following chapter critiques the judicial construction of the fraud rule and thereby addresses the third research question. In particular, it will suggest that the balance drawn by the English courts is not inevitable.³⁵¹ Subsequent courts have reiterated the *United City Merchants* analysis without considering the more expansive approaches adopted elsewhere or the unfortunate consequences that this analysis creates for international trade. A further critique is built upon empirical work conducted in the United States.³⁵² This research demonstrates that commercial parties use the credit mechanism more informally than doctrine suggests. This will be used to develop an argument that fraud deterrence is not merely a pre-contractual issue, as the courts have suggested, but that mechanisms exist throughout the exchange to control fraud. As it stands, “a successful plea of fraud appears to be illusory.”³⁵³ The totality of the arguments presented in Chapter Five demonstrate that a different policy balance could be drawn; indeed, a balance which gives greater credence to the notion that ‘fraud unravels all.’

³⁴⁹ Ibid [4.056].

³⁵⁰ Todd, ‘Outlawing dishonest international traders’ (n119) 394; Todd, *Maritime Fraud & Piracy* (n3) [4.041].

³⁵¹ Todd, *Maritime Fraud & Piracy* (n3) [4.014].

³⁵² Mann, ‘The role of letters of credit’ (n8).

³⁵³ WS Chong, ‘The abusive calling of performance bonds’ [1990] JBL 414, 416.

Chapter Five

Documentary Credits: A Critique of the Judicial Response to Fraud

The phrase ‘fraud unravels all’ does not adequately explain the effect of beneficiary fraud in the documentary credit context. There are, after all, no examples of a credit applicant successfully invoking the exception to prevent payment and the necessary procedural requirements are particularly onerous. As the discussion in the previous chapter demonstrated, the limited scope of the exception is the result of the courts weighing two competing policy concerns; the autonomy of the credit and fraud prevention.¹

In the English context, this balance has been drawn in favour of the doctrine of autonomy.² The fraud exception is narrow, permitting judicial intervention to restrain payment only in the most exceptional of cases and only when the fraud can be connected to the beneficiary. Given its design as a swift, unassailable payment mechanism, the credit demands minimal inroads into the doctrine of autonomy. This has been used by the courts to justify the limited confines of the fraud exception.

The starting point adopted by MacDonald Eggers in his work on deceit was the suggestion that rules on fraud developed to deter lying in the commercial and social sphere.³ In the credit context, however, the courts have consistently eschewed the notion that the fraud exception serves any instrumental purpose relating to deterrence.⁴ This makes sense when we consider that the exception is most commonly invoked to allocate losses between two innocent parties and will only rarely target the fraudster directly.⁵ It is, after all, difficult to see how a legal rule could function as a deterrent if it does not target the wrongdoer. The courts have therefore allocated responsibility for fraud deterrence to the parties as an aspect of pre-contractual

¹ N Enonchong, *The Independence Principle of Letters of Credit and Demand Guarantees* (OUP, 2011), [1.03]-[1.05]

² This is the same decision as was reached in the United States, see *Asbury Park & Ocean Cove Bank v National City Bank* 35 NYS 2d 985 (Sup Ct 1942) per Shientag J: “the efficacy of the letter of credit as an instrument for financing trade is the primary consideration.”

³ P MacDonald Eggers, *Deceit: The Lie of the Law* (Informa law, 2009), [1.4].

⁴ *Sanders v Maclean* (1883) 11 QBD 327, 343 per Bowen LJ.

⁵ See earlier, Chapter Four, text to fn 144.

negotiations.⁶ If the current legal framework is to be charged with any instrumental purpose, perhaps it is to encourage parties to take more effective precautions *ex ante*.⁷

The rationale of the narrow fraud exception – the needs of the commercial community – is a perfectly legitimate guideline for the trade finance courts. There has not, however, been any consideration of whether the fraud exception actually serves this purpose. The discussion in this chapter fills this gap. Two arguments will be developed to contend that commercial need does not dictate the restrictive parameters imposed by the English courts. A third argument then challenges the judicial view that fraud deterrence in credit transactions is confined to the pre-contractual stage. For convenience, the arguments are summarised here:

1. In comparison to the English rule, the fraud exception in the United States encompasses a much broader range of behaviour and the criteria for injunctive relief are less onerous. This more expansive approach has not reduced the popularity of the credit mechanism and has not adversely affected the banking system. This undermines the English insistence on a narrow rule for reasons of commercial need.
2. In setting the limits of the fraud exception in *United City Merchants*,⁸ the House of Lords misstated the contractual basis of the credit and conflated distinct issues of documentary compliance and defences to payment. This has resulted in consequences which are detrimental to commercial need which are difficult to equate with the rationale of the fraud exception.
3. Empirical work on documentary credits demonstrates that parties use the credit in a radically different manner than predicted by doctrine. This forces a reconsideration of fraud deterrence in credit transactions. It is argued that mechanisms to counter fraud

⁶ *Sanders* (n4) 343 per Bowen LJ.

⁷ A similar argument has been made in an analysis of the general contract law, see E Zamir and B Medina, *Law, Economics, and Morality* (OUP, 2010), 287: “if deception produces any positive outcomes at all, these outcomes are...: incentivizing people to ex ante obtain socially beneficial information, disseminating information in the market, or facilitating efficient contracting.”

⁸ *United City Merchants v Royal Bank of Canada (The American Accord)* [1982] 2 Lloyd’s Rep. 1 (hereafter referred to as *United City Merchants (House of Lords)*).

exist throughout the exchange relationship, and not simply *ex ante* as the courts contend.

I. The American Approach to Fraud

The widespread use of the Uniform Customs and Practice (UCP 600)⁹ has, to a considerable extent, harmonised the legal framework relating to credits. The UCP, however, makes no provision for fraud, considering that this is a task for which national jurisdictions are best equipped.¹⁰ The effect of fraud by the beneficiary will depend, therefore, on the relevant provisions of the governing law.¹¹ The resulting divergence provides scope for comparative analysis and the position in the United States has been chosen for this purpose.

The United States provides a good point of comparison given the shared basis for the fraud exception¹² and the mature body of law which has developed both in relation to fraud and the availability of interlocutory injunctions. An indication of the scale of the American jurisprudence is evident in the annual survey of letter of credit cases published in *The Business Lawyer* since 1965.¹³ The comparison is also triggered by Ackner LJ's comments in *United Trading v Allied Arab Bank*,

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...Moreover, their conception of fraud is far wider than ours and would appear to include ordinary breach of contract... 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.¹⁴

⁹ The current version is ICC, 'The Uniform Customs and Practice for Documentary Credits' (2007 Revision, ICC Publication no. 600) (hereafter referred to as the UCP).

¹⁰ ICC Banking Commission, 'Latest queries answered by the ICC Banking Commission' (1997) 3(2) *Documentary Credits Insight* 6 cited in A Davidson, 'Fraud, the Prime Exception to the Autonomy Principle in Letters of Credit' (2003) 8 *Intl. Trade & Bus L Ann* 23, 26.

¹¹ See earlier, Chapter Four, text to fn 60.

¹² *Sztejn v J Henry Schroder Banking Corp* 177 Misc 719 (NY Misc 1941); *United City Merchants (House of Lords)* (n8) 6; D Horowitz, *Letters of Credit and Demand Guarantees: Defences to Payment* (OUP, 2010), [2.09].

¹³ H Bailey, 'Commercial paper, bank deposits and collections and letters of credit' (1965) 20 *Bus Law* 711.

¹⁴ *United Trading Corporation v Allied Arab Bank Ltd* [1985] 2 *Lloyd's Rep* 554, 561.

If Ackner LJ's comments were accurate, it would suggest that the American courts have drawn a very different balance between the competing policy considerations of autonomy and fraud prevention than their English counterparts. This section examines the limits of the American fraud exception and the availability of injunctive relief. This is used to consider whether the "thrombosis"¹⁵ with which the English courts are preoccupied – and have used to justify a narrow exception – has occurred in the United States.

A. Conception of fraud in the United States

The English courts have restricted the availability of the fraud exception to circumstances in which the fraud is apparent on the face of the documents and committed by the beneficiary. By contrast, the American courts have embraced both documentary fraud and fraud in the transaction. This is traced to the decision in *Sztejn v J Henry Schroder*.¹⁶ The fraud in that case consisted of the seller's intentional failure to ship any of the goods which had been ordered. This was properly characterised by Shientag J as fraud in the transaction¹⁷ but, given that the documents appeared to conform, also consisted of material misrepresentations of fact in the bill of lading. Ackner LJ further contended that ordinary breach of the underlying sales contract was sufficient to disrupt payment under a credit.¹⁸ This, with respect, overstated the breadth of the American position. It is only fraud that will trigger the exception.¹⁹

The fraud exception has since been codified in Article 5, Uniform Commercial Code (UCC) and the statute has been enacted in almost all American states.²⁰ The exception was first drafted in 1962 and was the version in force at the time of Ackner LJ's comments. The 1962 version made the defence available where a document was "forged or fraudulent or there is fraud in

¹⁵ *Intraco Ltd v Notis Shipping Corporation of Liberia (The Bhoja Trader)* [1981] 2 Lloyd's Rep. 256, 257 per Donaldson LJ.

¹⁶ *Sztejn* (n12). See earlier discussion, Chapter Four, text to fn 134.

¹⁷ *Sztejn* (n12) 722 per Shientag J.

¹⁸ *United Trading* (n14) 561 per Ackner LJ.

¹⁹ *Sztejn* (n12) 634 per Shientag J. This was consistent with earlier American case law. See *Maurice O'Meara v National Park Bank* 146 NE 636 (NY Ct App, 1925), 639 per McLaughlin J: the bank was bound to pay "irrespective of whether it knew, or had reason to believe, that the paper was not of the tensile strength contracted for."

²⁰ Uniform Law Commission, 'UCC Article 5, Letters of Credit (1995)' available at: [http://www.uniformlaws.org/Act.aspx?title=UCC%20Article%205,%20Letters%20of%20Credit%20\(1995\)](http://www.uniformlaws.org/Act.aspx?title=UCC%20Article%205,%20Letters%20of%20Credit%20(1995)) (accessed 08/09/2017).

the transaction.”²¹ The reference to forgery and fraud in the transaction confirms Ackner LJ’s view that the American exception was broader than its English counterpart.

The Iranian hostage crisis between 1979 and 1981 triggered significant litigation relating to standby letters of credit.²² There was a concern that the Iranian government and/or state-governed banks would make fraudulent demands on standbys,²³ which had been obtained as security for the performance obligations of American contractors. This was concerning because the breakdown of the Iranian political system effectively removed any possibility that an American applicant would obtain redress following payment.²⁴ In *Itek Corp v First National Bank of Boston*,²⁵ an injunction was granted on the basis that access to Iranian courts was “futile”²⁶ and “the fact that damages may be reasonably calculable will provide Itek with little consolation in the event those damages ultimately prove uncollectible.”²⁷ The Court in *Itek* also held that a refusal to issue an injunction in circumstances of fraud would undermine the “fundamental purpose” of letters of credit which was to prevent one party enjoying the benefits of both parties’ performance simultaneously.²⁸ A similar result was reached in *Harris Corp v National Iranian Radio & Television* where the court largely rejected the arguments that the applicant could have negotiated for better protection *ex ante*²⁹ and was swayed by considerations of the difficulty of recovery.³⁰ The judicial desire to protect the American credit applicants in these circumstances is not demonstrated in every case involving an allegation of fraud but, is explained by the exceptional nature of the prevailing political situation.³¹

²¹ UCC §5-114(2) (1962).

²² For a comprehensive account of litigation during this period, see H Getz, ‘Enjoining the international standby letter of credit: The Iranian letter of credit cases’ (1980) 21 Harv Intl LJ 189.

²³ X Gao, *The Fraud Rule in the Law of Letters of Credit: A Comparative Survey* (Kluwer Law International, 2002), 79.

²⁴ Getz (n22) 212.

²⁵ *Itek v First National Bank of Boston* 511 F Supp. 1341 (D. Mass 1981), 1349.

²⁶ *Ibid* 1348.

²⁷ *Ibid* 1350; Similar points were made in *Stromberg-Carlson Corp v Bank Melli* 467 F Supp 530 (SDNY 1979), 533 per Weinfeld J: if injunctive relief was denied, the applicant would be left to take proceedings in Iran “which would make any relief questionable.”

²⁸ *Itek* (n25) 1350.

²⁹ *Harris Corp v National Iranian Radio and Television* (1982) 691 F 2d 1344, [55].

³⁰ *Ibid* [48]. At [55], the applicant could not be expected to bear “the risk of a fraudulent demand.”

³¹ J Dolan, *The Law of Letters of Credit Commercial and Standby Credits* (4th ed. AS Pratt & Sons, 2007), [7-106]; *Foxboro Co v Arabian American Oil Co* 805 F2d 34 (1st Cir. 1986), [9].

The judicial willingness to intervene during the Iranian crisis would suggest there was some merit in Ackner LJ's comments, particularly as there was no indication that credits declined in popularity at this time. In the years immediately before the UCC was revised, however, it was suggested that injunctive relief was being issued too frequently.³² The Task Force addressed this concern by amending Article 5 to include specific criteria for the grant of an injunction.³³ In the Official Comment to the UCC, it was noted that "[t]he standard for injunctive relief is high, and the burden remains on the applicant to show, by evidence and not by mere allegation, that such relief is warranted."³⁴ Article 5 now requires that four conditions are satisfied before an injunction will be issued.³⁵ These largely mirror the requirements under English law.³⁶ The purpose of this discussion is not to consider in detail the judicial interpretation of these criteria, but to consider whether there is still force in Ackner LJ's comments in relation to the availability of injunctive relief following the revisions to the UCC.

It should be noted, however, that the fraud exception as initially codified in 1962 did not resolve all matters relating to the fraud exception. It was unclear, for example, whether 'the transaction' aspect of the defence required the fraud to relate to the letter of credit contract, as would be the case if it had been induced by fraudulent misrepresentation, or the underlying contract of sale. The case law did not clarify matters. The court in *Cambridge Sporting Goods*³⁷ - a contract for the sale of new boxing gloves which were delivered ripped and mildewed -

³² Task Force on the Study of UCC Article 5 (Letters of Credit), 'An examination of UCC Article 5 (Letters of Credit)' (1989-1990) 45 Bus Law 1521, 1612 (hereafter referred to as 'UCC Task Force'); H Harfield, 'Code, customs and conscience in letter of credit law' (1971) 4 UCC Law J 7, 8; HL Ash and JL Schwartz, 'Letters of credit: Judicial apprehensions misplaced' (1983) 5 Nat LJ 13, 18 cited in S van Houten, 'Letters of credit and fraud: A revisionist view' (1984) 62 Can Bar Rev 371, 385.

³³ The availability of an interlocutory or permanent injunction is confirmed by UCC §5-109 (2)(b) (1995 revisions).

³⁴ American Law Institute, '[Revised] Article 5. Letters of Credit. Official Comment' available at: http://elearn.unisofia.bg/pluginfile.php/91213/mod_resource/content/1/Revised_UCC_Article_5.pdf (accessed 14/09/2016), [4].

³⁵ UCC § 5-109(b) (1995 revisions):

- (1) the relief is not prohibited under the law applicable to an accepted draft or deferred obligation incurred by the issuer;
- (2) a beneficiary, issuer, or nominated person who may be adversely affected is adequately protected against loss that it may suffer because the relief is granted;
- (3) all of the conditions to entitle a person to the relief under the law of this State have been met; and
- (4) on the basis of the information submitted to the court, the applicant is more likely than not to succeed under its claim of forgery or material fraud and the person demanding honor does not qualify for protection under subsection (a)(1).

³⁶ See earlier discussion in Chapter Four, III (F).

³⁷ *United Bank Ltd v Cambridge Sporting Goods Corp.* 392 NYS 2d 265 (NY 1976) (the case concerned a sale for a consignment of new boxing gloves but those delivered were old, ripped and mildewed.)

held that Article 5 embodied a flexible approach to fraud which could be used as the circumstances dictated.³⁸

In response to these concerns, a Task Force recommended changes to the fraud exception.³⁹ These were subsequently adopted in 1995. Article 5, Uniform Commercial Code now provides that, unless the presenter belongs to a protected class,⁴⁰ the issuer may dishonour a presentation⁴¹ which,

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 applicant⁴²

The first trigger for the exception is fraud in the required documents. Most notably, the statute does not explicitly require that this fraud is connected to the beneficiary.⁴³ This significantly broadens the exception in comparison to the English position. Where a document has been forged or is materially fraudulent, the courts are concerned with the *nature* of the documents and not the *identity* of their creator.⁴⁴ Thus, fraud perpetrated by third parties unconnected to the beneficiary will be caught by the exception. In this sense, the relatively uncontroversial standard of documentary fraud is far broader than the English exception established in *United City Merchants*.⁴⁵ Professor Dolan, a leading US academic working in this area, has suggested that the House of Lords' decision is inconsistent with the wording of

³⁸ Ibid 271.

³⁹ See generally, Article 5: Official Comment (n34); Gao, *The Fraud Rule* (n23) 82.

⁴⁰ UCC § 5-109(a)(1) (1995 revision).

⁴¹ UCC § 5-109(2) (1995 revision).

⁴² UCC § 5-109(a) (1995 revision).

⁴³ X Gao, 'The identity of the fraudulent party under the fraud rule in letters of credit law' (2001) 24(1) UNSW L Rev 119, 124.

⁴⁴ Ibid 124. This was a departure from the pre-revision case law, see for example, *Larson v First Interstate Bank of Arizona NA* 603 F Supp 467 (D Ariz 1983), 469. For academic support of the pre-revision position, see J White and R Summers, *Uniform Commercial Code (vol 3)* (4th ed., 1995) 185 as cited by Gao 'The identity of the fraudulent party' (n43) 123.

⁴⁵ *United City Merchants (House of Lords)* (n8).

the UCC⁴⁶ and, as a result, the English position establishes a “markedly higher hurdle” for the applicant seeking to invoke the exception.⁴⁷

The second part of Article 5 extends the exception to circumstances in which the fraud would constitute a material fraud against the issuer or the applicant. This includes fraudulent misrepresentation by the beneficiary which has induced⁴⁸ the applicant to procure the credit⁴⁸ and fraud connected to the underlying contract of sale.⁴⁹ This clarified the confusion present in the initial codification of the exception, discussed above.⁵⁰ The identity of the fraudster is critical to this part of the provision meaning that the exception will only operate in response to beneficiary fraud. Even with this additional requirement, the recognition that fraud in the transaction is sufficient to invoke the exception is much broader than the English approach to fraud.

Ackner LJ’s comments on the breadth of the American fraud exception, therefore, remain valid following the revision of Article 5. The UCC permits payment to be disrupted in many factual circumstances due to fraud. These include straightforward incidences of backdated documents,⁵¹ false assertions about the quality of the goods in documentation,⁵² false documentation,⁵³ the presentation of compliant documents where rubbish has been shipped,⁵⁴ and circumstances in which fraud has induced the underlying contract of sale⁵⁵ or issue of the letter of credit.⁵⁶ Notably, the UCC does not make the bank’s knowledge of fraud a pre-requisite to the operation of the defence. This broadens the exception elaborated in

⁴⁶ Dolan, *The Law of Letters of Credit* (n31) [7-85].

⁴⁷ *Ibid* [7-93].

⁴⁸ For example, *Mid-America Tire Inc. v PTZ Trading* 768 NE 2d 619 (Ohio 2002) cited in J Barnes and J Byrne, ‘Letters of credit: 2002 cases’ (2002-2003) 58 Bus. Law. 1605, 1608 (fraudulent misrepresentation by the seller to induce the buyer to enter the contract)

⁴⁹ See UCC Task Force (n32) 1625 for the recommendation that the revised article retains the ‘fraud in the transaction’ defence.

⁵⁰ See earlier, text to fn 37-38.

⁵¹ *Siderius v Wallace* 583 SW2d 852 (Tex. Civ. App., 1979).

⁵² *Regent Corp v International Inv & Commerce Bank Ltd* 686 NYS 2d 24 (App Div 1999) where the beneficiary asserted that the goods were of Bangladeshi origin to avoid charges due on Pakistani goods.

⁵³ *Shaffer v Brooklyn Park Garden Apartments* 250 NW 2d 172 (1977) where the preconditions for the issue of a certificate had not been satisfied but the document was issued anyway.

⁵⁴ Szejn (n12); *Cambridge Sporting Goods* (n37).

⁵⁵ *NMC Enterprises Inc, v Columbia Broadcasting Sys Inc.* 14 UCC Rep. Serv. 1427 (Sup. Ct. NY County 1974)

⁵⁶ *Ibid*; *O’Grady v First Union National Bank* 296 NsC 212, 250 SE2d 587 (1978) as cited in Dolan, *The Law of Letters of Credit* (n31) [7-112].

Sztejn where Shientag J insisted on the bank having notice of the fraud at the time the demand for payment was made.⁵⁷ The absence of this criterion further establishes Article 5 as embodying a more expansive position than the English fraud exception.

B. Standard of materiality

One of the driving forces behind the reform of Article 5 was the absence of a standard against which to judge fraudulent conduct. The procedural history of *Sztejn* meant that this was not a live issue for the court⁵⁸ and neither was this dealt with in the 1962 codification. Moreover, later cases had identified a range of varying standards which had created confusion.⁵⁹

Article 5 now demands that the fraud is material.⁶⁰ The Official Comment to the Uniform Commercial Code made clear that materiality was to be judged against the underlying contract and to the impact of fraud on the purchaser.⁶¹ This reflects the fact that the American exception encompasses both documentary fraud and fraud in the underlying transaction. An example of a material fraud was provided in the Official Comment. It was suggested that a shipment of 998 barrels of oil against documentation indicating a shipment of 1000 barrels would not be materially fraudulent because this shortfall was an “insubstantial and immaterial” breach of the underlying contract.⁶² A material fraud would have been practiced where the same documentation was used to claim payment in circumstances where only five barrels had been shipped.⁶³

Materiality is also the standard used by the English courts to determine whether the fraud is actionable. The focus, however, of the enquiry is different. In the English context, the concept of materiality is linked to the bank’s obligation to make payment, namely whether truthful

⁵⁷ *Sztejn* (n12) 722 per Shientag J.

⁵⁸ Dolan, *The Law of Letters of Credit* (n31) [7-67].

⁵⁹ UCC Task Force (n32) 1614.

⁶⁰ UCC § 5-109(a) (1995 revision)

⁶¹ Article 5: Official Comment (n34) [1] as cited in Gao, *The Fraud Rule* (n23) 84.

⁶² Article 5: Official Comment (n34) [1] cited in R Buckley and X Gao, ‘A comparative analysis of the standard of fraud required under the fraud rule in letters of credit law’ (2003) 13 *Duke J Comp & Intl L* 293, 317.

⁶³ *Ibid.*

statements on the bill of lading would have entitled the bank to reject the presentation.⁶⁴ If the backdating could have been connected to the beneficiary in *United City Merchants*, the fraud would have been regarded as material since the actual (late) date of shipment would have entitled the bank to reject the presentation. This is a much narrower conception of materiality than used in the United States which perhaps reflects the fact that the English courts only recognise documentary fraud as actionable.

The materiality requirement results in a much more flexible enquiry in the United States than under English law. This is favourable for the credit applicant where the transaction is to be governed by the UCC⁶⁵ since the enquiry will take account of the commercial realities of the fraud. Moreover, given that the fraud rule exists as an exception to the doctrine of autonomy, it is wholly legitimate that courts look beyond the credit itself to assess materiality. Accordingly, it is much easier to reconcile the American approach to materiality with the nature of the fraud exception than its English counterpart.

C. Availability of injunctions

In *United Trading*, Ackner LJ contended that an applicant would find it far easier to obtain injunctive relief in the United States than under English law.⁶⁶ It is important to note that the version of Article 5 in force at the time of Ackner LJ's comments did not specify conditions to be satisfied before relief would be granted.⁶⁷ Thus, the early American authorities do not provide a single test for injunctive relief. It is possible, however, to identify several factors which appear routinely in the judicial discussions. These include, for example, substantial evidence as to the merits (proof of fraud), the balance of hardships in favour of the injunction applicant, and a consideration of the broader public interest.⁶⁸ Commentators viewed these factors as a means of "prevent[ing] a flood of injunctions based upon the liberalization of the

⁶⁴ *United City Merchants (House of Lords)* (n8) 7-8 per Lord Diplock (rejecting two standards of materiality); A Malek and D Quest, *Jack: Documentary Credits* (4th ed. Tottel Publishing, 2009) [9.17]. See earlier discussion in Chapter Four, III (C)(i).

⁶⁵ See also C Destrée and C Spanos, 'Sensitivity to fraud: Demand guarantees & standby letters of credit' (March 2002) 52(2) *Keeping Good Companies* 94, 97.

⁶⁶ *United Trading* (n14) 561 per Ackner LJ.

⁶⁷ UCC Task Force (n32) 1534.

⁶⁸ See, for example, *Dynamics Corp of America v Citizens & Southern National Bank* 356 F Supp 991 (ND Ga 1973); *Larson* (n44).

fraud exception.”⁶⁹ These are not dissimilar to the requirements an applicant would need to satisfy under English law⁷⁰ but the American courts have been prepared to approach these considerations in a manner more favourable to the credit applicant.

Interestingly, in the cases in which the credit applicant was successful in obtaining an injunction under the 1962 codification of the exception,⁷¹ the courts discussed the same policy considerations which were employed in England to refuse relief. Indeed, the notion of pre-contractual due diligence has been important with the American courts determining that the risk of beneficiary fraud should fall on the credit applicant “who selected him rather than [] an innocent third party or upon the issuer.”⁷² Despite this, injunctions have been granted in cases where payment under the credit would cause further loss to the applicant⁷³ and where their prospects of later recovery against the beneficiary were slim.⁷⁴ This is a direct contrast to the position in England where courts have repeatedly insisted that the difficulty of later actions against the beneficiary will not assist the applicant in claims for relief.⁷⁵

The American cases have explicitly recognised that fraud prevention is a relevant policy concern⁷⁶ and that the refusal to grant injunctive relief in cases of fraud would send the wrong message to fraudsters.⁷⁷ It was stated in *Larson* that,

the failure to issue an injunction where otherwise appropriate would send a clear signal to those inclined to engage in fraudulent activities that they are likely to be

⁶⁹ van Houten (n32) 387; Dolan, *The Law of Letters of Credit* (n31) [7-78] (noting that criteria for an injunction should counter the broad meaning of fraud under US law).

⁷⁰ See earlier discussion, Chapter Four, III (E).

⁷¹ For example, *Itek* (n25); *American National Bank & Trust Co. v Hamilton Industries Inc.* 583F Supp 164 (ND Ill 1984); *Paccar International Inc. v Commercial Bank of Kuwait* 587 F.Supp 783 (CD Cal. 1984); *Regent Corp v International Investment & Commerce Bank Ltd* 686 NY S2d 24 (App Div 1999). Dolan, *The Law of Letters of Credit* (n31) [7-79] (arguing that even if an injunction is subsequently discharged, delay has already affected the beneficiary and diminished the efficiency of the mechanism.) See also M Moses, ‘Letters of credit and the insolvent applicant: A recipe for bad faith dishonor’ (2005-2006) 57 Ala L Rev 31, 37.

⁷² *Shaffer* (n53) 179; Gao, *The Fraud Rule* (n23) 138.

⁷³ *Shaffer* (n53).

⁷⁴ *Ibid*; *Dynamics Corp* (n68).

⁷⁵ *RD Harbottle (Mercantile) Ltd v Nat West Bank Ltd* [1978] QB 146, 155-156 per Kerr J.

⁷⁶ *Shaffer* (n53) 180: the role of the court is to balance the “protection of the consumer from the beneficiary’s fraud against maintenance of the letter of credit as a commercial instrument and business device.”

