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YANAN ZHANG

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ABSTRACT

The documentary letter of credit (L/C) is an important payment method and financial instrument in international trade. Two fundamental principles are independence and strict compliance. Its operation was standardised in UCP 600, which is used widely all over the world. However, the usage of L/C has been challenged by fraud. The approaches combine legal and business perspective.

The legal approach includes both criminal law approach and civil law approach. Fraud, as a crime, can be tackled under criminal law regime. The criminal legal remedy can be ineffective due to procedural problems between different jurisdictions. Fraud exception, as a judicial remedy to fraud in litigation, are examined under civil law regime.

The procedural instruments dealing with fraud exception are injunctions or stop-payment orders. We examine fraud exception rules in the UNCITRAL Convention at international level, and mainly in England and China at national level. With a comparative approach, we have found that the approach in China to fraud exception rules is to study different models in other countries and international rules, learn ideas from them, and then adapt them to its own context. We claim that it is a phenomenon of legal transplant (a more proper term: legal adaptation), which is a common method of reforming law in China.

Then we explore arbitration and other alternative methods for litigating international L/C fraud disputes. The research findings have shown that arbitration is possible, though several difficulties can occur in practice; the DOCDEX rules are not suitable for resolving L/C fraud disputes; negotiation or mediation is likely to be more effective when combined with some legal measures than being employed alone.

The final approach is a preventive and proactive approach, which is from business perspective. We have worked out several preventive measures for buyers, sellers, banks, and lawyers. Moreover, we have found that electronic L/C cannot totally protect L/C from the abuse of fraud.

Keywords: Documentary Letter of Credit, Fraud Exception, Comparative Law

ABSTRAKTI

Remburssi on tärkeä maksutapa kansainvälisessä kaupassa. Remburssin kaksi perusperiaatetta ovat remburssin itsenäisyys ja riippumattomuus pääsopimuksesta sekä ankara sopimuksenmukainen tulkinta (strict compliance). Reburssin toimintamalli on vakiinnutettu UCP 600 remburssisäännöissä, joita käytetään laajalti kansainvälisessä kaupassa. Petoksen mahdollisuus kuitenkin haastaa remburssijärjestelmän toiminnan. Väitöskirjassa tarkastellaan tätä ongelmaa sekä oikeudellisesta että kaupallisesta näkökulmasta?

Oikeudelliseen näkökulmaan sisältyy sekä rikosoikeudellinen että siviilioikeudellinen osuus. Petos on rikos, jota voidaan selvittää rikosoikeudellisesti. Rikosoikeudellinen seuraamus voi kuitenkin osoittautua tehottomaksi eri oikeusjärjestysten erilaisten prosessioikeudellisten ongelmien vuoksi. Fraud exception sääntöjä (remburssisääntöjen väistyminen petoksen vuoksi) oikeudellisena seuraamuksena tuomioistuinmenettelyssä tarkastellaan väitöskirjassa siviiliprosessin näkökulmasta.

Prosessioikeudelliset välineet, joita käytetään fraud exceptionin yhteydessä ovat kieltomääräykset (injunction order) ja maksunperuutusmääräykset (stop-payment order). Väitöskirjassa tarkastellaan fraud exception –sääntöjä kansainvälisellä tasolla UNCITRAL:n konventiossa sekä kansallisen lainsäädännön tasolla pääasiassa Englannissa ja Kiinassa. Vertailevasta näkökulmasta näyttää siltä, että Kiinassa suhtaudutaan fraud exception -sääntöihin vertailemalla muiden maiden erilaisia malleja ja kansainvälisiä sääntöjä ja soveltamalla niitä omassa kontekstissa. Kyseessä on oikeudellinen siirrännäinen (legal transplant) tai oikeammin oikeudellinen mukautuminen kansainväliseen järjestelmään, mikä on yleinen toimintatapa Kiinan lakireformeissa.

Sen jälkeen tarkastellaan välimiesmenettelyä ja muita vaihtoehtoisia riidanratkaisumenetelmiä remburssipetosriitoihin. Tutkimuksesta selviää, että välimiesmenettely on mahdollinen vaikkakin monia ongelmia voi sen osalta syntyä käytännössä. DOCDEX –säännöt eivät sovellu remburssipetosriitojen selvittämiseen. Neuvottelu ja sovittelu ovat yhdistettyinä muihin oikeudellisiin menetelmiin tehokkaampia kuin yksin käytettyinä. Viimeinen käsiteltävä näkökulma on liike-elämän ennakoiva (proaktiivinen) näkökulma. Tutkimuksessa on työstetty useita ennakoivia menetelmiä ostajille, myyjille, pankeille ja juristeille. Tutkimus osoittaa myös, ettei elektroninen remburssi pysty täysin suojaamaan remburssia petokselta.

Avainsanat: Remburssi, fraud exception –säännöt, vertaileva oikeus

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Joensuu, December 2010
Yanan Zhang

Contents

Abbreviations

AC	Appeal Cases (England)
ADR	Alternative Dispute Resolution
AICPA	American Institute of Certified Public Accountants
ALI	The American Law Institute
All E.R.	All England Law Reports (England)
Am. J. Comp. L.	American Journal of Comparative Law
APL	American President Lines
ASA	The Swiss Arbitration Association
BFLJ	Buffalo Law Review
Banking L.J.	Banking Law Journal
BL	Bill of Lading
BLR	Building Law Reports
Brit. J. Criminology	British Journal of Criminology
CA	Court of Appeal (England)
CCMT	China Foreign-related Commercial and Maritime Trial
CCPIT	China Council for the Promotion of International Trade
CCS	Commercial Crime Services
CEDR	Centre for Effective Dispute Resolution
Ch.	Chancery Division (Incorporated Council)
Chinese J. Int'l L	Chinese Journal of International Law
CID	Centre for International Development at Harvard University
CIETAC	China International Economic and Trade Arbitration Commisssion
CISG	United Nations Convention on Contracts for the International Sale of Goods
CITIC	China International Trust and Investment Company
CJJA	Civil Jurisdiction and Judgment Act 1982, England
C.J.Q.	Civil Justice Quarterly
C.L.C.	Commercial Law Cases (England)
Cl. & Fin.	Clark & Finnelly's House of Lords Cases (UK)
CNKI	China National Knowledge Infrastructure
Comp. Lawyer	Company Lawyer
Const.L.J.	Construction Law Journal
COSO	Committee of Sponsoring Organizations of the Treadway Commission
CPC	Communist Party of China
CPL	Civil Procedure Law (China)

CPR	Civil Procedure Rules (England)
CPS	Crown Prosecution Service (England)
DCI	Documentary Credits Insight
DLR	Dominion Law Reports (Canada)
DOCDEX	Documentary Instruments Dispute Resolution Expertise
EAW	European Arrest Warrant
EJCL	Electronic Journal of Comparative Law
ERM	Enterprise Risk Management
EU	European Union
E.W.C.A.Civ.	Court of Appeal, Civil Division (England & Wales)
EWHC	High Court of England and Wales
FRCP	Federal Rules of Civil Procedure (USA)
Fordham Int'l L.J.	Fordham International Law Journal
FSA	Financial Services Authority (England)
F.S.R.	Fleet Street Reports (England)
HCCH	Hague Conference on Private International Law
HL	House of Lords (England)
HLJ	Heilongjiang Province (China)
HPC	Higher People's Court (China)
IBLJ	International Business Law Journal
ICC	International Chamber of Commerce
ICCLR	International Company & Commercial Law Review
ICLOCA	International Centre for Letter of Credit Arbitration
ICPC	International Criminal Police Commission
ICSID	International Centre for Settlement of Investment Disputes
IIBLP	Institute of International Banking law & Practice
Int'l Law	International Lawyer
Int'l Rev. L. & Econ.	International Review of Law & Economics
J.B.L.	Journal of Business Law
JFC	Journal of Financial Crime
JIBL(R)	Journal of International Banking Law & Regulation
K.B.	King's Bench Division (England)
L/C	Letter of Credit
L/Cs	Letters of Credit
LLP	Lloyd's of London Press Ltd
LMCLQ	Lloyd's Maritime and Commercial Law Quarterly
Loy. L. Rev.	Loyola Law Review
LQR	Law Quarterly Review
MEDAL	The International Mediation Services Alliance
NCCUSL	National Conference of Commissioners on Uniform State Laws
NJ	New Jersey
NPC	National People's Congress (China)
N.Y.Sup.Ct.	New York Supreme Court

OECD	Organisation for Economic Co-operation and Development
PLC	Practical Law Company
P. R.C.	People's Republic of China
QB (D)	Queen's Bench Division (England)
RICO	Racketeer Influence and Corrupt Organisations Act
RMB	Renminbi
SCC	Supreme Court of Canada (Canada)
SFO	Serious Fraud Office
SGA	Sale of Goods Act 1979 (England)
SPC	Supreme People's Court (China)
SWIFT	Society for Worldwide Interbank Financial Telecommunications
UCC	Uniform Commercial Code
UCP	Uniform Customs and Practice for Documentary Credits
UK	United Kingdom
UKHL	United Kingdom House of Lords (England)
UN	United Nations
UNCITRAL	United Nations Commission on International Trade Law
UNCTAD	United Nations Conference on Trade and Development
UNIDROIT	International Institute for the Unification of Private Law
U.Pa. L. Rev.	University of Pennsylvania Law Review
URC	Uniform Rules for Collections
URDG	Uniform Rules for Demand Guarantees
US/USA	United States of America
Vand. J. Transnat'lL.	Vanderbilt Journal of Transnational Law
WLR	Weekly Law Reports (England)
WTO	World Trade Organization

1 Introduction

This dissertation is about different approaches towards the international documentary letters of credit fraud issue. Concrete approaches can be diverse, but there are generally two perspectives of looking at this issue: legal perspective and business perspective. To understand the complex problem which is under examination, we will start with a brief introduction to the documentary letter of credit system.

1.1 LETTER OF CREDIT: A PAYMENT SYSTEM

Payment for goods in a sales transaction is important, because the smoothness of payment somewhat indicates the successfulness of the whole transaction. However, payment is a more difficult problem in an international sales transaction than that in a domestic sales transaction. It is easy to see that an international sales transaction has its own international character. The parties are usually situated in different countries, where different legal rules might apply. Normally, buyers and sellers have different interests in international sales transactions. The sellers would like to ensure that they will get paid for the sold goods once the goods are delivered, whereas the buyers want to make sure that sellers have shipped the goods that were specified in the sales contract before making payment.[1]

1.1.1 Terminology

Documentary credit (also letter of credit, or more formally documentary letter of credit, hereinafter L/C), which was created in trade and business several hundred years ago, is a well known financial method for international trade parties nowadays. L/C has a long history and has been stated as "the life blood of international commerce" by English judges[2]. It is considered as an instrument that reconciles the interests of the seller and the buyer, thus providing security both to the buyer and seller.[3] The terms and conditions governing L/C transactions are almost always to be found in Uniform Customs and practice for Documentary Credits (UCP) issued by the International Chamber of Commerce (ICC)[4].

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[1] Van Houtte, Hans (2002), *The law of International Trade*, London: Sweet & Maxwell, 2nd ed., p. 265.
[2] D'Arcy, Leo (2000), *Schmitthoff's Export Trade - The law and Practice of International Trade*, London: Sweet & Maxwell, 10th ed., p. 166.
[3] Further analysis, see Llewellyn, K. N. (1929), 'Some Advantages of Letters of Credits', *Journal of Business of the University of Chicago*, Vol. 2, No. 1, Jan., pp. 1-16.
[4] UCP have six versions since they were first promulgated in 1933; UCP 400 came into effect on 1 Oct., 1984, and UCP 500 on 1 Jan., 1994, and the latest version is UCP 600, which came into effect on 1 July, 2007. The ICC is a private body made up of the union of national chambers of commerce, the World Business Organisation based in Paris and established in 1919, the global leader in the development of standards, rules and reference guides for international trade. The lawmaking process is argued to be a bottom-up approach. For further discussion see Levit, Janet Koven (2005), 'A Bottom-up Approach to International Lawmaking: The Tale of Three Trade Finance Instruments', *Yale Journal of International Law*, Vol. 30, p. 125.

L/C has various types designed to meet different demands of commercial parties. In order to make clear what kind of L/C we refer to in this research, we need to understand clearly several types of L/C. The first group we introduce is comprised of the revocable L/C (can be cancelled or altered by the buyer after it has been issued by a bank), which is the opposite to the irrevocable L/C (cannot be cancelled or amended without prior mutual agreement of all parties to the credit).[5] A revocable L/C provides a low level of security and is extremely rare in practice; whereas an irrevocable L/C guarantees payment by the bank to the seller provided the seller complies with all stipulated conditions and is widely used in international trade.[6] The second group we introduce is comprised of the clean L/C, which is the opposite of the documentary L/C. Under a clean L/C, a seller may draw payment without presentation of documents, whereas under a documentary L/C, a seller has the guarantee of getting paid by a bank when the required documents are presented.[7] In international trade, the documentary L/C is much more widely used than the clean L/C. Thus, the L/C we examine in this research refers to a L/C which is irrevocable and which requires a seller to present the stipulated documents. We will use the abbreviation L/C to represent the documentary letter of credit; and other specific types of L/C will be explained when mentioned.

In commercial practice, L/C[8] is a letter issued from a bank promising payment where the recipient of the letter (known as the beneficiary of L/C) presents to the bank the stipulated documents during a specific time period.[9] The buyer (known as the applicant) is the person who applies for a L/C for the beneficiary from a bank. These documents presented by the beneficiary of the L/C (also the seller of the sales contract) will then be passed on by the bank to the buyer. Thus, a L/C also signifies an agreement in which a bank acts for its customer and assures payment against presentation of the specified documents by the beneficiary.

Several common documents are required by a L/C, including: (1) Draft(s); (2) Commercial invoice; (3) Miscellaneous invoices, such as Pro Forma invoices, customs invoice, and consular invoice; (4) Shipping documents, usually bill of lading (hereinafter BL); (5) Insurance policy or certificate; (6) Packing documents; (7) Certificate of origin; (8) Inspection certification; (9) Other documents, depending on the type of underlying commercial transactions.[10] The required documents normally are evidence of the performance of the underlying contract by the seller, proving that the seller has delivered the goods.

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[5] See e.g. Chen, Yan & Liu, Ling (2005), *Documentary Letters of Credit in Practice*, Peking: University of International Business and Economics Press, p. 50.
[6] Sarkar, Rumu (2003), *Transactional Business Law: A Development Law Perspectiv*e, Hague: Kluwer Law International, p. 24.
[7] See e.g. Hinkelman, Edward G. (2003), p. 169 and pp. 176-177; Zhang, Sufang (2003), pp. 308-309.
[8] Further discussion about the theory about the legal feature of L/C: contract theory or debt theory, see e.g. Deng, Xu (2006), pp. 193-196.
[9] Dalhuisen, J. H. (2004), *Dalhuisen on International Commercial, Financial and Trade Law*, Oxford: Hart Publishing, 2nd ed., p. 463.
[10] Sarkar, Rumu (2003), p. 19; see also Hedley, William (1994), *Bills of Exchange and Bankers' Documentary Credits*, London: Lloyd's of London Press Ltd, 2nd ed., pp. 266-276; Chen, Yan & Liu, Ling (2005), pp. 77-142; Zhang, Sufang (2003), *International Trade Theory and Practice*, Peking: University of International Business and Economics Press, Part Two International Trade Practice, Chapter 14 Implementation of the contract, 4 Documentation, pp. 377-383.

1.1.2 Principles of L/C

In the L/C system, two fundamental principles are the autonomy of the credit (also the independence principle) and the doctrine of strict compliance.[11] The independence principle of the L/C is clear and is accepted worldwide.[12]

According to the autonomy principle, a L/C is separate from and independent of the underlying contract of sale or other transactions involved.[13] In other words, the banks concern themselves only with the documents, but are not concerned with the performance of the underlying contract. As long as the required documents presented by the seller conform to the terms contained in the L/C contract, the bank will make the payment to the seller without considering the actual performance or any disputes regarding the underlying contract between the buyer and seller.[14]

One scholar states that the whole rational of L/C in international trade is that it offers the beneficiary a secure and speedy instrument for payment regardless of the any problems resulting from the underlying sale contract.[15] There is also a saying to illustrate this independence principle: "pay first, argue later".[16]

The strict compliance doctrine, which accords with the first autonomy principle of the L/C, means that the beneficiary must strictly comply with the documentary requirements laid down in the L/C. In brief, the L/C has its documentation character, and the two fundamental principles of it allow L/C payment in international trade to operate in an efficient manner.

1.1.3 Working System of L/C

It is necessary to briefly introduce how the L/C in international trade works. It seems complex, as one L/C involves at least three different and independent contracts between different parties. Some scholars[17] have accepted the idea of the L/C as a contract between the bank and the beneficiary, although several theories have been advanced to explain the judicial basis of the L/C itself[18]. The principles of

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[11] D'Arcy, Leo (2000), p. 170; see also Gao, Xiang & Buckley, Ross P. (2003), 'The Unique Jurisprudence of Letters of Credit: Its Origin and Sources', 4 *San Diego International Law Journal* 91, pp. 119-124; Regal, Dorothea W. (2003), 'Basic Principles of Letters of Credit', 847 *Practising Law Institute* 13 (Commercial Law and Practice Course Handbook Series), February.

[12] See e.g. Ortego, Joseph J. & Krinick, Evan H. (1998), 'Letters of Credit: Benefits and Drawbacks of the Independence Principle', 115 *Banking L.J.* 487 (May); see also Chatterjee, Charles & Lefcovitch, Anna (2003), 'The Principle of Autonomy of Letters of Credit is Sacrosanct in Nature', *Journal of International Banking Regulation*, Sep., Vol. 5, No. 1, p. 72; Wang, Saisai (2007), 'Discussion on L/C Independence Principle', *Times Finance*, Vol. 7, pp. 31–33.

[13] For analysis from the legal perspective and contractual engagement, see Goode, Roy, chapter 9 'Abstract Payment Undertakings', in Cane, Peter & Stapleton, Jane (Eds.) (1991), *Essays for Patrick Atiyah*, Oxford: Clarendon Press, pp. 217-220.

[14] Van Houtte, Hans (2002), p. 266.

[15] Oelofse, A. N. (1997), *The Law of Documentary Letters of Credit in Comparative Perspective*, Pretoria: Interlegal, p. 355.

[16] Dalhuisen (2004), p. 470.

[17] For example, Raymond, Jack (1993), chapter 5, pp. 78-79.

[18] Penn, G. A. (1987), *The Law and Practice of International Banking - Banking Law*, Vol. 2, London: Sweet & Maxwell, pp. 295-303.

contract were applied when L/C cases were dealt with by courts in England[19]. In this research, we simply accept and employ contract theory to explain different legal relationships in L/C transactions.

The simplest L/C transaction involves a sales contract between the buyer and seller (which is referred to as the underlying contract), an application contract between the bank and the buyer, and a L/C contract between bank and the seller.[20] Where a L/C is established, the seller would obtain payment from a bank with the condition of presentation of conforming documents that are included in the underlying sales contract with the buyer.[21] In international trade, a typical international L/C transaction will usually involve a fourth party, which can be an advising bank or confirming bank (usually located in the seller's country).

The diagram below illustrates how the simplest L/C operates.

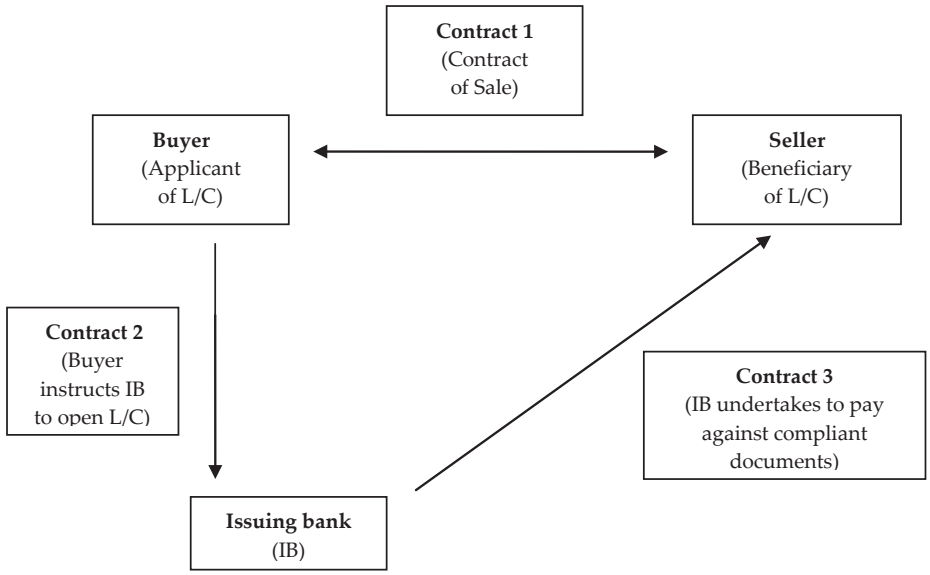

Figure 1: A simple documentary L/C transaction design

An explanation of such a system is as follows:

1) Firstly, the sales contract (Contract 1 in Diagram 1) is completed between the buyer (importer) and seller (exporter).

2) Then, the buyer (the applicant of L/C) applies to a bank (Issuing bank), asking it to make a payment to the seller on the condition that the compliant documents are presented within a specified time period by the seller (Contract 2 in Diagram 1). The

[19] Here are some examples: *Donald H.Scott & Co., Ltd v. Barclays Bank, Ltd.* [1923] 2 K.B. 1 p. 14; *Midland Bank Ltd. v. Seymour* [1955] 2 Lloyd's Rep. 147 p. 166; *Malas (Hamzeh) & Sons v. British Imex Industries Ltd.* [1958] 2 Q.B. 127, p. 129.

[20] For more on legal structures of different L/C transactions, see McLaughlin, Gerald T. (2002), 'Exploring Boundaries: A Legal and Structural Analysis of the Independence Principle of Letter of Credit Law', 119 *Banking Law Journal* 501, June.

[21] Sealy, L.S. & Hooley, R. J. A. (2005), *Commercial Law – Text, Cases and Materials*, Oxford: Oxford University Press, 3rd ed., p. 819.

buyer will notify the bank of the documentary requirements. The purpose of these requirements is mainly to ensure the seller performs his obligations conforming to the terms of the underlying sales agreement.

3) Finally, the seller (the beneficiary of L/C) will tender the required documents to the bank and request payment. If the documents presented by the seller are regarded as compliant with the L/C, the bank is obligated to pay the sum specified on the L/C to the seller (Contract 3 in Diagram 1).

1.2 INTRODUCTION TO L/C FRAUD AND L/C FRAUD DISPUTES

1.2.1 General Background

The character of the L/C facilitates international transactions, but makes it easy to be abused by fraudsters. The phenomenon of fraud is timeless and universal, and is found both in the East and West. Economic changes have significant influence on the desirability of particular fraud. During the mid-1980s, documentary fraud in the shipping of goods was overwhelming. Technological developments which were intended to facilitate ordinary commercial transactions, at the same time provide fraudsters advantageous opportunities to commit fraud. L/C fraud is not only widespread, but it is big business too, and its tentacles have spread throughout the world.

It has been reported that in the USA losses due to L/C fraud reached 0.5 billion US dollars in 1995.[22] According to the Commercial Crime Bureau, the loss as a result of fraud was 2.4 billion Hong Kong dollars (around 0.3 billion US dollars) in 1998, 1.1 billon Hong Kong dollars (around 0.15 billion US dollars) in 1997, and 21 cases were related to L/C fraud.[23] Since the UCP was accepted in the mainland of China, the L/C has been widely used in China's foreign trade.[24] Several L/C fraud cases have astonished the world in recent years[25], and the amount involved has become greater than in the past. Someone even predicted that the amount of losses in L/C fraud cases in mainland China is astronomical.[26]

According to the UNCTAD report, four kinds of L/C fraud have been popular: 1) where the cargo is non-existent, the documents are falsified by the beneficiary in order to obtain payment from the bank; 2) where the goods are of inferior quality or quantity; 3) where the same goods are sold to two or more parties; 4)

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[22] Barnes, James G. & Byrne, James E. (1996), 'Letter of Credit: 1995 Case', *The Business Lawyer*, Vol. 51, August, p. 1418.

[23] Gu, Xiaorong & Ni, Ruiping (Eds.) (2005), p. 224.

[24] However, it was claimed that the usage of the L/C in Hong Kong has dropped greatly in recent years as it is slow and expensive, see Ford, Mark, 'Where L/C Use is Weak – and Strong', available at www.iccbooks.coem/Home/L/CUse.aspx, accessed 30 Jan., 2007.

[25] For example, in 2000 in the case of L/C fraud committed by Mou, Qizhong, the bank's loss was 40 million US dollars, and in the case of L/C fraud committed by Sun, Zhonghui, the bank's loss was 13 million RMB.

[26] Yang, Liangyi (1998), *Letters of Credit*, Peking: China University of Political Science and Law Press, p. 1.

where bills of lading are issued twice for the same goods.[27] It can be seen that in the most common L/C fraud scheme, the victims are the buyers. Several typical examples of L/C fraud will be illustrated.

In 1981 an Egyptian buyer arranged a L/C for DM 350,000 in favour of a German exporter, who had a registered company in Liechtenstein[28]. The Liechtenstein company had an account at a Swiss bank. Only two documents – a clean BL and an invoice were required under the L/C. The German exporter obtained a BL, on which the Red Med Lines Company seemed to be the carrier, but who had in actual fact liquidated about nine months before. On the date when the BL was signed, the ship 'Helga Wehr' was unloading cargo in Lisbon instead of loading cargo in Hamburg as was written on the BL. The German exporter obtained the payment under L/C from the Swiss Bank in Zurich, by presenting the forged BL and invoice. The buyer started to suspect the fraud several months later when the cargo did not arrive as expected; and soon found that the German exporter was untraceable. Clearly the crime happened in Zurich: the forged BL was presented so that the German exporter fraudulently obtained the L/C payment, but the Swiss bank was reluctant to involve a criminal complaint because it had been reimbursed by the Issuing bank in Egypt. The Liechtenstein company was administered by a lawyer who withheld the information of the name of the true owner of the company under the protection of Swiss law.

Similarly, in 1990 a Japanese buyer suffered a 4 million US dollars loss as the presented documents for L/C payment were forged and worthless.[29] By presenting forged documents to obtain payment under L/C, Carlo Caresana – an Italian fraudster, made around 50 million US dollars from defrauding foreign buyers during the period at the beginning of the 1980s until 1993 when he was arrested; the inadequacy of the laws concerning international crime made him untraceable for many years.[30]

During the 1980s, buyers in China were often the target of documentary frauds, because most of them were inexperienced in L/C payment instrument and international trade. In 1989 a Taiwanese buyer was defrauded by 1.5 million US dollars under a L/C in favour of a fictitious seller in Lebanon.[31] It was recorded that from the end of 1984 to early 1986, five L/Cs totalling 18.5 million US dollars for steel cargo were paid out to Italian sellers, but the buyers in China received only one-third of the contracted amount.[32] The scale of such fraud was huge indeed. Similarly, South Africa has also suffered from various fraudulent L/C transactions.[33]

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[27] UNCTAD report (2003), prepared by the UNCTAD secretariat, 'A Primer on New Techniques Used by the Sophisticated Financial Fraudsters with Special Reference to Commodity Market Instruments' (UNCTAD/DITC/COM/39), 7 Mar., 2003, p. 7, available at http://www.unctad.org/en/docs/ditccom39_en.pdf, accessed 29 July, 2009.
[28] Kuo-Ellen, Lin S. (2002a), 'Fraud in Documentary Credit Transactions', *Journal of Money Laundering Control*; Winter; Vol. 5, No. 3, p. 197.
[29] Ibid, p. 199.
[30] Ibid, p. 197.
[31] Ibid, p. 198.
[32] Ibid, pp. 198-199.
[33] Golding, Henry (1997), 'Report 'Changes in South Africa Have Had their Impact on L/Cs'', *DCI (ICC)*, Winter, Vol. 3, No. 1, p. 16.

Besides L/C fraud against applicants, banks sometimes can also be the target.[34] The UNCTAD report mentioned that fraudsters could invest large sums of money for many years in creating a pattern of international activity though nothing exists; and they attempt to defraud paper-obsessed bankers.[35]

In 1991 six foreign banks in the UK suffered a total loss of 20 million pounds when a pharmaceutical manufacturer (owned by two brothers) in England collapsed. In this case, the two brothers as sellers colluded with the buyers in Switzerland and the USA; the sellers in England tendered fraudulent documents (including BL) and obtained L/C payment. In 1992 in Israel, Reaven Asa simply disappeared after owing over 170 million US dollars to banks, who had granted credit lines and trading facilities to Asa and its associated companies in Israel, New York and Switzerland; the banks eventually held worthless documents, as the goods did not exist.[36] In 1994 a Malaysian Kurniawan admitted obtaining 5 million US dollars by presenting a forged L/C when arrested, and according to the Commercial Crime Bureau the majority of the losses have not been recovered.[37] In 1997, a bank in China opened 11 L/Cs with one company in Korea as the same beneficiary; L/Cs were negotiated at a Korean bank, which requested 18 million US dollars from the issuing bank in China; the issuing bank could not debit the applicant's accounts as the beneficiary never shipped any goods, and finally the Chinese bank reimbursed the Korean bank by using its own fund.[38] In the LONECO case, it was discovered that 400 million US dollars were lost due to a L/C fraud scheme involving forged documents; 26 international banks in the Middle East and Europe (some even had sophisticated trade finance operations) were victims.[39]

Fraud in L/C transactions in international trade has become increasingly sophisticated and new L/C fraud schemes have developed.[40] Each year they are directly responsible for either the buyers or the banks in transactions losing huge amounts of money. In addition, fraud threatens international trade and battens on trust.[41] Trust in the institutions of commerce and for their integrity and efficiency is fundamental to the function of any economic system. Unfortunately, the importance of this point is sometimes overlooked.

Two problems in respect to L/C fraud issue shall be mentioned. Firstly, the issue is currently tackled under national laws (including criminal law and civil law). Secondly, how to prevent fraud in international L/C transactions is an underdeveloped and unsystematic area, which deserves a holistic study.

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[34] L/C fraud can also be connected with the crime of money laundering, see Ellen, Eric (1998), 'Complex L/C Frauds Put Banks at Risk', *DCI (ICC)*, Winter, Vol. 4, No. 1, p. 1.
[35] The UNCTAD Report (2003), p. 7.
[36] Kuo-Ellen, Lin S. (2002a), p. 202.
[37] Ellen, Eric (1996), 'Fraud Watch', *DCI (ICC)*, Spring, Vol. 2, No. 2, p. 2.
[38] Kuo-Ellen, S. Lin (2002a), p. 202.
[39] Mukundan, Pottengal (2008), Executive Director of the ICC Commercial Crime Services, 'Fraud with L/Cs– latest modi operandi', speech and material in the 2nd Annual International Conference on Letters of Credit, organized by ICC Austria , Vienna, 29 May, 2008.
[40] Mukundan, Pottengal (2009), 'Trade Finance Frauds', speech and material in the 3rd Annual Conference on Letters of Credit, organized by ICC Austria, Vienna, 14 May, 2009.
[41] See e.g. Guo, Yu (2006), *International Trade Law*, Peking: Peking University Press, pp. 410-411.

Normally there are two frameworks for dealing with L/C fraud in a country's national legal system – public prosecution system and civil dispute resolution between private parties. The crime of L/C fraud in international transactions presently is tackled under criminal law in a national jurisdiction; often difficult judgements are required to be made as to what constitutes a L/C fraud offence. Thus, the ways of dealing with L/C frauds in different countries are diverse.

Along with the increased L/C fraud, a growing number of international L/C fraud disputes[42] have arisen. In order to protect the trade parties' interests, and keep the credibility of the L/C system, judicial practice created a significant exception to the independence principle of the L/C in civil litigations. Such an exception refers to the rules of L/C fraud.[43] Where L/C fraud is established, the bank can either stop payment or be prohibited from making payment under a court order. L/C fraud exception is widely accepted by most the countries in the world[44], and is considered as a remedy to L/C fraud. The victims in L/C transactions are eager to prevent L/C payment when there suspect or have evidence of L/C fraud. Thus, victim parties may bring litigations before the courts in attempting to prevent L/C payment. However, too much litigation will seriously undermine the general healthy operation of the L/C system. It is one of the most interesting and important issues concerning the L/C. As L/C fraud exception rules are also dealt with by domestic law, such rules in different jurisdictions can be different.

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[42] A L/C fraud dispute in only one kind of L/C dispute, which widely refers to all kinds of disputes between individual parties in the process of applying, issuing and performing a L/C, and the cause of action can be e.g. refusal of the L/C by the issuing bank when beneficiary, negotiating bank, or confirming bank demands payment. For more on L/C fraud and refusal of reimbursement to bank by applicant, see e.g. Wang, Lili (Chief Ed.)(2004b), *Legal Risk Control on Bank Business Disputes*, Peking: Law Press China, 1st ed., p. 6.

[43] The relationship between the LC independence principle and fraud exception is also discussed from the point of view of law, see Liu, Nenghua (2004), 'Discussion on Relationship of LC Independence Principle and Fraud Exception', *Finance and Economy*, Vol. 2, 19; the theory basis of L/C fraud exception is argued to be divided into two levels: the first level is 'Reservation of public order' and the second level is about the principles of 'honesty', 'fair', 'security', 'efficiency', further discussion see Pei, Hongjun (2006), 'New Theory Basis of L/C Fraud Exception', *Journal of Hubei University of Economics (Humanities and Social Sciences)*, Vol. 3, No. 2, Feb., 114; see also Xu, Min & Zhou, Shaochen (2008), 'Analysis on the Principle of L/C Fraud Exception', *Journal of Yunnan University Law Edition*, Vol. 21, No. 3, May, 93, pp. 96-97; Liu, Zhan (2002), 'Preservation Order in L/C Fraud: Application of 'Fraud Exception'', *Journal of Nanjing University*, Vol. 39, No. 2 (General No. 146), 126, pp. 129-130; Dong, Gang (2005), 'L/C Fraud Exception Principle and Application', *Commercial Research*, No. 8 (Serial No. 316), 145.

[44] See e.g., Dolan, John F. (2006), pp. 479-503; in this article, it mentioned that the USA, UK, Austria, Canada, and other common law and civil law countries have accepted such an exception.

1.2.2 Reasons for L/C Fraud

Exclusive Use of Documents

The most significant reason for why L/C fraud takes place is argued to be the exclusive use of documents in international L/C transactions.[45] L/C by its nature is based on a system of documents. There is nothing else besides documents for the banks to consider when examining the presented documents and deciding to pay or not. As discussed earlier in this paper, the heart of such a documentary system is that when the beneficiary submits documents that conform to the stipulated requirements in the L/C, the bank is obligated to pay.

This documentary character makes the L/C easy to abuse by the unscrupulous. In the eyes of the fraudsters, the documents equal money. It is not difficult to fabricate or forge these required documents, especially with the advanced technology now available. By producing forged documents which are common in international trade, fraudsters may ship no goods at all. By making changes to the required documents (such as the BL or certificate of quantity) and eventually tendering them on their face conforming to the L/C, fraudsters might ship goods with a much lower value or quantity than was contractually agreed.

Geographical Distance

In international sales transactions, parties are located in different countries (usually with a vast geographical distance between them); and goods arrive at the destination often later than the payment. This is another reason for why the L/C is abused.[46] Therefore, the unscrupulous consider that it is a sure thing that they will have time to receive payment and then simply vanish before their fraudulent activities are discovered. Usually, the fraudulent activity would not come to light until the buyer is able to check the goods. However, at that time, the fraudsters would already have relocated to some place where jurisdiction cannot prosecute them.

Lack of Efficient Prosecution

In addition, lack of an efficient prosecution system is a significant reason for L/C fraud.[47] In spite of the huge loss resulting from L/C fraudulent activity in international trade, no international agreements have been reached to facilitate the detection and prosecution of such fraudsters. Neither banks nor buyers are able to find the fraudsters, even in cases were the fraudsters are detected; it seems impossible

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[45] Chen, Yan & Liu, Ling (2007), *UCP 600 and L/C Essentials*, Peking: University of International Business and Economics Press, p. 62; see also Demir–Araz, Yeliz (2002), 'International Trade, Maritime Fraud and Documentary Credits', *International Trade Law & Regulation*, 8(4), 128-135, p. 132; Yang, Zhengming (Ed.) (1999), *Financial Crime and Legal Control*, Peking: Linxin Accounting Press, 1st ed., p. 198; Bai, Jianjun (Ed.) (2000), *Research on Financial Crime*, Peking: Law Press China, p. 40; Chang, Ruoyun (2006), 'Causes and Controlling Measures of L/C Fraud', *Finance Theory and Practice*, No. 12 (General No. 329), 35.

[46] Demir–Araz, Yeliz (2002), p. 133.

[47] Demir–Araz, Yeliz (2002), p. 133; see also Yang, Zhengming (Ed.) (1999), p. 200; Gu, Xiaorong & Ding, Muying (Eds.) (2000), p. 154.

to do anything, such as bring legal action in a faraway and strange country. In this sense, national jurisdictions are obviously favourable to criminals.

In addition, victims are usually not willing to make great efforts to respond to L/C fraud as the costs involved can be larger than the loss; some victims simply swallow the loss without making it known after being defrauded, as they consider that it is bad for their business reputation.[48]

Diversity of Legal System and Restriction of Fraud Exception

Due to the differences of economic and legal systems between different jurisdictions, each jurisdiction applies diverse criterion on crime of L/C fraud under criminal law and L/C fraud under civil sanctions.[49] Some jurisdictions even deal with the crime of L/C fraud under civil regulations and ignore the criminal liability of the fraudsters, which leads to wide gaps in the application of criminal law.[50] Some countries impose very mild criminal punishment for L/C fraud; for example, an American criminal received only two-months of imprisonment after defrauding 9 million US dollars by forging a BL in Cuba.[51]

In addition, there is no international uniform requirements concerning applications for court orders (such as injunctions or stop-payment orders, which are intended to prohibit L/C payment); and in most jurisdictions it is difficult to establish L/C fraud and thus obtaining injunctive relief and applying L/C fraud exception rules in civil litigation.[52] For example, in England there is hardly any case in which L/C fraud is established and an injunction is granted. Demir-Araz argues that the courts' reluctance to interfere with banks' business and unwillingness to grant injunctions nearly makes this fraud exception of no use.[53] In a situation where a bank is aware of fraudulent conduct, but unable to prove it, the bank has to make payment. Thus, the difficulty of establishing L/C fraud in L/C fraud disputes is an advantage for fraudsters.

1.3 RESEARCH QUESTIONS

The research problem in this study is the approaches to resolving L/C fraud in international transactions and the evaluation of different approaches. The approaches include two fields: legal approach and business approach. In this study the legal approach refers to approaches under criminal law framework and civil

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[48] Sun, Dingjie (Chief Ed.) (1999), p. 156.
[49] Cai, Lei & Liu, Bo (1997), p. 288; see also Wang, Baojie (2005), 'Disucssion on Internationalisation of Punishment of L/C Fraud and Legal Remedy', *Politics and Law*, Vol. 1, 87, pp. 87 – 88; Wang, Yiwei & Sun, Maoying & Chen, Tingbin (2000), 'Analysis of L/C Fraud and Preventive Measures', *Economist*, No. 9, 125, pp. 125-126.
[50] Gu, Xiaorong & Ni, Ruiping (Eds.) (2005), p. 226.
[51] Ibid.
[52] Schütze, Rolf A. & Fontane, Gabriele (2001), *Documentary Credit Law throughout the World* (Annotated Legislation from more than 35 Countries), Paris: ICC Publsihing S.A., ICC Publication No. 633, pp. 34-36.
[53] Lu, Lu (2008), 'Comparative Study on L/C Fraud Exception in Common Law System', *Jianghai Academic Journal (Bimonthly)*, No. 1, 222, p. 226.

law framework; whereas the business approach means preventive and proactive approaches taken in business practice.

Consequently, we will address the following specific research questions:

1. How is international L/C fraud tackled under criminal law at the international and national level? The current regulation concerning L/C fraud in criminal law will be examined in order to answer this question.

2. How is international L/C fraud dealt with under civil law[54] at the international and National level; and how those rules at national level link with those at international level? The civil law approach at international level is primarily reflected in uniform customary rules and international conventions; and at national level it is mainly reflected in the L/C fraud exception rules in different countries (chiefly in the UK and China). These questions will be addressed by studying and comparing the rules at the different levels.

3. In dealing with an international L/C fraud dispute various difficulties need to be confronted in litigation. Are there any alternatives to litigating an international L/C fraud dispute? This question will be considered by exploring different possible alternatives.

4. International L/C fraud not only presents problem for legal practice. More importantly, it brings challenges to international business practice, which has to respond to this problem effectively. How does an enterprise manage international L/C fraud risk and what preventive and proactive measures are available to combat it? The questions will be answered by looking at possible measures different commercial parties may take.

[54] The concept of 'civil law' here refers to the body of laws of a state dealing with the rights of private citizens, rather than the system of law having its origin in Roman law, which is opposed to common law.

1.4 SIGNIFICANCE OF THE STUDY AND RESEARCH OBJECTIVES

In international trade, on the one hand, international convention, international uniform customary rules and trade usages, which attempt to unify rules for conducting business[55], are important. On the other hand, it is essential to be familiar with national laws. The knowledge of both levels is necessary in order to conduct an international transaction successfully. The rules of the UCP, which have governed L/C internationally[56] for more than 70 years, leave the fraud issue out. Such an approach leaves very few options for trading parties to handle L/C fraud. If such L/C fraud disputes are dealt with by civil litigation, it is necessary to know certain national laws. Basically the place where the L/C payment will be made, and where the civil litigation is preceded will decide which country's L/C fraud exception rules will come into use.

We chose England and China because the two countries represent the heterogeneity of legal systems in the world (England belongs to the common law system, whereas China basically belongs to the continental civil law system). Since L/C fraud is considered in the context of international commercial transactions which is desirable to reduce the diversity of rules, it is useful to compare the implementation and operation of such rules in two very different nations.

England is an important case, since London has been a leading commercial and banking centre during the past centuries. English courts have developed internationally affluent L/C case law. The exception of fraud rule has been recognised in a variety of court decisions in England. However, the relevant cases demonstrated the rigorous approach of dealing with L/C fraud exception by English courts. The reasons for such an approach and both the advantages and the disadvantages of it are worth exploring further.

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[55] The unification of international trade law is nowadays often called the Lex Mercatoria; for further discussion, see Cremades, B. M. & Plehn, S.L.(1984), 'The Next Lex Mercatoria and the Harmonisation of the Laws of International Commercial Transactions', *Boston University of International Law Journal*, p. 317; Mazzacano, Peter (2008), 'The *Lex Mercatoria* As Autonomous Law', CLPE Research Paper Series, Vol. 4, No. 6, and this paper was also presented at the Canadian Law and Economics Association, Annual Meeting, on 26-27 Sep. 2008, at the Faculty of Law, University of Toronto; for discussion of proponents and criticism of the Lex Mercatoria, see Chapter 7 'The Harmonisation of Private International Commercial Law – the *Lex Mercatoria*', in Wiener, Jarrod (1999), *Globalisation and the Harmonisation of Law*, London: Pinter, 1st ed., pp. 151-183; for discussion about Lex Mercatoria in arbitration, see Carbonneau, Thomas E. (Eds.) (1998), *Lex Mercatoria and Arbitration: A Discussion of the New Law Merchant*, Revised edition, Juris Publishing: Kluwer Law International; however, the harmonisation processes can be different, and three types of processes have been identified: (1) Institutionally organised harmonisation is basically developed in the context of an institution, which can either be governmental or public (such as UNCITRAL, UNIDROIT) or non-governmental (such as ICC); (2) customary, market based harmonisation develops out of international transactions and is not intentionally arranged; (3) pressure to conform/inter-jurisdiction competition; some states following 'international legal standards' attempt to compete with others and such practice may come from general pressure, which can be due to the need to attract foreign investment, the desire to qualify as a member of WTO and so forth. See Foster Nicholas, 'Chapter 4: Transmigration and Transferability of Commercial Law in a Globalized World', in Harding, Andrew & Örücü, Esin (Eds.) (2002), *Comparative Law in the 21st Century*, The Hague: Kluwer Academic Publishers, p. 57.

[56] The UCP usually do not have legal status in domestic law as they are customary rules and will be applied only if such rules are chosen by the parties; on the contractual feature, see UCP 600, article 1.

China, being a big developing country, has a different legal system. After around thirty years of economic reform and development[57], especially after becoming a member of WTO, China started to play an important role in international trade. As a payment mechanism, the L/C is widely used by Chinese trading parties in international sales transactions. However, the practice of using the L/C in China has not been long. More seriously, most often the trading parties in China have been victims of fraud concerning the L/C.[58] Due to the important role of China in international trade, and the increasing number of international L/C fraud disputes in China, examining how Chinese law and the courts in China deal with L/C fraud exception rules is practically important, both to Chinese parties and trading parties in foreign countries. The Supreme Court of China (SPC) issued the Judicial Provisions on some issues in the Adjudication of the Letter of Credit-related Cases in 2005, which came into effect in 2006. It is interesting to find out whether in judicial practice the provisions have been exercised as an effective legal tools to deal with L/C fraud disputes or not.

Currently some of the literature has dealt with the L/C fraud exception rules under the civil law framework in England. But, works concerning L/C fraud under the criminal law framework have not been seen. Most of the works about L/C fraud in China either under criminal law or civil law frameworks are limited to the Chinese language. Most court cases concerning L/C fraud exception rules in China are difficult to find, let alone for the analysis and evaluation.

We will bridge these gaps in this research concerning the L/C fraud issue. Important legal points concerning L/C fraud in court cases or in provisions will be made by comparing mainly England and China. In the discussion of legal approaches, how international L/C fraud is tackled by criminal law will be discussed in a brief manner. The lack of prosecution of criminals and enforcement of criminal judgment in international L/C fraud cases is indeed disappointing. This means the national criminal legal remedies are to a large extent ineffective. Thus we will limit ourselves merely to the examination of criminal legal rules in England and China at a very general level.

The ineffectiveness of the criminal legal remedy necessitates the examination of the civil legal remedy to L/C fraud, which is reflected in L/C fraud exception rules. The research will focus on how international L/C fraud is handled in civil disputes, which are in the context of civil litigation. The comparative approach is employed, in particular in terms of legal transplant. The research looks at not only

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[57] Before 1978, China adopted a 'planned commodity economy'; after the open policy was adopted in 1978, China's economic reforms were market-oriented, and gradually the market economy was established in China. For further explanation see Zhang, Xiaoguang (2000), *China's Trade Patterns & International Comparative Advantages: Studies in the Modern Chinese Economy*, New York: Palgrave Publishers, pp. 5-8.

[58] See e.g. Wang, Ning (2002), 'Application of L/C Fraud Exception Rules', published on 29 Oct., available at www.ccmt.org.cn/ss/explore/exploreDetial.php?sId=491, accessed 15 July, 2008; for concrete L/C fraud cases in business practice, see Zhao, Limei (2000), pp. 1209-1233; also Gu, Min (2000), *The New Guide to L/C Operations*, Peking: University of International Business and Economics Press, 1st ed., pp. 190-204; Wang, Haizhi & Ma, Youxin (2000), *Financial Risk Typical Cases Analysis and Prevention*, Peking: China Financial Press, pp. 205-234; Yang, Changchun (2002), *International Financial Fraud Cases*, Peking: University of International Business and Economics Press, pp. 175-260.

such rules in individual countries, but also at customary rules and international conventions.

Furthermore, it is known that there are various drawbacks and obstacles to dealing with international L/C fraud disputes through litigation. As such a question arises: can arbitration be an alternative for handling such disputes? However, this is a highly disputed issue and has not been studied much.

In this research, England and China are merely two typical examples, which represent Western developed and Eastern developing countries respectively. However, the study of some particular country's law does not exclude the study of relevant customary rules and international convention. Thus, international convention, US law, Canadian law and so forth (relating to some specific topic) will also be examined where necessary. We believe that such research will also benefit other countries who want to develop international business involving L/C successfully. Such studies would further enhance our understanding of the main method of establishing a new provision in a legal reform in China, and further allow us to understand China's constructive attitude towards the rules concerning international trade and its potential as a major trading nation in a rapid changing global economy.

In light of the above, the research aims to examine and explore the approaches of handling international the L/C fraud issue, which is a specific legal problem; and further it aims to point out the meaningfulness of approaching other general legal problems in international business from different perspectives.

The following specific objectives are included:

1. Where criminal law does not resolve L/C fraud and the approach of civil litigation is taken, to examine the fundamentals of the English courts' approach towards the L/C fraud exception and to explore the reasons for such an approach; to examine the Chinese courts' approach towards L/C fraud exception, China's provisions on L/C fraud and their development;
2. To critically evaluate both English and Chinese approaches to the L/C fraud problem and to review the efforts made by the international organisations from a comparative point of view;
3. To explore in theory the practicability and the potential problems of taking arbitration to handle the L/C fraud disputes;
4. To explore and to propose some possible measures to reduce and prevent fraud in international L/C transactions, from the perspective of risk management.

Regarding the audience of the research, the first group is made up of the scholars who are interested in comparative study in international commercial law, especially those who would like to know Chinese law. The second group is the legal practitioners who may deal with the L/C fraud problem, such as lawyers and judges. Thirdly, the target of this research is the international business enterprisers who may employ the L/C as a payment method when conducting international business.

1.5 THE METHODOLOGY OF THE STUDY

The methodology of this research mainly involves the comparative approach, and preventive and proactive approach. Comparative analysis provides an interesting and helpful way for understanding certain rules in different legal systems.[59] Some argue that the laws of a single country cannot be studied independently, and thus one must examine the laws beyond its own country so as to understand them.[60] Where a legal problem has an international character, a transnational approach is obviously necessary; and it is argued that even if a problem is entirely a national one, its solution still calls for a transnational method.[61] Definitely, countries trying to look for a solution to a legal problem are thus advised to look at ways of tackling the same problem in other countries, so as to find efficient solutions. Thus an international or translational approach will be taken. We would like to introduce the basic theory about the comparative approach and preventive and proactive approach respectively and demonstrate how they are employed in this study.

1.5.1 Comparative Approach

Definition and Uses of Comparative Law

The comparative approach is widely employed by legal scholars in different legal fields. The essential element of comparative work is the comparison by placing comparable elements of two or more legal systems against each other to identify their similarities and differences. According to Bogdan, comparative law can be understood from three points: firstly, it compares different legal systems to ascertain their similarities and differences; secondly, it works with the identified similarities and differences, such as explaining their origin evaluating solutions in the different legal systems and; thirdly, it deals with the methodological problems in dealing with the comparison.[62]

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[59] Generally, see e.g. De Cruz, Peter (1995), *Comparative Law in a Changing World*, London: Cavendish Publishing Limited, 1st ed.; Zweigert, Konrad & Kotz, Hein (1998), translated by Weis, Tony, *Introduction to Comparative Law*, Oxford: Oxford University Press, 3rd ed.; Professor Mattei had further argued for the approach of comparative law and economics in legal studies, which combines the comparative approach and economic approach, see See Mattei, Ugo (1996), *Comparative Law and Economics*, Michigan: University of Michigan Press, 1st ed.; the economic approach is also called economic analysis of law, generally see Miceli, Thomas J. (2004), *The Economic Approach to Law*, Stanford: Stanford Economics and Finance, 2nd ed.; Posner, Richard A.(1998), *Economic Analysis of Law*, New York: Aspen Publishers, Inc., 5th ed.; Shavell, Steven (2004), *Foundations of Economic Analysis of Law*, London: Belknap Press of Harvard University Press; Cooter, Robert & Ulen, Thomas (2003), *Law and Economics*, New York: Pearson Addison Wesley, 4th ed.; Dnes, Antony W. (1996), *The Economics of Law*, London: International Thomson Business Press, 1st ed.; especially concerning contract law, see Baird, Douglas G. (2007) (Ed.), *Economics of Contract Law*, Cheltenham: Edward Elgar; the economic approach to law is also accepted and discussed in China, see e.g. Chen, Guofu (2006), *Law and Economics*, Qianjin: Economy & Science Press, 1st ed.; Qian, Hongdao (2006), *The Economic Analysis of Law*, Peking: Tsinghua University Press; Feng, Yujun (Chief Ed.) (2006), *A Study of Law and Economics Application in China*, Peking: Law Press China, 1st ed..

[60] Gordley, James (1995), 'Comparative Legal Research: Its Function in the Development of Harmonized Law', 43 *Am. J. Comp. L.* 555, Autumn, p. 555.

[61] Gordley, James (1995), p. 562.

[62] Bogdan, Michael (1991), *Comparative Law*, Stockholm: Kluwer Law and Taxation Publishers, 1st ed., p. 18.

As the L/C is a payment instrument for international trade and as it has an international character as has the L/C fraud issue, will the rules dealing with international L/C fraud or disputes in different countries be similar or different? In what way the L/C fraud exception rules are similar or different in England and China will be examined with the help of the comparative approach. Particularly we will employ the comparative approach in Chapter 2 concerning the criminal legal remedy in English law and Chinese law, but at a general level. In addition, in Chapter 3 concerning the civil legal remedy, we would like to conduct a relatively deep study of comparative analysis. Chapter 4 concerning the issue of arbitrating international L/C fraud disputes also involves the comparative approach.

We believe such comparative legal studies will help us to understand our own legal system and legal phenomena better from a different point of view, help us discover other methods for resolving the same problems, and increase our knowledge and understanding of legal systems and cultures from other countries.

The Aims of Comparative Law

As a science or in its *theoretical-descriptive* form[63], comparative law aims to acquire better knowledge of law and attempts to discover to what degree the rules are similar or different.[64] We aim to examine how legal rules or systems dealing with L/C fraud are different or alike and discover some reasons for such similarities and differences. In its *applied* form, comparative law indicates how a particular problem can be best resolved under certain social and economic conditions.[65] More specifically, we will consider what rules to adopt to follow an international uniform law, or what proposals to recommend. In this research, we will eventually demonstrate the contribution that we have made to comparative legal studies, considering the aims of comparative law that we discussed.

To answer why there are such similarities and differences between the compared legal rules or to explore their significance for the broader cultures is one of the most important and interesting tasks of comparative law.[66] The factors which influence the formulation and development of legal rules or legal systems can be the economic system, political system and ideology, religion, history and geography, co-influence of other means of control, accidental and unknown factors; and such factors are interrelated with each other.[67] We do consider it is significant to discover the reasons for the similarities and differences between legal rules in different legal systems, and we try to explain the main causes (such as economic situation, legal history and system, influences of international rules) that we think are relevant and important.

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[63] Zweigert, Konrad & Kötz, Hein (1998), p. 11; the evaluation of the development of comparative law as a scholarly discipline, see Reimann, Mathias (2002), 'The Progress and Failure of Comparative Law in the Second Half of the Twentieth Century', 50 *Am. J. Comp. L.* 671, Fall.
[64] Sacco, Rodolfo (1991), 'Legal Formants: A Dynamic Approach to Comparative Law', 39 *Am. J. Comp. L.* 1, pp. 4-5.
[65] Zweigert, Konrad & Kötz, Hein (1998), p. 11.
[66] Bogdan, Michael (1991), p. 68; see also Reitz, John C. (1998), p. 626.
[67] Bogdan, Michael (1991), pp. 71-77.

Scope of Comparison and Comparability of Different Legal Systems

Generally, the scope of comparison can be wide and various. It can be bilateral or multilateral and it can concern substantive law or formal characteristics of legal systems or it can be a micro-comparison or a macro-comparison.[68] Quite often in a comparative study, one has to do comparison at both a micro and macro level, because the procedures that are applied in practice have to be studied in order to understand why a foreign solution deals with a particular problem in a particular way.[69] It is suggested that in an ideal world macro-comparison and micro-comparison should combine together, because to understand a micro-comparative issue, the whole legal system has to be taken into account.[70]

Therefore, in Chapter 3, we attempt to examine not only specific L/C fraud exception rules at the micro-level, but also the procedural instruments injunction or stop-payment order and also the whole legal system at the macro-level.

Based on the comparative lawyers' experience that the legal system of each society basically confronts the same problems, and solves the problems through different methods, the functionality is claimed to be the basic methodological principle of comparative law.[71] This is the most widely accepted so-called function approach in comparative law, which has been the mainstream.

Is it possible to conduct a comparative study of legal rules in different legal systems, such as between capitalist nations and socialist nations? There has been a long debate as to this question, and certain comparative jurists either from Western countries and socialist countries have doubts about the comparability.[72] However, legal systems with different economic bases can be compared without fearing the comparability, and the key matter lies in the extent of differences, which can be small or large.[73] Thus, when considering the comparability of legal rules, only the function of such rules matters; as long as the legal rules deal with the same situations and problems, they are comparable.[74]

In this research, we do a comparative study between different legal systems, mainly between England (a capitalist nation) and China (a socialist nation). It has long been recognised that rules that perform the same function and address the same real problem or conflict of interests can be meaningfully compared. Thus, we consider that L/C fraud exception rules addressing L/C fraud disputes are comparable.

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[68] Bogdan, Michael (1991), p. 57; for discussion on both the broader approach and the narrower approach on the macro-level and mircro-level, see Örücü, Esin (2004), pp. 41-50.
[69] Zweigert, Konrad & Kötz, Hein (1998), p. 5.
[70] Örücü, Esin, in Örücü, Esin & Nelken David (Eds.) (2007), p. 57.
[71] Zweigert, Konrad & Kötz, Hein (1998), p. 34; see also Bogdan, Michael (1991), pp. 59-60; however, for some criticism about the functional approach, see e.g. Legrand, Pierre (1997), 'The Impossibility of 'Legal Transplant'', 4 *Maastricht Journal of European Comparative Law* 111.
[72] Bogdan, Michael (1991), p. 61.
[73] Sacco, Rodolfo (1991), p. 7.
[74] Bogdan, Michael (1991), p. 62; however, there is a counter-argument that the functional-institutional approach does not resolve the comparability between different legal systems, see Örücü, Esin (2004), *The Enigma of Comparative Law: Variations on a Theme for the Twenty-first Century*, Leiden & Boston: Martinus Nijhoff Publishers, p. 25.

On the other hand, a non-mainstream or new approach, which can be called a contextual approach, has also been recognised.[75] As Twining argues, it is increasingly important to look beyond the surface of legal doctrine to further examine the realities of all forms of law.[76] This approach seems to imply that legal rules or institutions would be placed in a larger frame, rather than merely in legal-textual solitude, but it has never presented itself as a clear approach.[77] At least a specific legal rule is part of a broader context of other related legal rules, and a branch of law is influenced by other areas of law.[78] Foster argues that commercial law also is affected by the broader context and it is necessary to adopt a contextual approach when comparative commercial law is studied.[79]

It seems true that these two approaches focus on different points, but such methodological contradictions may be artificial concerning their essential features.[80] Thus, a more flexible understanding or more open attitude towards comparative law methodology is recommended.[81] Only by combining the knowledge of the "law as rules" and law in context" is there provided a comprehensive and deep knowledge of a legal phenomenon and its connections in society.[82]

Therefore, we take functionality as a starting point, thus accept that the L/C fraud exception rules deal with the same problem in L/C fraud disputes. At the same time we would acknowledge that a contextual approach is necessary and that we need to consider the broader context when examining "law as rules".

Problems in Studying Foreign Law

Before the discussion about the problems or difficulties in studying foreign law, we would like to look at a more basic issue: what does the "legal rule" refer to? Sacco proposed that speaking of "the legal rule" of a country is misleading, but rather the rules of constitutions, legislatures, courts; and the legal doctrine formulated by scholars and these different elements in a living law is called a "legal

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[75] Husa, Jaakko (2006), 'Methodology of Comparative Law Today: from Paradoxes to Flexibility?', 58 *Revue International de Droit Comparé*, 1095, p. 1105; for a similar view, see Small, Richard G. (2005), 'Towards a Theory of Contextual Transplants', *Emory International Law Review*, Vol. 19, 1431, the author argues that the context decides the necessity for a law and that context is transferable in some situations.
[76] Twining, William, 'Globalisation and Comparative Law', 69, in Örücü, Esin & Nelken David (Eds.) (2007), *Comparative Law – A Handbook*, Oxford & Portland, Oregon: Hart Publishing, 3rd ed., p. 77.
[77] Husa, Jaakko (2006), pp. 1105-1106.
[78] Nelken, David, 'Comparative Law and Comparative Legal Studies', 3, in Örücü, Esin & Nelken David (Eds.) (2007), p. 19.
[79] Foster, Nicholas HD, 'Comparative Commercial Law: Rules or Context?', in Örücü, Esin & Nelken David (Eds.) (2007), p. 263; for discussion about commercial law reform and legal transplant, see also Mistelis, Dr. Loukas A. (2000), 'Regulatory Aspects: Globalization, Harmonization, Legal Transplants, and Law Reform – Some Fundamental Observations', 34 *International Lawyer*, 1055-1069.
[80] Husa, Jaakko (2006), p. 1095.
[81] Husa, Jaakko (2006), pp. 1110–1116.
[82] Örücü, Esin, 'Developing Comparative Law', 43, in Örücü, Esin & Nelken David (2007) (Eds.), p. 45.

formant".[83] We agree that legal rules in a country include a greater range of elements, and should be understood in a wider sense.

In order to see the entire picture of a rule, one jurist must identify all the "legal formants" of the legal system and make out the proper scope of each, and must examine all relevant elements by interpreting various legal materials.[84] To identify what the law is in each jurisdiction, one must consider from an interior point of view, examine all the sources of information about the law, judge the gap between the law on the books and law in action, and the gap in information about the law either on the books or in action.[85]

At the same time, it has to be acknowledged that the identification of what rules or what principles in a mass of decided cases the courts have followed is difficult[86], and the significance of judicial decisions in different legal systems can be different.[87] In England, where the law is based on precedent, judicial decisions may play a more important role than in China where the law is based on statute.

It is suggested that both legalisation and case law must be studied in order to correctly identify differences and similarities among different legal systems.[88] In order to obtain reliable information, studying the primary sources or the official sources of law (such as the text of statutes, regulations, reports of precedents) is often considered the best method to study a foreign law.[89] The codes or case law in other countries may provide similar, different or no guidance as to a solution. However, the case law of one single jurisdiction is not the only source of such studies, because sometimes an English court may cite a case from Australia, Singapore, or the court of New York in the US when necessary.[90] Thus, such a search for a sound solution to a particular legal problem should not be limited to codes or case law. A transnational approach is proposed, but such an apprraoch requires one to study all the original sources – the existing law, the writings of the great scholars, the statutes and reports, and so forth.[91] Therefore, we will study mainly the primary sources. Important secondary sources will also be examined, as sometimes secondary sources of law (such as textbooks, journal articles) can also provide some advantages.

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[83] Sacco, Rodolfo (1991), pp. 21-22; such a concept can also be considered as "institutions" from the institutional economics point of view; "institutions" can be formal constrains (such as legislation) or informal constrains (such as attitudes, codes of behaviour), see North, Douglass C. (1990), *Institutions, Institutional Change and Economic Performance*, Cambridge: Cambridge University Press, 1st ed., pp. 3-4; Williamson has further presented a diagram about four-level institutions, which indicates the complex interaction between each, see Williamson, Oliver E. (2000), 'The New Institutional Economics: Taking Stock, Looking Ahead', *Journal of Economic Literature*, Vol. XXXVIII (September), pp. 595-613, p. 597.
[84] Sacco, Rodolfo (1991), pp. 22-27
[85] Reitz, John C. (1998), p. 628.
[86] Gordley, James (1998), 'Is Comparative Law A Distinct Discipline?', 46 *Am. J. Comp. L.* 607, Fall, p. 607.
[87] Sacco, Rodolfo (1991), p. 26.
[88] Sacco, Rodolfo (1991), p. 23.
[89] Bogdan, Michael (1991), pp. 42-43.
[90] Gordley, James (1995), p. 557; for examination of the use of comparative law by national and international courts, see Canivet, Guy & Andenas, Mads & Fairgrieve, Duncan (Eds.) (2004), *Comparative Law Before the Courts*, London: British Institute of International and Comparative Law.
[91] Gordley, James (1995), p. 558.

Furthermore, to fully understand legal rules, it is suggested that "non-legal" or the society's other aspects (such as the economic, political, cultural environment) have to be considered and understood.[92] In this way, one is able to understand better what role the legal rule plays in the society and how it functions in practice; and this point is especially important when the legal rules in different legal systems are compared, as the same or similar legal rules may play different roles and function in a different way in different societies.[93] In Chapter 3 we will consider non-legal aspects when we attempt to discover why L/C fraud exception rules are similar or different in English and Chinese law.

In this research, we are aware of the potential pitfalls in the study of foreign law. Thus, we collect materials both primary and secondary resources, consider both statutes and case law and other scholarly work, pay attention to other aspects of the society, and look at legal rules in the context of the entire system of a nation.

Process of Comparison

There are a number of ways and methods to do comparative legal research[94]. A typical process of comparison probably commences when separate and objective reports of different legal systems have been finished; this has been proved valid for constructing works on comparative law.[95] It is said that it is appropriate to conclude the process of comparison with the distinct features of each individual legal system or the common core regarding how laws address the particular subject under investigation.[96] The objective reports in Chapter 3 provide a comprehensive picture of a legal solution to a practical problem in a particular jurisdiction i.e. either in England or China, and such examination is with its particular statutory rules or judicial decisions, its particular concepts and its social context.

In addition, the way of organising or presenting a comparative study should be able to highlight comparison in a clear manner.[97] In this dissertation, we intend to use different ways of presenting a comparative analysis. In Chapter 3, we present a report of the fraud exception rules in each nation, and make a comparative analysis afterwards. In Chapter 4, we choose relevant issues concerning arbitrating international L/C fraud disputes, and make comparison in each sub-section.

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[92] Bogdan, Michael (1991), p. 78; for discussion on 'legal culture', see Glenn, H. Patrick, 'Legal Cultures and Legal Traditions', in Van Hoecke, Mark (Ed.) (2004), pp. 7-20; for the influence of cultural differences in legal transplantation, see Chase, Oscar G. (1997), 'Legal Processes and National Culture', 5 *Cardozo Journal of International and Comparative Law* 1, Spring; see also Watson, Alan (1983), 'Legal Change: Sources of Law and Legal Culture', 131 *University of Pennsylvania Law Review* 1121, April.

[93] Bogdan, Michael (1991), p. 54.

[94] Further explanation about different methods: *De lega Lata/ De lege Lata, De lege Ferenda/ De lege Lata, De lege Lata/ De lege Ferenda, De lege Ferenda/ De lege Ferenda*, see Karhu, Juha, 'How to Make Comparable Things: Legal Engineering at the Service of Comparative Law', in Van Hoecke, Mark (Ed.) (2004), pp. 79-83; see also Örücü, Esin (2004), Chapter 5 How to Compare, pp. 51-60.

[95] Zweigert, Konrad & Kotz, Hein (1998), p. 43.

[96] Reitz, John C. (1998), 'How to Do Comparative Law', 46 *Am. J. Comp. L.* 617 (Fall), p. 624.

[97] Reitz, John C. (1998), p. 633.

Evaluation of the Compared Solutions

Which of the compared solutions is the best one? This question seems difficult to answer, even after studying the similarities and differences regarding a certain legal problem in two or more legal systems. In the area of international commercial law, to ask what the best possible rule is would be an impractical question; but to evaluate which solution is preferable to other solutions could be more appropriate.[98]

To think of making a meaningful comparative evaluation of different solutions, comparative jurists have to carefully consider a certain set of values that they take, especially concerning unification of rules.[99] One must be careful not to easily criticise other solutions and determine which the best is by applying one's own values.[100] There are also some cases in which comparative judgment must be avoided, and deciding on which solution is better cannot be simply stated.[101] We must keep in mind that the understanding of what is proper or better differs from country to country and also differs from one person to another.

To conduct an evaluation of different solutions for the same legal problem is not an easy task. We would like to analyse different solutions from an objective point of view. However, we still cannot simply claim which solution is better, because each solution has its benefits and drawbacks.

Development of Chinese L/C Fraud Exception Rules: Legal Adaptation Persepctive?

In Chapter 3 we will examine the process[102] of developing L/C fraud exception rules in China from the perspective of legal transplant. We will explain and assess the L/C fraud exception rules in China by looking at the connection between such rules in China and English law, US law and international Convention. The development demonstrates that if a developing country tackles a legal problem where other countries or international conventions have already had some solutions, it may borrow and adapt the solutions in other legal systems into its own country from an economic point of view[103]. We will consider both the suitability of adaptation of other models to the Chinese legal system and its justifiability in modern Chinese law.

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[98] Glenn, H Patrick, 'Com-paring', 91, in Örücü, Esin & Nelken David (Eds.) (2007), p. 100.
[99] Bogdan, Michael (1991), p. 79; for further dicussion about the relationship between uniformity and legal transplants, see Menski, Werner (2006), *Comparative Law in a Global Context: the Legal Systems of Asia and Africa*, Cambridge: Cambridge University Press, 2nd ed., pp. 38-54.
[100] Bogdan, Michael (1991), p. 79.
[101] Zweigert, Konrad & Kotz, Hein (1998), p. 40.
[102] Following Alan Watson's theory of legal transplants, it is necessary to examine how laws originate, how they evolve by doing detailed comparative studies, see Ewald, William (1995), 'Comparative Jurisprudence (II): the Logic of Legal Transplants', 43 *Am. J. Comp. L.* 489, pp. 508-510.
[103] Matti argues for a successful transplantation of the economic analysis of law in civil law countries; for further discussion see Mattei, Ugo (1991), 'Law and Economics in Civil Law Countries: A Comparative Approach', 11 *International Review of Law and Economics* 265, December.

Legal transplant[104] is a very controversial concept, and may be found under different labels such as legal borrowing[105], reception, transposition or diffusion of law,[106] legal transfer[107], or legal adaptation[108]. There has long been a debate between several leading scholars such as Alan Watson and Otto Kahn-Freund[109], Lawrence Friedman, Pierre Legrand, and Esin Örücü. The scope and object of legal transplant used to focus on state law; however, Twining suggests that the scope of legal transplant should extend to non-state law as well by adopting a global perspective.[110] 'A naive model of reception/diffusion', which includes twelve factors affecting the process of reception, has been created; and some of possible variations from each factor in the model are also demonstrated.[111]

"Success" can be a criterion of the effect of legal transplant, but it cannot be defined from one perspective; thus pre-determined economic, social, cultural, ideological factors and so forth all can influence the result; efficiency, internationalisation, culture shift and the actual use of the new legal structures can all be the criteria for measuring whether it is a success.[112]

However, it may be impossible to adopt a foreign solution without adjustment, due to the differences of court procedures, the powers of the diverse authorities, the working system of economy, or the general social environment.[113] Thus, when one is learning from a foreign legal solution, it is necessary to consider proper adaptation based on one's own legal system. We will have further discussion on the idea of legal transplant and eleberate the development of L/C fraud exception rules in China from the perspective of 'legal adaptation' in Chapter 3.