⁷⁷ *Itek* (n25).

rewarded...there is at least as much public interest in discouraging fraud as in encouraging the use of letters of credit.⁷⁸

Moreover, the refusal of injunctions in such circumstances would have “an even greater adverse impact upon issuing banks, and ultimately discourage the use of letters of credit.”⁷⁹ The courts are clearly attuned to the fact that a mechanism which facilitated fraud would not be attractive to the commercial community. These arguments have not been made in England.

In both jurisdictions, the applicant will need to show that he will be without an effective remedy if the injunction is refused.⁸⁰ This should be relatively difficult given that the credit expressly preserves subsequent actions on the underlying contract. Indeed, the UCC facilitates this process as a result of the warranty provisions in art 5-110. In the event that the presentation is honoured, the beneficiary is taken to have warranted that the documents do not contain forgery or fraud⁸¹ and that the presentation does not violate any agreement between applicant and beneficiary.⁸² If it later transpires that the beneficiary has breached the warranty, the applicant will be entitled to bring an action for damages. This is designed to reduce actions for injunctive relief and encourage parties to settle disputes after payment has been made.⁸³

Despite the statutory warranties, American courts have interpreted this criterion generously, permitting applicants to adduce evidence that the beneficiary would be unable to satisfy “a post-honor damage claim.”⁸⁴ In *Hendricks v Bank of America*, evidence that the beneficiary was in financial distress and likely to dissipate the proceeds of the credit before the applicant

⁷⁸ *Larson* (n44) 470 citing *Itek* (n25) 1351.

⁷⁹ *Itek* (n25).

⁸⁰ J Dolan, ‘Letters of credit, article 5 warranties, fraud, and the beneficiary’s certificate’ (1985-1986) 41 *Bus Law* 347, 356.

⁸¹ UCC § 5-110(a)(1) (1995 revisions).

⁸² UCC § 5-110(a)(2) (1995 revisions).

⁸³ B Wunnicke, D Wunnicke and P Turner, *Standby and Commercial Letters of Credit* (3rd ed. Aspen Law & Business, 2000 (2013 Supplement)) 4-26.1; J Barnes and J Byrne, ‘Revision of UCC Article 5’ (1995) 50 *Bus Law* 1449, 1457. See generally, R Dole, ‘Warranties by beneficiaries of letters of credit under revised article 5 of the UCC: The truth and nothing but the truth’ (2002-2003) 39 *Hous L Rev* 375.

⁸⁴ *Langley v Prudential Mortgage* 64 *UCC Rep Serv*. 2d (West 661, 667) (ED Ky, 2007).

could obtain a remedy was sufficient for these purposes.⁸⁵ Similar arguments have been wholly rejected in the English context.⁸⁶ In *Harbottle*, for example, Kerr J commented that “these are risks which the merchants take...This is unfortunate for the plaintiffs, but it is what they have agreed.”⁸⁷ This suggests that an American applicant is more likely to satisfy this criterion than his English counterpart.

The evidential burden on the applicant and the additional policy arguments considered relevant by the English courts lends credence to Ackner LJ’s comments following the 1995 revisions. The English applicant must provide additional evidence, in particular relating to the bank’s knowledge of the fraud,⁸⁸ before an injunction to restrain payment will be granted. Injunctive relief under US law does not require the knowledge of the bank as an independent requirement. In addition, refusals by English courts to issue injunctions are rooted in considerations of the efficiency of the mechanism and the reputation of banks.⁸⁹ By contrast, the American courts have focused solely on the efficiency of the mechanism⁹⁰ without considering the reputation of US banks in actions for injunctive relief.

In conclusion, the fraud exception is more likely to operate in the United States than in England. There are several reasons for this. The American conception of fraud embraces a broader range of conduct including fraud in the transaction and documentary fraud attributable to a third party. In addition, the applicant need not establish the bank’s independent knowledge at the time of payment and will have the benefit of a more flexible standard of materiality. These criteria make it difficult for the credit applicant litigating in England to obtain relief.⁹¹ In relation to the availability of injunctive relief, the 1995 revisions

⁸⁵ *Hendricks v Bank of America* 398 F.3d 1165 (9th Cir, 2005). Later courts have denied relief where the claimant has been unable to demonstrate this, see *Drago v Holiday Isle* 537 F Supp 2d 1219, 1222 (SD Ala 2007); *Jameson v Pine Hill* No. 07-0111-WSB, 2007 WL 623807 (SD Ala Feb 23, 2007).

⁸⁶ *Themehelp Ltd v West* [1996] QB 84, 101 per Waite LJ noting the “appreciable risk” That assets might be dissipated, 103 per Evans LJ: “the present case cries out for Mareva relief” but see also 107 per Balcombe LJ noting that Mareva relief may come too late. See also, M Bridge, *Benjamin’s Sale of Goods* (9th ed. Sweet & Maxwell, 2015) [24-034] where the difference between the US and English approaches is noted.

⁸⁷ *Harbottle* (n75) 155-156 per Kerr J.

⁸⁸ See earlier discussion, Chapter Four, III (D) (iv).

⁸⁹ *Discount Records v Barclays Bank* [1975] 1 WLR 315, 320 per Megarry J; *Bolivinter Oil SA v Chase Manhattan Bank* [1984] 1 Lloyd’s Rep. 251, 257 per Sir John Donaldson MR; *Czarnikow-Rionda v Standard Bank* [1999] 2 Lloyd’s Rep. 187, 204 per Rix J.

⁹⁰ Dolan, *The Law of Letters of Credit* (n31) [7-79], [7-88].

⁹¹ *Ibid* [7-93].

have made the position more onerous for the American applicant. Despite this, the American claimant remains in a favourable position as against his English counterpart. This is because the American courts are willing to interpret the 'irreparable injury' criterion more favourably. It would also appear that fewer factors militate against the grant of an injunction in America than in England.

What then does this mean for the arguments by English courts that the narrow approach to fraud is justified by commercial need? The American exception would suggest that such a narrow approach is not necessary to ensure an efficient mechanism. In the first place, the codification of the American exception has enabled legislators to "balance competing interests or perspectives in a manner which fairly reflects the reasonable commercial expectations of the parties."⁹² This is an enviable position⁹³ which cannot be replicated in the English common law system. In addition, there is no evidence to suggest that the mechanism is any less popular in the United States than in England. If anything, the widespread use of standby credits in domestic transactions in America,⁹⁴ to which Article 5 also applies,⁹⁵ would suggest commercial acceptance of the fraud standard. The volume of litigation related to letters of credit has justified an annual survey published in *The Business Lawyer*.⁹⁶ This hints at the relative size of the market in the United States but, more importantly, that even the possibility of litigation has not had a negative impact on the market for credits. Accordingly, it would be more accurate to characterise the English approach as a distinct policy choice connected to the judicial conception of market need rather than an inevitable balance between competing policy arguments.⁹⁷

The American exception demonstrates that a more expansive approach to fraud does not necessarily result in the thrombosis so feared by the English courts. The second critique of

⁹² UCC Task Force (n32) 1538: stating that the purpose was "to preserve and enhance the integrity of the letter of credit as a vital instrument of commerce. In so doing, it has sought to balance competing interests or perspectives in a manner which fairly reflects the reasonable commercial expectations of the parties."

⁹³ J Barnes and J Byrne, 'Letters of credit' (2005 – 2006) 61 *Bus Law* 1591, 1596: "US courts applying US law are uniquely advantaged in having a comprehensive codification of the letter of credit fraud exception."

⁹⁴ Malek and Quest, *Jack* (n64) [12.14]; M Bridge, *Benjamin's Sale of Goods* (8th ed. Sweet & Maxwell, 2010), [23.237].

⁹⁵ Article 5: Official Comment (n34) 1.

⁹⁶ The first survey was published as Bailey (n13).

⁹⁷ Todd, *Maritime Fraud & Piracy* (2nd ed. Informa, 2010), [4.014].

the English approach to fraud argues that the judicial reasoning in *United City Merchants* is flawed and that this has set in motion consequences which are detrimental to commercial need. This severely undermines the traditional justification for a narrow fraud exception.

II. A Critical Analysis of *United City Merchants*

The narrow contours of the English fraud exception are justified by reference to the supremacy of autonomy and commercial need. However, in constructing the limits of the fraud exception, the House of Lords made an unfortunate misstep in their characterisation of the banks' duties under the letter of credit. This mischaracterisation is flawed in contractual terms and by reference to the UCP (A). An alternative analysis, based largely on arguments made by Professor Roy Goode,⁹⁸ will then be offered to demonstrate how the principle of strict compliance and the fraud exception should operate (B). Attention will then turn to the unintended consequences of this decision and suggest that these in no way contribute to the efficiency of the documentary credit as a payment device (C).

A. A critique of the reasoning in *United City Merchants*

The fundamental difficulty with Lord Diplock's analysis exists in his account of when the bank becomes bound to make payment to the beneficiary. The credit in *United City Merchants* was governed by the UCP 500 which imposed a duty of reasonable care on banks when they examined documents.⁹⁹ Lord Diplock stated that,

the contractual duty of each bank under a confirmed irrevocable credit is to examine with reasonable care all documents presented in order to ascertain that they appear *on their face* to be in accordance with the terms and conditions of the credit, and, if they do so appear, to pay.¹⁰⁰

⁹⁸ For example, R Goode, 'Abstract payment undertakings' in P Cane and J Stapleton (eds.), *Essays for Patrick Atiyah* (Clarendon Press, 1991), 228-243; E McKendrick, *Goode on Commercial Law* (4th ed. Penguin, 2010) 1105-1106.

⁹⁹ UCP 500 art. 13(a). This reference to reasonable care does not appear in the current version of the UCP, the UCP 600, but this does not substantively affect the burden on the paying bank, see Malek and Quest, *Jack* (n64) [8.3]-[8.7].

¹⁰⁰ *United City Merchants (House of Lords)* (n8) 7 per Lord Diplock (emphasis in original).

The difficulty is that Lord Diplock equated the bank's contractual obligation to pay with apparent compliance. This was, with respect, incorrect. The UCP 500 only *obliged* banks to pay when the stipulated documents – as distinct from documents which *appeared* to be those stipulated in the credit – were presented.¹⁰¹ This is also the case under the UCP 600 where the obligation to pay the beneficiary is only triggered by a complying presentation.¹⁰² This reflects the importance of genuine documents within credit transactions. In this light, the words from *Equitable Trust v Dawson Partners* bear repeating,

It is both common ground and common sense that in such a transaction the accepting bank can only claim indemnity if the conditions on which it is authorised to accept are in the matter of the accompanying documents strictly observed. There is no room for documents which are almost the same, or which will do just as well. Business could not proceed securely on any other lines.¹⁰³

How, then, did the House of Lords come to misunderstand the respective rights and obligations of the parties involved in documentary credit transactions? This is an interesting question, not least because the Lord Diplock's judgment diverged significantly from the Court of Appeal decision despite counsel presenting virtually identical arguments to the respective courts.¹⁰⁴ There would seem to be two explanations of this error.

The first of these relates to numerous references to apparent compliance within the UCP 500. The rule of apparent compliance is designed to protect a bank which, despite a (reasonable) examination of the documents, failed to uncover defects in the documents which later come

¹⁰¹ UCP 500 art. 9(a) "An irrevocable credit constitutes a definite undertaking of the Issuing Bank, provided that the stipulated documents are presented...and that the terms and conditions of the Credit are complied with."

¹⁰² UCP 600 art. 7(a) and art. 15(a) (issuing bank), art. 8(a) and art. 15(b) (confirming/negotiation bank); UCP 500 art. 9(a) "an irrevocable Credit constitutes a definite undertaking of the issuing Bank, provided that the stipulated documents are presented to the Nominated Bank or to the Issuing bank and that the terms and conditions of the Credit are complied with." UCP art. 9(b) sets out the same duty for confirming banks.

¹⁰³ *Equitable Trust Co of New York v Dawson Partners Ltd* (1926) 27 Ll L Rep 49, 52 per Viscount Sumner.

¹⁰⁴ Compare the following judgments where counsels' arguments are summarised: *United City Merchants v Royal Bank of Canada (The American Accord)* [1983] AC 168, 173-178; *United City Merchants v Royal Bank of Canada (The American Accord)* [1982] QB 208, 213-215. For further discussion of the approach taken by the Court of Appeal, see later, text to fn 139.

to light.¹⁰⁵ Reimbursement is entirely appropriate in these circumstances given that payment was made in good faith without notice of the fraud and that banks bear no responsibility for the genuineness of documents.¹⁰⁶ Without reimbursement, banks may well become unwilling to finance international transactions by way of documentary credit. As noted above, however, the UCP only imposes a contractual *obligation* to pay when the documents actually conform.¹⁰⁷ The effect of Lord Diplock's analysis – that the bank owes the beneficiary a duty to pay against apparently compliant documents – would extend this same protection to the beneficiary. This is an entirely inappropriate use of the rule of apparent compliance since the UCP only entitles the beneficiary to payment when he has presented documents stipulated by the credit. Interestingly, all but one reference to apparent compliance was removed when the UCP was revised in 2007.¹⁰⁸ This indicates the potential for confusion within the UCP 500 and will be examined further in due course.¹⁰⁹

A further explanation of the analysis – that the bank is obliged to make payment when the documents appear to comply – lies in Lord Diplock's view that the bank should be under identical duties in its contract with the beneficiary and the applicant.¹¹⁰ He began by stating that

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 forged¹¹¹

¹⁰⁵ M Bridge, 'Documents and contractual congruence in international trade' in Worthington, S. (ed.), *Commercial Law and Commercial Practice* (Hart, 2003).233. This was the result in *Gian Singh v Banque de l'Indochine* [1974] 1 WLR 1234, 1238-1239 per Lord Diplock: "in business transactions financed by documentary credits banks must be able to act promptly on presentation of the documents. In the ordinary case visual inspection of the actual documents presented is all that is called for. The bank is under no duty to take any further steps to investigate the genuineness of a signature which, on the face of it, purports to be the signature of the person named or described in the letter of credit."

¹⁰⁶ UCP 600 art.34.

¹⁰⁷ UCP 500 art. 9(a)-(b).

¹⁰⁸ UCP 600 art. 14(a); Horowitz (n12) [2.08] "Arguably, this is all the more the case under the UCP 600, where the 'on the face' terminology has been removed from all but one article."

¹⁰⁹ See later, text to fn 218.

¹¹⁰ *United City Merchants (House of Lords)* (n8) 7 per Lord Diplock.

¹¹¹ *Ibid* 7 per Lord Diplock.

Lord Diplock then asserted that it would be “strange”¹¹² if there was not a corresponding duty to the credit beneficiary i.e. to make payment when the documents appeared to conform. It is respectfully submitted that Lord Diplock was incorrect here. In the first place, the doctrine of autonomy demands that each contract is enforced by reference to its own terms.¹¹³ It follows that there is no need for the contracts within the network to be written on identical terms. It is also particularly odd that the bank should owe its customer – the credit applicant – a duty to pay in circumstances when it knows the documents are forged or inaccurate. This is tantamount to saying that the bank owes its customer a duty to be defrauded or, at best, to be misled by the documents.¹¹⁴ In any event, it would be legitimate to assume that the bank owed a greater loyalty to its (potentially longstanding) customer from whom it receives remuneration.

The proposition that banks should pay when the documents appear to conform impacted on the court’s consideration of third party forgeries. Lord Diplock held that forged documents, including cases in which the forgery rendered the document a nullity, did not constitute a ground for refusing payment.¹¹⁵ This was even the case where the forgery or nullity had been discovered prior to payment.¹¹⁶ He justified his position in the following terms,

This is certainly not so under the Uniform Commercial Code as against a person who has taken a draft drawn under the credit in circumstances that would make him a holder in due course, and 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.¹¹⁷

¹¹² Ibid 7 per Lord Diplock.

¹¹³ Todd, *Maritime Fraud & Piracy* (n97) [4-021].

¹¹⁴ McKendrick, *Goode on Commercial Law* (4th ed. Penguin, 2010) 1105; Horowitz (n12) [2.11].

¹¹⁵ *United City Merchants (House of Lords)* (n8) 9 per Lord Diplock.

¹¹⁶ Ibid 9 per Lord Diplock.

¹¹⁷ Ibid 9 per Lord Diplock.

Lord Diplock is certainly correct that the holder in due course enjoys a privileged position under the UCC.¹¹⁸ This is unsurprising given that this person has taken the draft for value, in good faith and without notice of any defect in the document.¹¹⁹ What is not clear, however, is why the seller-beneficiary who *could* have negotiated the credit, but chose not to, should be granted equivalent protection. With respect, Lord Diplock had evidently misread the relevant provisions of the UCC since the beneficiary is excluded from the list of parties to whom the bank *must* make payment in cases of forgery.¹²⁰ Given that the beneficiary's right to payment hinges on actual compliance, it is impossible to see how the mere fact that he could have negotiated the documents could alter the contractual position between him and the bank.¹²¹ It is noteworthy that Lord Diplock's approach to forgery was roundly rejected in the Singaporean case of *Lambias v HSBC* on the basis that the bank's rejection of forged documents would not extinguish the beneficiary's ability to bring an action for the price on the underlying contract of sale.¹²²

Despite these analytical difficulties, Lord Diplock's approach has been followed in subsequent case law.¹²³ Bridge has described this position as the orthodox view.¹²⁴ By contrast, the decision has been "roundly condemned"¹²⁵ by the academic community. The most persuasive arguments have been made by Professor Goode who has offered an alternative analysis of how the fraud exception should operate in concert with the doctrine of strict compliance. This

¹¹⁸ The version of the UCC in force at the time protected the holder in due course: UCC §5-114(2)(a). This is retained in the revised version of article five: UCC §5-109(a)(1).

¹¹⁹ UCC §3-302 (a)(2).

¹²⁰ UCC §5-109 (a)(1): "the issuer shall honor the presentation, if honor is demanded by (i) a nominated person who has given value in good faith and without notice of forgery or material fraud, (ii) a confirmer who has honored its confirmation in good faith, (iii) a holder in due course of a draft drawn under the letter of credit which was taken after acceptance by the issuer or nominated person, or (iv) an assignee of the issuer's or nominated person's deferred obligation that was taken for value and without notice of forgery or material fraud after the obligation was incurred by the issuer or nominated person"

¹²¹ Goode, 'Reflections on letters of credit – 1' [1980] JBL 291, 294; Goode, 'Abstract payment undertakings' (n98) 231.

¹²² *Lambias v HSBC* [1993] 2 SLR 751, 763 per Goh Phai Cheng JC.

¹²³ *Montrod Ltd v Grundkötter Fleischvertreibe GmbH* [2002] 1 WLR 1975, [56] per Potter LJ: The fraud exception "should not be avoided or extended by the argument that a document presented, which conforms on its face with the terms of the letter of the credit, is none the less of a character which disentitles the person making the demand to payment because it is fraudulent *in itself*, independently of the knowledge and bona fides of the demanding party."

¹²⁴ Bridge, 'Documents and contractual congruence' (n105) 239.

¹²⁵ M Bridge, 'Documents and cif contracts' (1998) available at: <http://sas-space.sas.ac.uk/3805/1/1622-2033-1-SM.pdf> (accessed 16/07/2016) 6.

is a compelling analysis, particularly considering earlier *dicta* supporting a similar conclusion. We first consider Goode's alternative analysis before discussing the consequences which flow from the decision in *United City Merchants*. It will be contended that these consequences are detrimental to the needs of commerce which weaken, therefore, the traditional justification of the narrow fraud exception.

B. An alternative analysis

Professor Goode's alternative analysis makes an important distinction between pre-requisites to payment and defences to payment.¹²⁶ This envisages a two-stage enquiry and, at the risk of doing Goode's arguments a disservice, his approach is briefly summarized here.

The first stage of the enquiry relates to compliance: do the documents strictly conform to the terms of the credit? This requires the court to focus on the nature of the documents and, if the documents do not conform, the bank is entitled to reject the presentation.¹²⁷ The beneficiary would simply have failed to satisfy the pre-conditions entitling him to payment in these circumstances although he may re-tender documents subject to the expiry of the credit. The standard of strict compliance which has been developed by the English courts permits the rejection of documents which contain minor discrepancies,¹²⁸ subject to the typographical errors permitted by the UCP.¹²⁹ The appropriate standard of non-conformity has varied in Goode's analysis over the years but, at its broadest, would encompass documents which have been forged, contain fraudulent misrepresentations and are nullities.¹³⁰ The identity of the party who is responsible for these discrepancies is wholly irrelevant at this stage. As Goode has made clear,

The beneficiary...is only entitled to be paid if the documents are in order. A fraudulently completed bill of lading does not become a conforming document merely because the fraud is that of a third party.¹³¹

¹²⁶ Goode, 'Abstract payment undertakings' (n98) 228, 232.

¹²⁷ McKendrick, *Goode on Commercial Law* (n114) 1106.

¹²⁸ *Kredietbank Antwerp v Midland Bank* [1999] CLC 1108, [12] per Evans LJ.

¹²⁹ Goode, 'Abstract payment undertaking' (n98) 228; UCP 600 art. 30.

¹³⁰ McKendrick, *Goode on Commercial Law* (n114) 1106.

¹³¹ Goode, 'Reflections – 1' (n121) 294.

It is also irrelevant to argue that the good faith of the beneficiary should make any difference to the question of documentary compliance. This is because even the most scrupulous of behaviour could not transform non-compliant documents into the genuine ones required under the credit.¹³²

Defences to payment only become relevant once the beneficiary has satisfied the necessary pre-conditions to payment. This is the second phase of the enquiry. Payment at this stage is virtually guaranteed – as demanded by the commercial community – since the doctrine of autonomy insulates the credit from disputes connected to the underlying contract.¹³³ Indeed, the exceptional nature of judicial intervention is appropriate at this stage since the beneficiary will have fulfilled the obligations entitling him to payment. Accordingly, it is right that the identity of the fraudster is critical at this stage¹³⁴ and it is only when the fraud can be connected to the beneficiary that the fraud exception will operate.

The consequences of the fraud exception further distinguish the second phase of the enquiry from the initial question of compliance addressed by the courts. Where the beneficiary has engaged in conduct sufficient to invoke a defence – for example, the submission of documents he knows to contain material misrepresentations – the right to payment is permanently barred. The court refuses to engage with the beneficiary in these circumstances as is typical of defences premised on *ex turpi causa*. There would be no opportunity for him to retender compliant documentation as would be the case during the first phase of the enquiry.

There is much to suggest that the sequential analysis is appropriate in relation to documentary presentations under a letter of credit. In the first place, the doctrine of strict compliance supports this approach; after all, the parties have contracted for the presentation of actually compliant – and thus genuine – documents. In addition, there was considerable *dicta* supporting a sequential approach prior to the House of Lords' decision in *United City Merchants*. In *Edward Owen Engineering v Barclays Bank*, Denning LJ made clear that payment was only due when “the documents are in order and the terms of the credit are

¹³² Ibid 294.

¹³³ Goode, 'Abstract payment undertakings' (n98) 233; M Brindle and R Cox, *Law of Bank Payments* (3rd ed. Sweet & Maxwell, 2004) [8.087].

¹³⁴ Goode, 'Abstract payment undertakings' (n98) 232-233.

satisfied.”¹³⁵ He continued that “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 when there is no right to payment.”¹³⁶ Shortly after the decision in *United City Merchants*, Gutteridge and Megrah suggested that, in respect of the earlier English cases, it was “permissible to assume that what they had in mind was fraud by a beneficiary.”¹³⁷ There is, with respect, no basis for this given that Lord Denning MR’s comments do not explicitly require the wrongdoing to be connected to the credit beneficiary.¹³⁸ The same analysis was employed by the Court of Appeal in *United City Merchants* as the following comments by Ackner LJ make clear,

A banker cannot be compelled to honour a credit unless all the conditions precedent have been performed, and he ought not to be under an obligation to accept or pay against documents which he knows to be waste paper. To hold otherwise would be to deprive the banker of that security for the advances, which is a cardinal feature of the process of financing carried out by means of the credit.¹³⁹

The sequential analysis has also been acknowledged in American case law.¹⁴⁰ The point was made succinctly in *Old Colony Trust Co v Lawyers’ Title & Trust Co.*; if a bank knows that a document is false or forged it “cannot be called upon to recognize such a document as complying with the terms of a letter of credit.”¹⁴¹ These earlier cases were used to develop the fraud exception in *Sztejn v Schroder*.¹⁴² In that case, Shientag J commented that “the

¹³⁵ *Edward Owen Engineering v Barclays Bank International* [1979] 1 QB 159, 169 citing *Bank Russo-Iran v Gordon Woodroffe & Co* [1972] 116 Sol J 921, 10 CL 296 per Browne J.

¹³⁶ *Edward Owen* (n135) 169.

¹³⁷ HC Gutteridge and M Megrah, *The Law of Bankers’ Commercial Credits* (7th ed. Europa Publications, 1984), 188. But cf. R King (ed.) *Gutteridge & Megrah’s Law of Bankers’ Commercial Credits* (8th ed. Europa Publications, 2001) which does not comment on this particular issue, 169 fn 10 where a quotation from *Edward Owen* is provided without further comment.

¹³⁸ *Edward Owen* (n135) 169 per Lord Denning MR: the bank ought not to pay “if it knows that the documents are forged or that the request for payment is made fraudulently in circumstances when there is no right to payment.”

¹³⁹ *United City Merchants v Royal Bank of Canada (The American Accord)* [1981] 1 Lloyd’s Rep. 604, 628 per Ackner LJ (hereafter referred to as *United City Merchants (Court of Appeal)*)

¹⁴⁰ R Buckley and X Gao, ‘The development of the fraud rule in letter of credit law: The journey so far and the road ahead’ (2002) 23(4) *Uni of Penn J of Int Ec Law* 663, 676.

¹⁴¹ *Old Colony Trust Co v Lawyers’ Title & Trust Co* 297 F 152 (1924), 158. See also Buckley and Gao, ‘The development of the fraud rule’ (n140) 676.

¹⁴² *Sztejn* (n12); --, ‘Decisions’ (1942) 42 *Colum LR* 149, 150-151: “It seems clear that the presentation of forged documents would not satisfy the requirements of the letter of credit and that the bank may defend on the grounds of forgery.”

application of this doctrine [of autonomy] presupposes that the documents accompanying the draft are genuine and conform in terms to the requirements of the letter of credit.”¹⁴³ Although *Sztejn* was highly influential in Lord Diplock’s judgment, he overlooked the first stage of the sequential analysis and limited his consideration of forgery and fraud to the operation of defences.¹⁴⁴

The author takes the view that the sequential analysis is to be preferred since it acknowledges the distinct roles of strict compliance and autonomy and reflects the bargain the parties have made. The analysis has been endorsed by a range of academic commentators.¹⁴⁵ Unfortunately, however, Goode has not been entirely consistent as to whether the sequential analysis would have led to a different result on the facts of *United City Merchants*. He has, on several occasions, argued that forgery, nullity and third party fraud all render a document non-conforming.¹⁴⁶ This is a broad approach to the compliance question¹⁴⁷ and would have justified rejection of the backdated bill of lading in *United City Merchants*. This, incidentally, was the unanimous result reached by the Court of Appeal.¹⁴⁸ Goode has also expressed the view that, despite the flawed reasoning of the House of Lords,

the ruling...might just possibly be sustainable on the ground that the insertion of a false shipping date in the bill of lading did not prevent it from being what it purported to be, so that it could be validly tendered by a beneficiary in good faith¹⁴⁹

This indicates a narrower approach in which non-conformity is equated with documents which have no legal effect. This would entitle banks to reject nullities for non-compliance but would recognise forgeries, including the bill submitted in *United City Merchants*, as compliant.