1.5.2 Preventive and Proactive Approach

A preventive and proactive approach is employed in Chapter 5 concerning the measures of preventing fraud in L/C transactions. The preventive approach seeks to make individuals and business enterprises legally healthy. Preventive law, which was first introduced by Brown,[114] is considered a way of anticipating

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[104] The discussion of legal transplant derives from Alan Watson, see e.g. Watson, Alan (1978), 'Comparative Law and legal Change', 37 *Cambridge Law Journal* 313.
[105] Alan Watson would equate the concept of 'legal transplant' with 'legal borrowing', see Watson, Alan (2000), 'Legal Transplants and European Private Law', *EJCL*, Vol. 4 (4 Dec.), available at http://www.ejcl.org/44/art44-2.html, accessed 17 March, 2008.
[106] Twining, William, 'Globalisation and Comparative Law', in Örücü, Esin & Nelken David (Eds.) (2007), p. 83.
[107] Nelken uses the metaphor 'legal transfer' for 'legal transplant', see Nelken, David, 'Legal Transplants and Beyond: of Disciplines and Metaphors', in Harding, Andrew & Örücü, Esin (Eds.) (2002), pp. 19-34.
[108] The concept of 'legal adaptation' may be more proper than 'legal transplant' in some circumstances; for further discussion and several case studies, see Nelken, David & Feest, Johannes (2001), *Adapting Legal Cultures*, Oxford & Portland, Oregon: Hart Publishing, 1st ed.
[109] The representative work, see Kahn-Freund, O. (1974), 'On Uses and Misuses of Comparative Law', 37 *Modern Law Review* 1.
[110] Twining, William, in Örücü, Esin & Nelken David (Eds.) (2007), p. 83.
[111] Ibid, p. 86.
[112] Örücü, Esin, 'A General View of 'Legal Families' and of 'Mixing Systems'', 169, in Örücü, Esin & Nelken David (2007) (Eds.), p. 178.
[113] Zweigert, Konrad & Kotz, Hein (1998), p. 17.
[114] For an example of work on preventive law, see Brown, Louis M. (1950), *Manual of Preventive Law*, New York: Prentice-Hall, Inc.

and avoiding legal problems by involving legal and practical principles.[115] The proactive approach is quite new in legal studies; it has not been widely practised, although it is known in the legal area.[116] The proactive approach has some basis in preventive law. One important idea going through the proactive approach is that putting legal knowledge into practice before something goes wrong is the best way of using it.[117] In addition to this principle, the proactive approach attempts to find methods of avoiding disputes, litigation and other risks, to help business and people build a sound operating network to achieve success.[118]

The preventive and proactive approach is meaningful with respect to the international L/C fraud issue. By studying the ideas of dealing with a problem preventively and proactively, the measures of preventing fraud in L/C transactions are expected to work out. Interestingly, the concept of transaction costs[119] in institutional economic analysis of law will be used, as commercial parties have to assess the costs of each preventive and proactive method. In this study, we understand transaction cost in a simple way: it refers to the cost that a party has to spend, including money, time, different resources and so forth for a transaction. A number of preventive measures can be costly, although some measures reduce transaction costs. But to make it clear, we do not attempt to calculate or measure any transaction cost mathematically.

1.6 SOURCES

This research sources used vary distinctively in type between the different chapters of the dissertation. Starting with the criminal legal remedy under criminal law, this builds mainly on primary resources of statutes and text of regulations, and research by English and Chinese criminal law scholars; but excludes case law sources.

In the civil legal remedy part, it includes the analysis of both primary and secondary resources; both resources in England, China and in other countries and at the international level. The primary resources that have been studied are L/C fraud dispute

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[115] 'Renaissance Lawyer Society: Preventive Law', available at http://www.renaissancelawyer.com/Vectors/t-PreventiveLaw.htm, accessed 5 Feb., 2007.
[116] Wahlgren, Peter (2006), p. 20.
[117] Lexpert, links, 'Proactive law and Proactive Contracting', available at http://www.lexpert.com./en/links.htm, accessed 06 Mar., 2007.
[118] Haapio, Helena, 'Introduction to Proactive Law: A business Lawyer's View', in Wahlgren, Peter (Ed.) (2006), *A Proactive Approach*, Series: Scandinavian Studies in Law, Volume 49, Stockholm: Elanders Gotab AB, p. 21.
[119] See Williamson, Oliver E. (1985), *The Economic Institutions of Capitalism – Firms, Markets, Relational Contracting*, New York: The Free Press, pp. 18-22; for theory and basics of transaction cost economics, see e.g. Williamson, Oliver E. & Masten, Scott E. (Eds.) (1995), *Transaction Cost Economics – Volume I : Theory and Concepts*, Aldershot: Edward Elgar; for the classic books that inspired the New Institutional Economics, see Coase, R. H. (1988), *The Firm The Market and the Law*, Chicago & London: The University of Chicago Press; North, Douglass C. (2005), *Understanding the Process of Ecnomic Change*, Princeton & Oxford: Princeton University Press; for more study on such field, see e.g. Carroll, Glenn R. & Teece, David J. (Eds.) (1999), *Firms, Markets, and Hierarchies - The Transaction Cost Economics Perspective*, New York & Oxford: Oxford University Press; for recent developments on New Institutional Economics, see Brousseau, Éric & Glachant, Jean-Michel (Eds.) (2008), *New Institutional Economics - A Guide Book*, Cambridge: Cambridge University Press, 1st ed.

cases judged by courts, the statutes, acts or regulations, text of customary rules and international conventions. The secondary resources mainly include reports issued by some organisations or institutions, textbooks and journal articles by scholars.

Concerning the civil legal remedy, the analysis of the English approach towards L/C fraud exception rules is based on court decisions, and scholarly work. The examination of the Chinese approach is based on Chinese laws, court decisions, commentaries and scholarly work. Concerning the laws and cases, in most cases the official Chinese version has been examined. English translations, when available, also have been consulted. In the text and in the footnotes the English translation of the name of the laws and court cases will be used.

In the part of arbitrating L/C fraud disputes, the research will be mainly based on arbitration Acts, a few arbitral cases by arbitral institutions, and scholarly work. In addition, we have conducted surveys targeted at particular experts and professors in the L/C field through email. The rest of the study builds on secondary literature, news reports, and reports made by international organisations such as the ICC and UN.

The above-mentioned resources are accessed through databases (in electronic form) available in libraries, such as Westlaw, LexisNexis, ProQuest, KluwerLaw, CNKI, Chinalawinfo, or through borrowing books, journal articles, and documents from libraries. Furthermore, the participation in conferences and postgraduate seminars is also an important source for developing the understanding of the research topic. Communication about some specific questions with experts and professors in the field of L/C either personally or through email contributes to the development of arguments in the dissertation.

1.7 THE STRUCTURE

This study is composed of six main parts, starting with the criminal law approach to L/C fraud in international transactions, developing the civil law approach (civil litigation), the possibility of arbitration, and advancing the preventive and proactive approach in business practice.

Chapter 2 mainly, but briefly, discusses the criminal law approach to L/C fraud in England and China, and points out the difficulties of dealing with international L/C fraud under national jurisdictions. At the beginning of this chapter, the background of the legal system of England and China is introduced.

Chapter 3 presents the current framework for dealing with L/C fraud disputes at the international level, including UCP by ICC and the Convention on Independent Guarantees and Standby Letters of credits by United Nations

(UN).[120] Then it will examine the current structure under the civil law approach at the national law, particularly focusing on the approach in England and China. The study of the civil law approach towards the L/C fraud problem in L/C fraud disputes is essentially a study of L/C fraud exception rules. In England, such rules are mainly reflected in court cases in dealing with a procedural issue, which is whether to grant an injunction or not. In China, such rules were developed in several documents and the judicial practice of the courts applying such rules to deal with L/C fraud disputes. The development of L/C fraud exception rules in China is examined from the point of view of a legal transplant. The similarities and differences in L/C fraud exception rules in England and China will be analysed. There are various obstacles of litigating international L/C fraud disputes, such as inconvenience in initiating litigation, difficulty of satisfying the courts' high standards of L/C fraud and enforcement of court orders.

Thus, Chapter 4 focuses on exploring the question of whether or not arbitration can be an alternative for handling such disputes, and other possible alternatives. This has not been studied much. The chapter starts with an analysis of arbitrating international L/C fraud disputes proposed by academics, and then follows the discussion of different points relevant to such a proposal. The goal is to examine what kind of problems may exist either in theory or in practice in arbitrating L/C fraud disputes.

Chapter 5 focuses on the preventive and proactive approach, which stands for the legal logic of problem solving and problem prevention. The perspective is taken mainly from business practice. The theory is based on fraud risk management, mainly including response to fraud and prevention of fraud. The purpose is to work out measures of preventing fraud in L/C transactions for different commercial parties. However, the prevention of L/C fraud needs to combine the efforts from business practice and legal practice.

Chapter 6 concludes the whole dissertation by summarising the main approaches towards the documentary L/C fraud issue in the international context. It assesses the value and shortcomings of each approach. Through such assessment, we demonstrate the contributions that have been made by this research. At the same time, we point out a number of questions that are interesting and worthwhile studying in the future.

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[120] It shall be noticed that the UCP 600 will take effect in July 2007, but there is no change concerning the fraud exception rule; Thus, previous literatures on the problem of fraud in documentary credit are still valuable; see e.g. Leacock, Stephen J. (1984), 'Fraud in International Transaction: Enjoining Payment of Letters of credit in International Transactions', 17 *Vand. J. Transnat'l L.* 885 (Fall); Bergsten, Eric E. (1993), 'A New Regime for International Independent Guarantees and Stand-by Letters of Credit: The UNCITRAL Draft Convention on Guaranty Letters' , 27 *Int'l Law* 859.

2 L/C Fraud Remedy Under Criminal Law Framework

2.1 INTRODUCTION

When fraud is mentioned, for most people the first thought that naturally comes to mind is that fraud is a crime[121]. The costs for victims from fraud can be tangible and intangible; in addition fraud can also lead to significant social costs.[122] Thus, considering approaches to dealing with L/C fraud, it seems inevitable that the approach of criminal law must be discussed. In this chapter we will examine what kind of remedy criminal law provides in cases of L/C fraud and how L/C fraud is tackled by criminal law.

It has been widely accepted that criminal law plays a significant role in being a deterrent or preventive, as it represents a disincentive to crime by way of enforcing sanctions.[123] One of the main purposes of criminal law is to protect society and to punish criminals[124] by investigating criminal cases, prosecuting criminals and enforcing criminal judgments, rather than care for the victims of crime[125]. Thus, it is argued that criminal prosecutions should not be considered as the main method for protecting individual and social interests.[126] That partially explains why other approaches towards L/C fraud must be considered from the perspective of helping victims.

Criminal law is often associated with national jurisdictions. Within a single chapter, it is obviously impossible to compare everything that is relevant to L/C fraud. In this chapter, we will be very selective and only discuss substantive rules

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[121] For various theories about crime, generally see Vold, George B. & Bernard, Thomas J. & Snipes, Jeffrey B. (2002); particularly concerning fraud, we consider "Chapter 11 Contemporary Classicism: Deterrence, Routine Activities, and Rational Choice" as the most suitable theory for explaining such economic crime, pp. 196-208; for the development of criminology in England, see Garland, David, 'Crimes and Criminals: The development of Criminology in Britain', in Maguire, Mike & Morgan, Rod & Reiner, Robert (Eds.) (2002), *The Oxford Handbook of Criminology*, New York & Oxford: Oxford University Press, 3rd ed., pp. 7-45.

[122] Cohen, Mark A. (2005), *The Costs and Crime and Justice*, London & New York: Routledge, 1st ed., p. 41; particularly concerning economic and white-collar crimes, see pp. 67-71.

[123] Ashworth, Andrew (2006), p. 16; however, Gardner argues that the 'Positive General Prevention' does not justify criminal law or criminal punishment, see 'the Functions and Justifications of Criminal Law and Punishment', in Gardner, John (2007), *Offences and Defences: Selected Essays in the Philosophy of Criminal Law*, Oxford: Oxford University Press, 1st ed., p. 200.

[124] The purposes of punishment by criminal law can be considered as general deterrence, special deterrence, rehabilitation, and the incapacitation of offenders; for further discussion see Fletcher, George P. (1998), pp. 30-33.

[125] It is argued that if criminal law is designed to merely satisfy the victim then punishment would be reduced to nothing more than vengeance or compensation; thus punishment must keep its public character, see Fletcher, George P. (1998), p. 39.

[126] Ashworth, Andrew (2006), *Principles of Criminal Law*, New York: Oxford University Press, 5th ed., p. 16.

under criminal law concerning L/C fraud in England and China. Courts cases are not studied, firstly because the reported international L/C fraud criminal cases dealt with by the courts in England and in China are not available and secondly because the study of criminal legal remedy for L/C fraud is not our focus. Such comparative criminal legal studies[127] deserve their own further study.

To understand the application of legal rules in practice, we have to grasp the general context in which these legal rules operate. Such background knowledge is also necessary for understanding the analysis of L/C fraud exception rules in Chapter 3. Therefore, the background of the legal system in general in England and China is introduced.

However, regarding L/C fraud in international transactions, it is certainly not enough only to consider national substantial criminal law. The role of the procedural rules[128], which attempt to guarantee the rights of defendants and protect the innocent, cannot be neglected. In particular, the issue of legal assistance between different countries where criminal cases are involved will be considered. Furthermore, the roles of some international organisations such as the UN and ICC in fighting against L/C fraud will be looked at. We are going to start by introducing the criminal law framework concerning L/C fraud in England. Then an examination of the criminal law remedy for L/C fraud in China will follow.

2.2 L/C FRAUD REMEDY UNDER CRIMINAL LAW IN ENGLAND

2.2.1 The Legal System of England

Sources of Law

The legal system of England has developed over many centuries and it is widely known that the law in England is typically recognised as a case-based system. In addition to two main historical sources – common law and equity[129], other principal sources of English law are legislation, the European Union (EU) law, custom, and treaties.[130] Common law was and is still one of the most important sources of legal rules; the doctrine of judicial precedent demonstrates the application of common law, thus governs the case law system.[131] Equity was developed

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[127] For further discussion on the purpose of studying criminal justice comparatively, methods of comparative research, and approaches to comparison in criminal legal studies, see Nelken, David, 'Comparing Criminal Justice', in Maguire, Mike & Morgan, Rod & Reiner, Robert (Eds.) (2002), pp. 175-198.

[128] For a discussion about criminal procedure in English system, see Spencer, J.R., 'The English System', in Delmas-Marty, Mireille & Spencer, J. R. (Eds.) (2002), *European Criminal Procedures* (English translation), Cambridge: Cambridge University Press, 1st ed., pp. 142-214.

[129] It is argued that the distinction between them is becoming unclear, as equitable remedies will be employed often so as to protect common law rights, see Mason, Anthony (1994), 'The Place of Equity and Equitable Remedies in the Contemporary Common Law World', *L.Q.R.*, 110 (APR), 238-259.

[130] Elliott, Catherine & Quinn, Frances (2000), *English Legal System*, Harlow: Longman, 3rd ed., pp. 6-83.

[131] De Cruz, Peter (1995), p. 105.

mainly to correct the deficiencies in the common law and equity would prevail when common law and equity were in conflict. Nowadays the effect of equity on substantive law is significant, particularly in areas of contract law and essential remedies such as injunctions.[132]

Legislation in England is becoming a major source of law and its function is beyond doubt, but the English legal attitude towards legislation is that legislations are to consolidate or clarify existing law, and are to develop based on existing case law.[133] The main source of English criminal law has been the common law, and now also can be scattered statutes.[134]

Distinction Between Civil and Criminal Matters

Usually the law separates civil and criminal matters and accordingly the burden and standard of proof of different matters is different. In civil proceedings a claimant bears the burden of proving a particular matter he claims, generally to the civil standard of the balance of probabilities; but in a criminal case the police and prosecution usually bears the burden of proof, and the standard of proof is beyond reasonable doubt.[135]

However, the boundary between criminal and civil matters has become gradually unclear.[136] It is not rare to see one criminal offence causing both civil and criminal proceedings. The prosecution can prosecute the criminal offender, and the victim of the criminal offence can sue the same person and claim for a civil remedy. It also has long been identified that there are difficulties for lawyers in understanding the nature of fraud because it is hard to differentiate civil wrongs and criminal wrongs; and such difficulties partly derive from the burden of proof[137] born by lawyers in cases of civil disputes, including that all the work would have been performed by police investigators.[138]

In addition, it is surprisingly noticeable that nowadays even in civil proceedings the standard of proof may be high or sometimes even identical to the

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[132] Ward, Richard & Wragg, Amanda (2005), *Walker & Walker's English Legal System*, New York: Oxford University Press, 9th ed., p. 6.
[133] De Cruz, Peter (1995), p. 105.
[134] Ashworth, Andrew (2006), p. 7.
[135] Ward, Richard & Wragg, Amanda (2005), p. 13.
[136] Ibid, p. 16.
[137] For an explanation of the concept, distinction between the concepts "burden of persuasion", "burden of going forward", "standard of proof", and distinction between the concepts "proof beyond a reasonable doubt", "proof by a preponderance of the evidence", "proof by clear and convincing evidence", see Fletcher, George P. (1998), *Basic Concepts of Criminal Law*, New York & Oxford: Oxford University Press, pp. 14-19; for an explanation of the principle of "the Presumption of Innocence" and "Proof beyond Reasonable Doubt", see also Spencer, J.R., 'Evidence', in Delmas-Marty, Mireille & Spencer, J. R. (Eds.) (2002), pp. 596-601 and Duff, R. A. (2007), *Answering for Crime: Responsibility and Liability in the Criminal Law*, Oxford & Portland & Oregon: Hart Publishing, pp. 195-202.
[138] See Tytell, Peter V., 'The Detection of Forgery and Fraud', in Jan van den Berg, Albert (Ed.) (2003), pp. 315-316.

criminal standard.[139] One common factor in such situations is that allegations of criminal or quasi-criminal conduct are claimed in civil proceedings.[140] This partly explains why the standard of L/C fraud exception is extremely high in L/C fraud disputes in civil proceedings in England, which will be studied through court cases in Chapter 3.

Precedents

Three main advantages of the precedent system have been identified: certainty, precision, and flexibility.[141] To be more specific, legal certainty derives from the judicial practice that the judges are bound to solve similar cases in a consistent manner; precision can be achieved through the reported cases providing specific answers to specific factual questions; and the achievement of flexibility is based on the possibility of adapting the law to new situations through overruling or distinguishing previous decisions.[142]

However, overruling or distinguishing a decision is not exercised easily and shall be subject to strict conditions.[143] Therefore, the biggest disadvantage of the precedent system lies in its inherent rigidity, which can sometimes lead to hardship.[144]

The application of the doctrine of precedents in England is closely related to law reporting;[145] without it the doctrine of precedents would probably not have developed to its current stage.

The Court System in England

The hierarchy of the courts[146] is considered, as it determines the operation of the doctrine of precedents in England. A court is bound by decisions of courts above it and is also bound by courts of equivalent level. The Supreme Court[147] is in the

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[139] Ward, Richard & Wragg, Amanda (2005), p. 14; a counter argument about the issue in law of England is that where there is an allegation of crime (e.g. fraud) in civil proceedings, the correct standard of proof is the one that is used generally in civil matters (balance of probabilities); but considering the serious nature of the allegation, a higher degree of probabilities, but within the general civil standard can be exercised, see Wallace-Brue, Nii Lante (1993), 'The Standard of Proof for Crime in Civil Proceedings – A Ghanaian Perspective', *International and Comparative Law Quarterly*, Vol. 42, Jan., pp. 157-160.

[140] Ward, Richard & Wragg, Amanda (2005), p. 14.

[141] Ibid, p. 79.

[142] Ibid.

[143] For a detailed discussion, see "Exceptions to *Stare Decisis*", in Cross, Rupert & Harris, J. W. (1991), *Precedent in English Law*, New York: Oxford University Press, 4th ed., pp. 125-163.

[144] Ward, Richard & Wragg, Amanda (2005), p. 79.

[145] This issue is also discussed as "publication of Judgments", see Bankowski, Zenon & Marshall, Geoffrey, 'Precedent in the United Kingdom', in MacCormick, D. Neil & Summers, Robert S. (Eds.) (1997), *Interpreting Precedents: Comparative Study*, Aldershot: Ashgate Publishing Company, pp. 320-321.

[146] For a general introduction about the court system in England, see Shears, Peter & Stephenson, Graham (1996), *James' Introduction to English Law*, London: Butterworths, 13rd ed., pp. 29-45; for an introduction about the court system concerning the criminal justice system and civil and commercial justice system, see Partington, Martin (2003), *An Introduction to the English Legal System*, New York: Oxford University Press, 2nd ed., pp. 112-129, and pp. 206-216.

[147] Earlier the House of Lords were in the highest position of the court system in England; The Supreme Court started to sit as the final court of appeal in the UK in Oct. 2009; The Role of Supreme Court, see http://www.supremecourt.gov.uk/about/role-of-the-supreme-court.html, accessed 27 Oct. 2010.

highest position of the hierarchy of the courts in England. Thus, the Supreme Court's decisions are binding upon all other courts either trying civil or criminal cases. The Court of Appeal (CA) has its Civil and Criminal Divisions. Decisions of the CA are binding on all inferior courts both trying civil and criminal cases, including divisional courts. The CA is bound by the Supreme Court, and by its own earlier decisions.

The jurisdiction of the High Court is both civil and criminal. The High Court now consists of three divisions: Chancery Division, Queen's Bench Division, and Family Division. Divisional courts of the High Court are bound by decisions of the Supreme Court and CA, and by their own earlier decisions. Finally, Magistrates' courts and county courts are bound by the decisions of all superior courts.[148]

The English law judges think their chief role and task is to resolve disputes between parties.[149] Thus, the typical common law style is considered pragmatic, mainly adapted to the adjudication and resolution of disputes.[150]

2.2.2 Concept of Fraud in England

Fraud[151] is currently a very significant economic crime problem. However, tackling fraud has been under-reported and under-resourced for a long time.[152] It was argued that the various frenetic UK anti-fraud activities unfortunately did not change the perception of treating fraud as a low priority.[153]

A number of fraud offences can be found through the statutes and in common law.[154] In English law, there is no specific definition about "fraud". For the purpose of this study, we borrow a definition from a research paper that defines it as follows: fraud is the obtaining of financial advantage or causing of loss by implicit or explicit deception; it is the mechanism through which the fraudster gains an unlawful advantage or causes unlawful loss.[155] But there is neither a specific concept, nor particular rules concerning L/C fraud under the criminal law regime in England.

Moreover, it is exceedingly difficult to find relevant statistics[156] about L/C fraud in England. Even in the case of fraud alone in general, it is claimed to be costly to construct credible evidence sources; and recorded crime statistics are not good

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[148] Ward, Richard & Wragg, Amanda (2005), p. 102.
[149] De Cruz, Peter (1995), p. 106.
[150] De Cruz, Peter (1995), p. 105.
[151] For further discussion about the fraud issue in the UK, see Wright, Rosalind (2003), 'Fraud after Roskill: A View from the Serious Fraud Office', *Journal of Financial Crime*, 11(1), 10-16; for a discussion about fraud from the economic point of view, see Buell, Samuel W. (2006), 'Novel Criminal Fraud', 81 *New York University Law Review* 1971, (December).
[152] Attorney General's Office.
[153] Sarker, Rinita L. (2007), 'Fighting Fraud – A Missed Opportunity', *Comp. Lawyer*, 28 (8), 243-244, p. 243.
[154] Ashworth, Andrew (2006), p. 404.
[155] Levi, M. & Burrows, J. (2008), 'Measuring the Impact of Fraud in the UK: A Conceptual and Empirical Journey', 48 *Brit. J. Criminology* 293, p. 299.
[156] For development of collecting and presenting crime data in England, see Maguire, Mike, 'Crime Statistics: The 'Data Explosion' and its Implications', in Maguire, Mike & Morgan, Rod & Reiner, Robert (Eds.) (2002), pp. 322-370.

guides, because there are many steps between a crime and its recording by the authorities.[157] Some high-value cases that appear to meet the criteria of criminal fraud may have been treated as civil matters for litigation and negotiation with "suspects" and third parties.[158]

In the following sections we will only examine two relevant laws closely relating to L/C fraud. According to the features of L/C fraud, a key element concerns forged documents. Therefore, we consider that the discussion of relevant rules in the Forgery and Counterfeiting Act 1981 and the Fraud Act 2006 will be worthwhile.

2.2.3 Forgery and Counterfeiting Act 1981

The Forgery and Counterfeiting Act 1981 is part of the codification of criminal law in England. Previous legislation, in particular the Forgery Act 1913, was abolished and the crime of forgery in common law was repealed. The Forgery in the 1981 Act rather than counterfeiting will be examined due to its relevance to our research topic.

Usually forgery is conducted as a preparatory step for some other offences and generally preparatory acts are not made criminal by the law; thus, it is argued that it is not necessary to have a separate forgery offence.[159] However, such an argument was not accepted by the Law Commission[160], which maintained that in addition to the historical reason, in a modern society there is a need to rely on the authenticity of documents as being the authority for the truth of the statements which they carry.[161]

The first relevant element concerns the subject matter of forgery. According to the Act, a person is guilty of forgery if he makes a false instrument; here "instrument" is defined as "any document, whether of a formal or informal character" in s 8 (1) (a). Then the question turns to what exactly does "document" refer to. It can be said that a document is written on paper or any material and the writing may include letters, figures or any other symbols with the purpose of conveying information.[162]

The Law Commission held the view that in order to be the subject of forgery, a document must usually have two distinct kinds of messages: first, a message about the document itself; and secondly, a message to be found in the words of the document that is to be accepted and acted upon.[163] The Law Commission pointed

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[157] Levi, M. & Burrows, J. (2008), p. 293; for an explanation on what happens after an offence has been reported to the police, see Ashworth, Andrew (2006), pp. 9-10; for general information about the process of criminal procedure in England, see Sprack, John (2002), *Emmins on Criminal Procedure*, Oxford: Oxford University Press, 9th ed..

[158] Levi, M. & Burrows, J. (2008), p. 293.

[159] Smith, J. (2002), *Smith & Hogan Criminal Law*, London: Butterworths, 10th ed., p. 673.

[160] In England, the Law Commission is the statutory independent body created by the Law Commissions Act 1965; it keeps the law under review and recommends reform where it is needed; its recommendations have a profound effect if implemented by Parliament, available at www.lawcom.gov.uk/about.htm, accessed 14 Jan., 2010.

[161] The law Commission, (No. 55), House of Commons, Criminal Law, Report on Forgery and Counterfeit Currency, 17th July 1973, para. 21.

[162] Ibid, para. 23.

[163] Ibid, para. 22.

out that the essence of forgery is "the making of a false document intending that it be used to induce a person to accept and act upon the message contained in it, as if it were contained in a genuine document", and only those documents which convey the two kinds of messages are under the protection of the law of forgery.[164]

S 9 of the Act provides the circumstances where an instrument is false[165], and a person is to be treated as making a false instrument if he alters an instrument so as to make it false in any respect[166]. According to s 9, the concept of "falsity" is comprehensive and the ordinary application of s 9(1) may not have serious difficulties.[167]

The *mens rea* of the offence are considered to have two aspects. First, there is the requirement of a mental element relating to the making, using or possessing of a false instrument; and secondly, it concerns the requirement that a person should intend that another should be induced to do some conduct to his own or another's prejudice due to accepting the false document as genuine.[168] Thus, if a person only makes a false document without appropriate intents, then this document is not a forgery under the context of this Act. S 10 of the Act defines "induce" and "prejudice" in a detailed way.

By s 6 the forgery offence is triable in either way: on summary conviction[169], the punishment is six months imprisonment and/or a fine not exceeding the statutory maximum; on indictment[170] by ten years imprisonment and/or a fine. This will be compared with the sentence level in Fraud Act 2006.

Forging specific documents is the most important type of L/C fraud. Thus it is reasonable to infer that if a person, who is subject to the jurisdiction of England, forges some documents in order to fraudulently obtain L/C payment, he/she may be prosecuted under the Forgery and Counterfeiting Act.

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[164] Ibid.

[165] The Forgery and Counterfeiting Act 1981, S 9 (1), which states that "An instrument is false for the purpose of this Part of this Act – (a) if it purports to have been made in the form in which it is made by a person who did not in fact make it in that form; or (b) if it purports to have been made in the form in which it is made on the authority of a person who did not in fact authorise its making in that form; or (c) if it purports to have been made in the terms in which it is made by a person who did not in fact make it in those terms, or (d) if it purports to have been made in the terms in which it is made on the authority of a person who did not authorise its making in those terms; or (e) if it purports to have been altered in any respect by a person who did not in fact alter it in that respect; or (f) if it purports to have been altered in any respect on the authority of a person who did not in fact authorise the alteration in that respect; or (g) if it purports to have been made or altered on a date on which, or at a place at which, or otherwise in circumstances in which, it was not in fact made or altered; or (h) if it purports to have been made or altered by an existing person but he did not in fact exist.

[166] The Forgery and Counterfeiting Act 1981, S 9 (2).

[167] Smith, J. (2002), p. 678.

[168] Ibid, p. 683.

[169] 'Summary' means the process of ordering the defendant to attend the court by summons, a written order usually delivered by post which is the most frequent procedure adopted in the magistrates' courts; 'Conviction' is a judicial determination of a case; 'Summary conviction' refers to a conviction in a magistrates' court (usually for most minor crimes); The Magistrates are the judges of both fact and law and must either convict or dismiss the case, see Elliott & Quinn (2000), pp. 268-269.

[170] 'Indictment' refers to a formal document containing the alleged offences against the accused, supported by brief facts; it is read out to the accused at the trial; it is usually for the more serious offences and such offences can only be heard by Jury in the Crown Court, see Elliott & Quinn (2000), p. 269.

2.2.4 Fraud Act 2006

The Fraud Act 2006[171] is a short criminal legislation, which took effect on 15 January 2007. It is asserted that the Act is to "clarify the law, and provide the law enforcers and prosecutors with a modern and flexible law of fraud".[172]

This Act replaced the eight deception based offences in the 1968 and 1978 Theft Acts, and creates a new and single offence of fraud in section 1. However, the Act does not define the concept of "fraud" and there is no generally accepted definition of fraud in common law either. According to section 1 there are three different forms of committing this offence. However, we will discuss only one form: fraud by false representation.

The first form of the fraud offence provided by section 2 of the Act is fraud by false representation. This seems to be the most frequently exercised form, and also is the most relevant part to L/C fraud. This section 2 has such a significant effect that it creates a very wide offence which essentially composes of lying for economic purposes.[173]

According to section 2 (fraud by false representation) of the Act, the offence of fraud is committed where a person dishonestly makes a false representation and intends by making the representation to make a gain for himself or another or to cause loss to another or to expose another to the risk of loss. Thus, the requirement of *actus reus* is satisfied when a person makes a false representation, and the *mens rea* requires the proof that he knew the representation was or might be false, and that he acted dishonestly, with intent to gain or cause loss.[174]

Then the key elements in this form of fraud offence will be examined briefly. A representation must be "made", expressly or impliedly (section 2, subs. (4)). As to "falsity", a representation is false if it is untrue or misleading and the person making it knows that it is, or might be untrue or misleading (section 2, subs. (2)). "Representation" broadly contains any representation as to fact or law, including a representation as to the state of mind of the person making it or any other person (section 2, subs. (3)).

From the Act, it can be seen that to charge a fraud offence, the Crown has to prove that the representation is false or misleading, and the defendant's knowledge as to its falsity. Generally the question on assessment of falsity will be normally decided by a jury.[175] The notion of falsity is essential to section 2, but no

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[171] Fraud Act 2006, available at http://www.england-legislation.hmso.gov.uk/acts/acts2006/pdf/ukpga_20060035_en.pdf; Explanatory Notes to Fraud Act 2006 (received Royal Assent on 8 November 2006), provides more information on the background, summary of the Act and commentary on different sections, available at http://www.opsi.gov.uk/acts/acts2006/en/ukpgaen_20060035_en.pdf; The Crown Prosecution Service also provides legal guidance on Fraud Act 2006, available at http://www.cps.gov.uk/legal/d_to_g/fraud_act/, accessed 13 July, 2009.

[172] The Home Office, Home Office Circular 042/2006, 'The Fraud Act 2006: Repeal of the Deception Offences in the Thefts Acts 1968-1996', available at http://www.homeoffice.gov.uk/about-us/publications/home-office-circulars/circulars-2006/042-2006/, accessed 12 Oct. 2009.

[173] Dennis, Ian (2007), p. 2.

[174] Ormerod, David (2007), 'The Fraud Act 2006 – Criminalizing lying?', *Criminal Law Review*, MAR , 193-219, p. 196.

[175] The basic principle in English law is that questions of fact are decided by the jury and questions of law by the judge, see Roberts, Paul & Zuckerman, Adrian (2004), *Criminal Evidence*, Oxford: Oxford University Press, p. 59.

definition is provided; it was thus argued that leaving the courts to determine such matters fails to promote certainty in this field.[176]

As for the defendant's knowledge, it is an awfully onerous *mens rea*. In general, proving the defendant's knowledge of the falsity of representations about existing facts, is very difficult.[177] Dishonesty is the essential *mens rea* element in this fraud offence and the notion of dishonesty is important to set the limits of liability.[178] Unfortunately, the new Act does not have a definition of dishonesty. Thus it is presumed that the courts will continue to apply the *Ghosh* test, and leave the jury to apply whichever standards of honesty that they believe in.[179]

A remarkable change to be stressed is that this regulation shifts from a result-based deception to a conduct-based representation crime, which is completed on the criminal offender's acts regardless of any result.[180] In other words, for this crime to have been committed, the law does not require that a gain or anything else should have been obtained, or that a loss should have been caused, or that any risk of loss should have been created.[181] Such change attracted criticism that the Act is developing in a frightening way by separating traditional criminal law elements of *mens rea* and *actus reus* from each other and in some cases from the consequences of crimes.[182]

Whether the offence of "conspiracy to defraud" should be excluded in the new Act caused heated debate during the drafting process of the Act. The need of including this offence was in serious doubt because of the new Act's wide scope of offences. However, it was argued that its abolition would cause problems of ability to prosecute multiple offences and the most serious cases of fraud.[183] Thus, this offence now remains in the Act. Therefore, the common law offence of "conspiracy to defraud"[184] exists alongside the possibility of statutory "conspiracy to defraud". However, it seems unclear when it is proper to charge a common law offence instead of a statutory conspiracy to defraud.

Concerning the punishment, the Act stipulates that a person who is guilty of fraud is liable on summary conviction to imprisonment for a term not exceeding 12 months or to a fine not exceeding the statutory maximum (or to both); on conviction on indictment, to imprisonment for a term not exceeding 10 years or a fine (or to both).[185]

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[176] Ormerod, David (2007), p. 198.
[177] Ibid, p. 202.
[178] Dennis, Ian (2007), p. 2.
[179] Ibid.
[180] Ormerod, David (2007), p. 193.
[181] Dennis, Ian (2007), I., 'Editorial: Fraud Act 2006', *Criminal Law Review*, JAN, 1-2, p. 1.
[182] McCluskey, David (2008), 'A New Kind of Criminal Law', *Criminal Lawyer*, 180, 1-3, p. 1; furthermore, the impact of such change is analysed: firstly, conduct is criminalised, regardless of result or intention; secondly, the idea of reparation based on civil law is more emphasised than punishment based criminal law.
[183] Ormerod, David & Williams, David Huw (2007), 'Legislative Comment: The Fraud Act 2006', *Arch. News*, 1, 6-9, p. 9.
[184] Ashworth, Andrew (2006), p. 404, and the factors of this common law crime were restated in *Scott v. Metropolitan Police Commissioner* [1975] AC 819.
[185] The Fraud Act, s.1. (3).

After having analysed and discussed the essential provision concerning fraud, we now turn to doing some evaluatation. Many practical advantages of the Fraud Act have been acknowledged, but it was criticised that this general offence is overbroad and excessively relies on vague concepts of falsity and dishonesty.[186] Similarly, it was criticised that the new Act is somewhat perplexing as the definition is not objectively distinct.[187] Furthermore, it seems that the Act does not have any increased deterrent effect, as the punishment is at the same level as in the previous law.[188] However, changes in sentencing levels regarding a crime do not need to be necessarily followed for their deterrent effects.[189] This partly explains why we do not propose to increase the level of sentencing in order to improve the effect of Fraud Act in England. It is clear that such broad offences are attractive to many prosecution agencies, such as Crown Prosecution Service (CPS)[190], Serious Fraud Office (SFO)[191], and Financial Services Authority (FSA)[192]; however, ensuring proper application of these new provisions will not be an easy task.

After the Fraud Act came into effect, several cases were dealt with by the courts in England. However, these reported cases[193] do not relate to L/C fraud, therefore it is not necessary to do further examination on those cases. It remains to be seen whether the new fraud Act can meet the great expectations that it is intended to.

From the laws we examined, it can be seen that the forgery offence in the Forgery and Counterfeiting Act 1981 can overlap with the fraud offence in the Fraud Act 2006. How such a problem is dealt with and how they are applied in L/C fraud cases requires further research. However, our research will limit itself to examining the relevant substantial laws to L/C fraud.

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[186] Ormerod, David (2007), p. 219.
[187] McCluskey, David (2008), p. 3.
[188] Ormerod, David (2007), p. 219.
[189] Ashworth, Andrew (2006), p. 16; a similar argument that increases in the severity of punishments may not reduce crime, see also Vold, George B. & Bernard, Thomas J. & Snipes, Jeffrey B. (2002), *Theoretical Criminology*, New York & Oxford: Oxford University Press, 5th ed., p. 208.
[190] The Crown Prosecution Service (CPS), official websit: www.cps.gov.uk; the CPS prosecutes criminal cases investigated by the police in England and Wales.
[191] Serious Fraud Office (SFO), official website: www.sfo.gov.uk; part of the UK criminal justice system is a government department that investigates and prosecutes serious or complex fraud; has a unit devoted to handling incoming international requests for mutual legal assistance in cases of serious and complex fraud, cooperates with counterparts authorities in many other national jurisdictions, and also with the anti-fraud office of the European Union.
[192] Financial Services Authority (FSA), official website: www.fsa.gov.uk; it has a wide range of disciplinary, criminal and civil powers to take action against individuals and firms. It has a statutory objective to reduce the extent to which businesses can be used for purposes connected to financial crime, such as fraud or dishonesty. It may take action against financial services firms failing to manage the risk of fraud.
[193] See Summers, Ben (2008), 'Update on Recent Fraud Cases', *Comp. Lawyer*, 29 (11), 342-344.

2.3 L/C FRAUD REMEDY UNDER CRIMINAL LAW IN CHINA

2.3.1 The Legal System in China

The legal system of the People's Republic of China (PRC) generally has the civil law tradition, but also was influenced earlier by the Soviet Union and later by the common law tradition.[194] It is mainly codified law; and is not derived from a historically developing body of judicial decisions (e.g. England). The sources of law in China are wide, including the Constitution of PRC 1982, National People's Congress (NPC) statutory law and other legislative enactments, international treaties and so forth.[195] The NPC, China's national legislature, is the supreme source of law in China; the basic laws and other laws issued by the NPC or its Standing Committee are the highest form of law after the Constitution.[196] The State Council, China's cabinet, and its subordinate ministries and administrative departments, are empowered to issue administrative regulations and measures and adopt regulations required for the implementation of laws passed by the NPC.[197] Thus, the statutues and laws issued by the NPC and the administrative regulations adopted by the State Council are important in China.

The system of courts in China will be introduced. Under the Constitution, the courts of China are established by the NPC to which they are responsible and by which they are supervised.[198] Judicial power is implemented by the courts at four levels, which respectively refer to the basic courts, intermediate courts, higher courts, and the Supreme Court plus special courts.[199] The first three are at the local and provincial levels and the Supreme Court is at the national level.

The basic courts are established at the level of county and district.[200] Each basic court mainly has three Trial Tribunals – criminal, civil, and economic,[201] but setups of each court may vary in practice. Intermediate courts and higher courts are created at the level of province or autonomous regions, or municipalities straightly under the central government or under the jurisdiction of a province or autonomous region.[202] Their internal divisions are the same as the basic courts. The Supreme People's Court (SPC) is the highest judicial organ and it is at the highest level of the hierarchies of the court system in China. The special

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[194] For further discussion, see Chen, Albert H.Y., 'Socialist Law, Civil Law, Common Law, and the Classification of Contemporary Chinese Law', in Otto, Jan Michiel & Polak, Maurice V. & Chen, Jianfu & Li, Yuwen (Eds.) (2000), *Law-Making in the People's Republic of China*, The Hague, London, Boston: Kluwer Law International, pp. 55 - 74.

[195] Shen, Zongling (2009), *Jurisprudence*, Peking: Peking University Press, 3rd ed., pp. 263-270; see also Su, Xiaohong (2006), *Fundamental Issues on Jurisprudence*, Peking: Law Press China, 1st ed., pp.141-143; Zhou, Wangsheng (2006), *Jurisprudence*, Xian: Xian Jiaotong University Press, 1st ed., pp. 220-224.

[196] The Constitution 1982, article 58, 59 and 100.

[197] The Constitution 1982, article 85 and 89; The Legislation law, article 56.

[198] The Constitution 1982, article 128.

[199] The Organic law of the People's Courts of PRC (Hereinafter 'The Organic Law'), adopted at the 2nd Session of the 5th NPC on 1 July, 1979, and revised for the 3rd time according to the Decision of the Standing Committee of the NPC on amending the Organic law as adopted at the 24th meeting of the Standing Committee of the 10th NPC on 31 October, 2006, article 2.

[200] The Organic Law, article 18.

[201] Ibid, article 19.

[202] Ibid, article 23.

courts in practice include Military courts, Railway Transportation courts, Forest Affairs courts, and Maritime courts. Ten maritime courts are established in the eastern coastal cities in China[203], and they also have the power to adjudicate L/C cases[204]. Assuming that judges in basic courts do not have sufficient knowledge about the L/C and in order to deal with L/C disputes in a fair and competent way, it was regulated that L/C disputes should at the very least be adjudicated by Intermediate courts.[205]

China follows the principle of two instances of trials for final adjudication, which are the first instance and on appeal.[206] Courts at higher levels can exercise their power in final judgments of appellate cases, thus having a binding effect on the inferior courts.

However, China does not have a formal system of judicial precedent.[207] Theoretically, the decision of each case stands on its own and a court judgment only binds the disputed parties in the particular adjudicated case. Nevertheless, in the English legal system, the *ratio decidendi* of a case is binding on cases with similar facts. The publication of decided cases in the Gazette of the SPC began in 1985, but such publication is not systematic, and many recent cases are not available.[208] However, the law reports in England have developed as an integrated system and it is easy to check a court judgment in different databases. The reported decisions in China may have some function as precedents, depending on the courts' comments and the sensitivity of the involved issues.[209] The problems with the published opinions are that they are profoundly edited, usually there is little or no legal reasoning and lower courts are not allowed to cite them in their decisions.[210] Therefore, such reported cases may merely offer some guidance to lower courts when they adjudicate cases with similar facts or with similar issues of law.

Judicial interpretations in China are significant to judicial practice. The power of issuing interpretations on questions concerning specific application of laws and decrees arising in judicial proceedings is given to the SPC.[211] In judicial practice, these interpretations are usually binding on the lower courts; the lower courts' judges often follow the judicial interpretations issued by the SPC.

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[203] China Foreign-related Commercial and Maritime Trial (CCMT), Maritime courts, official website: www.ccmt.org.cn/, accessed 12 Oct. 2009.
[204] The Provisions of the SPC on Some Issues Concerning the Jurisdiction of Civil and Commercial Cases Involving Foreign Elements, adopted at the 1203rd meeting of the Judicial Committee of the SPC on 25 December 2001, came into force on 1 March 2002, No. 5 [2002] of the Interpretations of the SPC, article 1 and 3 provide the courts which can deal with L/C fraud are at least intermediate courts; for comments on and the importance of this interpretation, see Yuan, Hegang (2004), 'Reflections on the Issue of Centralised Jurisdictions in Civil and Commercial Cases Involving Foreign Elements', *People Justice*, Vol. 2, 42.
[205] The provisions of the SPC on Some Issues Concerning the Jurisdiction of Civil and Commercial Cases Involving Foreign Elements, article 1 and 3.
[206] The Organic Law, article 12.
[207] See e.g. Zhang, Yadong (2008), 'Reflection on Case Guidance System', *Journal of Law Application*, No. 8 (General No. 269), 34.
[208] Huang, Nan (2008), 'Analysis of Feasibility of Establishing Precedents System in China', *Kejiao Wenhui*, No. 1 (1st Issue), 114.
[209] Liu, Nanping (1991), ''Legal Precedents' with Chinese Characteristics: Published Cases in the Gazette of the Supreme People's Court', 5 *Journal of Chinese Law* 107, p. 108.
[210] Liu, Nanping (1991), p. 108.
[211] The Organic Law, article 33.

Nevertheless, the legal status of judicial interpretation is never a clear and certain matter. According to the constitution, the highest lawmaking authority is the NPC, China's national legislature; the NPC also has the power to interpret statutes.[212] The People's Congress at local levels also has legislative authority; whereas local regulations shall not conflict with national legislation.[213] Thus, it can be seen that the lawmaking authority in China is the People's Congress. Although the SPC is authorised to issue binding interpretations of laws, its status does not officially have the confirmation of the Constitution.[214]

The forms of judicial interpretation are various, including Letters of reply, Opinions, Notices, Measures, Provisions, and Published model cases.[215] The functions of judicial interpretation have also been wide. It may provide explanations of statutory provisions when lower courts have such a request; it may also expand, supplement, or sometimes limit the applications of a statutory provision in order to harmonise different statutes; sometimes it can amend a particular statute or actually create new statutory provisions.[216] Thus, as one source of law, the judicial interpretation plays an increasingly important role in judicial practice in China.

2.3.2 L/C Fraud Rules Under Criminal Law

In order to crack down on serious financial crimes including L/C fraud[217], the Standing Committee of the NPC formulated the "Provision on Penalising Crime on Disrupting Financial Order" on June 30, 1995. In article 13 of this provision, it stipulates that the fraud in L/C is a crime and applies to the rules of economic crimes in Criminal Law. In 1997 China had its new version of Criminal Law[218] and the crime of L/C fraud is listed separately in the new Criminal Law. In article 195 on the crime of L/C fraud, it provides that the following acts are criminalised: (1) using a forged or altered L/C or any of its attached bills or documents; (2) using an invalidated L/C; (3) obtaining L/C fraudulently; (4) other types of L/C fraud.[219]

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[212] The Constitution, 1982, Article 57 and 58; Legislation Law of the PRC (Hereinafter the Legislation law) (adopted at the 3rd Session of the 9th NPC on March 15, 2000 and took effect on July 1, 2000), article 7.

[213] The Constitution 1982, article 96, 100, 107, 108; The Legislation law, article 63, 73.

[214] Cao, Shibing (2006), 'Legal Status of SPC Judgments and Judicial Interpretation', *China Legal Science Magazine*, No. 3 (General No. 131), 175.

[215] Zhang, Zhiming, 'Study on Legal Interpretations in Modern China', *China Social Science*, China Legal Science Website, available at http://www.iolaw.org.cn/shownews.asp?id=13739, accessed 16 July, 2010; see also Brown, Ronald C. (1997), *Understanding Chinese Courts and Legal Process: Law with Chinese Characteristics*, The Hague, London, Boston: Kluwer Law International, p. 69.

[216] Chen, Chunlong (2003), 'Status and Function of Judicial Interpretation in China', *China Legal Science Magazine*, No. 1 (General No. 111), 24.

[217] Since the 1980s, financial fraud crimes have been increasing rapidly in China and such crimes are endangering the financial security of China, see Hu, Anfu, 'Characteristics and Trends of Financial Fraud in China', in Chen, Guangzhong & Predontaine, Dianiel (Eds.) (1999), *Prevention and Control of Financial Fraud: Papers for 98' International Symposium on the Prevention and Control of Financial Fraud*, Peking: China Democratic and Legal Press, pp. 25-31; see also Zhao, Bingzhi, 'Features of Financial Fraud and Legal Sanctions in China', in Chen, Guangzhong & Predontaine, Dianiel (Eds.) (1999), p. 34.

[218] The Criminal Law of PRC was revised at the 5th Meeting of the Standing Committee of the 8th NPC of PRC on 14 March, 1997, and came into force on the same date.

[219] Other types of L/C fraud usually refer to 'L/C soft clauses' fraud; for further explanation and concrete circumstances for each type of L/C fraud, see Zhao, Bingzhi (Ed.) (2000), *Judicial Countermeasure to Distinguish Financial Crime*, Jilin: Jilin People Press, 1st ed., pp. 359-362; ee also Wei, Dong & Tang, Lei (2001), pp. 276-279; Li, Xiaoyong (1998), pp. 159-166.

In both criminal law theory and judicial practice in China, it is very common that a crime is approached by analysing four elements - subject, subjective element, object, and objective element.[220] According to Criminal Law 1997, the subjects who may commit L/C fraud include natural persons and legal persons[221]. Natural persons include not only natural persons with Chinese nationality, but also foreigners and those without nationality.[222] The subjective element for this crime is the intention of illegally possessing the properties of others under the L/C; intention only refers to direct intention, rather than indirect intention or negligence.[223] The object of L/C fraud is widely accepted as the harm to the national administering system of the L/C and public and private property rights.[224] The objective element of L/C fraud crime is the behaviours of committing L/C fraud, and it seems to include both presenting forged documents and acting fraudulently in underlying sales transactions.[225]

Article 195 (1) can be criticised in that it does not clearly state that one "knowingly" uses a forged or altered L/C or any of its attached bills or documents.[226] This is important so as to make it distinct from a situation where a person uses a forged L/C without knowing that it is forged. For example, a buyer forges a L/C and passes it to a seller, but it cannot be said that the seller commits L/C fraud even though the seller uses the forged L/C.[227] Moreover, it is possible that some part of a BL may not be exactly according to the facts, such as an anti-dated BL. Such a situation sometimes may be merely a breach of contract, rather than a crime. In L/C fraud disputes in civil litigation, some court cases have dealt with such issues and this will be discussed in Chapter 3. Some academics attempt to distinguish the crime of L/C fraud and L/C fraud behaviour under civil law in judicial practice, arguing that the legal consequences, subjective elements and the degree of harm of the two are different.[228] Nevertheless, some claim that it is impossible to clearly differentiate between them by looking at the behaviours.[229]

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[220] See e.g. Zhao, Bingzhi (2007), *Introduction to Criminal Law*, Peking: Renmin University of China Press, 1st ed., pp. 140-144; see also Wang, Zuofu (2007), *Criminal Law*, Peking: Renmin University of China Press, 3rd ed., pp. 60-61; Zhang, Mingkai (2007), *Criminal Law*, Peking: Law Press China, 3rd ed., pp. 96-98; Liu, Xianquan & Yang, Xingpei (2007), *Topics of Criminology*, Peking: Peking University Press, 1st ed., pp. 92-93.

[221] PRC Criminal Law, article 200, provides the sanctions of L/C fraud conducted by legal persons.

[222] PRC Criminal Law, article 8.

[223] This is considered as a fundamental feature of the subjective element of L/C fraud, see Sui, Qingjun (2006), *Theory and Practice of Dealing with Financial Crime Cases*, Peking: China Agriculture University Press, 1st ed., pp. 130-133, see also Chen, Li (2006), pp. 102-104; Zhao, Bingzhi & Zhou, Jiahai (2001), 'Discussion on 'Illegal Possession Intention' the Essential Condition of L/C Fraud', *People's Procuratorial Monthly*, Vol. 3, 5; but it is an arguable issue, as some academics and judges consider that such an intention is not necessary in order for it to constitute L/C fraud, see Yan, Renpeng & Chen, Guangxiu (2003), 'Comments on L/C Fraud Subjective Element – 'Illegal Possession'', *Contemporary Law*, (10), p. 44.

[224] See Wei, Dong & Tang, Lei (2001), p. 275.

[225] For further discussion on the features of the objective element; see Hou, Fang (2005), *Research on Crimes Concerning Letters of Credit and Credit Card*, Peking: Law Press China, 1st ed., pp. 27-65.

[226] Long, Bei (2004).

[227] Wei, Dong & Tang, Lei (2001), *Financial Crime Identification and Investigation*, Peking: People Publishing House, p. 279.

[228] For further discussion, see Sui, Qingjun (2006), pp. 133-134.

[229] Wang, Xiaodong (Ed.) (2006), *Research on Prevention of Modern Financial Crime*, Jinan: Shandong People Press, p. 78.

Furthermore, article 195 can be criticised in that it does not state clearly that the victims are banks and financing institutions.[230] This article is currently under the fifth section of "Financial Fraud" in the Criminal Law. It is argued that stating clearly who the victims are is key in distinguishing between L/C fraud and contract fraud.[231] If a seller defrauds a buyer to open a L/C, and after obtaining the L/C, the seller disappears without providing any contractual goods, then this situation belongs to contract fraud, rather than L/C fraud.[232] We consider that L/C fraud is not suitable to be classified by merely the criterion of "victims". If the victims of L/C fraud are only financial institutions, then the scope of L/C fraud is too narrow.

According to article 195, to constitute the crime of L/C fraud, the law does not require any criteria of sum or seriousness of crime. Therefore, it is a conduct crime: once a person conducts L/C fraud, the crime is committed; it does not matter whether the result of actual harm is caused or not.[233] This point is the same as the Fraud Act in England, in which fraud is considered as a conduct crime.

The criminal punishment of L/C fraud is serious; and provides different levels of punishment based on the amount involved. The lowest level of penalty for L/C fraud is fixed-term imprisonment of not more than five years or criminal detention plus a fine of not less than RMB 20, 000, but not more than RMB 200,000.[234] Furthermore, according to article 199, if the amount involved is especially large, and especially heavy losses are caused to the interests of the State and the people, the person whoever commits L/C fraud shall be sentenced to life imprisonment or death and also to the confiscation of property. It is argued that the upper limit of the penalty, which is the death penalty, is too harsh to be rational.[235] Nevertheless, most academics commonly consider that harsh punishment is necessary for combating financial crimes, including L/C fraud.[236]

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[230] Long, Bei (2004).

[231] For further discussion about the difference between L/C fraud and contract fraud, see Zhao, Bingzhi (Ed.) (2000), pp. 370-374; see also Sui, Qingjun (2006), pp. 135-136; Sui, Dingjie (1999), pp. 7-10; about the difference between civil fraud in contract and contract fraud in criminal law, see Du, Hongguang (2007), 'Distinction between Civil Fraud in Contract and Contract Fraud in Criminal Law', *Legal System and Society*, No. 5, 107.

[232] Long, Bei (2004).

[233] Whether 'comparatively large amount' is a condition for constituting L/C fraud is controversial: some consider that it should be a condition, whereas some think it is a conduct crime; others hold that either opinion is not appropriate, and it should not be a condition as the legislation does not impose such a condition, but the 'amount' should not be totally ignored, according to article 13 of Criminal Law, see Zhao, Bingzhi (Ed.) (2000), p. 364; Nie, Lie (2000), 'Discussion on L/C Fraud', *Law Review (Bimonthly)*, No. 5 (General No. 103), 31, p. 36.

[234] If the amount involved in the fraud is large, or if there are serious circumstances, the punishment is 5-10 years of imprisonment together with a fine of RMB 50,000 – 500,000. If the amount involved is especially large, or if there are especially serious circumstance, the criminal shall be sentenced to a fixed-term of imprisonment of not less than 10 years or life imprisonment together with a fine of RMB 50,000 – 500,000 or confiscation of property, Criminal Law, article 195.

[235] Li, Ziping & Hu, Xiangfu (2005), p. 304.

[236] Zhao, Bingzhi, 'Features of Financial Fraud and Legal Sanctions in China', in Chen, Guangzhong & Predontaine, Dianiel (Eds.) (1999), p. 46-47.

There are a large number of judicial cases with regard to domestic L/C fraud in China[237]; but all the criminals judged by the courts in China are Chinese citizens. In the case of L/C fraud in international transactions, bringing criminals from a foreign country before the courts in China and enforcement of judgments in criminal cases concerning foreigners would definitely face various obstacles and difficulties.[238]

Although the law clearly regulates L/C fraud, the article is criticised for being extraordinarily vague and general.[239] Without certain and specific rules, it is difficult for court judges in China to apply this provision in a consistent manner.

2.4 THEORY OF CRIME PREVENTION OR REDUCTION

It is noted that assessing and managing 'risk' is an important factor that drives contemporary criminal justice policy and practice.[240] The 'risk' in the context of criminal justice concerns the risk of offending and risk of victimisation.[241] Risk-focused prevention, which derives from the medicine and public health field, is an essential perspective concerning the theory of crime prevention or crime reduction.[242] The fundamentals of this approach are not only to discover the important risk factors for crime and to adopt preventive measures to counteract them; but also to identify critical protective elements against crime and to adopt preventive measures to enhance them.[243]

Three distinct but related perspectives on crime causation are recognised: structure, psyche, and circumstance.[244] The perspective of circumstance holds that crime may be reduced by making some changes in social and physical situations.[245] This point is closely connected with the point of 'situational prevention' discussed in the next paragraph.

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[237] Analysis of five typical L/C fraud cases, see Zhang, Geng & Fang, Gong (Ed.) (2005), *Criminal Cases Offences and Defences Analysis: Financial Crime*, Baoding: Chinese Procuration Press, 1st ed., pp. 123-162; analysis of Mou, Qizhong L/C Fraud case, see Qu, Xinjiu (2003), pp. 344-349; analysis of six L/C fraud cases, see He, Xie & Zhang, Xikun (2002), *Financial Crime Cases: Experience and Techniques of Preventing Financial Crime*, Peking: Economic Daily Press, pp. 228-262; utilising the L/C in order to fraudulently obtain a loan from the bank is one typical type of domestic L/C fraud in China, for a case analysis see Kang, Ying, 'Determination of Crime on Utilisation of L/C to Defraud Loan from Bank: Study of Legal Issue in the L/C fraud case of Chen et al'., in Peking Higher Courts (Eds.) (2007), *Economic Crime: New and Difficult Case Judgment Analysis*, Law Press China, 1st ed., pp. 112-118; domestic L/C fraud case list, available at http://edu.lawyee.net/OT_Data/Search_All.asp, accessed 07 Oct., 2007; Huang, Dongsheng (2004), 'Analysis of L/C Fraud Case by Lu', *Xiamen University Law Review*, Vol. 8, December, 172.

[238] Chen, Li (2006), *Theory and Practice of Economic Crime*, Xiamen: Xiamen University Press, 2nd ed., p. 105; see also Zhang, Shuling (2009), 'On Determination and Punishment about Crime of Fraud on L/C', *Legal Science Magazine*, No. 8, 40, p. 42.

[239] Long, Bei (2004), The Determination and Punishment of L/C Fraud, China Foreign-related Commercial Trial, 24 April, available at www.ccmt.org.cn, accessed 18 June, 2009.

[240] Maguire, Mike, 'Crime Statistics: The 'data explosion' and its Implications', in Maguire, Mike & Morgan, Rod & Reiner, Robert (Eds.) (2002), p. 330.

[241] Ibid.

[242] Farrington, David P., 'Developmental Criminology and Risk-Focused Prevention', in Maguire, Mike & Morgan, Rod & Reiner, Robert (Eds.) (2002), p. 657; the term 'crime reduction' has been favoured in recent years, see Pease, Ken, 'Crime Reduction', in Maguire, Mike & Morgan, Rod & Reiner, Robert (2002) (Eds.), p. 948.

[243] Farrington, David P., n. 242 above, p. 660.

[244] Pease, Ken, n. 242 above, pp. 948-949.

[245] Ibid, p. 949.

In general, four main prevention strategies have been identified: developmental prevention, community prevention, situational prevention and criminal justice prevention.[246] In particular we can mention situational prevention, which basically means measures for preventing crime by reducing opportunities and increasing the difficulty of committing crime.[247] Another known classification of crime prevention is to distinguish between primary, secondary, and tertiary prevention.[248]

Attention to crime victims seems to have increased during the last twenty years, and the important role of victims in the criminal justice process through the reporting of crime, furnishing evidence, acting as a witness in court and so forth is nowadays acknowledged.[249] In the field of crime prevention, private sector managers are expected not to conduct business in ways that facilitate crime from the perspective of reducing crime opportunities.[250] However, the placing of responsibility to prevent crime on private sectors can be criticised for reducing the liability of criminals and leading to victim blame.[251]

Theory is one thing, effectiveness is another. It needs to be considered as to whether or not crime prevention and reduction theory is successful. Cost-benefit analysis is an important approach in evaluating crime prevention programmes.[252] However, it must be pointed out that a standard how-to-do-it manual is still awaiting development to be used in all studies for measuring costs and benefits.[253]

In Chapter 5, we will further examine in detail 'situational prevention' and in particular consider the specific issue of L/C fraud from the perspective of potential victims. However, it is hard for us to answer questions about whether or not it is better to invest in some specific risk-focused early preventive methods by measuring their costs and benefits. We consider this as being significant to the general business enterprises who are involved in L/C transactions.

2.5 LEGAL ASSISTANCE IN CROSS-BORDER CRIMINAL CASES

Clearly, each country intends to combat L/C fraud in international transactions through its laws and enforcement of laws. Unfortunately, crime control, until now, has mainly remained at the national level. Generally, there are various problems when an international crime is concerned: territorial competence, investigation

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[246] Farrington, David P., n. 242 above, pp. 657-658.
[247] Ibid, p. 658.
[248] Pease, Ken, n. 242 above, p. 950.
[249] Zedner, Lucia, 'Victims', in Maguire, Mike & Morgan, Rod & Reiner, Robert (Eds.) (2002), p. 419 and p. 435.
[250] Pease, Ken, n. 242 above, p. 970.
[251] Ibid, p. 972.
[252] Farrington, David P., n. 242 above, p. 662.
[253] Ibid, p. 663.

and prosecution of the crime[254], extradition[255], exchange of documents for trial, recognition of foreign penal judgments[256], and so forth.[257] It is indeed a gloomy phenomenon that international fraud goes through borders, while bureaucratic delays and obstacles obstruct cooperation between national authorities.

The increase of international crime[258] has enhanced the willingness of States to develop co-operation concerning criminal matters through various forms of assistance mechanisms. Such cooperation will enhance the probability or certainty of arrest and sanction of criminals, which is argued to be a great determinant in crime reduction[259].

Bilateral or multilateral treaties have been a popular mutual assistance mechanism.[260] Some mutual legal assistance arrangements in criminal matters

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[254] For further discussion see Jiang, Lihua & Chen, Mingxin & Chen, Guozhen (2003), 'Discussion on Investigation of International Crime', *Journal of Shandong Public Security College*, No.1 (Ser. No. 67), Jan., 39; Shen, Huizhang (200), 'Discussion on Developing Cooperation of International Police Management in New Fields', *Journal of Xinjiang Police Officers' Academy*, No. 3 (Ser. No. 95), Jul., 17; Min, Jian (2005), 'Study on Present Pattern of International Police Affairs Cooperation', *Journal of Shanghai Public Security Academy*, Vol. 15, No. 1, Feb., 93.

[255] Extradition is the formal process whereby an offender is surrendered to the State in which an offence was allegedly committed so as to stand trial or serve a sentence of imprisonment; the process of extradition is based on reciprocity, comity and respect for differences in other jurisdictions and intends to further international co-operation in criminal justice matters, see Bantekas, Ilias & Nash, Susan (2003), *International Criminal Law*, London & Sydney: Cavendish Publishing Limited, 2nd ed., p. 179; for further discussion on extradition, see pp. 179-204; extradition is considered as a significant measure to combat cross-border financial crime, but is restricted by the diversity of penalty under criminal law in different countries, see Sun, Dingjie (1999), pp. 25-27; about discussion on extradition system and procedure in China, see e.g. Xu, Wenjie & Zhu, Shaochun (2006), 'Ananlysis on the Reform of Modern Extradition System from the Case of Yu Zhendong', *Journal of Shanghai Police College*, Vol. 16, No. 2, April, 78.

[256] For further discussion, see Cheng, Liangwen (2003), *Researches on Criminal Judicial Assistance*, Peking: Law Press China, 1st ed., pp. 130-144; it is suggested that the procedure of recognition and enforcement of foreign judgments should be added in the Criminal Procedure Act in China, see Huang, Feng (2007), 'Adding Recognition and Enforcement of Foreign Judgments to the Criminal Procedure Act', *Modern Law Science*, Vol. 29, No. 2, Mar, 135.

[257] Leigh, L. H. (1982), *The Control of Commercial Fraud*, London: Heinemann Educational Books Ltd, 1st ed., p. 279; see also Bequai, August (1978), *White-collar Crime: A 20th–century Crisis*, Lexington, Massachusetts & Toronto: D. C. Heath and Company, Chapters 15-19; Cheng, Rongbin (1999), 'Globalisation of Economy and Criminal Judicial Assistance', *China Law*, No. 4, 138; Li, Ying (2005), 'Economic Globalisation and the Countermeasure of International Crimes', *Journal of Political Science and Law*, Vol. 22, No. 6, Dec., 59; Cheng, Liangwen (2002), 'Development on International Criminal Judicial Assistance', *Journal of Public Security*, No. 2 (General No. 88), 84.

[258] For further discussion about the globalisation and cross-border crime and translational crime control, see Loader, Ian & Sparks, Richard, 'Contemporary Landscapes of Crime, Order and Control: Governance, Risk, and Globalization', in Maguire, Mike & Morgan, Rod & Reiner, Robert (Eds.) (2002), pp. 95-101.

[259] Hedderman, Carol & Hough, Mike, 'Chapter 4 Diversion from Prosecution at Court and Effective Sentencing', in Perry, Amanda E. & McDougall, Cynthia & Farrington, David P. (Eds.) (2006), *Reducing Crime: The Effectiveness of Criminal Justice Interventions*, West Sussex: John Wiley & Sons Ltd, p. 54; see also Vold, George B. & Bernard, Thomas J. & Snipes, Jeffrey B. (2002), p. 208.

[260] Bantekas, Ilias & Nash, Susan (2003), p. 227; for further discussion on the content and range of legal assistance, see Cheng, Rongbin, 'Strengthening Mutual Legal Assistance to Prevent and Control Financial Crimes', in Chen, Guangzhong & Predontaine, Dianiel (Eds.) (1999), pp. 709-712; until 30 May 2005, with regard to criminal judicial assistance, China has concluded bilateral treaties with 26 countries, and with regard extradition, with 19 countries, see Table on Dates of Signing and Effective Dates of Bilateral Judicial Assistance Treaties, Ministry of Foreign Affairs of P.R.C., available at www.fmprc.gove.cn/eng/wjb/zzig/tyfls/tyfl/2631/t39537.htm, accessed 15 Sep., 2009.

are developed to some extent, based on bilateral agreement between States.[261] The EU region seems to have a good record concerning legal assistance over criminal matters. The European Judicial Network was established in 1998; in this Network, there are representatives of national judicial and prosecution authorities who are designated by their governments as contact points for the exchange of information, working on international judicial cooperation.[262]. Eurojust consists of prosecutors and judges from each Member State and they are responsible for assisting national authorities in investing and prosecuting serious cross-border criminal cases.[263] It coordinates the activities of national authorities taking care of a particular case and facilitates collection of evidence under the EU and other international mutual legal assistance agreements.[264] Similarly, the European Police Agency (Europol) facilitates the cooperation of police within Member States of the EU.[265] Furthermore, the Convention on Mutual Assistance in Criminal Matters in 2000 represents the instrument covering policing rules and further develops mutual legal assistance in Europe.[266] Finally, to enhance European criminal investigations, prosecutions, extradition procedures and judicial cooperation, the framework decision on the European Arrest Warrant (EAW) took effect in 2004.[267]

However, mutual legal assistance in the EU in the real world is not without problems, and it was criticised as being time consuming and inefficient, because the mutual relations of the various European criminal agencies, bodies, and institutions are governed only by soft law.[268] Thus, establishing stronger horizontal

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[261] For discussion about the development and issues of criminal judicial assistance between the UK and other States, see Bantekas, Ilias & Nash, Susan (2003), pp. 240-242; between China and other States, see Cheng, Liangwen (2003), pp. 145-248; see also Ma, Jinbao (2002), *Research on Cross-border Crime*, Peking: People Press, pp. 399-405; about the issue in China, see Ji, Minli (2005), 'Exploration on Legal Problems of Punishing Fleeing Criminals: From the Perspective of International Criminal Legal Assistance', *Journal of Chinese People's Public Security University*, No. 6 (Sum 118), 102.

[262] European Commission, Judicial Network, 'The ECJ: Organised EU Judiciary against Organised Crime', available at http://ec.europa.eu/justice_home/fsj/criminal/network/fsj_criminal_network_en.htm, accessed 10 Dec., 2009.

[263] European Commission, Freedom, Security and Justice, Eurojust, 'Eurojust Coordinating Cross-border Prosecutions at EU Level', available at http://ec.europa.eu/justice_home/fsj/criminal/eurojust/fsj_criminal_eurojust_en.htm, accessed 10 Dec., 2009; for detailed discussion on Eurojust and Europol, see Fletcher, Maria & Lööf, Robin & Gilmore, Bill (2008), *EU Criminal Law and Justice*, Northampton, MA: Edward Elgar, pp. 65-80.

[264] Kennedy, Anthony (2007), 'Winning the Information Wars: Collecting, Sharing and Analysing Information in Asset Recovery Investigations', *J.F.C.*, 14 (4), 372-404.

[265] It was established under the third Pillar by the 1995 Europol Convention and became operational in 1999; for further discussion on police cooperation in criminal matters, see Fletcher, Maria & Lööf, Robin & Gilmore, Bill (2008), pp. 87-100.

[266] The Convention on Mutual Assistance in Criminal Matters between the Member States of the European Union, 2000/C 197/01, 12 July 2000, Official Journal of the European Communities; see also European Commission, Freedom, Security and Justice, 'Mutual Legal Assistance in Criminal Matters Introduced at European Union Level', available at http://ec.europa.eu/justice_home/fsj/criminal/assistance/fsj_criminal_assistance_en.htm, accessed 10 Dec., 2009.

[267] Sievers, Julia, 'Too Different to Trust? First Experiences with the Application of the European Arrest Warrant', in Guild, Elspeth & Geyer, Florian (2008), *Security Versus Justice? Police and Judicial Cooperation in the European Union*, Cronwall: Ashgate Publishing Limited, pp. 108-109; for further discussion on EAW and judicial cooperation in criminal matters, see Fletcher, Maria & Lööf, Robin & Gilmore, Bill (2008), pp. 103-141.

[268] Vlastník, Jiří, 'Eurojust – A Cornerstone of the Federal Criminal Jusitice System in the EU', in Guild, Elspeth & Geyer, Florian (2008), p. 47.

and vertical inter-institutional links is said to be an important task in the near future.[269]

The development of mutual legal assistance does not seem to be promising at the international level. It is acknowledged that there is no international police competence. The establishment of the International Criminal Police Commission (ICPC) (also known as Interpol)[270] to some extent facilitates co-operation between national law enforcement bodies, but it was criticised for its inefficiency on the exchange of information and doubt was placed on its ability to tackle the increasing level of organised crime.[271] The UN has developed a Model Treaty on Mutual Legal Assistance, which has a simple framework and guides States in developing their bilateral or multilateral agreements.[272] Nevertheless, no international agreement or convention concerning legal assistance in criminal matters has been agreed upon. L/C fraud in international trade has caused the victims huge losses every year, but the fraudsters could be safe enough with large amounts of fraudulent money by just making themselves disappear. It is indeed depressing that the limitations of jurisdiction seem to favour criminals.

Thus it is necessary for some organisations, such as the UN, to actively consider the issue of concluding international agreements to make prosecution efficient, reduce juridical barriers in different countries and facilitate cooperation between nations.[273] According to economic analysis, criminals would normally compare their illegal gains from criminal activities with their estimated costs, including the possibility of detection and being caught, and expected punishment.[274] Thus, the increasing possibilities of being caught resulting from cooperative efforts on jurisdiction of crime between nations would to some extent deter criminals from engaging in such fraudulent activities in L/C in international trade.

It was further recommended that the international cooperation should go beyond the negotiation of treaties and conventions, and should be developed at different levels: the governments should establish routes for reciprocal assistance; law enforcement agencies, security departments of the banking and financial industries, forensic accounting firms, and law firms should develop their networks to combat fraud.[275]

In spite of the serious difficulties in combating international L/C fraud in national criminal law enforcement, some organisations in the area of international trade have made their own efforts to combat commercial crimes. Currently,

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[269] Ibid.

[270] It is an intergovernmental, but non-political, independent policing organisation; and it is independent from other international bodies, such as the UN or the Council of Europe, official website: http://www.interpol.int/.

[271] Bantekas, Ilias & Nash, Susan (2003), pp. 269-270.

[272] UN Model Treaty on Mutual Assistance in Criminal Matters, A/RES/45/117, 68th Plenary Meeting, 14 December 1990, available at http://www.un.org/documents/ga/res/45/a45r117.htm, accessed 18 July, 2010.

[273] Zhang, Hengli (2001), 'Theory of International Fraud Control', *Politics and Law*, Vol. 1, 28, p. 29.

[274] Sjögren, Hans & Skogh, Göran (2004), *New Perspectives on Economic Crime*, Cheltenham: Edward Elgar, p. 4; study on economic analysis of crime, see e.g. Hellman, Daryl A. & Alper, Neil O.(2000), *Economics of Crime: Theory and Practice*, Boston: Pearson Custom Publishing, 5th ed.

[275] Yang, Vincent C., 'International Cooperation in Combating Fraud: Beyond the Treaties and Conventions' in Chen, Guangzhong & Predontaine, Dianiel (Eds.) (1999), pp. 735 -736.

Commercial Crime Services (CCS), the anti-crime arm of the ICC, set its purpose as combating different kinds of commercial crimes; being a membership organisation, it provides services to commercial parties and banks.[276] It can provide a member with the necessary information and resources to discover and prevent fraud, carry out investigations where there is evidence or suspicion of fraud, and help victims of fraud to recover their losses.[277] Therefore, where suspicion of fraud in L/C transactions occurs, a bank can always send suspicious documents to the CCS to check their authenticity. It can be seen that the increased possibility of authentication of sender, transmission, and of the contents of transmitted data (e.g. checking Lloyd's Directory concerning the registry of a named vessel and its location on a certain date) provides a significant instrument to combat fraud.[278] The Commercial Crime Bureau operates a database which offers useful information from different sources all over the world.

In addition, Fraudnet, initiated by CCS, was established in 2004. Fraudnet specifically purports to operate a leading network of law firms specialising in white collar crime, and one of its important tasks is to provide effective and straightforward solutions to victims in fraud cases.[279] Thus, it can be seen that the ICC has actively made efforts on dealing with fraud in international trade.

2.6 SUMMARY

One remedy against L/C fraud in international transactions is rendered by criminal law in national jurisdictions. Generally, England belongs to a common law system and China belongs to a continental law system. In England, there are no specific rules concerning L/C fraud, and possible relevant rules have to be found through the Forgery and Counterfeiting Act 1981, Fraud Act 2006 and possibly also the precedents in court cases. In China, the crime of L/C fraud is particularly regulated in the Criminal Law 1997. From the previous discussion, some similar points concerning the rules on L/C fraud in England and China can be identified. Firstly, under both criminal law regimes, L/C fraud can be considered a conduct crime. Secondly, either the unspecific rules over L/C fraud in England or vague provision of the crime of L/C fraud in China can lead to the difficulty of applying the law in a consistent manner. But the possible punishment for L/C fraud criminals under Chinese criminal law generally seems more severe than that under English law.

However, the remedy under national criminal laws is extremely weakened by the limitations of one jurisdiction dealing with cross-border crime. The limited enforcement in an open world has always been a significant barrier in the

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[276] ICC Commercial Crime Services, 'Commercial Crime Services: At the Forefront of the Fight against Fraud', available at http://www.icc-ccs.org/general/oveerview.php, accessed 28 Feb., 2007.
[277] Ibid.
[278] Barnes, James G. & Byrne, James E. (2001a), p. 27.
[279] ICC Commercial Crime Services, 'Fraudnet', available at http://www.icc-ccs.org.uk/, accessed 28 Feb., 2007.

fight against international fraud in L/C transactions. Mutual legal assistance over criminal matters between two countries is a traditional way of cooperation of different jurisdictions over cross-border crimes. Nowadays, such legal assistance over a large region such as the EU also becomes possible. However, there are no international conventions regarding such legal assistance or detection and prosecution of international maritime crimes. We propose that the UN can play an active role in establishing such international conventions.

Furthermore, we stress that commercial parties usually concern economic interests deriving from international trade; in case of L/C fraud in international transactions, commercial parties are concerned with how to avoid or recover financial losses. In England, a victim is obliged to report a crime, and the involvement of criminal authorities may in effect frustrate a victim's attempts to recover assets or losses.[280] Similarly, in China, where the criminal proceedings are initiated, the civil proceedings related to the criminal case are to be suspended. This may lead to the similar frustrating result concerning the victims' attempts.

Accordingly, we understand that the approach of the criminal law regime may not provide an effective remedy for the victims in L/C fraud in international commercial transactions through public prosecution. If it is so, the civil legal remedy, which is to prohibit L/C payment by a court order, such as an injunction or stop-payment order in private legal disputes, is worthwhile considering. This is the issue that we are going to examine in the next chapter.

[280] For a discussion of the reasons for such a situation, see Dutton, Antony & & Bodden, Michael & Bruton, Ben (2007), 'Multi-jurisdictional Enforcement: Chasing those Assets', PLC, October, available at www.practicallaw.com/0-376-2181, accessed 16 April 2009.

3 L/C Fraud Remedy Under Civil Law Framework

3.1 INTRODUCTION

Disputes are inevitable in many international commercial transactions and disputes on payment are a major area of international commercial disputes. Where the L/C is the payment instrument in international commercial transactions, refusing payment as an excuse or justification for fraud is a common type of L/C dispute. Resolving international L/C fraud disputes in civil litigation according to the legal process is a frequently exercised method due to the complex features of such disputes. Dealing with L/C fraud under civil litigation in national courts is to a large extent about examining whether or not the alleged fraud can be established so as to apply fraud as an exception to the L/C independence principle. In this chapter we will discuss the substantial rules concerning the L/C fraud exception and procedural instruments (such as injunction) utilised in civil proceedings; because procedural mechanics cannot be totally separate from the specific substantial dispute. However, the weight of discussion will be placed more on the substantial rules than on procedural instruments.

From a theoretical point of view, many legal problems are the same wherever they occur.[281] However, the solutions to the same legal problem may be different in each country, and very often the solutions are not perfect. Where a legal problem has an international character, the need to examine different approaches in different countries is inevitable.

This chapter will examine different approaches towards the problem of L/C fraud under the civil litigation regime both at the international and national level, as the formal mechanics of international litigation are coupled with multiple sources, including national and international rules. At the international level the approaches of both the UCP and the Convention on Independent Guarantees and Standby Letters of Credit (UNCITRAL Convention)[282] will be analysed.

At the national level, the approaches of the US, England and China will be studied. The American L/C fraud exception rules are influential and will be examined for two main reasons. Firstly, L/C fraud exception rules were first created in judicial practice in the US; and such rules in England were derived from a US case. Secondly, the US' Uniform Commercial Code (UCC) article 5 includes the

[281] Gordley, James (1995), p. 560.
[282] United Nations Convention on Independent Guarantees and Standby Letters of Credit, adopted on 11 December 1995, entered into force on 1 Jan. 2000.

provisions on the L/C fraud exception rules. Having such particular provisions is not only significant for dealing with the L/C fraud problem in the US, but also it is valuable for other countries which need to develop provisions for tackling such a problem. However, we will limit the study of the L/C fraud exception rules by only looking at article 5 of the UCC briefly. Furthermore, a case law study in the US will not be conducted as we are not using the US as part of the comparative research.

England and China are the main countries that we have selected for the purposes of our comparative study. England is a developed country with rich experience in maritime disputes; it is necessary to look at how it developed its rules concerning such issues. The English case law concerning the L/C has shown rigid attitudes from the courts towards the autonomy principle and the strict compliance doctrine of the L/C. As England is a case law country, the approach toward the L/C fraud issue under the civil law regime is reflected in the way the courts in England have dealt with L/C fraud dispute cases. The courts have developed very delicate L/C fraud exception rules.

China plays an increasingly important role in international trade. The large scale use of the L/C and the vast number of L/C fraud cases makes it necessary to develop the rules over L/C and L/C fraud exception rules in China. China is mainly a code law country, thus examining particular rules over L/C fraud is a major part of the study about rules in China. In order to discover the process of developing L/C fraud exception rules in China, typical court cases are examined.

When the L/C fraud exception rules in China are discussed, we will employ the idea of legal transplant. The term legal transplant describes the phenomenon of reception of laws by a foreign legal system. It is claimed that the development of Chinese law to a large extent is a process of legal transplantation.[283] We will briefly touch on the theory of legal transplant below.

Legal transplant is undeniably a contentious subject. Foster has categorised modern academic literature on legal transplant into two main fields: the debate between 'culturalists' and 'transferists' and attempts to move forward from such a debate.[284] On the one hand, we have a group of scholars represented especially by Watson. They consider that legal transplants are 'the moving of a rule or a system of law from one country to another'' and legal rules can be borrowed successfully where the receipt's social, economic, geographical and political circumstances are different from the donor's.[285] Legal transplants refer to the often so-called

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[283] Chen, Jianfu (2007), 'Modernisation, Westernisation, and Globalisation: Legal Transplant in China', 37 (Pt II) *Hong Kong Law Journal*; also one chapter in Oliveira, J.C. and Cardinal, P. (eds.), *One Country, Two Systems, Three Legal Orders –Perspectives of Evolution*, Springer-Verlag Berlin Heidelberg, 2009, p. 91; for an examination of examples of Chinese legislation concerning legal transplant, see Seidman, Ann & Seidman, Robert B. (1996), 'Drafting Legislation for Development: Lessons from a Chinese Project', 44 *Am. J. Comp. L.* 1; see also Zhu, Ni (2005), 'A Case Study of Legal Transplant: The Possibility of Efficient Breach in China', 36 *Georgetown Journal of International Law* 1145.

[284] Foster, Nicholas, 'Chapter 4: Transmigration and Transferability of Commercial Law in a Globalized World', in Harding, Andrew & Örücü, Esin (Eds.) (2002), p. 59.

[285] Watson, Alan (1974), *Legal Transplants – An Approach to Comparative Law*, Edinburgh: Scottish Academic Press, 1st ed., p. 21.

borrowing or assimilation from other countries' or regions' laws in China.[286] It is noticeable that a legal system can benefit from adoption of rules created by foreign legal systems. Practical utility explains much of legal transplants, and it seems simply efficient to borrow rules from other legal systems from an economic point of view.[287] In addition, Watson justified legal borrowing by considering the need for authority within one's own legal system.[288]

Furthermore, Alan Watson argues that there are three main categories concerning voluntary major transplants, one of which is that a country voluntarily accepts a part of the system of another country or countries.[289] However, legal receptions and transplants may come in various forms from the wholesale adoption of entire systems of law to the introduction of a single rule of a foreign country, and on most occasions, different methods can be mixed together. Nowadays, laws converging regionally or globally are not rare circumstances.[290] This is not merely adoption or pure imitation, but is to communicate and effectively converge between different legal systems. However, this does not mean building exactly the same laws, but instead means establishing a kind of harmonisation of laws. International Conventions and International treaties are good illustrations of such kinds of legal transplants.[291]

However, the idea of legal transplantation has encountered criticism from some scholars, who are represented by Legrand[292] and Seidmans. The principal idea is that law is culturally determined and cannot be transplanted. The Seidmans have even argued that law is non-transferable.[293] A typical argument can also be seen from Professor O. Kahn Freund's lecture "On Uses and Misuses of Comparative Law" delivered in 1973. The obstacles of legal transplantation in elements of environmental, social, economic, and cultural aspects were pointed out and discussed.[294] Such external factors cannot be successfully transplanted to a different legal system without changing their content. Furthermore, the effect of political elements was analysed as a changing impediment to legal transplants alongside societal development.[295] One of his crucial conclusions is that the belief

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[286] Shen, Zongling (1995), 'Legal Transplants and Comparative Law', *Journal of Foreign Law Translation and Evaluation*, No. 1, p. 5, available at http://article.chinalawinfo.com/article/user/article_display.asp?ArticleID=27280, assessed 27 Feb., 2008.
[287] See, Mattei, Ugo (1994), 'Efficiency in Legal Transplants: An Essay in Comparative Law and Economics', 14 *Int'l Rev. L. & Econ.* 3; however, Alan Watson also points out other possible reasons for transplantation, such as chance, difficulty of clear sight, and the need for authority, see Watson, Alan (1996), 'Aspects of Reception of Law', 44 *Am. J. Comp. L.* 335.
[288] Watson, Alan, 'Legal Culture v. Legal Tradition', in Van Hoecke, Mark (Ed.) (2004), *Epistemology and Methodology of Comparative Law*, Oxford and Portland Oregon: Hart Publishing, p. 3.
[289] Watson, Alan (1974), pp. 29-30.
[290] For a strategic explanation for convergence of legal rules, see Garoupa, Nuno & Ogus, Anthony (2006), 'A Strategic Interpretation of Legal Transplants', 35 *Journal of Legal Studies* 339, June.
[291] De Cruz, Peter (1995), pp. 485-489.
[292] See Legrand, Pierre (1996), 'European Legal Systems are not Converging', 45 *International and Comparative Law Quarterly* 52; Legand, Pierre (1997), 'The Impossibility of 'legal Transplants'', 4 *Maastricht Journal of European and Comparative Law* 111.
[293] See Seidman, A. & Seidman, R. B. (1994), *State and Law in the Development Process: Problem Solving and Institutional Change in the Third World*, Macmillan: Basingstoke, pp. 44-46.
[294] Kahn-Freund, O. (1974), 'On Uses and Misuses of Comparative Law', *Modern Law Review*, Vol. 37, No. 1, January, pp. 6-10.
[295] Kahn-Freund, O. (1974), pp. 11-13.

that rules or institutions are transplantable cannot be taken for granted and the use of comparative method involves knowledge of both the foreign law and its social context.[296]

Teubner pointed out that different fields of law are linked to 'social processes' to different extents and the degree of such connection may determine the degree of success of a transplant.[297] Foster has discussed the significance of academic debates to commercial law transplants, which indicates that if legal rules are transferable, or if commercial law is culture-neutral, transplanting commercial law should not be a problem; but if commercial law is culture-specific, transplanting is not possible; or the possibility depends on how strongly commercial law is linked to social processes.[298]

Regardless of where a legal problem occurs, a solution has to be worked out. Sometimes a legal problem is indeed so complex that it is difficult to find a clear and definitive solution. However, where a serious legal problem arises, a drafter or a judge has to tackle the problem, even if inadequately. When one jurisdiction confronts the same legal problem as other jurisdictions, it is useful to look at the different norms in other countries, although reconciling these diverse norms to solutions is not an easy task.[299]

We agree that certain external factors can strongly influence the effect of transplanted legal rules of a particular country. However, we do not think that such influences can conclusively render legal transplantation totally impossible. It is nowadays used as a strategy for a developing country like China to model its laws after rules adopted in other countries; although such a strategy requires a very thorough analysis of the relevant factors concerning certain legal rules both in the donor country and the recipient country.

To find out whether L/C fraud exception rules are transferable and in what way the transplantation from other countries or other systems to China has taken warrants further analysis. Thus, not only are these rules examined from a comparative perspective, but also the background of the L/C fraud problem and the process of how such rules are developed is discussed. The judgments of some court cases dealing with L/C fraud disputes are discussed. But the purpose of studying court cases is not to look at how precedents develop L/C fraud exception rules; but to find out the problems and difficulties of handling L/C fraud disputes where no particular rules over the L/C fraud issue were available, and to identify the right approach towards L/C fraud exception rules. It is those problems that prompted the need to formulate new provisions; and it is those right approaches in court judgments that formed part of the new provisions.

The similarity of such rules in the UN Convention, the US and China will be pointed out when the new provisions over L/C exception rules brought in to effect in China in 2006 are examined. The result of such comparison in a way

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[296] Kahn-Freund, O. (1974), p. 27.
[297] Teubner, Gunther (1998), 'Legal Irritants: Good Faith in British Law or How Unifying Law Ends up in New Divergences', 61 *Modern Law Review* 11.
[298] Foster, Nicholas, Chapter 4, in Harding, Andrew & Örücü, Esin (Eds.) (2002), n. 55 above, p. 60.
[299] Gordley, James (1995), p. 556.

demonstrates how L/C fraud exception rules travelled from other legal systems and mechanisms to China. The L/C fraud exception rules in China will also be evaluated from the perspective of discussing the effect of the legal transplant. Comparative analysis between the English courts' approach and the Chinese approach towards L/C fraud exception rules will be made at the end of this chapter.

3.2 APPROACHES TO L/C FRAUD EXCEPTION RULES AT THE INTERNATIONAL LEVEL

3.2.1 The UCP Approach

The widely used UCP does not touch upon the fraud problem and leaving the issue to national laws is the ICC's persistent attitude.[300] In fact, the UCP does not contain any articles concerning fraud or fraudulent documents. The explanation given by the ICC is that it is not the role of the UCP to regulate the fraud issue as the scope of exceptions (namely abuse of right or fraud) can be different in many jurisdictions and the national law and national courts should protect the interests of the trading parties who are in good faith.[301] In addition, as Goode observed, "the content and the explanation of ICC uniform rules are influenced by the fact that these uniform rules are rules of best banking practice, not rules of law…" and the fraud issue is regarded as "the province of the applicable law and of the courts of the forum".[302] Thus, it is the national laws which should tackle any injunctive relief on the basis of fraud. To put this in another way, ICC drafters have intentionally excluded the fraud issue in the UCP[303], in spite of the fact that they undoubtedly recognise this fraud issue[304].

According to Leacock, the approach of the UCP could be called an "unqualified liability" approach, since the UCP adopts the independence principle.[305] The

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[300] The ICC has clearly expressed its attitude on fraud rules and court injunctions by basically saying that the Commission could not give an opinion on such questions, for example, see ICC, edited by Bernard Wheble (1987), *Opinions of the ICC Banking Commission – On Queries relating to Uniform Customs and Practice for Documentary Credits 1984-1986*, ICC Publishing S.A., ICC Publication No. 434, p. 23; see also Kurkela, Matti (1985), *Letters of Credit Under International Trade Law: UCC, UCP and Law Merchant*, New York, London & Rome: Oceana Publications. Inc., pp. 31-32; a summary of 'Trade Finance methods and instruments: Legal issues and Conventions', which is based on an ITC publication entitled *Trade Finance: A Legal Guide for Cross-Border Transactions* (ITC, 2003) (www.intracen.org/tfs), pp. 25-36, p. 25, available at http://www.unescap.org/tid/publication/tipub2374_chap2.pdf, accessed 16 December, 2006; the latest UCP 600 does not include any fraud rule either, see e.g. Collyer, Gary, Presentation in Seminar 'UCP 600: Understanding the New Documentary Credits Rules', organized by ICC Finland, Helsinki, 21 March, 2007.

[301] ICC, *Opinions of the ICC Banking Commission 1995-1996*, ICC Publication No. 565, p. 22; see also 'Query: Rights of Recourse to the Beneficiary in the event of Fraud, in 'Latest Queries Answered by the ICC Banking Commission'', *DCI (ICC)*, Spring 1997, Vol. 3, No. 2, p. 7.

[302] Goode, Roy (1995), 'Abstract Payment Undertakings and the Rules of the International Chamber of Commerce', 39 *Saint Louis University Law Journal* 725, p. 727.

[303] Barski, Katherine A. (1996), 'Letters of Credit: A Comparison of Article 5 of the Uniform Commercial Code and the Uniform Customs and Practice for Documentary Credits', 41 *Loy. L. Rev.* 735, p. 751.

[304] Dolan, John F. (1993), 'Commentary on Legislative Developments in Letter of Credit Law: An Interim Report', 8 *Banking & Fin. L. Rev.* 53, p. 63; see also Dun, Yimin (2005), 'L/C Fraud Exception Principle', *Market Modernisation*, Oct. (2nd Issue) (Serial No. 446), 87, p. 88.

[305] Leacock, Stephen J. (1984), p. 912.

paying bank may make payment to the beneficiary without liability, when conforming documents are submitted, although the bank receives notice of alleged fraud from the buyer.[306] The reason is that the UCP clearly states that the bank deals with documents, not goods[307]. From another point of view, if the bank does not honour the payment, it will bring about the bank's liability to the seller, since the bank's responsibility is limited to examining the compliance of the presented documents at their face value. Moreover, the UCP does not offer any judicial injunction of payment for remedy.

The approach of the UCP to the fraud issue has been considered as a remarkable success by some scholars; and the point has been made that it is pointless to make any attempts to devise a uniform rule on the fraud issue, because the rule of fraud is to a great extent sensitive to various local laws.[308] They uphold the point that the UCP can encourage different jurisdictions to approaching the L/C fraud problem without hampering the marketability of documentary credits.[309]

However, such views are not without criticism. It is widely acknowledged that a good commercial law shall be able to facilitate commerce and provide certainty and predictability for the commercial community. However, nowadays the approaches to L/C fraud issue in different countries are various and vague. Thus, the UCP is to some extent unsatisfactory in this respect, as it creates uncertainty and unpredictability without providing any guidance to the important fraud problem.[310] The various approaches to the L/C fraud problem in different jurisdictions could be improved through uniform rules.[311] Even further, a transnational law on L/C was recommended so as to provide universally agreed solutions to L/C issues, including the fraud issue.[312] However, Rowe recognised a particular difficulty concerning the length of time that ratification may take by the way of intergovernmental legislation.[313] It is argued that either customary rules (UCP) or transnational law have to be updated to reflect the constant change of international trade.[314] In brief, the UCP intentionally excludes the issue of L/C fraud and leaves it to national laws. Such an approach may enhance the marketability of L/C internationally; but at the same time leads to uncertainty and unpredictability for the business community.

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[306] Ibid, p. 913.
[307] UCP 600, article 5.
[308] See e.g. Dolan, John F. (1993), p. 63.
[309] Ibid.
[310] Buckley, Ross P. & Gao, Xiang (2002), 'The Development of the Fraud Rule Letter of Credit Law: The Journey So Far and the Road Ahead', 23 *University of Pennsylvania Journal of International Economic Law* 663 (Winter), p. 701.
[311] See e.g. Kuo-Ellen, Lin S. (2002b), 'UCP Needs to Change', *Journal of Money Laundering Contro*l, Vol. 5, No. 3, p. 231; see also Zhang, Bian (2004), 'Improvement on Legislation on L/C Fraud', *Journal of East China Jiaotong University*, Vol. 21, No. 3, Jun., 112, pp. 114-115.
[312] Rowe, Miachel (1998), 'Do We Need a Transnational Law on Documentary Credits? Michael Rowe & Bernard Wheble Debate', *DCI (ICC)*, Spring, Vol. 4, No. 2, pp. 16-17.
[313] Ibid.
[314] Ibid, p. 18.

3.2.2 The UNCITRAL Convention Approach

The UNCITRAL Convention is intended to facilitate the use of independent guarantees and stand-by letters of credit. This Convention is the first document which presents details of the fraud rule in letter of credit transactions at an international level. Although this Convention limits its scope to independent undertakings, such as standbys and demand guarantees, it can also apply to international documentary credits.[315] This Convention takes effect between Contracting States,[316] and contains several articles dealing with the fraud issue and prevention of fraudulent or unjustified calling of standby letters of credit or independent guarantees. The UCP does not include such rules; and thus the Convention provides positive support to the UCP.[317] Three articles in this Convention concerns the fraud rule.

Article 15 of the Convention provides a requirement in a general way for a beneficiary demanding payment under a L/C or independent guarantee. Article 15(3) states that "[t]he beneficiary, when demanding payment, is deemed to certify that the demand is not in bad faith and that none of the elements referred to in subparagraphs (a), (b) and (c) of paragraph 1 of article 19 are present."[318] In other words, if the factors listed in Article 19 occur, payment under a documentary credit or independent guarantee is possible to prevent.

Article 19 – "Exception to Payment Obligation", offers a list of the circumstances under which the issuer might refuse payment demanded by the beneficiary.[319] Article 19, paragraph (1) presents that "the guarantor/issuer, acting in good faith, has a right, as against the beneficiary, to withhold payment" under three specified circumstances. These circumstances are that: "any document is not genuine or has been falsified; no payment is due on the basis asserted in the demand and the supporting documents; or Judging by the type and purpose of the undertaking, the demand has no conceivable basis", but an essential of the situations ought

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[315] UNCITRAL Convention , articles 19 and 20; for the impact of the adoption of the Convention on URDG (ICC Uniform Rulesfor Demand Guarantees), see Fayers, Roger (1996), 'UNCITRAL Update', *DCI (ICC)*, Spring, Vol. 2, No. 2, p. 23.

[316] UNCITRAL Convention, article 26.

[317] Goode, Roy (2004), *Transnational Commercial Law - International Instruments and Commentary*, Oxford: Oxford University Press, 1st ed., p. 341; furthermore, in 1999 the ICC endorsed this Convention on the unanimous consent of its Commission on Banking Technique and Practice, because it considers that this convention assures the independent feature of these undertakings and establishes a uniform international legal standard concerning the exception for fraudulent or abusive drawings, and the Convention can contribute to international standards where ICC rules are not effective, see Policy statement 'ICC Endorsement of the UNCITRAL Convention on Independent Guarantees and Stand-by Letters of Credit', Commission on Banking Technique and Practice, 21 June, 1999, available at http://www.iccwbo.org/id420/index.html, accessed 25 Jan., 2007.

[318] UNCITRAL Convention, article 15, para. 3; it is argued that article 15 (3) is a statutory warranty and has the same function as the American term 'warrants', for further explanation and comparison of this point between the UCC and the UNCITRAL Convention and the ambiguities of article 15 (3), see Turner, Paul (1998), Expert Commentary 'Paul Turner Makes Some Points on Warranties, Fraud and the UN Convention', *DCI (ICC)*, Winter, Vol. 4, No. 1., p. 17; for the connection between English law and article 15 (3), see 'Roger Fayers Responds to Paul Turner on Article 15 (3) of the UNCITRAL Convention', *DCI (ICC)*, Spring 1998, Vol. 4, No. 2, pp. 19-20.

[319] Comparison between English law and UNCITRAL Convention article 19, see 'Roger Fayers Takes Issue with Charles Debattista on Questions on Questions of Autonomy and Fraud under UNCITRAL Convention', *DCI (ICC)*, Spring 1997, Vol. 3, No. 2, pp. 16-17.

to be "manifest and clear".[320] Article 19, paragraph (2) further clarifies what the phrase "no conceivable basis" refers to, and states that: "

> (a) The contingency or risk against which the undertaking was designed to secure the beneficiary has undoubtedly not materialized;
>
> (b) The underlying obligation of the principal/applicant has been declared invalid by a court or arbitral tribunal, unless the undertaking indicates that such contingency falls within the risk to be covered by the undertaking;
>
> (c) The underlying obligation has undoubtedly been fulfilled to the satisfaction of the beneficiary;
>
> (d) Fulfillment of the underlying obligation has clearly been prevented by willful misconduct of the beneficiary;
>
> (e) In the case of a demand under a counter-guarantee, the beneficiary of the counter-guarantee has made payment in bad faith as guarantor/issuer of the undertaking to which the counter-guarantee relates."[321]

Besides the causes for the issuer to refuse payment, Article 19 also provides the applicant the possibility of taking court measures against fraudulent conduct. In particular, paragraph (3) of the Article states that "in the circumstances set out in subparagraphs (a), (b) and (c) of paragraph 1 of this article, the principal/applicant is entitled to provisional court measures in accordance with article 20".[322] Article 19 was considered successful from political and technical points of view.[323]

Article 20 of this Convention – "Provisional court measures", provides the actions a court can take, and reads that: "

> (1) Where, on an application by the principal/applicant or the instructing party, it is shown that there is a high probability that, with regard to a demand made, or expected to be made, by the beneficiary, one of the circumstances referred to in subparagraphs (a), (b) and (c) of paragraph 1 of article 19 is present, the court, on the basis of immediately available strong evidence, may:
>
> (a) Issue a provisional order to the effect that the beneficiary does not receive payment, including an order that the guarantor/issuer hold the amount of the undertaking, or
>
> (b) Issue a provisional court order to the effect that the proceeds of the undertaking paid to the beneficiary are blocked, taking into account whether in the absence of such an order the principal/applicant would be likely to suffer serious harm.
>
> (2) The court, when issuing a provisional order referred to in paragraph 1 of this article, may require the person applying therefore to furnish such form of security as the court deems appropriate.
>
> (3) The court may not issue a provisional order of the kind referred to in paragraph 1 of this article based on any objection to payment other than those referred to in subparagraphs (a), (b) and (c) of paragraph 1 of article 19, or use of the undertaking for a criminal purpose.[324]

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[320] UNCITRAL Convention, article 19, para.1.
[321] Ibid, article 19, para.2.
[322] Ibid, article 19, para.3.
[323] De Ly, Filip (1999), 'The UN Convention on Independent Guarantees and Standby Letters of Credit', 33 *Int'l Law* 831 (Fall), p. 843.
[324] UNCITRAL Convention, article 20.

Generally speaking, these provisions in this Convention are successful, as this Convention condensed most of the aspects of the fraud rules that have been developed in commercial practice by national courts and/or legislators. More importantly, detailed and useful guidance is given. In particular, there is a list of about what kinds of misconduct could lead to an application of the fraud rule,[325] and there is also a provision indicating that either fraud in the documents or fraud in the underlying transaction could apply to the fraud rule.[326] It is also apparent as to what actions the victims of fraud can take when fraud is clearly taking place. To be precise, the issuer can refuse to honour a presentation or withhold the payment,[327] the applicant could apply a court injunction in order to prevent the bank from making payment to the fraudsters.[328] Furthermore, essential guidelines for courts to consider applying the fraud rule are offered.[329] In a word, these provisions relating to the fraud rule in this Convention indicate a vital and positive development, and will offer guidance for national courts to exercise the fraud rule.[330]

However, theses provisions can be criticised as being vague due to the various difficulties of the independent undertaking practice; and a better policy might be to leave it to the commercial markets to incorporate existing rules.[331] In addition, some academics have expressed their fear that the rules may lead to variations in the process of application due to different interpretations by national courts, and thus become harmful to international business.[332]

Up until now, the US had joined the Convention, but neither England[333] nor China has signed it.[334] It would be interesting to see whether these two countries will go a step further in the near future. In brief, the convention demonstrates a

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[325] Ibid, article 19, para.1(a)-(c)
[326] Ibid, article 19, para.1 (a) and (c).
[327] Ibid, article 19, para. 1.
[328] Ibid, article 19, para. 3.
[329] Ibid, article 20.
[330] Gao, Xiang & Buckley, Ross P. (2003a), p. 333.
[331] Dolan, John F. (1997), 'The UN Convention on International Independent Undertakings: Do States with Mature Letter-of-Credit Regimes Need It?', 13 *B.F.L.R.*1, p. 23.
[332] Gorton, Lars (1996), 'Draft UNCITRAL Convention on Independent Guarantees', *LMCLQ*, Part 2, May, 42, p. 49.
[333] According to 'SITPRO's Report on the Use of Demand Guarantees in the UK– July 2003', published by SITPRO (UK's trade facilitation agency, was set up in 1970), few exporters in England knew about this Convention, and more expectation to be familiar with the Convention was placed on banks, and the SITPRO recommended that the Department of Trade & Industry in England be more active in issuing consultation documents on the Convention, this report was available from www.sitpro.org.uk/reports/demandguar.pdf, accessed 04 Dec., 2006; it seemed that England was reluctant to accede other international Conventions, for example, the CISG, for further discussion see Forte, Angelo (1997), 'The United Nations Convention on Contracts for the International Sale of Goods: Reason or Unreason in the United Kingdom', reproduced with the permission of 26 *University of Baltimore Law Review* (Summer), 51-56, available at www.cisg.law.pace.edu/cisg/biblio/forte.html; for discussion of the reasons of the UK not ratifying CISG, see also Moss, Sally (2005-06), 'Why the United Kingdom has not Ratified the CISG', *Journal of Law and Commerce*, Vol. 25: 483; one of the arguments against ratification was the fear that London would lose its status as a world centre in international arbitration and litigation, which seems logical in explaining why the UK is not willing to join the UNCITRAL Convention.
[334] UNCITRAL, 'Status: 1995 – United Nations Convention on Independent Guarantees and Stand-by Letters of credit', available at http://www.uncitral.org/uncitral/en/uncitral_texts/payments/1995Convention_guarantees_status.html, accessed 18 July, 2010.

constructive development on L/C fraud exception rules at the international level, although the application of such rules may be varied before national courts.

3.3 Approaches to L/C Fraud Exception Rules at the National Level

3.3.1 The Approach in the US

The L/C fraud exception rules originated from judicial practice in common law in the US. We will discuss a leading case (the *Sztejn* case), and this case is also the foundation of English L/C fraud exception rules. But we will not look at leading court cases in the US, as we do not intend to do a thorough study of L/C fraud exception rules there. Then the judicial remedy (also the procedural instrument) the injunction will be briefly introduced. Finally, we shall look at UCC§5-109 briefly, which is important to other countries which attempt to develop such rules.

The Sztejn Case [1941]

The leading case on L/C fraud exception rules in the US is *Sztejn v. J. Henry Schroder Banking Corp*[335]. In this case, the applicant applied for an injunction against the issuing bank to prevent payment under the L/C, with the allegation that what had been shipped by the Indian seller was only rubbish, rather than the contract goods.

In the New York Court of Appeal, Judge Shientag stressed the autonomy principle of the L/C saying that the L/C is independent of the sales contract between a buyer and a seller; the issuing bank agrees to pay upon presentation of documents rather than goods; this rule is necessary for maintaining the efficiency of the L/C as a financing instrument for international trade.[336]

However, by considering the particular facts in this case, the judge distinguished between the situation where there is only a dispute between a buyer and seller concerning a breach of warranty[337] and the current situation. The judge considered that in the present case, it must be assumed that the seller has intentionally failed to deliver any contracted goods, and that the bank has noticed the seller's fraud before the drafts and documents have been presented for payment, and therefore the independence principle of the L/C should not be used to protect the fraudulent seller.[338] Therefore, Shientag J applied the L/C fraud exception rule where the dispute was that "the seller has intentionally failed to ship any goods ordered by the buyer… where the merchandise is not merely inferior in quality but consists of worthless rubbish."[339]

Furthermore, the immunisation of fraud exception in the L/C was also recognised. In other words, there are some circumstances where even though fraud is established, fraud exception should not apply. In this case, the Judge clarified one

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[335] (1941) 31 N.Y. S.2d 631.
[336] Ibid, p. 721.
[337] A warranty (a term used in US law) is a representation that a fact is true, and it may be contractual or statutory, for further explanation see Turner, Paul (1998), p. 17.
[338] (1941) 31 N.Y. S.2d 631, pp. 721-722; such situation is considered 'fraud in transaction', see another case *Regent Corp. U.S.A. v. Azmat Bangladesh Ltd*., 32 UCC Rep. Serv. 2d (N.Y. Sup. Ct. 1997).
[339] (1941) 31 N.Y. S.2d 631, pp. 634-635, emphasis added.

point on immunisation of L/C fraud exception that "even though the documents are forged or fraudulent, if the issuing bank had already paid the draft before receiving notice of the seller's fraud, it will be protected if it exercised reasonable diligence before making such payment"[340].

Injunction

In the US, an injunction is a court order that requires the enjoined party to perform or to refrain from performing an action.[341] Two types of injunctive relief are provided in the Federal Rules of Civil Procedure (FRCP)[342] 65, including a temporary restraining order[343] and a preliminary injunction[344]. Temporary restraining orders and preliminary injunctions can be considered as interlocutory injunctions.[345] There is also a judicial remedy, the permanent injunction, which is issued only after a trial on the merits.[346]

UCC Article 5: Letters of Credit

Besides the case law on L/C fraud exception rules, the US also has uniformed L/C fraud exception rules contained in the UCC[347]. A permanent editorial board had also been established for the code, and it has published its official comments and papers concerning the code. Although these commentaries do not have the effect of law, they are often cited by courts as being a persuasive authority for determining the effect of some provisions.[348] Therefore, we will not only look at the text of the article, but also the official comment of this article.

The current UCC contains an article (article 5) particularly on the subject of letters of credit. The objectives of the drafting effort were to harmonise the US law with international rules and practices; and also to keep flexible enough to accommodate evolving changes in technology and practices, so that the usefulness

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[340] Ibid, (1941), p. 722.
[341] Wunnicke, Brooke & Wunnicke, Diane B. (1996), *Standby and Commercial Letters of Credit*, New York: Wiley Law Publications, 2nd ed., p. 174.
[342] They (FRCP) govern civil procedure in US district (federal) courts, and are promulgated by the US Supreme Court pursuant to the Rules Enabling Act, and then approved by the US Congress.
[343] The purpose of a temporary restraining order is to preserve the status quo for certain days, and such an order may be granted without notice to the enjoined party, FRCP 65.
[344] Such an order is granted after notice to the enjoined party and a hearing; an applicant for a preliminary injunction has to show sufficiently that the status quo should be preserved until the final hearing, FRCP 65.
[345] For discussion on the main differences between them, see Kozolchchyk, Boris, 'Chapter 5 – Letters of Credit', in Ziegel, Jacob S. (1979) (Chief Ed.), *International Encyclopedia of Comparative Law Volume IX Commerical Transactions and Institutions*, under the auspices of the Internatioonal Association of Legal Science, Martinus Nijhoff Publishers', pp. 123-124.
[346] It is issued as final judgment in a case, Cornell University Law School, LII/Legal Information Institute, 'Injunction', available at http://topics.law.cornell.edu/wex/Injunction, accessed 10 July, 2010; see also Liu, Yuxia (2007), 'Study on l Legislation on Court Injunction in L/C Fraud', *Economic and Social Development*, Vol. 5, No. 7, Jul., 117.
[347] The UCC is a joint project of the American Law Institute (ALI) and the National Conference of Commissioners on Uniform States Laws (NCCUSL); the objective of the UCC is to harmonise the law of sales and other commercial transactions in all states within the US; the UCC, created by private organisations, is not the law itself; but it is the rules that are recommended be adopted in various states, see UCC Text General Comment by the NCCUSL and ALI.
[348] Ibid.

and competitiveness of the L/C can be maintained and facilitated.[349] This article further covers provisions on L/C fraud exception rules. The most update provisions over L/C fraud exception rules are the 1995 version.[350]

It would be extremely helpful to examine these provisions. The revised UCC§5-109 with the title of fraud and forgery, stipulates the requirements that have to be satisfied in order to obtain injunctive relief. This article reads as follows:

> "(a) If a presentation is made that appears on its face strictly to comply with the terms and conditions of the letter of credit, but a required is forged or materially fraudulent, or honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant:
>
> (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 y the issuer or nominated person; and
>
> (2) the issuer, acting in good faith, may honor or dishonor the presentation in any other case.
>
> (b) If an applicant claims that a required document is forged or materially fraudulent or that honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant, a court of competent jurisdiction may temporarily or permanently enjoin the issuer from honoring a presentation or grant similar relief against the issuer or other persons only if the court finds that:
>
> (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).

From the new article UCC§5-109, it can be seen that it contains two main rules: fraud exception and fraud immunisation[351]. Article 5-109 (a) makes clear that fraud not only can refer to where there is forgery or fraud in the required docu-

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[349] The ALI and NCCUSL, UCC Article 5. Letters of Credit, Prefatory Note, 'Need for Uniformity'.

[350] The current UCC and official comments have experienced several changes since their first version was published in the 1950s, in order to keep up with the changes of commercial practice.

[351] For a more detailed explanation of this new article, see e.g. Wunnicke, Brooke & Wunnicke, Diane B. (1996), pp. 165-179; see also Huang, Cheng (2005), 'Discussion on Exceptions of L/C fraud Exception in American Law', published on 08 June, available at www.ccmt.org.cn/ss/explore/exploreDetial.php?sId=834, accessed 15 July, 2008.

ments, but also to where fraud is in the underlying transaction. It is stated that the courts can determine "whether a document is fraudulent or the beneficiary has committed fraud" or "whether the fraud was material" only by examining the underlying transaction.[352] Thus, for the purpose of judicial relief, the fraud must be material. However, it does not exactly define fraud; after all what does "material" refer to? So it would be useful to examine the official comment of this article.

The official comment formulates the materiality requirement that "the beneficiary has no colorable right to expect honor and where there is no basis in fact to support such a right to honor".[353] Some circumstances are summarised from decisions of court cases: the fraud must be "so serious as to make it obviously pointless and unjust to permit the beneficiary to obtain the money"; or the contract and circumstances manifestly demonstrate that the beneficiary's demand for payment has "absolutely no basis in fact"; or the beneficiary's conduct has "so vitiated the entire transaction that the legitimate purposes of the independence of the issuer's obligation would no longer be served".[354]

However, it was identified that UCC§5-109 and its official comment have not indicated that there is a requirement to prove the beneficiary's intention to defraud; thus it was argued that the UCC§5-109 considers more about the serious effect of fraud in the transaction instead of the state of mind of the beneficiary.[355]

"No injunction" is the general rule in dealing with L/C fraud cases. The official comment confirms that the standard for injunctive relief is high and the applicant must have competent evidence, rather than mere allegation.[356] Only high standards are reached in such L/C fraud disputes; and thus only the "exception" to the general "no-injunction" rules applies. Otherwise, such exceptions would threaten the independence principle of the L/C. It further points out that the courts must also cautiously grant "similar relief" (such as declaratory judgment[357] or attachment[358]); the same principles in applying injunctions should apply to such similar devices when the applicant intends to achieve the same legal result of injunction.[359]

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[352] UCC Article 5 Letters of Credit, UCC§5-109 Forgery and Fraud, Official Comment 1.
[353] Ibid.
[354] Ibid.
[355] Buckley, Ross P. (1995), 'The 1993 Revision of the Uniform Customs and Practice for Documentary Credits', 6 *Journal of Banking & Finance Law & Practice* 77, p. 97.
[356] UCC Article 5 Letters of Credit, UCC§5-109 Forgery and Fraud, Official Comment 4.
[357] 'Declaratory judgment' means a judgment of a court which determines the rights of parties under a statute, a will, or a contract; a declaration may be made on any issue of fact or law; such a judgment does not entail any type of coercive relief, see Bureau of International Information Programs, United States Department of State (2004), 'Outline of the U.S. Legal System', available at http://www.america.gov/media/pdf/books/legalotln.pdf#popup, accessed 02 Dec., 2010.
[358] 'Attachment' is a form of preliminary remedy; such an order secures or seizes property in dispute to force compliance with a decision which may be obtained in a pending suit, see e.g. Fletcher, George P. & Sheppard, Steve (2005), *Amercian Law in a Global Context: The Basics*, Oxford; New York: Oxford University Press, p. 511.
[359] UCC Article 5 Letters of Credit, UCC§5-109 Forgery and Fraud, Official Comment 5; it seems possible that an attachment order can be used in L/C disputes in the US, but the problem is that it is difficult to know when a draft will come in and when such an order can be applied in an effective way, see Byrne, James, et al. (1996), pp. 186-187.

In general, the approach of the US courts was considered as "an unduly narrow" approach[360], as the L/C fraud rule can only be exercised in limited circumstances[361]. It is also discouraging that the standard of fraud can be interpreted variously by different judges.[362] Thus, even with a uniform rule on the standard of 'material fraud', there might still be no uniform approach in judicial practice. It would be desirable and significant for the courts to have a common and workable construction of the UCC.[363] After briefly mentioning American law regarding L/C fraud exception rules, we are going to discuss such rules in England.

3.3.2 The Approach in England

Introduction

The L/C has been regarded as the lifeblood of international commerce by English judges, since its autonomy and abstract features facilitate international trade. However, such independent features have been challenged by fraud allegations in L/C transactions before the courts. The courts in England would not prevent and interfere with L/C payment obligations which are performed by banks, unless there is fraud supported by convincing evidence, and even the illegality or nullity of a sales contract could not influence such payment obligations.[364]

With regard L/C fraud exception rules, there is no specific code on them in England. But they are developed in a relatively consistent and detailed way in L/C fraud disputes through civil litigation by English courts. Thus, we will discuss

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[360] Barnes, James G. & Byrne, James E. (2001b), 'Letters of Credit: 2000', 56 *Business Law*. 4, reprinted in *Annual Survey of Letter of Credit Law & Practice* 13, 18 (2002).

[361] See Ortego, Joseph J. & Evan H. Krinick (1998), pp. 489-491; for discussion of the application of UCC section 5-109 concerning fraud defences and injunction typically in years 2005-2006 in the USA, see Barnes, James G. & Byrne, James E., 'Letters of Credit', in Byrnes, James E. & Byrnes, Christopher S. (Eds.) (2007), *2007 Annual Survey of Letter of Credit Law and Practice*, MD: The Institute of International Banking Law & Practice, Inc., pp. 39-42.

[362] Gao, Xiang & Bukley, Ross P. (2003a), p. 322.

[363] Mooney, J. Lowell & Blodgett, Mark S. (1995), 'Letters of Credit in the Global Economy: Implications for International Trade', *Journal of International Accounting, Auditing and Taxation*, Vol. 4, Issue 2, Pages 175-183, p. 183.

[364] D'Arcy, Leo (2000), p. 166; however, a different argument runs that in addition to fraud exception, there are other exceptions to the autonomy principle, such as initial illegality of the payment undertaking, frustration or suspension of the duty to pay through supervening illegality or governmental action, exercise of a right of set-off by the promisor, see Goode, Roy (1991), Chapter 9, p. 234; it was commented that the English commercial court has accepted the illegality as an exception to the autonomy principle in *Mahonia Ltd v. West LB AG*, [2004] EWHC 1938, for further discussion on the impact of the case see Barnes, Jim, 'the UCP in Court 'Illegality' as Excusing Dishonour of L/C Obligations', available at www.iccbooks.com/Home/UCPCourtillegality.aspx, accessed 30 Jan., 2007; under English law the main reasons leading to supervening illegality in L/C transactions may cover financial sanctions, anti-money laundering and counter-terrorism financing measures and injunctions, for further see Richardson, Kate, Presentation 'Supervening Illegality Affecting L/C Payment', Conference on Letters of Credit, ICC Austria, Vienna, 28 May, 2008; for further arguments and discussion on the illegality exception, see also Enochong, Nelson, 'The Autonomy Principle of Letters of Credits: An Illegality Exception', in Rose, F. D. (General Ed.) (2006), *Lloyd's Maritime and Commercial Law Quarterly*, London: Informa, pp. 404-425; for a discussion about the illegality defence in civil law fields in England, see e.g. Davies, Paul S. (2009), 'The Illegality Defence – Two Steps Forward, One Step Back?', *Conveyance and Property Lawyer*, 3, 182-208; the Illegality issue in L/C transactions is also discussed in Chinese legal circles, see e.g. Huang, Yaying (2003), 'The Fraud Exception and the Illegality Exception to L/C Independence Principle', published at *Law Journal*, Issue 3, available at http://article.chinalawinfo.com/article/user/article_display.asp?ArticleID=23782, accessed 05 May, 2008.

and analyse such rules through examining court cases. In England, the injunction order seems to be the most common judicial remedy to L/C fraud in England. Thus, in L/C fraud dispute cases before the courts, mostly the plaintiffs apply for an injunction order to prohibit payment under the L/C. Thus, the key research question to examine in this section can be formulated as the approach of the English courts towards the issuing of injunctions in L/C fraud disputes.

Both procedure and substance are important concerning the issue of injunction.[365] Thus, two essential interrelated topics will be discussed. The first issue is the question of injunction, which is mainly a matter of procedure law. In L/C fraud disputes, the applicant who applies for an injunction order from a court at least has to meet with strict requirements inherent in granting an injunction. The second topic is the fraud issue, which is a matter of substantive law. In English law, there is no definition of "fraud", which has to be decided case by case. But English case law has developed particular L/C fraud exception rules in judicial practice.

In England, four main types of L/C fraud disputes have been identified, where fraud is suspected and alleged. Firstly, the paying bank has not paid; and the L/C applicant applies an injunction order attempting to prohibit the paying bank from paying out under the L/C, on the grounds of fraud of the beneficiary.[366] Secondly, the beneficiary has tendered compliant documents, but the paying bank has refused to make payment on the basis of the beneficiary's fraud; the beneficiary sues the paying bank.[367] Thirdly, the paying bank has paid, and sought recovery of payment from the beneficiary because the presented documents are fraudulent.[368] Fourthly, the paying bank has paid, but the issuing bank refused to reimburse on the grounds of fraud; the paying bank sues the issuing bank to seek reimbursement.

In general, English case law adopted a consistent and strict approach towards L/C fraud exception rules. Clear principles concerning the fraud exception in the L/C were established in the late 1970s and these principles guided England in the way of their development. However, in England only a small number of cases concern this issue. Furthermore, it is interesting to notice that in most of such cases, the alleged fraud was not established and injunction was eventually not granted. Thus, whether or not such traditional remedies like an injunction are a useful instrument is doubted. Therefore, the function of another procedural instrument that of freezing orders in L/C fraud disputes needs to be explored. We first give a brief introduction to the procedural instruments interlocutory injunctions and freezing orders.

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365 But it seems that procedure is more heavily relied on than substance under English law, see Lookofsky, Joseph & Hertz, Ketilbjørn (2004), *Transnational Litigation and Commercial Arbitration: An Analysis of American, European, and International Law*, Copenhagen: Juris Publishing, p. 7.

366 Raymond, Jack (1993), *Documentary Credits –The Law and Practice of Documentary Credits including Standby Credits and Demand Guarantees*, London & Carlsbad & Calif: Butterworths, 2nd ed., para 9.2, pp. 207-208; see also Connerty, Anthony, 'Fraud and Documentary Credits: The Approach of the English Courts', available at http://www.wwwserv.co.uk/anthonyweb/FRAUD%20AND%20DOCUMENTARY%20CREDITS.pdf, accessed 24 April, 2008.

367 Ibid.

368 Ibid.

Injunctions

In England, where fraud is alleged in L/C disputes, the judicial remedy in procedure is likely to be an injunction. In most of the court cases discussed below, the applicants applied for an interim (interlocutory) injunction order from the courts, attempting to stop L/C payment. The injunction here is an equitable remedy in private law and thus is discretionary by the court.[369] In this part, injunction will be discussed mainly as a procedural issue.

As for the nature of the injunction, it can be prohibitory so as to restrain the doing, continuance or repetition of some wrongful act, or be mandatory to undo some wrongful act.[370] Injunction can be classified as interlocutory and perpetual. An interlocutory or interim or pre-trial injunction is granted in order to preserve the *status quo* before the trial of the action on the merits; whereas a perpetual injunction may be granted after the applicant has proved his case on the merits at the trial.[371]

Mareva injunctions, nowadays known as freezing orders in England[372], are in nature interlocutory injunctions, and often are granted on an *ex parte* application.[373] A Mareva injunction or a freezing order is "an order of the court restraining a party to proceedings from removing assets from the jurisdiction of the court or otherwise dealing with assets located within the jurisdiction and, in more limited circumstances, from dealing with assets outside the jurisdiction".[374] The main purpose of the Mareva order is to prevent the courts' judgments from being useless either by removing assets from the jurisdiction or by disappearing assets within the jurisdiction.[375]

As we can see, both instruments, interlocutory injunction and freezing order, are in nature basically injunctions. In this chapter, in order to make the usage of different injunctions clear, a Mareva injunction will be discussed under the name of freezing order, and the injunction mentioned below will mainly refer to interlocutory injunction, which has mostly been applied in court cases concerning L/C fraud disputes.

Interlocutory injunctions to some extent provide a legal remedy for the victims in fraudulent L/C transactions, because such injunctions can prohibit a L/C payment made to a beneficiary. Otherwise, once a L/C payment is made, it is very difficult for the victim to recover the loss if there is real L/C fraud involved. Where a beneficiary's fraud is in dispute, in theory both the paying bank and the buyer can be the applicant to seek an injunction. In order to maintain the current situation until the trial, the applicant applies for an interlocutory injunction either against

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[369] Ingman, Terence (1994), *The English Legal Process*, London: Blackstone Press Limited, 5th ed., p. 313; for a general idea of injunction, see Treitel, Guenter (2003), *The Law of Contract*, London: Thomson Sweet & Maxwell, 11th ed., pp. 1040-1048; Atiyah, P. S. & Smith, Stephen A. (2005), pp. 377-388.
[370] Ingman, Terence (1994), pp. 314-315.
[371] Ibid, p. 315.
[372] Sealy, L.S. & Hooley, R J A (2005), p. 852.
[373] Grunert, Jens (1996), 'Interlocutory Remedies in England and Germany: A Comparative Perspective', *C.J.Q.*, 15 (Jan), 18-43, pp. 22-26.
[374] Hapgood, Mark (1989), *Paget's Law of Banking*, London & Edinburth: Butterworths, 10th ed., p. 332.
[375] Ibid, p. 333.

the bank from paying out or against the beneficiary from presenting documents to demand payment under the L/C. However, in such circumstances, more commonly the bank would request the buyer to seek an injunction from the court. Thus the main function of an interlocutory injunction in L/C fraud disputes is to restrain banks from honouring the credit or against the seller to forbid presentation of documents for payment.

The freezing order can be another legal remedy in protecting a commercial party in a L/C fraud dispute in a different way from that of an interlocutory injunction. An applicant may apply for a freezing order to restrain the beneficiary from the removing the proceeds of the credit from the jurisdiction or dealing with them within the jurisdiction. But we will explore further after the court cases concerning interlocutory injunctions are discussed.

The English Courts' Approach

As England has its case law system, and the doctrine of precedents is significant to the development of legal rules, case law study will be conducted in this section. Several leading cases concerning L/C fraud exception rules in L/C disputes according to the issuing year of judgment are examined and evaluated. In each court case, key facts were introduced to help us to understand the principal legal relationship in the dispute; essential legal points concerning L/C fraud exception rules are discussed.

Classical Approach

In the area of L/C fraud exception rules, the cornerstone of English law is a leading American case *Sztejn v. J. Henry Schroder Banking Corp* in 1941, which was discussed in the section of the US approach. In this *Sztejn* case, Shientag J granted an injunction order to prevent L/C payment and applied the L/C fraud exception rule where the seller has intentionally failed to deliver any contracted goods. At the same time, the immunisation of L/C fraud exception, which inherently forms an integrated part of L/C fraud exception rules, was also recognised.

The decision of the *Sztejn* case was that the authority in England 'the court' may interfere to prevent a bank from effecting payment under a L/C, where the seller's fraud was known to the bank before paying out. This decision has been often quoted and referred to by English judges when they deal with fraud disputes in L/C transactions. Six court cases will be examined here. Generally, they represent the historical or traditional attitudes of the courts towards the L/C fraud exception rules.

Case No. 1: *Discount Records Ltd v. Barclays Bank Ltd and another* [1975] (Buyer v. Bank)

This case *Discount Records Ltd v. Barclays Bank Ltd and another*[376] is most probably the first reported case relating to fraud exception in England. In this case, the scope and character of fraud exception are dealt with in a detailed way.

[376] [1975] 1 Lloyd's Rep. 444.

In this case, the plaintiffs ordered cassettes and gramophone records specified by numbers from a French company. The goods were found not to comply with the order and the numbers on the boxes had been altered. Firstly, the plaintiffs instructed the bank not to pay the credit; but the bank did not accept the plaintiffs' instruction because they considered that the credit was an irrevocable confirmed credit and there was no ground to refuse payment. Then the plaintiffs applied to the court for an interlocutory injunction against the bank, claiming that the French seller had fraudulently shipped worthless goods to the buyer in order to obtain the payment under a L/C.[377]

The court did not grant the injunction. The main reasoning from the judgment was that firstly, the fraud was not established but merely alleged; and secondly, a sufficiently grave cause was not demonstrated.[378] The court further considered that the payment of the bank did not affect the buyer's interest, because if the bank had done it wrong in making payment to the seller, the buyer could still have demanded damages from the bank.[379] This goes along with the common law practice, as in common law jurisdictions, a court would not issue an injunction unless it is an absolute and final remedy, and unless the applicant has no other legal recourse.

According to the judgment, it seemed that if the plaintiff could sufficiently prove the existence of fraud, and the bank made payment despite such fraud, the bank has acted at its own risk.[380] Therefore, the bank unfortunately falls in an awkward and difficult situation, because if it refuses to pay without sufficient evidence of fraud, the bank is likely to be sued by the seller, but if it pays out in case of fraud, it may not be entitled to receive reimbursement from the buyer.[381]

When considering whether the L/C fraud exception rules could be applied, the court also contemplated a point concerning the immunisation of the L/C fraud exception. That is, whether a holder in due course is involved. In the case, the beneficiary might have already been paid by discounting a bill of exchange, which may have been negotiated and passed into a holder in due course; under such circumstances, the injunction would not be granted so as to interfere with ordinary banking business.[382]

Thus in this case the court recognised the possibility of L/C exception based on fraud. At the same time it distinguished a case of fraud and ordinary breach of contract and negated the possibility of obtaining an injunction under ordinary breach of contract by placing doubt on the evidence of fraud. Furthermore, the court kept in mind the immunisation of the L/C fraud exception, where a holder in due course is engaged, the bank's payment obligation should not be interfered with. This case probably represented the well-known classical approach towards

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[377] Ibid.
[378] Ibid, pp. 444-445.
[379] Ibid, p. 448.
[380] Ibid, p. 448.
[381] This point is also discussed in case *Society of Lloyd's v. Canadian Imperial Bank of Commerce* (Unreported) (QBD), see Baggs, Caroline (1993), 'Case Comment Letters of Credit – Knowledge of Fraud', *J.I.B.L.*, 8 (11), N. 216-217.
[382] [1975] 1 Lloyd's Rep. 444, p. 447.

fraud exception, which showed the usual reluctance of the English courts towards granting an injunction.

Case No. 2: *Harbottle v. National Westminster Bank* [1978]

The case *Harbottle v. National Westminster Bank*[383] concerned fraud disputes in guarantee transactions. However, in England the courts deal with a guarantee (performance bond)[384] and a L/C in a similar manner,[385] when concerning the impendence principle of both instruments. In this case, the court had draw analogies between performance bonds and L/C cases.[386] Thus, it is also useful to look at some leading cases dealing with fraud exception rules in guarantees.

In the case, the English plaintiffs concluded a sale contract with Egyptian buyers. In the contract it provided that the plaintiffs should establish a guarantee confirmed by a bank in favour of the buyers. The plaintiffs contended that the buyers had demanded payment under guarantee without justification. This claim was rejected and Sir Michael Kerr summarised a well-known passage referring to the fraud exception, which has often been quoted in other court cases where the fraud exception issue is involved. Sir Michael Kerr contended that

> *"It is only in exceptional cases that the court will interfere with the machinery of irrevocable obligations assumed by banks. They are the life-blood of international commerce. Such obligations are regarded as collateral to the underlying rights and obligations between the merchants at either end of the banking chain. Except possibly in clear cases of fraud of which the banks have notice, the courts will leave the merchants to settle their disputes under the contract by litigation or arbitration…… The courts are not concerned with their difficulties to enforce such claims: these are risks which the merchants take. In this case, the Plaintiffs took the risk of the unconditional wording of the guarantees. The machinery and commitment of banks are on a different level. They must be allowed to be honoured, free from interference by the Court. Otherwise, trust and international commerce would be irreparably damaged."*[387]

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[383] [1978] QB 146.

[384] In this context, a guarantee refers to a demand guarantee, in which the issuing bank agrees to make payment under a written demand by the beneficiary or a written declaration that the principal has defaulted; sometimes called a performance guarantee or performance bond, having a similar function as a standby L/C, whose purpose is to secure the performance of the underlying contract; see Sealy & Hooley (2003), pp. 886-887.

[385] Sealy & Hooley (2003), p. 893; see also O'Driscoll, Peter S. (1985), 'Comment: Performance Bonds, Bankers' Guarantees, and The Mareva Injunction', *Northwestern Journal of International Law and Business* (Fall/Winter), 380, pp. 384-386; but such an equation was doubted; there was an argument that some important differences about fraud in a L/C and guarantee and the notion of fraud in a L/C should be more rigid than in a guarantees is justified, see Bertrams, Roeland (2004), *Bank Guarantees in International Trade, the Law and Practice of Independent (First Demand) Gurantees and Standby Letters of Credit in Civil Law and Common Law Jurisdictions*, The Hague: Kluwer Law International, 3rd ed., pp. 391-392; for differences between documentary credits and demand guarantees, see also Goode, Roy (1996), 'Abstract Payment Undertakings in International Transactions', 22 *Brooklyn Journal of International Law*1, pp. 15-16; for examination on whether performance bonds equate with letters of credit concerning the independence of the underlying contract, Debattista, Charles (1997), 'Performance Bonds and Letters of Credits: A Cracked Mirror Image', *Journal of Business Law*, JUL, 289-305.

[386] Analysis of this case, see Howcroft, Paul (1990), p. 18.

[387] [1978] QB 146, pp. 155-156.

The court clearly confirmed that for the fraud exception rules to apply, firstly fraud must be clear; and secondly, the fraud has to be noticed by the bank. Furthermore, the importance of trust in such instruments that international merchants have and commitments of banks without interference is stressed.

Case No. 3: *Edward Owen Engineering Ltd v. Barclays Bank International Ltd* [1978]

This case *Edward Owen Engineering Ltd v. Barclays Bank International Ltd*[388] is important because it was the first significant case in which the English courts developed the principles on fraud exception. It concerned the performance bond; but the doctrines of fraud exception[389] adopted in the case could also apply to the L/C.

In the *Edward Owen* case, the plaintiffs – English suppliers, agreed to supply and erect glasshouses in Libya for Libyan buyers. According to the contract terms, the plaintiffs should provide a performance bond in favour of the buyers; and the buyers should open a confirmed irrevocable L/C in favour of the plaintiffs. The plaintiffs applied to the defendant Barclays Bank in England to provide the performance bond and the defendant asked the Umma Bank in Libya to issue the bond so as to pay the amount on demand without proof or conditions. However, the buyers did not open a L/C, after the bond was issued; then the plaintiff cancelled the supply contract. The buyers demanded payment under the performance bond from Umma bank, who then claimed reimbursement from the defendant. The plaintiffs applied for an injunction to prohibit the defendant from making payment.

An interim injunction was granted first, but was discharged later. The plaintiff appealed but the appeal was finally dismissed. The reason of dismissal was that the performance bond was arranged in a wide manner, allowing the payment without proof or conditions, and the plaintiffs had not satisfactorily established fraud. The English suppliers should bear the loss, because they had accepted such a commercial instrument, and they should have been aware of the potential risks.[390]

Concerning the fraud exception, Lord Denning stated "that case (the Sztejn case) shows that there is this exception to the strict rule: the bank ought not to pay under the credit if it knows that the documents are forged, or that the request for payment is made fraudulently in circumstances where there is no right to payment"[391]. Lord Justice Brown claimed that "that exception is that where the documents under the credit are presented by the beneficiary himself and the bank knows when the documents are presented that they are forged or fraudulent, the bank is entitled to refuse payment"[392]. Lord Justice Geoggrey Lane observed that "the only circumstances which would justify the bank not complying

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[388] [1978] 2 All ER 976 (CA).
[389] Some consider English courts to have recognised a number of exceptions to the autonomy principle in performance bond transactions, including infringement of international obligations, fraud and express contractual derogations from the autonomy principle, see e.g. Chong (1992), 'The Abusive Calling of Performance Bonds', *J.B.L.* 414.
[390] [1978] 2 All ER 976 (CA), p. 983.
[391] Ibid, p. 982.
[392] Ibid, p. 984.

with the demand…... is this, if it had been clear and obvious to the bank that the buyer had been guilty of fraud"[393].

At first thought, it seems unreasonable that the applicant has to bear all the loss resulting from the bad faith or fraudulent action of the beneficiary reflected in the underlying contract. This, to some extent, might lead to the situation of leaving fraud untouched or even further, encouraging fraud, by simply stating that the party was running the risk of being defrauded by agreement. However, after further consideration, it should be noticed that the main reason that the injunction was rejected was that the requirement of establishing fraud with clear and sufficient evidence was not satisfied.

Thus in this case, the principle of independence was clearly applied again.[394] The circumstances where fraud exception would apply were confirmed: there was clear evidence of fraud, the beneficiary committed the fraud himself and the bank knew about the fraud. But the fraud in the underlying contract was not considered[395], when deciding whether or not fraud was established.

Case No. 4: *Power Cuber International Ltd v. National Bank of Kuwait SAK* [1981] (Buyer v. Bank)

The case *Power Cuber International Ltd v. National Bank of Kuwait SAK*[396] involved the enforcement of an injunction order issued by a foreign court. Whether such an order is enforceable in England, and on what grounds reflected the English court's attitude towards L/C fraud exception.

In this case, the applicant had obtained an injunction order from a Kuwait court, prohibiting the issuing bank in England from making payment under the L/C, but the applicant did not satisfy the prerequisite of clear and established fraud. The applicant wanted to enforce that order in England. The CA refused to enforce that order because it considered that the applicant abused the independence principle of the L/C. The judgment demonstrated that the court continued to adopt an approach that the only possible exception allowing prohibition of payment under L/C was the fraud exception, which called for clear and established fraud, and and the knowledge of the bank with regard to the fraud. We observe that the approach adopted by the English courts was sensible and prevented the L/C independence principle from being abused.

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[393] Ibid, p. 986.

[394] For a similar demand guarantee case, see *Standard Chartered Bank London Ltd v. Canara Bank*, May 22, 2002, Moore-Bick J., in which the court confirmed the independent nature of the demand guarantee, with the the only exception being fraud, cited from McKnight, Andrew (2003), 'A Review of Development in English Law during 2002: Part 2', *Journal of International Banking Law and Regulation*, 18 (4), 160-172, p. 160.

[395] It was argued that the obiter dicta of this case and other similar cases implies another attitude towards the fraud rule, and the banks may be held to know of a fraud or be asked to pay more attention to the underlying transaction and then decide the validity of the call / the demand for payment, which is considered as an 'investigative approach' (either to establish fraud or to establish the validity of the call or demand), for analysis of the case *IE Contractors Ltd v. Lloyds Bank PLC* [1989] 2 Lloyd's Rep. 205 (QBD (Comm)), *GKN Contractors Ltd v. Lloyds Bank PLC* 30 B.L.R. 48 (CA (Civ Div)) and further discussion on this point, see Howcroft, Paul (1990), 'Performance bonds – the Tide Turns against the Banks', *J.I.B.L.*, 5(1), 17-24.

[396] [1981] 3 All ER 607.

Case No. 5: *United City Merchants (Investment) Ltd v. Royal Bank of Canada* [1983] (Buyer v. Bank)

The decision of the case *United City Merchants (Investment) Ltd v Royal Bank of Canada*[397] gives an outstanding explanation of the English law on L/C fraud exception, and the decision was regarded as a defence[398] for a bank against payment under a documentary L/C. The facts of the case are mainly concerned with a BL issued on December 16 being fraudulently dated December 15 so as to comply with the shipping period requirement contained in the L/C. However, the fraud was done by the shipping agents and the seller had no knowledge of it.

The case eventually went to the HL and the fraud exception was held not to apply in this case. The leading judgment of Lord Diplock firmly confirmed the autonomous nature of L/C and that the disputes on the goods are irrelevant to the L/C payment. One established fraud exception refers to "where the seller for the purpose of drawing on the credit, fraudulently presents to the confirming bank documents that contain, expressly or by implication, material representations of fact that to his knowledge are untrue"[399]. Lord Diplock cited the Sztejn case and stated that "the exception for fraud on the part of the beneficiary seeking to avail himself on the credit is a clear application of …'fraud unravels all'. The courts will not allow their process to be used by a dishonest person to carry out a fraud"[400]. Therefore, whether the seller (beneficiary) has the knowledge of fraud becomes the key factor in determining whether or not fraud exception rules will apply in this case.[401]

The bank argued that a BL should indicate the true lading date, thus the falsification of this document was a material fact.[402] However, Lord Diplock considered that it would be too broad to construe materiality and further held that the BL was valid because the shipped goods were those contracted for and the value of the BL was still available.[403] Thus in the case where a BL is antedated, but the BL is a genuine document, it is not always necessarily a case of fraud. Such an opinion accorded with judgments of some court cases dealing with L/C fraud disputes in China. Nevertheless, it is pointed out that if the loading brokers who antedated the BL were agents of the beneficiary, then the beneficiary might be regarded as having noticed the fraud and fraud exception may apply in such a circumstance.[404]

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[397] [1983] A.C. 168.
[398] On this point, [1983] A.C. 168 reversing [1981] 1 Lloyd's Rep. 604 and restoring [1979] 1 Lloyd's Rep. 267.
[399] [1983] A.C. 168, p. 183.
[400] [1983] A.C. 168, p. 184; it is argued that the court's view towards fraud can be explained by the theory of frustration of purpose and fundamental/total breach of contract, for further discussion see Jin, Keke (2007), 'Discussion on Judging 'Substantial' in L/C Fraud In Common Law', *Group Economy*, August (2nd Issue) (General No. 239), 390.
[401] For further discussion on beneficiary's fraud, see Gutteridge, H. C. & Megrah, Maurice (1984), *The Law of Bankers' Commercial Credits*, London: Europa Publications Limited, 7th ed., pp. 179-185.
[402] [1983] A.C. 168, p. 187.
[403] Ibid, p. 187.
[404] Fung, King Tak (2004), *Leading Court Cases on Letters of Credit*, Paris: ICC Publishing, ICC Publication 658, p. 177.

In this case the document of BL was valid and the alleged fraud was merely a technical matter. However, the following questions are interesting to consider: what if the date of BL was altered many days earlier than the true loading date? What if the shipped goods were not those contracted for? Does the alleged fraud depend on the graveness of fraudulent behaviours?