¹⁴³ *Sztejn* (n12) 634.

¹⁴⁴ Goode, ‘Abstract payment undertakings’ (n98) 232.

¹⁴⁵ Horowitz (n12) [3.01], [3.10]; R Hooley, ‘Fraud and letters of credit: Is there a nullity exception?’ [2002] CLJ 279, 280; A Guest et al., *Benjamin’s Sale of Goods* (7th ed. Sweet & Maxwell, 2006) [23-143]; Neo ‘A nullity exception in letter of credit transactions?’ [2004] Sing JLS 46, 60; Dolan, *The Law of Letters of Credit* (n31) [7-65]: “It is also consistent with the doctrine of the strict compliance rule to say that a beneficiary who presents fraudulent or false documents has not complied with the credit.”

¹⁴⁶ Goode, ‘Abstract payment undertakings’ (n98) 228-9, 230, 232, Goode, ‘Reflections – 1’ (n121) 294.

¹⁴⁷ Horowitz (n12) [3.18], [3.20].

¹⁴⁸ *United City Merchants (Court of Appeal)* (n139) 623 per Stephenson LJ, 628 per Ackner LJ and 633 per Griffiths LJ.

¹⁴⁹ Goode, ‘Abstract payment undertakings’ (n98) 231.

The above comments in which Goode appears to favour the narrower approach also suggest that the good faith of the beneficiary can affect the bank's response to the documents. This must be incorrect since the assessment of documentary compliance is objective and should be disassociated from the mindset of the beneficiary. Notwithstanding Goode's inconsistent approach to the appropriate standard of non-conformity, the author maintains that the sequential analysis is correct and will argue, in due course, for the narrower conception of non-compliance.¹⁵⁰ At this stage, it is convenient to discuss the consequences which flow from the flawed reasoning in *United City Merchants*. These consequences are detrimental to the efficiency of, and commercial confidence in, the credit mechanism. This is difficult to square with the policy construction of the fraud exception; to preserve the credit as an efficient system of trade financing.

C. The unintended consequences of the reasoning in *United City Merchants*
The reasoning adopted by the House of Lords in *United City Merchants* is detrimental to the efficiency of the documentary credit mechanism. This undermines the rationale of Lord Diplock's judgment; to ensure the credit's continued acceptability within the commercial community. This is not, strictly speaking, a consequence of the elaboration of the fraud exception itself but rather the result of Lord Diplock's conflation of fraud, forgery and nullity. As Bridge has made clear, the "question of forgery and nullity is closely related to the definition of fraud but should not be seen as bound up exclusively with fraud."¹⁵¹ The purpose of this section is to explore the detrimental consequences of this reasoning by noting, in part i, the impact on commercial confidence. Parts ii and iii then focus on the difficulties flowing from Lord Diplock's approach to forgery and nullity, respectively. The extent to which these consequences militate in favour of a new approach to forged and null documents presented under a letter of credit is then considered (part iv).

i. Commercial confidence in the documents

Given that the fraud exception is founded on *ex turpi causa*, it is not surprising that the exception is only triggered by the beneficiary's wrongdoing. However, the narrow contours

¹⁵⁰ See later, Part II (C)(iv).

¹⁵¹ Bridge, 'Documents and contractual congruence' (n105) 230.

of the fraud exception and the court's refusal to adopt the sequential analysis, means that forged documents, third party fraud and nullities will not constitute bases for stopping payment.¹⁵² This effectively permits non-genuine documents where the defect cannot be attributed to the beneficiary to circulate between commercial parties.¹⁵³ This is a concern because the credit mechanism, as all documentary transactions, rely to a large extent on trust.

Documentary transactions can only function when the contracting parties and banks have confidence that the requisite documents are what they appear to be.¹⁵⁴ The relatively unhindered circulation of non-genuine documents, therefore, is likely to undermine faith in the credit mechanism. Such considerations have played a significant role in the development of the law relating to bills of exchange.¹⁵⁵ In *Master v Miller*, Lord Kenyon commented that such instruments "which are circulated throughout Europe, should be kept with the utmost purity, and that the sanctions to preserve them from fraud should not be lessened."¹⁵⁶ This issue was colourfully highlighted by Cresswell J in his characterisation of antedated bills as "the cancer of international trade."¹⁵⁷ It is surprising, therefore, that the House of Lords delivered a judgment which permits the circulation of non-genuine documents between traders. It is also not possible to give Lord Diplock the benefit of the doubt here. His express refusal to permit banks to reject documents "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"¹⁵⁸ demonstrates his awareness of the potential consequences of his decision.

Given that the contours of the fraud exception were constructed with commercial need in mind, it is difficult to see how reduced confidence in the mechanism will facilitate international trade. If parties are unable to place their trust in the documents, banks may well

¹⁵² R Hooley, 'Fraud and letters of credit, part 1' (2003) 3 JIBFL 91 (online publication, page numbers omitted).

¹⁵³ Ibid; Horowitz (n12) [3.20].

¹⁵⁴ I Carr, *International Trade Law* (5th ed. Routledge, 2014) 468; Bridge, 'Documents and contractual congruence' (n105) 216; Gao, *The Fraud Rule* (n23) 130-131.

¹⁵⁵ MacDonald Eggers (n3) 11.

¹⁵⁶ *Master v Miller* (1791) 4 TR 320, 330 per Lord Kenyon.

¹⁵⁷ *Standard Chartered Bank v Pakistan National Shipping Corp (No. 2)* [2000] 1 Lloyd's Rep. 218, 221 per Cresswell J.

¹⁵⁸ *United City Merchants (House of Lords)* (n8) 9 per Lord Diplock.

become less willing to finance credit transactions¹⁵⁹ or else demand significantly higher compensation for their services. The banks could also require parties to take additional steps to authenticate the documentation thus increasing the expense and complexity of the mechanism.

ii. The issues relating to forgery

The House of Lords rejected forgery as an independent basis to prevent payment under a documentary credit. Lord Diplock held that a defence which did not require the beneficiary to have knowledge of the wrongdoing “would embrace the fraud exception and render it superfluous.”¹⁶⁰ This indicates his conflation of two distinct issues; documentary compliance and defences to payment. As discussed earlier, the identity of the wrongdoer only becomes relevant in relation to defences. The approach to forgery fails to respect the parties’ allocation of risk (a) and elevates the documentary credit above other negotiable instruments (b). This is likely to impact on commercial certainty, exactly the consequence that Lord Diplock sought to avoid in his construction of the fraud exception.

a. Distorts contractual risk allocation with respect to known forgery

The letter of credit is properly regarded as a compromise method of trade financing since it provides reassurance to both buyer and seller.¹⁶¹ This is particularly evident in the balance drawn in respect of the forgery risk. If strict compliance is analysed as a pre-condition to payment, the risk that third party defects are discovered prior to payment is borne by the beneficiary. By contrast, the rule of apparent compliance places the risk that documents are subsequently discovered to be forgeries on the applicant. The applicant may of course attempt to shift this loss back to his immediate seller by way of an action on the underlying contract.

The decision in *United City Merchants* fails to give due respect to this allocation of risk. It puts the whole risk of forgery – both known and unknown at the time of presentation – onto the

¹⁵⁹ EP Ellinger, ‘Fraud in documentary credits’ [1981] JBL 258, 269.

¹⁶⁰ *United City Merchants (House of Lords)* (n8) 7 per Lord Diplock.

¹⁶¹ See earlier, Chapter Four, text to fn 11.

credit applicant. This is because Lord Diplock's analysis contractually obliges banks to pay unless the forgery can be connected to the beneficiary at the time of presentation.

This lack of respect is surprising for several reasons. Firstly, the existence of the ICC's Commercial Crime Service enables banks to refer documents for authentication within the period permitted for examination.¹⁶² This creates the distinct possibility that banks would definitively know that a document was not genuine but would, on Lord Diplock's analysis, nevertheless be contractually bound to pay.¹⁶³ This is illogical given that the bank, by contrast, can reject documents for technical discrepancies. Moreover, non-genuine documents, against which the bank is bound to pay, are more likely to indicate an issue with the underlying transaction than those containing technical defects.¹⁶⁴ It is worth recalling that part of the doctrine of strict compliance is fraud deterrence since discrepancies may indicate a substantive issue with the beneficiary's performance.¹⁶⁵

The existence of the Commercial Crime Service also points to broader issues relating to the credit mechanism. In the first place, the Service facilitates knowledge acquisition by the bank which is surprising given that the bank's role is intended to be purely administrative. It would be interesting, therefore, to see how a court would reconcile the bank's discovery of non-conformity via the Commercial Crime Service with Article 34 UCP which expressly disclaims the bank's liability for the effectiveness and genuineness of documents.¹⁶⁶ The Commercial Crime Service provides further support for the sequential analysis i.e. that forged or null documents could be rejected for non-conformity. This is because there would seem to be little role, if any, for the Service if the bank was contractually obliged to pay, as per Lord Diplock's judgment, despite the discovery of defects before payment had been made.

¹⁶² ICC Commercial Crime Services, 'Trade Finance Documents Authentication', <https://www.icc-ccs.org/icc/imb/services/due-diligence/trade-finance-documents-authentication> (accessed 17/07/2016).

¹⁶³ A problem identified by W Blair, 'Commentary on 'Documents and contractual congruence in international trade'' in Worthington, S. (ed.), *Commercial Law and Commercial Practice* (Hart, 2003) 245; C Schmitthoff, 'Export trade (Case comment)' [1982] JBL 319, 321.

¹⁶⁴ P Ellinger, 'Documentary credits and finance by mercantile houses' in *Benjamin* (7th ed.) (n145) [23-143] as cited in Horowitz (n12) [3.19].

¹⁶⁵ Horowitz (n12) [3.19].

¹⁶⁶ There is, to the author's knowledge, no reported case in which these issues have arisen in the English courts.

Secondly, the judges have consistently followed the parties' agreed risk allocation elsewhere in the credit network. In relation to the fraud exception, for example, Kerr J made clear that the courts would not be swayed by the difficulties of later actions on the underlying contract because "these are risks which the merchants take...This is unfortunate for the plaintiffs, but it is what they have agreed."¹⁶⁷

Finally, the decision in *United City Merchants* departs from what would ordinarily be recognised as an efficient allocation of risk. The risk would generally be placed on the party closest to the potential forger as he is in the best position to prevent and uncover such forgeries.¹⁶⁸ Applying this logic to the credit context, one would expect the beneficiary to bear the risk in respect of forgeries discovered prior to presentation. Indeed, this was Stephenson LJ's approach in *United City Merchants* noting that it was the beneficiary "who put [the loading broker] in the position in which he made the bill, and made it fraudulently, and...it is they...who should pay."¹⁶⁹ The fact that the loss does not fall on the beneficiary in these circumstances is surprising,

English law...appears to protect shrewd sellers who utilise the services of third parties who are discreet enough to keep their fraudulent practices to themselves. The law in effect encourages sellers not to inquire into the details of the activities of third parties involved in their transactions so long as the bills of lading appear valid, for any knowledge of wrongdoing would jeopardise the sellers' chance of being paid.¹⁷⁰

The judicial disregard for the parties' agreement is likely to have consequences for commercial certainty and the popularity of the credit mechanism. If non-conformity was to be interpreted broadly, banks would be able to reject forged documents irrespective of the forger's identity. This solution would tend to reduce the incidence of fraud¹⁷¹ and transfer the

¹⁶⁷ *Harbottle* (n75) 155-156 per Kerr J.

¹⁶⁸ A Schwartz and R Scott, *Commercial Transactions Principles and Policies* (The Foundation Press, 1982) 21, 918; A Kronman, 'Mistake, disclosure, information, and the law of contracts' (1978) 7 J Leg. Stud. 1, 4.

¹⁶⁹ *United City Merchants (Court of Appeal)* (n139) 623 per Stephenson LJ.

¹⁷⁰ GL Smith, 'Irrevocable letters of credit and third party fraud: *The American Accord*' (1983-1984) 24 Va J Intl L 55, 70-71.

¹⁷¹ Gao, *The Fraud Rule* (n23) 133 (arguing that public policy and considerations of fraud prevention militate in favour of this construction).

risk of forgery discovered prior to presentation to the beneficiary. It will be remembered from the foregoing discussion that these documents remain effective to transfer ownership in goods. The author's conclusions on whether a broad or narrow approach to conformity is preferred will be discussed in due course (iv).

b. A distinction between documentary credits and negotiable instruments

The House of Lords' approach to forgery also creates an unhelpful distinction between documentary credits and negotiable instruments, such as bills of exchange and bank notes.¹⁷² The comparison between the credit and negotiable instruments is appropriate because these mechanisms are all designed to be "as good as cash."¹⁷³ Indeed, it is this characteristic of the documentary credit that serves to ensure swift payment in international transactions. The fewer ways in which a payment under one of these instruments can be disrupted, the more it will resemble cash.¹⁷⁴

The result in *United City Merchants* means that the law will respond differently to the forgery of a required document under a letter of credit than to a forged bill of exchange. In the context of documentary credits, the discovery that a required document has been forged will have no impact on the bank's duty to pay, unless that forgery can be attributed to the beneficiary in time. By contrast, the Bills of Exchange Act 1882 provides,

where a signature on a bill is forged or placed thereon without the authority of the person whose signature it purports to be, the forged or unauthorised signature is wholly inoperative, and no right to retain the bill or to give a discharge therefor or to

¹⁷² M Bridge, 'Documents and contractual congruence' (n105) 231 recognises "divergence" between letters of credit and bills of exchange. It is arguable that the English courts' refusal to recognise nullity as a separate defence to payment in *Montrod* corresponds with the treatment of negotiable instruments. See M Bridge, *The International Sale of Goods: Law and Practice* (2nd ed. OUP, 2007) [6.82] where he argues that "...*non est factum*, which have a close kinship with documentary nullities, may be asserted even against a holder in due course of a negotiable instrument."

¹⁷³ *Power Curber v Bank of Kuwait* [1981] 2 Lloyd's Rep. 394, 398 per Denning LJ; *Safa v Banque du Caire* [2000] 2 Lloyd's Rep. 600, 605 per Waller LJ.

¹⁷⁴ Bridge, 'Documents and contractual congruence' (n105) 231.

enforce payment thereof against any party thereto can be acquired through or under that signature.¹⁷⁵

Accordingly, the holder of a bill of exchange will be unable to obtain payment where the signature was forged, even though the forgery was carried out by a third party or that the creditor was unaware of that fact. The same rationale is applied to bank notes.¹⁷⁶

The approach to forgery in the law of negotiable instruments must be designed to ensure confidence in the mechanism. There also appears to be an efficiency consideration at play here, namely that the instrument becomes inoperative as soon as the forgery is established. There is no need to connect the wrongdoing with the person presenting the instrument. We have seen in the context of the fraud exception the difficulties associated with proving the mindset of the beneficiary.¹⁷⁷ It is unlikely that the commercial community would explicitly countenance the development of a payment mechanism which took a different, and more permissive, approach to forgery in comparison to other highly liquid instruments. This is however the bizarre, and no doubt unintended, effect of the decision in *United City Merchants*.

iii. *The issues relating to nullity*

Although the impact of null documents on the beneficiary's right to payment was not conclusively settled in *United City Merchants*,¹⁷⁸ there is no doubt that Lord Diplock's approach to non-genuine documents influenced the subsequent consideration of nullity in *Montrod v Grundkötter*.¹⁷⁹ The Court of Appeal refused to recognise nullity as an independent basis for rejection of the documents citing *inter alia* the unacceptable threat that this would pose to the doctrine of autonomy.¹⁸⁰ This is evidence of the Court's refusal to accept the sequential analysis in which documentary compliance is considered in isolation before defences to payment become relevant. The circulation of null documents causes problems

¹⁷⁵ Bills of Exchange Act 1882 s.24.

¹⁷⁶ C Proctor, *Mann on the Legal Aspect of Money* (7th ed. OUP 2012) [1.74].

¹⁷⁷ See earlier discussion, Chapter Four, Part III (D) (ii).

¹⁷⁸ *United City Merchants (House of Lords)* (n8) 9 per Lord Diplock.

¹⁷⁹ *Montrod* (n123) [55] per Potter LJ.

¹⁸⁰ *Ibid* [56] per Potter LJ.

for parties using documentary credits to finance their transactions. The first of these relates to the security that the documents represent for the ultimate buyer and the issuing bank (a). The approach to nullity also distinguishes documentary credits from CIF contracts and this is not justifiable on policy grounds (b).

a. The documents as security

Transactions financed by a letter of credit, much like other documentary transactions, rely on the fact that the shipping documents transfer ownership and other contractual rights from seller to buyer. In particular, the documents enable the ultimate buyer to take delivery of the goods¹⁸¹ and to bring a subsequent action if the goods have been damaged in transit.¹⁸² But the documents must be genuine for this purpose; the buyer will be unable to assert title or any other right in respect of the goods when he has received nullities.¹⁸³ Although the credit arrangement places the risk of poor quality goods on the final buyer, it is not designed to transfer the risk of worthless documents to the person in this position. This is because the doctrine of strict compliance should operate to screen out nullities before payment. The judicial approach to nullity thus exposes him to a greater risk – an inability to collect the goods or bring legal action in respect of them – than he was willing to accept under the credit.

The documents, perhaps more importantly, also represent security for the issuing bank in exchange for the advances it makes to the beneficiary on the applicant's behalf.¹⁸⁴ This reflects the fact that the credit mechanism transfers the risk of buyer insolvency from the beneficiary to the issuing bank. This risk is mitigated by two factors; firstly, that the bank retains the documents until it has been reimbursed by the buyer and, in addition, the bank's direct knowledge of the applicant's creditworthiness.¹⁸⁵ This enables the bank to determine

¹⁸¹ *Lickbarrow v Mason* 100 ER 35 (1787), 39 per Ashhurst J; *Benjamin* (9th ed.) (n86) [18-007]; R Goode, *Proprietary Rights and Insolvency in Sales Transactions* (2nd ed. Sweet & Maxwell, 1989), 59-60.

¹⁸² Carriage of Goods by Sea Act 1992 s.2(1); Bridge, 'Documents and contractual congruence' (n105) 216. Or to bring an action in negligence against the carrier, as was the case in *Niru Battery Manufacturing v Milestone Trading Ltd (No. 1)* [2002] 2 All ER (Comm) 705.

¹⁸³ P Todd, *Bills of Lading and Bankers Documentary Credits* (4th ed. Informa, 2007), [9.148].

¹⁸⁴ McKendrick, *Goode on Commercial Law* (n114) 1106: the tender of worthless documents "undermines the security of transactions for banks where they advance funds to their customers on the security of the documents."

¹⁸⁵ Smith (n170) 94-95: "The reply was unanimous: the credit-worthiness of the customer is the overriding and sometimes exclusive basis on which banks issue letters of credit. Expenses incurred in resale and the usually dramatic discount at which goods are resold in order to realize security makes the value of the goods as represented by the documents of almost academic significance in practice." See also, K Donnelly, 'Nothing for nothing: A nullity exception in letters of credit' [2008] JBL 316, 357.

whether to issue the credit and on what terms.¹⁸⁶ In the event of the buyer's insolvency prior to reimbursement, the issuing bank can sell the documents in the market to recoup its losses. This is impossible where the bank has received nullities.

The bill of lading in *United City Merchants* was not a nullity since the fraud merely related to the date and place of shipment. It remained a valid, transferable receipt for the goods¹⁸⁷ and did not diminish the bank's security interest to any material degree. It is for this reason that commentators, while criticising the reasoning that the House of Lords employed, have accepted the result on the facts.¹⁸⁸ But the House of Lords also refused to recognise the bank's interest as an overriding concern in circumstances where the documents were "worthless to the confirming bank as security for its advances to the buyer."¹⁸⁹ This is very difficult to justify since a bank in receipt of nullities will be unable to mitigate its loss in the event of the applicant's insolvency.¹⁹⁰ Of course, the bank's knowledge of the buyer's financial position means that insolvency is relatively unlikely to occur since the bank would refuse to issue a credit to a customer with a poor credit history.¹⁹¹ Unexpected insolvencies no doubt occur, however, and in such circumstances the bank would have no means of mitigating its loss and would not receive any consideration for its performance. This is a wholly unsatisfactory result which is directly attributable to the court's refusal to recognise nullity as a matter affecting documentary compliance.

b. [A distinction between documentary credits and CIF contracts](#)

The result of the Court of Appeal's decision in *Montrod* is that the presentation of a nullity will make no difference to the bank's duty to pay if the documents appear to conform. This distinguishes the documentary credit from the treatment of nullities presented under CIF contracts.

¹⁸⁶ Moses (n71) 73 (describing the insolvency of credit applicants as "rare" provided the issuing bank has engaged in adequate pre-contractual screening.)

¹⁸⁷ *United City Merchants (House of Lords)* (n8) 9 per Lord Diplock; Gao, *The Fraud Rule* (n23) 132.

¹⁸⁸ Goode, 'Abstract payment undertakings' (n98) 231: "the ruling...might just possibly be sustainable on the ground that the insertion of a false shipping date in the bill of lading did not prevent it from being what it purported to be, so that it could be validly tendered by a beneficiary in good faith"; Gao, *The Fraud Rule* (n23) 133.

¹⁸⁹ *United City Merchants (House of Lords)* (n8) 9 per Lord Diplock.

¹⁹⁰ Gao, *The Fraud Rule* (n23) 129-130. Recognised as a possibility in *United City Merchants (House of Lords)* (n8) 9 per Lord Diplock.

¹⁹¹ Moses (n71) 41; Smith (n170) 94-95.

In the context of CIF contracts, the judgment in *Gill & Duffus v Berger* created a general proposition that the buyer was required to accept apparently conforming documents.¹⁹² To do otherwise, Lord Diplock remarked, “would destroy the very roots of the system by which international trade, particularly in commodities, is enabled to be financed.”¹⁹³ At first glance, this would suggest that the approach to nullities is identical in CIF and documentary credit contracts and, moreover, depends on similar policy considerations. In the CIF context, however, this general proposition is modified by two considerations. Firstly, the seller is required to tender genuine documents, as distinct from those which only appear to be genuine.¹⁹⁴ The buyer, therefore, can reject non-genuine documents¹⁹⁵ without incurring any liability to pay the seller.¹⁹⁶ It is the character of the documents which is important here and not the mindset of the seller at the time of presentation. In addition, case law following *Gill & Duffus* has confined the application of the general proposition to enable the buyer to reject backdated¹⁹⁷ or null documents¹⁹⁸ even though the presentations may appear to conform. The current position, therefore, is that nullity will enable the CIF buyer to reject the documents whereas the issuing bank will be required to make payment where the documents presented under a credit appear to comply.

The question then is whether this difference in the treatment of nullities matters. In general terms, Professor Bridge has argued that CIF and documentary credit contracts need not be identical in their approach to the quality of tendered documents as they “are very different contracts.”¹⁹⁹ There is no doubt merit in this as a starting point, given that the banks’ involvement and the importance of the doctrine of autonomy in credit transactions

¹⁹² *Gill & Duffus SA v Berger & Co Inc* [1984] AC 382

¹⁹³ *Ibid* 391 -392 per Lord Diplock.

¹⁹⁴ *Hindley & Co v East Indian Produce Co* [1973] 2 Lloyd’s Rep. 515, 518 per Kerr J “an implied term of a contract of this nature that the bill of lading shall not only appear to be true and accurate in the material statements which it contains, but that such statements shall in fact be true and accurate.” *James Finlay & Co v Kwik Hoo Tong* [1929] 1 KB 400, 416 per Sankey LJ holding that the bill of lading must be genuine.

¹⁹⁵ For example, where the bill of lading covers goods not actually shipped: *Hindley* (n191) 518; a bill of lading bearing a false shipment date: *James Finlay* (n194) 413 per Greer LJ, *Kwei Tek Chao v British Traders and Shippers* [1954] 2 QB 459, 482 per Devlin J.

¹⁹⁶ *Benjamin* (9th ed.) (n86) [19-149].

¹⁹⁷ *Panchaud Frères SA v Etablissements General Grain Co* [1970] 1 Lloyd’s Rep. 53, 58 per Lord Denning MR; *Proctor & Gamble v Becher GmbH* [1988] 1 Lloyd’s Rep. 88, 91 per Leggatt J.

¹⁹⁸ *Hindley & Co* (n194) 519 per Kerr J; *Benjamin* (9th ed.) (n86) [19-035].

¹⁹⁹ Bridge, ‘Documents and contractual congruence’ (n105) 239.

distinguish the mechanisms.²⁰⁰ While it is true that autonomy has no application in the context of a CIF sale,²⁰¹ the overwhelming weight of academic commentary, with which the author agrees, makes clear that this distinction is irrelevant when it comes to nullity.²⁰² This is because a finding that a document has no legal value does not involve an enquiry into the goods or the underlying contract.²⁰³ Rather, the enquiry would simply relate to the quality or character of the tendered document. This would in no way threaten the autonomy of the contracts created by the documentary credit. It would be preferable, therefore, for the law to take the same approach to nullity in CIF and letter of credit contracts.²⁰⁴

The difference in treatment also makes little sense from the perspective of efficient risk allocation. The CIF seller and the credit beneficiary are both the closest party to the source of the nullity or backdating, in their respective transactions. Ordinary patterns of risk allocation, discussed above,²⁰⁵ would impose liability on the party best placed to identify defects at source, either because he takes the documents directly or selects the third party charged with creating them.²⁰⁶ There is no reason that the approach ordinarily regarded as efficient should be applicable in the CIF context but not in relation to letters of credit. This creates incentives for the CIF seller to take care in selecting third parties but absolves the credit beneficiary from all responsibility in this respect.

Analytical difficulties apart, the divergent approaches to nullity have a significant practical consequence in determining which party is without funds during the ensuing litigation. In the CIF context, the buyer can shift the risk of loss immediately back onto his seller if the documents are non-compliant or contain latent defects, such as a false shipping date.²⁰⁷ The onus is then on the seller to bring an action for wrongful rejection. This is contrary to the position involving a letter of credit where the buyer-applicant must bring an action against

²⁰⁰ Ibid 239; Bridge, 'Documents and cif contracts' (n125) 6.

²⁰¹ P Todd, 'Non-genuine shipping documents and nullities' [2008] LMCLQ 547, 566.

²⁰² Bridge, 'Documents and contractual congruence' (n105) 234; Horowitz (n12) [3.16], [3.29]; Neo, 'A nullity exception' (n145) 60.

²⁰³ Bridge, 'Documents and contractual congruence' (n105) 235; Horowitz (n12) [3.16].

²⁰⁴ Bridge, 'Documents and contractual congruence' (n105) 234.

²⁰⁵ See earlier, text to fn 168.

²⁰⁶ Schwartz and Scott (n168) 21, 918. Note that this is the logic adopted in *United City Merchants (Court of Appeal)* (n139) 623 per Stephenson LJ.

²⁰⁷ *Benjamin* (9th ed.) (n86) [19-080].

the seller for breach, having already reimbursed the issuing bank. This places the credit applicant in a much less favourable position which is difficult to justify given the foregoing discussion of risk allocation.

Given the clear judicial reluctance to recognise nullity as a basis for rejection,²⁰⁸ Professor Bridge has attempted to reconcile this inconsistency between CIF contracts and documentary credits. His solution was to draw an analogy with the decision in *Cargill International v Bangladesh Sugar*.²⁰⁹ In that case, the court held that a beneficiary who obtained an overpayment under a performance bond had a duty to account for the excess.²¹⁰ Bridge's suggestion was that the credit beneficiary would be under a similar implied duty to account for the price where the credit applicant had rejected the goods for non-conformity.²¹¹ With respect, this solution only goes so far. To put the onus on the buyer to bring an action for the price complicates matters and would require additional litigation. In addition, Bridge's solution is only likely to work in respect of the honest seller who, as an intermediate party in a string sale, had nothing to do with the physical defects and could in turn shift the loss back onto his seller. By contrast, in circumstances where the nullity is part of a fraudulent scheme but the credit applicant is unable to invoke the fraud exception, an action for the price may constitute no solution whatsoever. It follows that the position must be modified – to equate the approach in documentary credits with the CIF position – by the appellate courts in an appropriate case.

iv. A new approach to nullity and forgery?

The practical and analytical difficulties flowing from the decision in *United City Merchants* are not so much attributable to the restrictive approach to fraud, but to Lord Diplock's conflation of forgery, nullity and fraud. Significantly, these consequences undermine Lord Diplock's justification for a narrow approach to fraud by the beneficiary; to maintain the documentary credit as an efficient method of trade financing. The sequential analysis propounded by

²⁰⁸ *Montrod* (n123) [58] per Potter LJ.

²⁰⁹ *Cargill International v Bangladeshi Sugar & Food Industries Corp* [1998] 1 WLR 461. (confirmed in *Tradigrain SA v State Trading Corporation of India* [2006] 1 Lloyd's Rep. 216, [26] per Christopher Clarke J.) as cited in Bridge, 'Documents and contractual congruence' (n105) 240.

²¹⁰ *Cargill* (n209) 469 per Potter LJ.

²¹¹ Bridge, 'Documents and contractual congruence' (n105) 239-240.

Goode, discussed earlier in this chapter,²¹² provides a means of disentangling these related issues. It should be noted that Goode's analysis is not simply of theoretical interest; indeed, as founder of the Centre for Commercial Law Studies,²¹³ he could hardly be described as lacking real-world insight. To this end, this part of the discussion considers the extent to which the detrimental consequences flowing from *United City Merchants* demand a different approach to forged and null documents.

The sequential analysis first considers the conformity of the documents. As noted above, non-conformity has been conceptualised in both broad and narrow terms in the literature. The broad view of non-conformity would entitle the bank to reject documents containing any known forgery, fraudulent misstatement or nullity at the time of presentation. There is considerable academic support for this standard of non-conformity,²¹⁴ including Goode himself in the following comments,

The short point is that the UCP and the terms of every credit require the presentation of specified documents, that is, documents which are what they purport to be, and there is no warrant for the conclusion that this entitles the beneficiary to present, for example, any old piece of paper which purports to be a bill of lading...even if it is forged, unauthorised, or otherwise fraudulent.²¹⁵

By contrast, the narrower conception of non-conformity regards only null documents as non-conforming. The focus is whether the presented documents are capable of fulfilling their intended purpose. Indeed, this is the approach Goode uses to justify the actual result in *United City Merchants* given that "the insertion of a false shipping date in the bill of lading did not prevent it from being what it purported to be."²¹⁶

²¹² See earlier, text to fn 126 et seq.

²¹³ Queen Mary University of London, 'About the Centre for Commercial Law Studies (CCLS)' available at: <http://www.ccls.qmul.ac.uk/about/index.html> (accessed 02/09/2016).

²¹⁴ Hooley, 'Fraud and letters of credit' (n145) 280; Neo, 'A nullity exception' (n145) 60; Horowitz (n12) [3.21].

²¹⁵ McKendrick, *Goode on Commercial Law* (n114) 1106.

²¹⁶ Goode, 'Abstract payment undertakings' (n98) 231.

Whichever standard of non-conformity is preferred, it must be emphasised that to recognise forgery or nullity as independent bases to reject documents would not create a new defence to payment. Rather, it would simply enable the banks to fulfil their intended function; to determine objectively whether the presented documents are those required under the credit. Furthermore, to depart from the current judicial approach to nullity and forgery would not undermine the principle of autonomy. This is because, as Neo has noted, “a fraud in relation to a document that renders it a nullity must surely be directly linked to the document itself rather than a matter confined to the underlying contract.”²¹⁷ The doctrine of autonomy would only be threatened if issues relating to the underlying contract were used to disrupt payment under the credit itself.

The author’s view is that the narrow approach to non-conformity is to be preferred. This reflects the fact that null documents cannot fulfil their intended commercial function whereas forged documents remain capable of representing the goods. To treat null documents as non-conforming would overcome many of the difficulties associated with the current judicial approach to nullity. Most notably, the circulation of non-genuine documents would reduce and this would safeguard the bank’s position in the event of the credit applicant’s insolvency. The author’s preference for the narrow conception of non-conformity is borne of pragmatism, designed to reflect the importance of maintaining the credit as an efficient device for financing international trade without unduly increasing the number of rejected presentations. The price of pragmatism, however, is a loss of conceptual clarity because mere forgeries would not be regarded as non-compliant even though they cannot sensibly be regarded as the documents stipulated by the credit. This means that the consequences of the current approach to forgery – a distinction between documentary credits and negotiable instruments and the judicial failure to respect the parties’ risk allocation with regard to forgery – remain. As these issues are largely problematic from a conceptual standpoint, the author’s contention is that the efficiency of the credit mechanism overrides these conceptual difficulties and justifies the narrow approach to non-conformity.

²¹⁷ Neo, ‘A nullity exception’ (n145) 60.

For this to become a reality, a case would need to reach the Supreme Court to overcome both the House of Lords' decision in *United City Merchants* and that of the Court of Appeal in *Montrod*. Taking the approach to non-conformity in *United City Merchants* first, the UCP 600 makes it easier to recognise a null document as non-complying than it was under the UCP 500.²¹⁸ This is because the definition of complying presentation in Article 2 explicitly refers to documents "in accordance with the terms and conditions of the credit."²¹⁹ Documents without any legal effect could never satisfy this definition. Furthermore, the numerous references to 'on their face' have been removed which serves to confirm that the bank's obligation to pay is triggered by a complying presentation, and not merely one which appears to conform.²²⁰ These revisions to the UCP should enable a modern court to confine the decision in *United City Merchants* to credits which incorporated the UCP 500.

The Court of Appeal firmly rejected a nullity exception to autonomy in *Montrod*²²¹ without considering the issue as a matter of non-compliance. By contrast, the approach of the Singaporean Court of Appeal in *Beam Technology v Standard Chartered Bank*²²² provides useful guidance as to how a future court might distinguish *Montrod*. In *Beam*, the buyer had notified the seller that air waybills would be issued by freight forwarders, Link Express, although it later transpired that the named entity did not exist. The Singaporean Court preferred the reasoning of the Court of Appeal in *United City Merchants*²²³ and advocated the sequential analysis in the following terms,

While the underlying principle is that the negotiating/confirming bank need not investigate the documents tendered, it is altogether a different proposition to say that the bank should ignore what is clearly a null and void document and proceed nevertheless to pay. Implicit in the requirement of a conforming document is the assumption that the document is true and genuine although under the UCP 500 and common law, and in the interest of international trade, the bank is not required to

²¹⁸ Horowitz (n12) [3.26].

²¹⁹ UCP 600 art.2.

²²⁰ Horowitz (n12) [3.26]; UCP arts. 2, 6, 7.

²²¹ *Montrod* (n123) [58] per Potter LJ.

²²² *Beam Technology (Mfg) Pte Ltd v Standard Chartered Bank* [2002] SGCA 53.

²²³ *Ibid* [31] per Chao Hick Tin JA, Tan Lee Meng J.

look beyond what appears on the surface of the documents. But to say that a bank, in the face of a forged null and void document (even though the beneficiary is not privy to that forgery), must still pay on the credit, defies reason and good sense. It amounts to saying that the scheme of things under the UCP 500 is only concerned with commas and full stops or some misdescriptions, and that the question as to the genuineness or otherwise of a material document, which was the cause for the issue of the LC, is of no consequence.²²⁴

The Court further distinguished the decision in *Montrod* by reference to the fact that the document in the English case was “not...essential”²²⁵ in that it related only to the quality of the goods. While this reasoning is tenuous – compliance depends on *all* documentary conditions detailed in the credit being complied with – the decision in *Beam* usefully demonstrates the desire to move away from the English approach. Indeed, the Court also suggested that the definitional issues identified by Potter LJ²²⁶ could be overcome,

...there could be difficulties in determining under what circumstances a document would be considered material or a nullity, such a question can only be answered on the facts of each case. One cannot generalise. It is not possible to define when is a document a nullity. But it is really not that much more difficult to answer such questions than to determine what is reasonable, an exercise which the courts are all too familiar with.²²⁷

The fact that the Singaporean court easily overcame the supposed definitional issues makes it particularly disappointing that the House of Lords refused leave to appeal in *Montrod*.²²⁸ The approach to nullity contended for here depends on a suitable case reaching the Supreme Court. There is, as noted elsewhere in this thesis, an absence of recent case law on the proper parameters of the fraud exception, though this is more likely attributable to the chilling effect

²²⁴ Ibid [33] per Chao Hick Tin JA, Tan Lee Meng J.

²²⁵ Ibid [31] Chao Hick Tin JA, Tan Lee Meng J.

²²⁶ *Montrod* (n123) [58] per Potter LJ.

²²⁷ *Beam Technology* (n222) [36] per Chao Hick Tin JA, Tan Lee Meng J.

²²⁸ *Montrod* (n123) 1999.

of *United City Merchants* than an actual absence of fraud.²²⁹ One can readily understand commercial parties' reluctance to litigate seemingly settled doctrine. The situation has not been helped by subsequent judicial and academic discussion which has continued to conflate the related issues of fraud, forgery and nullity and to characterise them as requiring additional inroads into autonomy.²³⁰ While the author believes the arguments in favour of viewing nullity as a matter affecting documentary compliance are strong, there is not, at the time of writing, a case making its way to the Supreme Court which would enable the matter to be reconsidered.

The final critique of the judicial approach to fraud is based in empirical work conducted in the United States. The analysis is used to suggest that informal mechanisms to control fraud exist throughout the life of exchange, and not merely in the pre-contractual stage as English case law contends.

III. The Empirical Critique

The final critique of the English courts' approach to fraud is rooted in empirical work conducted in the United States in the late 1990s.²³¹ This work undermines the traditional explanation of the credit mechanism, namely that it is a device for assuring the seller of payment, and undermines the significance of strict compliance. This section reflects on the empirical picture of credit use and reconsiders fraud deterrence from this perspective.

The empirical work indicates that parties use credits more informally than doctrine would suggest. Payments were routinely made against seriously defective documentary presentations. The assurance of payment was therefore transformed into a payment discretion, precisely one of the risks that the seller sought to abrogate by using the credit in

²²⁹ See Bridge, *The International Sale of Goods: Law and Practice* (2nd ed. OUP, 2007), [6.84]: "failure of fraud cases to go to trial gives rise to some difficulty in defining fraud and giving instructive examples"

²³⁰ *Montrod* (n123) [58] per Potter LJ; Malek and Quest, *Jack* (n64) [9.23]: "such a rule [on nullity] will assist the integrity of the system of documentary credits as a means of financing international transactions, whereas any widening of the exception will detract from it.", [9.24]; EP Ellinger and D Neo, *The Law and Practice of Documentary Letters of Credit* (Hart, 2010), 168. See also Horowitz (n12) [3.12]. A notable exception, other than Goode, is Bridge, 'Documents and contractual congruence' (n105) 213, 230: "despite language used in some of the cases, fraud on the one hand and forgery and nullity on the other hand are analytically separate, the latter are not variations of fraud."; L Chin and Y Wong, 'Autonomy – A nullity exception at last?' [2004] LMCLQ 14, 18; Neo, 'A nullity exception' (n145) 67.

²³¹ R Mann, 'The role of letters of credit in payment transactions' (1999-2000) 98 Mich L Rev 2494.

the first place. The focus of the discussion here is to examine what this empirical evidence means for fraud and fraud prevention in documentary credits. It will be suggested that deterrence is not just a pre-contractual issue, as the English courts have typically suggested,²³² but one that survives the duration of the exchange and is managed by the same forces that shape the informal use of the mechanism.

The empirical data is now presented (A). The discussion will first consider why the credit remains popular given that its practical operation differs considerably from the written contract. Two explanations will be offered; firstly, Mann's suggestion that the credit constitutes verification by the issuing bank that the buyer has the capacity to, and will actually, pay against discrepant documents (i) and secondly, Katz's contention that the mechanism can only be understood in the context of providing reassurance to both parties (ii). This analysis situates the credit mechanism in the broader relational network of the market. The final part of the discussion considers what the empirical data tells us about fraud in credit transactions (B). The data will be used to provide concrete support for the judicial account of deterrence before developing a relational framework to suggest that deterrence mechanisms are present throughout the life of the exchange.

A. The empirical work

The empirical study which forms the basis for the discussion was conducted by Professor Ronald Mann in the late 1990s.²³³ He sought to test anecdotal evidence which suggested that documentary credits functioned very differently in practice than predicted by doctrine.²³⁴ Mann gathered data relating to 500 credit transactions from five American banks involving the American party as exporter in half of the transactions, and importer in the other half.²³⁵ He also conducted interviews with ten bank managers whose institutions specialised in letters of credit.²³⁶

²³² *Sanders* (n4) 343 per Bowen LJ.

²³³ Mann, 'The role of letters of credit' (n231).

²³⁴ *Ibid* 2495.

²³⁵ *Ibid* 2496-2497.

²³⁶ *Ibid* 2497.

The major finding from Mann’s work was that documentary presentations were typically discrepant but that discrepancies were not used as a means to refuse payment.²³⁷ Indeed, only 27% of the 500 presentations strictly conformed to the terms of the credit.²³⁸ The discrepancies ranged in severity from technical defects, such as issues with presentation rather than performance,²³⁹ to missing documents and those which indicated default on the underlying contract.²⁴⁰ To be clear, all of these discrepancies would have been sufficient for the bank to refuse payment. Instead, full payment was made against all but one discrepant presentation.²⁴¹ In this latter case, the beneficiary received 94% of the contract price.²⁴² Payment was made via the waiver process²⁴³ and, in most cases, waiver was obtained within one banking day.²⁴⁴

Mann’s results indicate that the day-to-day operation of the credit differs considerably from the doctrinal account of the mechanism. The difficulty for our purposes is that the data do not admit of simple interpretation. The results were not explicable by reference to the relative size of the parties nor their respective location.²⁴⁵ Unfortunately, the data are no longer available for further interrogation.²⁴⁶

The data fundamentally challenges the doctrinal account of the mechanism in which swift, certain payment is achieved by the presentation of conforming documents. While the waiver mechanism did not appear to elongate the process in Mann’s study,²⁴⁷ the mechanism necessarily complicates the autonomous nature of payment. This is because the waiver process tasks the buyer with the payment decision. This resurrects the risk that the buyer

²³⁷ Ibid 2502. This was described as “a general pattern of discrepancy.”

²³⁸ Ibid 2502.

²³⁹ Ibid 2504-2505.

²⁴⁰ Ibid 2503-2504.

²⁴¹ Ibid 2513.

²⁴² Ibid 2513.

²⁴³ The survey was conducted in the late 1990s during which time the UCP 500 was in force. Art. 14(c) UCP 500 established the waiver process. This has now been replaced by art. 16(b) in the UCP 600.

²⁴⁴ Mann, ‘The role of letters of credit’ (n231) 2514.

²⁴⁵ Ibid 2507.

²⁴⁶ Mann offered the dataset to other academics for interpretation and analysis, see *ibid* 2497 (fn 8 in original). Accordingly, I sought to obtain the data during this thesis but in personal correspondence with Professor Mann he has confirmed that they are no longer available, see statement by Professor Ronald Mann (Personal email correspondence, 20 May 2015) (on file with the author).

²⁴⁷ It would appear that in the majority of cases that the use of waiver did not unduly delay payment, see *ibid* 2514.

might behave opportunistically, in the sense that factors unrelated to documentary compliance may sway the decision. However, the data revealed a total absence of buyer opportunism during waiver.²⁴⁸ This is interesting because it is hard to imagine that in none of those transactions had market fluctuations rendered the bargain 'bad' for the buyer.²⁴⁹ Both Katz and Gillette have argued that the buyer should only be concerned by discrepancies which indicate substantive default on the underlying contract.²⁵⁰ The problem with this argument is that some of the discrepancies were substantive in nature and full payment was still made. This suggestion also overlooks the possibility that exact compliance might be required for reasons only peripherally connected to the transaction, for example so that the goods can clear customs.²⁵¹ The data further challenged the doctrinal account of the mechanism by indicating that the bank does not simply act in an administrative capacity but is more of a middleman between the buyer and seller. The basis for this will be considered when assessing the analyses of the empirical work in the forthcoming sections.²⁵²

For the purposes of the forthcoming analysis, it is assumed that the results are transferable to the UK context. In the first place, Mann's survey is likely to have included UK parties trading with American counterparts, whether as importer or exporter.²⁵³ If this is the case, it would suggest that UK parties are also using the credit in an informal manner. Evidence gathered by SITPRO, a non-departmental body funded by the UK Department for Business, Innovation and Skills²⁵⁴ has also demonstrated a very high rate of discrepancies on first presentation.²⁵⁵ These

²⁴⁸ Ibid 2513-2514.

²⁴⁹ Either due to a fall in the market or the prospect of a better deal with another party.

²⁵⁰ AW Katz, 'Informality as a bilateral assurance mechanism. Comments on Ronald Mann's 'The role of letters of credit in payment transactions' (1999-2000) 98 Mich L Rev 2554, 2566; C Gillette, 'Letters of credit as signals. Comments on Ronald Mann's 'The role of letters of credit in payment transactions'' (1999-2000) 98 Mich L Rev 2537, 2539.

²⁵¹ Malek and Quest, *Jack* (n64) [8.37].

²⁵² See later, Part III (i) and (ii).

²⁵³ The data are no longer available to determine how many transactions involved a UK party. Statement by Professor Ronald Mann (Personal email correspondence, 20 May 2015)

²⁵⁴ SITPRO, 'SITPRO Simplifying International Trade'
<http://webarchive.nationalarchives.gov.uk/20100918113753/http://www.sitpro.org.uk/> (accessed 03/05/2017)

²⁵⁵ SITPRO and Midland Bank, *Letter of Credit Management and Control* (SITPRO 1985): almost half of 1215 sets of documents were discrepant on first presentation. Later studies conducted by SITPRO provide further evidence of this and are documented in C Schmitthoff, 'Discrepancies of documents in letter of credit transactions' [1987] JBL 94, 94-95. SITPRO was a non-departmental government body with responsibility for harmonising procedures and documentation for international trade and advising traders, the business community and government on best practice. SITPRO closed in 2011 and its functions were passed to the Department for Business, Innovation and Skills, see <https://www.gov.uk/government/news/cable-announces-further-quango-closures>.

ideas have also been picked up to a limited extent in case law²⁵⁶ and academic commentary.²⁵⁷ Where perhaps this UK data differs from that collected in the US is the idea of cure. Schmitthoff described the SITPRO data using the phrase “failure rate”²⁵⁸ and this may suggest that the first presentation was rejected by the confirming bank. Regardless of the idea of cure, the high rate of initial discrepancy nevertheless suggests that the practical operation of credits in the UK does not mirror the traditional account of the mechanism. The following analysis proceeds on the basis that the empirical evidence is transferable to the UK context.

Two explanations of the empirical data will now be provided. A disclaimer is required; the purpose of these analyses was to advance debate surrounding documentary credits based on the empirical evidence rather to provide a ‘once and for all’ account of their use.²⁵⁹

i. Mann’s analysis: Documentary credit as verification institution

The way that credits are used in practice does not guarantee payment to the seller. This is contrary to the doctrinal account of the mechanism. As such, it becomes necessary to consider why parties opt for an expensive mechanism²⁶⁰ but then use it in a way that deprives it of its unique quality. Mann himself provided one such analysis for the continued use of documentary credits.

Mann first discredited the notion that parties using credits had a poor understanding of the mechanism or chose the device out of habit.²⁶¹ Those using credits are sophisticated market actors and it was “implausible that [they]...would organize such a large number of transactions in a way that systematically, repeatedly, and pointlessly increases the cost of

²⁵⁶ *Bankers Trust Co v State Bank of India* [1991] 2 Lloyd's Rep 443, 449 per Lloyd LJ.

²⁵⁷ J Ulph, ‘The UCP 600: Documentary credits in the 21st century’ [2007] JBL 355, 356 suggests 70% of documents are discrepant on first presentation.

²⁵⁸ Schmitthoff, ‘Discrepancies of documents’ (n255) 95. The notion that discrepant presentations are cured in the UK is strengthened by R Bergami, ‘Will the UCP 600 provide solutions to letter of credit transactions?’ (2007) 3 Intl Rev of Bus Research Papers 41, 42 where it is said that discrepancies cost £133 million/year to cure in the UK alone.

²⁵⁹ Mann, ‘The role of letters of credit’ (n231) 2533. Indeed, Katz (n250) 2573 and Mann (n231) 2533 both implored other academics to gather further data to test these assumptions. The author has found no evidence that anyone has yet taken up this challenge.

²⁶⁰ Letters of credit typically cost one quarter of 1% of the value of the goods sold i.e. in a transaction worth £1 million, the letter of credit would cost £2500, see Mann, ‘The role of letters of credit’ (n231) 2499.

²⁶¹ *Ibid* 2515-2516.

transactions.”²⁶² Instead the evidence suggested that credits were not the default choice in all international exchanges²⁶³ but were employed in exchanges where there was an absence of relational ties.²⁶⁴ This suggests a degree of discrimination in their use²⁶⁵ which makes it possible to dispose of the idea that parties are using credits out of habit.

Mann then suggested that the traditional understanding of the mechanism – guaranteed payment to the seller – was incomplete since, in practice, the credit did not provide sellers with a legal right to payment.²⁶⁶ The data also suggested the defects were not cured, even in cases in which cure would have been straightforward,²⁶⁷ which led Mann to argue that the presentation of strictly complying documents was less important than suggested in the doctrinal account.²⁶⁸

A baseline assumption in Mann’s analysis was that commercial parties opted for a letter of credit because they believed it strengthened the underlying transaction. The doctrinal account would suggest that this strength is the virtual guarantee of payment to the seller. If the practical usage of the credit does not provide this guarantee i.e. because strictly conforming documents are not routinely presented, the letter of credit must bolster the underlying transaction in some other way and by providing something that the parties cannot (easily) obtain themselves.²⁶⁹ Mann argued that the very issue of the credit provided two types of information: firstly, that the buyer can and will pay notwithstanding documentary defects and secondly, that the transaction is legitimate.²⁷⁰ This discussion focuses on the first type of information, a signal of the buyer’s creditworthiness and non-opportunistic behaviour directed to the seller.

²⁶² Ibid 2516.

²⁶³ Ibid 2518.

²⁶⁴ Ibid 2518.

²⁶⁵ Ibid 2518.

²⁶⁶ Ibid 2519.

²⁶⁷ Ibid 2535: “the defects were curable in about 62% of the 341 cases in which there was a defect...overall, the defects were cured in 35% of the 193 cases for which the defects were curable.”

²⁶⁸ Ibid 2519.

²⁶⁹ Ibid 2521.

²⁷⁰ Ibid 2521.

In Mann's analysis, the issuing bank acts as a reputational intermediary for the buyer.²⁷¹ The feasibility of systems in which a third party stands for the behaviour of another depends on the existence of a sanction should that third party provide false information.²⁷² This would typically be a reputational sanction. The effectiveness of such sanctions demands that credible information about a party's behaviour is available and that it can be transferred to others considering dealing with that party.²⁷³ Mann contended that a reputational sanction existed in the credit context in that a bank's ongoing business would suffer if payments were unsuccessful.²⁷⁴ Mann did not consider how notice of default would be circulated amongst the potential trading community.

A system of reputational intermediation makes sense in the context of letters of credit. Firstly, the seller can assess the reputation of a foreign bank far easier than it can a foreign buyer.²⁷⁵ This may be due to the existence of information local to the seller²⁷⁶ or simply because there are fewer specialist documentary credit banks than there are potential trading partners.²⁷⁷ In this way then the letter of credit minimises transaction costs. Assuming this to be the case, the bank can provide information about the buyer that the seller would otherwise find difficult to obtain. This information relates to the buyer's creditworthiness, namely his ability to pay, and that he will not opportunistically refuse payment during the waiver process. The bank's information is built on *ex ante* screening,²⁷⁸ actual knowledge of the buyer from previous interactions and its ability to monitor the buyer's behaviour throughout the transaction.²⁷⁹ The interview evidence confirmed the banks' dislike for opportunistic rejections, with one interviewee noting that the bank would cease to act on behalf of opportunistic clients.²⁸⁰

²⁷¹ Ibid 2521. See more generally on this topic: R Mann, 'Verification institutions in financing transactions' (1998-1999) 87 Geo LJ 2225, 2258 et seq.

²⁷² Gillette, 'Letters of credit as signals' (n250) 2541.

²⁷³ Ibid 2544.

²⁷⁴ Mann, 'The role of letters of credit' (n231) 2521-2522, 2525.

²⁷⁵ Ibid 2522.

²⁷⁶ Ibid 2533.

²⁷⁷ Ibid 2533.

²⁷⁸ Ibid 2526. Screening by the bank to ensure the creditworthiness of the applicant also makes sense as part of the doctrinal story. For example, Moses (n71) 62 argues that it is particularly important in the event of the applicant's insolvency since the bank will become obliged to make payment against a complying presentation.

²⁷⁹ Mann, 'The role of letters of credit' (n231) 2529.

²⁸⁰ Ibid 2526-2527.

It is important to note that the use of a letter of credit goes beyond reputational intermediation; it displaces the buyer as the primary obligor for payment under the contract.²⁸¹ Of course, there is the possibility that the underlying contract will revive, where, for example the bank fails or the credit expires, and with it the buyer's duty to pay under the original contract.²⁸² In these circumstances the creditworthiness of the buyer would be important to the seller. In general terms, however, this is not how the credit is designed to work; it is intended that the bank makes payment in the first instance and is then reimbursed by the buyer. The absence of strict compliance creates a potential difficulty for the beneficiary if the applicant subsequently goes insolvent.²⁸³ Once the issuing bank (or trustee in bankruptcy) has become aware of the insolvency, they will not permit discrepancies to be waived, even if the applicant had already sanctioned payment.²⁸⁴ Notably, the UCP does not bind the paying bank to the applicant's decision on waiver²⁸⁵ and in these rare²⁸⁶ circumstances the risk of insolvency will be borne by the beneficiary, much like in a transaction without the support of a documentary credit.

For Mann, the continued use of credits was explained by the information that the issuing bank provided to the seller. This information served to reassure the seller that the buyer would pay against discrepant documents and was secured by the threat of a reputational sanction against the bank.

ii. Katz's analysis: Documentary credits and bilateral incentives

An alternative analysis of the empirical data was provided by Professor Avery Katz.²⁸⁷ He contended that Mann's account was incomplete because it failed to recognise that credits are

²⁸¹ Gillette, 'Letters of credit as signals' (n250) 2541-2542.

²⁸² The idea of the letter of credit as 'conditional payment' is evident in *WJ Alan & Co v El Nasr Export and Import Co* [1972] 2 QB 189, 210 per Lord Denning MR.

²⁸³ Moses (n71) 34. This is not a problem in the doctrinal account of the mechanism since seller's routinely present strictly compliant documents which assure them of payment from the bank, irrespective of the applicant's subsequent insolvency.

²⁸⁴ *Ibid* 34.

²⁸⁵ UCP 600 art. 16 (c)(iii)(b).

²⁸⁶ Moses (n71) 73.

²⁸⁷ Katz, 'Informality as a bilateral' (n250).

designed to reassure both parties.²⁸⁸ Moreover, he suggested that the credit could not simply be about the flow of information from bank to seller as similar information was available more cheaply from other sources.²⁸⁹ Of course, if sellers simply wanted an assurance of payment, the bank could send a stronger signal by opening itself to legal, and not simply reputational, liability.²⁹⁰ The routine presentation of discrepant documents means that the bank does not become legally bound to make payment.