This decision could lead to some confusion. In theory, the beneficiary of a L/C should be liable for the fraudulent document presented by him to the bank. Goode strongly argues that the HL's proposition that if the documents appear to conform to the credit, the bank is entitled and obliged to pay is flawed.[405] He contends that a L/C does not entitle the beneficiary to get payment by presenting documents appearing to comply with a L/C but not so in fact.[406] To accept HL's proposal in the case seems to accept that a bank has a duty to allow a beneficiary to defraud by using forged documents.[407] Goode further provides his reasoning that a forged document which is a nullity cannot be considered as complying with a L/C and a condition of payment under a L/C is that the presented documents are genuine.[408] Goode pointed out that where a document is forged, the fraud is not only relevant considering the fraud exception rule, but also considering the doctrine of strict compliance.[409] Under English law, forgery is not a defence to the autonomy principle unless it is committed by the beneficiary; but forgery also means the document is not genuine and thus is not a conforming document.[410] The issue of conformity should have been considered first, and the fraud defence is a question for a later stage.[411]

Similarly, Professor Guest posed a critical question as to whether it could be argued that these documents are meant to include false statements, although the beneficiary of a L/C is entitled to obtain payment against documents specified in it[412] It seems indeed embarrassing that a document indicating the true lading date would have been rejected by the bank due to the strict compliance principle, but a document stating a fraudulent lading date was valid.[413] Professor Pennington gave comments that it is very strange that an issuing bank should accept shipping documents which to its knowledge are forgeries and it should pay the amount of the credit against such false shipping documents.[414]

In spite of these criticisms, we think HL's decision was legally, commercially and practically reasonable, by considering two aspects. Firstly, it was consistent with the traditional English courts' approach towards L/C fraud exception rules,

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[405] Goode, Roy, 'Chapter 9: Abstract Payment Undertakings', in Cane, Peter & Stapleton, Jane (Eds.) (1991), p. 229; for a similar discussion on the issue of genuineness and validity of documents under LC, see Smith, Guy W. Lewin (1983), 'Irrevocable Letters of Credit and Third Party Fraud: The American Accord', 24 *Virginia Journal of International Law*, Fall, 55.
[406] Goode, Roy (1991), n. 405 above.
[407] Ibid, p. 230.
[408] Ibid, pp. 230-231.
[409] Ibid, p. 232.
[410] Ibid.
[411] Ibid.
[412] Guest, A. G. (Ed.) (2002), *Benjamin's Sale of Goods*, London: Sweet & Maxwell, 6th ed., para. 23 -140, p. 1683.
[413] Ibid.
[414] Pennington, R. R. (1987), *Bank Finance for Companies*, London: Sweet & Maxwell, p. 28.

as in this case the beneficiary did not know about or participate in the documentary fraud of antedating the BL. Secondly, it considered the value of the BL by looking beyond the fact of a minor alteration of the loading date of the BL. Thus, the performance of the underlying contract is taken into account when the court determines not to apply L/C fraud exception rules. The beneficiary delivered the contracted goods and performed the sale contract in good faith; in other words, the beneficiary did not have any fraudulent conduct in the performance of the sales contract. If a third party's fraud without the beneficiary's knowledge could result in the application of the L/C fraud exception rules, then the bank's payment under the L/C to the beneficiary is prohibited, and it will also harm the healthy operation of L/C transactions, in which beneficiaries are an important part in the chain.

Unfortunately, an important issue of whether the fact of forgery makes the document null or not, and thus worthless to the bank was not decided, because the court considered this question as unnecessary. This issue is significant since it represents one opportunity for extending the exceptions in the L/C. The *Montrod* case will be discussed later, since it provides a sufficient examination of the issue of nullity exception.

Case No. 6: *Tukan Timber v. Barclays Bank* [1987] (Buyer v. Bank)

In the case *Tukan Timber v. Barclays Bank*[415] the plaintiffs (L/C applicants) applied for an injunction restraining its bank either temporarily or permanently from paying out under the L/C. The bank had noticed the forgery and had twice rejected the demands of payment. Mr Justice Hirst accepted that on the evidence of the strict burden of proof of the beneficiary's fraud and the bank's knowledge of that fraud was satisfied. However, the granting of an injunction was eventually refused because the plaintiffs failed to prove that a further demand of payment under the L/C by the beneficiary would be fraudulent. Another reason of concern was related to the analysis of the balance of convenience. The judge did not accept the contention that the plaintiffs would suffer irreparable damage, as the plaintiffs could have a certain claim against the bank for damages for breach of contract; whereas the damage to the beneficiary would be irreparable merely by the plaintiff's cross-undertaking, if the injunction was granted.[416]

In order to decide whether an injunction could be granted, in addition to the issuing of whether fraud could be established, balance of convenience was also an important issue to consider. In the analysis of the balance of convenience, both parties' interests are weighed and compared if an injunction is granted; in particular as to whether the damages to one party are irreparable, and as to whether the damages to one party should be greater than for another party. This reflects the exercise of the court's discretion on whether an injunction order is granted in L/C fraud disputes; and this is probably the most difficult test to pass for the plaintiffs who would like to obtain an injunction order from the court.

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[415] [1987] 1 Lloyd's Rep. 171.
[416] Ibid, p. 177.

Based on the forgoing discussion of the court cases, we would like to summarise the classical approach of English courts towards L/C fraud exception rules. L/C fraud can only be found in a L/C transaction, rather than an underlying transaction; and to apply the L/C fraud exception rules, the court usually requires the following conditions:

1. Fraud must be established; in a way, the evidence of fraud must be clear and sufficient;
2. The beneficiary has the knowledge of the fraud;
3. The bank has noticed or has knowledge of the fraud before paying out. This is also a point concerning the exceptions or immunisation of L/C fraud exception, which essentially refers to where a holder in due course is involved, the commitment of bank under the L/C should not be intervened with.
4. "Balance of convenience" must be favorable to granting an injunction. This test includes the assessment on whether monetary compensation is not enough under common law and whether there will be irreparable damage to the applicant if an injunction is not granted; and the weight of both parties' interests if injunction is granted. This test is also an inherent requirement concerning the procedure of injunction itself.

Move Away from Classical Approach

The following two cases concern the fraud exception rules in the bank's undertaking of performance guarantee (bond) transactions. In England, the L/C and performance guarantee (bond) are dealt with by the courts on the same footing. These cases are slightly removed from the very strict historical approach towards fraud exception rules. However, they deal with the argument of whether fraud exception would cover fraud in underlying sales transactions. It is a very important point in L/C fraud exception rules, but has not been clearly accepted by English courts.

Case No. 7: *Themehelp Ltd v. West and others* [1996]

Themehelp Ltd v. West and others[417] case is one of the rare cases where an interlocutory injunction was granted against the beneficiary on the ground of fraud. The buyers agreed to purchase the seller's business by payment instalments. A third party performance guarantee concerning the third instalment was provided by the buyers. The buyers later sued the sellers for rescission of contract on the grounds of the sellers' fraudulent misrepresentation[418]. The buyers then applied for an interlocutory injunction to restrain the sellers from demanding the guarantee payment until the trial. The injunction was granted on the grounds that firstly, the evidence showed a clear case of fraud by the sellers; and secondly, the

[417] [1996] Q.B. 84.

[418] Under English law, damages can be awarded where misrepresentation is established, see Collins, Hugh (2003), *The Law of Contract*, London: LexisNexis UK, 4th ed., pp. 192-196; but there is a distinction between fraudulent misrepresentation and negligent misrepresentation; for further discussion about the basis, the principles and the aims of damages for misrepresentation, see Poole, Jill & Devenney, James (2007), 'Performing Damages for Misrepresentation: The Case for Coherent Aims and Principles', *Journal of Business Law*, May, 269-305.

demand had not been made under the guarantee, and thus the injunction would not threaten the integrity of the guarantee.[419]

Lord Justice stated that the present case was exceptional because the relief was against the beneficiary alone to prevent the enforcement of the guarantee by giving notice of the other party's default and thus the guarantor is not a party in the proceeding.[420]

However, Lord Justice Evans delivered a dissenting judgment; and contended that Mareva relief would have been proper and then whatever sums due from the bank may be required to be paid into court.[421] Although such a contention was not accepted in this case, it might provide an alternative possibility of exercising the procedure of freezing orders in L/C fraud disputes, which will be discussed further in later sections.

The decision dealt with arguments as to whether or not fraud must be in a guarantee transaction or whether it is adequate that fraud is in the underlying transaction. The discussion on this issue is significant, because such arguments were not brought forth and analysed in earlier cases.

The plaintiff contended that during the process of negotiation of the sales contract, the beneficiary had fraudulently provided false facts, which formed the basis of the conclusion of the contract. Lord Justice Evans expressed his opinion that if the validity of the underlying contract is doubted, then further performance of the contract might be restrained until the court's decision of that dispute.[422] In addition, his Lordship stated that the granting of an injunction relieves the applicant's need to decide whether to rescind the underlying agreement or not; and allegations of fraudulent misrepresentation in the underlying contract is a different issue from whether a demand for a payment under the guarantees would be fraudulent.[423] The burden of proving the former issue is lighter than the latter; and thus the integrity of the bank's independent undertaking would be harmed.[424] It is important to point out that English law deals with fraud in a different way concerning the principles of liability and remedies, compared with misrepresentation.[425] It is claimed that in a case of fraud, it is rational to impose broader liability on an international wrongdoer, in order to achieve a deterrent and maintain moral values.[426]

However, Waite L. J. argued that if fraud in the underlying transactions is disputed between the parties before any question of the enforcement of guarantee between beneficiary and guarantor is raised, an injunction against the beneficiary does not seem to threaten the autonomy of the guarantee, as the guarantor is not a party in such proceedings.[427] Eventually a majority of the

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[419] [1996], Q.B. 84.
[420] Ibid, p. 97.
[421] Ibid, p. 103.
[422] Ibid, pp. 103-104.
[423] Ibid, p. 103.
[424] Ibid.
[425] Poole, Jill & Devenney, James (2007), p. 302.
[426] Ibid.
[427] [1996] Q.B. 84, p. 99.

CA supported the fraud exception and held that the plaintiff had satisfied the burden of proof.

Furthermore, the exercise of the injunction in this case is against the beneficiary, instead of banks as in most other cases. It requires attention, as the analysis of the balance of convenience can run the opposite course. In the judgment, Waite L. J. assessed the test of balace of convenience in the following manner[428]:

Firstly, if the sellers are allowed to demand payment under guarantee, the guarantors will be entitled to get indemnity to the same substantial amount from the buyers. Secondly, if the buyers successfully establish fraud at trial, they can only fully recover that sum if the sellers have assets for an equivalent amount in damages for fraudulent misrepresentation (in this case rescission seems totally impracticable and damages are the only remedy). However, both defendants are not in the jurisdiction, and no evidence shows that there are sufficient assets available in the country to satisfy the court's judgment; thus there is a great risk that the court's judgment cannot be fully satisfied. Thirdly, if the buyers fail to establish fraud at trial, the sellers' interest is wholly covered by the guarantee. Furthermore, if the sellers have suffered any damages due to the delay of enforcement of guarantee, they will be protected by the buyers' undertakings.

Will a party's fraudulent misrepresentation, which induces a contract with another party influence his right to payment under the L/C? This is an interesting question but it has an unclear position under English law.[429] Goode contends that if there is fraud in the underlying transaction, but the fraud does not reflect itself in the documents required under the L/C, then such fraud probably is not a defence to the autonomy principle of the L/C.[430]

We would like to underline two points from this case. Firstly, fraud can be found either in the payment instrument transaction or in the underlying transaction. This approach is different from a historical approach, which focuses on documentary fraud or fraud could only be found in payment instrument transaction. Secondly, where fraud is established, a balance of convenience test could be different between where the prohibited party is a beneficiary and where the prohibited party is a bank. In cases where the applied injunction is against the beneficiary, the balance of convenience has greater possibility of favouring the granting of an injunction than that in the cases where the applied injunction is against the paying bank.

Case No. 8: *Kvaerner John Brown v. Midland Bank PLC* [1998]

This *Kvaerner John Brown v. Midland Bank PLC*[431] case was a reported case similar to the *Themehelp* case, since an injunction was granted on the grounds of fraud. The plaintiff KJB and Polyprima included a contract, in which KJB supplied plant and materials and provided design and engineering services for the construction

[428] Ibid, pp. 100-101.
[429] Goode, Roy, 'Chapter 9: Abstract Payment Undertakings', in Cane, Peter & Stapleton, Jane (Eds.) (1991), p. 234.
[430] Goode, Roy, n. 429 above, p. 235.
[431] [1998] CLC 446.

of a chemical plant. KJB's performance obligations were guaranteed by a performance bond, which was issued by the Midland Bank in favour of Polyprima. According the contract, to get the payment, Polyprima had to declare that KJB was in default and that Polyprima had given notice in writing to KJB. Polyprima made a demand on Midland Bank maintaining that it had given notice to KJB. However, in fact, there were merely several oral notices in the negotiations with KJB. It was held that an injunction restraining Midland from making payment and restraining Polyprima from receiving such payment was granted, but an injunction restraining further demand by Polyprima was refused to be granted. The court considered that the required certificate of written notice was false, known to the bank and Polyprima, which formed the grounds for fraud.

In these two cases, injunctions were granted on the grounds of fraud. Essentially, fraud in underlying transactions was recognised as a fraud exception[432]; but it does not seem clear what exactly the standards of established fraud are when compared with earlier cases.

These decisions certainly did not belong to the mainstream attitudes of English authority; and caused much criticism[433]. The critics' main argument is that such judgments provided supportive arguments to an extension of the fraud exception to fraud in the underlying transaction, and seemed to erode the independence principle.[434] However, we suggest that this approach accords with the attitude of Lord Diplock that 'fraud unravels all', which means that the court will not allow a beneficiary to achieve payment by means of fraud.

Steps Back to Classical Approach

After the two cases, the English courts seem to take a step back, and adopt the classical approach again, thus sticking rigidly to the independence principle of the instrument and being strict on the application of L/C fraud exception rules.

Case No. 9: *Czarnikow-Rionda Sugar Trading Inc. v. Standard Bank London Ltd* [1999] (Buyer v. Bank)

In the *Czarnikow-Rionda Sugar Trading Inc. v. Standard Bank London Ltd*[435] case, the plaintiff – Rionda applied for a pre-trial injunction against the defendant (Standard Bank) in order to prevent it from making payment to two Swiss banks at maturity of L/Cs. Standard Bank opened three L/Cs under the application of its customer (Rinoda). The Swiss banks were the advising and confirming banks under the request of the Standard Bank. Rionda applied for an injunction on the basis of fraud.

The fraud concerned sugar cane which ought to have been delivered to a warehouse but that did not exist, and tanks which should have contained alcohol

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[432] A counter argument states that fraud in underlying transactions has never been clearly expressed as fraud exception in English law, see 'Roger Fayers Takes Issue with Charles Debattista on Questions of Autonomy and Fraud under UNCITRAL Convention', *DCI (ICC),* Spring 1997, Vol. 3, No. 2, p. 16.
[433] See e.g. Staughton L. J. (obiter) in *Group Josi Re v. Walbrook Insurance Co Ltd* [1996] 1 WLR 1152, pp. 1161-1162.
[434] Paterson, Stuart & Johnson, Adam (2001), p. 40.
[435] [1999] C.L.C. 1148.

contained only water. However, a few facts should not be disregarded: firstly, the Swiss banks had already discounted the L/C either directly to the beneficiary, or indirectly under a back-to-back L/C issued to the beneficiary's suppliers; secondly, the discounting has been done before the dispute of fraud was raised; thirdly, the shipping documents of the goods had already been negotiated and accepted by Standard Bank.

Thus, the court had to deal with two questions: whether the facts proved the establishment of fraud; and whether a pre-trial injunction properly considered the balance of convenience.[436]

Rix J. did not grant the pre-trial injunction, since the court considered that according to the L/C fraud exception rules established in precedents, the bank's knowledge about fraud before making payment is not established, and the balance of convenience test was against the issuing of injunctive relief. The main reasoning Rix J delivered is as follows[437]: firstly, the fraud has to be clear to the paying bank before its making payment; otherwise, the great interest involved in the banking contracts under which the banks are liable to pay cannot be interfered with. Secondly, fraud must be established; otherwise, a buyer cannot seek to prevent the seller from drawing on the L/C and the reliability of banking contracts could not be maintained. Thirdly, as the plaintiff has the benefit of the lower standard of proof on a pre-trial hearing, the court has to consider an extra requirement, which is the discretion not to interfere with the fulfilment of the independent banking commitments. Fourthly, regarding the balance of convenience, Rix J cited the convincing passage from Kerr J. in the *Harbottle* case that "it is only in exceptional circumstances that the Courts will interfere with the machinery of irrevocable obligations assumed by banks. They are the life blood of international commerce". In addition, the loss of the plaintiff could be reduced by the possibility of damages as alternative and sufficient remedy and the court also has jurisdiction to issue a freezing order on the beneficiary's assets.

Rix J. finally concluded that: the Swiss Banks, who have given full value of documentary credit before the fraud arose, are entitled to get reimbursement from the issuing bank; if the injunction is granted, the real loser would be the Swiss Banks; it is too late to prevent the beneficiary from benefiting from their fraud; and there is little reasoning to support the plaintiff's claim.[438]

The decision can be said to be a pleasant step back to what could be regarded as the classical position.[439] The autonomy principle of the L/C prevailed over other matters, and the banking commitment thus shall be independent from disputes between merchants.

Therefore, in this case it is clear that the historical approach to the L/C fraud exception rules was confirmed again. For L/C fraud exception to apply, fraud must be established and fraud has to be clear to the bank. The immunisation

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[436] Arora, Anu (2000), 'Annual Round Up: Banking Law', *Comp. Lawyer*, 21 (8), 234-244, pp. 237-238.
[437] [1999] C.L.C. 1148.
[438] Ibid.
[439] Paterson, Stuart & Johnson, Adam (2001), 'Fraud and Documentary Credits', *J.I.B.L.*, 16(2), 37-40, p. 40.

of L/C fraud exception was considered and the balance of convenience test was exercised. More interestingly, the alternative of applying for a freezing order on beneficiary's assets was mentioned, when the alternative remedy in L/C fraud is concerned.[440] We will explore further the issue of the freezing order as another possible remedy.

Case No. 10: *Banco Santander S. A. v. Banque Paribas* [2000] (Bank v. Bank)
In the *Banco Santander S. A. v. Banque Paribas*[441] case, a confirming bank sued an issuing bank for reimbursement under a L/C. The case is discussed here, as its decision caused great concern to the banking community and it seemed that the risk of fraud discovered before maturity but after the discounting of a deferred L/C was shifted from the issuing bank to the confirming bank.[442]

Banque Paribas ("Paribas") issued a deferred payment L/C, payable at 180 days from the BL issuing date, in favour of Bayfern Ltd ("Bayfern"). The documents under the L/C were required to be presented to the confirming bank - Banco Santander SA ("Santander"). Santander discounted this L/C before its maturity, to the beneficiary Bayfern. After the discounting, some of presented documents were found to be fraudulent. Thus, the issuing bank Paribas refused to reimburse the confirming bank Santander. Then Santander sued Paribas in the Queen's Bench Division for reimbursement, alleging that it should be protected from the fraud in spite of the fact of fraud taking place. Fraud was considered to have been established in this case, but the problem is who should bear the consequential loss of fraud. The trial court held that the issuing bank was entitled to refuse payment to the confirming bank due to the established fraud and the CA upheld the trial court's decision.[443]

The preliminary issues held by Langley J. in the first instance were that Bayfern had been guilty of fraud; that one or more documents were falsified; and that Santander and Bayfern had notice of the fraud before the maturity date. Langley J. took the view that Santander could have the right to get reimbursement only at maturity, and Santander took on the beneficiary's rights as against Paribas as an assignee.[444]

Santander appealed, alleging that the consequence of the discounting was not to take Bayfern's rights as an assignee, but was a discharge of Santander's obligation to the beneficiary Bayfern, generating an independent right of reimbursement un-

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[440] For further discussion, see Ellinger, E.P. (2000), 'Developments in Banking Law', *Journal of Business Law*, Nov., 618-628, p. 624.
[441] [2000] C.L.C. 906, CA.
[442] Paterson, Stuart & Johnson, Adam (2001), p. 39; see also Aharoni, Daniel & Johnson, Adam (2000), p. 25.
[443] It was claimed that the US court would have a different judgment on the same facts by applying revised UCC article 5, as Santander might be held as a nominated, confirming bank and it honoured its confirmation in good faith, for further discussion, see John V H Pierce, Wilmer, Cutler and Pickering, '22. The Fraud Exception in US Law – a US Perspective on Banco Santander v Banque Paribas', in ICC Commercial Crime Services (2002b), *Trade Finance Fraud: Understanding the Threats and Reducing the Risk* (A Special Report prepared by the ICC International Maritime Bureau), Barking: ICC Commercial Crime Services, ICC Publication No. 643, pp. 66-70.
[444] [1999] C.L.C. 1321, QBD; see also comment on the case, Ellinger, E. P. (2000), pp. 624-625.

der Article 14(a)(i) of UCP 500.[445] The key issues examined by the CA were whether Santander was an assignee of Bayfern; and if so, whether Paribas could have the same defence against Santander as they would have had against Bayfern.[446]

Waller L.J. considered that the UCP did not satisfactorily handle the issue of which party takes the risk of fraud concerning deferred payment documentary credit, and issued the following decisions that[447]:

> (1) The finding of Langley J was right that Santander took the rights of Bayfern as merely an assignee. It could be seen clearly that the amount of claim from Santander for reimbursement was the full amount of the documentary credit, instead of the amount discounted to Bayfern, which was less than the full amount. Thus, Santander proposed to keep the rights of Bayfern active under the documentary credit. Through discounting the credit before maturity, the rights of Bayfern were assigned.
>
> (2) The fraud defence available to the issuing bank as against Bayfern was also available against the assignee. Thus Santander's claim that the discounting was a discharge of Santander's obligation to Bayfern failed.
>
> (3) Santander was not entitled to reimbursement because Paribas had requested Santander only to confirm the L/C on maturity. However, on maturity there would be no obligation to pay because of the fraud committed by Bayfern. In other words, if Santander had not discounted, but had waited until the maturity date, they would have had a ground for refusing to pay Bayfern.

The case raises an important issue relating to a deferred L/C: how does the fraud exception apply during the operation of such a L/C, particularly under circumstance where the deferred L/C is discounted by the paying or confirming bank and the authority to discount is not obtained?[448] It is important to determine what position a bank is in the chain of L/C transactions.

The decision seems to comply with commercial sense and thus is welcomed by the commercial community. In particular, it was commented that the decision is logical and complies with sound legal principles.[449] But this case did not concern an injunction, thus the balance of convenience test was not used.[450]

This case also shows why a bank has to take the L/C fraud issue as a serious matter. Sometimes it is necessary for banks to check some documents further for the bank's own interests where their authenticity is suspected. Otherwise, a bank might become the bearer of the loss resulting from L/C fraud.

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[445] [1999] C.L.C. 1321, QBD.
[446] Ibid.
[447] Ibid.
[448] Arora, Anu (2001), 'Annul Round-up: Banking Law', *Comp. Lawyer*, 22 (10), 298-307, p. 304.
[449] Aharoni, Daniel & Johnson, Adam (2000), 'Case Comment – Fraud and Discounted Deferred Payment Documentary Credits: The Banco Santander Case', *Journal of International Banking Law*, 15 (1), 22-25, p. 25.
[450] Paterson, Stuart & Johnson, Adam (2001), p. 40.

Case No. 11: *Montrod Ltd v. Grundkotter Fleischvertriebs GmbH* (GK) [2002] (Buyer v. Seller)

This *Montrod Ltd v. Grundkotter Fleischvertriebs GmbH*[451] case is significant as it discussed the issue of nullity exception, which was considered as being a possibility for extending the fraud exception.[452]

The basic facts in this case were that the seller GK (a Germany company), contracted with Ballaris (A Russian company), which was the agent of Montord, and the payment method was a documentary L/C. Concerning L/C transactions, GK was under the guidance of its German bank – Commerzebank. GK agreed with Ballaris that some certificates of inspection could be signed for Montrod by GK's employee. A Montrod company stamp was sent to GK by Ballaris for such a purpose, and the GK employee signed the required certificates.

When the bank informed Montrod that the presented documents complied with the documentary credit terms, Montrod notified the bank that it had not signed the certificates and the bank should not make payment as the certificates obviously were forgeries. However, the bank finally decided to pay due to the conformity of presented documents. Montrod applied to the court for an injunction, but it was refused due to no proof of forgery by the GK. Montrod further argued "nullity exception" (another reason for non-payment in law), which refers to that if by the time of payment, the only rational interference is that a document, which was created by the beneficiary, tendered under a L/C is not what it shows to be, but is a nullity, then the bank could refuse to pay.[453]

The trial court rejected Montrod's argument, as the trial judge found that GK had completely no knowledge of fraud.[454] An essential matter was that Ballaris had no authorisation to represent Montrod; but this fact was unknown to GK, and GK dispatched the contracted goods, and then tendered the required documents including the inspection certificates to the bank for payment. More importantly, the trial court considered that the authority in England does not support such a nullity exception and Montrod's argument is contrary to the provisions of the UCP.[455]

Several provisions of the UCP were also discussed in the CA by Potter L.J., who decided that the autonomy principle, the rule by which the banks deal with documents, not goods[456], and the issuing bank's obligation to pay if the presented documents are compliant with the requirements[457] make the beneficiary GK legally able obtain the payment from the issuing bank. Either as a general principle, or under the UCP, an issuing bank has no obligation to question or investigate the authenticity of documents. Moreover, the UCP clearly provides that the examination of the presented documents limits the documents alone[458],

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[451] [2002] C.L.C. 499, CA.
[452] McKnight, Andrew (2003), p. 161.
[453] [2002] C.L.C. 499; for detailed discussion on this point, see pp. 504-505.
[454] [2001] C.L.C. 466.
[455] [2001] C.L.C. 466, p. 467.
[456] See UCP 500, article 3 and 5.
[457] Ibid, article 9.
[458] Ibid, article 14 b.

and the bank is not liable or responsible for the genuineness or legal effect of such documents[459].

As for the issue of nullity exception, his Lordship clarified that extending the fraud exception to cover the circumstance where the beneficiary is innocent of any knowledge of forgery would extend the law, and the fraud exception to the autonomy principle should be limited on the fraud or knowledge of fraud on the part of the beneficiary.[460] His Lordship further explained the reasons of the current policy of not extending the nullity as an exception as follows[461]:

Firstly, the function of the UCP was to provide to some extent uniformity and reliability in international payments in international transactions and the acceptance of a general nullity exception would undermine the autonomy principle. Secondly, the fraud exception is extremely narrow in its scope due to its requirement of establishing fraud by the seller or the seller's agent with his knowledge. Conformity of documents at their face value is the requirement for payment provided by the UCP, and banks are not compulsory to make their investigations into the genuineness of tendered documents. An essential matter is that the allegations of fraud or an application to the court for injunction by a buyer or other concerned parties have to be able to provide sufficient evidence. Thirdly, if a general nullity exception to payment in England is accepted, it would push the banks to perform an extensive examination of the authenticity of documents, which seems time consuming and impractical. Such extension would invalidate a fundamental principle in the UCP, which is that banks do not guarantee the genuineness of the documents, and what they are required to do is to use reasonable care to check the conformity of those documents with the stipulations in credit on their face. Fourthly, a nullity exception might frustrate beneficiaries who take part in a chain of contracts where their good faith is not questionable. Therefore, accepting this new nullity exception would seriously erode the system of financing international trade by L/Cs.

Thus, the courts keep the L/C fraud exception in England still under its narrow scope, by refusing to accept the nullity exception argument. Clear evidence of fraud by the beneficiary is required in order to establish L/C fraud. When considering the knowledge of fraud of a beneficiary, the performance of the underlying sales contract by the beneficiary is taken into account. The disadvantages of accepting nullity exception in L/C transactions are emphasised by looking at the impracticality for banks to make investigations of documents, and the potential distrust in the L/C system from beneficiaries. The courts interestingly discussed the relationship of L/C fraud exception and UCP. In a word, the court considered that such an extension of the L/C fraud exception would undermine the fundamental principle of the L/C, and then undermine the entire system of the L/C.

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[459] Ibid, article 15.
[460] [2002] C.L.C. 499, p. 500.
[461] Ibid, para. 58, p. 512.

However, some academics propose that there should be a separate nullity exception to the independence principle of the L/C in common law.[462] Such an exception will not impose higher burdens for examining documents than the current practice on banks.[463] As widely recognised, fraudulent documents, being the evil of international trade, will undermine the trust of the L/C system. If a nullity exception is not accepted, more fraudulent documents may come into L/C transactions and thus may lead to distrust in the system. It was further argued that the certainty guaranteed by the autonomy principle should not be achieved at the cost of trust in the whole L/C system.[464]

Case No. 12: *Standard Chartered Bank v. Pakistan National Shipping Corporation and others* [2003] (Bank v. Carrier & others)

The *Standard Chartered Bank v Pakistan National Shipping Corporation and others*[465] case is significant, since it discusses the possible liability of a bank to contributory negligence in the situation where false documents are presented for a L/C payment, but such a payment could have been refused on the basis of other grounds. Interestingly, a court case in China (Shenzhen Branch Sanhe Bank Case No. 3) was similar to this case, which will be discussed and compared in a later section.

A sales contract was concluded between Oakprime (seller) and a Vietnamese organisation (buyer). Under the requirement of the buyer, a Vietnamese bank (Incombank) issued the L/C, which was confirmed by Standard Chartered Bank (Standard). As loading was delayed, with the knowledge of the managing director of Oakprime (M), Pakistan National Shipping Corporation (PNSC) issued a BL bore a false shipment date. Then Oakprime presented documents to Standard to demand payment under the L/C. Oakprime re-submitted documents to Standard due to one omitted document and a few discrepancies in its first presentation, but the final date for negotiation of the L/C had passed. Standard nevertheless waived late presentation, authorised payment, and demanded reimbursement from Incombank with a cover letter stating that the documents had been presented before the expiry date. Incombank rejected the documents because of the discrepancies which Standard had not discovered during its examination. Standard then sued PNSC (the shipping company), Oakprime (the seller), and M (the managing director of Oakprime) for deceit. In the first instance, Cresswell J held that all the defendants were liable for damages, as they had joined in issuing a false BL and intended it to be used to draw payment from Standard under the L/C.[466]

M appealed on the grounds that the fraudulent representation he made was for Oakprime, and thus he should not be personally liable; PNSC appealed, alleging that Standard's loss partly resulted from its own 'fault' under s.1(1) of the Law

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[462] See e.g. Chin, L.Y. & Wong, Y. K., Case and Comment 'Autonomy – A Nullity Exception at Last *Beam Technologies v. Standard Chartered Bank*', in Rose, F.D. (General Ed.) (2004), *Lloyd's Maritime and Commercial Law Quarterly*, London & Singapore: LLP, 14, p. 18.
[463] Ibid.
[464] Ibid.
[465] (No. 2) [2003] 1 Lloyd's Rep. 227.
[466] [1998] 1 Lloyd's Rep 684.

Reform (Contributory Negligence) Act 1945, and thus the amount of its damages should be reduced.[467] On the point of M's liability, the CA upheld M's allegation and decided that M was not liable for deceit. Concerning the issue of Standard's contributory negligence, the court held that although unpleasant, Standard's conduct was not at 'fault' as defined in the 1945 Act and it was not a defence to an action in deceit in common law.[468] Lord Justice Ward stated that Standard's loss was due to the defendant's deceit, and

> *"the responsibility for the damage is wholly that of the defendant. It was the defendant who set out to deceive and succeeded in deceiving. The mixed motives of the Claimant do not mitigate that dishonesty. Commercial fraud must be condemned. It can only be properly condemned by an award of the whole of the damage which the Defendant intended to cause... in the law of deceit, there is to be apportionment... In this field it is all or nothing. In my judgment the Claimant is entitled to recover all its damage….."*[469]

The decision of the CA on personal liability of M was strongly criticised, as it did not follow the already accepted decisions that the agents were liable for deceit.[470] PNSC and Standard appealed to the HL. However, before the hearing, PNSC agreed a full and final settlement with Standard, and withdrew the appeal. The HL upheld the CA's decision on the issue of whether Standard's conduct was at 'fault', but restored the judgment of Cresswell J by deciding that M made a fraudulent misrepresentation intending to deceive Standard; liability for fraud could not be escaped with a defence that one committed fraud on behalf of someone else; M was sued for his own tort and he should be liable for fraud where all the elements of that tort were proved.[471] It was commented on that the decision of HL treated fraudsters in a harsh manner under English law, which supported that the law should play its part in deterring fraud by imposing wider liability on an international fraudster.[472]

The case demonstrated the possible remedy of claiming damages from the fraudsters on the grounds of tort where it is inappropriate to seek an injunction from the court. L/C fraud in this case was established, but the confirming bank had already made payment. The reimbursement that the confirming bank sought from the issuing bank was refused legally on the grounds that the confirming bank accepted and negotiated an expired L/C without obtaining the issuing bank's authority, rather than on L/C fraud. In the case, anti-dating BL was considered as L/C fraud, as the beneficiary knew the fact, which is different from an earlier case *United City Merchant*. Fraud was grounds for claiming damages for the plaintiffs, rather than as a L/C fraud exception to apply for an injunction. It seems clear that the establishment of fraud was based on the beneficiary knowing

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[467] [2000] C.L.C. 133.
[468] No. 2, [2000] C.L.C. 1575.
[469] Ibid, pp. 1602-1603.
[470] Parker, Benjamin (2003), 'Fraudulent Bills of Lading and Banker's Commercial Credits: Deceit, Contributory Negligence and Directors' Personal Liability', *LMCLQ* 1-144, Part 1, February, p. 5.
[471] [2002] C.L.C. 1330, p. 1331.
[472] Parker, Benjamin (2003), p. 4.

about the fraud and intentionally using the fraudulent document to defraud the bank, which accords with the historical approach of English courts to the fraud establishment in L/C fraud exception rules.

From the previous discussion of the cases, those points emphasised in the classical approach towards the L/C fraud exception rules were reconfirmed. Fraud must be established and clear, the beneficiary has the knowledge of fraud, the bank must notice the fraud, and the balance of convenience test must be in favour of granting an injunction. It seems that L/C fraud can only be found in L/C transactions, and the fraud in performance of underlying contract should not be considered. The immunisation of L/C fraud exception is obviously followed, such as if a bank has already made payment before fraud is discovered or established, the bank becomes an innocent party and is entitled to receive reimbursement.

Classical Approach Versus Future Approach

Generally speaking, it would be extremely difficult for the applicant to successfully obtain an injunction in L/C fraud disputes. In England, where a plaintiff applies an interlocutory injunction to prevent a bank from paying out or to prohibit a beneficiary from making a call on credit on the grounds of fraud, such a court order would normally be refused in order not to interfere with the smooth transaction of the L/C system. The applicants have to consider several issues before initiating such a court procedure.

The first issue to consider is cause of action. In a L/C fraud dispute, the applicant has to contemplate whom to prohibit, and what the grounds are for the application.[473] In other words, the applicant has to establish a substantive cause of action against the party to be restrained.[474]

If the restrained party is a beneficiary, there should not be a problem in finding a cause of action concerning interlocutory injunction relief, as the beneficiary is a contracting party to the underlying sales contract with the buyer.[475] However, such an application has to be done before the beneficiary presents documents to demand L/C payment. If the beneficiary has demanded payment under the L/C, it would be too late to apply an injunction against the beneficiary. Under such circumstances, the applicant has to consider the paying bank as the defendant to prohibit.

If the restrained parties are banks, the first bank to pay during the chain of payment in L/C transactions should be the defendant. Otherwise, once the first bank has paid, it then has its reimbursement rights, which are even more difficult for the court to interfere with. If the bank to be prohibited is the issuing bank, there should be no difficulty in finding a cause of action as the applicant has a contract with it.[476] A common problem might be that the bank to be prevented is the confirming bank, but normally there is no contract between the L/C applicant and the confirming bank.[477]

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[473] Raymond, Jack (1993), p. 225.
[474] Sealy, L. S. & Hooley, R. J. A. (2005), p. 851.
[475] Raymond, Jack (1993), p. 225.
[476] Ibid.
[477] Ibid.

The second issue the applicant has to face is the burden of proof of fraud in L/C disputes. The tremendously high standard of proof of fraud has led to great difficulty for applicants in England. The issue of L/C fraud exception in England has been examined in court cases in the previous section. Almost all of the court cases have highlighted the requirements that the beneficiary's fraud and the knowledge of such fraud to the bank must be clearly established. In particular, the Court required strong corroborative evidence about a fraud allegation to be clear and the only realistic interference that the court would consider was that the beneficiary was guilty of fraud.[478] Brown LJ similarly confirmed that 'it is certainly not enough to allege fraud: it must be "established"'.[479] In the Edward Owen case Lord Denning MR affirmed that 'the only exception is where there is a clear fraud of which the bank had notice'.[480]

The third, but hardest, issue concerns the balance of convenience. It causes a further difficulty for the plaintiff on the way to successfully obtaining an injunction in L/C fraud disputes. Whether the balance of convenience favours the grant or refusal of the injunction is always an important question for the courts to ask in making a decision on an application for an injunction. Whether damages are sufficient, and whether more damage will be caused by granting than by refusing the injunction will be carefully examined by the courts. Such difficulty was clearly illustrated by the *Harbottle* case, in which Kerr J explained that the plaintiffs sought to prevent the bank from paying and debiting their account; the injunction would not be appropriate because it causes greater damage to the bank than the plaintiffs could pay on their undertaking as to damages and because the plaintiffs could obtain a sufficient remedy in damages; thus the balance of convenience would be against the plaintiffs.[481] Similarly, such difficulties could also be noticed in the case *GKN Contractors v. Lloyds Bank*[482]: if there is no breach by the bank, there is no reason for an injunction; if there is or may be a breach, the bank will be capable of paying the possible damage, and then an injunction is not necessary. Therefore, in the cases where the restrained parties are banks, it seems that the balance of convenience is most probably against the granting of the injunction.

It is important to point out that if the injunction is against the beneficiary, the balance of convenience analysis may be clearly different, as discussed in the *Themehelp* case. Therefore, in theory, it seems that the possibility of obtaining an injunction against a beneficiary is greater than an injunction against a bank. However, problems and limitations of applying an injunction against a beneficiary cannot be ignored. If the beneficiary under an international L/C is located in a foreign country, the problem of enforcing an injunction order issued by an English court in a foreign country may lead to the frustration of the applicant's purpose.

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[478] See *United Trading Corpn SA v. Allied Arab Ban*k [1985] 2 Lloyd's Rep 554.
[479] [1978] QB 159, p. 173 A.
[480] [1978] QB 159, p. 171 C.
[481] [1978] QB 146, p. 155.
[482] [1985] 30 BLR 48, p. 64.

Thus, by requiring the high standard of proof, fraud and strictly sticking to the autonomy principle in L/C fraud disputes, the English courts seemed to have taken an attitude favouring the beneficiary in L/C transactions. But should England consider a change in its rigid approach, considering the healthy operation of the L/C in international circumstances?

Looking at the L/C fraud exception rules on worldwide basis, the UNCITRAL convention and the US have developed different approaches. The main difference of dealing with L/C fraud exception rules is that the English approach seems to have accepted the fraud in L/C documents, but is not ready to recognise fraud in underlying transactions; whereas the approaches of the UNCITRAL convention and the US clearly consider both fraud in documents and fraud in the underlying transactions where L/C fraud is disputed. Generally speaking, the US adopts a more flexible approach, compared with the approach in England.[483]

If English case law is to develop L/C fraud in a way that it includes fraud in underlying transactions, it may in a sense imply that it is establishing a process of investigating underlying transactions under some circumstances. This would contradict with the autonomy principle of L/C according to their classical approach.

Which direction will the English courts develop over the L/C fraud exception rules in the future? Will England be willing to keep up with international practice or will it stick to its classical approach? It remains an interesting question. But whatever, great care needs to be taken so that the autonomy principle would not be abused by fraud in L/C transactions.

It can be seen that the English courts have expressed their noticeable reluctance to issue an interlocutory injunction in L/C fraud disputes. Under such situations, it would be necessary to explore further whether and how the freezing orders, which was proposed in some court cases, could be a helpful legal remedy for parties in L/C fraud disputes. This topic has not been particularly studied under the context of L/C fraud disputes before. There seems no discussion of leading precedents dealing with freezing orders in L/C fraud disputes in England until now. Thus the research in the next section concerning freezing orders is more explorative in nature than the study of L/C fraud exceptions rules in England.

Freezing Orders in England

Introduction

The freezing order, earlier known as the Mareva injunction, is an essential and powerful[484] weapon for the disputants in civil litigation to protect assets pending trial or during the enforcement stage. As mentioned previously in the introduc-

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[483] Gao, Xiang & Buckley, Ross P. (2003a), 'A Comparative Analysis of the Standard of Fraud Required under the Fraud rule in Letter of Credit Law', 13 *Duke Journal of Comparative and International law* 293.
[484] According to Rule 1A (1) of Ord. 29 of the Rules of the Supreme Court 1965, the court has the power to further order the restrained party being cross-examined on his disclosure affidavit, but the court has to guard against the abuse of such a procedure by the plaintiff, for further discussion see Case Comment (1997), 'Cross-Examination of Mareva Defendant as to Assets', *C.J.Q.*, 16 (Jan), 3-4.

tion of injunction part, the freezing order operates in personam[485] and the main function of a freezing order is to prohibit the defendants removing assets from the jurisdiction or disappearing assets within the jurisdiction in England.

The history of the freezing order could be traced back to the late 15th century in a process named "foreign attachment" which was not widely accepted in England.[486] Then the Mareva injunction was created in a case *Yusen Kaisha v. Karageorgis* by the Court, and later was further developed in a case *Mareva Compania SA v. International Bulk Carriers*.[487] The Mareva injunction was renamed as the freezing injunction[488] after the Civil Procedure Rules (hereinafter CPR) came into force on 26 April 1999. The Supreme Court of Judicature (Consolidation) Act 1925, section 45(1) provided the original judicial basis for freezing orders; and later the Supreme Court Act 1981, section 37(3) reconfirmed the court's right of granting an injunction, either interlocutory or final, in all cases in which it seems to the court to be just and convenient.

Freezing orders on assets resulting from criminal activity can also be used in criminal proceedings.[489] But obviously limitations are imposed where freezing orders are applied by prosecutors who wish to freeze accused persons' assets pending conviction, and the particular difficulty in the criminal proceedings results from the requirement established in the *Siskina* case, which was hard for prosecutors to satisfy.[490] The so-called criminal Marevas' ambit in England has been enlarged to a great extent, and their use was encouraged by the Proceeds of the Crime Act 2002.[491] However, the majority of the discussion on freezing orders in this part will be on their use in the context of civil litigation disputes.

As for freezing orders in L/C fraud disputes, it can be said that they have the function of catching the proceeds of the L/C received by the beneficiary, and thus a party may apply such an order to restrain the beneficiary from dealing with the L/C proceeds.[492] We will explain this point by analysing two questions. The first question is whether the proceeds of the issuing or confirming bank's undertaking under L/C applies to the meaning of an asset under a freezing order or whether a freezing order will restrain the disposal of the proceeds of the L/C.[493] According

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[485] Different from another procedural instrument 'attachment order', which has the *in rem* nature, further discussion about their differences and convergence in England, see McEvoy, John J. & Dine, Janet M. (1989), 'Are Mareva Injunctions becoming Attachment Orders', *C.J.Q.*, 8 (July), 236-248.
[486] Steven Gee (1990), *Mareva Injunctions and Anton Piller Relief*, London: Longman, 2nd ed., p. 1.
[487] Meisel, Frank (1980), 'The Mareva Injunction-Recent Developments', *LMCLQ*, p. 38.
[488] CPR, Part 25 (1)(f).
[489] See e.g. Epp, John Arnold (1997), 'Freezing Funds for Fines and Mareva Injunctions', *Journal of Business Law*, Jan, 72-76.
[490] Lomnicak, Eva Z. (1989), 'Case Comment – Availability of Mareva Injunctions to Financial Services Regulators', *J.B.L.*, Nov, 509-513, p. 509.
[491] Pester, Iain (2006), 'Publication Review – Commercial Injunctions (Steven Gee)', *C.J.Q.*, 25 (JAN), 116-119, p. 119.
[492] See e.g. Fung, King Tak (2005), extract of some cases discussed in *Leading Court Cases on Letters of Credit*, published by DC-PRO, 18 Jan. 2005.
[493] Hapgood, Mark (1989), pp. 340-341; to consider this question, one has to distinguish between those legal systems that allow pre-judgment and post-judgment attachments, also distinguish those attachments sought by third parties and by the credit applicant, for further discussion see 'David M. Sassoon on Attachment of Letter of Credit Proceeds', *DCI (ICC)*, Vol. 3, No. 4, Autumn 1997, pp. 6-7.

to the principle of the case of *Z v. A-Z*, and the classic authority[494], operations of L/Cs and bills of exchange were left out from the scope of the freezing order. However, a freezing order may be granted once the amount has been credited to the account of the debtor.[495] As Lord Denning MR stated, the freezing order does not prevent payment under a L/C, but it may apply to the proceeds as and when received by or for the defendant.[496] Thus, it is assumed that an irrevocable credit turns to be binding once it is contracted with the beneficiary; the proceeds of the paying bank's undertaking of the L/C is clearly an asset to which a freezing order in a standard form will apply.[497]

If a freezing order applies, another issue is whether such an order will be made to restrain the paying bank from performing its obligation to the defendant, or otherwise intervene with banks' contract. This function of the freezing order was recognised in *Bolivinter Oil SA v. Chase Manhattan Bank* case, which confirmed that the freezing order has its limitations, which imposes restrictions on the freedom of the beneficiary to handle the L/C proceeds only after he obtains it.[498] Thus, it is clear that the court will not restrain the paying bank from performing its obligation to the beneficiary, but may restrain the beneficiary from transferring the proceeds under a L/C abroad[499]. Thus it does not violate the autonomy principle of the L/C.[500] This is consistent with the purpose of a freezing order, in that it will not be allowed to intervene with the performance of a contract between a third party and the beneficiary.

Thus a freezing order, intended to restrain L/C proceeds, can be placed side by side with an interlocutory injunction in L/C fraud disputes. Where it is almost impossible for the applicant in a L/C fraud dispute to prevent a L/C payment on the grounds of fraud through an interlocutory injunction, it is possible to consider applying for a freezing order to restrain the beneficiary from removing the proceeds of the L/C from the jurisdiction or dealing with them within the jurisdiction. An advantage of a freezing order in L/C fraud disputes is that the applicant does not have to apply for it on the grounds of fraud, because it is not for preventing payment under the L/C.[501] In this circumstance, the applicant does not have to meet with the high standard of the fraud establishment.

Previously a freezing order only could be granted where the English court had jurisdiction over the substantive claim; but the scope was criticised as being

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[494] *Mackersy v. Ramsays, Bonars & Co*, (1843) 9 Cl. & Fin. 818.
[495] Case Comment (1993), 'Position of Collection Bank', *J.B.L.* May, 274-275, p. 275.
[496] *Z Ltd v. A-Z and AA-LL* [1982] QB 558, p. 574; pre-judgment attachment (temporary or interlocutory, being granted before trial, aiming at freezing the defendant's assets in order to aid the plaintiff in collecting the debt from a judgment favourable to the plaintiff is issued) in Israel, deriving from the civil law system, seems impossible on L/C proceeds for third parties, and thus impossible for L/C applicants, for further discussion see Yifrach, Meir (2001), 'Case Comment: Third Party's Attachment on Letter of Credit Proceeds', *Journal of Business Law*, Mar, 157-165.
[497] Hapgood, Mark (1989), p. 341.
[498] *Bolivinter Oil SA v. Chase Manhattan Bank* [1984] 1 Lloyd's Rep 251, [1984] 1 WLR 393, [1984] 1 All ER 352.
[499] Rowe, Michale (1997), *Letters of Credit*, London: Euromoney Books, 2nd ed., p. 258.
[500] For a similar argument and the justification for it, see 'David M. Sassoon on Attachment of Letter of Credit Proceeds', *DCI (ICC)*, Vol. 3, No. 4, Autumn 1997, pp. 6-7.
[501] Sealy, L. S. & Hooley, R. J. A. (2005), p. 852.

extremely narrow.[502] Nowadays though, English case law has developed and issues freezing orders worldwide.[503] After the brief introduction of the history and evolution of the freezing order, the general guidelines for granting a freezing order will be examined. Furthermore, the effect and problem of worldwide freezing orders will be discussed.

General Conditions for Granting Freezing Orders

This section will look at the conditions required by the courts in order to obtain a freezing order in England. It would be useful to discuss some general principles or matters that the courts will consider when making a decision on the application of a freezing order. In L/C fraud disputes, when seeking a freezing order from a court, the applicant has to meet the same requirements.

The first condition is that the plaintiff must have a substantive cause of action which can be litigated in the jurisdiction.[504] And this point was confirmed recently by the decision in the case *Fourie v. Le Roux*[505]. The *Siskina*[506] was the leading case, in which is was decided that the jurisdiction to grant a freezing order must be a jurisdiction in personam; and a freezing order was not available if it did not have the support of a substantive cause of action arising out of an actual or threatened legal or equitable right, and enforceable against the defendant within the jurisdiction.[507]

The second condition to meet the minimum threshold for granting a freezing order is that a good arguable case must be established. This requirement was decided in *Ninemia Maritime Corp v. Trave Schiffahrtsgesellschaft & Co* and clarified by Kerr L.J. in the CA.[508]

Thirdly, the plaintiff must establish that there is a real risk of the defendant's assets being removed or dissipated before the judgment or award is enforced, if unrestrained by the court order; mere suspicion is not enough.[509] If there is no real danger of the defendant dissipating his assets, a freezing order should be refused.[510] Regarding those assets, a precondition is that the assets must be located in England.[511] Thus, a further requirement is that the plaintiff has to prove that the

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[502] D'Arcy, Leo (2000), p. 465.
[503] Article 24 of the Brussels and Lugano Conventions 1988, section 25 of the Civil Jurisdiction and Judgments Act 1982, and Part 25 of CPR provides the statutory support.
[504] Capper, David (2007), 'Case Comment: Asset Freezing Orders – Failure to State the Cause of Action', *C.J.Q.* 26 (APR), 181-184, p. 181.
[505] [2007] UKHL 1.
[506] *Siskina (Cargo Owners) v. Distos Compania Naviera SA* [1979] AC 210, HL.
[507] Siskina, Lord Diplock, p. 256.
[508] The Niedersachsen [1984] 1 All ER 398 pp. 414-415, [1983] 1 WLR 1412, p. 1417, CA.
[509] The Niedersachsen [1983]; furthermore, concerning the question of risk of dissipation, some factors can be relevant, such as whether there is proof that the defendant has taken steps to remove or dissipate its assets (see *Aiglon Ltd v. Gau Shan Co Ltd*, [1993] 1 Lloyd's Rep. 164); whether the defendant has any history of non-compliance with court orders and has taken other action disregarding court orders (see *Great Future International Ltd v. Sealand Housing Corp*, [2003] EWCA Civ 682); whether the defendant has any past incidents of debt default can be considered (see *Third Chandris Shipping Corp v. Unimarine SA* [1979] 1 Q.B. 645); where a defendant intended to sell his or her business at a price much below the market price (see *Customs and Excise Commissioners v. Anchor Foods Ltd* [1999] 1 W.L.R. 1139).
[510] *Z Ltd v. A-Z* [1982] Q.B. 558.
[511] See *Derby & Co. Ltd v. Weldon (No. 3 and 4)* [1990] Ch. 65.

defendant has assets within the jurisdiction; and this derives from the principle that "equity will not act in vain".[512]

Fourthly, the plaintiffs have to afford an undertaking in damages, such as a bond or a security, in case his claim fails or the injunction becomes unjustified.[513] But in exceptional cases, it is possible for a freezing order to be granted although the plaintiff has limited financial means.[514]

Fifthly, the plaintiffs should fully and frankly disclose all relevant key facts known to them or which would have been known to them if they had reasonably and appropriately made all inquires in the particular circumstances.[515] On the whole, this is a general duty for all applications for an injunction made *ex part* (without notice). This duty especially applies to a freezing order as it is likely to cause substantial prejudice to the defendant.[516]

Sixthly, a freezing order, like other injunctions, is under the discretion of the court. In other words, the eventual test for the court to exercise a freezing order is whether the case is "just and convenient".[517] Thus, even though all the foregoing requirements are satisfied, the court can still refuse to grant such an order. Lord Denning M.R was of the view that in practice the freezing order has been most valuable to London and to all those who are in the shipping world and elsewhere, but the judges must be cautious not to stretch too far to become a danger to the proper conduct of business.[518] To sum up, in order to obtain a freezing order, the applicants have to satisfy the courts with various requirements and conditions.

Worldwide Freezing Orders

The issuing of worldwide freezing orders has been increasingly addressed by jurisprudence.[519] Where a foreign defendant is located in a foreign country, will a freezing order still work as an effective instrument? In international disputes, it is especially helpful to examine the situation where the issuance and enforcement of a freezing order concerns two different countries.

It has been identified that in terms of international implications, freezing orders are often dealt with regarding three elements: assets located abroad, a defendant within or otherwise subject to jurisdiction of the domestic court, and third parties within the jurisdiction or abroad who control the property in question.[520] However, these factors may not always be the same in different cases.

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[512] Suen, Henry & Cheung, Sai On (2007), 'Mareva Injunctions: Evolving Principles and Practices Revisited', *Const.L.J.* 23 (2), 117-136, pp. 120-121.
[513] The Niedersachsen [1984], p. 416.
[514] See *Allen v. Jambo Holdings Ltd* [1980] 2 All E.R. 502, CA.
[515] *Third Chandris Shipping Corpn v. Unimarine SA* [1979] QB 645, pp. 668-669.
[516] See *Bank Mellat v. Nikpour* [1985] F.S.R. 87, p. 92.
[517] The Niedersachsen [1983], p. 1426.
[518] *Negocios del Mar SA v. Doric Shipping Corp SA* [1979] 1 Lloyd's Rep. 331, p. 334.
[519] Particularly concerning the situation in offshore jurisdictions, see Aslett, Pepin (2003), 'Cross-border Asset Protection: An Offshore Perspective', *Journal of Financial Crime*, 10(3), 229-245.
[520] Devonshire, Peter (1996), 'The Implications of Third Parties Holding Assets Subject to a Mareva Injunction', *LMCLQ*, (May), Part 2, p. 269.

The English courts initially hesitated in issuing worldwide freezing orders, and it was not until 1988 that the English courts started to grant such relief. With such a freezing order, the defendant's assets outside the jurisdiction can appropriately be restricted whenever his assets within the jurisdiction are inadequate.[521] Thus, in exceptional cases, the court may grant worldwide freezing orders, especially in cases such as fraud.[522]

During the development of freezing orders, the courts have been confronted with two problems.[523] The first issue is the risk of oppression to the defendant deriving from the ability of the claimant to enforce the order in different jurisdictions; and the main difficulty lies in the requirement of obtaining the court's permission to seek enforcement abroad for a plaintiff.[524]

The factor in the court's discretion of being "just and convenient" will be discussed further particularly in relation to the extra-territorial freezing order. By empowering the court discretion of granting a freezing order, it provides the court maximum flexibility in deciding this matter based on the particular circumstances and terms. Even though no clear limitations have been imposed on the exercise of this discretion, judicial authority has to a great extent restricted its scope.[525] For example, in *Channle Tunnel Group Ltd v. Balfour Beatty Construction Ltd*, it was stated that although in law such discretion is wide, a long history of judicial self-denial has firmly established that "they are not to be taken at their face value and that their application is subject to severe constraints".[526] In *Dadourian Group Int. Inc v. Simms*[527] (Dadourian), the CA clarified that to decide what is just and convenient the court has to take into account all possible options, in particular the terms on permission of enforcing abroad, which can reduce oppression. The court is also required to consider the safeguards under a foreign court's normal practices.[528] If permission of enforcement abroad is given, the worldwide freezing order is really a powerful weapon.

The second issue concerns how to address third parties, in particular banks, affected by a worldwide freezing order, as banks which operate worldwide often become the targets of such orders.[529] If the third party is within the jurisdiction of England, such an order can be enforced; however, if the third party is out of the jurisdiction, the court does not have the power to enforce the order.[530] This issue is discussed further in the following separate subsection.

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[521] *Derby & Co Ltd v. Weldon* (*No. 3 and 4*) [1989] 1 All ER 1002, p. 1007, [1989] 2 WLR 412, p. 419.
[522] Tumbridge, James (2008), 'Case Comment: How Far Will the English Court Go in Awarding Worldwide Freezing Injunctions in Support of Foreign Arbitration', *I.C.C.L.R.*, 19(9), 290-294.
[523] Meisel, Frank (2007), 'Case Comment: Worldwide Freezing Orders – the Dadourian Guidelines', *C.J.Q.*, 26 (APR), 176-180, p. 176.
[524] Ibid.
[525] For futher disucssion on this point, see Yang, Liangyi & Yang, Daming (2000), *Injunctions*, Peking: China University of Political Science and Law Press, 1st ed., pp. 293-301.
[526] [1993] A.C. 334, pp. 360-361. See also Lord Browne-Wilkinson's comments, pp. 341-343.
[527] [2006] EWCA Civ 399; [2006] 3 All E.R. 48.
[528] [2006] EWCA Civ 399, para. 33.
[529] Meisel, Frank (2007), p. 176.
[530] Ibid, p. 177.

Effect of Worldwide Freezing Order on Third Parties Holding Assets

It has been long recognised that the effectiveness of a freezing order often relies on restraining not only assets in the hands of the defendant, but also property within the third parties' control. In the context of a L/C fraud dispute, the third party in particular refers to banks, holding the L/C proceeds of the defendant. This section discusses some persistent and difficult problems concerning the court's jurisdiction to restrain third parties. Furthermore, issues in relation to enforcement of freezing orders on third parties will also be addressed.

When a worldwide freezing order becomes possible, in order to identify the effect of it on third parties who control the defendant's property is necessary. The effect of a freezing order on third parties could be evaluated based on the nature of the imposed obligations.[531] Thus, the essential issues are whether such third parties should also abide by the freezing order and what the consequences of failing to do so would be, if there are any.[532] In principle, with the freezing order from the court, the bank may have a lawful defence against a claim from the defendant that the bank is in breach of its contract with its customer.[533] If a domestic bank with which the foreign defendant has an account is served with a freezing order, the bank can be held in contempt of a court order due to breach of the freezing order if it agrees to the wishes of the defendant to dispose of money. Therefore, third parties within the jurisdiction ought to obey any obligations regarding the defendants' foreign assets under their control.[534] In case *Mercedes-Bens A.G. v. Leiduck*[535], it addressed a situation where the third parties hold assets of a foreign defendant; and inferred that the property within the jurisdiction would generally be caught by a freezing order imposed by a domestic court.[536]

The enforcement of a worldwide freezing order presents different and greater problems than those in the domestic context. When the extension of freezing orders to assets abroad was allowed, some limitations on the extraterritorial effect of such orders on third parties were also identified. Third parties beyond the jurisdictional reach of the court are in principle not subject to the obligations of the court order.[537] If a defendant disposes of assets and stays outside the territo-

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[531] Devonshire, Peter (1996), p. 279.

[532] Ibid, p. 268.

[533] Statement from Lord Denning M. R.: "any prior mandate from the customer is automatically annulled when the bank receives notice of the Mareva injunction", see *Z Ltd v. A-Z and AA-LL* [1982] Q.B. 558, p. 574; see also *Acrow (Automation) Ltd. v. Rex Chainbelt Inc.* [1971] 1 W.L.R. 1676.

[534] The standard form worldwide Mareva Order in *Practice Direction (Mareva Injunctions and Anton Piller Orders*) [1994] 1 W.L.R. 1233, Annex 2, provides that the order is enforceable against "a person who is subject the jurisdiction of this Court and (i) has been given written notice of this Order at his residence or place of business within the jurisdiction of this Court and (ii) is able to prevent acts or omissions outside the jurisdiction of this Court which constitute or assist in a breach of the terms of this Order".

[535] [1995] 3 W.L.R. 718.

[536] For further comment on this case, see Case comment (1996), 'Extra Territorial Jurisdiction and Mareva Relief', *C.J.Q.*, 15 (Jan), 6-8.

[537] This is revealed in the standard form worldwide Mareva order in *Practice Direction (Mareva Injunctions and Anton Piller Orders)*, Annex 2, n. 534 above; subject to certain qualifications, Annex 2 states that "the terms of this Order do not affect or concern anyone outside the jurisdiction of this Court until it is declared enforceable or is enforced by a Court in the relevant country and then they are to affect him only to the extent they have been declared enforceable or have been enforced…" see further, *Baltic Shipping Co. v. Translink Shipping Ltd* [1995] 1 Lloyd's Rep. 673

rial jurisdiction of the court, no effective punishment can probably be imposed on him. The limits of the court's jurisdiction have always been challenged. In the case *Babanaft International Co. S. A. v. Bassatne*, Nicholls, L.J. asserted the inappropriateness of imposing a freezing order regarding overseas assets against a defendant within its jurisdiction, or to impose or attempt to impose obligations on persons not before the court concerning their acts on property outside the jurisdiction; and that would be to unreasonably claim an extraterritorial jurisdiction".[538]

To enforce a worldwide freezing order against third parties result in particular problems. Generally, freezing orders are not to be granted against a bank;[539] as they might place a bank's business in danger by interfering with its normal manner of doing business and the maintenance of confidence on banks might be damaged.[540] However, it still seems that the banks are likely to fall in potential conflicts when dealing with the frozen accounts because the existence of an order does not completely end their obligations to the customer.[541] In addition, where the third party is located merely outside the jurisdiction, international comity has to be considered, as it may be improper to force such a third party to obey the order of a foreign court.[542] One solution was to insert some terms into the court order.[543] It was said that the purpose of such terms are to bind third parties who are able to obey the order and excuse those who are not.[544] However, most international banks seem to still have problems with compliance with freezing orders.[545]

Freezing Orders Supporting Foreign Litigations

The issue of extending jurisdiction of granting a freezing order, where a substantive issue is preceded in a foreign jurisdiction has also attracted the attention of academics.[546] Will English courts grant freezing orders to assist other substantive proceedings in the context of international L/C fraud disputes, if the plaintiff initiates a L/C fraud dispute in another country? This is an interesting and relevant question.

The English courts have dealt with the principles of exercising their discretion to grant freezing orders in support of foreign litigation in several cases. *S & T*

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[538] [1990] Ch. 13, p. 44.
[539] 'Case Comment – Mareva Injunction on Bank's Assets in the Context of Tracing Action', *J.B.L.*1992, Jul, 416-419.
[540] See case *Polly Peck International plc v. Nadir, Unreported*, judgment of March 19, 1992.
[541] For instance, the intervening effect of a freezing order does not override the duty of confidentiality owed by a bank, see *Bankers Trust Co. v. Shapira* [1980] 1 W.L.R. 1274.
[542] Babanaft [1990] Ch. 13, p. 40.
[543] See *Derby v. Weldon* (No. 3 and 4) [1990] Ch. 65, pp. 78-80 (Lord Donaldson M. R.).
[544] Capper, David (1996), 'The Trans-Jurisdictional Effects of Mareva Injunctions', *C.J.Q.* 15 (JUL), 211-233, p. 219.
[545] Capper, David (1996), p. 220; see also cases *Baltic Shipping Co. v. Translink Shipping Ltd and another* [1995] 1 Lloyd's Rep. 673; *Galaxia Maritime SA v. Mineralimportexport* [1982] 1 W.L.R. 539.
[546] See Capper, David (1998), 'Further Trans-Jurisdictional Effects of Mareva Injunctions', *C.J.Q.*, 17 (JAN), 35-40; the freezing order is only one type of interim remedy, other interim remedies such as attachment order are also available, see Case Comment (2008), 'Interim Remedies: Support of Foreign Proceedings –Scope of Relief', *Civil Procedure News* 2008, 3 (MAR), 2-3.

Bautrading v. Nording[547] addressed the desirability of co-operation between courts in different jurisdictions in fighting against international fraud.[548]

In the case *Motorola Credit Corp v. Uzan*[549], the court confirmed the basis of the law on freezing orders in support of foreign litigation. The CA pointed out that it is necessary for the English court to perform as an "international policeman" as long as the rules are permitted in circumstances of the existence of international fraud; but the court also agreed that a policing role was not practical and expedient unless the court was able to enforce its order if disobeyed.[550] The main ways that a court could enforce its order lie in individuals or assets existing within its jurisdiction.

It has been commented that a decisive thing for the court to consider when granting a worldwide order is whether there are assets of defendants within the English jurisdiction; only then can the court be assured that it is possible to enforce its orders.[551] In spite of the complex fact in the case, the Court of Appeal had clarified clear guidance on the circumstances where substantive proceedings are initiated in another jurisdiction and an ancillary freezing order is applied from the English court.[552]

In brief, freezing orders are usually made *ex parte* and under an urgent circumstance, and are granted only in unusual circumstances. Trying to enforce a freezing order worldwide may come up against particular difficulties. However, if such an instrument is available, and is employed properly, it could become a powerful and effective mechanism in international commercial disputes especially in cases of fraud.

Summary of Freezing Orders in England

As we discussed in the previous chapter, the English courts are in general unwilling to restrain payment under L/Cs, in spite of any dispute between the buyer and the seller. Thus, a bank usually will perform its obligation to pay the beneficiary under L/Cs unless enjoined by a court order. However, the plaintiff may apply for a freezing order against the proceeds under the control of the recipient, as this alternative is not against the accepted judicial opinion that the payment mechanism of L/Cs or other similar instruments should not be interfered with.[553]

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[547] [1997] 3 All E.R. 718.

[548] See statement from Millett L.J: "commercial necessity has encouraged national courts to provide assistance to each other without waiting for such co-operation to be sanctioned by international convention. International fraud requires a similar response. It is becoming widely accepted that comity between the courts of different countries requires mutual respect for the territorial integrity of each other's jurisdiction, but that should not inhibit a court in one jurisdiction for rendering whatever assistance it properly can to a court in another in respect of assets located or persons resident with the territory of the former." [1997] 3 All E.R. 718, p. 730.

[549] [2002] EWCA Civ 752; [2004] 1 W.L.R. 113.

[550] Ibid.

[551] See Hewetson, Charles & Hart, Simon (2003), 'Jurisdictional Disharmony and Confusion – The Court of Appeal Looks Worldwide Freezing orders, Assets and Jurisdiction', *J.I.B.L.R.*, 18 (11), 463-466, p. 466.

[552] For further discussion on the criteria of granting such an order, see judgment of the case, [2002] EWCA Civ 752; [2004] 1 W.L.R. 113.

[553] See Lord Denning, M. R., in *Z Ltd v. A-Z* [1982] 1 Q.B. 558, 574, under which he states: "The injunction does not prevent payment under a letter of credit… but it may apply to the proceeds as and when received by or for the defendant."

Freezing orders are also a kind of judicial remedy under equity; and are in nature interlocutory injunctions. Thus the English courts have dealt with freezing orders in a similarly cautious manner. The applicants have to establish several conditions, such as substantive cause of action, a good arguable case, a real risk of dissipation of assets, providing undertakings and so forth, in order to satisfy the courts for issuing a freezing order. It is eventually under the discretion of the court and is only granted in exceptional cases.

In L/C fraud disputes in international transactions, the examination of granting worldwide freezing orders will bring more meaningful points than simply discussing freezing orders issued domestically. Two difficult problems have been highlighted during the discussion on the development of worldwide freezing orders. One concerns the effect of such an order, including two particular issues: the risk of oppression on the defendants and the problem of addressing a third party (especially a bank). Another difficulty concerns the enforcement of such an order, which can somehow overlap with the first problem. Although a worldwide freezing order is developed in a careful manner, the English courts have demonstrated the attitude of granting such an order in international fraud cases. In addition, English courts are also willing to issue such an order to support a foreign litigation under exceptional cases. Thus, it may be inferred that where fraud is established in international L/C disputes, an applicant may obtain support from the courts in England by granting a freezing order.

Possible Alternatives to Interlocutory Injunctions and Freezing Orders

Considering the drawbacks of legal instruments of interlocutory injunctions and freezing orders in L/C fraud disputes, two proposals are provided to complement them. One is the appointment of a receiver; and the other is for the buyer to insert some articles in the L/C to protect himself and to cooperate with the sellers in L/C transactions.[554]

Where a L/C is payable in England, it is possible for the buyer who suspects fraud on the part of the seller to apply to the court for the appointment of a receiver and for an order that payment under the L/C be made not to the seller, but to the receiver during the period of the dispute between the buyer and the seller.[555] Under this order, the receiver takes the L/C payment for the seller, thus preventing the seller from possessing the funds due under the L/C. This method has the advantage of putting funds under the control of an independent third party, whereas a freezing order merely prevents the seller removing or dissipating it.[556] Thus, we propose that the method of appointing a receiver could be exercised.

We further suggest that the method of appointing a receiver can be an amiable alternative in L/C fraud disputes. Firstly, it avoids the risk of paying out under a L/C; thus avoiding the problem of recovering such a payment after making

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[554] Raymond, Jack (1993), p. 231.
[555] The Supreme Court Act 1981, Section 37 provides the jurisdiction to appoint a receiver.
[556] Raymond, Jack (1993), para 9.41, p. 231.

it. Secondly, it is advantageous to the bank, as the bank does not have to run the risk of losing its reputation by refusing to honour its obligation. But such a method also has to meet with a certain standard of evidence or certain conditions. Otherwise, it is unfair to the sellers, as it in a way delays the L/C payment. It may also be acceptable if the applicant can agree to pay certain damages to the seller if the court decision in the substantive proceeding finds that there is no L/C fraud.

It is also suggested that the L/Cs could contain an article in which some of the presented documents for payment are to be performed by the buyer or his agent.[557] Such a provision included by the buyer could be designed to provide some protection for the buyer himself. For example, such an article could be that the certificate of the shipped goods requires the buyer's signature. However, this provides the possibility for the buyer to frustrate the L/C by refusing to sign the document when he/she should do so.

No exact term concerning such L/C clauses (they are called "L/C soft clauses" in China) has been discussed in England. Thus, it seems that such L/C clauses have not been clearly recognised as 'L/C soft clauses' by the courts in the UK. Occasionally, the English courts may issue an order to enforce the buyer to complete the document so that the beneficiary could present the document to the bank for payment or it could order a third party, who most probably is the officer of the court, to perform the document on behalf of the buyer.[558] However, such a document may be refused by the paying bank on the grounds of incompliant documents under the L/C.

The *Astro Exito Navegacion SA v. Southland Enterprise Co. Ltd (No 2) (Chase Manhattan Bank NA intervening)* case illustrated the problem of such clauses.[559] In this case, the sales transaction was financed through a L/C by a London bank. There was a clause requiring the notice of readiness to be signed and accepted by the buyer's agent for an amendment of the L/C, but the buyer refused to sign it. The judge ordered that the buyer or the buyer's agents should sign the notice by noon of 28 October, since the L/C would expire on 30 October; and if the buyer failed to do this, a master of the Supreme Court was to sign the notice on the basis of the Supreme Court Act 1981, section 39. Eventually, the seller tendered the documents including the required notice signed by a master of the Supreme Court. However, the bank refused to pay because the documents were not compliant with the credit of their face value.

Such clauses inserted in L/Cs require some cooperation and performance from the buyer. As for the situation where such clauses are inserted and documents such as an inspection certification from the buyer are required, but the buyer refuses to sign or issue such documents, the beneficiary is not able to present compliant documents to obtain the L/C payment. Certainly the beneficiary will face huge losses resulting from such L/C clauses, and this is a common phenomenon in China. In China, such clauses, which are called "L/C soft clauses", bring forth

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[557] Ibid.
[558] Raymond, Jack (1993), para 9.42, p. 231.
[559] [1983] 2 AC 787.

different problems, and sometimes they can be misused as a way for conducting fraud. Such issues will be discussed in the section regarding the approach towards the L/C fraud exception rules in China; and the discussion may bring forth interesting points.