In Katz's analysis, the role of the credit was to provide both parties with an incentive to perform.²⁹¹ To demonstrate how the credit fulfilled this function, Katz distinguished two sets of actions which were undertaken in the period before documents were presented for payment. These actions provide concrete information to the parties about each other.

The first category is observable behaviour which cannot be easily or cheaply verified by a third-party enforcer, such as a court.²⁹² These are the actions that the parties take soon after agreeing to trade and depend in large part on the broader network in which the agreement is located. Examples of these behaviours include the exchange of preliminary documentation in which the precise specification of the goods is confirmed, amendments to the underlying agreement as well as information obtained through conversations with other market actors and gossip.²⁹³ This provides information about each party's character and indicates how they are likely to perform over the course of the exchange. Indications of cooperation and flexibility in this phase would suggest that the party is committed to the transaction. Parties can rely on this information because it comes directly from their experience and from other market participants.²⁹⁴ As these soft signals cannot be verified by a court, these actions cannot form the basis of legal obligations.²⁹⁵ Incidentally, the existence of such information channels

²⁸⁸ Ibid 2555-2556.

²⁸⁹ Ibid 2557-2558.

²⁹⁰ Ibid 2555.

²⁹¹ Ibid 2555-2556; The bilateral assurance provided by the mechanism is also recognised by Gillette, 'Letters of credit as signals' (n250) 2539.

²⁹² Katz (n250) 2564.

²⁹³ Ibid 2564.

²⁹⁴ O Williamson, 'Transaction-cost economics: The governance of contractual relations' (1979) 22(2) J Law & Ec 233, 248; G Gundlach, 'Exchange governance: The role of legal and nonlegal approaches across the exchange process' (1994) 13(2) J of Pub Pol & Mark. 246, 253.

²⁹⁵ Katz, 'Informality as a bilateral' (n250) 2564-2565.

would constitute the means by which the reputational sanction in Mann's analysis could be transmitted.²⁹⁶

The second type of action which occurs before the presentation of documents is directly related to the parties' substantive obligations under the contract.²⁹⁷ As such, they are easily and cheaply verifiable by a court and can therefore form the basis of legally enforceable duties.²⁹⁸ These include the completion and procurement of detailed documentation evidencing performance such as the commercial invoice, bill of lading and certificates issued by third parties.²⁹⁹ The completion of these tasks provides a strong signal of a party's willingness to perform their substantive obligations but are expensive and time consuming for the parties to complete.³⁰⁰

On this analysis, the period prior to the presentation of documents provides information to both buyer and seller about their counterpart's willingness to perform and commitment to the transaction. Katz further contended that the exchange of information during this phase determined whether presentation and payment would be dealt with strictly or on a more informal basis.³⁰¹ Katz distinguished two scenarios for this purpose.

If the buyer received sufficient soft signals indicating substantive performance, Katz suggested that he would be less concerned about exact documentary compliance.³⁰² The buyer, assured of substantive performance in this way, would be likely to waive defects. This would reduce the costs associated with strict compliance for the seller.³⁰³ The buyer may also receive indications of deficient performance in the early phases of exchange.³⁰⁴ If this was the case, the buyer would be unwilling to accept discrepant documents and, in these

²⁹⁶ See earlier, text to fn 271 et seq.; Gillette, 'Letters of credit as signals' (n250) 2544.

²⁹⁷ Katz, 'Informality as a bilateral' (n250) 2565.

²⁹⁸ Ibid 2565.

²⁹⁹ Ibid 2565.

³⁰⁰ Gillette, 'Letters of credit as signals' (n250) 2540: strict compliance is expensive because it requires more effective monitoring of third parties and agents and, in the event of rejection, the costs of cure and re-tender are high.

³⁰¹ Katz, 'Informality as a bilateral' (n250) 2565.

³⁰² Ibid 2565, 2567.

³⁰³ Ibid 2565.

³⁰⁴ Ibid 2565.

circumstances, one would expect parties to behave in accordance with the written terms of the credit.³⁰⁵

Pre-presentation information has the potential to reassure the buyer that substantive performance is forthcoming. The opportunity to minimise the expense of strict compliance provides an incentive for the seller to perform his substantive obligations without adhering strictly to the documentary conditions.³⁰⁶ This is only half of the story. To reassure both parties that their counterpart will perform, the mechanism also needs to provide an incentive for the buyer. This is where the issuing bank becomes significant in Katz's analysis.³⁰⁷ By issuing the credit, the bank reassures the seller that the buyer will not behave opportunistically during waiver.³⁰⁸ The information comes from the same sources as in Mann's analysis, namely *ex ante* screening and monitoring during performance.³⁰⁹ It is important to note that the issuing bank has a more limited role in Katz's analysis; the information provided relates only to whether the buyer will pay (opportunism) and not to whether the buyer can pay (creditworthiness).³¹⁰ This comports with the doctrinal account of the mechanism; once the credit has been issued, the seller should have no regard for the buyer's creditworthiness since he will ordinarily look to the bank for payment.³¹¹

Much like Mann, Katz relied on the notion of reputational intermediation by the issuing bank on behalf of its customer, the credit applicant. In order that such intermediation is effective, there must be a sanction imposed on the bank if the buyer behaves opportunistically. Katz recognised both reputational and legal penalties for this purpose.³¹² This goes further than Mann's analysis where the penalty was limited to a reputational sanction. According to Katz, a bank which rejected substantially complying documents would suffer a reputational penalty because it and its customers would garner a reputation for nit-picking.³¹³ Sellers dealing with

³⁰⁵ Ibid 2565, 2567.

³⁰⁶ Ibid 2566.

³⁰⁷ Ibid 2566.

³⁰⁸ Ibid 2566.

³⁰⁹ Ibid 2567.

³¹⁰ Ibid 2566.

³¹¹ Gillette 'Letters of credit as signals' (n250) 2542. This ignores the possibility that the seller may need to seek payment directly from the buyer as where the credit has expired or the bank has itself gone insolvent.

³¹² Katz, 'Informality as a bilateral' (n250) 2566-2567.

³¹³ Ibid 2567.

that bank in the future would know that strict compliance was required which would increase the price of dealing through that bank.³¹⁴ This would render the bank and its customers a less attractive proposition. In Katz's estimation, however, a reputational penalty is insufficient to support the bank's signal alone.³¹⁵ As such, he suggested that the threat of legal liability strengthened the bank's signal and created an incentive for effective monitoring.³¹⁶ The threat of legal liability exists because a seller who had performed substantively could subsequently procure strictly complying documents,³¹⁷ albeit at greater expense, at which point the bank would become legally obliged to pay. The combination of these sanctions incentivised the bank to monitor the buyer effectively.³¹⁸

Contractual arrangements which are underpinned by a strict legal framework but operate informally are common in the empirical contract literature.³¹⁹ Indeed, Katz himself makes this link.³²⁰ To adopt Professor Lisa Bernstein's language, the strict legal framework constitutes a series of 'endgame' norms which are employed when the relationship has broken down.³²¹ The flexible and informal operation of the credit are explicable as 'relationship-preserving' norms which dictate the day-to-day interactions between the parties.³²² Where the parties are engaged in a successful ongoing relationship, documentary discrepancies may not warrant asserting one's legal rights by demanding strict conformity of the presented documents.³²³ If this is correct, one would expect to see a greater insistence on strict compliance in one shot transactions than in exchanges between repeat players.³²⁴ The data

³¹⁴ Ibid 2567.

³¹⁵ Ibid 2560-2562 (the reasons are not particularly relevant for this analysis).

³¹⁶ Ibid 2566-2567

³¹⁷ Ibid 2566.

³¹⁸ Ibid 2567. Katz does not suggest how these incentives motivate the bank in this way.

³¹⁹ For example, L Bernstein, 'Private commercial law in the cotton industry: Creating cooperation through rules, norms, and institutions' (2000-2001) 99 Mich L Rev 1724; S Macaulay, 'Non-contractual relations in business: A preliminary study' (1963) 28(1) Am Soc Rev 55; R Ellickson, 'Of Coase and cattle: Dispute resolution among neighbors in Shasta County' (1986) 38 Stan LR 623.

³²⁰ Katz, 'Informality as a bilateral' (n250) 2569.

³²¹ L Bernstein, 'Merchant law in a merchant court: Rethinking the law's search for immanent business norms' (1996) 144 U Pa L Rev 1765, 1796-1797. This may not be the full picture. See D Campbell, 'Arcos v Ronaasen as relational contract' in D Campbell, L Mulcahy and S Wheeler (eds.), *Changing Concepts of Contract: Essays in Honour of Ian Macneil* (Palgrave Macmillan, 2013) (arguing that an insistence on strict legal obligations may be perfectly acceptable within competitive markets.)

³²² Bernstein, 'Merchant law' (n321) 1796-1798.

³²³ Gillette 'Letters of credit as signals' (n25) 2540.

³²⁴ See also ibid 2546 where he makes a similar point in relation to the types of exchange in which the letter of credit is employed.

was not differentiated in this way and, as noted above,³²⁵ are no longer available for further analysis.

A degree of precision is required here.³²⁶ The studies which are traditionally used to exemplify the power of reputational sanctions involve economic exchange between ethnically homogenous communities³²⁷ or in geographically closed spaces.³²⁸ The efficiency of reputational sanctions in these settings depends on the shared norms of market participants and the direct channels through which sanctions can be levied. By contrast, documentary credit contracts typically involve strangers, separated both geographically and culturally. It is important to consider, therefore, whether the characteristics indicative of reputational penalties exist in the credit context.

To begin with the geographical distance separating parties to a credit transaction, the studies of internet sales provide support for reputational sanctions in long distance contracts between anonymous parties. This requires a small diversion from the main argument. These transactions arguably bear greater similarity to letter of credit contracts³²⁹ than studies of closed commercial societies. The scale of internet-based commerce would today suggest that mechanisms have evolved to counter the natural absence of trust between anonymous parties. Rietjens' work provides a useful example of how eBay, the online auction website, has created a community of traders providing publicly-available feedback after each transaction.³³⁰ This reputation system "collects, distributes and aggregates feedback about participants' past behaviour"³³¹ which can be used to predict future behaviour.³³² The cost of poor performance is primarily reputational in these markets which, as in the case of eBay,

³²⁵ See earlier, text to fn 246.

³²⁶ This element of the analysis was developed as a result of a question and answer session with Professor Sally Wheeler at 'Main Currents in the Contemporary Sociology of Law' (Centre for Law and Society Conference, Cardiff School of Law and Politics, 10 June 2016)

³²⁷ L Bernstein, 'Opting out of the legal system: Extra-legal contractual relations in the diamond industry' (1992) 21 JLS 115.

³²⁸ Bernstein, 'Private commercial law' (n319); Macaulay, 'Non-contractual relations' (n319).

³²⁹ B Rietjens, 'Trust and reputation on eBay: Towards a legal framework for feedback intermediaries' (2006) 15(1) Info & Comm Tech L 55, 60: transactions "conducted with people or organizations who are strangers to each other and often have an unknown record of past behaviour."

³³⁰ Ibid 58-59.

³³¹ Ibid 59 citing P Resnick et al., 'Reputation systems' (2000) 43 Communications of the ACM 45, 46.

³³² C Gillette, 'Reputation and intermediaries in electronic commerce' (2002) 62(4) Louisiana L Rev 1165, 1167; Mann, 'Verification institutions' (n271) 2230; C Weiszacker, *Barriers to Entry* (Farrar Straus Giroux, 1981) 72-73.

may also be underpinned by a formal enforcement structure.³³³ Although enforcement mechanisms in consumer internet contracts are of little direct interest to the project, they demonstrate that reputation can constrain behaviour in long distance, anonymous exchanges provided an effective feedback loop exists.

The second issue to consider is the cultural distance which may exist in credit transactions. The studies involving ethnically identical traders demonstrate that shared community norms moderate behaviour. It is, of course, virtually impossible to attribute a similar group of shared norms to *all* commercial parties using documentary credits. There is, however, evidence to suggest that common norms exist within industries.³³⁴ As Beale and Dugdale found in their study of engineering manufacturers, for example, “certain terms and certain customs or “unwritten laws” were widely accepted.”³³⁵ These tacit understandings enabled the parties to economise on contractual planning³³⁶ and provided a foundation for how parties would behave during the transaction. The ability of norms to moderate behaviour in the credit context will be considered in detail in due course. At this stage, however, there is nothing to suggest that similar unwritten rules do not exist between the parties to a credit transaction which constrain harmful behaviour.

The main thrust of Katz’s analysis is that the credit mechanism motivates both parties to perform substantively and provides reassurance of their counterpart’s performance. This is achieved, from the buyer’s perspective, from knowledge he acquires about the seller in the pre-contractual phase. The issuing bank provides reassurance to the seller that the buyer will not seize on trivial discrepancies during waiver. Reputational and legal sanctions underpin the role of the issuing bank in this analysis. This is a more comprehensive, and therefore preferable, analysis than that offered by Professor Mann.

³³³ Rietjens (n329) 62, 73.

³³⁴ Macaulay, ‘Non-contractual relations’ (n319) 62-63; H Beale, and T Dugdale, ‘Contracts between businessmen: Planning and the use of contractual remedies’ (1975) 2(1) *Brit J Law & Soc* 45, 47; R Lewis, ‘Contracts between businessmen: Reform of the law of firm offers and an empirical study of tendering in the building industry’ (1982) 9 *J Law & Soc* 153, 169.

³³⁵ Beale and Dugdale (n334) 47.

³³⁶ *Ibid* 47, 59.

The empirical work challenges the orthodox, doctrinal account of the credit mechanism. It is my contention that the empirical work can lead us to a different view about fraud in transactions financed by documentary credit. Indeed, the remainder of the chapter argues that fraud deterrence is not simply a matter for partner selection *ex ante*, but a background matter for the duration of the exchange.

B. Empirical evidence of documentary credits: Implications for fraud

Unlike other commercial fraud rules, the trade finance courts do not characterise the fraud exception as a deterrent. This is because the contracting parties are deemed to undertake sufficient pre-contractual screening to combat the risk of fraud. This is not routinely questioned. It is argued here that the judicial account of deterrence lacks detail with regard to the mechanics of pre-contractual screening and also fails to explain how incentives for fraud during performance are mitigated. After establishing the shortcomings of the judicial account (1), the empirical evidence – and in particular, Katz’s analysis thereof – is used to suggest a more comprehensive account of fraud deterrence in documentary credit transactions. It is argued, firstly, that reputational sanctions function *ex ante* to constrain fraud across transactions (2). The empirical evidence is then used to develop two arguments about how incentives to fraud during performance are mitigated (3).

i. *Limitations of the judicial account*

As far as the trade finance courts are concerned, deterrence is a matter for the contractual parties and depends on the selection of an appropriate counterpart.³³⁷ Lord Bingham’s comments in *HIH Casualty* usefully summarise the judicial view; “parties entering into a commercial contract...will assume the honesty and good faith of the other; absent such an assumption they would not deal.”³³⁸ Despite the apparent logic of this assertion, there are several shortcomings with this judicial account of deterrence.

³³⁷ *Sanders* (n4) 343 per Bowen LJ.

³³⁸ *HIH Casualty & General Insurance v Chase Manhattan Bank* [2003] 2 Lloyd’s Rep. 61, [15] per Lord Bingham.

Firstly, and much like the position in insurance,³³⁹ there is no empirical evidence underpinning this assertion.³⁴⁰ The courts are reliant, as so often, on judicial intuition and speculation. It remains the case that we do not know for sure whether parties would refuse to deal with a party whose honesty was in doubt.³⁴¹

Second, the courts are silent about how pre-contractual screening operates and on what calibre of information it relies. There is an implicit assumption that sufficient information about a party's character and propensity to fraud is easily and cheaply available in the market. This is difficult to accept at face value. If we remember that the credit is chosen to compensate for the lack of information about a party's creditworthiness,³⁴² one would assume that similar difficulties hamper discovery about a party's propriety. The argument made in (2) is that the empirical data can be used to overcome this shortcoming of the judicial account of deterrence.

The judicial account further assumes that the entire fraud risk can be mitigated *ex ante*. This wholly ignores the possibility that incentives to fraud arise during performance, either due to structural weaknesses of the mechanism or to the underlying character or financial position of the trader. Given that the fraud exception is not characterised as a deterrent,³⁴³ it appears, from the court's perspective, that there is no mechanism to deter fraud in performance. The geographical separation of trading parties, economic fluctuations and containerisation³⁴⁴ make fraud both possible and difficult to detect during this phase of the transaction. The courts' failure to consider deterrence at this stage is a notable shortcoming. In part (3), the empirical data is used to suggest that deterrents do exist in this phase of the transaction and rely largely on norms which have developed between the parties.

³³⁹ See earlier discussion, Chapter Three, text to fn 1.

³⁴⁰ J Davey, 'Honesty & the relational commercial contract: Towards a law of post-contractual misrepresentation', (Insurance Fraud Symposium, University of Southampton Law School, 13 July 2016), 11.

³⁴¹ *Ibid* 11: noting the absence of work concerning whether commercial parties "genuinely expect honesty or 'else [they] would not deal' for all aspects of performance."

³⁴² Mann, 'The role of letters of credit' (n231) 2522. See also, Moses (n71) 36.

³⁴³ *Sanders* (n4) 343 per Bowen LJ; Todd, *Bills of Lading and Bankers Documentary Credits* (n183) [6.2], [6.49].

³⁴⁴ Todd, *Maritime Fraud & Piracy* (n97) [4-058].

ii. *An empirical explanation of pre-contractual screening and fraud*

The courts confine deterrence to the pre-contractual stage. While there is a certain logic to the contention that sophisticated parties would take steps to ensure the reliability of potential counterparts, the courts do not specify the mechanics of pre-contractual screening nor the type of information on which it depends. The empirical data is used here to expand upon the judicial account and demonstrate how pre-contractual screening may prevent fraud in credit transactions.

In his analysis, Katz hypothesised the existence of information channels which connected the individual parties and wider market participants.³⁴⁵ These channels conveyed “soft signals”;³⁴⁶ information which was sufficient for the parties to determine how to behave but which could not form the basis for legal obligations nor be verified by a court.³⁴⁷ The quality of information conveyed in the early phases of performance dictated the formality of the parties’ exchange. Where, for example, soft signals of compliant performance were conveyed, the buyer was willing to waive strict documentary compliance. Conversely, Katz suggested that indications of deficient, and by extension fraudulent, performance would cause the credit applicant to insist on strict compliance.³⁴⁸ To be clear, it is not suggested that this option was exercised by any of the credit applicants in Mann’s study since the documentary defects were waived, and full payment made, in all but one of the discrepant presentations.³⁴⁹

Strict documentary compliance has several consequences for the beneficiary. Firstly, the transaction costs of the instant exchange will increase as he will be required to monitor third parties more closely and may incur costs to cure defects and retender documents.³⁵⁰ More broadly, signals of fraudulent behaviour in one transaction will have consequences for future business.³⁵¹ As some of these soft signals are generated by other market actors, evidence of fraud will impact the trader’s reputation. This will reduce the quantity of positive soft signals

³⁴⁵ Katz, ‘Informality as a bilateral’ (n250) 2564.

³⁴⁶ Ibid 2564.

³⁴⁷ Ibid 2564-2565.

³⁴⁸ Ibid 2565, 2567.

³⁴⁹ Mann, ‘The role of letters of credit’ (n231) 2513.

³⁵⁰ Katz, ‘Informality as a bilateral’ (n250) 2565; Gillette, ‘Letters of credit as signals’ (n250) 2540.

³⁵¹ T Hawkins, CM Wittmann and M Beyerlein, ‘Antecedents and consequences of opportunism in buyer-supplier relations: Research synthesis and new frontiers’ (2008) 37 Ind. Mark. Man. 895, 907.

he can send in future transactions which in turn will make those exchanges more expensive. On this basis, it is argued here that the reputational and associated financial costs of fraudulent performance have the capacity to constrain misconduct.

This argument depends on the recognition in the business management and economics literatures that reputation is able to exercise a moderating effect on behaviour.³⁵² These literatures demonstrate that reputation can play this role where there are channels through which information of poor performance can be circulated to other market participants.³⁵³ Provided these channels exist, reputation overcomes the fact that parties cannot predict with certainty how their counterpart will behave over the course of the exchange. Weizsacker's 'extrapolation principle' explains how reputation functions,

...the phenomenon that people extrapolate the behavior of others from past observations and that this extrapolation is self-stabilizing, because it provides an incentive for others to live up to these expectations...By observing others' behavior in the past, one can fairly confidently predict their behavior in the future without incurring further costs.³⁵⁴

In the credit context, Katz's analysis provides clear support for the existence of channels through which reputational information can flow.³⁵⁵ The precondition for reputational sanctions to constrain behaviour, as suggested in the business management literature, is met. Accordingly, the suggestion is that the risk of such sanctions encourages parties to behave in accordance with the express terms and informal norms of their agreement to minimise transaction costs in the current exchange and attract future business.³⁵⁶ This reinforces the judicial account of deterrence as an *ex ante* matter and demonstrates more specifically how pre-contractual screening can prevent fraud.

³⁵² R Coase, 'The nature of the firm: Influence' (1988) 4 J of L, Ec & Org 33, 44: opportunism is "effectively checked by the need to take account of future actions on business"; G Gundlach and R Achrol, 'Governance in exchange: Contract law and its alternatives' (1993) 12(2) J of Pub Pol & Mark. 141, 143.

³⁵³ For example, Gillette, 'Reputation and intermediaries' (n332) 1169; Mann, 'Verification institutions' (n271) 2256; H Collins, *Regulating Contracts* (OUP, 1999) 114.

³⁵⁴ von Weizsacker (n332) 72-73.

³⁵⁵ Katz, 'Informality as a bilateral' (n250) 2564.

³⁵⁶ J Abeler, D Nosenzo and C Raymond, 'Preferences for truth-telling' (IZA Discussion Paper No. 10188, September 2016) available at: <http://ftp.iza.org/dp10188.pdf> (accessed 15/09/2016), 7, 19.

iii. Mitigating the fraud risk during performance

The judicial suggestion that the fraud risk is mitigated *ex ante* through careful partner selection ignores the fact that opportunities for fraud may arise during performance. Such opportunities may stem from economic or market fluctuations or difficulties linked to the shipment of the goods which are beyond the beneficiary's control. A comprehensive account of deterrence necessarily requires consideration of how these opportunities for fraud are managed. The remainder of the chapter uses Mann's empirical data to develop two novel suggestions as to how fraud is mitigated during performance. The first contends that an exchange of positive soft signals in the early phases of the exchange reduces the force of any subsequent opportunities for fraud (a). The second contention suggests that a relational model of governance develops to constrain opportunistic behaviour because of the social norms which evolve between the parties in the initial phases of the exchange (b).

a. Positive soft signals reduce incentives for fraud

The first argument relies on the soft signals exchanged between the parties in the early phases of performance. The following example illustrates the position. Imagine that the beneficiary has shipped the correct goods but cannot obtain strictly compliant documentation because, due to issues beyond his control, the shipment was late or from a different port. In these circumstances, the seller has three options: (i) to tender non-conforming documents and hope the buyer waives the defects, (ii) to seek an amendment to the credit or (iii) to procure falsified documentation so that the presentation appears to comply with the terms of the credit. None of these options is entirely risk free. In option (i) the buyer may refuse waiver.³⁵⁷ In (ii), amending the credit involves delay, additional expense³⁵⁸ and requires the buyer's agreement. The risk of option (iii) is obvious; should the fraud be discovered, the beneficiary risks his right to payment.³⁵⁹

³⁵⁷ This is on the basis that it is not possible to obtain conforming documentation once the goods have been shipped late or from the wrong place.

³⁵⁸ Malek and Quest, *Jack* (n64) [3.37].

³⁵⁹ Provided that the applicant can establish the necessary criteria for an injunction, see earlier discussion in Chapter Four, III (E).

Adopting the analysis suggested by Katz, the seller who has sent sufficient soft signals of substantive compliance need not be concerned in this hypothetical illustration. He should be confident that his buyer will waive the defects and permit payment. This theoretically reduces the incentives for him to behave fraudulently. Accordingly, the beneficiary who has shipped the correct goods but is unable to obtain conforming documentation should choose option (i), provided sufficient soft signals of reliability have been communicated to his buyer.

b. *The relational governance argument*

The final argument is more complex and makes use of literatures in contract theory, economics and business management. The starting point is the activities that Katz suggested took place in the time between agreement and document presentation. These activities included finalising the detail of the products, specifying the practical aspects of shipment and the completion of preliminary documentation.³⁶⁰

The suggestion that the exchange evolves after the written contract is signed adopts a relational view of contract. Relational contract theory views economic transactions and the way in which exchange hazards are mitigated in fundamentally different terms than classical and neo-classical theory.³⁶¹ These are significant distinctions which will now be discussed.

1. *Models of contracting behaviour*

Classical and neo-classical contract law regarded economic transactions as “simple, one-time bargaining between individual actors pursuing individual outcomes.”³⁶² This characterises the contracting parties as self-interested actors who pursue outcomes to maximise their own gain from the transaction.³⁶³ This may mean, therefore, that a seller would take advantage of a rise in the market to extract a higher price from his buyer. The classical analysis further considered that the parties discussed the entirety of their exchange during negotiations and

³⁶⁰ Katz, ‘Informality as a bilateral’ (n250) 2564.

³⁶¹ Much has been written on relational contract theory and its intricacies are not at issue here. An indicative selection of sources not cited here include D Campbell, L Mulcahy and S Wheeler, *Changing Concepts of Contract: Essays in Honour of Ian Macneil* (Palgrave Macmillan, 2013); D Campbell, ‘Good faith and the ubiquity of the ‘relational’ contract’ (2014) 77 MLR 475; R Scott, ‘The case for formalism in relational contract’ (1999) 94(3) Nw U L Rev 847; I Macneil, ‘Relational contract: What we do and do not know’ (1985) Wis L Rev 483; I Macneil, ‘The many futures of contract’ (1973-1974) 47 S Cal L Rev 691.

³⁶² Gundlach, ‘Exchange governance’ (n294) 246.

³⁶³ R Brownsword, ‘From co-operative contracting to a contract of co-operation’ in D Campbell and P Vincent-Jones (eds.), *Contract and Economic Organisation* (Dartmouth Publishing Co., 1996), 15.

committed this agreement to paper. The resulting contract set out the parties' substantive obligations as well as their rights in the event of breach by the other party.³⁶⁴ Since the entire agreement was contained within the written contract, the wider context in which the exchange took place was considered irrelevant. The contract was self-contained, isolated from all prior and future events.³⁶⁵

By contrast, a relational approach recognises economic exchange as a social endeavour³⁶⁶ and explicitly takes account of the social, economic and market context in which the specific exchange is embedded.³⁶⁷ This is an important distinction because it moves away from the view that economic exchange is an isolated, singular event and instead recognises transactions as a spectrum of behaviour.³⁶⁸ This is usefully demonstrated by Macneil's relational-discrete axis. On the left-hand side of the axis is the "as-if-discrete" transaction; the one-shot exchange between strangers whose shared context perhaps consists solely of a common language and currency.³⁶⁹ An example typically cited in the literature is "purchasing local spirits from a shopkeeper in a remote area of a foreign country to which one never again expects to visit nor refer his friends."³⁷⁰ At the other end of this spectrum is the highly relational exchange which develops over time to accommodate the needs of the parties and to changes in the world beyond the relation.³⁷¹ Such exchanges are "usually associated with long-term, flexible and open-ended agreements that display a high degree of reliance on trust and ongoing co-operation in performance, rather than law."³⁷² The relational analysis also moves away from the proposition that contracting parties are inherently self-interested. The

³⁶⁴ This is known as presentation – the process of bringing all potential matters into the present for the purposes of contractual planning. See I Macneil, 'Economic analysis of contractual relations: Its shortfalls and the need for a rich classificatory apparatus' (1981) 75 Nw U L Rev 1018, 1019, 1039; C Mitchell, *Contract Law and Contract Practice: Bridging the gap between legal reasoning and commercial expectations* (Hart Publishing, 2013), 173.

³⁶⁵ Gundlach, 'Exchange governance' (n294), 246. See also P Atiyah, *Essays on Contract* (Clarendon Press 1986) 5-6 where the neoclassical conception of exchange is explained as "the (1) discrete, (2) two-party, (3) commercial, (4) executory, (5) exchange."

³⁶⁶ D Campbell (ed.), *The Relational Theory of Contract: Selected Works of Ian Macneil* (Sweet and Maxwell, 2001) 130; I Macneil, 'Values in contract law: Internal and external' (1983) 78 Nw U L Rev 340, 341-342 "all contracts are relational. Nevertheless, some contracts...are far more relational than others." (emphasis in original).

³⁶⁷ I Macneil, 'Reflections on relational contract theory after a neo-classical seminar' in D Campbell, H Collins and J Wightman (eds), *Implicit Dimensions of Contract* (Hart Publishing 2003), 217.

³⁶⁸ I Macneil, *Contracts: Exchange Transactions and Relations* (2nd ed. Foundation Press, 1978), 12.

³⁶⁹ Macneil, 'Values' (n366) 343; Mitchell (n364) 175.

³⁷⁰ Williamson, 'Transaction-cost economics' (n294) 247.

³⁷¹ I Macneil, 'Contracts: Adjustment of long-term economic relations under classical, neoclassical, and relational contract law' (1977-1978) 72 Nw U L Rev 854, 889-890.

³⁷² Mitchell (n364) 175-176.

model instead recognises the nuances of human behaviour and provides for both the competitive and cooperative aspects of behaviour.

The social and market context is significant in the relational analysis of contract. This conceptualises exchange as an embedded activity which is not isolated from the world in which it takes place. This is important because this wider context will inform the parties' expectations about the transaction.³⁷³ Indeed, a relational analysis regards economic exchange as having the "propensity to generate norms, define or inform parties' expectations, provide sources of reassurance, facilitate co-operation, [and] create interdependence."³⁷⁴ These norms and expectations may develop as a result of personal interaction³⁷⁵ and by virtue of specific trade or industry practices.³⁷⁶ These norms and understandings are typically unspoken and do not form part of the written contract. The result is that the written agreement is likely to be incomplete since parties will avoid the expense of detailed planning in circumstances where these norms are a sufficient guide for conduct.³⁷⁷

2. The mitigation of contractual hazards

International trade is risky because the parties do not perform their obligations simultaneously. This means that market fluctuations may incentivise one or both parties to breach, or act in a manner inconsistent with, the terms of the original deal. These risks – broadly referred to as exchange hazards – need to be mitigated to safeguard economic exchange. In the context of international sales, the seller's primary concern is that the buyer will be unable or unwilling to pay when the goods are delivered. The buyer's concern, by contrast, relates to the probity of the seller. These risks explain the use of documentary credits to support international sales transactions. The credit, however, is unable to prevent the beneficiary engaging in fraudulent conduct. The discussion draws on literatures in

³⁷³ Ibid 172.

³⁷⁴ D Kimel, 'The choice of paradigm for the theory of contract: Reflections on the relational model' (2007) 27 OJLS 233, 236.

³⁷⁵ Discussed in Mitchell (n364) 175; S Wheeler, 'Contracts and corporations' in P Cane and H Kritzer (eds), *The Oxford Handbook of Empirical Legal Research* (OUP 2010), 127.

³⁷⁶ I Macneil, *The New Social Contract* (Yale University Press, 1979), 37. Beale and Dugdale (n334) 47.

³⁷⁷ Beale and Dugdale (n334) 47-48.

contract theory and business management to consider how the fraud risk is mitigated during credit transactions.

Before considering how classical and relational contract theory explain the mitigation of hazards, it is important to define 'opportunism' and 'governance'. A party who takes advantage of one of these hazards for private gain would be characterised as opportunistic. The literature defines opportunism as "self-interest seeking with guile."³⁷⁸ The reference to 'guile' here distinguishes opportunism from ordinary competitive behaviour, acceptable in the market. It includes "lying, stealing, cheating, and calculated efforts to mislead, distort, disguise, obfuscate, or otherwise confuse."³⁷⁹ This embraces the deliberate breach of express contractual terms³⁸⁰ – which would typically meet the legal definition of fraud³⁸¹ – as well as conduct which contravenes the parties' own set of norms.³⁸²

Governance mechanisms are required to combat the risks of opportunism and preserve economic exchange. As Dixit has described,

...if market economies are to succeed, they need a foundation of mechanisms to deter such privately profitable but socially dysfunctional behaviors, and thereby to sustain adequate incentives to invest, produce, and exchange. In other words, markets need the underpinning of institutions of economic governance.³⁸³

Given the fundamental differences between classical and relational contract theory, it should come as no surprise that the governance mechanisms required to safeguard exchange similarly differ between these competing theories.

³⁷⁸ O Williamson, *Markets and Hierarchies* (The Free Press, 1975), 6.

³⁷⁹ O Williamson, *The Economic Institutions of Capitalism* (The Free Press, 1985) 47.

³⁸⁰ K Wathne and J Heide, 'Opportunism in interfirm relationships' (2000) 64 *J of Marketing* 36, 38.

³⁸¹ *Derry v Peek* (1889) 14 App Cas 337.

³⁸² O Williamson, 'Opportunism and its critics' (1993) 14(2) *Manag and Decision Econ* 97, 101; Macneil, 'Economic analysis of contractual relations' (n364) 1023 defining opportunism as "self-interest seeking contrary to the principles of the relation in which it occurs."

³⁸³ A Dixit, *Lawlessness and Economics* (Princeton University Press, 2004), 2.

Classical and neo-classical theory, as discussed above, consider that the contracting parties commit everything to paper in advance of performance. This means that the contract sets out legal sanctions to respond to breach. With the certainty of this framework in mind, classical theory presumes that a decision to behave opportunistically is taken in full cognisance of the resulting legal penalty. It further presumed that an individual only decides to act opportunistically where the gains from fraud exceeded the legal penalty. In the classical analysis, therefore, the law provided a disincentive to opportunism – the threat of legal sanctions – which was designed to keep the exchange on course. Following a breach, the courts would simply give effect to the penalties contained in the contract.³⁸⁴

By contrast, relational scholars do not view the contract as a comprehensive account of the exchange. This means that it will be unable to constitute the single source of guidance for the parties or the courts in dealing with disputes. This does not remove the law from the governance equation entirely but it does mean that an additional governance mechanism is required. The relational model suggests that tacit understandings and industry norms generated by economic exchange function as a governance mechanism. Norms are effectively an unwritten code of conduct which “circumscribe[s] acceptable behavior between exchange partners.”³⁸⁵

The balance of these mechanisms – legal sanctions and relational governance – will depend on the characteristics of the specific transaction under discussion. As a general guide, exchanges appearing towards the ‘as-if-discrete’ end of Macneil’s axis would typically be reliant on legal sanctions for governance.³⁸⁶ By contrast, one would expect highly relational transactions to display evidence of relational governance in the parties’ response to difficulties during performance.³⁸⁷ It may also be the case that exchanges towards the right of the spectrum display relational governance in some areas but rely on comprehensive

³⁸⁴ J Feinman, ‘Critical approaches to contract law’ (1982-1983) 30 UCLA L Rev 829, 832.

³⁸⁵ S Sheng, J Brown, C Nicholson and L Poppo, ‘Do exchange hazards always foster relational governance? An empirical test of the role of communication’ (2006) 23 Intl. J of Research in Marketing 63, 65.

³⁸⁶ Mitchell (n364) 173.

³⁸⁷ R Speidel, ‘The characteristics and challenges of relational contracts’ (1999-2000) 94 Nw U L Rev 823, 827, 829.

contractual planning and pre-agreed legal sanctions in others.³⁸⁸ Of course, the particular balance of governance will depend on the transaction under discussion.

The suggestion made here is that exchange hazards in credit transactions may be governed relationally. To develop this argument, the hallmarks of transactions demonstrating relational governance will be examined (3) before considering whether these are replicated in credit transactions (4). This is made possible by Katz's analysis of the empirical data, most notably that the exchange evolves after the written agreement is signed.

3. The hallmarks of relational governance

Relational governance has been used extensively in the fields of economics and business management to explain behaviour in economic exchange.³⁸⁹ The discussion in this section identifies the norms typically found in these relations and explains how norms constrain opportunistic conduct.

Transactions which display relational governance are characterised by norms of trust,³⁹⁰ flexibility³⁹¹ and commitment.³⁹² These exchanges will be less susceptible to opportunism because these norms encourage exchange-sustaining behaviour. When confronted by economic conditions which create an incentive for opportunism – such as a rise or fall in the market – a party within a relational exchange will likely forgo this opportunity for private gain and instead be willing to renegotiate or offer a concession to his counterpart. In these circumstances, norms constitute a “general protective device against deviant conduct.”³⁹³

³⁸⁸ Beale and Dugdale (n334) 47, 51.

³⁸⁹ Sources not cited elsewhere in this thesis include G Baker, R Gibbons and K Murphy, 'Relational contracts and the theory of the firm' (2002) Feb Quart. J Economics 39; R Gulati, 'Does familiarity breed trust? The implications of repeated ties for contractual choices in alliances' (1995) 38(1) Acad. Man. J 85; M Paulin, J Perrien and R Ferguson, 'Relational contract norms and the effectiveness of commercial banking relationships' (1997) 8(5) Int J of Service Ind. Man 435; M Yaqubi, 'Antecedents, consequences and control of opportunistic behavior in strategic networks' (2009) 7(2) J of Bus & Ec. Research 15.

³⁹⁰ A Zaheer and N Venkatraman, 'Relational governance as an interorganizational strategy: An empirical test of the role of trust in economic exchange' (1995) 16(5) Strat. Man. J 373, 378; J Jarillo, 'On strategic networks' (1988) 9(1) Strat. Man. J 31, 36.

³⁹¹ L Poppo and T Zenger, 'Do formal contracts and relational governance function as substitutes or complements?' (2002) 23 Strategic Management Journal 707, 710.

³⁹² R Scott, 'A relational theory of default of rules for commercial contracts' (1990) 19 J Leg Stud. 597, 614; G Gundlach, R Achrol and J Mentzer, 'The structure of commitment in exchange' (1995) 59(1) J of Mark. 78, 78, 85-86.

³⁹³ B Heide and G John, 'Do norms really matter?' (1992) 56(2) J of Marketing 32, 35.

The ability of norms to shape behaviour in a way which safeguards economic exchange has been explained in both economic and sociological terms. The economic explanation relies on the fact that the expectation of future exchange encourages cooperation in the present.³⁹⁴ In short, the risk of reputational damage keeps parties honest.³⁹⁵ This suggests that cooperation is a rational, deliberate choice³⁹⁶ in which the long-term commercial gains are considered greater than those which would be achieved through short-term opportunism.³⁹⁷

The sociological explanation, by contrast, relies on the idea of control from within the relation. Lai *et al* have suggested that behaviour is controlled in two ways; through the internalisation of relational norms and self-control.³⁹⁸ Where the norms mirror the individual's own set of values, we would describe the norms as having been internalised.³⁹⁹ Subsequent behaviour in accordance with shared norms occurs because the actor has accepted them as correct and gains an intrinsic benefit from compliance.⁴⁰⁰ In addition, appropriate behaviour is achieved through self-discipline. Macaulay, for example, argued that social ties created "pressures for conformity to expectations."⁴⁰¹ As a result of these pressures, parties refrain from opportunistic conduct by exercising self-discipline and moral control.⁴⁰² Parties may also conform due to the social consequences of opportunism. The earlier discussion suggested that a poor reputation makes exchange expensive and risks future business.⁴⁰³ These reputational effects may, in certain communities, extend into the social and personal life of

³⁹⁴ Poppo and Zenger (n391) 710.

³⁹⁵ B Richman, 'Firms, courts and reputation mechanisms: Towards a positive theory of private ordering' (2004) 104 Colum L Rev 2328, 2335.

³⁹⁶ Poppo and Zenger (n391) 710.

³⁹⁷ O Williamson and S Winter, *The Nature of the Firm Origins, Evolution and Development* (OUP, 1993) 71; B Klein and K Leffler, 'The role of market forces in assuring contractual performance' (1981) 89 J of Pol Econ 615, 616-7. The language adopted in these accounts implies a law & economics understanding of rationality; Klein and Leffler, for example, speak in terms of wealth maximisation. It is noteworthy that the modern behavioural understanding of behaviour has not permeated these discussions.

³⁹⁸ C Lai *et al.*, 'Governance mechanisms of opportunism: Integrating from transaction cost analysis and relational exchange theory' (2005) 5 台灣管理學刊 1, 2.

³⁹⁹ H Kelman, 'Compliance, identification and internalization: Three processes of attitude change.' (1958) 2(1) J of Conflict Resolution 51, 53.

⁴⁰⁰ *Ibid* 53. This echoes the work of N Mazar and D Ariely, 'Dishonesty in everyday life and its policy implications' (2006) 25(1) J of Pub Pol & Mark. 117, discussed in Chapter Three, see text to fn 110 *et seq*.

⁴⁰¹ Macaulay, 'Non-contractual relations' (n319) 63.

⁴⁰² A Larson, 'Network dyads in entrepreneurial settings: A study of the governance of exchange relations' (1992) 37(1) Admin Science Quarterly 76, 90.

⁴⁰³ See earlier, text to fn 314 *et seq*.

opportunistic market participants.⁴⁰⁴ In Bernstein's studies of the cotton and diamond industries, she identified that individuals who had not met appropriate standards of conduct in commercial life would also be shunned in social situations.⁴⁰⁵

In both the economic and sociological accounts, repeat exchange is considered valuable. This is because it provides parties with concrete and valuable information about who to trust.⁴⁰⁶ This overcomes parties' lack of knowledge about the future behaviour of their counterpart⁴⁰⁷ and reduces the need to invest in expensive contractual safeguards.⁴⁰⁸

The marketing literature confirms the existence of relational governance in joint ventures, strategic alliances and licensing agreements.⁴⁰⁹ What these 'exchanges' have in common is their extended duration⁴¹⁰ and a relatively equal balance of power between the parties.⁴¹¹ Efficient communication channels in these settings enable the parties to respond to problems which arise during the transaction⁴¹² and form personal relationships.⁴¹³ It is the combination of these factors which foster the development of relational norms.

4. Application to the documentary credit context

The critical question is whether transactions financed by documentary credit embody the factors indicative of relational exchange. The position advanced here is that, in general terms

⁴⁰⁴ Richman (n395) 2344-2345.

⁴⁰⁵ Bernstein, 'Opting out of the legal system' (n327) 138—140, 157; Bernstein, 'Private commercial law' (n319) 1748-1750.

⁴⁰⁶ Poppo and Zenger (n391) 710; M Granovetter, 'Economic action and social structures: The problem of embeddedness' (1985) 91(3) *American J of Sociology* 481, 490; R Gulati, 'Does familiarity breed trust? The implications of repeated ties for contractual choice in alliances' (1995) 38(1) *Academy of Management J* 85, 86, 107.

⁴⁰⁷ See earlier, von Weizsacker (n332).

⁴⁰⁸ E Posner, 'Law, economics, and inefficient norms' [1996] 144 *U Penn L Rev* 1697, 1705.

⁴⁰⁹ R Kingshott, 'The impact of psychological contracts upon trust and commitment within supplier-buyer relationships: A social exchange view' (2006) 35 *Ind. Mark. Man.* 724; Y Lee and S Cavusgil, 'Enhancing alliance performance: The effects of contractual-based versus relation-based governance' (2006) 59 *J of Bus Res.* 896; Gulati (n353). See also the work on 'vested outsourcing' i.e. K Vitasek and K Manrodt, 'Vested outsourcing: A flexible framework for collaborative outsourcing' (2012) 5(1) *Strategic Outsourcing* 4, 6 which promotes a model in which parties are "mutually committed to each other's success, creating a long-term win-win relationship based on achieving mutual determined goals."

⁴¹⁰ Gundlach and Achrol (n352) 141, 144; Poppo and Zenger (n391) 717, 719.

⁴¹¹ Sheng et al (n385) 72.

⁴¹² Ibid 64, 67; Williamson also recognises that communication can encourage parties to develop "sensitive", cooperative problem solving, see Williamson, 'Transaction-cost economics' (n294) 240.

⁴¹³ Sheng et al (n385) 67-68.

at least, credit transactions are capable of displaying the more informal relational model of governance.

In Katz's analysis, the phase between agreement and performance enabled the exchange of soft information about whether each party would perform their substantive obligations.⁴¹⁴ I would suggest, however, that this phase of the exchange also enables the development of relational norms. This is because the early tasks will commonly require the involvement and collaboration of buyer and seller and other parties in the supply chain. As such, indications of flexibility and cooperation at this stage will begin to develop norms to govern the remainder of the exchange. This is also the stage at which parties will interact to finalise the details of the exchange. As discussed above, social interaction fosters personal relationships which in turn solidifies norms likely to sustain the exchange.

It was noted above that the potential for repeat business would encourage parties to forgo opportunities for private gain. While buyer and seller may be unknown to each other at the outset of the transaction – which itself justifies the use of a credit⁴¹⁵ – other parties in the contractual network may have had prior dealings. This includes the buyer and seller's relationships with their respective banks, dealings between the issuing and confirming institutions as well as other parties only peripherally connected to the transaction, such as agents of the buyer and seller, loading brokers and shipping line employees. These connections facilitate the flow of information between buyer and seller and provide sources of concrete information about their counterpart. These layers of repeat business are likely to depend on (some) industry-specific norms and this is likely to influence and support the relation at hand. Indeed, it is possible to interpret the informal operation of documentary credits, despite the rigid contractual framework, as a norm of these transactions. Furthermore, Mann suggested that the acceptability of certain documentary discrepancies would depend on the particular market.⁴¹⁶ This adds credence to the relational analysis because it suggests differences in market context affect the understanding of a given exchange.

⁴¹⁴ Katz, 'Informality as a bilateral' (n250) 2564.

⁴¹⁵ Mann, 'The role of letters of credit' (n231) 2518.

⁴¹⁶ *Ibid* 2527.

The literature also establishes that a relatively equivalent balance of power aids the development of relational governance.⁴¹⁷ The argument here is that the use of a documentary credit overcomes, or at least reduces, any power asymmetry which would have otherwise existed between buyer and seller. This analysis holds both by reference to the doctrinal and empirical accounts of the credit mechanism. On the doctrinal view of the mechanism, the credit makes payment contingent on the presentation of strictly conforming documents. This envisages an objective assessment by the bank which limits the pressure a powerful seller could impose on his buyer. The credit removes the risk of buyer opportunism at payment since this is dependent on documentary compliance alone. Under the empirical view of the credit mechanism, the payment discretion is returned to the buyer. This does not cause an imbalance in power between the parties, however, since the buyer's behaviour during the payment phase will be closely monitored by the issuing bank, as described above.⁴¹⁸ These analyses suggest that the credit creates a more equal balance of power than if the parties had chosen to arrange the transaction differently, for example on open account. This accords with the characterisation of the credit as a compromise mechanism.⁴¹⁹

The position advanced here is that relational governance is a plausible account of deterrence in the performance phase of transactions financed by documentary credit. If correct, the relational mechanism reduces the likelihood of fraud by the beneficiary and explains, alongside the role of the issuing bank, the absence of buyer opportunism during waiver.⁴²⁰ There is undoubtedly scope for further empirical work to determine the accuracy of this contention and the norms at work in this context.

It is important to note that relational norms do not guarantee that contracting parties will forgo every opportunity for misconduct. In particular, norms will be ineffective when one party stands to make a considerable gain from fraud, especially where these gains exceed the

⁴¹⁷ Sheng et al (n385) 72.

⁴¹⁸ Mann, 'The role of letters of credit' (n231) 2529; Katz, 'Informality as a bilateral' (n250) 2567.

⁴¹⁹ See earlier, Chapter Four, text to fn 11.

⁴²⁰ This was not adequately explained by either of the analyses discussed above.

value of future business.⁴²¹ In those circumstances, the defrauded party – typically the credit applicant – would need to rely on contractual mechanisms and the fraud exception to deter, and subsequently sanction, the beneficiary. Given the difficulties involved in invoking the fraud exception,⁴²² it is highly unlikely that the exception will ever operate to deprive the fraudulent beneficiary of payment. On this basis, it becomes difficult to characterise the fraud exception as an effective deterrent. To this extent, therefore, the empirical data can be used to support the judicial assertion that the fraud exception does not function as a deterrent.⁴²³

IV. Conclusion

The limits of the fraud rule are traditionally justified by reference to commercial need. This is a laudable objective, but reflection is required to ensure the rule serves its intended purpose. Accordingly, this chapter has critically examined the policy balance underpinning the English fraud exception from which three critiques have emerged.

The English courts have consistently rejected a broader fraud exception due to fears that it would paralyse international trade. A comparison with the American approach to fraud in Part I demonstrated that such fears are unfounded. The credit mechanism remains popular in the United States notwithstanding a broader conception of fraud and greater availability of injunctive relief. In addition, the American exception is the result of legislative reform which enabled policymakers to balance competing considerations and construct a rule in consultation with the commercial community. This is preferable to the piecemeal, common law development of the English fraud exception.⁴²⁴ There is, of course, no reason that the response to fraud should be identical in all jurisdictions but the English courts should recognise that their approach to fraud is a distinct policy choice, rather than the manifestation of best commercial practice.

⁴²¹ E Posner, *Law and Social Norms* (Harvard University Press, 2000) 160; R Scott, 'Conflict and cooperation in long-term contracts' (1987) 75 Cal L Rev 2005, 2030; Scott, 'A relational theory' (n392) 615. See also, Mazar and Ariely (n400) as discussed earlier, Chapter Three, text to fn 112.

⁴²² See previous discussion, Chapter Four, text to fn 343.

⁴²³ *Sanders* (n4) 343 per Bowen LJ.

⁴²⁴ Dolan, *The Law of Letters of Credit* (n31) [7-94] describing the decision in *United City Merchants* in the following terms, "one gets the feeling that such a result is exactly what the English judges desire."

The House of Lords' judgment in *United City Merchants* was examined in detail in Part II. In his attempt to confine the fraud enquiry, Lord Diplock held that the exception would only operate when the fraud was attributable to the beneficiary.⁴²⁵ This is perfectly legitimate given that the exception is underpinned by *ex turpi causa*. However, in so doing, Lord Diplock conflated – the related but distinct – issues of forgery and nullity.⁴²⁶ The result was that banks are contractually obliged to pay when the documents appear to conform notwithstanding that the tendered documents are known to be forged or null. This wholly undermines the doctrine of strict compliance and results in consequences which are detrimental to the credit mechanism. These consequences challenge Lord Diplock's justification for a narrow fraud rule; the efficiency of the documentary credit as a device for international financing. This prompts a reconsideration of the proper approach to null and forged documents. The author's preference would be for the courts and UCP to endorse the narrow approach to non-compliance. This would enable banks to reject nullities as non-compliant but permit the continued acceptance of known forgeries as good tender. This distinction is justified by reference to the fact that nullities cannot serve their intended commercial purposes whereas forgeries remain capable of transferring ownership and providing security to the paying bank. This is a pragmatic solution which would not threaten the autonomy of the credit nor extend the fraud exception.

A significant new analysis of fraud deterrence in documentary credit transactions was presented in Part III. It was rooted in empirical work⁴²⁷ which indicated a more flexible standard of documentary compliance in practice. The data was initially employed to support the judicial account of deterrence by suggesting sources of information which might enable parties to undertake pre-contractual screening. More significantly, the data was then used to develop an account of fraud deterrence during the performance of credit transactions. It first contended that the informality of the mechanism in practice reduced the need for the beneficiary to engage in fraud. This is a plausible analysis in circumstances when the goods have been shipped but complying documentation cannot be obtained for reasons beyond the beneficiary's control. The discussion then considered incentives to fraud which arise because

⁴²⁵ *United City Merchants (House of Lords)* (n8) 7 per Lord Diplock.

⁴²⁶ Bridge, 'Documents and contractual congruence' (n105) 230.

⁴²⁷ Mann, 'The role of letters of credit' (n231).

of market or economic fluctuations during performance. The development of cooperation and interaction between the parties in the early phases of the exchange prompted consideration of the relational governance literature. Exchanges governed in this manner rely on norms developed between the parties and derived from the broader context of the exchange to limit opportunistic behaviour. It was argued that credit transactions bear the hallmarks of relational exchange and that this form of governance may explain why parties are deterred from behaving fraudulently during performance. The combination of arguments put forward in Part III provides a comprehensive account of deterrence in credit transactions. This is a wholly novel analysis which challenges the judicial view that the entire fraud risk is mitigated by careful partner selection *ex ante*.

This thesis considers the extent to which ‘fraud unravels all’ accurately expresses the legal response to insurance claims fraud and fraud by the beneficiary in a transaction financed by documentary credit. The foregoing chapters have critiqued the judicial construction and respective policy arguments of these rules from a doctrinal and comparative perspective, and in light of a body of evidence drawn from related disciplines. The final chapter, Chapter Six, unifies the discussion and concludes the project.

Chapter Six

Conclusion

I. Introduction

This project commenced by noting the simplicity of the maxim *ex turpi causa* which proclaims that fraud unravels all. A singular – and possibly punitive – approach to fraud was similarly employed as the starting point in MacDonald Eggers’ excellent work on deceit,

Our civil law of deceit theoretically deals with all lies in the same way, no matter why they were told, provided of course that they committed the deceived to a course of action that they would not have undertaken but for the deception and that they caused damage.¹ The existence and formulation of a particular rule of law may have its genesis in utility, certainty or fairness. The law concerning fraud and deceit, attested to by such ancient advocates as Hyperides, Aristotle and Cicero, is underpinned by our moral duty to tell the truth and the social and commercial necessity of deterring untruths drawing the innocent to their harm.²

MacDonald Eggers concludes his comprehensive analysis of deceit by recommending a more nuanced framework which would enable the law to operate flexibly and “mirror the law’s contemporary policy or moral judgment.”³ The examination of two related but distinct areas of law – fraudulent insurance claims and fraud in documentary credit transactions – undertaken in this thesis has similarly demonstrated the fallacy of the simplistic account. When fraud arises, the courts are not automatically led to the easy answers implicit in the maxim because notions of deterrence must often be weighed against countervailing policy considerations. Importantly, these competing concerns depend on the nature of the specific mechanism and the contractual context in which the fraud has occurred. This means,

¹ It was noted in the Introduction that the response to insurance claims fraud and fraud in transactions financed by documentary credits do not contain any element of causation. This is because the fraud rule is (typically) designed to operate before the underwriter or applicant has been deceived. The requirements for a claim in deceit have also been modified by the decision in *Hayward v Zurich Insurance Co.* [2016] UKSC 48, [67], [71] per Lord Toulson, see earlier discussion, Chapter Two, text to fn 204.

² P MacDonald Eggers, *Deceit: The Lie of the Law* (Informa Law, 2009), [1.4].

³ *Ibid* [9.2], [9.4].

therefore, that the extent to which fraud unravels all depends on how the courts balance these competing issues within the broader contractual context. As has been demonstrated in the foregoing discussion of fraud in marine insurance and documentary credits, this leads the courts to conceive of fraud differently and to propose solutions aligned with the judicial view of the specific mechanism. The divergent accounts of fraud developed by the insurance and trade finance courts explain the absence of a single theoretical framework within this thesis.