Summary of the Approach in England

It can be observed that in England the fraud exception in L/C transactions is in its scope narrow, requiring the clear establishment of the beneficiary's fraud and knowledge of the fraud by the paying bank before performing its obligations under the L/C. A mere nullity of a document will not have any effect on the bank's payment obligations, where the tendered documents comply with the requirements of the L/C on their face value. The courts' disapproval of the extension of the nullity exception is clear and certain. Although in practice the English approach sometimes moved a bit away from the classical narrow and strict approach, it finally went back to the classical approach. The essential principle in the English courts' approach is that the autonomy of the L/C is paramount.

Why have English courts adopted such a rigid approach? We think there are at least two reasons. Firstly, economic interest may partly contribute to explaining such an approach. By strictly sticking to the autonomy principle of the L/C, the certainty and stability of the L/C system is maintained, and then more international business transactions may be attracted. Secondly, it is closely related to the case law system in England. Such a system requires the courts to follow strictly the precedents established. Once key principles and policy over an issue were established in precedents, the courts have real difficulty in overruling or distinguishing precedents.

This approach is obviously reasonable since this principle is to preserve the efficiency of the L/C system in financing international trade. A reliable and certain L/C system is without doubt important for smooth operation of international transactions. Thus, it is welcomed by English authorities and most legal scholars.

However, it shall be noticed that if the fraud exception is applied too narrowly, the effectiveness of the L/C will be reduced. A very rigid approach runs the risk of increasing fraudulent behaviour by beneficiaries, or together with third parties, thus at the same time discourages the use of the L/C in trade and eventually undermines the commercial utility of the L/Cs. Thus the balance of different parties' interests has to be weighed up carefully.

But we are not satisfied with only examining L/C fraud exception rules established by English courts in dealing with interlocutory injunctions in L/C fraud disputes. Freezing orders have not been exercised often in L/C fraud disputes. However, as it has the function of freezing over the proceeds of a L/C, we further explore the potential value and problem of freezing orders in the section. Similarly, the granting of freezing orders has to satisfy strict conditions. But it does not require the proof of fraud, which is so high that it almost renders the legal instrument of an interlocutory injunction useless. The possibility of obtain-

ing a worldwide freezing order makes the remedy of freezing orders valuable, especially in an international fraud case. Thus, we propose that the applicant in a L/C fraud dispute considers employing the legal instrument of freezing order where necessary. However, the effectiveness of such an order in L/C fraud disputes remains to be seen in judicial practice.

3.3.3 Approach Towards L/C Fraud Exception Rules in China

Introduction

The L/C started to be used in China from the 1980s after the open policy was adopted. The banking industry in China accepted the UCP as international banking practice after the Bank of China adopted the UCP400 on 1 August 1987. Thus L/C transactions in China have been practiced for more than twenty years, which is indeed a short period of time. However, the L/C is the main method of payment in China's foreign trade, and it is used in about 80 per cent of all transactions involving international payment instruments.[560]

This section examines two main questions: firstly, whether the L/C fraud exception rules in China is a legal transplant or not. In particular, we want to know what the civil legal remedies to L/C fraud are according to legislation; and how L/C fraud dispute cases are dealt with and developed by courts in China. Secondly, we want to know what the effects of such rules are through the perspective of considering the effect of legal transplant. In particular, we want to know whether the rules are effective and why, and if not, what proposals would be provided to improve the situation.

The legal framework relating to L/C fraud exception rules in civil litigation will be looked at. Relevant court cases concerning this topic will also be examined. Important literature on this topic (most of them are in the Chinese language) in China will be critically reviewed.

The structure of this section is as follows: firstly, an overview of the main types of L/C fraud in China is provided. Secondly, the question will be addressed to procedural legal instruments for remedying the applicants in L/C fraud disputes. The preservation order (freezing order) was frequently but wrongly exercised in China, when the new rules on L/C fraud exception were not available. Thirdly, the main types of L/C fraud disputes are briefly classified in order to examine court cases in a relatively logical and clear manner. Then court cases in civil litigations involving L/C fraud before the new provisions concerning L/C fraud took effect in 2006 will be discussed. Fourthly, the new provisions on L/C disputes especially regarding stop-payment order will be examined from the perspective of legal transplant. Finally, a summary is provided.

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[560] Liang, Shuxin (2007), *Documentary Credit and Foreign Trade*, Peking: Peking Posts & Telecom Press, 1st ed., p. 51; however, it was stated that the L/C usage is dramatically decreasing in China, for further discussion on the reasons and alternatives of L/C, see Nie, Qinghua (2006), 'The Cause & Effect of the Weakness of Letter of Credit and Counter Strategy in Chinese Foreign Trade', *Academic Research (Integrated edition)*, Vol. 1, 80; also Fan, Weipei & Wang, Yue (2007), 'In China L/C Utilisation Significantly Decrease, Fraud Cases often Occur', *International Business Daily*, 25 June 2007.

Main Types of L/C Fraud in China

Five Main Types of L/C Fraud

L/C fraud happens quite often in China during its international trade. Before the 1990s most L/C fraud was involved in the importing sector.[561] Businessmen in foreign countries, being the seller, often forged required documents, received the payment for goods and then disappeared. Either there were no goods at all, or sometimes the delivered goods were merely rubbish. After the 1990s, with the development of the economy in China and a sharp increase in foreign trade, L/C fraud began to happen not only in the importing trades but also in the exporting trades, with variant types of L/C fraud taking place. The following part introduces several typical types of L/C fraud in China.[562]

Firstly, the most common type of L/C fraud in China is when the beneficiary presents the fraudulent documents to the bank to demand payment.[563] Fraudulent documents could be a forged BL, where there are no delivered goods, or the delivered goods are rubbish, or in a very small quantity. Sometimes, the beneficiary and the carrier conspire to defraud L/C payment.

Secondly, the buyer and the seller conspire to defraud the issuing bank by presenting forged documents.[564] This is a common phenomenon in L/C transactions in China; and was especially so during the 1990s.[565] The applicant and beneficiary collude to sign a sales contract first, and then apply for a L/C from a bank. After presenting the forged documents, they obtain payment through the issuing bank. Once the fraud succeeds, the applicant and beneficiary will then quickly disappear.[566] Quite often the applicant has a small percentage of deposit or no deposit in the issuing bank, and thus the bank cannot attach any properties of the applicant.[567]

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[561] Gu, Xiaorong & Ni, Ruiping (Eds.) (2005), *Research on Internationalization of Punitive Regulations on Financial Crimes*, Peking: Law Press China, 1st ed., p. 225.

[562] There have also been several new types of L/C fraud deriving from old types in recent years, such as forging the amendement of L/C, forging confirming L/C, using revocable L/C, see Cao, Yuanfang (2006), 'New Trend and Corresponding Solutions to L/C Fraud', *Practice in Foreign Economic Relations and Trade*, No. 11, 51, pp. 51-52.

[563] This point is discussed in various literature, see e.g., Jin, Saibo (2002), *PRC Letter of Credit Law and Comments on Typical Cases*, Peking: University of International Business and Economics Press, pp. 94-95; Wu, Guoping (2005), 'LC Documentary Fraud and Relief of Bank's Responsibility of Payment and Questions', Business Consultation, *Practice in Foreign Economic Relations and Trade*, No. 5, 25, p. 26; Wang, Jingen (2009), 'Seller's L/C Fraud against Buyer and Prevention', *Practice in Foreign Economic Relations and Trade*, No. 12, 64, pp. 64-65.

[564] Jin, Saibo (2002), p. 96; see also Li, Xiaoyong (1998), p. 161; Cheng, Zhengyun (1997), p. 150; Wang, Linxia (2006), 'Brief Analysis of L/C Fraud and Prevention', *HLJ Foreign Economic Relations & Trade*, No. 8 (Serial No. 146), 59, pp. 59-60; Li, Jian (2005), 'Study on the Legal Problem of L/C Fraud in International Trade', *Market Modernisation*, Dec. (1st Issue) (Sum. No. 451), 46.

[565] See e.g. Zhao, Limei (2000), pp. 1201-1202.

[566] See e.g. Guo, Xiaojie (2005), 'Risk and Countermeasures of L/C Fraud', *Market Modernisation*, Dec. (1st Issue) (Sum. No. 451), 39, p. 40.

[567] Jin, Saibo (2002), p. 97; see also Yang, Ming (2001), 'Certain Risks and Prevention in Usance L/C Transaction', *South China Finance*, No. 2, 45.

The third type is to use a false or a blank-out L/C, or to obtain L/C through deceitful means.[568] This type of L/C fraud used to be rampant in China.[569] However, nowadays it is much easier to identify whether a L/C itself is authentic through the banking internal system.

Fourthly, the issues on back-dated BL, ante-dated BL and re-issued BL[570] deserve attention. Both antedating and re-issuing BL are serious maritime frauds[571], but whether they are L/C fraud is debatable. Most PRC court cases confirmed that they are L/C fraud; whereas some court cases demonstrated that antedating or backdating BL does not always constitute L/C fraud. Furthermore, some academics argue that the BL is itself real and authentic, from the theoretical and practical point of view;[572] and these behaviours do not necessarily result in criminal liabilities and transactions may still continue[573].

The fifth category is called L/C soft clauses fraud, in which the buyer takes advantage of some clauses in the L/C to defraud the seller.[574] This is commonly considered as one type of L/C fraud by the banking and commercial community in China.[575] We will go deeper into this type of L/C fraud than into the other types, as it is complicated and controversial.

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[568] Sui, Qingjun (2006), *Theory and Practice of dealing with Financial Fraud Cases*, Peking: China Agriculture University Press, 1st, 2006, pp. 125-126; see also, Chen, Zhengyun (Ed.) (1999), pp. 400-406; Li, Xiaoyong (1998), p. 162; Chen, Zhengyun (1997), pp. 139-141; Tan, Xinghua (2005), 'Discussion on L/C Fraud Types, Forms, and Preventive Measures', *Journal of Dalian University*, Vol. 26, No. 5, Oct., 74, p. 76.

[569] For features and cases of such type of L/C fraud, see Chen, Yulong & Lin, Hong (1995), *International Financial Fraud Identification and Countermeasures*, Peking: Peking Economic College Press, 1st ed., pp.142-143; Sun, Dingjie (1995), *Combating Non-criminal Financial Fraud and Criminal Financial Fraud*, Peking: Chinese Prosecutor Press, 1st ed., pp. 644-650.

[570] For further explanation and case examination on these issues which are considered as L/C fraud, see Gu, Xiaorong & Ding, Muying (2000), pp. 184-189, for cases in this type of L/C fraud, see Gu, Min (1993), *International Trade Fraud and Prevention*, Peking: University of International Economics and Business Press, pp. 59-62; particularly about anti-dated BL fraud, see Liu, Yuliang (2006), 'Beware of Cheat Trap in Global Trade', *China Economy and Trade*, View & Commercial Observation, (June), 78, pp. 79 -80.

[571] For further discussion about the concept of maritime fraud and its legal problems and judicial remedy in China, see Zhang, Xianwei (2002), 'Several Legal Issues and Maritime Judicial Remedy of Maritime Frauds', published on 28 May, available at www.ccmt.org.cn/hs/explore/exploreDetial.php?sId=133, accessed 15 July, 2008; Yin, Xiyang (2007), 'Current Situation Analysis and Countermeasures of International Maritime Fraud', *Law and Society*, Vol. 8, 173; Zhang, Xianglan (2000), 'Study on Legal Problem of International Maritime Fraud', *Law Review (bimonthly)*, Vol. 1, 107; about the jurisdiction and applicable law, Li, Feng (2000), 'The Jurisdiction and Applicable Law of International Maritime Fraud', *Tianjin Sailing*, Vol. 1, 39; about prevention, Zhang, Meisheng & Du, Ming (2005), 'Prevention and Control and International Maritime Fraud', *Crime Study*, No. 1, 15; also Zhang, Xianglan & Wang, Huaiyu (2000), 'Studies on the Legal Mechanism of Prevention and Control of International Maritime Fraud', *Modern Law Science*, Vol. 22, No. 4, August, 112.

[572] Sui, Qingjun (2006), p. 102.

[573] Chen, Li (2006), p. 98.

[574] It is also possible that the buyer will conspire with the issuing bank to defraud the seller, see Li, Xiaoyong (1998), pp. 164-165; Chen, Zhengyun (Ed.) (1999), *Distinguish and Deal with Economic Fraud Crime*, Peking: China Fangzheng Press, p. 406; for concrete L/C soft clause cases and analysis, see e.g. Jiang, Xianling (Chief Ed.) (2005), *International Trade Settlement Practice and Cases*, Peking: University of International Economy and Business Press, pp. 273-278.

[575] This opinion is so widely accepted in China, see Li, Ziping & Hu, Xiangfu (2005), *New Comments on Financial Crimes*, People Press, 2005, p. 303; Zhou, Ying (2003a), 'Dilemma in Preventing Documentary Credit Fraud', *Economy Professional*, Vol. 5, pp. 46-47; Bai, Jianjun (1994), *Financial Fraud and Prevention*, Peking: Chinese Legal Press, pp. 33-34; there are quite a number of L/C fraud cases concerning soft clauses, see e.g. Chen, Yu (2002), 'Guarding Against L/C Soft Clauses Pitfall: Comment on Jiaxing L/C Fraud Case', *International Business Study*, No. 2, 64; Tu, Yonghong (2006), 'Case Analysis on L/C Soft Clauses Fraud', *New Finance and Economics*, No. 3, 116.

Soft Clauses in L/C Transactions: Is it L/C Fraud?

There is no internationally acceptable definition for the term "soft clauses"; neither is such a term mentioned in UCP 600. Some practitioners in Hong Kong, China, considered such an issue as 'built-in discrepancy'.[576] According to the statistics from the Bank of China, the fraud of L/C soft clauses has led to a loss of millions of dollars since 1992.[577]

The term soft clauses can be discussed by comparing them with normal clauses in the L/C. According to the independence principle of the L/C, the only condition for a paying bank to decide on whether to honour a L/C payment is that the documents presented by the beneficiary conform to the L/C itself. In an ordinary L/C, the beneficiary who honestly performs the sales contract is able to obtain the required documents. Such clauses that can be satisfied through the beneficiary's performance are normal clauses.[578]

However, sometimes there are other L/C clauses, in which some special documents are required to be presented by the beneficiary, such as the buyer's receipt of goods, inspection of goods issued by the buyer, or the L/C will take effect under some conditions.[579] With such clauses, whether the beneficiary can get specified documents or whether the stipulated conditions can be satisfied, partially or entirely depends on the buyer or other parties, rather than the beneficiary's performance of contract; such clauses can be regarded as soft clauses in the L/C.[580]

Soft clauses are commonly abused by dishonest businessman as a tool for committing fraud, breach of contract or dishonour; thus L/C soft clauses can make a beneficiary's obtainment of the L/C payment risky and uncertain.[581] Very often L/C soft clauses are connected with the applicant's intention to deceive a prepaid performance deposit, a L/C issuance deposit and so forth from the beneficiary.[582] Once the applicant has received such a prepaid deposit, the applicant would find faults with the quality of goods, refuse to issue an inspection certification, and finally achieve the fraudulent purpose. The risk of such a clause is that the applicant can take advantage of it by refusing to appoint someone to inspect goods or they can simply reject the goods in times when the market falls or crashes or the importer finds cheaper goods.[583] Thus the financial payment of the L/C

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[576] Fung, King Tak (2005), extract of some cases discussed in *Leading Court Cases on Letters of Credit*, published by DC-PRO, 18 Jan., 2005; in this extract, Fung argues that although the bank may refuse L/C payment because of a discrepancy under the L/C, it does not discharge the payment obligation of the buyer to the seller under the sales contract.

[577] Cai, Lei & Liu, Bo (1997), *International Trade Fraud and Prevention*, Peking: Law Press China, p. 278; see also Chen, Zhengyun (Ed.) (1999), pp. 402-403; this type of L/C fraud still happens nowadays, see e.g. Chen, Qian (2007), 'International Fraud Trial Hangs on Credit Letters', *Shanghai Daily*, 04 August.

[578] Xu, Donggen (2005), p. 299.

[579] Zhang, Zongliang (2005), p. 215.

[580] He, Xie & Zhang, Xikun (2002), p. 248; see also Yu, Jingsong (Chief Ed.) (2003), *Current Issues of International Economic Law*, Wuhan: Wuhan University Press, 1st ed., pp. 231-232; see also Dong, Guoshu & Li, Dejun (2006), 'Discussion on L/C Risk and Prevention', *Market Modernisation*, Jan. (2nd Issue), (Sum. No. 456), 14.

[581] Zhao, Limei (2000), *Guide to Letter of Credit Operations*, Vol. 2, Peking: China Economy Press, p. 1199.

[582] Cai Lei & Liu, Bo (1997), *International Trade Fraud and Prevention*, Peking: Law Press China, p. 278; see also Shi, Zheng (2006), 'Value Evaluation of L/C in International Trade', *Enterprise Economy*, No. 4 (Sum. No. 308), 174, p. 176.

[583] See Xu, Junke (2007), pp. 97-98.

guaranteed by the credit of the bank in a way becomes a commercial payment depending on the credit of one trading party.[584]

However, soft clauses of a L/C do not always mean fraud, as sometimes soft clauses in a L/C can be accepted due to different business customs in different countries or agreements between trading parties.[585]

Identifying which clauses are L/C soft clauses and which clauses are reasonable requirements from the buyer can be difficult. The forms of L/C soft clauses are various and changeable; sometimes they can be formulated in a very obscure way.[586] Therefore, it is sometimes difficult for the the beneficiary to notice and understand them.

The problem of soft clauses seriously affects the beneficiary's legal rights and further deteriorates the value and function of the L/C as a payment method in international trade.[587] Are L/C soft clauses a kind of L/C fraud? To answer this question, we will start by discussing the main types of L/C soft clauses.

Various Categories of L/C Soft Clauses in China

Soft clauses in a L/C take on various forms, as the forms and expressions of a L/C issued by different banks are different.[588] But it is still helpful to explain the problem by classifying different types of soft clauses so as to find out the common features of this problem.

Category 1: Conditions for a Valid L/C

The first type of soft clauses in a L/C in essence make an irrevocable L/C become a conditional L/C.[589] A normal L/C is effective and valid when the beneficiary receives it. However, some L/Cs are valid with some conditions[590] and the specified conditions can be controlled by the buyer, or controlled by a third party in the buyer's country such as an authorised certificate from the importer's government, or certification of approval from the Foreign Exchange Office in the importer's country.[591]

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[584] See e.g. Ma, Guobing & Weng, Di (2005), 'Discussion on Risk of Fraud and Prevention under L/C', *HLJ Foreign Economic Relations & Trade*, No. 5 (Serial No. 131), 61, pp. 61-62.

[585] Liu, Debiao & Yu, Youyan (2003), *International Business Cases Selection*, Peking: International Economy and Business University Press, p. 95; Leng, Hanbing & Jiang, Xiaochun (2000), 'Soft Clauses and Forgery – Two Means of L/C Fraud', *China Foreign Exchange Management*, 5, p. 33; see also Xu, Junke (2007), p. 99.

[586] See e.g. Qi, Hongwei (2003), 'Analysis and Countermeasure on L/C Fraudulent Soft Clauses', *Jiangsu Business View*, No. 10, 39.

[587] Xu, Xin & Mao, Xuegang & Guo, Yu (2009), 'Discussion on L/C Soft Clauses: from a L/C Dispute Case', *Theory Research*, No. 5 (General No. 179), 127, p. 128.

[588] The categories are different under different opinions, see e.g. Hu, Yuexiu (2007), 'L/C Soft Clauses and Risk Prevention', *Market Modernisation*, August (2nd Issue), 295, pp. 295-296; Zhang, Zongliang (2005), 'L/C Soft Clauses Analysis and Prevention', *Market Modernisation*, December (2nd Issue), 215, pp. 215-216.

[589] See Qu, Xinjiu (2003), *Finance and Financial Crime*, Peking: CITIC Publishing House, 1st ed., pp. 340-341; see also Li, Jinze (2004), *Letter of Credit and Legal Problems in Financing of International Trade*, Peking: China Finance Press, pp. 19-20.

[590] See e.g. Wu, Cuihua (2005), 'Risk and Prevention of L/C Soft Clauses', *Economic Forum*, No. 12, 32; Yuan, Hui (2005), pp. 91-92.

[591] Wang, Xitong (2007), p. 77.

In particular, such a type of soft clauses can be written for example as, "This credit will be effective only after receiving further instruction", or "This credit will become an effective instrument with confirmation from the applicant"[592]. Some other soft clauses can become more complicated where the condition of a valid L/C is reflected in the L/C amendment.[593] If the buyer does not give any further notice or instructions on shipping date or vessel, then it can result in great loss to the seller where part of the performance of the sales contract has been done. Thus, with such clauses, the buyer decides whether or not a L/C will be effective. But how one defines the legal nature of such a clause is a debatable issue in theory. Should such an amendment clause belong to the preconditions of an effective L/C or should it be considered as an amendment agreement clause later?[594]

Two concrete case examples are provided in order to illustrate such a problem. The first case can demonstrate the problem of this type of L/C soft clauses, in which some conditions are controlled by the buyer. One seller in China concluded a contract with KAM WA Enterprises Inc. USA; then it received an irrevocable L/C with the L/C amount of 1, 9 million dollars.[595] One term of the L/C was that, "Shipment can only be effected upon receipt of applicants' shipping instructions through L/C issuing bank nominating the name of carrying vessel by means of subsequent credit amendment".[596] The Chinese seller shipped all the goods to Dalian Port in China before the valid period of shipping, waiting for further specific notice from the buyer. The buyer nominated a deputy to inspect the goods before shipping, but the deputy refused to give notice of shipping date and the name of the vessel. Subsequently, the transaction could not continue and the Chinese seller could not draw on the L/C. But the Chinese exporter also paid 2, 6 million RMB (Chinese currency) as the quality guarantee to the deputy of the buyer, after receiving the L/C. Thus, the deputy of the USA buyer drew out the Chinese seller's prepaid deposit, and disappeared.[597]

The second case illustrated the problem of such a type of L/C soft clauses, in which some condition is controlled by a third party in the buyer's country. Company A in China concluded a contract with Company B in Canada, paid by an irrevocable L/C.[598] Company B applied for bank C in Canada to issue 5

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[592] Xu, Donggen (2005), *Study on L/C Law and Practice*, Peking: Peking University Press, p. 301.
[593] For example, such clauses may read that the "carrying vessel of shipment, date of shipment and destination port shall be informed by the issuing bank in the form of L/C amendment upon receipt of the notification from applicant", "The goods will be shipped upon receipt of shipping advice issued by opener of L/C appointing the name of vessel, which will be issued by way of an amendment to this credit by the issuing bank"(see Tang, Jinlong (2005), p. 177), or "The goods will be shipped upon the appointing of the vessel by the Applicant of L/C and adding a Cable/Telex Amendment of L/C by Issuing Bank to Advising Bank, which should be negotiated accompanied with the original documents" (see Chen, Yan & Liu, Ling (2007), p. 203); see also Jia, Qinghong (2003), 'L/C Fraud, Prevention and Treatment', *International Economy Cooperation*, No. 5, 48, pp. 48-49.
[594] Further discussion, see Fang, Shuangfu (2003), 'The Legal Character and Judicial Remedy of L/C Soft Clauses', *People's Justice*, No. 5, 28.
[595] Gao, Jie (2006), *International Settlements Cases Analysis*, Peking: University of International Business and Economics Press, 1st ed., pp. 59-61.
[596] Ibid.
[597] He, Xie & Zhang, Xikui (2002), *Financial Crime Cases – Experience and Techniques of Preventing Financial Crime*, Peking: Economy Daily Press, pp. 247-248.
[598] Gu, Xiaorong & Ding, Muying (2000), pp. 203-204.

L/Cs from July to October 1991. However, the L/C payment is effective only after the issuing bank receives the notice of approval of importing such goods by the Canadian government. After the goods arrived at the destination port, Company B did not present the Inspection Certification issued by the Agriculture Department of Canada to the bank. Then bank C notified the Bank of China that all the issued letters of credit were invalid and they would not honour the payment.[599] In this case, according to the contract, the L/C was irrevocable, but in fact it was conditional. The purpose of inserting such clauses most probably was to obtain the goods first and then to avoid payment. Generally, such clauses are not valid unless some conditions are satisfied; thus, they provide no guarantee to the beneficiary.

Category 2: Obstacles to Obtain Documents

The second type of L/C soft clause in essence creates obstacles for the beneficiary to obtain the required documents under the L/C. Under such a soft clause, the L/C documents presented by the beneficiary need to include an inspection certificate or cargo receipt signed by the L/C applicant or the person appointed by the applicant (the agent).[600] The issuance of an inspection certificate by the applicant violates the commercial customary rule, as inspection of goods usually is conducted by a third independent institution (authoritative, qualified, professional institution) excluding trading parties.[601]

Sometimes such an inspection certificate or other documents are required to be certified by the issuing bank or advising bank.[602] It is argued that such clauses obviously violate customary practice of international trade, as banks shall not engage in trade according to UCP, but such clauses involve banks in a trading business.[603]

In addition, an applicant can leave one person's specimen in the issuing bank, but appoint another person to sign.[604] When the market rises, the applicant may issue the inspection certification; however, once the market falls at the time of hon-

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[599] Later Company A applied for arbitration to the International Commercial Arbitration Certre in Canada, claiming the payment for goods. However, Company B was in debt long ago, and had already signed agreements with all its creditors to discharge 1/4 of its debts by reason of bankruptcy. Finally, this arbitration case ended up with Company A obtaining only 1/4 of the payment.

[600] See Chen, Li (2006), p. 101; see also Li, Qiujuan (2003), 'Typical L/C Soft Clauses Forms and Harm', *Economist*, No. 10, 48; see also Liu, Aie (2009), 'Main Forms and Preventive Measures of L/C Soft Clauses', *Commercial Accounting*, Vol. 11, No. 21, 33, pp. 33-34.

[601] Song, Jie (2010), 'Features and Risk Prevention of L/C Soft Clauses in Foreign Trade', *Commercial Times*, No. 10, 38.

[602] Hu, Meilun (2006), 'L/C Fraud and Risk Legal Study', *Exploration*, No. 12, 117; Several examples of such type of soft clauses are provided below: a) "cargo receipt and signed by XXX and the signature must be in strict compliance with that of our file" b) "The certificate of Inspection would be issued and signed by the authorized Agent of the Applicant of L/C before Shipment of cargo and the Signature will be inspected by the Issuing Bank"c) "Commercial Invoice in Triplicate, all duly signed and countersigned by Mr. xx and whose signatures must be in conformity with the specimen signatures(s) held in xx Bank" d) "Quality confirmation issued and signed by authorized person(s) of Applicant (whose signature must be conformed with that hold in your file), certifying that goods are in good condition, and stating date, value, quantity of goods and dated", see Chen, Yan & Liu, Ling (2007), p. 203.

[603] Jin, Saibo (2002), p. 99.

[604] Xu, Junke (2007), *Study on International Trade Law Special Topics: New Development under WTO Framework*, Peking: China Legal Publishing House, p. 99.

ouring payment, the applicant may collude with the bank to refuse to pay on the grounds of the incompliant documents.[605] The problem is that the beneficiary knows nothing about the seal or specimen left by the applicant in the issuing bank.[606] Thus, the beneficiary cannot ensure their presented documents conform to the L/C, and thus there is no guarantee for the seller to obtain the payment under the L/C.

Category 3: Other types of L/C Soft Clauses

There are some other different types of soft clauses in the L/C;[607] and conflicting clauses are sometimes stipulated in the sales contract and the L/C.[608] Sometimes, different types of soft clauses may be combined together in one L/C.

For example, the Xiamen Branch of the Bank of China received one L/C issued by one bank in Singapore, for the amount of 1 million dollars in 1993.[609] In this L/C, one clause was that "Shipment can only be effected after the L/C applicant has nominated the carrying vessel by way of subsequent tested telex amendment to this credit via opening bank to advising bank, the tested telex amendment must accompany original documents presented for negotiation", which seems to fall in the first type of L/C soft clauses as discussed earlier. The other clause was that "Inspection Certificate to be issued prior to shipment and signed by authorized signatories of applicant whose signatures must be verified by L/C issuing bank", which falls into the second type of L/C soft clauses. With these two L/C clauses, the buyer controlled the transaction by nominating a ship, and controlled the L/C payment by issuing an inspection certificate. In this case, the beneficiary seller was required to pay the deposit of performance of contract in advance, with the amount of 5 -10 percent of the whole contracting amount, in order to get a L/C issued. After 10 million RMB remitting to the bank account instructed by the buyer, the deputy of the buyer immediately withdrew it from the bank. Thus the buyer intended to deceive the performance deposit from the seller by taking advantage of inserting such L/C soft clauses.

The discussed L/C soft clauses can either make the L/C ineffective, or the applicant can in fact control the L/C payment. It is also possible that the applicant colludes with the issuing bank, or advising bank to delay or avoid payment. In fact, with such L/C soft clauses, the L/C payment, which is guaranteed by a bank, has already been changed to a kind of conditional commercial payment, which is controlled by one party. Thus, the beneficiary's rights and interests can be seriously harmed. It is strongly recommended that the sellers pay careful attention to such a kind of clauses in L/C transactions.[610]

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[605] Ibid.
[606] Li, Qiujuan (2003), p. 48.
[607] Gu, Xiaorong & Ding, Muying (2000), *Letter of Credit, Credit Card and Foreign Bills – Cognizance and Sanctions*, Peking: Taihai Press, 1st ed., p. 203.
[608] Yuan, Hui (2005), 'How Foreign Trading Company will Identify and Prevent L/C Soft Clauses', *International Business – Periodical of University of International Business and Economics*, No. 1, p. 91; see also Bai, Jianjun (1994), p. 28; Yang, Yishi (2007), 'Identification and Types of L/C Frauds', *Business Weekly*, May 5, 84, p. 86.
[609] Sun, Dingjie (1995), pp. 653-654.
[610] Wang, Xitong (2007), 'Reflection on L/C Soft Clauses and Countermeasures', *Decision Exploration*, No. 3 (1st Issue), 78, p. 79.

The Approach of the Courts in China towards L/C Soft Clauses

Some cases concerning L/C soft clauses have been decided by the courts in China. However, the courts have demonstrated their different views from the banking and commercial community, who mostly consider L/C soft clauses as a crime (L/C fraud).

In the case of *Tsaolian v. China Agriculture Bank Hunan Branch*[611], the buyer Hulong Company applied for a L/C through China Agriculture Bank Hunan Branch. The branch issued a 90 days usance L/C with the Tsaolian Material Corporation Limited as the beneficiary, and Hong Kong South Pacific Commercial Bank as the advising bank. Article 48A.3 of this L/C stated that "the signature of the applicant on the receipt of goods shall be in compliance with the signature specimen held by the issuing bank". This is a typical L/C soft clause falling in the second type. The beneficiary had the receipt from the applicant, but the signature on the receipt was different from the specimen held in the issuing bank. Thus the issuing bank did not honour the payment. Then the beneficiary sued the issuing bank in the Hunan High Court with the cause of action that the issuing bank broke its credit obligation.

The First Instance Court decided that the beneficiary should perform according to the terms and conditions of the credit since the beneficiary had accepted the L/C.[612] The issuing bank has the right to refuse the payment in accordance with the strict compliance doctrine, because Tsaolian presented one incompliant document. Tsaolian appealed to the SPC. The SPC held that the beneficiary should understand the specific condition in the L/C before he accepted it.[613] The acceptance of the credit showed that the beneficiary and applicant mutually agreed on this contract about the L/C. Based on the contract autonomy, the court should respect the agreement. The documents presented by the beneficiary were not compliant with the L/C, thus the issuing bank has the right to dishonour payment. As a result, the SPC approved the judgment of the First Instance Court.[614]

The case *Sanhe Bank Shenzhen Branch v. China Communication Bank Changsha Branch*[615], decided by the SPC, also shows the same attitude as in the case discussed above towards soft clauses in a L/C. One of the documents in the L/C was the receipt of goods to be signed by the applicant, and the signature of the receipt should conform to the specimen in the issuing bank. The SPC decided that the "soft clause" in the L/C should bind on the relevant parties to the credit as a result of the willingness of all parties.[616] Furthermore, due to the incompliance of the signature on receipt with the requirements of the L/C, the issuing bank is entitled not to reimburse the negotiating bank.[617]

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[611] The SPC, Civil Court, the 4th Tribunal (2006), *Selected Court Cases of Letter of Credit Disputes*, Peking: China Democracy and Legal Press, pp. 40-42.
[612] Ibid.
[613] Ibid.
[614] For further comment on this case, see Tang, Jinlong (2005), pp. 172-177.
[615] *Sanhe Bank Shenzhen Branch v. China Communication Bank Changsha Branch*, Judgment of December 31, 2000, (1999) Series No. 86, The SPC.
[616] Ibid.
[617] Ibid.

Three points can be identified concerning the SPC's attitude towards L/C soft clauses. Firstly, the cases involving the L/C soft clauses were dealt with under the principle of contract law. The validity of the L/C soft clauses was confirmed by regarding it as an agreement between parties. The courts in civil cases did not show any tendency of considering soft clauses in the L/C as a way of L/C fraud. This illustrates the conflicting judicial view between civil law and criminal law, as the PRC Criminal Law 1997, Article 195 (4) – other types of L/C fraud is explained as the fraud of soft clauses in the L/C by legislature.[618] Thus, some argue that soft clauses in a L/C are not a kind of L/C fraud;[619] and it is wrong for criminal law to regulate such a type of L/C fraud and it should be amended.[620]

However, there are criminal cases which constituted fraud by the way of stipulating soft clauses in the L/C.[621] As some examples have shown, with L/C soft clauses, either the sellers' performance deposit was deceived, or the seller's goods were taken but without L/C payment. We perceive that in such cases the buyers have intended to deceive deposit or goods from the sellers by misusing the instrument of the L/C. Therefore, cases would be handled according to their own facts.

Summary of the L/C Soft Clauses Problem

Soft clauses in the L/C are not fraud in themselves. On the one hand, in some particular circumstances, designing and inserting soft clauses in the L/C is a kind of protective measure taken by the buyer against L/C fraud committed by the seller. L/C soft clauses could be influenced by several elements, such as trading practice, features of the goods and the buyer's market; not all soft clauses in the L/C are unreasonable and tricky. Thus, considering the balance of rights and interests of both parties, it is impossible to entirely prohibit L/C soft clauses. On the other hand, soft clauses in the L/C can be abused by the buyer to conduct deceitful behaviours or even to commit fraud with intention, such as defrauding goods without payment or deceiving deposit of performance of contract or guarantee of the L/C issuance.

It is interesting to mention here the earlier discussion about the possible alternatives to injunctions and freezing orders in the England approach. To insert such clauses is a proposal in order to protect the buyer from fraud in L/C transactions. Where some documents issued by they buyer are required, and if the buyer refuses to issue or sign such documents, the English court may order the buyer or third party on behalf of the buyer to do so. However, a problem arose where a third party on behalf of the buyer is ordered to sign or issue such documents. The paying bank may consider such documents as not being compliant documents and refuse to honour the L/C payment. Thus, the solution of the English would still not protect the seller against the problem of obtaining the L/C payment.

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[618] Discussion, see chapter 2.

[619] Yang, Jianhong (2002), 'Clarifying Soft clauses in L/C', *Journal of Southwest University for Nationalities, Philosophy and Social Sciences*, Vol. 23, No. 12, Dec., pp. 190-192.

[620] Jin, Saibo & Li, Jian (2004), *The Law of Letters of Credit*, Peking: Law Press China, 1st ed., p. 766.

[621] See one case - Li, Hua (South African), Fraud, 2005, cited from Tu, Yonghong (2006), pp. 166-167; however, it should be pointed out that in this case the criminal was accused as having committed fraud, instead of L/C fraud.

In summary, the L/C soft clauses can take various forms; and the most important thing for the sellers is to reduce the risk resulting from soft clauses to the lowest degree. Certainly, the sellers in international sales transactions have to be able to identify soft clauses when manipulating the payment method of the L/C, and inform the buyers to amend it without delay, in order to solve such problems at an early stage. Nevertheless, it is up to the sellers to decide whether to accept such soft clauses or not, depending on the particular customer and trading business.

Development of L/C Fraud Exception Rules in China

Legislation Framework

With the globalisation of the world economy, studying and following international practice is necessary.[622] Especially after its accession to the WTO, China seems to have entered a period that is dynamic and open to new models internationally, as international business practice may have created solutions common to all legal systems. In the course of maritime judicial practice, following international practice[623] is important due to the international nature of maritime disputes. In practice, parties in L/C transactions most often would stipulate that the L/C is governed by UCP. Therefore, when dealing with L/C disputes, the courts in China often refer to UCP[624]. However, as shown in the previous discussion, the UCP cannot solve all L/C-related problems, and it does not provide any guidance on L/C fraud exception rules. Therefore, national laws have to be resorted so as to deal with this particular problem, and China has to look for a solution from its own laws and other sources.

There is no specific law particularly concerning the L/C in China; thus, several laws have to be found so as to deal with L/C fraud disputes in civil cases. First, general principles can be turned to General Principles of the Civil Law of the PRC[625] and contract law. China unified its contract laws in 1999, so contracts in China are now governed by the PRC contract law[626]; a contract may be void as

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[622] For an analysis of the relationship between international practice and domestic law in China, see Zhang, Xingquan (2002), 'International Practice and Foreign Commercial and Maritime Trial', published on 28 Jan., CCMT, available at www.ccmt.org.cn/ss/explore/exploreDetial.php?sId=30, accessed 21 July, 2008.

[623] But the application of international practice cannot violate public policy, which is a principle in China when applying foreign laws and international practice, for further discussion on the concept, nature of international practice, and application of international maritime practice in China, see Rao, Zhongxiang & Wang, Jianxin (2004), 'On the Application of the International Maritime Practice', published on 16 Jan., CCMT, available at www.ccmt.org.cn/hs/explore/exploreDetial.php?sId=544, accessed 21 July, 2008.

[624] See Answers to the Questions of Foreign-related Commercial and Maritime Judicial Practice (I), 2004, question No. 54.

[625] General Principles of the Civil Law of the PRC, adopted at the 4th Session of the 6th National People's Congress, promulgated by Order No. 37 of the President of the PRC on 12 April 1986, and took effect on 1 January 1987; article 4 provides that in civil actions, the principles of voluntariness, fairness, giving compensation of an equal value, honesty and credibility shall be observed.

[626] Contract Law of PRC was adopted at the 2nd Session of the 9th NPC on 15 March 1999, and came into effect on 1 October 1999.

a result of fraud.[627] Contracting parties also have a general duty of good faith in conducting and performing contracts.[628] However, there are no specific provisions concerning the L/C in Contract law 1999. The problem is that in L/C transactions, several parties are involved and legal relationships are complicated, which makes the General Principles of the Civil law and Contract law insufficient for handling the L/C fraud issue.

Second, several specific documents on the L/C and L/C fraud can be consulted. Before the relevant documents on L/C fraud are introduced, the explanation of the forms that documents have taken is necessary. In China, most provisions in laws are not specific and not ready to be applied in individual cases. The imperfect quality of legislation in general leads the SPC to issue judicial interpretations of statutes, rules, memoranda and specific instructions to local courts. The legitimacy and legal basis of these various documents is doubtful according to the constitution law, because the power of law creation or interpretation of the constitution or statutory law is given to the NPC, and judicial power is limited to deciding individual cases according to the law established by the People's Congress.[629] Although there is no formal system of judicial precedent in the Chinese legal system, such various documents issued by the SPC are generally followed by lower courts in judicial practice.

In addition, large gaps in legislations lead to difficulties to make decisions in cases for the judges. Where the problem of a gap arises in dealing with individual cases, it is common that courts resort to "international practice" (not clearly defined) or international agreements that China has ratified.[630] This method of gap-filling is understandable and practical when there are no exact laws applicable to decide particular cases, as the court is required to issue a judgment with a legitimate basis. However, this method is criticised as being unsatisfactory, since frequently resorting to unclear international practice to solve a legal issue rather than having suitable domestic laws may undermine the development of a rational legal structure in China.[631] In the development of the law on the L/C in China, resorting to international practice in court judgments dealing with L/C fraud disputes has frequently be seen, and we will examine this later in the section looking at court cases in China.

The documents issued by the SPC specifically purporting to handle L/C fraud are studied. The first is the 1989 SPC Memorandum concerning Economic

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[627] Contract law 1999, article 54; for further discussion on the legal features of fraud and civil liability, see e.g. Cheng, Zongzhang (1999), 'Exploration of Legal Counterplan on Transnational Frauds', *Journal of Anhui Radio & TV University*, Vol. 4, 11, pp. 11-14.
[628] Contract law 1999, article 6.
[629] PRC Constitution article 62(3) provides that the NPC has the power to make "basic" law; article 67(2) and (3) states that the Standing Committee of the NPC also has law-making and law-interpreting powers; article 67(6) provides that the Standing Committee also has supervisory power over the SPC.
[630] Shao, Shaoping, 'The Theory and Practice of the Implementation of International Law in China', in Chen, Jianfu & Li, Yuwen & Otto, Jan Michiel (Eds.) (2002), *Implementation of Law in the People's Republic of China*, Hague, London & New York: Kluwer Law International, p. 201.
[631] See e.g. Williams, Mark (2004), p. 165; further the author explains that such a method is unpredictable, since there are no clear rules with regard to when and in what circumstances such resort to international practice will take place.

Disputes involving Foreign Elements.[632] This document is still important regarding whether or not a case is L/C fraud. Three points require attention in this Memorandum. Firstly, the principle of no court order is established, which means that the L/C contract is independent of the underlying sales contract and the L/C payment should not be interfered with by the court in normal L/C disputes. Secondly, it concerns the issue of sufficient evidence of L/C fraud and the immunisation of fraud exception. More specifically, it is clear that if sufficient evidence is available to prove that the seller is committing fraud by using the L/C, and Chinese banks have not made the payment, the court may prohibit the payment under the request of the applicants. Concerning the immunisation of fraud exception, it is stated that the courts shall not prohibit the payment if the issuing bank has accepted the draft, because once the draft has been accepted by the bank, the bank's obligation to honour the payment becomes unconditional according to the negotiable instrument law. Thirdly, it requires that the court shall be very cautious when issuing such a court order to prevent L/C payment and shall contact the involved bank, and consult its higher court if necessary. Such principles apply to the application of a freezing order over L/C payment forwarded from Arbitration institutions. After this document was published, most Chinese courts have strictly applied its principles when dealing with L/C fraud cases.[633] Although this Memorandum is the main legal document for handling the fraud exception issue in the L/C, its legitimacy is questionable.[634] Therefore, this Memorandum has merely the meaningfulness of consultation, thus cannot be cited directly in judgments or orders, and the local courts did not pay sufficient attention either.[635]

The second document is the guideline highlighted by the SPC on the problem of freezing L/C payment is entitled Notice No. 321 in 1998.[636] The guideline mainly underscored the same point, in that to obtain a court order on the grounds of L/C fraud, the applicant should have sufficient and ample evidence showing that the beneficiary is committing fraud, and that the draft accepted by the issuing bank has thus far not been negotiated.

The third document is the Notice of the SPC on Prohibiting the Random Order of Stop Payment for L/C, issued by the SPC in 2003.[637] This document concerned the adverse influence abroad by randomly-issued stop-payment orders from some

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[632] This document was issued and took effect on June 12, 1989, www.court.gov.cn , in Chinese language; further comment see Liu, Peng (2002), 'Application of Fraud Exception Under UCP 500', *International Economics and Trade Research*, No. 5, 71, p. 73; also Jiang, Nan (2003), 'Application of Fraud Exception in Documentary L/C', *People Justice*, No. 4, 33, p. 34.

[633] Gao, Xiang (2002), *The Fraud Rule in the Law of Letters of Credit: A Comparative Study*, The Hague, London & New York: Kluwer Law International, p. 175; futher commentary and analysis, see pp. 176-177.

[634] For further discussion on the legitimacy of this document, see Tai, Bing (2005), 'On the Legal Sources of the Application of L/C Fraud Exception in Mainland China', *Journal of International Economic Law (Chief Ed.)*, Peking: Peking University Press, Vol. 12, No. 1, p. 258.

[635] Wang, Lili (Chief Ed.) (2004a), *Case Studies on Legal Risk Control of Banks*, Peking: Law Press China, 1st ed., p. 189; the limitation of this document, Xiao, Liangping & Huang, Shengkai (2005), 'Discussion on Application of L/C Fraud Exception', *Enterprise Economy*, No. 11 (Serial No. 303), 202, p. 204.

[636] He, Bo (2002a), 'Fraud Exception in L/C Transaction', *Chinese Journal of Law (Bimonthly)*, No. 2, 81, p. 90.

[637] The SPC, (Fa [2003] No. 103), issued and came into effect on 16 July 2003.

courts, and its purpose was to maintain the international reputation of the courts and the banks in China. Firstly, it restated that the independence principle of the L/C shall be rigidly adhered to and in most circumstances the stop payment order should not be issued due to the disputes of underlying transactions, because the L/C and the underlying transaction belong to different legal relations. Secondly, it required strict adherence to the conditions of L/C fraud exception; only when there is sufficient evidence to prove L/C fraud or the bank has not paid out within reasonable time, is the court allowed to issue such an order under the request of the applicant of the L/C and where security is provided. However, if the L/C has been accepted and assigned, or negotiated, such an order should not be issued

The fourth document is the Answers to the Questions of Foreign-related Commercial and Maritime Judicial Practice (I), issued by the SPC, Civil Courts, the 4th Tribunal in 2004.[638] This was published in order to strengthen uniform standards of Law Enforcement and thus all levels of courts may have it for reference; and such guidance was based on the law, trial practice and a wide range of comments. The questions from No. 59 to No. 64 concerned L/C fraud disputes and connected procedures. Question No. 59 answers what kinds of circumstances constitute L/C fraud.[639] In this document, it recognised that there were no uniform standards about L/C fraud internationally; but most countries accepted that when there is L/C fraud, the L/C and underlying transaction relations can be considered together. Under some conditions, the paying bank is entitled to refuse payment under the L/C. As the L/C transaction is a transaction of documents, L/C fraud usually connects with documents, such as the beneficiary or other third party forging documents, providing false documents thus leading to the defeat of the contract purpose; the applicant colludes with the beneficiary or other third party and presents false documents without any real underlying transaction existing. Another kind of L/C fraud is connected with the underlying transaction, such as the beneficiary did not deliver the goods or the delivered goods almost have no value, including the delivered goods are rubbish, or the goods, although with some value, cannot be used and so forth. However, a serious quality problem concerning the goods cannot be considered as L/C fraud.

Question No. 60 answers in which circumstances the L/C payment cannot be prohibited although L/C fraud is constituted.[640] As the L/C transaction is a complicated process, in several circumstances L/C payment should be made even though L/C fraud is established. For example, the issuing bank or the holder in due course pays in good faith; the party nominated or authorised by the issuing bank, does not know about the fraud and made payment according to the issuing bank's constructions; the confirming bank paid in good faith; the negotiating bank did not participate in the fraud and negotiated in good faith; the second beneficiary of a transferable L/C did not know about the fraud and paid in good faith.

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[638] The SPC, released by China CMT, available at http://www.ccmt.org.cn/news/show.php?cId=5034, accessed 22 May, 2008.
[639] The Answers to the Questions of Foreign-related Commercial and Maritime Judicial Practice (I), question No. 59.
[640] Ibid, question No. 60.

Question No. 61 answers under what conditions a L/C payment can be prohibited.[641] It requires that the court must have the jurisdiction over the case; the applicant must provide a security and sufficient evidence to prove fraud either in the underlying transaction or in the L/C; the possibility of irreparable damages to the applicant if such a stop-payment order is not issued and so forth. The preservation measure has to follow the relevant procedure in PRC Civil Procedure Law. If the court considers that the requirements are fulfilled, the court shall issue such an order in 48 hours and execute it immediately.

The final important document is the most updated and specific one on the L/C in China; and it is titled as the Provisions of the SPC on some issues in the Adjudication of L/C-related cases[642]. This judicial interpretation[643] aims to provide guidance on issues in the adjudication of L/C-related cases in accordance with the General Principles of the Civil Law of the PRC, Contract Law of the PRC and Civil Procedural Law of the PRC, as well as by referring to relevant international practices, particularly those as reflected in the UCP, and considering the adjudicative practice in China. In this document, it makes clear its scope, and brings forward the fraud exception of the L/C on the basis of confirming the autonomy principle of the L/C. Moreover, other crucial issues, such as the standards of document examination, the circumstances of fraud exception, the conditions and procedures for applying for an order to suspend payment under the L/C are clarified. In general, the provisions are rather rational and to a great extent demonstrate the attempt of the SPC to unify the judicial practice on adjudicating L/C-related cases. The background and process on how these judicial provisions were formulated and several articles concerning L/C fraud exception rules will be analysed in detail in later sections.

These documents issued by the SPC have reflected the continuing judicial efforts for handling L/C disputes, and have played an important role in guiding the courts in China to deal with L/C fraud disputes in a relatively proper manner. After looking at the legislation concerning the issue of L/C fraud disputes, we will consider briefly procedural instruments involved in such disputes.

Procedural Instruments: Stop-payment Order and Preservation Order

Under the current legalisation framework, the procedural remedy to L/C fraud in disputes is the stop-payment order and preservation order. The stop-payment order is regulated particularly in the new provisions, and it is specially designed to prohibit L/C payment in L/C fraud disputes. This will be discussed in the section of new provisions on L/C fraud exception rules later. The preservation order

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[641] Ibid, question No. 61.

[642] Judicial Interpretation, No. [2005] 13, adopted at the 1368th Meeting of the Adjudication Committee of the SPC on 24 October, 2005, came into effect on 1 January, 2006; we point out that the SPC is not the legislature, but this judicial interpretation, as explained in Chapter 2, plays a significant role in judicial practice.

[643] Whether the legitimacy problem is solved by issuing a Judicial Interpretation by the SPC is doubted, see Tai, Bing (2005), pp. 265-269.

is regulated in Civil Procedural law[644], and under the context of L/C fraud disputes, it particularly refers to a freezing order. We will introduce this procedural instrument in order to understand the problems that courts have encountered when dealing with L/C fraud disputes.

Article 92-96 of the Civil Procedural law of PRC (CPL)[645] provides the rules of property preservation. According to article 94, property preservation shall be effected by sealing up, distraining, freezing, or other methods as prescribed by law. Therefore, the application of a freezing order over L/C payment which is held by a bank should follow the rules of application for a property preservation order under the CPL.

Article 92 concerns the application of a property preservation during the proceedings; in order to obtain such an order, an applicant is required to demonstrate to the court that if the property preservation order is not issued, the enforcement of the court judgment would probably be impossible or difficult because of the acts of the defendant or for other reasons.[646] Article 93 concerns the application before the proceedings; according to this article, the applicant shall demonstrate to the court that the circumstances are urgent and without such an order the applicant would suffer irreparable damages. If an applicant applies before the litigation proceedings commence, the applicant has to bring an action within 15 days after the property preservation order is adopted by the court against the party whom the freezing order is imposed on; otherwise, the court order is ineffective after that stated period. However, applying for a freezing order before the proceedings, the applicant shall provide a security; otherwise, the application shall be rejected.

Generally speaking, the grounds for application for such a measure must be based on facts, instead of reason and grounds reached by subjective deduction. There must be legitimate grounds in order to obtain such an order. Preservation can only be made where the enforcement of a judgment becomes impossible or difficult due to the acts of one party or for other reasons.[647] The actions of the respondent must be able to justify the preservation order; for example, there is the likelihood of the respondent transferring and hiding its assets.

In practice, it seems that to obtain a freezing order, the court does not require the applicant to demonstrate that there is a realistic likelihood that it would succeed on the merits of the case or a good arguable case. On the contrary, in most common law jurisdictions, it is definitely necessary for the applicant to show it is a good arguable case in order to obtain the grant of interim measures. Some

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[644] For a general discussion about the definition, types, conditions, procedure, measures, validity of such an order, see e.g. Chang, Yi (2008), *Civil Procedure Law*, Peking: China University of Political Science and Law, pp. 242-247; see also Jiang, Wei (2005), *Research on Civil Procedure Law*, Peking: China Renmin University Press, 1st ed., pp. 255-266.

[645] Civil Procedure Law, adopted at the 4th Session of the 7th NPC on 9 April, 1991, and revised according to the Decision of the Standing Committee of the NPC on Amending the Civil Procedure Law of the PRC, which was adopted at the 30th session of the Standing Committee of the 10th NPC on 28 October, 2007 and came into force as of 1 April, 2008.

[646] CPL, article 92.

[647] Ibid.

scholars do put doubts on such kinds of practice in China. Kwan expressed that it is surprising that there is no such requirement for a party to obtain a freezing order.[648] Moreover, it was argued that the protection of security provided by the applicant is not sufficient, because the respondent may have the chance to resort to such security a few years later, and by that time, the respondent, having been affected by a freezing order, may become bankrupt due to its incapability to pay its debts.[649]

However, there were no specific guidelines and conditions concerning the issuance of a property preservation order, except the relevant articles in the CPL. What kind of circumstances make further enforcement impossible or urgent? In a way, to decide whether to issue such a court order is under the discretion of the court, which is similar to that in England. However, in the Chinese legal system, there is no formal precedent system as in England. When dealing with disputes before the courts, the judges in China can not look for authority concerning specific rules through precedents, which are reported and organised through the law reporting system, as do the judges in England.

In China, before the new provisions on the L/C took effect, the applicants mostly applied for freezing orders from a court in L/C fraud disputes.[650] A freezing order on a party's property in Chinese law is a kind of procedural measure to secure the applicant's interests, considering the possible failure of enforcement in the future. However, the applicants' application for freezing orders in the context of L/C fraud disputes, clearly was not to freeze the beneficiary's property, but was intended to prohibit the bank from making payment under the L/C to the beneficiary. It can be seen that the function of freezing orders in this particular context[651] had the similar function[652] as that of an injunction in England or the US. In the previous documents on L/C fraud that the SPC issued, the usage of stop-payment in the L/C referred to the procedure of a freezing order from the court, as there was no legal concept for a stop-payment order or injunction in the civil procedure law.

However, freezing orders and injunctions do have different origins, functions and procedures. If the freezing order procedure was simply used, attempting to have the function of an injunction, problems in law and judicial practice would be caused. The reasons for why a freezing order is not a suitable instrument for dealing with L/C fraud disputes are as follows: firstly, it does not satisfy the components of a freezing order, as the unpaid payment either is the property of the applicant or third party (bank); secondly, it does not accord with the objective condition of a freezing order, as the object of a freezing order is property, rather than

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[648] Kwan, James (2004), *Arbitration in China: A practical Guide*, Sweet & Maxwell Asia, Part 2: Procedure, Chapter 10: Interim Measures in PRC Arbitrations, 6. Requirements, 10-45.
[649] Ibid.
[650] For further analysis on the problem of such an application to prohibit an L/C payment, see Zhao, Hong, 'Discussion on L/C Fraud and Remedy', in Guangdong Higher People's Court (2004), *Study on China's Foreign-related Commercial Trials*, Peking: Law Press China, 1st ed., p. 169.
[651] It was argued that such an order belongs to one of the liability types in tort cases allowed in the General Principles of the Civil Law in China: stopping infringement, see Zhang, Xianwei (2002).
[652] See e.g. He, Bo (2002a).

an action; thirdly, it does not conform to the legal features of a freezing order, as a freezing order is only a remedy in procedure, but prohibiting L/C payment is a kind of remedy in substance when an underlying contract dispute and fraud dispute are tried together in judicial practice.[653] The problem of applying freezing orders in L/C fraud disputes will be demonstrated by previous court cases.

Court Cases on L/C Fraud Disputes Prior to 2006

After introducing the legal framework and procedural instrument over L/C fraud disputes in China, it would be helpful to look at how L/C fraud is dealt with in civil cases in judicial practice. The court cases that will be discussed below were handled before the Chinese new provisions on L/C took effect, but this does not render the discussion of such court cases meaningless. On the contrary, the examination of such court cases is important, as the new provisions would not have been formulated as they are now without previous judicial experience having taken place. The court cases that will be examined are not only from the Supreme Court, but also from the lower courts, as analysis of only court decisions limited to the level of the Supreme Court or the higher courts may not provide the whole picture of the judicial reality[654].

Examining court cases can serve several purposes. Firstly, to observe the problems of using a freezing order in L/C fraud disputes. Secondly, to look at how the courts in China adapt such procedure into the particular context of L/C transactions where no other legal instrument was available. Thirdly, to understand what was referred to as L/C fraud in China, and how the rules of L/C fraud exception were established in China. Fourthly, to understand the new provisions concerning L/C fraud exception so as to know how to apply them properly in future cases.

We would organise the court cases according to the types of L/C fraud disputes. To a great extent the types of L/C fraud disputes are related to the L/C fraud types. But they are not exactly corresponding to each other. The main types of L/C fraud disputes in China are similar to those in England. The first main type is where a L/C applicant attempts to prevent a paying bank from making payment or prevents a beneficiary from drawing on the L/C based on the beneficiary's fraud. Secondly, a L/C beneficiary brings an action against the paying bank, as the bank has wrongly refused to pay under the L/C on the grounds of fraud. Thirdly, the paying bank has already made payment, and recovery either against another bank or against the L/C beneficiary is sought on the grounds of fraud relating to the documents presented.

Buyer v. Seller (Seller & Carrier)

In the following L/C fraud disputes, either the seller alone or in collusion with the carrier, defrauded the buyer through the L/C. Usually they forged relevant documents required under the L/C, such as the BL, packing list, cargo receipt and

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[653] Xiang, Yaping (2007), 'Comment on Civil Remedy to L/C Fraud in China', *HLJ Foreign Economic Relations & Trade*, No. 11 (Serial No. 161), 73, p. 74.
[654] Van Hoecke, Mark, 'Deep Level Comparative Law', in Van Hoecke, Mark (Ed.) (2004), p. 192.

so forth, then did not deliver the goods or delivered a very small portion of the goods. The buyer firstly attempted to apply for a preservation order to withhold or prevent L/C payment through the court, and then brought litigations against either the seller alone or both the seller and the carrier. We will summarise the main points concerning L/C fraud exception rules after discussing the following five court cases.

Case No. 1: *Hainan Province Timber Company, China (Timber) v. Titan Shipping Ltd. (Titan) Singapore and Tatpin Private Ltd. Singapore (Tatpin)* [1990] (Buyer v. Seller & Carrier)

This was probably the earliest case concerning fraud in a L/C transaction in judicial practice.[655] The dispute[656] was between a buyer in China and a seller and carrier in Singapore. The plaintiff Timber (buyer) had a sales contract with the defendant Tatpin (seller), and Timber applied to open a L/C through a bank. Tatpin did not have the goods to deliver, but colluded with Titan (carrier) to forge a clean BL with the intention of defrauding L/C payment. The plaintiff brought litigation; claimed the invalidity of the sales contract and BL, and claimed for damages. At the same time, the plaintiff applied for a preservation order to freeze over the L/C payment, and the court accepted this application.

Two key legal points involved in the case were: firstly, whether or not the other party could rescind the contract where one party forged the BL and did not deliver any goods in an international sales contract; secondly, whether or not the L/C applicant could claim annulment of the L/C through the court where there was sufficient evidence to prove the seller colluded with the carrier to defraud.[657]

The court employed the concept of 'reservation of public order' to exclude the application of international customary rules, and held that the evidence demonstrated that both defendants conducted fraud together to defraud L/C payment, that they had no good faith to perform the contract, that the contract and the forged BL were invalid, and that the defendants' conduct constituted joint-tort and they should be jointly responsible for the damages of the plaintiff, according to article 58, 61 and 131 of General Principles of Civil law.[658]

In the judgment, the legal points of L/C fraud and L/C fraud exception rules were not discussed clearly as in English court cases, because the plaintiff had claims for annulment of contract and BL, as well as damages on the grounds of fraud in the sales contract, rather than L/C fraud. Thus, the concept of L/C fraud exception was not developed in this case.

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[655] There were also some cases in which the buyer sued the carrier only because of an anti-dated BL, for further analysis of such cases, see e.g. Tang, Shumei (2006), pp. 38-44; mostly anti-dating BL brings forth tort dispute, e.g. *Sinochem International Corporation v. Malaysia International Shipping Corporation Berhad & Pan Ocean Shipping Co. Ltd*, further deails and comment about this case, see Luo, Guohua (2007) (Chief Ed.), sponsored by Guangzhou Maritime Court, *Annual of China Maritime Trial 2006*, Guangdong: People Jiaotong Press, 1st ed., pp. 640-652.

[656] Guangzhou City, Maritime Court, trial date was 29 June, 1990.

[657] Ibid.

[658] Ibid.

However, it demonstrated that L/C fraud was common in China's international trade. Furthermore, where fraud was established, in China the civil remedy in substantial law was annulment of contract and claim for damages; and in legal procedure was the preservation order of property to freeze L/C payment. In a way, such an order was intended to have a similar purpose as prohibiting a bank from paying out as an injunction order in England. Such an order was the only legal instrument that commercial parties in China could choose to apply before 2006 in L/C fraud disputes. However, it was later criticised for being wrongly applied[659].

Case No. 2: ***Xiamen Xiangyu Free Trade Zone Zhongbao Material Import and Export Co. Ltd. (Zhongbao) v. Hong Kong Billion Gold International Ltd. (Billon Gold), Hong Kong Winwick Shipping Co. Ltd., and Rishelle Navigation Shipping Co. Ltd.*** **[1996] (Buyer v. Seller & Carrier)**

In this case[660], the buyer Zhongbao had a sales contract with the seller Billon Gold with a L/C as the payment method. However, Billion Gold did not deliver any goods, but presented forged shipping and other documents to defraud the L/C payment. There was sufficient evidence to prove that Billion Gold and the carriers colluded to forge documents so as to obtain payment under the L/C.[661]

One of the essential legal points raised was whether L/C payment can be prevented when there is fraud (the seller and the carrier conspire together to defraud the buyer) in the underlying transaction.

The cause of action of the case was the fraud of BL, thus the judgment did not have adequate discussion and analysis of L/C fraud. Furthermore, the court did not point out the fact that after the paying bank had accepted the draft under the L/C, the fraudulent beneficiary assigned the draft to another company who did not know about the fraud at all. This circumstance is one of the exceptions or immunisation of L/C fraud exception: there is a holder in due course holding the draft under the L/C.[662] Under such circumstances, the L/C fraud exception should not apply; otherwise, the smooth transaction of bills and L/Cs will be intervened with unjustifiably.

This was a typical defective court decision where although L/C fraud was established, the court did not consider the immunisation of the L/C fraud exception.[663]

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[659] See e.g. Long, Zhuhua (2006), 'Civil Legal Remedy of L/C Fraud: Reviewing The New Provisions of SPC', *International Economic and Trade Exploration*, Vol. 22, No. 5, Sep., 42, p. 45; Qu, Tian (2004), 'L/C Fraud and L/C Fraud Exception', published on 14 Dec., available at www.ccmt.org.cn/ss/explore/exploreDetial.php?sId=742, accessed 15 July, 2008.

[660] Xiamen City, Maritime Court, First Instance, No. 074; judgment was issued on 21 December, 1996; another example of a similar case was where a L/C was already accepted and negotiated by another bank, and then an Intermediate Court in Shanghai granted a freezing order upon L/C payment, see Wang, Lili (2004a), *Case Studies on Legal Risk Control of Banks*, pp. 190-197; Sun, Jiang (2005), 'The Problem of Application of L/C Fraud Exception in Judicial Practice in China', *HLJ Foreign Economic Relations & Trade*, No. 3 (Serial No. 129), 50, p. 51.

[661] Ibid.

[662] For further comment about the point in the case, see e.g. Liu, Debiao & Yu, Youyan (2003), pp. 104-105.

[663] For further comment, see e.g. Deng, Xu, 'On the Practice and Theoretical Analysis of L/C Law in China', in Gao, Yongfu & Cheng, Jingying (2006), *Journal of International Trade Law*, Vol. 1, Peking: Peking University Press, 1st ed., p. 211.

Case No. 3: ***Shenzhen Branch Sanhe Bank, Hunan Import and Export Corporation Boneng Petrol Chemical Company (Boneng) v. Hong Kong Changshun Development Co. Ltd (Changshun), Changshun Trading Company, Changsha Branch Bank of Communications (Changsha Branch), et.al*** **[1999] (Buyer v. Seller, banks participated the proceedings as third parties)**

This case[664] is important as it concerned the liability of a bank due to its own negligence in a case where fraudulent documents are presented to demand payment under a L/C. It is interesting to make a comparison with the decision of the *Standard Chartered Bank* case (Case No.12 in section 3.3.2.3.3) in England.

In this case, the plaintiff Boneng sued the defendant (seller) as the seller fraudulently obtained L/C payment from the negotiating bank, whereas the issuing bank and the negotiating bank participated in the litigation as third parties. The First Instance Court held that the defendant shall pay the loss of the plaintiff and the negotiating bank; and dismissed the negotiating bank's claim of requiring reimbursement from the issuing bank.[665] The negotiating bank appealed to the SPC, and the SPC dismissed the appeal on the grounds that the presented documents do not conform to the L/C requirement and that this was the negotiating bank's own fault.[666]

Two of the key legal questions were that: firstly, shall the negotiating bank itself bear the loss resulting from the seller's fraud, if the negotiating bank did not take reasonable examination on the obviously discrepant documents and check the seal with the issuing bank? Secondly, if there is fraud in a L/C transaction, does the court have the right to issue an order to prohibit payment under the L/C?

In the case, there was no dispute that the beneficiary conducted fraud in the performance of the sales contract, thus constituting L/C fraud. The problem is the legal position of a paying bank, and whether the L/C fraud exception should apply. The paying bank Shenzhen Branch did not make an agreement with Changsha Branch concerning negotiation of the L/C; therefore Shenzhen Branch was not a negotiating bank in a legal sense under UCP. After it received the documents, and made payment to the presenter, it was in the position of beneficiary. Thus, the issuing bank Changsha Branch had the defence of L/C fraud exception against Shenzhen Branch (the position of beneficiary), because the documents

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[664] SPC, civil judgment, (1999), Economic Tribunal, Final, No. 86; judgment was issued on 31 December, 2000; The basic legal relationships were that the buyer Boneng concluded a sales contract with the seller Changshun; Boneng applied for a L/C with Changshun as the beneficiary through the issuing bank Changsha Branch. One of the specified documents under the L/C was the cargo receipt, which had to be issued by the buyer or signed by its legal representative, and the signature had to conform with the specimen filed in Changsha Branch. Changshun forged the packing lists and cargo receipt, and negotiated at Shenzhen Branch Sanhe Bank (Shenzhen Branch) through an advising bank. After Shenzhen Branch received the request of negotiation, it neither informed the issuing bank Changsha Branch to request acceptance of the L/C, nor did it check whether the signature on the cargo receipt conformed with the specimen, but immediately paid the beneficiary Changshun. Then Shenzhen Branch sent documents to Changsha Branch to demand acceptance and reimbursement. Changsha Branch, however, refused the acceptance on the grounds of discrepancies, and then returned the documents to Shenzhen Branch; Shenzhen Branch was later informed that the beneficiary did not deliver any goods, but forged the signature and seal on the cargo receipt, and Hunan Province Higher Court issued an order to prohibit payment.

[665] Ibid.

[666] Ibid.

presented by Shenzheng Branch were fraudulent. The rule of L/C fraud exception thus applies in such a situation.

As the court stated, this was a dispute over L/C payment resulting from the beneficiary's conduct of fraud, and without doubt the person who should be liable for the loss is the beneficiary; however, where the beneficiary is unable to make the compensation, the legal responsibility of Changsha Branch and Shenzhen Branch shall be determined according to the principle of faulty.[667] It was Shenzhen Branch's fault that it made the L/C payment without checking the conformity of signature of cargo receipt as required under the L/C, whereas Changsha Branch did not have any fault concerning it.[668] Therefore Changsha Branch should not bear any responsibility with regard to the loss occurred by Shenzhen Branch.

Similarly in the *Standard Chartered Bank* case in England, the paying bank discounted the L/C earlier than the stipulated date, without informing the issuing bank. That means such discounting did not obtain the authority of the issuing bank, and then the paying bank under UCP is not in the position of a negotiating bank. After the discounting of the L/C, the paying bank stood as the position of beneficiary. Thus, the paying bank itself bears the risk of not getting paid under the L/C when presenting fraudulent documents which were originally from the fraudsters. Where the beneficiary's fraud has been established, and such fraud is noticed by the issuing bank, the L/C fraud exception rules take effect. In other words, the issuing bank was able to refuse the L/C payment legally on the grounds of fraud.

Case No. 4: *Fengyi International Trade Company, Tianjin, China* (Fengyi) *v. Aslchem International Inc., Canada* (Aslchem) [2004] (Buyer v. Seller & Carrier)

This appeal case[669] was a dispute between international sales contract parties and a carrier about damages due to antedated BL. The First Instance Court discussed three key issues: whether the carrier antedated BL; whether the damages of Fengyi resulted from antedating BL; and whether Fengyi was entitled to the court order to prevent the L/C payment.

With regard the first question, the First Instance Court decided that antedating BL was established. As for the second issue, the court recognised the independence principle of the L/C and L/C fraud exception, because law will not protect fraud under any circumstances.[670] The court considered that the L/C fraud exception works where there is substantial fraud engaged in the underlying sale

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[667] Ibid.
[668] Ibid.
[669] Tianjin City, Higher Court, Civil Judgment, (2004) Civil Tribunal No. 4, Final, No. 021; judgment was issued on 10 June 2005; the basic facts: the buyer Fengyi concluded a sales contract with Aslchem using a L/C as the payment method. Then Fengyi applied for a L/C with Aslchem as the beneficiary through Tianjin Branch, Bank of Communications, China (Tianjin Branch). Tianjin Branch informed Fengyi to pay for the documents presented by Aslchem. Fengyi applied for preservation of evidence before litigation, and then brought a suit against the seller Aslchem and the carrier Islamic Republic of Iran Shipping Lines Tehran on the grounds of the collusion of fraud due to antedating BL. Fengyi applied to Tianjin Maritime Court for a freezing order to prevent payment under the L/C.
[670] Ibid.

transaction and the applicant of the L/C applied for a court order to prevent payment under the L/C; thus the precondition of applying the L/C fraud exception is that the seller conducted or participated in serious fraud when performing the sales contract.[671] Furthermore, as there were no rules over the L/C instrument at that moment, the court looked at the guidance issued by the SPC in 1989 when deciding whether antedating BL applies to the L/C fraud exception.

The First Instance Court held that the L/C fraud exception does not apply for the following reasons[672]: firstly, Fengyi did not provide sufficient evidence to prove the seller Aslchem colluded with the carrier to antedate BL, thus it could not prove that Aslchem knew about the antedating of the BL or intentionally conducted such fraud. Fraud can only be established under deliberation, rather than negligence, according to Article 68 of Opinions of the SPC on Several Issues concerning the Implementation of the General Principles of the Civil Law (for Trial Implementation)[673]; as Aslchem did not request or participate in the course of antedating BL, Aslchem's fraud towards Fengyi was not established. Secondly, when the goods arrived at Tianjin, Fengyi negotiated for a lower purchase price due to the fall in the market price of such goods, and Aslchem agreed to compensate Fengyi with 40,000 dollars. This fact to a certain degree showed the good faith of Aslchem in performing the sales contract. Furthermore, Fengyi had already taken the contracted goods; but it was not legal for Fengyi to have the goods without having made payment. Thus the court, by considering both the L/C relationship and the underlying sales contractual relationship, finally held that the L/C fraud exception in this case did not apply.

On the legal point of L/C fraud exception in the First Instance judgment, Fengyi appealed on the grounds that the antedating BL itself constituted fraud, and could evoke the application of the L/C fraud exception, no matter whether the seller had conducted or participated in antedating BL.

Thus in the appeal, the key disputed issues were again of whether the BL was antedated, and whether the preservation order should be kept for freezing the payment under the L/C by applying the L/C fraud exception. The appeal court overruled the First Instance Court's decision over the issue of antedating the BL; and held that the BL was not antedated. On the issue of the L/C fraud exception, the appeal court confirmed the judgment of the First Instance Court that there has to be sufficient evidence to prove the existence of fraud in the underlying sales contract; however, no evidence showed Aslchem conducted or participated in serious fraud; thus Fengyi should make payment to Aslchem.[674]

In the court judgment, on the legal point of the L/C fraud exception, the court in particular considered the beneficiary's knowledge of the fraud, the performance of the beneficiary concerning the sales transaction, and pointed out one

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[671] Ibid.
[672] Ibid.
[673] The 'Opinions' was delivered and adopted at the Judicial Committee of the SPC on 26 January 1988, and came into effect on 02 April, 1988, article 68 provides that if one party deliberately informs false information or deliberately conceals the true fact to the other party, and induces the other party to make a false representation, this can be considered as fraud.
[674] See judgment of the case, n. 669 above.

kind of L/C fraud – fraud in the underlying sales contract. However, the court did not touch on the point of L/C fraud in documents.

Case No. 5: *Fujian Metals & Minerals Import & Export Company, China* (Fujian Company) *v. Srilanka AMM Industry Ltd. (AMM), third party - Xiamen Branch, China Merchants Bank Co. Ltd (Xiamen Branch)* [2004] (Buyer v. Seller)

This was a dispute[675] in which the buyer in China sued the seller in Sri Lanka over the L/C payment and the bank was a third party in the same lawsuit. This case is important, because the court observed the principle of the L/C fraud exception, and discussed the difference between substantial fraudulent conduct and breach of contract[676] in the judgment.

The court clearly stated that the L/C fraud exception was widely accepted by many countries; although the criteria and practices of applying this principle are different between each country, one common principle that was generally accepted that when there is L/C fraud, it is possible to consider the L/C and underlying sales transactions together; and if fraud is established and no specific circumstances of immunisation of the L/C fraud exception exist, then the L/C payment can be refused.[677]

Furthermore, the court pointed out that L/C fraud refers to that the seller presents forged documents under the L/C or the seller's negotiation request is based on a right without legal entitlement according to the real situation; thus L/C fraud includes fraud in the documentation and fraud in performing the underlying sales contract.

In this case, the BL was issued by the carrier, but after issuance, some amendments were made without the acknowledgement of the carrier. The behaviour of altering the shipping date clearly was to make the document comply with the L/C on its face value so as to obtain acceptance or payment under the L/C. The current evidence demonstrated that such an alteration was not done by the carrier. Even though there was no direct evidence to prove that such conduct was performed by the beneficiary, at least it is reasonable to infer that the beneficiary had the possibility of doing it, considering the interests associated and the purpose of such conduct.[678]

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[675] Fujian Province, Xiamen City, Intermediate Court, (2004), Civil Tribunal, First Instance, No. 352; judgment was issued on 2 December, 2005; the basic legal relationships were that: based on a sales contract, Fujian Company (buyer) applied for opening an L/C with AMM as the beneficiary through Xiamen Branch. AMM submitted documents through a bank in Srilanka to Xiamen Branch. After examining the documents, Xiamen Branch found that on the two sets of BL, the original dates of receiving and shipping cargo were amended. The carrier proved that the real shipping date was 3 October, 2004, instead of 30 September, 2004, and such an amendment was not known to the carrier. Xiamen Branch sent its dishonour notice to the advising bank in Sri Lanka, on the grounds of discrepancies of documents. The buyer Fujian Company applied for a preservation order of evidence through the Notarial Office, and applied for a freezing order through the court to prevent Xiamen Branch from paying out under the L/C. Then the plaintiff brought this litigation.

[676] This important issue is also discussed in Li, Yi & Bai, Yan (2001), 'L/C Fraud and Legal Problems of Judicial Intervention in L/C Payment', *People Justice*, No. 3, 41, p. 42.

[677] See judgment of the case, n. 675 above.

[678] Ibid.

However, the L/C fraud in this case was mainly embodied in the fact of delivering a very small amount of goods, which was only 10 percent of the contracted goods. Such conduct of the seller was ascertained as substantial fraud, which was done intentionally. The reasoning of the court was as follows[679]: firstly, the BL showed that it was the defendant, the owner of the goods who loaded the goods and sealed the containers, rather than the carrier or others; the big difference in the weight of the cargos between the BL and the quantity of delivered goods in itself demonstrated the subjective state of mind of the defendant was deliberate, rather than negligent; secondly, the false record on the BL by the defendant may well lead to the result of getting payment in full under the L/C. Finally, the value of the delivered goods was almost negligible, compared to the value of the contract goods; therefore, the conduct of a serious shortage of goods was not an ordinary case of breach of contract, and would obviously lead to loss by the plaintiff. Accordingly, the fraudulent conduct by the defendant satisfied the elements of L/C fraud and thus L/C fraud was established in this case.

In addition, there are no such circumstances as a third party – a holder in due course of the draft under the L/C or a negotiating bank has paid the price in good faith, which means the exception of the L/C fraud exception does not apply.[680] Therefore, the rule of the L/C fraud exception applies and the bank shall not make payment under the L/C.

The judge Bingkun Ye in this case made comments on the definition of L/C fraud in the Kuchifuchi case (Case No. 10) arguing that such concept may be misunderstood and that the scope of L/C fraud is exhaustive, and includes only the case of forging documents, covering the kinds of circumstances where the beneficiary does not deliver goods at all and the delivered goods were of a very poor quality. In a way, such a definition excluded the current case of serious shortage of goods, which clearly is unable to reflect the ever-changing nature of fraud in reality.[681]

With reference to foreign jurisprudence and doctrine, the court put forward the two cases of L/C fraud which cover documentary fraud and fraud in the performance of the underlying sales contract.[682] A partial statement of this judgment concerning the definition of L/C fraud was cited from the observation of Lord Denning in *Edward Owen Engineering Ltd* case[683].

The court determined that to decide whether the beneficiary's conduct constitutes L/C fraud, the court had to look at the widely accepted theory of L/C fraud, provision of fraud in civil law and the features of the L/C transaction.[684] There is no standard international practice of ascertaining L/C fraud; in order to determine the elements of L/C fraud the relevant provisions of the applicable domestic law need to be looked at. According to article 58 of the General Principles of the

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[679] Ibid.
[680] Ibid.
[681] Ibid.
[682] Such opinion is also accepted by some academics, see e.g. Xu, Jinli (2009), 'The Right of Dishonour of L/C Issuing Bank', *Practice in Foreign Economic Relations and Trade*, No. 9, 57, p. 58.
[683] [1978] QB 159, p. 169.
[684] See the judgment of the case, n. 675 above.

Civil Law of PRC and article 68 of the Opinions of the SPC on Several Issues Concerning the Implementation of the General Principles of the Civil Law of PRC (for Trial Implementation), fraud means "one party intentionally informs the other party false information or deliberately concealing the real situation, induces the other party into making any false meaning of acts, or making an act contrary to their true meaning". Therefore, usually fraud shall involve four elements[685]: firstly, the party has given the other party false information or concealed the true situation; secondly, such behaviour is conducted by the party; thirdly, the subjective state of mind of the party can only be intentional; fourthly, the other party expresses their unreal intention or acts in a way that departs from their genuine intention. Clearly, the fourth element cannot be applied in L/C fraud disputes, as once the paying bank has paid out, it is too late for the court to prevent payment. Thus this element in L/C fraud should be replaced as although this act has not yet occurred, it is a fraudulent act in order for achieving the purpose of obtaining payment and if the fraud has not yet been discovered, it most certainly will be.[686]

It is clear that the case of delivering a serious shortage of goods is different from the cases of non-delivery of goods or delivery of worthless goods, which are typical cases of L/C fraud. How to distinguish between ordinary breach of contract and fraud is a very sensitive and vague issue, but it is a very important question when deciding whether L/C fraud is established or not.

The Court took into account several factors[687]: first, to weigh and compare the interests, the proportion of the goods that the defendant actually delivered against the contract value of goods clearly exceeded a reasonable ratio of breach of contract. Second, the defendant made a serious misrepresentation in the BL, which is to be presented to banks for payment; intending to obtain full payment with such small amount of goods; from another point of view, their action is not an ordinary breach of contract, but fraud to obtain full value far beyond their actual value. Third, considering the vast difference between the actual weight and the weight of the contract weight, and the benefits such differences may lead to, the defendant had made false statements deliberately, rather than negligently or by fault. Fourth, the act may have caused a substantial damage to the paying bank if it had succeeded.

The court analysed L/C fraud from two points of view: one is documentary fraud and another concerns the performance of sale contract. The court considered that the defendant's conduct involves both kinds of L/C fraud. Firstly, the weight of goods in the BL does not accord to the real situation, which constitutes a serious false representation and in a way belongs to documentary fraud.[688] In reality, a false representation is reflected not only with regard the quality of the delivered goods, but also the shortage of goods and other cases of breach of contract in the course of presenting documents under the L/C. Secondly, maliciously

[685] Ibid.
[686] Ibid.
[687] Ibid.
[688] Ibid.

delivering a serious shortage of goods is actually fraud in the performance of the contract.[689] Thus, from both sides, L/C fraud could be established, and the L/C payment could be prohibited according to the L/C fraud exception rules.

We consider it to be a court judgment with sound analysis over L/C fraud exception rules, and thus could be recommended as a model case dealing with L/C fraud disputes, and should be welcomed by the legal and commercial community. In this judgment, two typical cases of L/C fraud were recognised – fraud in documents and fraud in underlying transactions. The discussion over why L/C fraud was constituted in the case was reasonable and persuasive. The reasoning over the analysis of four elements in constituting L/C fraud has its legislative origin in civil law. The exceptions to the L/C fraud exception were also considered. In addition, the issue over the difference between L/C fraud and breach of contract was put under deliberate discussion. It is difficult to draw a line between L/C fraud and breach of contract, and most often it is a delicate issue in commercial practice. In many cases, L/C fraud was only alleged; such disputes may simply be a breach of contract. Thus, it is important to distinguish between the differences of the two subject matters. Such a discussion in this judgment provides guidance to other judges who may deal with similar disputes.

To sum up, the L/C fraud concept was gradually recognised, and the L/C fraud exception rules were gradually developed based on definition of fraud in the civil law of China and with reference to judicial practice in other countries. The courts seemed to resolve such disputes by looking at both the L/C transaction and performance of the underlying transaction; and they naturally consider that fraud can be found either in L/C transactions or in underlying transactions. In order to establish L/C fraud, clearly the beneficiary has to know and conduct fraud; such fraud also has to be clear to the paying bank. Essential principles in L/C transactions, such as a holder in due course has to be protected were later confirmed after several flawed court decisions were made by failing to consider circumstances about the immunisation of the L/C fraud exception.

Seller v. Bank

In the following court cases, the beneficiary sued the bank to make payment under the L/C, because the bank refused to pay either on the grounds of discrepancy or fraud or on both grounds. In some cases, the bank refused to pay under the request of the buyer due to the contractual disputes, rather than due to real fraud. But in a way, the courts have to determine whether the facts of a breach of contract have constituted fraud.

[689] Ibid.

Case No. 6: ***Xian Medicine &Health Products Import & Export Company (Xian Company) v Australia and New Zealand Banking Group Limited (Australia and New Zealand Bank)*** **[1997] (Seller v. Issuing bank)**

This was a L/C dispute[690] in which the seller (beneficiary) sued the paying bank because the seller's demand for payment under the L/C was refused. The key legal issues involved were: firstly, whether the L/C fraud exception should apply to the conduct of antedating BL; and secondly, whether antedating BL is a L/C fraud when the beneficiary did not request or participate in the process of antedating BL, but at the same time the buyer agrees to accept such an antedated BL.

The court held that the beneficiary's conduct did not constitute fraud, although the BL was antedated; thus the L/C fraud exception did not apply in this case. The reasoning from the court was as follows[691]: under the fraud of antedating BL, usually it is the beneficiary who requires the carrier to issue BL with a false date in order to make documents complying with L/C shipment requirements. The essence of the L/C fraud exception is to prevent the seller (beneficiary) from conducting a fraudulent transaction towards the buyer, by misusing the strict compliance principle of the L/C; and the purpose of the fraud exception is to ensure the buyer's interests under the protection of law. However, in this case, the issuance of antedated BL by the carrier was under the circumstance where the buyer agreed to accept such BL, but the beneficiary did not request or participate in such conduct.

Furthermore, the beneficiary delivered the contracted goods to the carrier on time, and the beneficiary did not have the intention to defraud by using contracts and documents; although the beneficiary knew the BL was antedated before presenting the documents to demand payment, such conduct is essentially different from the legal concept of 'know' in the intentional fraud in the L/C fraud exception rules.[692]

In this case, it was the carrier who failed to meet with the shipping schedule due to problems with its transporting sectors; and then an agreement about antedating the BL was reached between the carrier and the buyer. The beneficiary neither had the intention of fraud, nor conducted any fraudulent behaviour. The beneficiary only found out the facts about the BL when it asked for the BL from the carrier. The beneficiary passively accepted the fact in order to continue the performance of contract and reduce potential losses. Therefore, the court finally held that the L/C fraud exception does not apply to this case, and Australia and New Zealand Bank shall make the L/C payment, including the interest thereof.[693]

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[690] Shanghai City, (1997), Intermediate Court No. 2, Economic Tribunal, First Instance, No. 842; judgment was issued on 25 September, 2000; the basic facts: The plaintiff Xian Company (seller) concluded a sales contract with the buyer Michael Waring Trading Ltd. (Michael Ltd). Under the request of Michael Ltd, Australia and New Zealand Bank issued a L/C with Xian Company as the beneficiary. Xian Company presented compliant documents to Australia and New Zealand Bank, but the bank refused to make payment with the defence of L/C fraud.

[691] Ibid.

[692] Ibid.

[693] Ibid.

A positive comment about the judgment was that the court considered the element of fraudulent intention by the beneficiaries.[694] However, the decision may also bring forth the following negative influence: firstly, banks do not have the duty to know and follow arrangements, such as anti-dating the BL between business parties; secondly, presenting an anti-dated BL so as to get payment means fraudulent conduct towards the bank, and the court needs also to consider this from the perspective of the L/C and documents, rather than only the underlying transaction; thirdly, if the bank is obligated to pay for the documents including a fraudulent document, the bank may not be able to get reimbursement from the L/C applicant.[695] In addition, to demand a bank to examine whether the parties have fraudulent intention beyond the documents when a bank examines documents or decides to accept or refuse documents is neither feasible nor reasonable.[696] Such a decision may increase the risk that buyers and sellers collude together to defraud banks and encourages indirectly the behaviour of anti-dating the BL in practice.[697] At the same time, it was pointed out that although the intention of making false representation is established, such false representation is not substantial; thus applying the L/C fraud exception does not seem proper.[698]

The judgment considered the beneficiary's knowledge on fraud, and the performance of the beneficiary concerning the underlying sales contract when deciding about L/C fraud. Thus, it was similar to an English case *United City Merchants* (Case No.5), in which a BL was antedated by one day, and the judge held that the beneficiary did not know about the fraud; furthermore, the BL was valid as the delivered goods were still the contracted goods. We approve of the opinion that whether or not antedating a BL in L/C transactions constitutes L/C fraud cannot be stated in a certain manner, and it always depends on the facts of an individual case.

Case No. 7: ***Newco Commdodities AD (Newco) v. Huichun Sub-branch of Jilin Province Branch of the Construction Bank of China (Huichun sub-branch)*** **[1998] (Seller v. Issuing bank)**

This is an appellate case[699] concerning the disputes over the dishonour of the payment under the L/C. In the First Instance case, Newco claimed that Huichun sub-branch conspired with a person not involved in this case to conduct a fraudulent

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[694] Jin, Saibo (2003b), 'Does Anti-dating BL Constitute L/C Fraud'.
[695] Ibid.
[696] Ibid.
[697] Ibid.
[698] Ibid; see also comment on this case, Tang, Jinlong (2005), pp. 183-190.
[699] Civil Judgment of the SPC of PRC, Final Judgment of the Economic Tribunal No. 336 (1998); In this case, Huichun sub-branch issued an irrevocable L/C for the beneficiary Newco (in Switzerland) under the application of Jilin Foreign Trade Import & Export Co. (Jilin Foreign Trade, in China); Frankfurt Branch of New York Bank was the advising bank. Newco submitted documents under the L/C to Frankfurt Branch and demanded L/C payment. After examining the documents, the Frankfurt Branch informed Huichun Sub-branch of seven discrepancies; then Huichun sub-branch telexed Frankfurt Branch that it would dishonour the payment. Later, Frankfurt Branch notified Newco about the telex of dishonor and it returned the complete set of documents to Newco. However, the goods delivered by Newco were taken by Huichun International Trade Industrial Co. Ltd (Huichun International Trade), which is the foreign trade agency of Jilin Foreign Trade. Newco requested that Huichun sub-branch pay for the goods, but this was rejected. Thus, Newco sued Huichun sub-branch to HPC of Jilin Province of the PRC and pleaded with the court to order Huichun sub-branch to honour the payment.

act. The Higher People's Court (HPC) held that the proof of establishment of L/C fraud by Huichun sub-branch was insufficient and thus this claim was rejected. The court went further stating that Newco's goods were taken away by others without payment is a separate case.[700]

Newco then appealed[701] to the SPC; and the SPC pointed out that this case was a dispute between the beneficiary and the issuing bank over refusal of payment for the goods under the L/C and rejected Newco's claim that Huichun sub-branch in collusion with Huichun International Trade defrauded the goods under the L/C, because such a claim comes up short on both a factual and legal basis.

In the SPC's judgment it correctly identified one disputed element: the issue of whether or not the issuing bank conducted an act of defrauding the beneficiary in collusion with the applicant of the L/C.[702] However, the problem seemed to be that the judgment was due to a lack of adequate discussion on the reason of why L/C fraud was not established in this case.

It can be seen that it was a case concerning dishonouring a L/C payment on the grounds of discrepancies. However, the goods delivered by the beneficiary were taken by another party, rather than the buyer in the underlying sales contract. The beneficiary applied to claim the L/C payment due to the paying bank's dishonour, on the grounds of the collusion of the paying bank with another party. This was an exceptional circumstance, because in common L/C fraud disputes, the applicants applied to the court to prohibit the L/C payment on the grounds of fraud.

We would point out that L/C fraud disputes are often intertwined with dishonouring L/C payment issues, but in both kinds of disputes, the grounds of fraud may be argued about. Thus, in both kinds of L/C disputes, issues of L/C fraud and the L/C fraud exception rules can be found.

Case No. 8: ***Liaoning Province Textile Import & Export Corp., China (Textile) v. Istituto Bancario San Paolo DI-Toriuo, Italia (Paolo Bank)*** **[1999] (Seller v. Bank)**
This was a L/C dispute[703] in which the seller in China sued the paying bank in Italy in order to receive payment under the L/C. This case was chosen as it is a typical type of L/C fraud dispute, where there is no fraud but merely a breach of contract, and where the bank refused to pay by using the defence of a court order from the local court because of contractual disputes between the buyer and the seller[704].

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[700] Ibid.
[701] Ibid; in the appeal, Newco claimed that Huichun sub-branch issued this L/C when knowing clearly that the Huichun International Trade was applying for the L/C in the name of Jilin Foreign Trade; this was an act of fraud by taking advantage of L/C in order to defraud its goods in collusion with Huichun International Trade.
[702] Ibid.
[703] Peking City, Intermediate Court No. 2, civil judgment, (1999), Economic Tribunal, First Instance, No. 1636; judgment was issued on 9 June, 2000; In the case, the seller Textile made an agreement with the buyer MGA2SRL Company in Italia (MG). Paolo Bank was the issuing bank, and Liaoning Branch, Bank of China was the advising bank. Paolo Bank refused to pay under the L/C on the grounds that Italian court had frozen the L/C payment in the litigation brought by MG due to the contractual dispute over the quality of the goods.
[704] For examples of two similar cases in China, in which Intermediate courts issued a freezing order upon L/C payment in disputes concerning the quality of the goods, see Wang, Lili (2004a), *Case Studies on Legal Risk Control of Banks*, pp. 182-189 and pp. 212-220.

Palolo Bank argued that the Italian buyer sued because of a shortage of goods, and whether this constituted fraud or not should be decided by the court; the guidance about L/C fraud and the L/C fraud exception issued by the SPC of PRC are only effective in courts in China, and do not have any effect on the court order issued by an Italian court in Italy. In this case, the effect of the Italian court's order was to prohibit the L/C payment to the beneficiary, but the proceeds of the L/C were put into an account under the name of the buyer and such an account was strictly under the restriction of the Italian court.[705]

Concerning the L/C fraud issue, the court in China held that the case was clearly a contractual dispute between the buyer and the seller; there was no evidence to show that L/C fraud had taken place; as L/C is independent from the underlying contract, the issuing bank shall bear the first responsibility of making payment to the beneficiary where the beneficiary submits compliant documents; the contractual dispute should not force the paying bank to become involved.[706]

It can be seen that the problem of wrongfully issuing a court order to stop payment under the L/C seems to be a problem of the courts not only in China, but also in other countries. However, wrongfully issuing a court order does negatively affect on the reputation of the courts in the eyes of other countries; it may further affect on a country's international business. Therefore, the courts must carefully consider whether to grant a court order when dealing with the application of an order prohibiting L/C payment.

Case No. 9: ***Credit Bank, Italy v. Harbin Economic Technology Development Trading Company, China (Harbin Company)*** **[2000] (Seller v. Bank)**

This was an appeal[707] from Credit Bank against Haerbin Company over a dispute of L/C payment. Such a dispute was typical, as the paying bank in a foreign country refused to make payment under the L/C to the seller in China with the defence of a freezing order from a court in their country, and then the seller in China brought an action in China.

In the first instance[708], the plaintiff's claims were supported by the court. Credit Bank then appealed, arguing that the Italian Court has issued a freezing order against the issuing bank, and thus it could not pay under the L/C. In the second instance, the court held that the freezing order from the court was only issued in the case of the establishment of fraud, but there was no evidence for establishing the fraud in the present case; therefore, such a freezing order could not bind both parties of the case.

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[705] See the judgment of the case (Case No. 8), n. 703 above.
[706] Ibid.
[707] Peking City, Higher court, (2000), final, No. 376, judgment was issued on 20 November 2000; the basic facts in the case were as follows: Credit Bank issued a L/C under the applicant of an Italian company in favour of Hong Kong Huixing Company, which assigned its L/C to Harbin Company. Haerbin Company submitted the documents through the advising bank Haerbin branch, Bank of China to Credit Bank. Credit Bank refused to pay based on discrepancies, but the notice of its dishonour was not given within seven working days, which meant that it accepted the documents according to UCP 500. Harbin Company claimed the L/C payment and interest thereof, and monetary damages from Credit Bank.
[708] Peking City, Intermediate Court No. 2 (1998), Economic Tribunal, No. 55.

From the cases, it can be observed that China had adapted the particular conditions of issuing freezing orders in the context of L/C fraud disputes. The establishment of fraud is necessary in order to obtain such an order from the court. But the problem is that there were no clear conditions or requirements discussed.

Case No. 10: ***Kuchifuku Foods Company, China (Kuchifuku) v. Industrial Bank of Korea and Nuclear Power Plant Sub-branch of the Bank of China (Nuclear Power)*** **[2003] (Seller v. Bank)**

This was an appeal[709] from the paying bank Industrial Bank of Korea to the Higher Court of Jiangsu Province. In the first instance, this dispute concerned the beneficiary Kuchifu suing the paying bank to claim payment under the L/C.[710] The Intermediate People's Court of Nanjing City held that the L/C is independent from the underlying contract and is not subject to claims or defenses from the underlying contract relationship, but fraud was an exceptional case; Industrial Bank of Korea did not submit any evidence to prove the existence of fraud within the proof period, thus it shall pay the L/C price to Kuchifuku.[711] Then Industrial Bank of Korea was dissatisfied and appealed, claiming that it was entitled to dishonour the L/C payment, because Kuchifuku forged the documents, antedated the date of shipment of the BL, and the quality of the goods was inferior.

Therefore, in the second instance, two of the key issues were that whether the fraud concerning the forged documents existed, and whether antedating the BL constituted fraud. With respect to the first issue, the court observed that L/C fraud refers to situations where the beneficiary delivers no cargo at all or cargo of an excessively inferior quality, forges one or more types of specified documents alone or by maliciously collaborating with others, and obtains payment by fraud.[712] Kuchifuku delivered goods, produced documents and there was no evidence to establish that it had committed L/C.

As for the second issue, the evidence proved that the goods were loaded between 31 May and 1 June, 2002, the carrier issued the BL on 1 June, while the date of shipment was actually 31 May; thus the BL was antedated. The court held that this act does not mean that Kuchifuku committed L/C fraud for several reasons.[713] Firstly, Kuchifuku organised and delivered the cargos, and the carrier

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[709] Civil Judgment of the Higher Court of Jiangsu Province of PRC, Tribunal No. 3, Final Judgment, No. 52 (2003).

[710] Ibid, the background of the case: the seller Kuchifuku in China entered into a sales contract with the buyer Changji Business Corporation, Seoul, Korea (Changji). The issuing bank Industrial Bank of Korea issued an irrevocable documentary L/C, with Kuchifuku as beneficiary. Kuchifuku delivered the goods and presented the required documents to the Nuclear Power, which sent documents to Industrial Bank of Korea. Upon the submission, Industrial Bank of Korea firstly dishonoured this L/C on the grounds of a few discrepancies, then later did not mention the discrepancies but stated that the applicants Changji told Industrial Bank of Korea that they have informed Nuclear Power about the fraud and they were suing the beneficiary because of fraud, with evidence to prove that the documents are forged. Nuclear Power later received the returned documents and the photocopy of a stop-payment order issued by Seoul Court, Korea from Industrial Bank of Korea. Finally, Nuclear Power delivered the returned documents back to Kuchifuku, who brought this litigation.

[711] See the judgment of this case, n. 709 above.

[712] Ibid.

[713] Ibid.

promised the loading on 31 May, so Kuchifuku did not have any objective need to antedate the BL. Secondly, no evidence was provided from Industrial Bank of Korea to prove that Kuchifuku had participated in antedating the BL and had the subjective purpose to conduct such an act; such behaviour was a fraudulent act committed by the carrier in order to fulfil its promise to Kuchifuku and had nothing to do with Kuchifuku. Thirdly, Industrial Bank of Korea did not submit evidence to prove its allegation that it suffered substantial damages from the delay of the arrival of cargos. As Kuchifuku had no fault in the fact of antedating the BL, and no intention to defraud under the L/C, L/C fraud was not established and Industrial Bank of Korea shall not take it as a defence to dishonour the L/C payment.[714]

Before delivering the judgment, the Higher Court of Jiangsu Province requested instructions about the key issues from the SPC.[715] As for the anti-dating BL issue, the Higher Court had two groups of opinions. One group took the view that the South Korean bank could not refuse payment on the grounds that the BL was anti-dated, because the beneficiary had not participated or conducted fraudulent behaviour and anti-dating the BL did not cause substantial loss.[716] In contrast, the other group held that usually anti-dating a BL would harm business transactions, and the issuing bank had the right on the grounds that the document did not comply with the L/C, regardless of whether or not the beneficiary had participated in the anti-dating.[717]

The SPC replied that anti-dating a BL does not necessarily constitute L/C fraud, and does not necessarily lead to the bank dishonouring the L/C payment.[718] If the beneficiary conducted such behaviour in bad faith, even if it is done by the carrier, such behaviour can be considered as L/C fraud, thus the bank is entitled to refuse L/C payment; if anti-dating the BL is not conducted by the beneficiary in bad faith, and the applicant does not suffer real damages due to anti-dating the BL, then such behaviour should not be considered as L/C fraud and the bank cannot refuse L/C payment on the grounds of L/C fraud.[719] In this reply, the SPC also directed the Higher Court to investigate the situation of the goods so as to avoid new disputes.[720] In the judicial practice concerning L/C disputes, it is a common phenomenon that the inferior courts request instructions about the key issues from the SPC in order to avoid defective judgments.

In this judgment, the court discussed several typical L/C fraud circumstances. Furthermore, it is clear that the establishment of L/C fraud exception requires the element of clear and sufficient evidence of fraud; the beneficiary knows and

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[714] Ibid.
[715] The SPC, Letter of Reply of the SPC to the Request for Instructions on the L/C disputes between Kuchifuku Foods Company and the Industrial Bank of Korea, [2003], Civil Court, Tribunal No. 4, Tazi, No. 33, issued and came into effect on 11 Dec. 2003.
[716] Ibid.
[717] Ibid.
[718] Ibid; this opinion is also supported by some academics, see Wu, Haizhen (2007), 'Anti-dated Bill of Lading and L/C Fraud Exception', *Zhejiang Finance*, No. 4, 61, p. 62.
[719] Letter of Reply of the SPC, n. 715 above.
[720] Ibid.

participates in the fraud. The fraud committed by a third party (such as a carrier), cannot be considered as a case of L/C fraud exception. This case also reflects the same legal opinion on the L/C fraud exception rules as in the *United City Merchants* case (Case No. 4) in England, which is that where a third party's fraud in the presented documents is established, but the beneficiary did not have the knowledge of the fraud, the beneficiary is still entitled to obtain the L/C payment.

Case No. 11: ***Dalian Zhongken Xinyuan International Trading Company, China (Xinyuan Company) v. Xinhan Bank, Korea (Xihan Bank)*** **[2004] (Seller v. Bank)**
In this dispute[721], the beneficiary in China sued the paying bank in Korea to request payment under the L/C. The buyer Sam Lip International Company in Korea (Sam) applied a L/C through Xihan Bank, with the beneficiary as Liaoning Xinxing Import and Export Company (Xinxing Company), which later assigned the L/C to Xinyuan Company. Xinhan Bank refused to pay Xinyuan on the grounds of the discrepancies; and also claimed that Xinyuan committed fraud, thus it would not perform the payment according to the principle of the L/C fraud exception; furthermore, it could not pay because of the stop-payment order from the Korean court.

As for the L/C fraud exception issue, the court held that the evidence provided by a third party, S.T. Shipping Company, to prove the BL was forged did not support its argument; and the evidence concerning the quality and quantity of the goods were not relevant to its argument, as L/C transaction is independent from the underlying sales contract.[722] The court confirmed the independence principle of the L/C, and stressed the requirement of clear and sufficient evidence to prove the alleged fraud; without the satisfaction of this basic requirement, the bank's obligation of making payment under the L/C should not be intervened with.[723]

In summary, these court cases demonstrated that the courts in China stressed the independence principle of the L/C, and thus disputes concerning the underlying contract do not affect L/C transaction. In order to establish L/C fraud, sufficient evidence of L/C fraud is required. At the same time, it is also required that the beneficiary has knowledge of fraud and participates in the fraud. Otherwise, a freezing order should not be granted by the courts. To determine that L/C fraud has not been established, the performance of the underlying contract can be taken into account. If a BL is anti-dated or forged concerning some facts in documents, but the goods has been delivered or no damages have been caused, such a situation does not necessarily constitute L/C fraud.

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[721] Tianjin, Intermediate Court No. 2, Civil Judgment, (2004), Tribunal No. 3, First Instance, No. 105; judgment was issued on 7 June, 2005.
[722] Ibid.
[723] Ibid.

Case No. 12: *Tokai Bank Kobe Subbranch (Tokai Kobe) v. Agricultural Bank of China Nanjing Branch, China (Nanjing Branch)* [1999] (Negotiating bank v. Issuing bank)

This was a dispute[724] over L/C payment between a negotiating bank and an issuing bank. One of the key issues was whether the fraud of the party in the underlying sales contract could challenge the reimbursement rights of Tokai Kobe. With regard to this point, the judge confirmed that the L/C is a documentary transaction independent of the sales contract; and that the rights of Tokai Kobe shall not be affected by any act of fraud by the party in the underlying sales contract, as there is no evidence proving the fraud of Tokai bank.

From this judgment, it can be seen that the independence principle of the L/C prevailed over other issues. The idea of fraud exception in the L/C was not demonstrated clearly in this case; whether the beneficiary committed fraud in the underlying sales contract was not discussed. However, it cannot be simply stated that the judge took the view that the L/C fraud exception was not recognised. On the contrary, it is clear to see one principal point concerning immunisation of the L/C fraud exception: L/C payment shall not be affected if the negotiating bank has negotiated in good faith.

Case No. 13: *Jiangbei Bank of China (Jiangbei Branch) v. Fandong Agricultural Bank (Fandong Branch), et al* [2005] (Bank v. Bank)

This was a dispute[725] between the issuing bank Jiangbei Branch, the guarantor bank Fandong Branch, and the L/C applicant Chongqing Yubei Foreign Company (Yubei Company) over L/C payment and the guaranty thereof under the jurisdiction of the SPC.

The SPC held that Yubei Company fabricated import facts, defrauded applications of L/Cs according to paragraph 1 (3) of article 58 of the General Principles of Civil Law of the PRC, which provides that, "Those civil acts performed by a person against his true intentions as a result of cheating, coercion or exploitation of his unfavourable position by the other party shall be null and void; and thus the legal relationship of opening L/C in this case shall be declared as null and

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[724] Civil Judgment of Nanjing Intermediate People's Court, First Instance Judgment No. 106 (1999), Intermediate People's Court; judgment was issued on 6 January, 2000; the basic facts: the buyer Nanjing Textile Import and Export Corporation (Nanjing Textile) in China concluded a sales contract with the seller Tomashi Corporation (Tomashi) in Japan. Nanjing Branch, under the application of Nanjing Textile, issued an irrevocable usance L/C, with Tomashi as the beneficiary. Tomashi presented the stipulated documents and drafts to Tokai Kobe for negotiation. Tokai Kobe negotiated the L/C and then sent documents to Nanjing Branch for reimbursement. However, Nanjing Branch refused to pay the L/C; and the defences were that there were discrepancies in the documents and the L/C was suspected of being involved in fraud, which was under investigation by the local judicial organ.

[725] Administrative Judgment of the SPC, No. 21 (2005); the basic facts: under the application of Yubei Company, Jiangbei Branch had in total issued four Letters of credit with different companies as the beneficiary. However, it was later found that the buyer and seller colluded together to defraud the issuing bank by making use of L/C. The legal representative of Yubei Company was sentenced to life imprisonment due to the crime of L/C fraud.

void, and the guaranty contract is null and void due to the principal contract is null of void."[726] The court finally held that the guarantor Fandong Branch shall not bear any civil liability and Yubei Company should repay to Jiangbei Bank the amount of the L/C and interest thereof.[727]

The type of L/C fraud that the buyer and the seller conspired to use together to defraud the bank's funds by using the L/C used to be quite common during the 1990s in China; but it can still be found nowadays. Although the L/C fraud is established, the rule of L/C fraud exception could not be operated as a remedy for the bank, as the bank had already made payment. L/C fraud in this dispute merely provides a valid ground for the bank to attempt to recover the payment paid out from the fraudster.

Seller v. Buyer

Case No. 14: ***Korea Shinho Co. v. Sichuan Province Euro-Asia Jingmao, China (Jingmao)*** **[2000] (Seller v. Buyer)**

In this appeal case[728], the main procedural problem was that whether an arbitration clause in the sales contract governed any dispute could apply to the L/C. Fraud exception was also examined in this case during dealing with this procedural issue.

The SPC discussed the L/C principles as well as the L/C fraud exception. The SPC clearly stated that the L/C is independent from the underlying transaction, and is a document transaction, which follows the strict compliance principle; a party shall not apply for suspension of L/C payment with a reason deriving from the underlying transaction.[729] Furthermore, the SPC confirmed that the exception of L/C fraud means that the L/C and the underlying transaction shall be independent from each other except where there is substantial fraud in the underlying transaction.[730]

Concerning the applicant's appeal, the SPC finally held that the court order was valid on the grounds that the buyer had a right to apply to the court to prevent payment where the buyer had sufficient evidence to prove fraud.[731] As for the arbitration clause in the sales contract, it did not state clearly the extent

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[726] Ibid.
[727] Ibid.
[728] Civil Order of the SPC of the PRC, Final order of the Economic Tribunal of No. 155 (2000), available at www.court.gov.cn/study/civil/200303040123.htm, accessed 16 July, 2009; in this research, Korea refers to South Korea; several facts have been verified by the SPC: the Jingmao (the buyer) claimed that Korea, Shinho (the seller) neither provided the goods, nor loaded or delivered them, but forged the shipping BL and committed fraud. The main proof was that according to the shipment showed in the BL, the goods should have arrived at Shantou, the destination port, by the end of October, 1997; however, Shantou Maritime Security Supervision Bureau under the Ministry of Communications of the PRC proved that, from January to December, 1997, there was not a single ship passing in and out of the port. The buyer sought a freezing order to prevent the L/C payment and succeeded in the HPC of Sichun Province. Shinho appealed to the SPC and alleged that the freezing order was inapplicable, because the sales contract stated that all disputes between parties should be settled by arbitration and this clause should also apply to the L/C payment dispute.
[729] Ibid.
[730] Ibid.
[731] Ibid.

of coverage of the term. Thus, this clause did not apply to the L/C, since the two contracts were separate according to the independence principle. However, the two contracts were associated with each other where the fraud exception applied.

The SPC reconfirmed the autonomy principle of the L/C in this case and it was the first time that the SPC clearly confirmed there is an exception to the autonomy principle of the L/C, that is, fraud exception. This demonstrated that the standpoint of the SPC toward the autonomy principle of the L/C is clear and consistent, after the publication of the first Newco case judgment.

Furthermore, the SPC at the first time pointed out the criterion of "substantial fraud" in the underlying transaction. Such decisions may help to clarify that fraud must be 'substantial' or 'serious', which requires standards of proof higher than usual civil disputes.[732] However, the decision did not state how to determine 'substantial fraud', and what factors should be considered when determining this issue, which may still be under the discretion of the courts.[733] Finally, it only mentioned such fraud in the underlying transactions; but we understand that it does not seem to mean that L/C fraud only refers to fraud in the underlying transaction, as L/C fraud clearly includes fraud in documents.

Bank v. Buyer

Case No. 15: *China Investment Bank v. Hualong Construction (Hualong)* [2002] (Bank v. Buyer)

It was a dispute[734] in which the issuing bank sued the L/C applicant to demand reimbursement. In the case, the issuing bank China Investment bank sued Hualong for reimbursement and won the case. Then Hualong appealed to the SPC, claiming that the payment should have been dishonoured because of fraud (deficient quality of the goods) committed by the seller. The SPC rejected the appellant's argument. The court pointed out that the sales contract and the L/C contract were separate, and the fact of a defect in quality of goods could not be a valid defence to affect the bank's obligation to honour payment under the L/C.[735]

The court explained the fraud exception further by stating that: "The fraud exception has been accepted by many overseas jurisdictions. The practice of international trade cannot simply ignore the circumstance where beneficiary seek to fraudulently obtain payment. However, if the presented documents do not show

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[732] Jin, Saibo (2003b), 'Does Anti-dating BL Constitute L/C Fraud'.
[733] Ibid.
[734] Civil Judgment of the SPC of PRC, Final Judgment of the Economic Tribunal No. 208 (1999); decision No. 21 of 2002, available at www.court.gov.cn/study/civil/200303050009.htm, accessed 19 September 2009; the basic facts: Heilongjiang Guoji Gongcheng Jishu Hezuo Group (Heilongjiang) made a contract with Hualong to sell construction equipment and the payment method was a L/C. Hualong applied a L/C at China Investment Bank in favour of Heilongjiang. Later Hualong was not satisfied with the quality of the machinery, thus sought to prevent payment under the L/C. However, the payment had already been made by the corresponding bank – China Everbright, to Heilongjiang, because the presented documents conformed to the requirements of the L/C. China Everbright was then reimbursed by China Investment Bank. Hualong refused to pay the issuing bank.
[735] Ibid.

any sign of discrepancy on their face and there is no evidence to prove the alleged fraud, then L/C applicant is not entitled to prevent payment."[736]

In this case, the SPC correctly confirmed the principle of autonomy of the L/C and the scope of the fraud exception, where it makes it clear that the contractual disputes (such as quality of the goods) cannot be a reason to apply for a court order under the L/C fraud exception rules.[737] However, in this judgment, there was no citation of legislative origin of rule in Chinese law, which should be essential in a civil jurisdiction, but merely with a reference to international practice.[738]

From this case, it can be seen that contractual disputes used to be a common reason for the buyer to apply for a court order for prohibiting L/C payment. During the earlier period, some courts issued a court order to prevent payment under the L/C on the grounds of the contractual disputes. However, such a defect was soon recognised and the approach that the L/C is independent from the underlying contract was adopted.

Bank v. Seller (&Carrier)

Case No. 16: *Qingdao Subbranch of China Merchants Bank, China (Qingdao Branch) v. Sung Chang Rubber Company, Korea (Sung Chang Korea), Yulsan Shipping and Air Cargo Transport Company, Korea (Yulsan)* [2003] (Issuing bank v. Seller & Carrier)

This was a dispute[739] between the issuing bank Qingdao Branch, the beneficiary Sung Chang Korea and the carrier Yulsan on maritime fraud. The case was classified as a L/C dispute resulting from forged shipping documents. The court observed that the independent principle or the autonomy principle of the L/C was clearly provided for in UCP 500, but such a principle does not protect fraudulent behaviour; and all kinds of fraudulent conducts in L/C transactions should be prohibited; the rule of the L/C fraud exception was recognised and accepted in the L/C and judicial community all over the world, as was the case in China.[740] The key issue in the case was whether Sung Chang Korea's conduct constituted fraud.

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[736] Ibid.

[737] However, concerning a statement in the judgment of SPC 'LC is a promise by bank to beneficiary, if the documents on the face do not show there is fraud, and no other evidence proves fraud, then it can be considered that the law does not empower the applicant limits the bank's right of making payment', it was critisied that it may lead to the conclusion that the issuing bank seems to have a liability to investigate whether there is fraud on the face of documents under the LC, which shows a lack of support from UCP, see Li, Jinze (2007), *Application of UCP 600 and L/C Legal Risk Control*, Peking: Law Press China, 1st ed., pp. 65-66.

[738] Williams, Mark (2004), pp. 166-167.

[739] Qingdao Maritime Court, Civil Judgment, (2003) Qingdao Maritime First Instance No. 73, judgment was delivered on 2 June, 2004; the basic facts: under the application of Sung Chang Rubber Company, Qingdao, China (Sung Chang Qingdao), Qingdao branch issued two L/Cs, as the defendant Sung Chang Korea as the beneficiary. Sung Chang Korea presented documents including two sets of BL issued by Yulsan through a bank in Korea to Qingdao branch. Qingdao branch accepted the documents but had not made payment. Qingdao branch alleged that Sung Chang Korea did not deliver the goods under the BL at all, so it was not entitled to obtain payment under the L/C; and then it applied for a freezing order to prevent payment under the L/C to Sung Chang Korea.

[740] Ibid.

With regards to the point of the L/C fraud exception, the court discussed the rules concerning the L/C fraud exception provided in documentation in 1998 and 2003 issued by the SPC. The court further considered that this rule conforms to China's relevant laws and regulations; L/C relationship in its essence is a civil relationship, thus the beneficiary submitting specified documents to the paying bank and the issuing bank accordingly making the payment or acceptance belong to civil acts; both parties shall follow the principle of good faith and other relevant laws. Article 58 of the General Principles of Civil Law of the PRC was citied in this judgment. In order to maintain the credibility of the L/C and to avoid abusing the principle of L/C fraud exception, it was insisted that only under the circumstances of substantial fraud or serious fraud could the commitment of L/C payment be made invalid.[741]

Generally, there are three circumstances which can constitute substantial or serious fraud: firstly, the beneficiary, in order to defraud the bank, forges documents or presents false documents to the bank, leading to the frustration of purpose of the underlying contract; secondly, the beneficiary did not deliver contracted goods, or deliver worthless goods; thirdly, the applicant and the beneficiary or other third parties collude together to present false documents without any real underlying transaction.[742] These analyses are important because they formulated part of the provision about the L/C fraud exception rules in new provisions in 2006.

There is sufficient evidence to prove that Yulsan issued two sets of BLs, which could not be exchanged for goods; no goods under such BLs had ever reached the destination ports. In addition, Yulsan could not provide any evidence that the goods had been shipped. In other words, Sung Chang Korea did not deliver any goods to the carrier Yulsan to ship and the two sets of BLs were forged. It was held that the Sung Chang Korea knew that the BLs were false, but still presented them to the bank for payment under the L/C; such behaviour constituted substantial fraud, thus the acceptance of the L/C made by Qingdao branch did not have any legal effect, and Sung Chang Korea was not entitled to obtain the payment under the L/C.[743]

In this case, the court pointed out the typical circumstances of fraud in the L/C. The approach in the court is that for the L/C fraud exception to apply, the evidence to establish the fraud must be sufficient, the beneficiary should know about the fraud, and the bank should notice the fraud before paying out. The court prevented L/C payment in time by exercising the power to issue a court order, and successfully protects the interests of merchants in L/C transactions.

Evaluation of the Court Decisions in China

The role of the courts in China is mainly to apply the law to adjudicate cases before them. As there were no specific rules over the L/C fraud exception, it can be

[741] Ibid.
[742] Ibid.
[743] Ibid.

seen that the approach of the courts is somewhat fragmented and not systemic. Generally, the method of accepting internationally established customary rules in civil and commercial cases is helpful to fill the gaps of the legal system in China. In some L/C fraud disputes the reliance was mainly placed on international practice. It can be said that the legal basis in these judgments is rather weak.[744] In addition, strictly following international practice without adaptation most probably is not what the legal community and business community expect.

Several steps for handling fraud disputes involving the L/C by the courts in China have been identified in general. Firstly, they determine whether the documents are fraudulent; secondly, they examine whether the beneficiary has participated in or knew about the fraud; thirdly, they consider the protection for an innocent third party; fourthly, they require the applicants to provide security.[745] Concrete problems that the courts have encountered in dealing with L/C fraud disputes can also be discovered. Firstly, the protection towards an innocent third party is not sufficient; secondly, the standards of determining L/C fraud are various; thirdly, the protection towards L/C parties is not satisfactory concerning the procedure; fourthly, the courts did not pay proper attention to the difference between the L/C and the draft under the L/C.[746]

However, the courts recognised the L/C fraud exception, and were aware of the problem of employing a freezing order to L/C fraud disputes. Thus, the courts attempted to adapt such freezing orders to the context of L/C fraud disputes, by developing the rules over the L/C fraud exception. Thus some documents were issued by the SPC providing guidance on "freezing order under L/C fraud exception". But as a freezing order is in essence an unsuitable instrument for prohibiting L/C payment, no concrete conditions to obtain such a court order have been developed. Furthermore, when dealing with L/C fraud dispute cases, a major problem in judicial practice is that the courts most often could not keep a proper balance between the independence principle of the L/C and the fraud exception.[747]

The development of the L/C fraud exception rules can be seen from the court judgments. Several essential issues on the L/C fraud exception rules have been identified, analysed and discussed. Firstly, L/C fraud includes both fraud in documents and fraud in underlying transactions. Secondly, several typical L/C fraud circumstances were identified, such as the beneficiary delivers no cargo at all, or forges one or more specified documents alone or colludes with others in order to obtain the L/C payment. These circumstances are part of one article about L/C fraud in the new provisions in 2006. Thirdly, the exceptions or immunisation to

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[744] Williams, Mark (2004), 'Documentary Credits and Fraud: English and Chinese Law Compared', *J.B.L.*, Mar, 155-170, p. 169; see also Zhang, Jianwei & Tai, Bing (2005), 'Study on Legal Application of L/C Fraud Exception', *Shanghai Finance*, No. 10, 51, p. 52.

[745] He, Bo (2002b), 'L/C Fraud Exception in Legislation and Judicial Practice in China', published 13 April, available at www.ccmt.org.cn/ss/explore/exploreDetial.php?sId=76; see also Xiu, Xiaoxia (2004), 'L/C Fraud and How to Handle It', published on 19 Feb., available at www.ccmt.org.cn/ss.explore/exploreDetial.php?sId=558, accessed 15 July, 2008.

[746] Li, Jinze (2004), pp. 95-100.

[747] Ma, Lihong & He, Yan (2009), 'Inspiration of L/C Fraud Exception Principle in Foreign Countries', *Legal System and Society*, No. 5 (1st Issue), 113, p. 114.

the L/C fraud exceptions were also recognised in some court judgements. The acceptance of such a principle is important, and thus a particular article concerning the immunisation of L/C fraud is included in new provisions in 2006.

New L/C Fraud Exception Rules in China in 2006

The Background and Process of Drafting the Rules

The most updated and specific document on the L/C in China is entitled Provisions of the Supreme People's Court on some issues in the Adjudication of L/C-related Cases.[748] In order to explain the phenomenon concerning legal transplant of the L/C fraud exception rules in China from other countries and international practice, we will look at the background and process[749] of how such rules were formulated.

As can be seen from the discussion of court cases, in China there were unspecific rules on the L/C; consequently, the courts have different opinions on dealing with L/C-related cases. One crucial reason for the drafting of judicial provisions on the L/C was the strong demand from the Banking community in China, especially the People Bank of China and the Bank of China.[750] After the introduction of the L/C into China, the fraud problem in L/C cases also grew gradually and became more serious. In confronting the increasing amount of court cases in L/C fraud disputes, the courts in China had only one legal tool – the freezing order, which is argued to be ill-suited for prohibiting payment. Furthermore, during the years 1994-1997, the courts in China in many cases had prohibited L/C payment not on the ground of L/C fraud, but on the applicant's application. With such a court order, banks had the obligation to refuse honouring L/C payment. Thus the reputation of the banks[751] in China was seriously harmed among the banking community worldwide.[752] Beside the procedural problem of the freezing

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[748] Judicial Interpretation No. [2005] 13, adopted at the 1368th Meeting of the Adjudication Committee of the SPC on 24 October 2005, came into effect on 1 January 2006.

[749] Such a process might be considered as 'legal transplant process', which is discussed in a small amount of literature; see e.g. Schauer, Frederick (2000), 'The Politics and Incentives of Legal Transplantation', Centre for International Development at Harvard University (CID) Working Paper No. 44 (April), *Law and Development Paper No. 2*, available at http://www.hks.harvard.edu/var/ezp_site/storage/fckeditor/file/pdfs/centers-programs/centers/cid/publications/faculty/wp/044.pdf, accessed 8 Jan. 2011, this paper argues that political, economic and reputational incentives can be important factors during the process of legal transplant; for discussion on this topic particularly from the perspective of sociological typology, see Miller, Jonathan M. (2003), 'A Typology of Legal Transplants: Using Sociology, Legal History and Argentine Examples to Explain the Transplant Process', 51 *Am. J. Comp. L.* 839.

[750] Jin, Saibo (2008), 'Review of the Provisions of the SPC on Some Issues in the Adjudication of L/C Cases', article 1, available at http://blog.sina.cn/s/blog_540752bd010007bw.html, accessed May 22, 2008.

[751] Such a bad influence on banks' reputation refers to the fact that the level of credibility of banks in China can be lowered by an international evaluative institution, which increases financial costs and reduces income of business; this belongs to invisible losses, see Wang, Lili (2004a), *Case Studies on Legal Risk Control of Banks*, p. 194.

[752] Tao, Yibo & Xue, Xiang (2006), 'Discussion on L/C Fraud Remedy', *HLJ Foreign Economic Relations & Trade*, No. 5 (Serial No. 143), 55, p. 57; for further analysis of the risk to banks' reputation arising from being sued or failure in a legal suit, see Wang, Lili (Chief Ed.)(2004b), *Legal Risk Control on Bank Business Disputes*, p. 20; Liu, Yincha (2005), 'Study on Documentary L/C Fraud', *Hebei Finance*, No. 5, 38, p. 39; Xie, Jie (2004), 'L/C Fraud and Remedy to Bank', *Research on International Finance*, No. 3, 74, pp. 76-77.

order, the courts in China produced an unsystematic and inconsistent approach towards L/C fraud.

The new provisions on L/C fraud were due to eight years of effort by various parties, including judges, specialists and academics on the L/C both in China and worldwide since 1997. In the process of creating the provision of L/C fraud rules in China, the drafters did take an open and practical approach. During the drafting process, a thorough study was conducted on the approach of English law, American law, German Law, French Law and so forth. Academics and jurists were invited to become involved in the drafting process to provide their ideas and comments. Where possible, the drafts of the provisions were commented on by foreign academics and practitioners. Public discussion is a primary type of public participation in law-making in modern China, in which draft bills are usually published in the press and broadcast on radio and television so that the public can participate in the discussion of the drafts.[753] The final draft of the provisions was thus available both on the website of the China Court and People's Court Newspaper so as to ascertain the observations and remarks of the public.[754]

In general, as the preface of the Interpretation stated, the provisions were based on the General Principles of the Civil Law of the PRC, Contract Law of the PRC and Civil Procedural Law of the PRC, as well as the reference to relevant international practices, particularly those as reflected in the UCP.[755] The provisions as a whole cover seven main areas, including the application of the UCP, the L/C autonomy principle, examination of documents and discrepancies, fraud exception, conditions for applying the fraud exception, legal procedures for applying for or discharging a stop payment order and guarantees issued connected with L/C issuance applications. However, we will limit our examination to only the rules relating to the L/C fraud exception. Five specific articles concerning the L/C fraud exception in this Interpretation will be analysed.

Articles on the L/C Fraud Exception Rules

Article 8: L/C Fraud

Article 8 concerns L/C fraud and according to the drafter, this provision is based on the principles and elements constituting civil fraud in the General Principles of the Civil Law of the PRC, and makes reference to the circumstances of the L/C fraud exception in case law in other countries.[756]

Article 8 any of the following circumstances shall be considered to constitute L/C fraud:

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[753] Zhu, Jingwen, 'Public Participation in Law-Making in the PRC', in Otto, Jan Michiel & Polak, Maurice V. & Chen, Jianfu & Li, Yuwen (Eds.) (2000), p. 147.
[754] ICC China (2005), 'Explanation of the Judicial Interpretation No. [2005] 13', 28 Dec., available at www.icc-china.org/news/read_new.asp?id=135, accessed 26 Feb., 2007.
[755] The Preamble of the Judicial Interpretation No. [2005] 13.
[756] The Preamble of the Judicial Interpretation; see also Huang, Hanzhang (2007), 'Discussion on Principle of L/C Fraud Exception', *China Water Transport*, Vol. 7, No. 5, May, 238, p. 239.

(I) the beneficiary has forged or incorporated false contents in any of the presented documents;
(II) the beneficiary, in bad faith, delivers no goods or delivers goods of no value;
(III) the beneficiary, in conspiracy with the applicant or any third party (parties), presents documents while no real underlying transactions exist;
(IV) other circumstances where fraud under a L/C may be found.

Article 8 avoids defining L/C fraud in an abstract way as usual, but provides several concrete examples, thus enhancing the operability of the article in judicial practice.[757] If we look at the expression of Article 8 (I), it is similar with the UCC§5-109 (a) "a required (*presentation*) is forged or materially fraudulent" and the Convention article 19(1)(a) "any document is not genuine or has been falsified". These articles refer to the L/C fraud in documents. The content of Article 8(II) is also similar with the circumstances described in the American *Sztejn* case, and other court cases that amount to the UCC§5-109 (a) "honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant". The Convention article 19 (1) (c) and (2) explains "the demand has no conceivable basis", which provides that L/C fraud can also be connected with the performance of the underlying contract.

However, article 8 (I) brings forth two further questions. The first problem is what if the documents presented by the beneficiary are forged by a third party, which the beneficiary does not know about when the beneficiary submits the documents.[758] Some argue that this article has not provided a clear answer, and no such dispute has come before the court yet.[759] However, some consider that it is clear that it includes third party fraud, since it is not necessary to distinguish who makes the forgery.[760] Furthermore, it is argued that both the buyer and the seller are innocent where fraud is committed by a third party; whether or not the L/C fraud exception applies to third party fraud is essentially about how to allocate the third party fraud risk between buyers and sellers.[761]

Proponents argue that allocating risk of third party fraud to sellers seems more reasonable, as sellers obtain such documents from a third party earlier than the buyers.[762] The particular reasons of embracing third party fraud in the L/C fraud exception from several perspectives are as follows: firstly, one of the purposes of establishing the L/C fraud exception is to protect the banks and L/C applicants from invasion of fraudulent documents; fraud from either the beneficiary or third party will lead to damages to banks and the L/C applicants, thus putting

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[757] Ji, Lei (2008), 'Application of L/C Fraud Exception in Judicial Practice', published on 29 June, available at www.ccmt.org.cn/hs/explore/exploreDetial.php?sId=3248, accessed 15 July, 2008.
[758] Jin, Saibo (2008), Review of Article 8; see also Zhu, Biyun (2009), 'Development of L/C Fraud Principle in China', *Cooperative Economy & Science*, No. 2 (2nd Issue) (Serial No. 363), 126, p. 127.
[759] See e.g. Jin, Saibo (2008), Review of Article 8.
[760] See e.g. Huang, Yaying (2006), 'Discussion on L/C Fraud Exception and Third Party Fraud', published on 12 Jan., available at www.ccmt.org.cn/ss/explore/exploreDetial.php?sId=2075, accessed 15 July, 2008.
[761] Huang (2006), n. 760 above.
[762] Huang (2006), n. 760 above; see also Guo, Yu (2006), p. 418.

third party fraud aside will not achieve the purpose aforementioned.[763] Secondly, excluding third party fraud means that banks or L/C applicants need to provide additional evidence or further investigate whether the beneficiary knows about or has conducted the fraud, besides the proof of fraudulent documents, which seems to be extremely difficult and unfair to the innocent banks and L/C applicants.[764]

Accordingly, it is argued that applying the L/C fraud exception to third party fraud has the following advantages: firstly, it helps to fully achieve the purpose of the L/C fraud exception and maintains the value of the independence principle of the L/C; secondly, it is more objective and easier to apply the L/C fraud exception in judicial practice; thirdly, it avoids the disadvantage of determining whether the beneficiary has the knowledge of fraud and whether the beneficiary has colluded with a third party.[765] Nevertheless, exclusion of third party fraud from the L/C fraud exception may discourage sellers from checking further and stopping fraudulent documents.[766]

On the contrary, the opponents assert that including third party fraud means extending the application of the L/C fraud exception, thus derogating the effect of the L/C independence principle.[767] In addition, such inclusion may make the innocent beneficiary become a victim of fraud by third party.[768]

Another problem concerns whether anti-dating the BL leads to substantial fraud, thus constituting L/C fraud.[769] What if the beneficiary knows that the shipping date on a BL is anti-dated, and still presents such a document to a bank to demand payment, but the bank does not know that the BL is anti-dated? The earlier court cases have provided different and contrasting answers towards such a situation.[770] The answer to this situation seems unclear in this article.

Article 8 (II) concerns fraud in the underlying transaction. It was commented that the words 'no value' may lead to confusing situations, because the meaning of 'no value' is not clear.[771] Does it refer to 'basically no value', 'totally no value', or

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[763] Huang (2006), n. 760 above.
[764] Huang (2006), n. 760 above; there are different reasons for supporting the inclusion of L/C fraud: it is the sellers who deliver the goods, and collect documents, thus the sellers have the duty to supervise the carrier and warranty the authenticity of documents; comparatively speaking, it is more convenient for the sellers to take some measures towards the fraudster than for the buyers, see Zhu, Lina (2006), 'Discussion on L/C Fraud Exception Principle', *Journal of Dalian Maritime University (Social Sciences Edition)*, Vol. 5, No. 1, Mar., 32, p. 33.
[765] Huang (2006), n. 760 above.
[766] Huang (2006), n. 760 above; see also Guo, Yu (2006), p. 418.
[767] Huang (2006), n. 760 above.
[768] Huang (2006), n. 760 above; another element for excluding third party fraud is about the intention of the fraudster, see also Wang, Xiangxin (2007), 'Discussion on L/C Fraud Exception', *Journal of Mudanjiang University*, Vol. 16, No. 4, Apr., 65, p. 66.
[769] Jin, Saibo (2008), Review of article 8; see also Ji, Lei (2008), n. 757 above; for further discussion on the legal features of anti-dating BL, see The 3rd Civil Court, Higher People's Court of Jiangsu Province (2004), 'Whether Anti-dated BL Constitutes L/C Fraud', *People Justice*, Vol. 4, 67; also Wu, Haizhen (2007), 'Anti-dated BL and L/C Fraud Exception', *ZheJiang Finance*, Vol. 4, 61; about preventing anti-dated BL, Yang, Jian (2007), 'Exploration on Preventing Anti-dated and Back-dated BL Problem', *Finances and Economics Circle*, Vol. 1, 57.
[770] Jin, Saibo (2008), review of article 8; see also Ji, Lei (2008), n. 757 above; comments on several cases involving anti-dating the BL, see Jin, Saibo (2003b), 'Does Anti-dating BL Constitute L/C Fraud', published on 27 Jan., available at www.ccmt.org.cn/ss/explore/exploreDetial.php?sId=337, accessed 15 July, 2008.
[771] Jin, Saibo (2008), Review of article 8; see also Ji, Lei (2008).

not being able to reach certain percent required under the L/C, or fundamentally cannot achieve the purpose of opening the L/C?[772] If 'no value' means 'totally no value', fraud can be encouraged to a certain degree, which obviously is not the objective of the judicial interpretation. Therefore, some argue that insignificant breach upon the quality or quantity of goods cannot be considered as 'no value' and whether a situation is 'no value' or not depends on whether the purpose of the underlying sales transaction is achieved.[773]

It is argued that article 8 (I) and (II) may to some extent overlap, as the distinction between fraud in documents and fraud in underlying transactions is vague.[774] In most cases they are connected with each other; fraudulent transactions usually lead to fraudulent documents.[775] However, it still seems meaningful to separate them; as such separation helps the courts to determine L/C fraud from different perspectives.[776]

The circumstance of Article 8 (III) also relates to fraud in the underlying contract, where the underlying transaction does not exist at all. A close similarity can be found between article 8 (III) and the UCC§5-109 (a) "a material fraud" and the Convention Article 19 (1) (c) and (2). Article 8 (III) particularly reflects the specific situation of L/C fraud in China, where cases of conspiracy between beneficiary and applicant or any third parties frequently occurs in practice.[777]

Article 8 (IV) is a kind of sweeping clause covering any L/C fraud not exemplified in the preceding three sub articles[778], allowing court judges some discretion in dealing with complex and various of L/C fraud cases in practice. This is a typical way of drafting a provision in China. However, it must be pointed out that such an article may lower the threshold for parties who wish to claim fraud.[779] In addition, such discretion for judges seems much wider, and it is not clear whether L/C fraud includes the situation of L/C soft clauses and the underlying contract breaking some compulsory law,[780] which may be considered as the issue of illegality exception.[781] It is recommended that the concept of 'substantial fraud' should

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[772] Ibid.
[773] Ji, Lei (2008), n. 757 above.
[774] Ji, Lei (2008), n. 757 above; thus some suggest that article 8 (II) should be deleted, see e.g. Qiu, Gaixin (2009), 'Disucssion on L/C Fraud Exception', *Cards World*, Vol. 13, No. 10, 18, p. 20.
[775] Ji. Lei (2008), n. 757 above.
[776] Ibid.
[777] Ibid.
[778] Hou, Fangmiao (2006), 'Brief Analysis of Related Provisions of L/C Fraud', *HLJ Foreign Economic Relations & Trade*, No. 12 (Serial No. 150), 69, p. 70; Mao, Yijian (2007), 'L/C Fraud and Judicial Remedy', *Annual of China Maritime Law*, No. 17, Jan, 186, p. 195.
[779] Fung, King Tak (2006), 'Chinese Guidelines for L/C Disputes', *DCI (ICC)*, Vol. 12, No. 2, April –June, 2006.
[780] Jin, Saibo (2008), Review of Article 8; see also Liu, Bing (2007), 'Reflection on L/C Fraud Exception Principle', *Practice in Foreign Economic Relations and Trade*, No. 3, 58, p. 60.
[781] It is argued that China should accept such an exception, but it can be difficult to apply in practice, for further discussion, see Yu, Weiquan (2007), 'On the Independence Principle of Letter of Credit', *Journal of China Lawyer and Jurist*, Vol. 6, No. 3, available at www.jurist.org.cn/doc/lawyer200706/lawyer20070605.pdf/, pp. 5-6, accessed 22 May, 2008, see also Zhao, Xin & Wu, Haiying (2007), p. 49; for the difficulty of the illegality exception in theory and in practice, see Feng, Zhongming & Li, Xiaoying & Chen, Yang (2005), 'Dilemma and Solutions to the Independence Principle of Letter of Credit', *Journal of Yunnan University of Finance and Economics*, Apr., Vol. 21, No. 2, pp. 90-91.

be introduced into the standards of L/C fraud in order to avoid the abuse of the L/C fraud exception.[782]

Article 9 and Article 15: Stop-payment Order

As for judicial remedy, there is no legal concept or instrument in PRC procedural law similar to an "injunction" under common law. The SPC thus formalised the "stop payment order" or "suspension order" especially for dealing with L/C fraud dispute cases. Articles 9 and 15 especially concern such a new instrument.

Article 9 provides that the applicant of L/C, issuing a bank or any other stakeholder(s) may apply for an order to suspend payment under a L/C from a competent People's Court when it discovers any of the circumstances stipulated in article 8 and determines that the payment will cause irreparable damage to its interests.[783] The scope of the applicant of such a court order seems wide, including not only the applicant of the L/C, but also the issuing bank or other parties. It can be said that such an article provides a wide scope of applicants and may lead to abuse of the application procedure.[784] It can be seen that the function of such an order in article 9 is the same as that "preliminary injunction" in the US, and the "interlocutory injunction" in England, although the name of "stop payment order" is different from the term of "injunction". However, it is pointed out that an injunction under the common law system is against a person; whereas a preservation order under the Chinese legal system is against an object.[785] Thus, we probably cannot say that the stop-payment order, which is based on the preservation order, is exactly the same instrument as an injunction.

Furthermore, what does 'irreparable damages'[786] mean under the context of L/C fraud disputes in China? The article does not provide a clear answer, and it will be under the discretion of courts. According to Fung, it probably means situations where the L/C proceeds are impossible to be recovered if the L/C is paid out.[787]

Article 15 stipulates that upon determination through a substantive trial that L/C fraud is established and none of the circumstances stipulated in Article 10 are present, a judgment shall be made to terminate payment under the L/C. The final judgment to terminate payment after a substantive trial in article 15 seems to have the same purpose of the "permanent injunction" in the US, and the "perpetual injunction" in England.

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[782] Li, Jingjing (2009), 'L/C Fraud Exception', *Commerce Economy*, No. 2 (General No. 319), 82, p. 105; Zhou, Xintu (2007), 'L/C Fraud Legislative and Judicial Practice', *Modern Business Trade Industry*, Vol. 19, No. 12, 246, p. 247; Li, Xiaoxia (2009), 'Research on Application of L/C Fraud Exception Principle in China', *Science & Technology Information*, No. 27, 326.

[783] It is argued that although this article provides a judicial remedy to L/C fraud, it does not provide a legal basis for such a remedy, see Zhang, Shuling (2006a), 'Definition of L/C Fraud and Relevant Problems', *Law Science Magazine*, No. 2, 117, p. 119.

[784] Li, Yanjun & Sui, Xiaofeng (2008), 'Study on L/C Fraud Legal Regime', *Changbai Journal*, No. 4 (Serial No. 142), 157.

[785] Zhang, Lin (2006), 'Judicial Remedy Measures under L/C Fraud', *Law Forum*, No. 2, 118, p. 119.

[786] This issue is closely related to how to determine 'fraud', which is argued to be 'substantial fraud', which leads to irreparable monetary losses to the victim, for further discussion see e.g. Guo, Guangke (2007), 'Discussion on Improving Legal Regime of L/C Fraud Judicial Assertion', *Law Study*, No. 8, 16, p. 17.

[787] Fung, King Tak (2006).

Article 10: Immunisation of the L/C Fraud Exception

Article 10 stipulates the rule of fraud immunisation in the L/C fraud exception, which is also called the exception of "the L/C fraud exception". Such immunisation is the essential limitation on the L/C fraud exception and it is significant having this article in the new provisions.[788] Such immunisation has not been fully respected in previous judicial practice in China and.[789] This has already been recognised by many other countries and is to protect any third innocent party and encourage third parties to participate in L/C transactions.[790] However, immunisation can be criticised for leaving a loophole in the law for fraudsters, as fraudsters will immediately discount the draft on the market; and this is a blow to the real victims.[791]

Under the situations contained in article 10, where payments have been duly effected by the issuing bank, paying bank, confirming bank and/or negotiating bank in good faith, the court will not order suspension or termination of L/C payments. Article 10 reads that

> "Upon determining that L/C fraud exists, the People's Court shall render an order to suspend or judgment to terminate payment under the L/C, except in any of the following circumstances:
>
> (I) A party nominated or authorized by the issuing bank has made payment in good faith according to the issuing bank's instructions;
>
> (II) The issuing bank or a party nominated or authorized by it has accepted the draft under the L/C in good faith;
>
> (III) The confirming bank has paid in good faith;
>
> (IV) The negotiating bank has negotiated in good faith."

It is argued that article 10 borrowed the provisions of UCC article 5-109.[792] One may compare article 10 with the UCC article 5-109 (a) 1, where there are four situations provided where the payment shall be honoured. The two provisions have shown similarities in both formulation and substance. However, there still remains a problem as to whether L/C payment can be prohibited if the L/C has

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[788] An, Yidan (2010), 'On L/C Fraud Exception', *Journal of Longdong University*, Vol. 21, No. 1, 44, Jan., p. 46.

[789] Zhang, Hua (2005), 'Limiting the Principle L/C Fraud Exception', *Journal of China Foreign Affairs University*, No. 2 (Serial. No. 81), April, 101, pp. 106-107; Liu, Dinghua & Li, Jinze (2002), 'Study on Certain Problems of L/C Fraud Exception', *China Legal Science*, No.5, 106, pp. 115-116.

[790] Liu, Nenghua & Sun, Chunhui (2006), 'L/C Fraud Exception and Judicial Practice in China', *Journal of Jiangxi University of Finance and Economics*, No. 1 (Serial No. 43), 87, p. 89; Wang, Jinlan & Chen, Nan (2005), 'Exemption of L/C Fraud Exception' , *Journal of Tianjin University (Social Sciences)*, Vol. 7, No. 5, Sep., 397; Li, Jinze (2002), 'L/C Fraud Exception: Several Issues in Operation', *International Financial Study*, No. 2, 69, pp. 75-76; Yang, Ting (2009), 'L/C Fraud and L/C Fraud Exception', *Popular Business*, No. 3 (General No. 99), 199.

[791] Yu, Haojie (2008), 'L/C Fraud Exception Limitation and Improvement', *Commercial Times*, No. 2, 69, p. 70.