This chapter summarises the main findings of this research. Accordingly, it is convenient to recall the research questions established at the outset of this project:

1. How is the fraud rule constructed in doctrinal and procedural terms?⁴
2. What policy arguments have been used by the courts to justify the scope of and the procedural criteria required to invoke the fraud rule?⁵
3. To what extent are these policy justifications valid in light of comparative and empirical evidence?⁶

This discussion prompts a consideration of what these findings mean for the future shape of the fraud rule and the accompanying judicial narratives in these contexts. This task is undertaken in Part II (C) and Part III (C), respectively. The discussion is then widened in the final part of the chapter to consider, more generally, what this research tells us about English commercial law's response to, and conception of, fraud. The major call in Part IV is for courts and academics to resist the lure of instinctive answers to hard policy questions, in preference for a context-specific, empirically-informed response to fraud which overcomes the idiosyncrasies of the common law system.

II. Insurance

A. The judicial response to insurance claims fraud

At first glance, the judicial response to insurance claims fraud is an exemplar of the simplistic model propounded by the courts and initially identified by MacDonald Eggers.⁷ The judicial,

⁴ This was addressed in Chapter Two (insurance) and Chapter Four (documentary credits).

⁵ This was addressed in Chapter Two (insurance) and Chapter Four (documentary credits).

⁶ This was addressed in Chapter Three (insurance) and Chapter Five (documentary credits).

⁷ MacDonald Eggers (n2) [1.4].

and now statutory,⁸ emphasis on the forfeiture rule gives the impression of a singular response⁹ which applies to all types of fraudulent conduct. Forfeiture operates to deprive an assured of the entirety of the claim to which the fraud relates, including any genuine loss. The rule, moreover, is underpinned by *ex turpi causa* and only operates in response to wrongdoing by the assured. In some circumstances, however, forfeiture responds more harshly than would the common law of illegality; removing the assured's right to claim for genuine loss and requiring the repayment of interim sums.¹⁰ The punitive character of the forfeiture rule is particularly apparent in these circumstances.

The far-reaching consequences of forfeiture are routinely justified by reference to policy; the deterrence of fraud. Indeed, the courts often refer to industry statistics on the prevalence of claims fraud¹¹ and have clearly accepted the role of legal sanctions in deterrence. Indeed, in the tradition of rational choice theory, the insurance courts have conceptualised deterrence as dependent on harsh legal sanctions and developed the forfeiture rule accordingly.

The dominance of deterrence in the judicial discourse can be attributed to the relative absence of competing policy objectives. Issues of proportionality, though critical in overcoming the tension between forfeiture and avoidance *ab initio* in this setting, have not generally affected the development of the forfeiture rule. It must of course be noted that considerations of proportionality were at the heart of the recent decision in *Versloot* which ring-fenced collateral lies from the threat of forfeiture.¹² This judgment is, however, the sole occasion in which proportionality has been used to alter the scope of the forfeiture rule in its almost 200-year history. In addition, the narrative propounded by the courts – the vulnerable underwriter and deceitful assured – dovetails with the importance of deterrence and underpins the importance of judicial intervention to prevent fraud.

⁸ Insurance Act 2015 s.12.

⁹ There are, however, other remedies available to the underwriter, see, for example, the earlier discussion on the availability of damages in *Parker v NFU Mutual Insurance Society* [2012] EWHC 2156 (Comm), [2013] Lloyd's Rep. IR 253.

¹⁰ *Axa General Insurance Ltd v Gottlieb* [2005] EWCA Civ 112, [2005] 1 All ER (Comm) 445, [29] per Mance LJ.

¹¹ *Versloot Dredging BV v HDI Gerling Industrie Versicherung AG* [2016] UKSC 48, [56] per Lord Hughes (hereafter referred to as *Versloot (Supreme Court)*); *Royal & Sun Alliance Insurance Co v Fahad* [2014] EWHC 4480 (QB), [24] per Spencer J; *Direct Line Insurance plc v Khan* [2002] Lloyd's Rep. IR 364, [38]-[39] per Arden LJ; *Khan v Hussain* (16 May 2007, Huddersfield County Court) [9] per Judge Hawkesworth QC.

¹² *Versloot (Supreme Court)* (n11) [26] per Lord Sumption.

B. The critique of the judicial response to fraud

While there is no doubt that fraud should be deterred and sanctioned appropriately, this does not mean that the judicial approach to insurance fraud should be left unquestioned. Three key findings emerged from this critique and are summarised here:

- i. The forfeiture rule is, in effect, the only civil sanction for claims fraud. This rule operates counterintuitively given the spectrum of fraudulent behaviour.
- ii. The judicial understanding of deterrence depends on an outdated model of decision making which results in ineffective policy prescriptions.
- iii. The characterisation of the underwriter requires modernisation to reflect the insurer's ability to take proactive steps to prevent fraud in today's market.

i. The counterintuitive nature of forfeiture

The forfeiture rule was developed in the context of exaggerated claims and here one can see the judicial logic; the threat of losing the entire claim would dissuade an assured from committing fraud. Over time, however, forfeiture was presumed to be the remedy for all types of fraud irrespective of the fact that claims appear on a spectrum of increasing culpability and severity. This has resulted in a rule which operates counterintuitively. As a response to the most serious wrongdoing – the wholly fraudulent claim – forfeiture is ineffective because there never was any genuine claim to sacrifice. At the lowest end of the culpability scale, however, forfeiture was draconian given that it deprived the assured of an insured loss. The counterintuitive operation of forfeiture makes little sense given that the courts have constructed the rule on the basis that harsh sanctions deter. Despite the theoretical availability of damages¹³ and actions in deceit,¹⁴ the fact that forfeiture is, in practice, the sole sanction for insurance fraud cannot be reconciled with this conception of deterrence.

¹³ *Parker* (n9) [205] per Teare J.

¹⁴ *Insurance Corporation of the Channel Islands v McHugh* [1997] 1 LRLR 94, 135 per Mance J; Law Commission, *Insurance Contract Law: Business Disclosure; Warranties; Insurers' Remedies for Fraudulent Claims; and Late Payment* (Law Com No 353, 2014), [22.30].

The Supreme Court have to some extent corrected the counterintuitive nature of forfeiture in *Versloot*; the rule no longer applies to claims embellished by a collateral lie.¹⁵ This is to be broadly welcomed¹⁶ and would probably encompass some lies which would also find mitigation in MacDonald Eggers' justificatory analysis in the tort of deceit.¹⁷ However, if the position prior to *Versloot*¹⁸ was criticised for being pro-underwriter, it is surely no better for the law to develop in an equally simplistic, albeit pro-fraudster, direction. In reality, the judgment may go too far and simply shift the problem to one of definition – what exactly is a collateral lie? – and focus attention on claims where the assured has suppressed a defence.¹⁹ The Association of British Insurers has also expressed concern that the ruling in *Versloot* may give the impression that lying is acceptable²⁰ and contradict recent public information efforts undertaken by the industry.²¹ If underwriters are concerned about the judgment, they should simply make use of standard terms which already provide remedies for claims tainted with the pre-*Versloot* equivalent of a collateral lie.²² While the precise impact of *Versloot* remains to be seen, the earlier discussion of modern deterrence theory²³ leads the author to agree with the late Lord Toulson that the decision will probably not trigger a wave of fraudulent claims,

I am not a psychologist, but I am sceptical about the idea that knowledge of this judgment will incentivise people with valid insurance claims to lie in support of their claims. Those who are honest will not do so because it would not be in their nature, while some who are dishonest may do so if they think that they will get away with it,

¹⁵ *Versloot (Supreme Court)* (n11) [26] per Lord Sumption.

¹⁶ See P Rawlings and J Lowry, 'Insurance fraud and the role of the civil law' (2017) 80(3) MLR 525, 531 where the judgment is described as achieving "mixed reviews".

¹⁷ MacDonald Eggers (n2) [5.32]-[5.46], [5.57]-[5.64], [9.7].

¹⁸ *Versloot (Supreme Court)* (n11).

¹⁹ J Hjalmarsson, 'Exit "fraudulent means and devices"' [2016] (July) Shipping & Trade Law (published online, 25 July 2016).

²⁰ J Dalton, 'Lies are lies: Supreme Court ruling sends out the wrong message to customers' (27/07/2016) available at: <https://www.abi.org.uk/news/blog-articles/lies-are-lies-supreme-court-ruling-sends-out-the-wrong-message-to-customers/> (accessed 12/09/2017).

²¹ For example, ABI, 'From Mr Whippy to giggling comen no let up as insurers turn up the heat on insurance cheats' (13/09/2016) available at: <https://www.abi.org.uk/news/news-articles/2016/09/from-mr-whippy-to-giggling-comen-no-let-up-as-insurers-turn-up-the-heat-on-insurance-cheats/> (accessed 12/09/2017).

²² This is the suggestion made by Rawlings and Lowry, 'Insurance fraud and the role of the civil law' (n16) 532. In the marine context, underwriters could contract on the basis of International Hulls Clauses (01/11/03), cl.45.3.1.

²³ See, in particular, Chapter Three, Part I (C).

despite the risk of it having a boomerang effect on whether the court believes anything that they say.²⁴

Instead of *Versloot* and the statutory provisions in the 2015 Act settling the civil response to claims fraud, it is not hard to imagine further litigation to probe the precise limits of the new regime. As Richard Aikens, former Lord Justice of Appeal has argued recently, “we have not heard the last in the “fraudulent claims” saga.”²⁵

Whatever the future holds for the notion of the collateral lie, neither *Versloot* nor the Insurance Act 2015 does anything to correct the imbalance in respect of the wholly fraudulent claim. Of course, it would be inappropriate to castigate the Supreme Court in this regard given the narrow facts of the case before them. The absence of a further remedy in the Act is particularly noticeable given that the Law Commission had initially proposed a statutory cause of action which would have entitled underwriters to recover costs incurred in the investigation of fraudulent claims.²⁶ As was discussed in Chapter Three, the proposal was not taken forward despite the broad support of consultees.²⁷ The fact that wholly fraudulent claims are not addressed by the 2015 Act means that there is still not an effective sanction for the most serious wrongdoing. This is conceptually problematic given the court’s explanation of how legal sanctions deter.

ii. *An outdated model of decision making*

The second major finding relates to the outdated model of decision making which underpins the judicial account of the forfeiture rule. The insurance courts have assumed that harsh legal sanctions deter and have constructed forfeiture on this basis. This mirrors rational choice theory. However, modern deterrence theory suggests that harsh legal penalties are less effective deterrents because decision makers do not weigh up the prospect of punishment in the objective manner assumed in a rational framework. Focussing solely on legal sanctions,

²⁴ *Versloot (Supreme Court)* (n11) [108] per Lord Toulson.

²⁵ R Aikens, ‘When is a “fraudulent claim” only a “collateral lie”?’ [2017] LMCLQ 340, 345.

²⁶ Law Commission, *Insurance Contract Law: Post Contract Duties and Other Issues* (Law Com CP 201), [8.19].

²⁷ See earlier, Chapter Three, text to fn 207.

modern research on deterrence indicates that sanction certainty is a much more significant indicator of compliance with the law than sanction severity. The key to deterrence more broadly, however, lies beyond law. Decisions to engage in dishonesty are instead shaped by social or informal sanctions such as guilt associated with contravening one's own moral code, embarrassment and loss of reputation. In comparison to legal sanctions imposed by the state, informal penalties are levied by the offender himself and his immediate community. Modern deterrence theory demonstrates that these informal sanctions exercise a much stronger deterrent effect than legal sanctions. This is not to say that legal sanctions are absent from the modern deterrence model; indeed, formal sanction threats provide a foundation for the imposition of informal sanctions²⁸ and confirm social attitudes towards wrongdoing.²⁹ Accordingly, Chapter Three concluded that the forfeiture rule could only function as a weak deterrent to opportunistic claims fraud.

An article co-written by the author and Professor James Davey³⁰ which discussed modern deterrence theory in the context of forfeiture was presented to the Supreme Court in *Versloot*.³¹ Indeed, Lord Mance requested the empirical literature on modern deterrence theory to read while writing his judgment. While these insights were ultimately not used to reverse the approach to collateral lie claims,³² the author suggests that modern deterrence theory resulted in the Supreme Court undertaking a much deeper analysis of the correct approach to such claims than would otherwise have been the case. Two considerations lead to this conclusion. Firstly, it is interesting to note the considerable degree to which the Supreme Court departed from *The Aegeon* in formulating the new test. This is despite the "several powerful reasons"³³ which led Christopher Clarke LJ to apply *The Aegeon* as a matter of ratio at the Court of Appeal. This indicates the degree to which the law applying to device claims was regarded as settled pre-*Versloot*. In addition, the Law Commission suggested in

²⁸ S Klepper and D Nagin, 'The deterrent effect of perceived certainty and severity of punishment revisited' (1989) 27 *Criminology* 721, 741; A Ogus, *Costs and Cautionary Tales* (Hart Publishing, 2006), 130.

²⁹ R Paternoster and S Simpson, 'Sanction threats and appeals to morality: Testing a rational choice model of corporate crime' (1996) 30 *L & Soc Rev* 549, 577; J Kidwell, 'A caveat' (1985) *Wis L Rev* 615, 618.

³⁰ J Davey and K Richards, 'Deterrence, human rights and illegality: The forfeiture rule in insurance contract law' [2015] *LMCLQ* 315.

³¹ *Versloot (Supreme Court)* (n11).

³² *Ibid* [10] per Lord Sumption, [108] per Lord Toulson, [124] per Lord Mance.

³³ *Versloot Dredging BV v HDI Gerling Industrie Versicherung AG* [2014] *EWCA Civ* 1349, [2015] *Lloyd's Rep IR* 115, [106] per Christopher Clarke LJ (hereafter referred to as *Versloot (Court of Appeal)*).

their final report that the lie in *Versloot* failed to satisfy the common law requirements of substantiality and materiality.³⁴ The Supreme Court could have taken a similar approach on the facts of *Versloot* to permit the assured to recover without making any significant amendments to the test established in *The Aegeon*. The degree of departure is, in the author's view, indicative of the level of reconsideration prompted by modern deterrence theory.

A final point should be noted in relation to rational choice theory. Mazar and Ariely's work on decisions around dishonesty suggested that harsh legal penalties can serve to deter an offender when he stands to gain considerable external – often financial – benefits from dishonesty.³⁵ In these circumstances, informal sanction threats are no longer an effective deterrent. It was argued in Chapter Three that the wholly fraudulent claim was an example of dishonesty which promised considerable external benefits. Accordingly, the argument made here is that a harsh legal sanction would constitute an effective deterrent to this type of claim. This is a further reason why the absence of an effective legal sanction to penalise the wholly fraudulent assured, as noted above, cannot be supported.

iii. Modernising the portrayal of the underwriter

It was argued in Chapter Three that the judicial characterisation of the underwriter as vulnerable was outdated and does not reflect the modern state of the insurance industry. Today's insurer is no longer required to wait for news of a casualty in a riverside coffee house as was his eighteenth-century counterpart. Instead, the modern underwriter is a sophisticated entity, comprising significant experience and expertise in loss prevention and risk reduction. It has access to databases enabling a pre-contractual assessment of the assured's propensity for fraud and has access to loss adjusters and investigators in the immediate aftermath of a loss. These modern developments mitigate many of the information asymmetries which would otherwise imperil the claims process.

³⁴ Law Com 353 (n14) [22.24] "We think there is an argument that the "fraudulent device" employed in that case [Versloot] does not satisfy the common law requirements for fraud of substantiality and materiality."

³⁵ N Mazar and D Ariely, 'Dishonesty in everyday life and its policy implications' (2006) 25(1) J of Pub Pol & Mark. 117, 120.

The modernisation of the underwriter is not reflected in the Insurance Act 2015. This is problematic since it further entrenches the narrative of judicial responsibility for fraud deterrence and wholly ignores the proactive steps taken by the industry to reduce such claims. This should also be contrasted with the updated portrayal of the underwriter with respect to the assured's pre-contractual disclosure obligations. The Act requires underwriters to take a more active role during the disclosure process³⁶ which reflects the insurer's knowledge of what information is material for underwriting purposes. The remedies for the assured's failure to make a fair presentation are also aligned with the impact of non-disclosure on the insurer.³⁷

The suggestion that the modern underwriter is less susceptible to fraud undermines the centrality of deterrence in the judicial explanation of forfeiture. Indeed, it suggests that the development of a remedial framework which combines deterrence and proportionality would be appropriate in this context. It is disappointing, therefore, that the Law Commission did not recommend a more nuanced regime through the introduction of a judicial discretion to mirror the position in Australia³⁸ and the English Criminal Justice and Courts Act.³⁹ The limited consideration of these alternatives appears to be attributable to Merkin's swift dismissal of the same in his 2006 report for the Commission in which he noted that a discretion "would send the wrong message."⁴⁰ This, with respect, failed to give due weight to the successful operation of the discretion in practice⁴¹ and broad acceptance by the insurance industry in Australia.⁴²

C. Looking forward

It remains to consider what these findings mean for the future of the civil response to insurance claims fraud. There is no doubt that the above discussion militates in favour of a

³⁶ Insurance Act 2015 s.3(4)(b).

³⁷ Insurance Act 2015 Sched. 1 (2), (4)-(6).

³⁸ Australian Insurance Contracts Act 1984 s.56(2)(3).

³⁹ Criminal Justice and Courts Act 2015 s.57(2)(3).

⁴⁰ R Merkin, 'Reforming insurance law: is there a case for reverse transportation? A report for the English and Scottish Law Commissions on the Australian experience of insurance law reform' (2006) available at: http://www.lawcom.gov.uk/app/uploads/2015/03/ICL_Merkin_report.pdf (accessed 24/09/2017), [6.9].

⁴¹ The Hon M Kirby, 'Insurance contract law reform—30 years on' (2014) 26 *ILJ* 1, 17.

⁴² Merkin (n40) [6.9].

remedy to deter the wholly fraudulent claim. The precise shape of this remedy is beyond the scope of this thesis⁴³ although it should be noted that a sliding scale of remedies would better reflect the reality of insurance fraud. It is pleasing to see that MacDonald Eggers reached a similar conclusion in his restatement of the tort of deceit,

...a liability in deceit should be answerable by a broad range of remedies available to the claimant, subject to the court's discretionary control to ensure a flexible response to the deceit and its seriousness.⁴⁴

Parties are free to contract out of the statutory provisions on fraudulent claims, subject to the transparency requirements contained in the Act.⁴⁵ This entitles underwriters, therefore, to contract expressly for investigation costs and/or punitive damages in the event of a wholly fraudulent claim. Market appetite, as ever, will dictate whether policies will be written on such terms in the future. From a practical perspective, underwriters should be encouraged to seek additional financial penalties. Certainly, the courts do not appear averse to making such orders, as was evident in *Parker*⁴⁶ and the several motor insurance claims in which punitive damages have been awarded.⁴⁷

S.12 Insurance Act 2015 was not designed as a 'once and for all' restatement of the law on fraudulent claims. Indeed, the express purpose of the Law Commission was to develop "piecemeal solutions for demonstrated problems where there was consensus for reform."⁴⁸ Indeed, the 2015 Act has already been amended to include provisions on damages for late

⁴³ The author has begun work on the shape of a suitable remedy, see K Richards, 'Redressing the balance: Fabricated insurance claims and (harsh) civil remedies' (American Society of Comparative Law Younger Comparativists Committee Conference, Koç University (Istanbul), April 2017). Paper on file with the author.

⁴⁴ MacDonald Eggers (n2) [9.7]. See also the foreword to this book in which Rix LJ comments 'His well-argued prescription is for the law to restrain its opprobrium for the really deserving cases of deliberate dishonesty and for a more careful delineation of remedies to match the seriousness of the case.' (at vii).

⁴⁵ Insurance Act 2015 s.17.

⁴⁶ *Parker* (n9).

⁴⁷ *Churchill Insurance v Shajahan* (11 September 2015, Birmingham County Court); *Tasneem v Morley* (30 September 2013, Central London County Court); *Vasile v Pop Loan* (17 November 2015, Willesden County Court); *Liverpool Victoria v Ghadhda* (30 June 2010, Central London County Court).

⁴⁸ T Goriely, 'Good faith: The residual impact of s.17 Marine Insurance Act 1906' (Good Faith in Contract Law, Exeter University, July 2017).

payment.⁴⁹ Unlike the position for breaches of fair presentation under the Consumer Insurance (Disclosure and Representations) Act 2012,⁵⁰ there is no suggestion in the 2015 Act that s.12 constitutes “the only such remedies”⁵¹ for fraudulent claims. There is some scope, therefore, for further amendments to the Act to establish a distinct remedy for the wholly fraudulent claim. A statutory remedy for this type of conduct, though unlikely due to the constraints on parliamentary time, would bring conceptual clarity to the judicial model of deterrence. The imposition of harsh legal sanctions in these circumstances would further accord with modern research into dishonesty involving large external benefits. In short, a statutory cause of action or structural incentives to encourage underwriters to make use of common law remedies already in existence would create an effective legal deterrent where none currently exists.

Modern deterrence theory offers a wealth of insights which could be operationalised to develop a comprehensive anti-fraud framework. In general terms, the insights discussed in this thesis should caution judges against relying solely on instinct to construct legal penalties. It is worth reiterating that Lord Mance, writing extra-judicially, reached the same conclusion in respect of the law on illegality.⁵² To this end, the author’s recommendation is that such insights remain an important frame of reference for any future judicial or parliamentary response to the collateral lie and forfeiture, more generally.

The lessons of modern deterrence theory should also cause the insurance industry to reflect on the structural opportunities for fraud within the claims process. From a practical perspective, this could initiate the development of a behaviourally-informed claim form and claims handling processes designed to trigger the deterrent effect of social sanctions.⁵³ This would also be an opportunity to challenge the biases and heuristics by reminding the assured of the potential sanctions when the opportunity for fraud arises. This is significant since, unchallenged these mental shortcuts might otherwise lead an assured to commit fraud. The

⁴⁹ Enterprise Act 2016 ss.28-30 inserting ss.13A, 16A into Insurance Act 2015.

⁵⁰ Consumer Insurance (Disclosure and Representations) Act 2012 s.4(3).

⁵¹ Consumer Insurance (Disclosure and Representations) Act 2012 s.4(3).

⁵² (Lord) J Mance, ‘Ex turpi causa—When Latin avoids liability’ (2014) 18 Edin L Rev 175, 176.

⁵³ See also BBC, ‘Insurance fraud tops £1bn a year for the first time’ (27/07/2013) available at: <https://www.abi.org.uk/globalassets/sitecore/files/documents/publications/public/2016/fraud/effective-counter-fraud-practices-checklist-for-insurers-and-partners.pdf> (accessed 23/07/2017).

examples discussed in Chapter Three demonstrate that simple administrative tweaks informed by behavioural science can reduce claims fraud.⁵⁴ The final report of the Insurance Fraud Taskforce is promising in this regard. One of the Taskforce's central recommendations was for the ABI to commission research into behavioural economics to determine its utility in relation to fraud deterrence. At the time of writing, it remains to be seen what recommendations will emerge from this but, as a direction of travel, it is to be welcomed.

Industry reflection would also serve an important conceptual purpose. At present, the characterisation of forfeiture as a deterrent and the importance of judicial intervention creates the impression that underwriters are distanced from efforts to deter fraud. The recognition that underwriters can enact structural mechanisms to deter fraud would shift responsibility for fraud prevention. A more balanced narrative in which the industry and the courts have a role to play in deterrence would better reflect the characteristics of the modern underwriter and the reality of deterrence. Importantly, this would also mirror industry efforts beyond the courtroom, most notably the funding of the Insurance Fraud Enforcement Department,⁵⁵ industry-wide data sharing via the Insurance Fraud Bureau⁵⁶ and the creation of the Insurance Fraud Register.⁵⁷

The critique undertaken in this thesis has the potential to shape the future development of the forfeiture rule and of a more comprehensive and efficient deterrence regime. The focus now shifts to consider the judicial construction of the fraud exception in documentary credits.

III. Documentary Credits

⁵⁴ See earlier discussion, Chapter Three, text to fn 171 et seq.

⁵⁵ IFED, 'About IFED' available at: <https://www.cityoflondon.police.uk/advice-and-support/fraud-and-economic-crime/ifed/Pages/About-IFED.aspx> (accessed 12/09/2017).

⁵⁶ Insurance Fraud Bureau, 'About us' available at: <https://www.insurancefraudbureau.org/about-us/supporting-the-insurance-industry> (accessed 23/07/2017).

⁵⁷ Insurance Fraud Register, 'About the IFR' available at: <http://www.theifr.org.uk/en/about> (accessed 23/07/2017).

A. The judicial response to fraud

The fraud exception to autonomy in the law of documentary credits shares some of the characteristics of the simplistic account of fraud rules. The exception, for example, has been described as “a clear application of...*ex turpi causa*”⁵⁸ and is singular in nature, responding to all instances of fraudulent conduct in the same way. The development of the exception, however, has required the courts to overcome the tension between two competing policy considerations; the autonomy of the credit and fraud deterrence. These considerations stand in direct opposition to one another since the requirements of an autonomous mechanism – swift, efficient payment with minimal judicial intervention – would be fatal to a rule designed to uncover and deter fraud.⁵⁹ The trade finance courts have repeatedly demonstrated a preference for autonomy and have refused to intervene in disputes relating to the underlying transaction. The resulting fraud exception is narrow in scope and requires the claimant to satisfy onerous procedural criteria to invoke the exception. The courts, importantly, will not permit the exception to be used as a proxy for airing concerns about the underlying contract of sale. Assuming for a moment that an applicant has established evidence of beneficiary fraud in time, the impact of the exception – to deny the beneficiary any right to payment – has the penal character typically associated with civil law rules against fraud.

The fact that the fraud exception has never been successfully established in English law reflects the practical difficulty of the procedural criteria as well as judicial adherence to the autonomy of the credit. Fraud may well unravel all in hypothetical terms but this is not the case in practice. Accordingly, the characterisation of the documentary credit as a ‘pay now, argue later’ device’ is apt; parties are left to settle any disputes subsequently under the contract of sale. As for deterrence, the courts have not regarded this as a matter for commercial law and have instead assumed that parties mitigate the fraud risk through careful partner selection.

The distinctiveness of the fraud exception is also attributable to the broader contractual network created by the credit. The fraud rule does not just arise as a means of preventing

⁵⁸ *United City Merchants v Royal Bank of Canada (The American Accord)* [1982] 2 Lloyd’s Rep. 1, 6 per Lord Diplock (hereafter referred to as *United City Merchants (House of Lords)*).

⁵⁹ P Todd, *Maritime Fraud & Piracy* (2nd ed. Informa, 2010), [2.022]-[2.023].

payment to the fraudulent beneficiary, but is also employed by the credit applicant against the issuing bank. In these circumstances, the applicant employs the fraud exception to refuse reimbursement to the issuing bank or to prevent the bank from making payment to the beneficiary. The fraudulent beneficiary is excluded from these actions and the fraud exception instead functions as a loss allocation device between two innocent parties. It is understandable that deterrence is much less relevant where the action excludes the fraudster. The inclusion of the banks within the contractual network is also critical in understanding the judicial response to fraud. The limited opportunity for judicial intervention enables the banks to make payment with confidence. This increases the certainty of payments which the courts have regarded as vital for the global reputation of UK banks.⁶⁰

B. The critique of the judicial response to fraud

It is difficult to disagree with the proposition that courts should develop law with commercial need in mind. Indeed, this notion underpinned Lord Irvine's characterisation of commercial law in his 2001 Modern Law Review article.⁶¹ To focus solely on commercial need in the context of documentary credits, however, overlooks another, equally significant policy consideration; the deterrence of fraud. The discussion in Chapter Five critically examined the trade finance courts' construction of the fraud exception and clear preference for the doctrine of autonomy. Three key findings emerged from this discussion:

- i. The balance between competing policy objectives surrounding the fraud exception is not fixed by commercial need.
- ii. The conflation of three distinct issues – fraud, forgery and nullity – in *United City Merchants* has had consequences which impact on the efficiency of the credit mechanism. These contradict the policy rationale of the narrow English fraud exception.
- iii. Deterrence is not merely an *ex ante* issue for the parties but rather is a process which continues throughout the transaction.