[792] Zhang, Guang (2007), 'Discussion on Immunization of L/C Fraud Exception', *Journal of Mudanjiang University*, Vol. 16, No. 1, Jan., 11, pp. 11-12; this article is argued to have borrowed the experience of many other countries, see Wu, Jun & Sun, Xiaomin (2009), 'Principle of Fraud Exception and Protection of Participants in Good Faith', *Journal of Nanchang Institute of Technology*, Vol. 28, No. 5, Oct., 79, p. 81.

been accepted but has not been paid.[793] Fung assumed that in such a situation, L/C payment is suspended, so as to prevent the fraudster gaining from fraud.[794] On the contrary, Jin commented that according to article 10 (II), the issuing bank or the party nominated or authorised by it cannot prohibit L/C payment, even if the party who demands payment is the fraudster or the negotiating bank conspired with the fraudster, once the acceptance is made.[795] Therefore, it is argued that the expression in an earlier document of 'has accepted and paid' is more reasonable than the current expression.[796] It is feared that article 10 (II) may lead to disastrous consequences for the applicants of the L/C and issuing banks in China in future L/C transactions.[797]

Article 11: Conditions for Stop-payment Order

Article 11 states the conditions of application for a suspension order from the court. A combination of several circumstances shall be satisfied in order to obtain the stop payment order. Article 11 reads that:

> "Application for suspension of L/C payment filed by a party prior to initiating a suit shall be accepted by the People's Court, provided that the following conditions are met:
>
> (I) The court which accepts the application has jurisdiction over the dispute on which the application is based;
>
> (II) The evidence provided by the applying party demonstrates the existence of any of the circumstances stipulated in Article 8;
>
> (III) The applying party's legal rights and interests would be irreparably damaged if payment under the L/C were not suspended;
>
> (IV) The applying party has provided reliable and sufficient security;
>
> (V) No circumstances stipulated in Article 10 exist.
>
> Application for suspension of payment under a L/C during the course of litigation shall comply with conditions (II), (III), (IV) and (V) of the preceding paragraph."

It would be interesting to compare article 11 with the UCC article 5 (b) and the Convention article 20. The requirement of jurisdiction in Article 11 (I) obviously accords with the expression of "a court of competent jurisdiction" in the UCC article 5-109(b). The condition of establishment of fraud in Article 11 (II) is nearly the same idea as the UCC article 5-109 (b) 3. Similarity is also to be found between this condition and the expression of the Convention article 20 (1) "one of the circumstances referred to in subparagraphs (a), (b) and (c) of paragraph 1 of article 19 is present". Moreover, article 11 (III) concerning the irreparable damage to the applicant's legal rights if the suspension order is issued is an inherent element required to be considered by the court either in US or England when the balance of convenience test is weighed. The condition of reliable and sufficient security

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[793] Fung, King Tak (2006).
[794] Ibid.
[795] Jin, Saibo (2008), Review of article 10; see also Ji, Lei (2008), n. 757 above.
[796] Ji, Lei (2008), n. 757 above.
[797] Jin, Saibo (2008), Review of article 10; similar opinion, see also Chen, Huiting (2009), 'L/C Fraud and L/C Fraud Exception Principle', *Journal of CPC Fujian Provincial Party Committee Party School*, No. 10, 54, p. 59.

from an applicant in article 11 (IV) is similar in design to the UCC article 5-109 (b) 2, where the law requires the enjoined party's loss that it may suffer because the relief is adequately protected. A similar substance is also found between article 11 (IV) and the Convention article 20 (2). Finally, article 11 (V) actually requires that situations of the fraud immunisation does not exist, which falls into the same idea of the UCC article 5-109 (b) 4. It was commented that such conditions may to a large extent discourage a party intending to obtain a court order by merely alleging fraud.[798]

However, article 11 (II) can be criticised as it does not provide the standards of proof.[799] Should the evidence be 'clear' and 'established' as that in English case law or 'sufficient' as in some earlier court cases in China or other standards? The answer seems not clear, which may continue to result in uncertainty in the future.[800]

Article 11 (III) raises a similar question as in article 9: what does the 'irreparable damage' mean? Under Chinese law, the consideration of this concept by the courts can be the possibility of a final court judgment will not be enforced if a stop-payment order is not granted.[801] Furthermore, the requirement of 'irreparable damage' enhances the difficulty of applying a stop-payment order.

In general, article 11 enhances the requirements of applying for a stop-payment order for the applicants; the procedure is more complicated and the costs of such an application are higher than before.[802] Therefore, obtaining a stop-payment order does become more difficult, which also means that the judicial intervention to the L/C system in China is now highly restricted.[803] Nevertheless, some articles can be criticised for going too far to properly balance different parties' interests in the L/C system, and they may be abused by fraudsters and cause higher risks for the applicants and issuing banks in China.[804]

In order to deal with L/C fraud disputes, the L/C fraud exception rules were created after the examination of the rules in other countries and in international conventions. From the discussion of the process of how the L/C fraud exception rules were formulated, and from the analysis of similarities between the rules in other countries and in China, we conclude that the the L/C fraud exception rules in China are a result of legal transplant. However, drafters of such rules did not copy them exactly from other countries, but to some extent adapted such rules based on current Chinese law and the specific situation in China. Therefore, we perceive that "legal adaptation" is a more appropriate term than "legal transplant" for explaining the process of the L/C fraud exception rules in China.

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[798] Fung, King Tak (2006).
[799] Jin, Saibo (2008), Review of Article 11.
[800] Ibid.
[801] Lu, Yixiao (2008), 'Certain Procedural Issues in L/C Stop-payment Procedure', *Market Modernisation*, March (2nd Issue) (General No. 533), 287.
[802] Jin, Saibo (2008), Review of Article 11; see also Yang, Qiuxuan (2006), 'Discussion on LC Fraud Prevention and Remedy in International Trade', *Contemporary Manager*, No. 21, 626, p. 627.
[803] Jin, Saibo (2008), Review of Article 11; see also Zhao, Xin & Wu, Haiying (2007), 'The Independence Principle of L/C', *Journal of Law Application*, Vol. 6, pp. 48-49; Zhao, Yanbo (2007), 'Application of L/C Fraud Exception Principles in China', *Commercial Times*, No. 27, 54, p. 55.
[804] Jin, Saibo (2008), Review of Article 11.

Evaluation of L/C Fraud Exception Rules in New Provisions in 2006

The evaluation of the L/C fraud exception rules in China is conducted from the point of view of evaluating the effect of a legal transplant. Legal transplants are indeed a complicated issue; however, evaluating the effect of a legal transplant is much more difficult. There are a number of problems involved. A key question is: what is the criterion of legal transplant effect. In comparative law study, such an effect is often classified as success or failure. As Alan Watson noted, a successful legal transplant will develop in its new environment and become part of the new system and continuous development in the new system should be considered rejection.[805] Apart from the adoption of certain rules, a successful legal transplant also requires considering the institutional structures and conditions, the real application of the rules and the teaching of the rules.[806] Without real effects on the legal problem in the recipient country, the transplanted rules would only become an adjustment of law on paper. Following the forgoing arguments, a critical evaluation towards "paper laws" and "law in action" is required, when effects of "legal transplant" are discussed.

It is argued that the transplanting process would affect indirectly on economic development via its impact on legality, and the way the law was transplanted and received is an important determinant of the legality.[807] It is also argued that in the countries that adapted the transplanted law, and/or have a population familiar with the basic principles of the transplanted law, the legality is more effective than the countries that merely copied foreign law without any adaptation.[808]

Looking back at the whole process of drafting the provisions, it can be noticed that the drafter was aware of the local adaptation of legal rules when trying to transplant similar rules from other countries. The drafter did not forget their own country's legal culture and legal framework; neither did they blindly abandon the right judicial experience accumulated in judicial practice. They purposely adapted an injunction order in other countries to stop a payment order in China, and invented the procedure of the stop-payment order mainly based on the freezing order regulated in Chinese legal procedural law.[809] The freezing order is familiar to the Chinese judicial and business community, thus such adaptation seems not too strange to the practitioners.

However, it seems that an injunction order has not been treated as such an important procedure as has the preservation orders in China. In Chinese law, a court order which plays a similar function to an injunction order, can be seen separately in litigation of foreign maritime contractual disputes, intellectual property tortious disputes and also L/C fraud disputes. As such an order is scattered in different substantive laws it seems impossible to be applied generally to

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[805] Watson, Alan (1974), p. 27.
[806] Ibid.
[807] Berkowitz, Daniel & Pistor, Katharina & Richard, Jean-François (2003), 'The Transplant Effect', 51 *Am. J. Comp. L.* 163, pp. 169-188; in this article, the legality was defined as the effectiveness of legal institutions; transplant effect as a proxy for the process of legal transplantation and reception.
[808] Ibid.
[809] Mao, Yijian & Gong, Baohua (2007), 'Reflection on Certain Legal Problems of L/C Fraud', *Jiangxi Social Sciences*, No. 5, 171, p. 174.

other legal fields, and it seems also difficult for the courts to apply it in a proper manner without clear rules in procedural law.[810] Therefore, it is proposed that the injunction order scattered in different laws and judicial interpretations should be unified and a uniformed system should be built into Chinese Procedural law.[811] We take the same view concerning such a proposal, and contemplate if it is a rational and feasible suggestion.

The definition of fraud in L/C disputes is also familiar to the legal and commercial community, since it applies a similar idea in the General Principles of Civil Law in China. The circumstances of L/C fraud provided in provisions were recognised by nearly everyone around the world. In particular, the provisions take into account the circumstance where a third party may collude with a beneficiary to commit fraud. This broad inclusion is especially responding to the serious situation of such types of L/C fraud in China. Thus, this reflects that the drafter did consider the speciality of this problem in China.

The purpose of legal transplants in general is to seek improvements in one's own legal system or to replace some inappropriate rules or principles, or to fill some gaps in some regulations. The importance of the L/C fraud rules in China can be reflected in the following four points. Firstly, China has its statute[812] on the L/C, whereas very few other countries have a statute system to officially regulate the L/C.[813] Secondly, the issuance and application of these rules follows closely that of international practice.[814] New L/C fraud exception rules, in keeping with globalisation and international harmonisation, indicate legal uniformity and certainty. Thus, international business transactions are attracted, and benefits are produced consequently for the domestic economy. Thirdly, such rules will standardise the way the court deals with L/C dispute cases.[815] Finally, it provides clear guidance for courts in determining about the L/C fraud issue and stop-payment order in procedure.[816] Thus, with regard to the purpose of legal transplant of the fraud exception rules, the provisions fill a gap between the previous unofficial documents, and create a new legal instrument for the courts to deal with the fraud issue due to the special features of the L/C system. At this point, it may be good to say that this legal transplant is to some extent effective.

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[810] Yang, Jinshun (2002), 'Rebuilding Injunction System in Civil Litigation in China after Joining WTO', published on 25 Sep., available at www.ccmt.org.cn/ss/explore/exploreDetial.php?sId=245, accessed 15 July, 2008.

[811] For a detailed proposal about the term, conditions, jurisdiction, remedy to defendant, detailed procedure and so forth, see Yang, Jinshun (2002); similar proposal, see also Feng, Bo & Liu, Xin (2006), 'On the Legal Balance Between the Independent Character of L/C and Fraud Exception Principles', *Journal of Henan University of Technology (Social Science)*, March, Vol. 2, No. 1, p. 106; Lei, Fa & Xie, Xiaoliang (2009), 'Improvement on Judicial Remedy to L/C Fraud in International Trade', *Cards World*, Vol. 13, No. 5, 92, p. 93.

[812] Here statute shall be defined as a broad sense, including any legal rules.

[813] The USA and Russia have such a legal system; whereas England, Germany, France and most other countries basically follow the case law or follow the international customary practice, see Jin, Saibo (2008), Review, Introduction.

[814] Jin, Saibo (2008), Review, Introduction.

[815] Ibid.

[816] Zhang, Shuling (2006b), 'On Improvement of Legislation on L/C System in China', *Journal of Peking University of Technology (Social Sciences Edition)*, Vol. 6, No. 2, Jun., 71, p. 74.

In general, the provisions are a significant legal development concerning the L/C in China. The cautious attitude towards the issuing stop-payment order, the high standards of proof towards fraud, the difficult procedure of obtaining a court order and the sufficient consideration of protecting an innocent third party make the L/C fraud exception rules in China much more like such rules in developed countries. Such provisions may prevent the applicants from relying on improper judicial intervention and create a sound legal environment for the L/C system.[817] They may enhance the reputation of banks and courts in China, thus further enhancing the trust and confidence of conducting international business for business parties.[818]

However, it is argued that a solely rule-based approach most probably would result in ineffective and little used legislation; on the contrary, a contextual approach may lead to a successful transplantation by acknowledging the difference in the formulation, practice, interpretation and enforcement of law, and the difficulties relating to legal transplants and harmonisation.[819]. Can we conclude that the drafters have found efficient solutions to the legal problem of fraud in L/C fraud disputes in China, because of the establishment of new provisions on L/C fraud? Clearly this perspective is merely based on the law on paper. It is true that a gap will generally exist between law on paper and law in action.

Legal transplant in developing countries is an instrumental practice since lawmakers often expect the transplanted rules to perform certain functions.[820] Effectiveness of the transplanted law is a key issue. Therefore, the most important question is whether the transplanted technique is capable of carrying out the function that lawmakers originally expected.

Obviously it takes time for the rules to influence the business community, for lawyers and banks to gain more familiarity with the new rules, and for cases to come to court for clarification and interpretation.[821] To evaluate the effectiveness of the new provisions concerning the L/C fraud exception rules in practice in China, we need to examine court cases in recent years. However, until now there are few officially published L/C fraud disputes in which the new L/C fraud exception rules are applied. We have found four court cases concerning the L/C fraud exception rules until August 2010: one case with the court judgment and the other three from comments on court cases in journal papers. One case is a dispute between a food company in China and a seafood company in South Korea. This is an appeal of L/C fraud dispute.[822] The key issues are whether the seafood com-

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[817] Ji, Lei (2006), 'L/C Fraud Exception Rules and Judicial Application and Analysis of the Judicial Interpretation of SPC', published on 20 June, available at www.ccmt.org.cn/ss/explore/exploreDetial.php?sId=2170, accessed 15 July, 2008.

[818] Zhang, Yanling (2005), 'Standing in the First Place of Judicial Practice in the World: Judicial Interpretation [2005] No. 13', ICC China, published 09 January, 2006, available at www.icc-china.org/news/read_new.asp?id=137, accessed 26 February, 2007.

[819] Foster, Nicholas HD, in Örücü, Esin & Nelken David (2007), pp. 279-280.

[820] See e.g. Berkowitz & Pistor & Richard (2003), pp. 165-166.

[821] See Cooter, Robert D. (1996), 'Decentralized Law for a Complex Economy: The Structural Approach to Adjudicating the New Law Merchant', 144 *U. Pa. L. Rev.* 1643.

[822] *A food Co. Ltd Dalian China v. B seafood Co. Ltd in South Korea*, [2008] Dalian Fourth Civil Court (Final) No. 1, the judgment was delivered on 12 November 2009, through database www.chinalawinfo.com.

pany conducted L/C fraud, and whether L/C payment should be prohibited. The main points are that: the seafood Ltd deliberately did not deliver any goods, and thus this constituted L/C fraud; the Bank negotiated in good faith, thus the stop-payment order should not be issued. In this case, article 8 (II), article 10 (IV) of the new provisions were applied. Two other similar cases concern stop-payment orders, both are appeal cases[823], but the intermediate courts did not consider the circumstance of immunisation of L/C fraud and that the negotiating bank had negotiated in good faith; thus a stop-payment order should not be granted, and article 8 (II), and article 10 (V) should be applied. The fourth case is an appeal case concerning L/C fraud.[824] The main points in the case are: fraud in the underlying sales contract is determined as the seller in South Korea did not deliver the goods; B Bank in South Korea could not be considered as a negotiating bank, in addition the documents presented did not conform to the L/C requirements, thus A Bank in China has the right to refuse or dishonour the L/C payment. These court cases demonstrated the proper application of relevant provisions concerning the L/C fraud exception rules in China.

It seems true that the independence principle of the L/C is highly maintained by restricting the conditions of obtaining a stop-payment order to L/C transactions through the new provisions. The requirements for obtaining a stop-payment order become difficult to satisfy, thus not allowing the applicants to easily apply such a court order in L/C disputes; and such provisions are rarely exercised in judicial practice. But is it welcomed by the banking community and commercial parties? This question is worth exploring further in future research.

Summary of Approach towards the L/C Fraud Exception Rules in China

The L/C fraud exception rules in China are developed mainly through the courts. This was seen not only in documents or guidance issued by the SPC, but also the courts' approach in dealing with L/C fraud disputes, where the guidance was sufficient. The latest L/C fraud exception rules are provided in the SPC's Interpretation especially concerning L/C disputes. Such rules took into account not only the judicial practice in China but also the rules of other countries dealing with the same problem. The drafters carefully follow the international customary rules concerning the L/C, and carefully chose the essential principles that have been widely accepted by other jurisdictions. But at the same time, they took care of adapting such rules to the Chinese legal culture. Thus, we consider that the L/C fraud exception rules in China is a legal transplant; and to some extent, a successful legal transplant.

We understand the L/C fraud exception rules in China in the following way: Firstly, it has to do with L/C fraud. L/C fraud in China includes the circumstances

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[823] [2008] Lu Fourth Civil Court (Final) No. 1 and [2008] Lu Fourth Civil Court (Final) No. 2; for further details and comments about the two cases, see Fu, Benchao (2009), 'Legal Elements of Stopping Payment under L/C', *People Justice*, No. 2, 93.

[824] *A Bank in China v. B Bank South Korea*, [2009] Lu Fourth Civil Court (Final) No. 38, for further details and comments about the case, see Yu, Xifu (2009), 'Case Study: Determination of Discrepancies of Documents, Identity of Negotiating Bank and L/C Fraud' , *People Justice*, No. 18. 87.

that the beneficiary forges documents, but delivers no goods or goods with no value, or the beneficiary conspires with the applicant or any third party presenting forged documents for L/C payment but without any real underlying transaction and so forth. Secondly, the proof or standards of L/C fraud follow the procedural rule in civil litigation, which is the balance of probabilities. Thirdly, the rules of immunisation of the L/C fraud exception must be considered, as they are to protect innocent third parties and they are inherent in the customary rules of the L/C. The essential elements in such circumstances are that a third party, including banks, has paid or accepted, or negotiated a draft or a L/C in good faith. Fourthly, it concerns the consideration of procedure of the stop payment court order. It requires that the applicant has to provide sufficient security, which is a similar requirement when courts issue freezing orders. Fifthly, one condition is that the defendant's legal rights or interest would be irreparably damaged if a stop payment order is not granted. However, whether damage in a case is irreparable or not is under the discretion of the court.

3.4 SUMMARY OF CHAPTER 3

It is possible to make a comparison concerning the L/C fraud exception rules in England and China, although England and China belong to different legal systems. The reason is that the L/C, as a payment instrument, is discussed in the context of international commercial transactions, and the common function of the L/C fraud exception rules is mainly to deal with L/C fraud allegations in L/C fraud disputes.

Generally in England, it is the courts that developed the L/C fraud exception rules in L/C fraud disputes and did so carefully and sensitively. In China, the courts dealt with L/C fraud disputes without specific rules and proper legal procedural instruments; thus there was a process of developing the L/C fraud exception rules from the observation of documents issued by the SPC and previous court judgments.

The L/C fraud exception rules involve and combine three essential rules: the degree of fraud, the locus of the fraud, and procedural limits on injunctive relief.[825] Only when such rules are considered together, can the L/C fraud exception be addressed in the correct manner. We will compare the L/C fraud exception rules in England and China on the points of L/C fraud, proof of L/C fraud, L/C fraud immunisation, and procedural considerations.

As for L/C fraud in England, there is no clear statement from the courts indicating exactly what L/C fraud refers to. L/C fraud in forging documents is recognised, but L/C fraud in underlying transactions is not a clear-cut issue, and most probably will not be easily acknowledged. But in China, L/C fraud clearly includes fraud in documents required by the L/C and fraud in underlying trans-

[825] Dolan, John F. (2006), 'Tethering the Fraud Inquiry in Letter of Credit Law', *Banking & Finance Law Review*, June, 21, 3, pp. 480-481.

actions; and at least three common circumstances where L/C fraud happens were found. It seems that the English courts emphasise more the L/C independence principle in order to maintain smooth transaction of the L/C.

As for proving L/C fraud in England, the courts stressed that fraud must be "established", and the evidence of fraud should be clear, which is argued to be almost as high as in criminal cases. From the English court cases, we can see that the application of the L/C fraud exception also requires that the beneficiary has knowledge of fraud and has conducted fraud, and that the bank has not paid out after having already noticed the fraud. In China, generally, the courts follow the usual standard of "balance of probabilities" in civil litigation. In particular, the evidence of L/C fraud must be sufficient, the beneficiary knows and commits the fraud, and the bank notices the fraud before paying out. According to Chinese civil law and judicial practice, for a L/C fraud to be established, the subjective state of mind of the beneficiary is "intentional". Generally speaking, the proof or standard of L/C fraud adopted by the English courts seems to be higher than in China, although several factors are commonly acknowledged in both England and China.

Regarding the immunisation of the L/C fraud exception rules, the same rules apply both in China and in England, as they are part of widely accepted customary rules concerning the L/C. With regard to the procedures in England, injunction orders, being an equitable remedy, will only be granted where monetary damage is not sufficient. The judicial practice in England has developed a delicate procedure to follow and many elements to consider when an injunction order is granted. The "balance of convenience" is only one of the tests or criterion that needs to be passed. Such a test includes not only whether irreparable damage will be caused to the applicant if an injunction is not granted but also the weight of both parties' legal rights and interests; and the analysis of such a test can be different depending on the prohibited party is a beneficiary or a bank. In China, there is a similar requirement that the court must consider whether irreparable damage will be caused if a stop payment order is not issued. But during the discretion of the court as to decide whether or not to issue such an order, there are more and clearer elements to consider for a court in England than one in China.

In England, most L/C fraud dispute cases were handled in procedural proceedings by deciding whether an injunction should be granted. However, in China, in most cases, a preservation order was generally issued and the questions of whether L/C fraud is established and whether the L/C fraud exception is applied are decided by subsequent substantive proceedings.

In England, in most of the L/C fraud disputes, L/C fraud is not established, and the L/C fraud exception does not apply. In contrast, in China in most of the L/C fraud disputes, L/C fraud is established, and the L/C fraud exception did apply. In a way, it reflects that the standards of establishing L/C fraud might be different. It may also reflect that the general environment concerning L/C fraud is different in these two countries.

England, with an advanced market economy, has a long history of practicing the L/C; and the commercial and banking communities are familiar with the L/C instrument. The English courts adhere rigidly to the L/C independence principle to maintain the certainty and smoothness of a L/C transaction. Thus, L/C fraud is considered a rare exception, and is considered as a challenging task for commercial parties.

However, in China the L/C has only been accepted and practiced for a short period. In order to be part of the world economy, China follows and accepts the international customary rules of the L/C. But both banks and commercial parties often encountered L/C fraud and caused large amounts of financial losses due to lack of experience in using the L/C. One the one hand, China has to obey the basic customary rules of the L/C when it is involved in international L/C transactions. Even though the acceptance of international practice in international commercial disputes by the courts is welcomed, it still needs to be kept in mind that the strict nature and narrow scope of the fraud exception established in developed countries may not be suitable for China. Some circumstances are common in China, but perhaps are unusual in developed countries. The strict compliance doctrine together with the narrow scope of fraud exception of the L/C may to a great extent encourage fraud in China. Therefore, on the other hand, China has to indeed consider tackling L/C fraud and provides a remedy for potential victims.

In England, it seems that the banks consider that the prevention of L/C payment has a negative effect on their reputation, and probably regard the injunction order as an unpleasant matter. Accordingly, they are more likely to perform their due payment obligations where fraud is more than likely taking place. Thus, it seems that banks have never taken the initiative in applying an injunction order when customers have alleged a fraud is taking place. In contrast, in China it seems that banks do not consider a court order prohibiting L/C payment as a taint on their reputations.[826] Under some circumstances, banks work more actively together with their customers when fraud is likely to be going on. Banks even apply for court orders when their customers suspect fraud is taking place.

The purpose of the court in dealing with disputes also seems different. In England, courts merely decide on the issues that come before them. In China, courts may consider both the legal relationship of a L/C and an underlying contract, and try to avoid further disputes.

Freezing orders, which have the function of restraining L/C proceeds, should not be forgotten by commercial parties. Nevertheless, the parties have to develop and take different arguments from applying for an injunction or stop payment order. Although we do not intend to make a comparison of this procedural instrument in China and England, we would point out that in theory it is also a powerful and effective weapon in L/C fraud disputes if employed properly. Thus, we would propose that international commercial parties take the measure of

[826] Several other Asian banks have a similar attitude to the banks in China towards injunctions in that they usually do not take legal steps to lift an injunction, but accept and use it to justify their non-payment, see Smorthwaite, Kevin (1997), Report 'A Recent ICC Meeting in Singapore Found No Widespread Misuse of the UCP in Asia', *DCI (ICC)*, Winter, Vol. 3, No. 1, p. 15.

applying for freezing orders where the circumstances are suitable and laws are available.

In Chapter 3, we have discussed the L/C fraud exception rules developed in L/C fraud disputes under the framework of civil litigation. Could fraud, being a sensitive and controversial matter, merely be resolved through the method of litigation? Are there any other alternatives to litigating L/C fraud in international commercial transactions? These are the issues that we are going to explore in the next chapter.

4 Alternatives For Litigating L/C Fraud Disputes

4.1 INTRODUCTION

From the foregoing discussion, it can be seen that the civil legal remedy to L/C fraud allegations (such as the interlocutory injunction in common law countries, and the stop-payment order in China) is temporarily in civil litigations. Furthermore, in judicial practice, applicants rarely obtain such a remedy. However, even if an applicant obtains such a remedy from a court, the dispute on the underlying international sales contract between commercial parties will not be simply resolved through the procedure of whether or not to grant an injunction or a stop-payment order, because such procedure is generally auxiliary in nature. However, matters in disputes concerning a sales contract between commercial parties have to be decided.

Dealing with L/C fraud through litigation[827] obviously has several drawbacks. Firstly, it concerns the difficult accessibility of an injunction or stop-payment order and various standards of dealing with L/C fraud. Secondly, litigation generally places heavy costs on the victim party, including the long process of court proceedings, high and various expenses and so forth.[828] Thirdly, where the victim party wins in the court litigation, the challenges of getting a court judgment enforced may wait ahead. More importantly, excessively litigating L/C fraud disputes seems to weaken the independence principle of the L/C system. Concerning the problem of diversified standards over L/C fraud under different jurisdictions, a single court was proposed to be established, and this court has the jurisdiction to deal with L/C disputes, including fraud disputes, involving parties from different jurisdictions.[829] However, the likelihood of such a proposal in practice is in doubt. Therefore, it is important to explore the alternatives to litigating L/C fraud disputes.

As has been discussed, L/C fraud essentially includes fraud in documents required by the L/C (that is to say fraud in L/C transactions), and fraud in the underlying sales contract; the disputants in L/C fraud disputes mainly are the buyer, the seller, the bank, and sometimes the carrier. The bank is a financing institution and intermediary in L/C transactions. The features of the bank's function in

[827] For further discussion about the issue of litigation across national borders, see e.g. Baumgartner, Samuel P. (2004), 'Is Transnational Litigation Different?', 25 *University of Pennsylvania Journal of International Economic Law* 1297, (Winter).
[828] For detailed analysis of costs in litigation from an economic point of view, see e.g. Wang, Lili (Chief Ed.)(2004a), pp. 58-59.
[829] For further discussion, see Morris, Richard (1994), 'Editorial: The Need for an International Court of Commerce', *J.I.B.L*, 9(6), 219-221.

exploring the alternatives have to be taken into account. For the bank, it is merely an intermediary party providing the service of L/C instrument according to certain rules. The banks are obviously not willing to be dragged into the dispute of international sales transactions between commercial parties. Thus, an alternative dispute resolution[830], which is suitable for resolving disputes between commercial parties, may not be suitable for dealing with disputes where a bank is involved[831].

In this chapter, we will explore and discuss the possibility of alternatives to litigating an international L/C fraud disputes. The first alternative we examine is arbitration. Then extra-judicial mechanism (similar to expert determination) will be considered. Thirdly the method of negotiation and mediation is briefly touched upon. Finally, a concise summary is followed. In this chapter, a transnational approach[832] towards dispute resolution will be employed, where necessary.

4.2 COULD ARBITRATION BE AN ALTERNATIVE FOR LITIGATING L/C FRAUD DISPUTES?

4.2.1 Academic Proposals for Arbitrating International L/C Fraud

In 1998 American scholars, Blodgett and Mayer, proposed an arbitral alternative to litigating in international L/C fraud.[833] Their main proposals were as follows: firstly, suppose that the buyer and seller have a sales contract; the contract includes a clause stating that all disputes arsing from their transaction will be handled by arbitration and the UCP applies.[834] Then, further assume that the arbitration agreement concludes that an arbitrator has the power to issue an award containing the attorney's fees, compensatory and consequential damages, if the demand of the seller under the L/C has no conceivable basis, or involves wilful or international fraud.[835] The buyer and seller may also agree that punitive damages may be awarded where particularly outrageous conduct by one party is established with conclusive evidence.[836] The proposed clauses provide the arbitral method of solving disputes between commercial parties; and provide the buyer with the remedy of obtaining damages where fraud is involved.

Secondly, the L/C application contract between a buyer and an issuing bank has also to be considered, since any arbitration agreement between a buyer and a seller would not prevent a buyer from applying for an injunction from a court

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[830] Generally about dispute resolution from an economic point of view, see Anderson, David A. (Ed.) (1996), *Dispute Resolution: Bridging the Settlement Gap*, London: JAI Press Inc.; for discussion about why ADR is supported and techniques used to support ADR, see Zeleznikow, John (2002), 'Risk, Negotiation and Argumentation – A Decision Support System Based Approach', 1 *Law, Probability & Risk* 37, (July).

[831] Analysis of the necessity of employing ADR in resolving disputes concerning banks in China from the perspective of enterprise management, see Wang, Lili (Chief Ed.)(2004b), pp. 249-252.

[832] Such a transnational approach gets support from some scholars, see e.g. Lookofsky, Joseph & Hertz, Ketilbjørn (2004), pp. 6-9.

[833] Blodgett, Mark S. & Mayer, Donald O. (1998), 'International Letter of Credit: Arbitral Alternatives to Litigating Fraud', 35 *American Business Law Journal* 443, Spring.

[834] Blodgett & Mayer (1998), p. 462.

[835] Ibid.

[836] Ibid.

against a bank.[837] Thus a clause in a L/C application contract was proposed as follows: account party agrees that it will not seek to prohibit payment under the L/C in any event where the bank receives documents conforming to the credit's requirements; account party agrees that any legal claims or equitable actions arsing from the seller/beneficiary's fraud, the problem of quality, lack of quantity, or non-existence of goods will be pursued directly against the seller, whether by arbitration or litigation".[838] Such a clause deprives the buyer the right to seek injunction against the bank through the court system; and directs commercial parties to resolve their various kinds of disputes including fraud between them rather than involving a third party – bank. By including both this clause and the arbitration agreement between the buyer and seller, a L/C fraud dispute will be resolved by arbitration. With the above clauses, a court may dismiss a buyer's application for an injunction without delay.

Blodgett and Mayer argued that such a practice might reduce the costs of L/Cs; to some extent it may also rectify a false belief that judicial equitable relief offers a possible remedy for fraudulent activity by a seller.[839] They further justify their proposals by stating that such schemes do not demand new establishment of any special forum, nor do they exceed the capability of the arbitrators, as the questions involved neither are technical nor request specialised knowledge.[840] The problems in any buyer-seller L/C fraud case handled through arbitration would be different types of fraud under law.[841] It seems true that judges might handle such issues better than arbitrators, as judges have long judicial experience. However, the difficulties in defining L/C fraud and the inconsistencies in dealing with injunctions on the grounds of fraud in court cases have demonstrated the judicial struggle in the L/C fraud issue.[842]

It was further suggested that the proposal would make it clear that neither party will seek a court order, and any action based on fraud would be dealt with by arbitration, and that the arbitral location will not be too inconvenient for the buyer.[843] Under such proposals, the seller can still have the advantage of payment through the L/C, and thus will obtain payment by presenting the complying documents; on the other hand, the buyer will have the remedy of an arbitral tribunal if fraud is committed, and the tribunal can award both compensatory and consequential damages.[844] The New York Convention provides some safeguard with regard the enforcement of an arbitral award in most countries.[845]

It can be seen that Blodgett and Mayer's proposals exclude the possibility of litigating L/C fraud, and suggest that L/C fraud disputes be resolved under the

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[837] Blodgett & Mayer (1998), pp. 462-463.
[838] Blodgett & Mayer (1998), p. 463.
[839] Ibid.
[840] Blodgett & Mayer (1998), p. 464.
[841] Ibid.
[842] Ibid.
[843] Ibid.
[844] Ibid.
[845] By 06 Jan. 2011, 145 countries had ratified the Convention, see UNCITRAL, 'Status: 1958 – Convention on the Recognition and Enforcement of Foreign Arbitral Awards', available at http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/NYConvention_status.html, accessed 06 Jan. 2011.

sales contractual relationship through arbitration. If such proposals are put into practice, L/C fraud disputes over court orders of injunction or stop-payments through civil litigations would be reduced to some extent. Furthermore, potential disputes that are not resolved through court procedure would be resolved under arbitration.

However, it can be seen from the above discussion that the proposals actually have several limits. Firstly, it totally excludes the possibility of applying for a court order; thus under whatever circumstances, even if fraud is indeed involved, no injunction order will be sought through litigation. Secondly, the proposals merely consider the case where the seller is engaged in fraud, and have not considered other circumstances of L/C fraud. Thirdly, the proposals have not clarified the scope of L/C fraud disputes; but mix disputes about fraud in L/C transactions and fraud in underlying sales contracts. Thus, in principle such proposals[846] are an arbitral alternative to litigating international fraud disputes in sales contract in which the L/C is the payment instrument; and such proposals concern particularly L/C fraud disputes between international sales contract parties.

Technically speaking, resolving L/C disputes through arbitration is a different issue from resolving disputes over underlying sales contracts. Banks play an important rol in L/C transactions; thus banks may frequently be one party of the disputants in L/C disputes. Accordingly, the attitude of banks towards arbitration as being a dispute resolution method in financial matters needs to be considered. It is said that the world of arbitration and the world of banking are separate; arbitration is not a popular instrument to solve disputes concerning financial matters for the banking community.[847] Arbitration practitioners think that bankers do not show sufficient appreciation to the many benefits that arbitration provides; whereas bankers criticise arbitrators for not fully understanding the basics of bankers' business.[848]

Nowadays, most banks provide a standard L/C application form for creating a L/C application contract between the applicant and the bank. The dispute resolution clause on a standard L/C application form normally states that the dispute shall be subjected to exclusive jurisdiction of a particular court. Similarly, the L/C document between the issuing bank and the beneficiary has been developed into its standard form by banks. Such standard forms provide the applicant or the beneficiary no other dispute resolution choices, except litigation or cause great difficulty for them in changing the dispute resolution method from litigation to arbitration or another method.

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[846] Such proposals would be updated later; information from a survey answer by email from the author Blodgett, Mark S., Professor of Business Law, Frank Sawyer School of Management, Suffolk University, expressed that he would like to update that journal article ten years ago, 20 September, 2008.

[847] Affaki, Georges, 'A Banker's Approach to Arbitration', in Kaufmann-Kohler (2003), *Arbitration in Banking and Financial Matters*, ASA Special Series No. 20 (ASA Swiss Arbitration Association, Conference on 31 January, 2003 in Geneva), August, p. 63; arbitration seems not popular in banking disputes in China either (it was said that 70 percent of banking disputes were resolved by litigation); although arbitration seems to be increasingly used recently by banks, see Wang, Lili (Chief Ed.) (2004b), *Legal Risk Control on Bank Business Disputes*, pp. 254- 255.

[848] Affaki, Georges (2003), n. 847 above, p. 63.

Ten reasons for why, in general, commercial banks do not favour the dispute resolution of arbitration have been identified. We would emphasise several of them[849]: firstly, it is assumed that the commercial courts of the world's financial centres have the necessary expertise to handle financial disputes; thus it is not so necessary to resolve such disputes by experts in arbitration proceedings. Secondly, usually it is possible for a bank's plaintiffs to seek summary judgment in national courts; but if an arbitration clause is included in the agreement, litigation would be stayed by the national courts, and therefore such a swift remedy would be unavailable. Thirdly, banks can choose a forum for litigation which is convenient for them and enforce a court judgment straight in that country; but where international commercial arbitration has taken place in a neutral country, the enforcement of such an award may have to be done in another country, thus the process of enforcement in arbitration may be more complex than that in litigation. Fourthly, applications to national courts concerning jurisdiction may delay the arbitration process, and thus it can take a long time before arbitral proceedings can commence. Fifthly, it is well recognised that an arbitral tribunal may decide disputes under general equitable principles or fairness, which may lead to potential uncertainty. Thus bankers prefer their disputes to be handled by national courts, which apply certain laws

During the past years, although several conferences were held to examine the complex relationship between banking and arbitration and many learned articles concerning such issues were published, the result in practice was disappointing.[850] According to the ICC Court of Arbitration Secretariat statistics on 29 January, 2003 only nine cases involved banks as the party, and there has not been any banker acting as an arbitrator, among the pending 1135 cases that were before the ICC Court at that time.[851] ICC Banking Commission members also have questioned as to whether the available arbitration rules are the most effective procedure for resolving L/C disputes.[852]

James Byrne, who has practiced in the L/C field for years, argued that arbitration has never been very successful or broadly exercised in L/C disputes; one of the reasons has been the problem of educating the arbitrators and lawyers, and by the time those have been performed, the court system may have already worked through the issue.[853] Blodgett and Mayer agreed that L/C disputes between banks most often concern the more technical aspects of L/Cs, although at the same time they believed the issue of fraud or non-existence of goods could be dealt with by arbitration.[854]

In contrast, some even claimed that more technical aspects of L/C disputes may be handled better by the specific arbitrators with expertise of the L/C than

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[849] Connerty, Anthony (1999), pp. 65-66.
[850] Affaki, Georges (2003), n. 847 above, p. 63.
[851] Ibid.
[852] Chung, Isabella S. (1996), 'Developing A Documentary Credit Dispute Resolution System: An ICC Perspective', 19 *Fordham Int'l L.J.*, April, 1349, pp. 1361-1362.
[853] Byrne, James, et al. (1996), Special Section, Seminar Proceeding, 'Disputes Involving Letters of Credit', 7 *World Arbitration & Mediation Report* 185, p. 190.
[854] Blodgett & Mayer (1998), p. 464.

randomly allocated judges.[855] In addition, it was argued that in the area of disputes concerning bank guarantees and the L/Cs, there was a growing acceptance of arbitration, and such an increase was evidenced by the statistics of the main arbitral institutions and confirmed by some legal practitioners.[856] It was stated that commonly parties agree to their L/C disputes subject to arbitration, because of the need to efficiently resolve such disputes; and often parties choose arbitral tribunals which are often experienced in such a field.[857] However, we are cautious to generalise such a statement; and will not simply claim that the traditional views of bankers towards arbitration have been changed, and L/C disputes including L/C fraud disputes are better being handled by arbitration than litigation.

It's more than ten years since Blodgett and Mayer's proposals were brought out, and the practice of arbitrating international L/C disputes does not seem to have become popular, let alone international L/C fraud disputes. In the US, International Certre for Letter of Credit Arbitration (ICLOCA), was established by the Institute of International Banking Law & Practice (IIBLP) specifically to deal with L/C disputes. The IIBLP had played a significant role in revision of UCC Article 5 and the UN Convention on Independent Guarantees and Standby Letters of Credit, and has been active in combating commercial and financial instrument fraud.[858] The establishment of ICLOCA itself to a large extent demonstrated that the idea of resolving L/C disputes through arbitration had support from a group of academics and practitioners. Unfortunately, such an idea did not seem to spread widely in practice, and during more than ten years, ICLOCA has received very few cases. Recent queries concerning L/C fraud disputes addressed to the ICLOCA did not receive helpful answers.[859] Revisiting the website of the IIBLP, where previously one could find information about the ICLOCA and its arbitration rules, showed that such information was no longer available. This is only one aspect that we discovered about L/C disputes through arbitration in the US. It is stated that in Europe L/C disputes are usually resolved by a private agreement between the parties and in court, rather than going to arbitration.[860] Specific data including cases and discussions concerning L/C disputes handled by arbitration in China and in England is not available.

Nevertheless, it is important to consider in theory how dispute resolution systems will respond to the complex disputes in increasingly international financial transactions. Can arbitration be an alternative to litigating international

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[855] Ibid, p. 465.
[856] Cirielli, Stefano E. (2003), 'Arbitration, Financial Markets and Banking Disputes', 14 *American Review of International Arbitration* 243, p. 263; see also Horn, Norbert (2000), 'The Development of Arbitration in International Financial Transactions', *Arbitration International*, Vol. 16, No. 3, 279, pp. 285-286; for discussion about arbitration and other ADR measures in disputes involving financial institutions in the US, see Smith, Robert M. (2007), 'Alternative Dispute Resolution for Banks and Other Financial Institutions', 46 *American Jurisprudence Trials* 231.
[857] Cirielli, Stefano E. (2003), p. 266.
[858] Byrne, James E., Executive Summary, Institute of International Banking & Practice, InC, available at http://www.iiblp.org/files/uploads/pdf/IIBLP%20Resume.pdf, accessed 4 September, 2008.
[859] We conducted a survey about L/C disputes through arbitration, addressed several queries to the ICLOCA through email in October 2008, but did not get any response.
[860] 'Jean-Pierre Mattout on Injunctions, The Draft Standby Rules and First Demand Guarantees', *DCI (ICC)*, Summer 1997, Vol. 3, No. 4, p. 11.

L/C fraud at all? If yes, can arbitration provide some real benefits to the commercial disputants? However, such issues never seem to have caused serious debates.

In this section, we would like to explore whether L/C fraud disputes can be handled through arbitration and what problems might result from arbitrating such disputes. Deriving from Blodgett and Mayer's proposals of arbitrating L/C fraud, several relevant issues will be discussed. Firstly, it will address the issue of the arbitrability of fraud disputes. Secondly, it will touch upon some aspects of arbitration agreements between parties concerning L/C disputes. Thirdly, interim measures involved in arbitration will be examined. Fourthly, whether punitive damages can be issued by arbitrators and whether punitive awards will be enforced will be considered. Finally, the issue of enforcement of an arbitral award in which fraud allegations are handled will be discussed.

4.2.2 Can Fraud Disputes be Dealt with by Arbitration?

What kind of disputes can be dealt with by arbitration is termed as arbitrability.[861] Arbitrability is a legal restriction of the validity of an arbitration agreement and the jurisdiction of an arbitral tribunal.[862] Several claims are widely considered as not arbitral, such as labour or employment, intellectual property, competition, due to their assumed public importance or a need for formal judicial protections.[863] In the US, the arbitral tribunal's jurisdiction to handle a dispute in which a contract is claimed to be induced by fraud has long been accepted.[864] It is argued that where allegations of fraud in the procurement or performance of a contract are claimed, no real obstacles seem to exist for the arbitral tribunal to accept jurisdiction. In fact, such allegations are frequently made, much less frequently proved.[865]

In England, the term arbitrability is not frequently used, but "matters which are (not) capable of settlement by arbitrators" is more generally referred to.[866] The issue of arbitrability of a dispute is not decided by a single criterion that is applicable in all circumstances.[867] According to English law, arbitrability is determined by common law. The Arbitration Act of 1996 in England and Wales (Arbitration Act) does not provide a clear definition of arbitrability.[868] Instead, Arbitration Act

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[861] Poudret, Jean-François & Besson Sébastien (2002), Translated by Berti, Stephen & Ponti, Annette (2007), *Comparative Law of International Arbitration*, Zurich: Sweet & Maxwell, 2nd ed., p. 281.
[862] Ibid.
[863] Born, Gary B. (2001), p. 245; see also Poudret, Jean-François & Besson Sébastien (2002), pp. 295-314 ; who decides arbitrability about a matter is also an interesting question, for further discussion see e.g. Pierce, Kenneth R. (2004), 'Down the Rabbit Hole: Who Decides What's Arbitrable', *Journal of International Arbitration*, 21 (3): 289-302.
[864] Lew, Julian DM & Mistelis, Loukas A & Kröll, Stefan M (2003), p. 213; see also a case which illustrated this point, *Prima Paint Corporation v. Flood & Conklin Mfg Co*, 87 S Ct 1801, 18 L Ed 2d 1270.
[865] Redfern, Alan & Hunter, Martin (2004), 3-23, p. 171.
[866] Poudret, Jean-François & Besson Sébastien (2002), p. 282.
[867] Rubino-Sammartano, Mauro (2001), *International Arbitration Law and Practice*, Hugue: Kluwler Law International, p. 174.
[868] However, an earlier provision – s. 24 (2) of the Arbitration Act 1950, provided that 'the question of whether any such party has been guilty of fraud' should be determined by the High Court; see also a case concerning this point, *Camilla Cotton Oil c. v. Granadex S.A. and Tracomin S.A.*, *Shawnee Processors Inc. v. Same* [1976] 2 Lloyd's Rep. 10, House of Lords.

section 81(1) (a) leaves the question of arbitrability to "any rule of law" and the "law" refers to "common law". In English law, arbitrability seems to be such a broad concept that two scholars even claim that it is difficult to think of any examples of such disputes that are not capable of settlement through arbitration.[869]

The only general rule for prescribing non-arbitrability appears to be the disputes which affect "the public at large".[870] The English courts have also declined the power of an arbitral tribunal to determine on certain kinds of illegal contracts.[871] Apart from such cases, it appears that the arbitrability issue does not cause wide debate in England. Most scholars mention it briefly; and the case law on this issue has not been especially developed.[872]

There are few discussions on whether L/C fraud disputes can be handled by arbitration in England. It is quite common that arbitration deals with contractual disputes. The possibility of referring tort claims to arbitration had been considered by the courts. For example, in the Lonrho case, Lonrho made claims on breach of contract and on tort (conspiracy, unlawful interference with a contract and negligence), and the court held that a tortuous claim closely connected with the contractual claim referring to arbitration due to an arbitration agreement, thus the tortuous claim has to be decided by arbitration.[873] Connerty used to argue that L/C fraud allegations should be dealt with in the national courts[874]; however, he later claimed that such allegations can be handled by arbitration, in the same manner as that in civil litigation by national courts.[875]

In China, generally, there seems no theory concerning the issue of arbitrability in Chinese law. The Arbitration Law 1994 merely deals with the issue of arbitrability indirectly and briefly by providing the disputes which cannot be submitted to arbitration, including disputes over marriage, adoption, guardianship, child maintenance, inheritance and administrative disputes.[876] According to this provision, the disputes which cannot be handled by arbitration do not clearly include fraud disputes. Therefore it appears that arbitration is able to deal with fraud disputes.

Some practitioners in China argued that L/C fraud disputes are not suitable to be arbitrated; if the claim is based on L/C fraud, then the disputes normally are resolved under L/C regime through litigation; if the allegation is based on fraud in an underlying sales contract, then the dispute would be dealt with according to

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[869] Rutherford, M and Sims, J. (1996), *Arbitration Act 1996: A Practical Guide*, London: Sweet & Maxwell, para.81.4. p. 238.
[870] Mustill, M. J. and Boyd, S. C. (1989), *The Law and Practice of Commercial Arbitration in England*, London and Edinburgh: Lexis Law Publisher, 2nd ed., p. 149.
[871] Ibid, p. 150.
[872] Ibid, pp.149-150.
[873] *Lonrho Ltd. (UK) Companhia do Pipeline Mocambique Rodesia S. a. r. L (Mocambique) v. The Shell Petroleum Company Ltd. (UK) The British Petroleum Company Ltd. (UK) et al*., High court, England, January 31 (1978), Yearbook Commercial Arbitration 1979, at 320, cited from Rubino-Sammartano (2001), p. 178.
[874] Connerty, Anthony, Barrister in Practise at Lamb Chambers, Temple, London, Counsel and Arbitrator in international trade law and international commercial arbitration, see his article 'Fraud and Documentary Credits: The Approach of the English Courts'.
[875] A survey answer in email, from Connerty, Anthony, on 28 Sep., 2008.
[876] PRC Arbitration Law 1994, article 3.

the sales contract.[877] However, some argue the L/C fraud disputes are possible to refer to arbitration where the arbitration agreement is reached between relevant parties.[878] In earlier judicial practice in China, some courts were likely to deny the validity of an arbitration agreement between commercial parties and the jurisdiction of an arbitral tribunal, where fraud was involved in a contract[879], even if the payment method were the L/C, and were likely to ascertain such disputes as tort disputes, rather than contractual disputes.[880] However, the court was strongly criticised for firstly determining the substantial dispute, then avoiding a logical analysis of the validity of the arbitration agreement, which violated the basic logic principle that 'procedure fist, substance later'.[881]

Until now, a few cases concerning L/C have been dealt with by the ICC International Court of Arbitration.[882] Most of the cases regard the failure of opening the L/C and breach of underlying contract.[883] There was an arbitral case related to L/C fraud – *Bank (Thailand) v. Bank (Spain)* in 1977.[884] In this case, under the request of a Spanish importer, the defendant Spanish bank opened an irrevocable L/C in favour of a Thai exporter. The claimant, a Thai bank, confirmed the first L/C payment on behalf of the Thai exporter. However, a second application for L/C payment was rejected, because the defendant bank claimed that the documents submitted by the exporter, were forgeries, in spite of their conformity with

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[877] A survey answer in an email from Dr. Saibo Jin, a L/C expert in China, Partner of Commerce & Finance Law Firm, Bejing, 27 August, 2008; however, according to Answers to the Questions of Foreign-related Commercial and Maritime Judicial Practice (I), 2004, question No. 64, if a party brings litigation on the ground of fraud in underlying contract, the courts may deal with this dispute and L/C legal relationship together.

[878] A survey answer in an email from Dr. Yaying Huang, Professor of Law Department at Shenzhen University, China, 17 May, 2008.

[879] For example, in an appellant case *Jiangsu Province Wuzi Group Light Industry v. Yuyi Group Limited (Hong Kong) and Taizi Development Limted (Canada)*, the SPC in China determined that fraud is out of the scope of contractual disputes, and thus the dispute is not an arbitral case although the parties had an arbitration agreement in the sales contract; the Light Industry Limited had the right to bring a tort suit, and did not have to be restricted by the arbitration agreement, the court judgment of the case is available at http://www.hrbmzj.gov.cn/mzbk/04/JJF/JDAL/1007.htm, accessed 22 May, 2008; but this case later was overturned by the SPC, and was held that CITEAC had the jurisdiction to deal with tort disputes and the court had no jurisdiction on such an issue where there is an arbitration clause, see Liu, Xiangshu (2007), 'The Issue of Independence of Arbitration Clause', *Legal Education*, available at http://www.chinalawedu.com/news/18500/189/2007/4/zh706133110147002454-0.htm, accessed 22 May, 2008.

[880] For details of one case in 1986, see Du, Yonghao (2002), 'New Argument on the Autonomy of Arbitration agreement in Commercial Arbitration and Comment on Case *China Technology Import & Export Company v. Switzerland Industrial Resource Company*', CCMT, published on 22 Aug., available at www.ccmt.org.cn/ss/explore/exploreDetial.php?sId=218, accessed on 15 July, 2008.

[881] Ibid.

[882] Mechanism of ICC Arbitration, see an example, Huang, Yaying (2005), 'Exploration of ICC Arbitration Mechanism', published in *China Arbitration*, Vol. 3, available at http://article.chinalawinfo.com/article/user/article_display.asp?ArticleID=30782, accessed 05 May, 2008.

[883] See e.g. *Buyer (France) v. Seller (Brazil)*, dispute about failure of opening L/C, ICC Award No. 1675, in 1969, Digest of ICC – International Court of Arbitration Awards ICC, Award Abstract and Commentary, Germany; *Employer (Libya) v. Enterprise (Spain)*, dispute about contract, late opening of L/C, ICC Award No. 2583, in 1976, France; *Manufacturer (France) v. Buyer (the Netherlands)*, dispute about failure of opening L/C, failure of delivery of goods, and breach of contract, ICC Award No. 3226, in 1979, Belgium; *Company – Agent (Spain) v. Bank (Kuwait)*, dispute about refusing payment under L/C, and buyer's refusal of goods, ICC Award No. 3820, in 1981(13 July); *Seller, Texas (USA) v. Buyer, Ministry (Syria)*, dispute about delay of opening L/C, ICC Award No. 4338 in 1984, France.

[884] ICC Award No. 3031, in 1977, Digest of ICC – International Court of Arbitration Awards ICC, Award Abstract and Commentary, JDI 1978, pp. 999-1004.

the L/C. The sole arbitrator established that the L/C did not bind the defendant bank to meet the demand for L/C payment when supported by fraudulent documents. The decision mainly deals with the interpretation and effect of certain articles of the UCP (1974 version). Although the outcome of this case is not wholly reported, it can be seen that the arbitral award was issued following the relevant customary rules and essential principles reflected in court cases.[885]

Some arbitration practitioners hold positive attitudes towards arbitrating L/C fraud disputes. For example, Georges Affiki states that it is a fact that to date all reported L/C fraud cases have been adjudicated by courts, rather than by arbitral tribunals; however, this does not mean that arbitration is not suitable for such cases because it has the advantages of rapidity and expertise; and which way is better should be considered on a case-by-case basis.[886] In a word, generally it can be said that there seems to be no problem if fraud disputes are handled by arbitration, although the arbitrability is not a clear-cut issue.

4.2.3 How does an Arbitration Agreement Function in L/C Fraud Disputes?

When parties consent to deal with their disputes by arbitration, they give up the right to resolve those disputes by a national court. Therefore, with an arbitration agreement, one abandons an essential right to have disputes decided judicially, but creates another important right to establish the private process for resolving the dispute.[887] In an arbitration agreement, the parties are generally allowed to select the rules that will govern the procedure, the location and language of the arbitration, the law governing the arbitration, and arbitrators who are the decision-makers of the disputes. The arbitration agreement between the buyer and the seller is normally in the form of a clause or clauses that are included in commercial contracts.

Principle of Arbitration Agreement – Separability

Under most rules and laws, an arbitration clause is regarded as a separate and distinct agreement from its main contract. Therefore, an arbitration agreement can continue to be valid[888], when its main contract is null and void. In most countries, the principle of separability[889] allows the arbitrators to decide the disputes be-

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[885] Some say that within an arbitration institution, a case law of precedents applies in rendering arbitral awards, see Culinovic-Herc, Edita (1998), 'Arbitration and Banking: Arbitral Settlement of Documentary Credits Disputes', 5 *Croatian Arbitration Yearbook* 151, p. 162.

[886] Information in email to author from Dr. Georges Affiki, who is Global Head of Energy and Asset Finance Legal Affairs at BNP Paribas and a member of the Executive Committee of the Corporate and Investment Bank, Vice-Chairman of the Banking Commission of the ICC, 5 September, 2008.

[887] Moses, Margaret L. (2008), *The Principles and Practice of International Commercial Arbitration*, New York: Cambridge University Press, 1st ed., p. 18.

[888] It is argued that the validity of an arbitration agreement depends on the relevant factors concerning the agreement itself, such as the capability of parties, the geniuses of submitting to arbitration of parties, the content and formality of the agreement, and its validity does not relate to the validity of the main contract, see e.g. Liu, Jianhong (2004), 'The Autonomy of Arbitration Agreement and the Clause of Silently Citing Arbitration Agreement' , published on 11 April, available at www.xxmt.org.cn/ss/explore/exploreDetial.php?sId=612, accessed 21 July, 2008.

[889] Can also be called 'severability', see Poudret, Jean-François & Besson Sébastien (2002), p. 133; or 'autonomy', see Tweeddale, Andrew & Tweeddale, Keren (2005), p. 122.

tween commercial parties even though one party alleges that the main contract is terminated, or never existed at the beginning, or is invalid as it was fraudulently made. Generally speaking, such allegations would not remove the jurisdiction of arbitrators because of the problems of the main contract.

Fraudulent inducement and fraud in the factum are two common grounds for challenging the validity of international arbitration agreements; and such claims often will involve application of separability doctrine.[890] The two different grounds can lead to different legal results: the former may result in illegality ex post of the contract, whereas the latter its illegality ab initio; and this begs a further question of whether the arbitrator should apply a different standard concerning arbitrability and separability under the two different circumstances.[891] It is also pointed out that a vitiating factor such as error or fraud can affect the validity of the main contract, thus it is necessary to differentiate between circumstances where the entire contract is affected and where the arbitration agreement is not affected.[892] The essential point is that an arbitration agreement can be independent from an invalid main contract which is concluded by fraud. Therefore it is important to distinguish between where a main contract is concluded through fraud and where an arbitration agreement is concluded through fraud; only the latter circumstance can determine the invalidity of an arbitration agreement.[893] The proponents of such a standpoint argue that this is a reasonable way to deal with this issue, because the fraudulent party aims to obtain some benefits or avoid some liabilities; the arbitration agreement leads to the arbitration procedure which will not necessarily make an award beneficial to the fraudulent party; and the consequence does not depend on the will of the fraudulent party in the main contract.[894]

The separability doctrine is recognised by most arbitration laws and rules.[895] In England, section 7 of the Arbitration Act 1996 clearly provides that an arbitration agreement shall not be considered invalid, non-existent or ineffective because the other agreement is invalid, or did not come into existence or has become ineffective, and it shall be treated as a distinct agreement. As long as there is an arbitration agreement between particular parties, the courts in England would respect the intention of the parties. In *Harbor Assurance (UK) Ltd v. Kansa General International Insurance*[896], it was held that an arbitration agreement within a contract is separate from the main contract.

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[890] Born, Gary B. (2001), *International Commercial Arbitration: Commentary and Materials*, The Hague: Kluwer Law International, p. 196; for further discussion, case materials in the US law, UNCITRAL Model Law, French law, Swiss Law, see pp. 195-208.
[891] Kreindler, Richard H., 'Aspects of Illegality in the Formation and Performance of Contracts', in Jan van den Berg, Albert (Ed.) (2003), pp. 214-215.
[892] Rubino-Sammartano (2001), p. 225; for further discussion and case materials, see pp. 225 – 231.
[893] Liu, Jianhong (2004).
[894] See e.g. Wang, Xikang (2005), 'Discussion on the Autonomy of Arbitration Agreement and its Application in Commercial Arbitration', CCMT, published on 10 Nov., available at www.ccmt.org.cn/ss/explore/exploreDetial.php?sId=2010, accessed 15 July, 2008.
[895] For discussion of the rationale for the doctrine of separability, see Tweeddale, Andrew & Tweeddale, Keren (2005), *Arbitration of Commercial Disputes: International and English Law and Practice*, New York: Oxford University Press, 1st ed., p. 125; see also Tan, Bing (2005), *The Reform and Perfection of Arbitration System of China*, Peking: People Press, 1st ed., pp. 262-265.
[896] [1992] 1 Lloyd's Rep. 81.

A recent case also exemplifies the court's attitude. The case *Premium Nafta Products Limited & Others v. Fili Shipping Co & Others*[897], concerned a dispute between a Russian shipping company Sovcomflot and certain charterers of vessels over allegations of fraud. In 2006 Sovcomflot agreed with the charterers that the dispute about whether the charters (argued to be procured by fraud) were rescinded would be submitted to arbitration. However, Sovcomflot applied to the High Court for an injunction to prevent the arbitration from taking place, and obtained the injunction[898]. The charterers appealed to the CA, which unanimously overturned the decision of the High Court and held that the issue of whether Sovcomflot had lawfully rescinded the charters should be handled by arbitration. Sovcomflot then appealed to the HL, which confirmed the CA's decision to permit the dispute to proceed through arbitration. Such a decision was welcomed by the business community and legal practitioners, as it means that in most cases, the arbitration will not be challenged by one party due to the validity issue of the main contract, where an arbitration agreement is reached. Mike Lax commented that the HL in the judgement seems to reduce the ability of parties to seek the remedy of the courts, when parties have already agreed to submit their disputes to arbitration.[899]

In China, article 19 of the Arbitration Law 1994 similarly recognises the doctrine of separability by stipulating that any arbitration agreement shall exist independently; any changes to, rescission, termination or invalidity of the contract shall not affect the validity of the arbitration agreement.[900] Article 57 of the PRC Contract Law provides that "if a contract becomes invalid, rescinded or terminated, it shall not affect the validity of the dispute settlement clause which independently exists in the contract". Unfortunately, neither the Arbitration law nor the contract law provides a clear answer to the question of whether an arbitration agreement is valid or not if the main contract is concluded by fraud.[901]

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[897] [2007] UKHL 40.

[898] The term of such an injunction particularly refers to 'anti-suit injunction', which prohibits the parties who have agreed to resolve their disputes by arbitration litigating in courts, further discussion see e.g. Gross, Peter (2006), 'The Anti-suit Injunction in England and Arbitration', translated by Huang, Yongshen to Chinese language, published on 22 Mar., available at www.ccmt.org.cn/hs/explore/exploreDetial.php?sId=2102, accessed 21 July, 2008; there is no such anti-suit injunction either in relation to litigation or arbitration in China, for further discussion on how Chinese parties deal with foreign anti-suit injunctions and proposal of including such injunction in Chinese legal system, see Ou, Yongfu (2007), *Anti-suit Injunction in International Civil Litigation*, Peking: Peking University Press, 1st ed., pp. 229-264.

[899] See News 'House of Lords Backs London Arbitration in Sovcomflot Dispute', *MarEx Newsletter*, available at http://www.newsletterscience.com/marex/readmore.cgi?issue_id=265&article_id=2641&l=%3C, accessed 07 May, 2007.

[900] For further discussion on this doctrine in China, see Hou, Gang (2004), 'Study on Validity of Commercial Arbitration Agreement', *Economics and Law*, No. 10, 111, p. 112; see also Zhou, Tingting (2008), 'The Autonomy of Arbitration Clauses', in Guangzhou Arbitration Commission (2008), *Arbitration Study*, Peking: Law Press China, Vol. 14, p. 17; The attitude towards this principle in China has actually gone through a process from 'strictness' to 'looseness'; in judicial practice, some judges are inclined to deny the validity of an arbitration agreement and have adopted different attitudes towards domestic and foreign-related arbitration agreements, see Yao, Zhenhuan (2008), 'Discussion on the Validity of the Arbitration Agreement', Chengdu Arbitration Commission, available at www.ccdc.org.cn/Article/ShowArticle.asp?ArticleID=43, accessed 22 May, 2008.

[901] Wang, Xikang (2005).

Will an Arbitration Agreement in Sales Contracts Bind on L/C Fraud Dispute?
It is a debated issue as to whether an arbitration agreement included in an underlying sale contract binds on a L/C agreement, because of the independence principle of the L/C. We can use a case[902] in China to explain the essential points. Company A and B concluded a sales contract and the payment was to be made by L/C. The sales contract also provided that all disputes should submit to a commercial arbitration institution in a third country. Company A applied to Bank C for the issuance of a L/C with company B as the beneficiary, and Bank D was the negotiating bank. However, it was later proved that company B did not ship any goods and the Negotiating Bank D knew that company B presented forged documents, but still submitted such documents to Bank C in order to defraud the credit.

One of the main issues in this case is whether the L/C dispute is governed by the arbitration clause contained in the underlying sales contract. Some argue that the arbitration agreement is included in the sales contract, and has nothing to do with L/C fraud[903]; whereas others hold that L/C is merely the payment method of the sales contract, thus the L/C fraud dispute should be bound by a arbitration agreement.[904] In addition, it is claimed that where the fraud leads to the invalidity of the main contract, whether the arbitration clause is valid or not depends on the intention of the party who is defrauded; and this is to protect the good-faith party.[905]

From the previous chapters, we know that the L/C is independent from its underlying sales contract; even if the sale contract is mentioned in the L/C, banks have no legal relationship with the sales contract, and thus banks should not be bound by the sales contract. The analysis on why an arbitration clause in sales contracts cannot be effective in L/C fraud disputes in the example case is as follows: firstly, where the L/C payment method is agreed in an international sales contract, there will be different contracts concluded between different parties. Accordingly, the sales contract binds only the buyer and seller (in this case, company A and B). However, a L/C transaction can include an application contract between the applicant and issuing bank, a payment contract between the issuing bank and beneficiary, a delegation contract between the issuing bank and negotiating bank; thus it may concern four parties: applicant (Company A), issuing bank (Bank C), negotiating bank (Bank D) and beneficiary (Company B). Each contract will only bind parties who are involved in the specific agreement.

The arbitration agreement in sales contracts is apparently applicable to sales contract disputes, such as delays in delivering the goods and the goods not con-

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[902] Shenzhen Arbitration Commission (2006), Arbitration Guide, Case Analysis, n. 906 below.
[903] Shen, Yalan (2006), 'LC Transaction is Independent of Arbitration Clause in Sales Contract', http://www.chinacourt.org/html/article/200611/28/225231.shtml, accessed 22 May, 2008; see also Guo, Shuangjiao (2008), 'Study on Complicated Problems of L/C Fraud Exception in China', *Journal of Hunan International Economics University*, Vol. 8, No. 3, Sep., p. 40.
[904] Shenzhen Arbitration Commission (2006), Arbitration Guide, Case Analysis, n. 906 below.
[905] Zhou, Chan (2008), 'The issue of Non-Independence of Arbitration Clause in Foreign-related Contract Fraud', Contract Law, available at http://www.hetong66.com/shewaihetong/1090.html, accessed 05 May, 2008.

forming to the sales contract. Some observe that "all disputes" in the arbitration clause necessarily include L/C fraud disputes, and such disputes are predictable for the parties when concluding the sales contract.[906] However, some argue that according to the independence principle of the L/C, the L/C itself is separate from its underlying sales contract; and thus a L/C is not bound by the clauses in its underlying sales contract and the arbitration clause in the sales contract does not have any legal effect on the L/C.[907]

Furthermore, generally speaking, for an arbitration agreement to be valid, it has to be in the form of writing. It can be said that arbitration is a creature of agreement, and the agreement should be freely, knowingly and competently given.[908] Therefore, many national arbitration laws require an arbitration agreement to be in writing in order to demonstrate the parties have agreed.[909] In England, Arbitration Act 1996 section 5 stipulates such a requirement. The New York Convention article II has almost the same requirement; but further requires that the written agreement be signed by both parties in some circumstances. PRC Arbitration Law 1994 article 16 requires that the arbitration agreement shall be arbitration clauses in a contract and any other written form of agreement[910]. It was argued that if there are differences concerning the requirement between the New York Convention and a domestic law, the New York Convention would prevail over the domestic law.[911]

In this case, there were the signatures of both company A and B on the sales contract, which means that Company A and B had agreed the arbitral proceedings concerning disputes between them. However, Bank C and D did not sign on the sales contract. Moreover, there was no arbitration clause either in the L/C applicant agreement, the L/C payment contract, or in the L/C delegation contract. Thus arbitration concerning L/C fraud disputes between banks and the seller or the buyer was not agreed. Therefore, we consider that the L/C and the sales contract are separate and independent of each other; and the arbitration agreement is only the dispute resolution of the sales contract.

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[906] Shenzhen Arbitration Commission (2006), Arbitration Guide, 'Case Analysis, L/C transaction is Independent of the Arbitration Agreement in Underlying Sales Contract', 22 December, available at http://www.szac.org/guide_05.asp#a, accessed 9 October, 2008; there is a similar argument that an arbitral tribunal has the jurisdiction concerning the tort disputes on LC fraud by forging documents, with two reasons, for further discussion see He, Nao (2003), 'Examination on One LC Fraud Case', *Practice in Foreign Economic Relations and Trade*, 22, pp. 23-24.

[907] Shenzhen Arbitration Commission (2006); see also Ji, Lei (2008), n. 757 above.

[908] Moses, Margaret L. (2008), p. 18.

[909] But there are differences between different systems on what 'writing' should refer to and between legislative requirements and business practice, see Landau, Toby, 'The Requirement of a Written Form for an Arbitration Agreement: When 'Written' Means 'Oral'', in Jan van den Berg, Albert (Ed.) (2003), p. 20.

[910] Interpretation of the Supreme People's Court concerning Some Issues on Application of the Arbitration Law of the PRC, was adopted at the 1375th meeting of the Judicial Committee of the SPC on Dec. 6, 2005, and came into force on Sep. 8, 2006, article 2 further specifies that any other written forms shall include contracts, letters or data exchange, such as telegraph, telefax, fax, electronic date interchange, email.

[911] For further discussion, see Huang, Yaying (2004), 'Analysis of New York Convention and the Form of Arbitration Agreement', *Law Journal*, Vol. 2, also available at www.ccmt.org.cn/ss/explore/exploreDetialphp?sId=610, accessed 15 July, 2008.

The uncertainty on whether an arbitration clause in an international sales contract can bind L/C fraud disputes sometimes raises jurisdiction problems[912]. There may be two kinds of situation concerning the jurisdiction of courts towards the L/C fraud issue, where there is an arbitration clause in the underlying transactions. Firstly, where the arbitration clause is invalid, and there is substantial fraud in the underlying transaction, the courts may have the jurisdiction towards both the underlying transaction and the L/C disputes.[913] Secondly, how can the victim party be appeased if fraud happened in the underlying transaction, where the arbitration agreement in the underlying sales contract is valid, but there is no arbitration clause in the L/C?[914] It was argued that the party can either apply to an arbitration institution or court for a court order.[915]

In addition, it is clear that such jurisdiction disputes can delay the dispute settlement process. The intensified international disputes concerning sales contracts and L/C between the Tianda Tiancai (Tianda) in China and ShinEtsu Chemical Industry Company in Japan (ShinEtsu) has lasted for almost four years and can demonstrate the complexity of L/C disputes.[916] It was remarked that the arbitration agreement in a sales contract does not bind L/C disputes, and L/C disputes

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[912] This refers to the issue of who can decide who has the jurisdiction to deal with such a dispute, if there is a 'jurisdiction objection' of arbitration from a party; in China, both the court and the arbitration institution can decide the issue, but who actually decides such an issue depends on which party is applied to; for further about the provisions and the advantages and disadvantages of such a system, see Gao, Lili (2005), 'Principle of Self-jurisdiction and Ascertaining Jurisdiction of Arbitration in China', published on 12 Dec., available at www.ccmt.org.cn/ss/explore/exploreDetial.php?sId=2052, accessed 21 July, 2008.

[913] Jin, Saibo (2003a), 'Applicable Law, Jurisdiction and Service Issue L/C Cases in China', published on 25 June, available at www.ccmt.org.cn/ss/explore/exploreDetial.php?sId=408, accessed 15 July, 2008; see also Tang, Jinlong (2005), *New Version of Case Study: Financial Law*, Peking: China Renmin University Press, 1st ed., pp. 202-205.

[914] Jin, Saibo (2003a), n. 913 above.

[915] Jin, Saibo (2003a), n. 913 above; some claim that if the arbitration clause is valid, the party can submit such a dispute to an arbitration institution, then the arbitration institution forwards the application from the party to the court, see 'Stop-payment Order in L/C Fraud Disputes', in Yu, Gujie (Chief Ed.) (2003), *Verge of Law and Theory: Civil and Commercial Difficult Case Study*, Guangzhou: Guangdong Renmin Press, p. 22.