⁶⁰ For example, *Bolivinter Oil SA v Chase Manhattan Bank* [1984] 1 Lloyd's Rep. 251, 257 per Sir John Donaldson MR: the injunction undermines "the bank's greatest asset...namely its reputation for financial and contractual probity. Furthermore, if this happens at all frequently, the value of all irrevocable letters of credit and performance bonds and guarantees will be undermined."

⁶¹ (Lord) D Irvine, 'The law: An engine for trade' (2001) 64(3) MLR 333.

i. *The balance between competing policy objectives is not inevitable*

The fraud exception requires national jurisdictions to balance the autonomy of the credit mechanism and fraud deterrence. The International Chamber of Commerce's determination that fraud is controversial⁶² suggests that there is not a simple answer and creates the conditions in which divergent responses to fraud have emerged. The English courts have consistently presented this policy balance as dictated by the needs of the commercial community. Put simply, autonomy has been preferred to deterrence and this has led to the construction of a narrow fraud exception. The position taken in this thesis is that a different balance could be drawn between these competing policy objectives.⁶³

The American approach to fraud is a useful starting point. The fraud exception, embodied in UCC art 5-109, adopts a more expansive definition of fraud which includes forgery and fraud in the underlying transaction.⁶⁴ Injunctive relief is also easier to obtain in the United States. Significantly, this more expansive approach to fraud has not resulted in the commercial dislocation so feared by the English courts.

Of course, different jurisdictions are entitled to reach different conclusions on policy grounds. This much is explicit in the ICC's decision to leave fraud to national courts. However, the fraud exception has developed differently in the jurisdictions under discussion. The English fraud rule is a product of the common law and largely of Lord Diplock's speech in *United City Merchants*. Few fraud cases have since reached the highest courts – no doubt in part due to the chilling effect caused by the narrow confines of the rule – meaning that the rule has not undergone adequate judicial scrutiny. While the American exception was initially developed

⁶² ICC Banking Commission, 'Latest queries answered by the ICC Banking Commission' (1997) 3(2) Documentary Credits Insight 6 cited in A Davidson, 'Fraud, the Prime Exception to the Autonomy Principle in Letters of Credit' (2003) 8 Intl. Trade & Bus L Ann 23, 26.

⁶³ This view is similar to that expressed in Canada, see *Bank of Nova Scotia v Angelica-Whitewear* [1987] 1 RCS 59, 72 per Le Dain J: "differences of view or emphasis with respect to these issues, reflect the tension between the two principal policy considerations: the importance to international commerce of maintaining the principle of the autonomy of documentary credits and the...importance of discouraging or suppressing fraud in letter of credit transactions".

⁶⁴ Uniform Commercial Code § 5-109 (a) (1995 revisions).

by the courts,⁶⁵ it is now enshrined in the Uniform Commercial Code.⁶⁶ The 1995 revisions to the UCC followed a lengthy consultation process which permitted the Taskforce to take a comprehensive view of the mechanism with the benefit of participation of a wide range of market actors.⁶⁷ The piecemeal approach of the English common law system means that such oversight is impossible.

The broader definition of fraud in the UCC does not mean that fraud deterrence has been prioritised at the expense of autonomy. Concerns about unnecessarily disrupting international trade are equally relevant in the American context. This is apparent both in judicial discussion⁶⁸ and in the statutory cause of action facilitating post-presentation actions against a fraudulent beneficiary.⁶⁹ Indeed, the very purpose of these warranties contained in art 5-110 was to reduce the actions for injunctive relief and encourage parties to resolve disputes following payment.⁷⁰ This demonstrates that a more permissive approach to fraud does not necessarily jeopardise international trade as feared by the English judiciary.

It is important to comment on the widespread use of standby credits in America and to consider specifically whether the greater use of standbys has dictated the policy balance drawn in the UCC. As a starting point, the case underpinning the fraud exception in both jurisdictions – *Sztejn v Schroder*⁷¹ – involved an ordinary documentary credit as distinct from a standby. True, Shientag J did not reference fraud deterrence explicitly but it is implicit in his judgment that the law should not be used to assist the fraudster. Indeed, he commented that there would be “no hardship”⁷² if the bank could refuse payment to a fraudster and was unwilling to extend the protection of the autonomy doctrine to a fraudulent beneficiary.⁷³ It

⁶⁵ *Sztejn v J Henry Schroder Banking Corp.* 177 Misc. 719 (N.Y. Misc. 1941).

⁶⁶ UCC art.5-109 (1995 Revisions).

⁶⁷ Task Force on the Study of UCC Article 5 (Letters of Credit), ‘An examination of UCC Article 5 (Letters of Credit)’ (1989-1990) 45 Bus Law 1521. (Hereafter referred to as ‘UCC Task Force’).

⁶⁸ *Sztejn* (n65) 721 per Shientag J. See also J Dolan, *The Law of Letters of Credit Commercial and Standby Credits* (4th ed. AS Pratt & Sons, 2007), [7-79], [7-88].

⁶⁹ Uniform Commercial Code § 5-110 (a) (1995 revisions).

⁷⁰ B Wunnicke, D Wunnicke and P Turner, *Standby and Commercial Letters of Credit* (3rd ed. Aspen Law & Business, 2000 (2013 Supplement)) 4-26.1; J Barnes and J Byrne, ‘Revision of UCC Article 5’ (1995) 50 Bus Law 1449, 1457. See generally, R Dole, ‘Warranties by beneficiaries of letters of credit under revised article 5 of the UCC: The truth and nothing but the truth’ (2002-2003) 39 Hous L Rev 375.

⁷¹ *Sztejn* (n68).

⁷² *Ibid* 723.

⁷³ *Ibid* 722.

would appear, therefore, that the standby mechanism is not at the root of the policy balance drawn in the United States but that the American position simply reflects a more even balance between the competing policies than under English law.

The repeated entrenchment of the English position by subsequent courts and academics may appear daunting to a court asked to diverge from the orthodox approach. By way of analogy, it should also be remembered that prior to the Supreme Court decision in *Versloot*,⁷⁴ it was widely thought that the law on insurance fraud was “relatively settled”.⁷⁵ The outcome in that case – a narrowing of the scope of the forfeiture rule – indicates that courts will be prepared to engage in a considered analysis of an orthodox position, notwithstanding its age or elucidation by an expert judge.⁷⁶

ii. *The detrimental consequences of conflation*

In *United City Merchants*, Lord Diplock confirmed the existence of a narrow fraud exception but in so doing, mischaracterised the contractual basis of the credit and conflated the distinct issues of fraud, forgery and nullity. This has resulted in several detrimental consequences for the efficiency of the credit mechanism, which undermine Lord Diplock’s very rationale for a restrictive approach to fraud.

The difficulty stems from the circumstances in which Lord Diplock held that the bank was contractually obliged to make payment. He held that the bank’s duty to pay was engaged by the presentation of apparently complying documents.⁷⁷ In circumstances when the presented documents were fraudulent, forged or null, the bank would only be entitled to refuse payment when the defect could be attributed to the beneficiary. The fact that the fraud exception can only be triggered by the personal wrongdoing of the beneficiary correctly reflects the juridical basis of the rule; *ex turpi causa*. However, the consequence of obliging

⁷⁴ *Versloot (Supreme Court)* (n11).

⁷⁵ Law Com 353 (n14) [20.6]; [22.22]-[22.24]; Law Com 201 (n26) [8.10].

⁷⁶ Note that Mance LJ, as he then was, who is widely acknowledged to be the leading insurance law judge extended the forfeiture rule to fraudulent device claims in *Agapitos v Agnew (The Aegeon)* [2003] QB 556, [45] and was part of the court in *Versloot (Supreme Court)* (n11).

⁷⁷ *United City Merchants (House of Lords)* (n58) 7 per Lord Diplock.

banks to pay against apparently compliant documents is that it must pay for known nullities and forgeries unless these can be attributed to the beneficiary. The procedural hurdles to proving fraud, discussed in Chapter Four, mean that the fraud exception will only very rarely operate to disrupt payment. This is, according to the courts, the hallmark of a mechanism developed with commercial need in mind.⁷⁸

It was wholly legitimate for Lord Diplock to focus on the author of the documentary defect to determine whether the fraud exception should operate. However, this meant that his Lordship overlooked a prior question: did the documents comply with the terms of the credit? Documents which, at the time of presentation, were known forgeries or nullities should properly be regarded as non-compliant. Since compliance requires banks to assess the documents objectively, the identity of the person responsible for the defect is wholly irrelevant at this stage of the enquiry.⁷⁹ Indeed, the identity of the wrongdoer only becomes relevant when the documents have been deemed compliant and the focus shifts to whether there is a legitimate basis for the bank to refuse payment. This two-stage enquiry treats questions of compliance as a threshold in that considerations of fraud do not arise until and unless this threshold has been satisfied.⁸⁰ It is unclear why the House of Lords overlooked earlier dicta establishing the two-stage analysis⁸¹ and diverged so considerably from the Court of Appeal judgment, particularly since the arguments made by counsel for the buyer were virtually identical on appeal.⁸² The rule of apparent compliance is also mischaracterised in Lord Diplock's analysis. The rule was established to safeguard the bank's right to reimbursement when fraud was subsequently discovered. The rule does not, and was never intended to, establish the circumstances in which the bank's obligation to pay arises.

The decision in *United City Merchants* cannot be reconciled with the express terms of the UCP and this has resulted in several practical difficulties for the credit mechanism. Most notably,

⁷⁸ Ibid 7 per Lord Diplock.

⁷⁹ R Goode, 'Abstract payment undertakings' in P Cane and J Stapleton (eds.), *Essays for Patrick Atiyah* (Clarendon Press, 1991), 232.

⁸⁰ Ibid 233-234.

⁸¹ *Edward Owen Engineering v Barclays Bank International* [1979] 1 QB 159, 169 per Denning LJ citing *Bank Russo-Iran v Gordon Woodroffe & Co* [1972] 116 Sol J 921, 10 CL 296 per Browne J.

⁸² Compare the following judgments where counsels' arguments are summarised: *United City Merchants v Royal Bank of Canada (The American Accord)* [1983] AC 168, 173-178; *United City Merchants v Royal Bank of Canada (The American Accord)* [1982] QB 208, 213-215.

the court's approach to nullities has effectively meant that documents devoid of commercial or legal value can stand as good currency. This is troubling since documentary transactions depend on trust.⁸³ A further practical difficulty relating to the circulation of null documents relates to the bank's role in financing credit transactions. Indeed, banks are only willing to finance such transactions because they take the documents as security to guard against the risk of applicant insolvency prior to reimbursement.⁸⁴ It goes without saying that nullities will not enable banks to recoup losses suffered because of their customer's insolvency. Similar issues stem from the acceptance of forged documents as good currency, most notably that the approach to forgery differs between documentary credits and other negotiable instruments.

The doctrinal analysis of the credit mechanism values the principles of autonomy and strict compliance equally. This is not reflected in the decision in *United City Merchants* since the court demonstrated a preference for the doctrine of autonomy. This is not merely of conceptual interest since the principle of strict compliance performs several important commercial functions.⁸⁵ These are inevitably undermined by the judgment in *United City Merchants*.

The consequences of this decision are also apparent in subsequent case law concerning the circumstances in which banks can refuse payment. The failure to treat compliance and fraud as distinct elements of the enquiry has meant that subsequent discussions about documentary defects have been mischaracterised as exceptions to autonomy rather than as an instance of a beneficiary failing to satisfy the preconditions to payment. This is particularly apparent in the Court of Appeal's discussion in *Montrod v Grundkötter*.⁸⁶ Subsequent discussions have become unduly dominated by fraud at the expense of legitimate enquiries focussing on documentary compliance.

⁸³ I Carr, *International Trade Law* (5th ed. Routledge, 2014) 468; M Bridge, 'Documents and contractual congruence in international trade' in Worthington, S. (ed.), *Commercial Law and Commercial Practice* (Hart, 2003), 216; X Gao, *The Fraud Rule in the Law of Letters of Credit: A Comparative Survey* (Kluwer Law International, 2002), 130-131.

⁸⁴ EP Ellinger, 'Fraud in documentary credits' [1981] JBL 258, 269.

⁸⁵ See earlier, Chapter Four, text to fn 98 et seq.

⁸⁶ *Montrod Ltd v Grundkötter Fleischvertreibe GmbH* [2002] 1 WLR 1975, [56] per Potter LJ.

This thesis has argued that the conflation needs to be corrected in a manner that gives due consideration to the commercial need for an efficient mechanism. The suggestion made in Chapter Five was to reinstate the threshold analysis suggested in earlier case law.⁸⁷ This would focus the initial enquiry on documentary conformity and enable banks to reject nullities as non-compliant. This reflects the fact that the documents will be required to function as security for the ultimate buyer and the bank in the event of its customer's insolvency. This would not unduly hinder the payment process, however, as the beneficiary can resubmit documentation before the credit expires. This differs from the impact of the fraud exception whereby the beneficiary's right to payment is permanently barred. Although forged documents are strictly speaking non-compliant, the position advocated in this thesis would entitle banks to make payment against forgeries. This is a pragmatic approach to the compliance question which, in the author's view, can be justified because forged documents remain capable of serving their commercial purpose.

iii. Deterrence in documentary credit transactions

The courts have repeatedly asserted that traders bear responsibility for mitigating fraud through the careful pre-contractual selection of honest counterparts. The view is that absent honesty, there would be no deal.⁸⁸ There is nothing in the judicial account to suggest how such information is gathered or circulated between parties. The trade finance courts have further characterised commercial law as offering protection from insolvency and not to guard against fraud.⁸⁹ In tandem, this view of the law perhaps explains the absence of any judicial or academic discussion of fraud deterrence in credit transactions. The approach to documentary credit fraud, therefore, diverges significantly from both the insurance approach to deterrence and the general shape and function of fraud rules in English law. This thesis, therefore, represents a significant and more comprehensive analysis of fraud in documentary credit transactions. The discussion relied on empirical evidence of credit use, gathered by

⁸⁷ *Edward Owen* (n81) 169 per Denning LJ.

⁸⁸ J Davey, 'Honesty & the relational commercial contract: Towards a law of post-contractual misrepresentation', (Insurance Fraud Symposium, University of Southampton Law School, 13 July 2016), 11.

⁸⁹ *Sanders v Maclean* (1883) 11 QBD 327, 343 per Bowen LJ,

Professor Mann in the late 1990s.⁹⁰ The data diverged considerably from the doctrinal account of credit use, demonstrating that payment was achieved via the waiver process, notwithstanding serious documentary discrepancies. This data is not routinely cited or considered in the English context.⁹¹ It was used in this thesis to develop two specific arguments about deterrence.

The first argument used the empirical data to strengthen the judicial account of fraud prevention; *ex ante* screening. It was contended that the information channels identified in Katz's analysis of the data provided a framework in which pre-contractual screening could occur. These channels provided the structure in which information about a party's reputation and propensity for wrongdoing could be dispersed among the community. This adds colour and depth to the judicial explanation of deterrence.

The second argument considered the mitigation of incentives for fraud which arise during performance of the credit contract. This was a novel analysis given that the judicial account confines deterrence to the pre-contractual period. In particular, opportunities for fraud arise during performance when the beneficiary ships the contractual goods but cannot comply with the terms relating to shipment or encounters financial difficulty. It was suggested here that relational governance operates during credit transactions to mitigate incentives for fraud during performance. This is an informal mechanism of governance which depends on norms of trust, flexibility and cooperation and industry-specific norms to guide behaviour within the transaction. A relational mechanism constrains misconduct in commercial transactions because of the commercial importance attached to a good reputation. It was contended in Chapter Five that these norms could plausibly develop in credit transactions following the conclusion of the written contract. The process of finalising the details of the exchange will typically require parties to cooperate and engage in personal interaction. These are the hallmarks of a transaction underpinned by relational governance.

⁹⁰ R Mann, 'The role of letters of credit in payment transactions' (1999-2000) 98 Mich L Rev 2494.

⁹¹ The author has identified the following two references to the empirical work: Bridge, 'Documents and contractual congruence' (n83) 227 (fn 68 in original); J Ulph, 'The UCP 600: Documentary credits in the 21st century' [2007] JBL 355, 362 (fn 29 in original). Neither account discusses the data in detail or what it might mean for the use of documentary credits, as has been undertaken in this thesis.

Readers will note that neither of these arguments about deterrence refers to the fraud exception. In this way, the thesis lends support to the judicial account that the fraud exception to autonomy is not designed to deter fraud.⁹² Instead, deterrence is explained by reference to extra-legal mechanisms, namely due diligence in the pre-contractual phase and relational governance during performance.

C. Looking forward

It is convenient at this stage to consider what these findings mean for the future development of the fraud exception in documentary credits.

The first, and perhaps overarching, impact of these findings is conceptual in nature. The research undertaken in this thesis demonstrates that English courts could broaden their approach to fraud and the availability of injunctive relief without risking the utility of the credit mechanism or the reputation of UK banks. In short, the English courts have been incorrect to suggest that the particular contours of the rule are fixed by reference to commercial need. To this end, a more flexible and reflective approach to the policy questions surrounding documentary credits would ensure that the law achieves its aim of facilitating trade.

The practical impact of these findings is dependent on a suitable case reaching the appellate courts or on legislative intervention. The latter course of action is highly unlikely given the constraints on parliamentary time. In relation to judicial action, a case would need to come before the Supreme Court in order to re-examine the House of Lords' decision in *United City Merchants*. As argued in Chapter Five, a modern court could simply distinguish the earlier decision on the basis that the transaction incorporated the UCP 500, as distinct from the revised UCP 600 in common usage today. A more courageous Supreme Court would also have grounds for overruling the decision in *United City Merchants*. Firstly, the court could argue that the House of Lords fundamentally misunderstood that the beneficiary was under an express contractual duty to present strictly compliant documents to gain payment. The

⁹² *Sanders* (n89) 343 per Bowen LJ.

Supreme Court could also demonstrate the flawed understanding of the rule of apparent compliance and reinstate that rule as a protective device for banks and not a standard for establishing the bank's duty to make payment. Irrespective of which course of action was taken – to distinguish or overrule the decision in *United City Merchants* – the Supreme Court would, in general terms, be entitled to alter the policy balance between fraud deterrence and autonomy. More specifically, a judicial restatement of the proper role of apparent compliance and the doctrine of strict compliance would enable banks to respond to nullities in the way suggested above, namely to legitimately reject such documents as non-compliant without considering the party responsible for the defects. The approach advocated here depends on a suitable case reaching the Supreme Court although, at the time of writing, there is no such case on the horizon. This, it should again be noted, is attributable to the chilling effect of the House of Lords' decision in *United City Merchants*.

At the time of writing, the International Chamber of Commerce are drafting a new version of the UCP. This is unlikely to deal with fraud given the ICC's repeated insistence that this is a matter for national jurisdictions. However, to continue the drive for clarity and further reduce defective presentations,⁹³ the UCP 700 could clarify the definition of 'complying presentation' in line with the findings of this thesis. In particular, the ICC could confirm that nullities are not complying for the purposes of the UCP. This would firmly distinguish documentary compliance and fraud without encroaching on national courts' jurisdiction to legislate for fraud. A workable definition of nullity would be required for these purposes. This issue troubled the English Court of Appeal in *Montrod* and was used to reject the development of a nullity exception to payment in English law.⁹⁴ The solution to the definition problem could be easier than the English courts have suggested. The ICC offer banks a document authentication service⁹⁵ which presumably relies on a working definition of nullity to assess documents. This would be a fruitful line of enquiry should the ICC wish to enshrine nullities as non-compliant in the UCP 700. In any event, as a voluntary set of guidelines for credit

⁹³ ICC, 'The Uniform Customs and Practice for Documentary Credits' (2007 Revision, ICC Publication no. 600) (see introductory comments by G Collyer).

⁹⁴ *Montrod* (n86) [58] per Potter LJ. But see the approach in *Beam Technology (Mfg) Pte Ltd v Standard Chartered Bank* [2002] SGCA 53, [36] per Chao Hick Tin JA, Tan Lee Meng J where the matter "can only be answered on the facts of each case."

⁹⁵ ICC Commercial Crime Services, 'Trade Finance Documents Authentication', <https://www.icc-ccs.org/icc/imb/services/due-diligence/trade-finance-documents-authentication> (accessed 17/07/2016).

transactions, if the UCP 700 – complete with a strengthened definition of compliance – was unacceptable to traders, parties could simply incorporate an earlier version of the UCP. The author would suggest, however, that the likelihood of a new version being unacceptable to traders is relatively slim given that the drafting process includes both banks and traders.

If the recommendations detailed above were reflected in the UCP 700 and English jurisprudence, a further issue would arise; the singularity of the remedy. Much like the simplistic overview of deceit first identified by MacDonald Eggers,⁹⁶ the remedy for fraud in credit transactions operates like a switch to deprive the fraudulent beneficiary of his entire right to payment. There is, as the rule is currently constructed, no scope for the courts to consider the severity of the fraud or the culpability of the beneficiary. To illustrate the problem, it will be remembered that the fraud exception can be equally satisfied by a phantom shipment as by the falsification of documents to conceal late shipment of the contractual goods. There is no doubt that the beneficiary responsible for a phantom shipment is more culpable and deserving of punishment than his counterpart in this example. The singular nature of the fraud exception would result in similar counterintuitive effects as have been demonstrated in the insurance context. Similarly, therefore, a framework of nuanced remedies to combat fraud would be more appropriate. This mirrors the recommendation made above in respect of insurance claims fraud and MacDonald Eggers' conclusions on the tort of deceit.⁹⁷ There is no doubt, however, that we are a long way from such arguments taking root in the documentary credit context.

IV. Concluding Reflections

This thesis has focussed on the judicial conception of fraud in insurance and in transactions financed by documentary credit. The discussion now reflects, more generally, on what these findings tell us about commercial law.

The English commercial courts fall back on simple phrases to explain intervention in fraud cases. It seems unlikely that a three-word phrase could ever accurately explain judicial action and yet this is the intention when 'fraud unravels all' is invoked by the courts. Simple phrases

⁹⁶ MacDonald Eggers (n2) [1.4].

⁹⁷ Ibid [9.7].

such as this do not have the capacity to recognise contextual matters which distinguish areas of law and justify different treatment. The importance of context is particularly apparent in the comparison between the fraud rules in marine insurance and documentary credits. These bodies of law, and the rules relating to fraud, serve fundamentally different purposes and trigger different policy concerns. It is likely, therefore, that a consideration of other commercial fraud rules would bring to light additional policy concerns to be balanced against deterrence, and further demonstrate the importance of understanding contextual issues affecting the operation of a rule.

Policy arguments have been critical in the judicial response to insurance claims fraud and fraud in credit transactions. There is no reason to suppose that a similar reliance on policy would not be found in other commercial fraud rules. What has been particularly interesting is that the courts have characterised their policy choices as inevitable; a classic example of judges 'finding' the law. But, if we recognise policy as simply a "value-judgment,"⁹⁸ typically employed in cases where "the rules of the legal system do not provide a clear resolution",⁹⁹ this notion of inevitability diminishes. As Todd has argued in the context of documentary credits,

There is nothing inevitable about these policies, and the autonomy principle in particular is less strongly developed in the United States...They represent the uncompromising choice that has been made by the English courts.¹⁰⁰

The same conclusion can be drawn about factual assumptions¹⁰¹ made by the courts as well as the assumed behavioural consequences flowing from a judicial decision.¹⁰² This should lead academics to be wary of simple answers indicated by policy and to approach such questions

⁹⁸ J Bell, *Policy Arguments in Judicial Decisions* (Clarendon Press, 1983), 36.

⁹⁹ *Ibid* 22-23.

¹⁰⁰ Todd, *Maritime Fraud & Piracy* (n59), [4-014].

¹⁰¹ A Kronman, 'Mistake, disclosure, information, and the law of contracts' [1978] 7 J Leg. Stud. 1, 2: "Every contractual agreement is predicated upon a number of factual assumptions about the world. Some of these assumptions are shared by the parties to the contract and some are not. It is always possible that a particular factual assumption is mistaken."

¹⁰² P Cserne, 'Policy arguments before courts: Identifying and evaluating consequence-based judicial reasoning' [2009] *Humanitas J of Eur. Studies* 9, 15-16: "a more or less educated guess about hypothetical scenarios as to how certain groups of legal subjects would change their behaviour in response to this or that decision."; Bell (n33) 67.

with an open mind. Robust, empirically-informed models should be preferred to law making based on simplistic and instinctive rules of thumb. The costs associated with this approach would no doubt be justified by the nuanced and more efficient legal rules which would result.

The piecemeal nature of the English common law system also merits consideration.¹⁰³ The courts are limited by the facts of the instant case and, certainly at the lower levels, constrained by the doctrine of precedent. This aspect of the English system is highlighted by the fact that foreign jurisdictions have reached different answers to the same questions of policy, typically after lengthy consultation and legislative processes.¹⁰⁴ On a related note, it is difficult to dispute the suggestion that the fraud exception in documentary credits has been hindered by the absence of cases reaching the appellate courts. This contrasts starkly with the much greater volume of judicial discussion of the forfeiture rule. The common law courts are necessarily reliant on private parties litigating disputes and this limits the opportunities to reflect on the development of the law. This should be remembered on the rare occasions that courts have the opportunity to reconsider the direction or shape of the law.

Rawlings and Lowry have described Lord Mance's dissent in *Versloot* as "unsurprising"¹⁰⁵ and this is certainly a sentiment the author would endorse following a brief conversation with his Lordship at this year's Society of Legal Scholars conference. The author's overriding sense of the decision in *Versloot* is one of dissatisfaction. If the pre-*Versloot* position was criticised for its severity and pro-underwriter stance, it is no better for the Supreme Court to have replaced that model with an equally simplistic one which instead favours the fraudster. The author is equally dissatisfied with the simplistic approach to fraud which has been developed in the context of documentary credits.¹⁰⁶ To develop the law with commercial need in mind is admirable, but the courts should not be content with a fraud rule which is, in practice, wholly "illusory."¹⁰⁷ This thesis is, in broad terms, a rejection of simplistic ideas used to shape legal

¹⁰³ Rawlings and Lowry, 'Insurance fraud and the role of the civil law' (n16) 525, described as "the happenchance of litigation."

¹⁰⁴ For example, Task Force on the Study of UCC Article 5 (Letters of Credit), 'An examination of UCC Article 5 (Letters of Credit)' (1989-1990) 45 Bus Law 1521, 1532, 1536; Australian Law Review Commission, *Insurance Contracts* (ALRC Report 20, 1982).

¹⁰⁵ Rawlings and Lowry, 'Insurance fraud and the role of the civil law' (n16) 529-530.

¹⁰⁶ Indeed, this was the author's headline argument in her SLS presentation (paper on file with author).

¹⁰⁷ WS Chong, 'The abusive calling of performance bonds' [1990] JBL 414, 416.

policy. It is also designed to highlight the importance of challenging seemingly settled judicial doctrine in favour of nuanced, empirically-informed legal rules. Indeed, the author intends to explore the shape of more flexible remedial regimes in future work, to mirror the recommendations of MacDonald Eggers in his convincing restatement of the tort of deceit.¹⁰⁸

¹⁰⁸ MacDonald Eggers (n2) [9.5]-[9.9].

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