[916] SPC, Civil Order, (2004) the 4th Civil Tribunal, Final, No. 11; Tianjin City, HPC, Civil Order, (2004), the 4th Civil Tribunal, First, No. 1-1; and Tianjin City, HPC, Civil Order, (2004), the 4th Civil Tribunal, First, No. 1; see Jin, Saibo (2005), pp. 36-44; Tianda (the buyer) and ShinEtsu (the seller) entered into a long-term sales agreements in 2001, with the performance period from 1 October, 2001 to 31 March, 2007, L/C being the payment method, the China CITIC Industrial Bank being the issuing bank. After the contract was signed, the price of similar products in the international market started to decrease substantially. But ShinEtsu refused to reduce the contract price, which meant that the products of Tianda bought from ShinEtsu were not market competitive. Then Tianda argued that ShinEtsu was involved in material fraud concerning the sale contracts and L/Cs. In 2003 Tianda applied for the preservation of property over L/C payment from Tianjin High Court, which issued the freezing order over L/C. According to the court order, the China CITIC Industrial Bank stopped paying the L/C after 7 January, 2004. ShinEtsu immediately challenged the jurisdiction of Tianjin High Court, but the objection was rejected. Then ShinEtsu appealed to the SPC concerning the jurisdiction of Tianjin High Court. On 31 August, 2004, the SPC held that Tianjin High Court has the jurisdiction of the L/C disputes, but does not have the jurisdiction over the long-term sales agreement disputes. In 2005 ShinEtsu applied to the Japanese Commercial Arbitration Association for arbitration, claiming compensation of about RMB 136 million from Tianda and requested the arbitration to hold that ShinEtsu is not engaged in any fraud; the sales agreement is still in force and should continue to be performed, See, News, 'Letters of Credit Disputes Become Intensified, International Arbitration are with Hidden Financial Risks', available at http://www.zs91.com/news/htm/377/2005_3_23_73960.html, accessed 28 August, 2008.

have their own jurisdiction and rules, which demonstrates the independence principle of L/C from the procedural perspective.[917] If L/C fraud disputes involve proceedings of both litigation and arbitration, the procedures are further complicated. The problem of the jurisdiction of a L/C fraud dispute may prolong the final dispute settlement.

Generally, it can be said that whether or not a L/C fraud dispute would be handled by arbitration depends on which particular parties are involved in the dispute, whether there is an arbitration agreement between these particular parties, and which grounds the plaintiff's claim is made on.

4.2.4 Applicable Law in L/C Fraud Disputes

Remedy to Fraud in Contract Law in England and China

Generally, where the buyer and the seller reaches an arbitration agreement concerning disputes (including fraud), which country's rules or laws are applicable to the potential disputes are of significance.[918] Contract law is the most relevant field when dealing with contractual disputes. However, concerning the point of fraud, there are ambiguities and gaps in contract laws either in individual countries or in international convention.

For instance, under English law, fraud in the contract law area is generally considered as a circumstance of misrepresentation and particularly refers to fraudulent misrepresentation. In principle, where one party enters a contract on the basis of the other's misrepresentation, this party has a right to set aside the contract.[919] Besides this right, frequently the victim party is entitled to claim damages.[920] The rules concerning damages mainly concern the law of tort; but tort law rules often intertwine with contract law rules. Interestingly, under English law concurrent liability in tort and contract is allowed.[921]

In China according to Article 54 (2) of PRC Contract Law[922], if a contract is concluded by means of fraud, the injured party shall have the right to request a court or an arbitration institution to modify or revoke it. In other words, this provision allows the party options either to amend or to annul the contract where a contract is induced through fraud by one party against the other party's actual intention.

However, neither English nor Chinese contract law provides clear guidance as to the rights and obligation where one party commits fraud during the performance of a contract. Some academics in China argue that fraud in the perfor-

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[917] Yang, Bingshun (2006), 'Discussion of Application of L/C Independence Principle In Court Practice in China', *Journal of Law Application*, Vol. 4, 69, p. 70.

[918] The situation can be different concerning complex long-term contracts, see Frick, Joachim G. (2001), *Arbitration and Complex International Contracts: With Special Emphasis on the Determination of the Applicable Substantive law and on the Adaptation of Contracts to Changed Circumstances*, The Hague: Kluwer Law International.

[919] Atiyah, P. S. & Smith, Stphen A. (2005), *An Introduction to the Law of Contract*, Oxford: Oxford University Press, 6th ed., p. 254; see also Treitel, Guenter (2003), pp. 369-376.

[920] Atiyah, P. S. & Smith, Stephen A. (2005), p. 260; see also Treitel, Guenter (2003), pp. 343-344.

[921] Atiyah, P. S. & Smith, Stephen A. (2005), p. 260.

[922] For further discussion about Chinese Contract Law, see e.g. Webb, Duncan (1996), 'Towards a Contract Law of China: Some Salient Features', *LMCLQ*, (May), Part 2, pp. 245-267.

mance of contract may be considered as a breach of contract, and the scope of liability of the fraudster includes both direct and indirect losses.[923] However, both from the perspective of theory and from court cases discussed in Chapter 3, it can be inferred that where there is such fraud, generally the victim party has the right to avoid the contract and/or claim damages under the law of tort[924].

Remedy to Fraud in CISG

In arbitration clauses, international rules[925] may frequently be chosen as the applicable law of a contract. Thus, it is also interesting to look at the rules concerning fraud in an international convention – CISG, which stands for United Nations Convention on Contracts for the International Sale of Goods.

The CISG convention, founded in 1980, represents the most successful attempt to unify various rules of contract law in international commerce.[926] CISG Convention has attracted 74 Contracting States[927], and has been increasingly accepted in practice. National courts and arbitral tribunals in almost every Contracting State have delivered a large number of decisions concerning many provisions of CISG Convention.[928] Due to its wide practice it is important to examine how the CISG Convention deals with the fraud issue in international sales transactions. What are the remedies to fraud if CISG is applied?

Generally speaking, the CISG does not provide guidance rules on the issue of fraud in international sales transactions. Article 4 of the CISG provides the issues that are excluded from the Convention; and article 4 (a) excludes the issue of "validity of the contract or of any of its provisions or of any usage". But no provision in CISG restricts or interferes with the rights and remedies that domestic law offers to parties who have been induced to conclude a contract by fraud (this is considered as a very different issue from the problem of quality of the contracted

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[923] Zhang, Defu (2002), 'Discussion on the Features and Law Application of Maritime Fraud', published on 29 Mar., available at www.ccmt.org.cn/hs/explore/exploreDetial.php?sId=70, accessed 15 July, 2008.
[924] See an example, Wang, Xiaoxian (2008), 'Discussion on Elements of Fraud and Legal Consequences', available at http://www.chinacourt.org/html/article/200801/18/283711.shtml, accessed 07 August, 2008.
[925] In international commercial arbitration, whether or not non-national or transnational law is the applicable law, and whether arbitral tribunals can choose to apply non-national law if the arbitration agreement is unclear with the matter of applicable law, are controversial, for further discussion, see e.g. Kirchner, Stefan, 'Transnational Law and the Choice-of-law Competence of Arbitral Tribunals in International Commercial Arbitration', available at http://ssrn.com/abstract=988677, accessed 28 Jan., 2008.
[926] For an analysis of the relationship between trade usages (so-called *lex mercatoria*) and CISG, see e.g. Pamboukis, Ch. (2005-06), 'The Concept and Function of Usages in the United Nations Convention on the International Sale of Goods', *Journal of Law and Commerce*, Vol. 25:107, Gillette, Clayton P. (2004), 'The Law Merchant in the Modern Age: Institutional Design and International Usages under the CISG', Pubic Law and Legal Theory Research Paper Series, Research Paper No. 74, New York University School of Law, available at http://ssrn.com/abstract=485263, accessed 24 May, 2008.
[927] United Nations Commission on International Trade Law (UNCITRAL), 'Status: 1980 – CISG Convention', available at http://www.uncitral.org/uncitral/en/uncitral_texts/sale_goods/1980CISG_status.html, accessed 27 Oct, 2009; particularly about the application of CISG in China, see e.g. Ding, Ding, 'China and CISG', reproduced with permission from Michael R. Will ed., CISG and China: Theory and Practice, Faculté de droit, Université de Genève (1999) 25-37, available at www.cisg.law.pace.du/cisg/biblio/dingding.html, accessed 17 Feb., 2009.
[928] Schlechtriem, Peter & Schwenzer, Ingeborg (Eds.) (2005), *Commentary on the UN Convention on the International Sale of Goods (CISG)*, Oxford: Oxford University Press, 2nd (English) edition, Preface.

goods).[929] The general rule of article 4 governing only the obligations "arising from [the] contract" in a sense maintains domestic protection against international fraud.[930] Thus, it is clear that domestic laws rather than the Convention rules provide remedies to the buyer for the seller's fraud or deceit, which is beyond a mere lack of conformity of the contracted goods.[931]

The Convention does not deal with any factual circumstances involving fraud; but this does not mean that this area of law is totally being overlooked by CISG. Fraudulent conduct in performance of an international sales contract at least can be considered as a breach of contract.[932] Thus, according to CISG article 74, one party's fraud in action at least may lead to damages for breach of contract to the injured party.[933]

A Canadian case *Sonox Sia v. Albury Grain Sales Inc*[934] in 2005 will be analysed, as this case mainly concerns the issue of the validity of an arbitration clause, which stated that all contractual disputes be arbitrated by the ICC and the CISG is the governing law. The plaintiff, a Latvian company, Sonox Sia (Sonox) (the buyer) concluded a purchase of grain contract with a Canadian company, Albury Grain Sales Inc (Albury) (the seller). Sonox paid the deposit of 413, 000 US dolloars as demanded in the contract. However, Albury refused to ship the goods or to return the deposit, based on a claim of a default by Sonox. Sonox then brought an action in the Quebec Superior Court against Albury and two of its principals, alleging that Albury was engaged in an international fraud scheme in collecting deposits from buyers without any intention of delivering any contracting goods, thus the contracts are invalid. Sonox sought declaratory relief, an order supporting the pre-judgment seizure and damages for 800, 000 US dollars. Albury, the defendant, sought to dismiss or stay the action and refer the parties to arbitration, alleging that the court lacks jurisdiction in the subject matter due to the existence of the arbitration clause.

It would be helpful to do further analysis by looking at the arbitration clause in the contract. Article 11 of the contract with the title of "binding arbitration" reads that "the buyer and seller agree to attempt to resolve all disputes in connection with this contract of the fulfilment of this contract through friendly discus-

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[929] Honnold, John O. (1999), *Uniform Law for International Sales under the 1980 United Nations Convention*, Hague: Kluwer Law International, 3rd ed., p. 66.
[930] Ibid, p. 67.
[931] Schlechtriem & Schwenzer (2005), Article 35, V. Remedies, 45 (c), p. 431.
[932] If a breach is fundamental, avoidance is possible under article 49 (1)(a); it seems that the buyer has the right to avoid the contract if the seller does not provide 'clean' documents, under the L/C payment method, which is considered from the documentation perspective; the author holds the view that CISG, used together with INCOTERMS and UCP may solve potential problems in documentary sales law, for further discussion, see Schwenzer, Ingeborg (2005-06), 'Avoidance of the Contract in Case of Non-Conforming Goods (Article 49(1)(A) CISG), *Journal of Law and Commerce*, Vol. 25: 437; generally, see Magnus, Ulrich (2005-06), 'The Remedy of Avoidance of Contract Under CISG – General Remarks and Special Cases', *Journal of Law and Commerce*, Vol. 25: 423.
[933] It is argued that the remedy of damages under CISG has caused several problems which are not dealt with in a uniform manner; for further arguments and suggestions, see Saidov, Djakhongir (2005-06), 'Damages: the Need for Uniformity', *Journal of Law and Commerce*, Vol. 25: 393; for different approaches towards the application of provisions concerning damages, see Eiselen, Sieg (2005-06), 'Proving the Quantum of Damages', *Journal of Law and Commerce*, Vol. 25: 375.
[934] 2005 CarswellQue 5537, Cour supérieure du Québec, 2005, Court File No.: 500-17-026371-057, Buffoni J.C.S., Judgment delivered on 27 July, 2005.

sion. If the dispute cannot be resolved through friendly discussion, the dispute shall be arbitrated in London, UK by the ICC with the prevailing law to be the 'UN Convention on Contracts for the International Sale of Goods (1980)' and the law of Canada"[935].

Sonox argued that the arbitrators would not have the jurisdiction to decide contracts voidable from the beginning, even though arbitrators generally have jurisdiction to interpret and apply contracts; and claimed that it lacked the essential consent to voluntarily refer disputes to arbitration, because of the fraudulent misrepresentations made by Albury.[936] The court held that the actions alleging false representations and seeking the annulment of contract are not excluded from the application of an arbitration clause.[937] Sonox's argument on the lack of consent was rejected, according to the rule that an arbitration clause is distinct from the main agreement. Therefore, the arbitration clause was separate from the main contract, which accords with the principle of avoidance of contracts generally in article 81(1) of the CISG. Thus, the court eventually decided that the matter should be referred to arbitration due to the arbitration clause and the court did not have jurisdiction; whether or not the fraud taints the contract was a question that the arbitrator should have dealt with.[938]

In this case, the court can be criticised for not dealing with the impact of the allegation of fraud and the exclusion of validity issue under article 4(a) of the CISG.[939] Making a case decision by rigidly following the literal wording of an arbitration clause seems unsatisfactory when fraud occurs, because fraudulent misrepresentations are rarely within the realistic expectation of parties when concluding a contract.[940]

Furthermore, the fact that the court did not consider the timing of the plaintiff's objection to the arbitration clause due to the alleged fraudulent misrepresentations was criticised.[941] If Sonox had argued that Sonox would not have agreed to enter into a contract without the fraudulent misrepresentation, then the court may have addressed whether the arbitration clause was an "additional or different term' that significantly changed the terms of the original offer.[942] Article 19(3) of the CISG provides that "additional or different terms relating, among other things, to the price, payment, quality and quantity of the goods, place and time of delivery, extent of one party's liability to the other or the settlement of disputes are considered to alter the terms of the offer materially". It was argued that the court failed to analyse whether the substance of the fraud allegations constituted sufficient grounds to nullify the arbitration clause.[943]

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[935] Ibid.
[936] Ibid.
[937] Ibid.
[938] Ibid.
[939] Pribetic, Antonin I. (2006), 'Arbitration and Fraudulent Misrepresentation: Another Canadian Court overlooks the CISG', *The Globetrotter*, Vol. 10, No. 3, January, available at www.smhilaw.com/Publications/intgljan06_extract.pdf, accessed 9 October, 2008, p. 6.
[940] Ibid.
[941] Ibid, p. 7.
[942] Ibid.
[943] Ibid.

Even though there are the above criticisms, we consider that the court correctly confirmed the separability principle of arbitration agreement based on widely accepted arbitration theory, where the applicable CISG does not provides applicable rules. It can be observed that as fraud is not a normal circumstance, usually it is not handled in a clear manner in contract law; in almost all fraud disputes, a domestic law has to be turned to in order to determine such disputes.

4.2.5 Interim Measures in Arbitration Proceedings

Interim measures in arbitration are literally kinds of relief granted before the final awards.[944] Nowadays, most arbitration laws and rules accept that both the courts and the arbitral tribunal have the jurisdiction to grant interim measures, but there are still some countries that only allocate such authority to national courts.[945] Nevertheless, the term "interim measure" has been practiced differently in different jurisdictions; in other words, there are still differences concerning where, how and when to apply for such measures in different countries.[946]

Even if the jurisdiction of arbitrators of granting interim measures in general is recognised, it is still controversial as to whether or not to include some particular measures, such as a freezing order or interlocutory injunction.[947] In cases of emergency or necessity, *ex parte* order (an order without notice) is necessary, but most national legislation, conventions and arbitration rules are silent on this kind of order.[948] This unfortunately leaves a gap and gives the arbitration practice concerning interim measures an uncertain status. Furthermore, one has to distinguish interim measures against one of the parties to the arbitration agreement and those against third parties, because the arbitration agreement can limit arbitrators to grant orders issued only against the parties of the agreement.[949]

Interlocutory injunctions or freezing orders belong to interim measures.[950] We intend to find out how these legal instruments operate as a remedy in arbitration proceedings over L/C fraud disputes.

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[944] Moses. Margaret L. (2008), p. 100; can also be called "provisional measures", see Born, Gary B. (2001), p. 919, Poudret, Jean-François & Besson Sébastien (2002), p. 518.
[945] Redfern, Alan & Hunter, Martin (2004), pp. 393-401; see also Rubino-Sammartano, Mauro (2001), pp. 617-622.
[946] For discussion on the evolution of interim measures in international commercial arbitration, the authority of national courts to order interim measures in arbitral proceedings, the issue of enforceability and so forth, see e.g. Fry, Jason (2003), 'Interim Measures of Protection: Recent Developments and the Way Ahead', *International Arbitration Law Review*, 6 (5), 153-160.
[947] Poudret, Jean-François & Besson Sébastien (2002), pp. 522-523.
[948] Tweeddale, Andrew & Tweeddale, Keren (2005), p. 304.
[949] Rubino-Sammartano, Mauro (2001), p. 631.
[950] The various types of interim measures have been classified into five groups: measures for the preservation of evidence; measures to regulate and stabilise relations between the parties during the proceedings; measures to secure the enforcement of the award; measures to provide security for costs; orders for interim payments, see Lew, Julian DM & Mistelis, Loukas A & Kröll, Stefan M (2003), pp. 595-600.

In England

In England, by and large the arbitrators are assumed to be much more active than the courts as to interim measures.[951] According to the Arbitration Act 1996, the arbitrators have certain powers, including the power to order security for costs, to inspect and preserve property, and to preserve other evidence, as long as the parties have not agreed otherwise.[952] If there is an agreement between the parties, the arbitrators may also have other powers, such as the power to make provisional awards regarding money or property.[953] Thus, making provisional awards is a power that can only be exercised under the express agreement of the parties. However, it should be born in mind that such an agreement may only take effect when parties have selected arbitration rules that allow the arbitrators such powers. Therefore, in theory, the arbitral tribunal subject to Arbitration Act 1996 may issue interlocutory injunctions and freezing orders in arbitration proceedings.

In addition, interim measures may also be issued by English courts to support foreign arbitration proceedings.[954] In the development of international arbitration law, the majority seems to prefer the view that court intervention should be limited in arbitration cases; however, it is argued that the role of the court can be supportive, rather than disruptive.[955] We will consider this issue particularly where fraud allegations are involved in arbitration cases.

Section 44 of Arbitration Act 1996 provides that the courts have the power to support arbitral proceedings; one such court power is the granting of a freezing order under application. In a recent case *Mobil Cerro Negro Ltd v. Petroleos de Venezuela SA*[956], a worldwide freezing order was set aside, but the freezing order had been granted in earlier proceedings to support a New York ICC Arbitration between the Venezuelan state-owned Petroleos de Venezuela SA (PDVSA) Oil Company and a subsidiary of Exxon-Mobil. The significance of the decision lies in the examination of the court's ability to exercise freezing orders in support of foreign arbitrations. Such power of exercising a freezing order was similar to the power under the CJJA 1982, s.25 regarding support to foreign litigation. A "sufficient connection" to England has to be established in order for the court to exercise both powers, but such a requirement of connection can be ignored in a case of fraud.[957]

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[951] Section 44 (5) of the Arbitration Act provides that "in any case the court shall act only if or to the extent that the arbitral tribunal, and any arbitral or other institution or person vested by the parties with power in that regard, has no power or is unable for the time being to act effectively", and is interpreted that in general the courts should refrain from dealing with such measures, unless it is necessary, see Rubino-Sammartano, Mauro (2001), p. 651.

[952] English Arbitration Act 1996, section 38.

[953] Ibid, section 39; for further discussion about arbitration agreement and authority of arbitrators to grant interim measures, see Drahozal, Christopher R., 'Party Autonomy and Interim Measures in International Commercial Arbitration', in Jan van den Berg, Albert (Ed.) (2003), pp. 179-189.

[954] However, the court could apply a different approach, which reflects the general principle that the supervisory and supportive jurisdiction should be the courts of the seat of the arbitration, Tumbridge, James (2008), p. 294; see *Econet Wireless Ltd v. Vee Networks Ltd* [2006] EWHC 1568 (Comm).

[955] Reynomd, Claude (1993), 'Case Comment: The Channel Tunnel Case and the Law of International Arbitration', *L.Q.R.*, 109 (Jul), 337-342, p. 341.

[956] [2008] EWHC 532 (Comm).

[957] Tumbridge, James (2008), p. 293.

However, generally, English courts are very cautious in granting such orders where an arbitration agreement has been chosen by the parties.[958] In the *Channel Tunnel* case, the HL decided that it had jurisdiction, but refused to issue the injunction order because of the potential conflict between the court's tentative assessment of the merits of a case and respect for the choice of arbitral tribunal by the parties.[959]

In China

Interim measures mainly refer to the order of preservation of property in China. Article 94 of PRC Civil Procedure Law limits the scope of the property subject to the order to that being "relevant to the case" and provides the methods of carrying out property preservation order, including sealing up, distaining, freezing or other methods prescribed by law. Under the PRC Arbitration Law 1994, arbitrators do not have the powers to issue interim measures, and the arbitral tribunal should submit one party's application to the courts based on the regulations of CPL.[960] It was recommended that the arbitration law in China should grant the power of ordering interim measures to the arbitral tribunal so as to advance arbitration in China.[961]

According to the PRC Arbitration Law 1994, it can be deduced that the application for a freezing order should be filed between the beginning of arbitration proceedings and the issuance of the award. However, if there is an urgent need to preserve property before arbitration proceedings commence, the applicant can apply for a preservation order directly to the competent court.

The case *China Everbright Foreign Trade Hubei Branch v. For-Trameyer GmH* (2003) concerns several important points, including the liability of the beneficiary, the preservation order in arbitration, the impendence principle of L/C, the court intervention to L/C and so forth.[962] The preservation order we are discussing is merely one of the key issues. In the case, China Everbright in a CIETAC arbitration applied for the preservation of property (freezing order) with regards to an

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[958] Lew, Julian DM & Mistelis, Loukas A & Kröll, Stefan M (2003), *Comparative International Commercial Arbitration*, The Hague: Kluwer Law International, p. 625.

[959] *Channel Tunnel Group Ltd v. Balfour Beatty Construction Ltd* [1993] AC 334; for further comment on the case about the point of the court's jurisdiction relating to international arbitration, see Collins, Lawrence (1993), 'Case Comment: The End of the Siskina', *L.Q.R.*, 109 (JUL), 342-344.

[960] See PRC Arbitration Law 1994, article 28.

[961] Deng, Jie (2005), *Theory and Practice of Commercial Arbitration Law*, Lanzhou: Lanzhou University Press, 1st ed., pp. 179-180; Cao, Lijun (2005), 'Interim Measures of Protection in the Context of Arbitration in China', *International Arbitration Law Review*, 8(3), 103-109, p. 109; this article also discusses the factors that the courts consider when dealing with applications for interim measures, the granting of ex parte measures, appeals against the granting of interim measures and so forth.

[962] For further comment concerning each issue, see Tang, Shumei (2006), pp. 54-59.

unpaid L/C on the grounds of falsification of the BLs by For-Trameryer.[963] China Everbright applied for arbitration to CIETAC in September 1994 according to the arbitration clause of the sale contract, alleging about RMB 17 Million as compensation for the applicant's losses.[964] However, the grounds of the claim were that the respondent falsified documents and antedated BLs, which seriously delayed the arrival date and constituted a fundamental breach of the contract. After submitting the case to arbitration with CIETAC, China Everbright applied to freeze the funds under the four L/Cs endorsed by the bank. On 21 September, CIETAC transferred the request to Hubei Province High People's Court for a property preservation order and China Everbright provided a guarantee to the court connected with the application. The Court decided that the application for property preservation was legitimate and ordered that the funds be frozen under the L/Cs which were merely endorsed but not paid by the bank.

Thus, some arbitral tribunals may have the power to issue interim measures like the courts, but they are more likely subject to parties' agreement and such powers depend on where the arbitral tribunal is located and which arbitration procedural rules are chosen. In some other countries, such as in China, the arbitral tribunal may not be allowed to have such powers of granting some interim measures. In that case, it is still the courts that handle the issues of interlocutory injunctions or freezing orders.

4.2.6 Can an Arbitral Tribunal Award Punitive Damages?

Generally, the powers of an arbitral tribunal are not precisely parallel to those of a court. An arbitral tribunal usually has no power to imprison anyone and to impose penalties in the form of fines, which are sovereign powers reserved to judges in national courts. However, it is attractive if an arbitral tribunal has the same jurisdiction to a national court to award damages according to the law applicable to substantive merits of a dispute. In some cases, an arbitral tribunal

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[963] Hubei Province, HPC, Civil Order, see Jin, Saibo (2005), *PRC Law on Letter of Credit & Trade Financing: Cases and Regulations*, Peking: Law Press China, 1st ed., pp. 527-530; The basic facts are as follows: China Everbright (the "applicant"), and For-Tranmeyer (the "respondent") concluded two sales contracts in 1994. According to the contracts, the respondent was obliged to have the shipment to be delivered to Shantou Port, within 40 days after the L/C was opened. The applicant opened four L/Cs in favour of the respondent, through the Bank of Communications, Wuhan Branch. Then he applicant received from the respondent a shipment notice stating that the goods had been delivered according to the later amended shipping date. After this notice, the applicant then entered into a sale contract with Shantou Zhongjian Real Estate Development Corporation (Shantou Zhongjian) and the contracted goods were the goods purchased by the applicant from the respondent. Thereafter, Shanout Zhongjian paid RMB 14.4 Million deposit to the applicant. The respondent presented the full sets of BLs to the issuing bank, which endorsed on such L/Cs with an agreed payment date. However, the respondent failed to deliver the goods by the contracted date, and the ship arrived 9 days late. Shantou Zhongjian did not accept the goods; subsequently it filed a claim against China Everbright and required China Everbright to refund two times the deposit amount and to pay the liquidated damages. It was found with conclusive evidence that two of the four BLs were falsified and the others had been antedated. The real delivery date was 11 June 1994, instead of the agreed contracting date 25 May.

[964] There was another similar case between a buyer in China and a seller in America, concerning antidated BL and L/C; in the arbitration, both parties accepted the fact of anti-dating BL, and the buyer claimed damages, see Tang, Shumei (2006), *International Economic Case Analysis*, Peking: China Renmin University Press, 2nd ed., pp. 36-38.

may even have wider powers than those of a judge, because the tribunal's powers primarily derive from the arbitration agreement.[965]

Traditionally, in the civil law field, compensations and damages are fundamentally based on the maxim of equivalence. Generally in tort and contract disputes, compensation for damages is governed by the principle of full compensation, which means that the victim shall be compensated in a situation as if no damage had occurred. Thus, either in case law or in common law countries or in statutes of civil law countries, the ideas of compensatory damages are widely accepted and practiced.

In addition, the idea of liquidated damages and contractual penalties in certain types of contract, dealing with the parties' anticipation of the consequences of a breach of contract, are also recognised in an international Convention CISG.[966], but their validity is governed by domestic laws.[967] To distinguish the two concepts is necessary: liquidated damages represent a measure of damages in the event of a breach; but a penalty is a guarantee for the performance of a contract and generally functions to provide compensation and also as a threat.[968] However, it has to be kept in mind that some jurisdictions such as England may consider contractual penalty clauses as having a punitive element and generally are not enforceable.[969]

In the area of international trade, compensatory damages under a fair and full principle seem inadequate under some circumstances[970]; further damages may be required from the injured party when the wrongful act performed was aggravated by cases of violence, oppression, malice or fraud.[971] The civil liability towards punitive or exemplary damages thus is developing. The main purpose of such punitive damages is not to compensate but to punish the faulty conduct of the tortfeasor and to deter future similar wrongful action.[972] In the countries where punitive damages are allowed, the main area remains in torts disputes. However, it also seems possible to find punitive damages in the field of contractual liability (especially international contractual liability) where the wrongful act done to the victim was aggravated by the cases of violence, oppression, malice or fraud.[973]

As Blogett and Mayer proposed earlier, an arbitration clause may allow an arbitral tribunal the power to award punitive damages under particular circumstances. However, it seems that the idea of punitive damages is indeed a debated issue, and many countries have different attitudes toward it. If judges have to be

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[965] Redfern, Alan and Hunter, Martin (2004), *Law and Practice of International Commercial Arbitration*, London: Sweet & Maxwell, 8-11, p. 423.
[966] CISG, article 74, VI. Contractual provisions regarding liability, 1. Liquidated damages and penalties.
[967] Schlechtriem & Schwenzer (2005), article 4, 23 (e) Assignments, penalties, p. 74.
[968] Cremades, Bernado M. (2002), p. 330.
[969] Ibid.
[970] Robin, Guy (2004), 'Punitive Damages in International Transactions', *I.B.L.J.* 3, 247-267, p. 247.
[971] Cremades, Bernado M. (2002), 'Liquidated Damages, Penalty Clauses and Punitive Damages within International Contracts', *I.B.L.J.* 3/4, 329-345, p. 333.
[972] Wier, Tony (2002), *Tort Law*, Oxford: Oxford University Press, 1st ed., p. 200; see also Feng, Lijia (2009), 'Punitive Damages', *Legal System and Society*, No. 1 (2nd Issue), 375; further discussion on the function of punitive damages, see Sun, Meng (2010), 'Function and Value of Punitive Damages', *Youth Science*, No. 5, 42.
[973] Robin, Guy (2004), pp. 247-248.

bound by national laws when dealing with punitive damages in disputes, are arbitrators indeed able to award punitive damages only based on an arbitration agreement, without considering what national laws have specified on punitive damages? Will awards containing punitive damages be enforced as normal arbitral awards?

In order to answer the proposed questions, and to appreciate the value of punitive damages brought to international transaction disputes, we will firstly examine the development of punitive damages in several individual countries. In this section, most of the the relevant cases concerning punitive damages discussed in different countries are dealt with by the courts. On the one hand, it is important to consider the courts' attitudes towards punitive damages, as the courts have a final decision when the enforcing of an arbitral award including punitive damages becomes necessary. On the other hand, few arbitral cases have touched on the issue of punitive damages. Then, the issue of arbitrators' jurisdiction towards punitive damages, arbitral awards containing such damages, and the recognisation and enforcement of such arbitral awards will be discussed respectively.

Development of Punitive Damages in Different Countries

In England

Multiple damages statutes were already part of English law early in 1278, and there were also court cases concerning punitive damages in the 18th century.[974] Under the law in England, traditionally punitive damages are allowed in torts, such as trespass, conversion, defamation and intimidation.[975] The application has been gradually restricted by the HL in 1964 and the fundamental principle is that punitive damages are not applied in contractual liability, but restricted in tort, especially in cases of infringement to public rights and in case of slander.[976] Lord Devlin's speech seemed to limit the scope of punitive damages in torts in three particular categories of cases.[977] In *Mafo v. Adams*[978], the CA seemed to have had a debate on whether punitive damages could be applied in tort of deceit. The case *R. v. Secretary of State for Transport* reconfirmed the previous principle that merely compensatory damages should be awarded; penal damages are only possible where the English statute explicitly provided so.[979]

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[974] Brand, Ronald A. (2005), 'Punitive Damages Revisited: Taking the Rationale for Non-recognition of Foreign Judgment Too Far', *Journal of Law and Commerce*, No. 24: 181, p. 182.
[975] Anderson, Lesley J. (1992), 'An Exemplary Case for Reform', *C.J.Q.*, 11 (JUL), 233-260, p. 247. For contract cases, see *Addis v. Gramphone Co. Ltd* [1909] A.C. 488, with exceptions to the general rule at 495; for actions in tort see *Rookes v. Barnard* [1964] A.C. 1129, [1967] 1 Lloyd's Rep. 28, HL.
[976] Robin, Guy (2004), p. 249.
[977] "oppressive, arbitrary or unconstitutional action by representatives of the Government; where the defendant's conduct has been calculated by him to make a profit for himself which may well exceed the compensation otherwise payable to the plaintiff; where exemplary damages are expressly authorised by statute", see *Rookes v. Barnard* [1964] A.C. 1129, and *Cassell & Co. Ltd v. Broome* [1972] A.C. 1027.
[978] [1970] 1 Q.B. 548.
[979] Gordon, Charles A. (1998), p. 144.

Interestingly, where claims both in contract and tort are available, the decisions over such disputes are essential, as they determine whether such damages are applicable for pure contractual claim.[980] However, the authority in England demonstrated its negative attitude against punitive damages in contractual disputes.[981] The Law Commission in 1997 suggested widening the scope of punitive damages to civil offences and to "equitable wrongs", but made it clear to exclude cases concerning breach of contract.[982]

Can a foreign court judgment covering punitive damages be enforced in England? In general, the English courts would not enforce (either directly or indirectly) a penal law.[983] However, in England the enforcement of punitive damages is not considered as being against public policy.[984] But English law will greatly affect the enforcement issue. We will discuss this issue by analysing a court case in which a US court judgment awarding such damages requested enforcement in England.

In the case *Lewis v. Eliades and others*[985], the CA dealt with the enforcement issue of an original US court judgment awarding multiple damages on grounds of fraud, breach of fiduciary duty, breach of contract and racketeering. The legal basis in the US supporting the multiplied damages was the Racketeer Influence and Corrupt Organisations Act (RICO). The judgment creditors Lewis initiated enforcement proceedings in England to request the damages awarded in New York. Important questions could be: did the RICO factor render the whole judgment unenforceable; or could the damages be separated so as to enforce the part of it allowed by the English law?[986]

The judgment debtors argued that such a judgment could not be enforced according to the Protection of Trading Interests Act 1980[987](1980 Act), because this 1980 Act did not allow multiplied damages to be enforced.[988] The judgment

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[980] Anderson, Lesley J. (1992), p. 248.
[981] *Drane v. Evangelou* [1978] 1 W.L.R. 455; *Kenn v. Preen* [1963] 1 Q.B. 499; *Perera v. Vandiyar* [1953] 1 All E.R. 1109.
[982] The Law Commission, the 32nd Annual Report 1997, Modern Law for Modern Needs, Law Commission document No. 250, Part 2 Common Law, Damages, Para 2.2, p. 17, available at http://www.lawcom.gov.uk/docs/L/C250.pdf, accessed 17 Nov., 2009.
[983] Further discussion, see Loble, Steven, 'Enforcement of Foreign Judgments in England', available at www.loble.co.uk/enforcement_of_foreign_judgments.htm, accessed 08 May, 2008.
[984] *S A Consortium General Texitles v. Sun and Sand Agencies Limited* [1978] 1 Lloyd's Rep.134 (CA, Civ Div.).
[985] [2004] 1 W.L.R. 692 (CA (Civ Div)); [2003] EWCA Civ 1758, Potter, Carnwath and Jacob LJJ, 2003 Oct 9, Dec. 8.
[986] Malcolm, Emma (2004), 'Case Comment – Winning the Fight for the Enforcement of US Damages', *Entertainment Law Review*, 15(4), 133-134, p. 133.
[987] 1980, c.11; in force on 20 March 1980; section 5 of this Act, titled as "Restriction of enforcement of certain overseas judgments, concerning the enforcement of multiplied damages from foreign countries, reads that: "*(1) A judgment to which this section applies shall not be registered under Part II of the Administration of Justice Act 1920 or Part I of the Foreign Jurisdictions (Reciprocal Enforcement) Act 1933 and no court in the United Kingdom shall entertain proceedings at common law for the recovery of any sum payable under such a judgment. (2) This section applies to any judgment given by a court of an overseas country, being – (a) a judgment for multiple damages within the meaning of sub-section (3) below; … (3) in sub-section (2) (a) above a judgment for multiple damages means a judgment for an amount arrived at by doubling, trebling or otherwise multiplying a sum assessed as compensation for the loss or damage sustained by he person in whose favour he judgment is given.*"
[988] [2004] 1 W.L.R. 692 (CA (Civ Div)), paras. 30-36, pp. 700-701.

debtors further claimed that the entire judgment was indivisible, and thus wholly unenforceable.[989] The court construed that the s.5 (3) of 1980 Act prevents the recovery of the part of the award that had been multiplied, rather than the entire award.[990] Thus, if the RICO punitive factor of the award was taken off, then the remaining part could be considered as compensatory damages (a remedy also available under English law), and should be enforced.[991] The court further inferred that where only part of a judgment constituted an exception to enforcement, the court should consider whether that part could be separated or distinguished from the entire judgment; if it could, the remaining sums should be enforceable.[992] Thus, generally, it seems that where enforcement of a foreign court judgment covering punitive damages is sought in England, only the part of a compensatory nature can be enforceable.

In USA

The origin of the punitive damages in the United States derives from the case law in England, but their application seems broader than in England. The principle of punitive damages has been practiced for a long time in America. It is more interesting to point out that certain federal jurisdictions have applied the idea to cases of breach of contract involving fraud or to outrageous civil offences.[993] However, the standards of applying the idea are not at the same level in State jurisdictions.[994]

In Canada

The principle of punitive damages is generally accepted in Canada and the watershed case was *Whiten v. Pilot Insurance Co*[995] in 2002. Canadian courts have to a large extent accepted the principle of punitive damages since 1989.[996] In general, the traditional principles against punitive damages for breach of contract prior to the Whiten case have been summarised as follows: first, the aim is to punish the defendant where compensatory damages would not do; second, such awards are restricted to definite classes of cases; third, in contractual disputes, such awards may only be available where an wrongful action which is not necessarily a crime or a tort had to be committed; fourth, the conduct of the defendant has to be egregious in some manner.[997]

In the case *Royal Bank of Canada v. W. Got and Associates Electric Ltd*[998], the punitive damages were awarded for breach of contract by a bank; the Supreme

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[989] Ibid, paras. 37-39, pp. 701-702.
[990] Ibid, para. 41, p. 702.
[991] Ibid, paras. 48-52, pp. 703-705.
[992] Ibid, paras. 53-62, pp. 705-706.
[993] Robin, Guy (2004), p. 249.
[994] For instance, in order to allocate punitive damages, a certain level of bad faith within the breach of contract seems enough to satisfy the courts in California, but generalised fraud, which indicates a high degree of immorality or dishonesty, has to be established for the courts in New York, see Robin, Guy (2004), p. 249.
[995] (2002) 209 D.L.R. (4th) 257 (SCC).
[996] Ogilvie, M. H. (2004), 'After Whiten: Punitive Damages for Breach of Contract in Canada', *J.B.L.* Sep., 549-563, p. 551.
[997] Ibid, p. 553.
[998] (1999) 178 D.L.R. (4th) 385, (SCC).

Court considered that the conduct of the bank "did not have to rise to the level of fraud, malicious prosecution, or abuse of process", and it seriously offended the administration of justice.[999] In the case, deterrence, being one primary purpose of punitive damages was recognised by the court; and "administration of justice" justified further deterrence where only compensatory damages could not provide.[1000] But it was criticised that the court did not consider any theoretical issues or policy rationale, and thus the reasons and principles for punitive awards were unclear.[1001]

In the case *Whiten v. Pilot Insurance Co*, the Supreme Court of Canada dealt with the issue of whether or not punitive damages could be applied in cases of breach of contract. The discussion of the nature of punitive damages in contract disputes and the extensive citation of the *Whiten* case demonstrated a new development in the law of damages for breach of contract by the courts in Canada.[1002] However, the principle of punitive damages in contractual disputes has not been taken up on a in a large-scale in Canada. After the *Whiten* case, the Canadian courts were actually prudent in awarding such punitive damages; and the relevant cases still fall into the types of wrongful dismissal and breach of good faith by insurance companies.[1003]

As for the enforcement of foreign punitive awards, the development in Canadian courts seemed to be more dynamic than in other countries. It is reported that the Supreme Court of Canada supported the enforcement of punitive damages granted by a Florida court in the case *Beals v. Saldanha*.[1004] In the legislation field, Canada developed a new Uniform Enforcement of Foreign Judgments Act[1005], which had been adopted in 2003[1006]. According to Section 6 of this Act, the Canadian courts are allowed to recognise and enforce both punitive and "excessive" damages, but the enforceable amount is limited by the law of the province or territory where enforcement is sought. It was commented that the liberal approach adopted by Canadian courts towards foreign judgment recognition seems more appropriate to international business transactions in a modern and global world.[1007]

In Germany and France

Generally, in civil law countries, the legal concept of punitive damages is rarely known. The German and French legal system does not allow punitive damages, as the civil law does not accept the punitive role of such damages; and punitive

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[999] Ibid, pp. 394 -395.
[1000] Edelman, James (2001), 'Case Comment - Exemplary Damages for Breach of Contract', *L.Q.R.*, 117 (OCT), 539-545, p. 540.
[1001] Ogilvie (2004), n. 996 above, p. 553.
[1002] Fridman, G. H. L. (2003), 'Punitive Damages for Breach of Contract – A Canadian Innovation', 119, *L.Q.R.* 20.
[1003] Oglive (2004), n. 996 above, p. 559.
[1004] Brand, Ronald A. (2005), p. 191.
[1005] Available at http://www.ulcc.ca/en/us/index.cfm?sec=1&sub=1e5, accessed 17 Nov. 2009.
[1006] Table V – 2006, Uniform Acts Adopted since 2000, showing implementation by Jurisdiction, available at http://www.ulcc.ca/en/us/Table_5_En.pdf, accessed 17 Nov. 2009.
[1007] Brand, Ronald A. (2005), p. 195.

damages are considered an undue enrichment to the victim and thus do not conform to the principle of proportionality between compensation and damage.[1008] Thus, it is possible that the German or French courts dismiss the enforcement on the grounds of being against public order, as it does not follow the principle of equality.[1009]

However, the enforcement of a foreign arbitration award may not always fall in the same situation as the enforcement of a foreign court judgment, because the application of punitive damages in arbitration derives from the will of parties, and an explicit agreement should be respected by civil law.[1010]

In China

In the academic world in China, generally there are two contrasting schools of thought towards punitive damages. One is that damages can be both compensatory and punitive; whereas the other is that damages in general are compensatory in nature, and the punitive element only applies to exceptional circumstances.[1011] However, punitive damages have been stated in several laws in China. The first is article 49 of the Law on Protection of Consumer Rights and Interests.[1012] This is considered as a breakthrough to the traditional principle of compensation in China, but this article is argued to have limited scope and function,[1013] and the remedy after a consumer suffers the damage is limited.[1014]

The second is the Interpretation of the SPC on the Relevant Issues concerning the Application of law for Trying Cases on Dispute over Contract for the Sale of Commodity Houses, article 9.[1015] This advanced the application of punitive damages in China.[1016] The third is the recently issued Food Safety law, article

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[1008] Robin, Guy (2004), p. 250.
[1009] Ibid.
[1010] Ibid, pp. 250 -251.
[1011] Yang, Lixin (2008), *Tort Damages*, Peking: Law Press China, 4th ed., pp. 322-324; Cheng, Zongzhang, 'Enforcement of Punitive Damages judgment', available at http://kbs.cnki.net/forums/20191/ShowThread.aspx, accessed 27 Oct., 2009.
[1012] Adopted at the 4th Meeting and the Standing Committee of th 8th NPC on 31 Oct., 1993, and entered into force as of 1 Jan., 1994, article 49 provides that "business operators engaged in fraudulent activities in supplying commodities or services shall, on the demand of the consumers, increase the compensations for victims' losses; the increased amount of compensations shall be two times the costs that the consumers paid for the commodities purchased or services received".
[1013] Song, Zhihui (2008), 'Study on Punitive Damages of Products Liability', *Market Modernisation*, No. 7, 255; some recommend that the elements that can apply punitive damages include not only fraud, but also deliberation, malicious tort, culpable negligence and so forth, see Song, Jie & Song, Qian (2007), 'On the Punitive Damages System', *Shandong Justice*, Vol. 23, No. 5 (Serial No. 178), 80, p. 82.
[1014] Dong, Chunhua (2008), 'Comparative Study of Punitive Damages System in Different Countries', *Eastern Forum*, No. 1, 119, p. 123; for further discussion on the shortcomings of this article, see Hao, Yuhong (2007), 'Application and Improvement of Punitive Damages System', *Journal of Zhongzhou University*, Vol. 24, No. 3, Jul., 20, p. 21; see also Liu, Guangjian & Chen, Shiqiang (2010), 'On Punitive Damages in Consumer Rights Protection in China', *Industrial & Science Tribune*, Vol. 9, No. 1, 101.
[1015] Was adopted at the 1267th meeting of the Judicial Committee of the SPC on 24 March 2003, and came into effect on 1 June 2003; article 9 provides that after a seller makes a sales contract of commodity house with a buyer, three specific circumstances can lead to the contract being invalid or revoked; in such situations, if the buyer has paid for the house, the buyer can require the seller to refund the paid amount and the interest thereof and compensate for the loss incurred, and the buyer can also require the seller to take the liability of paying damages not more than one times the paid amount for buying the property.
[1016] Zhang, Xinbao & Li, Qian (2009), 'Legislation Choice of Punitive Damages', *Tsinghua Law Review*, Vol. 3, No. 4, 5, p. 10.

96.[1017] The fourth is the most recently issued Tort law of the PRC[1018]; article 47 clearly states that the victim has the right to claim appropriate punitive damages from the tortfeasor, where the tortfeasor knows a product is defective, but still produces and sells the product thus leading to death of others or causing serious damage to health of others. This article makes enterprises take a more strict liability, and reconfirmed the positive attitude of legislators towards punitive damages in China.

The scope of application of punitive damages is a significant issue. It has been pointed out that the laws in China on punitive damages are more about product liability[1019], and concern the contracts between business operators and consumers and relate to the consumers' rights.[1020] It is argued that it would be improper to widely adopt punitive damages in China when its market economy is at its early stage.[1021] It is recommended that punitive damages be applied mainly in tort liability, and narrowly in the contract field.[1022] It is claimed that punitive damages is applicable in circumstances of a wilful breach of contract in China; and judicial interpretation in China has confirmed punitive damages.[1023] However, it seems that punitive damages have not been accepted in disputes concerning normal commercial contracts between two commercial parties.[1024] Furthermore, as for the issue of whether punitive damages can be applied in international commercial arbitration, neither legislation nor judicial practice is clear in China.[1025]

The court judgments based on such laws are likely to be considered as punitive awards. Where the disputes concern international commercial parties, it is unavoidable that punitive awards in China are required to be enforced in foreign countries, or foreign punitive damages are asked to be enforced in China. Does

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[1017] Was adopted at the 7th Session of the Standing Committee of the 11th NPC on 28 Feb., 2009, and came into force on 1 June, 2009, article 96 stipulates that "if provisions of this law are violated and personal, property or other damages are resulted in, producer or sellers shall be liable for compensation; producing foods that do not meet food safety standards and knowingly selling foods that do not meet with food safety standards, consumers can ask the producers or sellers to pay the ten times of compensation, in addition to damages".

[1018] Adopted at the 12th session of the Standing Committee of the 11th NPC on Dec. 26, 2009, was hereby promulgated and came into force on 1 July 2010, Decree of the President of PRC (No. 21),

[1019] For further discussion, see e.g. Liu, Di (2009), 'Study on Punitive Damages in Application of Tort Law in China', *Law and Practice*, No. 2, 20.

[1020] Wang, Liyun (2009), 'Analysis of the Current Situation and Future Development of Punitive Damages System in China', Intermediate Court of Zhuzhou City, available at http://zzzy.chinacourt.org/public/detail.php?id=1660, accessed 27 Oct. 2009; see also Chen, Zhi (2008), 'Current Legislation and Improvement of Punitive Damages System in China', *Journal of Nantong University*, Vol. 24, No. 1, Jan., 125, p. 128; Mo, Xiaochun (2010), 'Study on Punitive Damages in Consumer Contracts', *Commercial Times*, No. 12, 88.

[1021] Wang, Liming (2000), 'A Study of Punitive Damages', *China Social Science*, No. 4, 112; for the reasons for preventing the extension of scope of application of punitive damages especially concerning product liability, see He, Fang (2009), 'Establishment and Limitation of Application of Punitive Damages in China', *Legal System and Society*, No. 1 (1st Issue), 186.

[1022] Chu, Saifa (2009), 'Study on Introduction of Punitive Damage System', *Legal System and Society*, No. 3 (2nd Issue), 358; see also Long, Xin (2009), 'Feasible Proposals on Constructing the Punitive Damages System in China', *Theory Research*, No. 11, 113, p. 114.

[1023] For further discussion, see Sun, Liangguo & Yu, Zhongchun (2009), 'Study on Wilful Breach', *Legal and Social Development (Bimonthly)*, No. 6 (General No. 90), 96.

[1024] Jia, Jing (2008), 'Discussion on Punitive Damages System', *Legal Construction*, No. 1, 73.

[1025] Ji, Jingwang (2010), 'Discussion on Punitive Damages in International Commercial Arbitration', *Journal of Anhui Vocational College of Police Officers*, Vol. 9, No. 1 (General No. 46), 34.

enforcement of foreign punitive damages violate the fundamental legal principles in China?[1026] Unfortunately, the answer cannot be given in a certain manner. Some argue that punitive damages judgments clearly violate the public order of China, and China should refuse such kinds of judgments, although more countries are accepting punitive damages judgments.[1027] Some argue that China may accept such court judgments, but it is recommended that several elements be considered: such a judgment is based on the party's tortuous acts; the object of punitive damages payment is the private party; and whether the amount of punitive damages is reasonable.[1028] However, it is claimed to be difficult to handle punitive damages in judicial practice.[1029]

From the above discussion on the development of punitive damages in several countries, we can observe that whether or not to accept the concept of punitive damages in civil disputes is indeed a controversial issue generally between common law countries and civil law countries. The essential reason for such a debate concerns the punitive element or feature reflected in punitive damages. Even in the countries where punitive damages are recognised, the scope of application is usually narrow and limited to specific types of disputes (e.g. tort), which are mainly regulated in domestic statutes or laws. Furthermore, the disputes in which punitive damages are applied mostly concern 'public order' or 'pubic interest'. The enforcement of a punitive damages court judgment in individual countries seems to be diverse and ambiguous. However, basically the part of a punitive damages court judgment, which is compensatory in nature can be enforced.

Jurisdiction of Arbitrators to Award Punitive Damages

As is widely known, values such as the fight against corruption or money laundering has become universal.[1030] In a similar vein, immoral or illegal behaviour of parties in international trade should also be sanctioned; and punitive damages may be awarded by arbitrators where appropriate.

In the arbitration world, many international arbitration institutions have been established and provide wide powers to arbitrators. In theory, commercial parties also are free to choose the powers that arbitrators may have in deciding their disputes. It is argued that the application of punitive damages by arbitrators may raise the problem of fairness as there is limited juridical review over arbitral

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[1026] Some academics seem to claim that we cannot simply refuse to enforce such judgments because of this principle, see e.g. Hu, Chunxiu (2008), 'Analysis of the Necessity and Feasibility of Establishing Punitive Damages System in China', *Guangxi Zhengfa Ganbu Management College Journal*, 2002, 46-48, available at www.fdc001.cn/falv/2008/0626/article_191.html, accessed 27 Oct. 2009.

[1027] Liu, Enyuan (2010), 'Discussion on Recognition and Enforcement of Punitive Environmental Damages Judgment', *Commercial Times*, No. 3, 86.

[1028] Hu, Minfei (2009), 'Recognition and Enforcement of Foreign Court Judgments Concerning Punitive Damages', *Journal of Zhejiang Gongshang University*, No. 2 (General No. 95), 21, p. 23.

[1029] Yin, Zhiqiang (2006), 'Should Punitive Damages System to be Introduced in Chinese Civil Law', *Legal Science Magazine*, Vol. 27, No. 3, 78.

[1030] See Vincke, François & Heimann, Fritz (Eds.) (2003), *Fighting Corruption – A Corporate Practices Manual*, Paris: ICC, ICC Publication 652; also Karsten, Kristine & Berkeley, Andrew (Eds.) (2003), *Arbitration – Money Laundering, Corruption and Fraud*, Paris: ICC, ICC Publication 651.

awards.[1031] However, it cannot be denied that in most countries, an arbitral award is usually subject to challenges by the law of the seat of arbitration.

In England, it seems unclear as to whether or not arbitrators could award punitive damages in arbitration cases.[1032] Some arbitrators in England consider that it is wrong to issue an award concerning a provision which constituted a penalty under English law, as such an award can be invalid and thus unenforceable.[1033] In the US, there has been a long debate concerning whether the arbitrators may have the power to grant punitive damages.[1034] But the Supreme Court confirmed in a case that the parties could agree to endue arbitrators the power to award punitive damages, whatever a state law regulates.[1035]

Arbitral Awards of Punitive Damages

An arbitral tribunal having the power of awarding punitive damages does not necessarily follow that such damages will be awarded. In addition to the powers and limitations imposed by the parties, an arbitral tribunal will also have to act within the limits of applicable law of the disputes. Thus, when higher damages, on the grounds of breach of contract, than the victim's losses are claimed, the arbitrators must think about whether such damages are appropriate in the dispute under the law applicable to the substance of the dispute.

Besides the issue of applicable law, arbitrators will also have to consider the law of the place of arbitration, because arbitration should be preceded according to the mandatory rules of public policy of the country where arbitration takes place.[1036] Moreover, an essential matter such as enforceability should also be considered by arbitrators. Cautious arbitrators would refuse to award punitive damages where the enforcement of the award has the potential for great risk. Therefore, it is important to carefully draft clauses relevant to punitive damages.[1037]

Recognition and Enforcement of Punitive Damages Internationally

In the early 1990s, the Hague Conference on Private International Law (HCCH) developed work on a new Convention concerning the recognition and enforcement of foreign judgments[1038] in civil and commercial matters. Negotiations between Member States had been conducted several times; unfortunately, there was

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[1031] Cremades, Bernado M. (2002), p. 336.
[1032] Gordon, Charles A. (1998), 'United States Bad Faith Claims: The English Perspective', *International Insurance Law Review*, 6(5), 143-146, p. 145.
[1033] See e.g. Connerty, Anthony (2002), 'The Parties, Not the Arbitrators, Control the Arbitration', 16th ICCA Congress, London, 12-15 May, available at http://www.wwwserv.co.uk/anthonyweb/ICCA%20Paper%2030-04-02.pdf, accessed 25 April, 2008.
[1034] Different State courts held contrasting views towards this issue, see Rubino-Sammartano (2001), p. 186-187; see also Scanlon, Kathleen M. (2003), 'Excluding Punitive Damages in Arbitration Clauses', 21 *Alternatives to High Cost Litigation* 1, June, p. 1.
[1035] Gordon, Charles A. (1998), p. 145.
[1036] Cremades, Bernado M. (2002), p. 337.
[1037] For particular suggestions concerning how to draft such clauses, see Scanlon, Kathleen M. (2003), pp. 2-4.
[1038] For legal analysis on enforcement of foreign commercial judgment, see e.g. Ho, H. L. (1997), 'Policies Underlying the Enforcement of Foreign Commercial Judgments', *International and Comparative Law Quarterly*, Vol. 46, (April), 444.

no consensus on many jurisdiction issues. In particular, concerning punitive and excessive damages, such legal principles seemed extremely unpopular in many countries and there was great doubt about whether the exclusion of such damages would satisfy the Member States.[1039]

Such a project was re-orientated during 2002-2003, and eventually the Convention on Choice of Court Agreements was adopted in 2005. This Convention mainly concerns business to business cases, aims to provide support to the business community and intends to function as a complementary instrument to the 1958 New York Convention.[1040] As to the point of damages, article 11 of the 2005 Convention provides that "recognition or enforcement of a judgment may be refused if, and to the extent that, the judgment awards damages, including exemplary or punitive damages, that do not compensate a party for actual loss or harm suffered". As of 9 November 2009, Mexico, the USA, and the European Community have ratified this Convention.[1041]

Most arbitral awards are performed voluntarily in practice. However, enforcing arbitral awards in national courts is still an important question that cannot be avoided. As examined above, most countries do not recognise punitive damages, and even in countries where punitive damages are allowed, different national courts may have different views towards the applications of such awards. Therefore, if enforcement proceedings are necessary, will an international arbitral award involving punitive damages be enforced?

The main difficulty of enforcing a punitive damage under the New York Convention lies in the "public policy exception" established in article V (b). Article V (b) provides that:

> "Recognition and enforcement of an arbitral award may also be refused if the competent authority in a country where recognition and enforcement is sought finds that:
>
> (a) the subject matter of the difference is not capable of settlement by arbitration under the law of that country; or
>
> (b) the recognition and enforcement of the award would be contrary to the public policy of that country."

As most countries do not accept the principle of punishment in civil liability, most likely enforcement of punitive damages awards would be considered as against the public policy of most countries.

For instance, an ICC arbitration case, conducted in Geneva, concerning a claim for punitive damages, could illustrate such a difficulty. The arbitrators in the case refused such a claim, as they considered that such damages went beyond compensatory nature and constituted a punishment of the wrongdoer, which is contrary to Swiss public policy; but the Swiss public policy must be respected by

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[1039] Borchers, Patrick J. (1998), 'A Few Little Issues for the Hague Judgments Negotiations', *Brooklyn Journal of International Law*, Vol. XXIV: 1, 157, pp. 162-163.
[1040] HCCH, 'Outline Hague Choice of Court Convention', September 2008, available at http://www.hcch.net/upload/outline37e.pdf, accessed 17 Nov., 2009.
[1041] Status Table, 'Contracting States to this Convention', available at http://www.hcch.net/index_en.php?act=conventions.status&cid=98, accessed 09 Nov. 2009.

an arbitral tribunal sitting in Switzerland even if the arbitral tribunal must determine a dispute according to a law that may allow punitive damages.[1042] It was considered that the enforcement of such an award may be refused in Switzerland based on the Swiss Private International Law Statute.[1043]

Thus, it seems that whether a punitive award is enforceable to a great extent depends on the public policy of that country where the award is enforced. However, the uncertain and inconsistent definitions and applications of domestic public policies in different countries make it highly difficult to find a clear conclusion. Fortunately, it seems that more and more countries have understood the public policy exception in the New York Convention as the international principles of fairness and procedural due process, rather than domestic policies or laws; and have accepted that usually the scope of international public policy is narrower than the domestic one.[1044] Furthermore, courts in some countries have recognised that an international rather than a domestic public policy shall be applied to Convention awards.[1045]

Punitive damages have been shown to be particularly valuable in responding to destructive commercial and contractual behaviours in international trade. However, the role of punitive damages in contract law is difficult to predict, as it goes beyond the traditional principle of compensation of losses and has not been accepted worldwide. It seems that arbitrators may play an important role in developing punitive damages in international sales contractual disputes, since arbitrators seem to have more capability and fewer restrictions than national judges.

4.2.7 Enforcement of Arbitral Awards Involving Fraud Allegations

The enforcement of arbitral awards is significant in successfully resolving an arbitration dispute. Arbitral awards that are not performed voluntarily will have to undergo enforcement procedure. Enforcing arbitral awards in another country involves the judicial review or intervention by the court which is applied to. However, such judicial intervention is usually at the minimum level, mainly including the review of arbitrability and procedure.[1046] Will the arbitral awards dealing with fraud allegations in disputes be treated in the same manner as other awards? Will the enforcement of such arbitral awards meet with particular difficulties, thus depriving of some of the advantages that arbitration offers to international commercial parties?

[1042] ICC Case 5946 (1991), XVI Yearbook Commercial Arbitration 97.
[1043] Ibid.
[1044] Cremades, Bernado M. (2002), p. 342.
[1045] Cremades, Bernado M. (2002), p. 341; it was also argued that the enforcement judge should have no real reason not to apply international public policy when examining a request for enforcement, see Briner, Robert (1999), 'Philosophy and Objectives of the Convention', in *Enforcing Arbitration Awards under the New York Convention: Experience and Prospects*, United Nations Publication, available at www.uncitral.org/pdf/english/texts/arbitration/NY-conv/NYCDay-e.pdf, accessed 21 Feb., 2008, p. 9.
[1046] See e.g. Wang, Shengdong (2002), 'Discussion on Judicial Intervention in International Commercial Arbitration', *Law Application*, Vol. 12, also available at www.ccmt.org.cn/ss/explore/exporeDetial.php?sId=390, accessed 15 July 2008.

In England

Enforcing an arbitral award in England depends on where the award was issued. The process for enforcement in a particular case depends on the seat of arbitration and the applicable arbitration rules. The enforcement of arbitral awards in England can be under several different mechanisms, including the Arbitration Act 1996, the New York Convention, the Geneva Convention 1927, the Administration of Justice Act 1920 and the Foreign Judgments (Reciprocal Enforcement) Act 1933, and Common law.[1047] However, considering that our main interest concerns international commercial disputes, we will discuss two of the most important regimes: the Arbitration Act 1996 and the New York Convention.

According to the Arbitration Act 1996, section 66 applies to all domestic and foreign arbitral awards. Under this section, enforcement of an international arbitral award in the UK requires the court's permission. Once the court has granted such permission, judgment may be entered in terms of arbitral award and enforced in the same manner as a court judgment or order.[1048] However, permission will not be given by the court if the party against whom enforcement is sought can prove that the tribunal lacked substantive jurisdiction to make an award and the right to raise such an objection has not been lost.[1049]

Sections 101-103 of the Arbitration Act provide the subject on recognition and enforcement of arbitral awards under the New York Convention 1958. According to this Convention, an arbitral award will become an award under the convention, if it is made in a country which is a party to the Convention. An award is regarded being made at the seat of the arbitration wherever it is signed, sent from or delivered to. For instance, if an award is made in Peking, the seat of the award is China. China is a party to the New York Convention and the award can therefore be enforced internationally as a New York Convention award. Section 101 of the Arbitration Act provides that an award subject to the Convention shall be recognised as binding between the parties; and can be enforced in England in the same manner as a judgment or court order with the court's permission. However, recognition or enforcement of an arbitral award can be refused under a few circumstances. Section 103 (2) of the Act stipulates several cases which may lead to refusal of recognition or enforcement. One of the cases concerns the invalidity of an arbitration agreement, which specifies that an arbitration agreement may be invalid under the law to which the parties are subjected or under the law of the country where the award is made. However, other cases concern particular defects in procedures.

Section 103 (3) further provides that recognition or enforcement of an award may be refused where the award deals with the matter which is not capable of settlement by arbitration, or if it would be contrary to public policy. In the UK, the reported cases concerning public policy are very few in number. *Soleimany v.*

[1047] Pinsent Masons, Advice Note, 'Enforcing International Arbitration Awards in England and Wales', available at www.pinsentmasons.com/PDF/EnforcingInternationalArbitrationAwards.pdf, 10 October 2008.

[1048] See Arbitration Act 1996, England, section 66 (1) and (2).

[1049] Ibid, section 66 (3).

Soleigmany[1050] is considered to be the first case in which English courts refused to enforce an arbitral award due to public policy. The CA held that the agreement between the father and the son was illegal, and the enforcement of such an award based on an illegal contract would violate English public policy. Some commentators criticised this for being a rigid approach; English courts cannot strictly apply the domestic public policy concept to an international case where an international convention is concerned, simply assuming international and domestic public policies are the same; and if such domestic public policy notions extend to international cases, then this can only be regarded as insensitive to other countries' legal systems.[1051] In another English case, the CA held that an agreement concluded under coercion, duress or undue influence is unenforceable due to public policy.[1052] Furthermore, where an award would lead to a breach of England's treaty obligations, an award may also be refused on grounds of public policy.[1053]

However, it is argued that the English courts had not confronted a circumstance of sufficient seriousness which constitutes a ground for refusal of enforcement.[1054] In general, the national courts in England are disinclined to refuse enforcement of an arbitral award on grounds of public policy.[1055]

In China

Under the current legislations of China, it seems neither the CPL 1991 nor the Arbitration Law 1994 includes detailed procedural rules for enforcing arbitral awards.[1056] But the CPL article 269 particularly concerns the recognition and enforcement of foreign arbitral awards[1057], and provides that

> "If an award made by a foreign arbitral organ requires the recognition and enforcement by a people's court of the P.R. China, the party concerned shall directly apply to the intermediate people's court of the place where the party subject to enforcement has his domicile or where his property is located. The people's court shall deal with the matter in accordance with the international treaties concluded or acceded to by the P.R. China or with the principle of reciprocity."

[1050] [1998] 3 WLR 811.
[1051] Seriki, H. (2000), 'Enforcement of Foreign Arbitral Awards and Public Policy – A Note of Caution', *The Arbitration and Dispute Resolution Law Journal*, 9, pp. 202-203.
[1052] *Israel Discount Bank of New York v. Hadjipateras* [1983] 3 ALL ER 129.
[1053] Tweeddale, Andrew & Tweeddale, Keren (2005), p. 889.
[1054] Seriki, H. (2000), p. 195.
[1055] Redfern, Alan and Hunter, Martin (2004), p. 542.
[1056] The Arbitration Law, article 62 simply states that if one party applies to the court for enforcement, the procedures shall follow the relevant provisions in CPL 1991 (CPL 1991; article 260 simply stipulates that courts are allowed to refuse enforcement only for a limited number of procedural reasons); concerning the issue of interim preservation of assets and evidence in the Arbitration Law, article 28, similar content can be found in CPL 1991 (CPL 1991, article 258, states that a party may apply to the arbitration commission for preservation of the other party's assets in order to prevent funds from being transferred or making the award unenforceable; then the arbitration commission files these papers with the court).
[1057] This provision is added particularly to meet the needs of joining both the New York Convention [1958] and the Washington Convention 1965, and to be able to honour its international obligations, see Chen, An (2005), 'Is Enforcement of Arbitral Awards an Issue for Consideration and Improvement? – The Case for China', Symposium 'Making the Most of International Investment Agreements: A Common Agenda', Co-organised by ICSID, OECD and UNCTAD, 12 Dec., Paris, available at http://www.oecd.org/dataoecd/5/40/36054525.pdf , accessed 15 Dec., 2007.

China became a member of the New York Convention in 1987[1058]; and thus arbitral awards made in China are enforceable in other signatory countries or in a similar vein arbitral awards made in other contracting States of the New York Convention are enforceable in China.[1059] However, no official statistics are available to show the number of foreign awards that are enforced in China.[1060]

According to the New York Convention Article V. (2), two areas may constitute defences - arbitrability and public policy.[1061] As we discussed in the earlier section about "arbitrablity", generally fraud allegations are able to be handled by arbitrators and thus the arbitrablity issue would not become a barrier during enforcement procedure. But will the notion of public policy become a potential problem during enforcement?

Generally, China has adopted a prudent approach[1062] towards refusal[1063] of foreign arbitral awards, and has made great efforts to improve the enforcement of arbitral awards either domestically and abroad.[1064] However, when it comes to the

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[1058] Generally about the legal status of international treaties in the Chinese domestic legal system, see Xue, Hanqin & Jin, Qian (2009), 'International Treaties in the Chinese Domestic Legal System', 8 *Chinese J. Int'l L* 299, pp. 299-413, particularly about treaty obligation concerning recognition and enforcement of arbitral awards, see pp. 317-319; a statistical analysis of cases concerning setting aside and enforcement of international commercial arbitral awards in China, see Huang, Jin & Du, Huanfang (2008), 'Chinese Judicial Practice in Private International Law: 2003', 7 *Chinese Journal of International Law* 227, pp. 248-255.

[1059] China made a reservation on reciprocity when joining the Convention and also limits its Convention obligation only to awards made in the contracting states, see Article 1 of the Notice on Implementation of the New York Convention, 10 April, 1987, issued by the SPC; for further explanation and application of the principle of 'Reciprocity' , see e.g. Huang, Yaying & Li, Weiwei (2002), 'Recognition and Enforcement of Chinese Arbitral Awards in Foreign Countries – Case Analysis and Problems', *Arbitration China Journal*, Vol. 6, published on 23 July, also available at www.ccmt.org.cn/ss/explore/exploreDetial.php?sId=191, accessed 15 July, 2008; see also Blazey, Patricia & Gillies, Peter (2008), 'Recognition and Enforcement of Foreign Judgements in China', Macquarie Law WP 2008-5, Mar., available at http://ssrn.com/abstract=1103364, accessed 06 Jan. 2011; such reservation can be ambiguous and leads to misunderstanding, for further discussion see Zhou, Jian (2006), pp. 425-426.

[1060] Ye, Ariel (2007), 'Enforcement of Foreign Arbitral Awards and Foreign Judgments in China', *Defense Counsel Journal*, July, 248, p. 251.

[1061] For further discussion, see Huang, Yaying (2003), 'New York Convention and Recognition and Enforcement of Foreign Arbitral Awards', People's Court Newspaper, 17 Oct., 3rd section: Legal Forum, also available at www.ccmt.org.cn/ss/explore/exploreDetial.php?sId=474, accessed 15 July, 2008.

[1062] For an example of a dispute *Lion Dragon Ltd v. Peking Smartdot Technology Development Ltd*, the Peking Court narrowly and correctly interpreted the social and public interest as the overall interest of the whole society, and held that the arbitral award did not violate China's social and public interest, Cao, Lijun (2006), 'China: Lion Dragon Limited v. Peking Smartdot Technology Development Limited', *International Arbitration Law Review*, 9 (2), N21-22.

[1063] Particularly concerning the issue of setting aside or challenging of arbitral awards in China, see Godwin, William (2007), 'Challenging Awards in China-sited Arbitrations', *International Arbitration Law Review*, 10(5), 160-163; see also Hu, Li (2001), 'Setting Aside an Arbitral Award in the People's Republic of China', 12 *American Review of International Arbitration* 1.

[1064] A pre-reporting system on refusing a foreign award is established, 'The Supreme People's Court Notice on the Relevant Issues Concerning Foreign-related Arbitration and Foreign Arbitration', issued by the SPC (No. FA /8/1995); the grounds for refusal are limited to a review of procedural matters, Arbitration Law 1994, articles 70-71, for further discussion see Wang, Wenying (2006), 'Distinct Features of Arbitration in China: An Historical Perspective', *Journal of International Arbitration*, 23 (1): 49-80, pp. 69-70; for further discussion of enforcement of arbitral awards in China, see e.g. Peerenboom, Randall (2001), 'Seek Truth form Facts: An Empirical Study of Enforcement of Arbitral Awards in the PRC', 49 *Am. J. Comp. L.* 249, Spring; the efforts that China has made and suggestion for improvement, see e.g. Reinstein, Ellen S. (2005), 'Finding a Happy Ending for Foreign Investors: the Enforcement of Arbitration Awards in the Peoples' Republic of China', 16 *Indiana International and Comparative Law Review* 37.

term of public policy or public order (normally read as "fundamental and social interest in China"), it seems that the Courts need to exercise their own discretion in particular cases[1065]. The concept of public policy[1066] is general and unclear; and usually the courts in China rarely refuse recognition and enforcement of foreign arbitral awards on the grounds of violating public order.[1067] However, such a term could be interpreted in a broad manner in practice, although the SPC holds the view that such a term should be interpreted in a narrow way and should be limited to occasional cases.[1068]. Therefore, it is recommendable to define such concepts as 'public order' or 'social public interests' in the Arbitration Law so as to make it more transparent and clearer.[1069]

In theory, usually arbitral awards do not involve the issue of public policy during the enforcement process. However, it can be a different situation, if punitive damages are awarded in arbitral cases. As the principle of punitive damages has not been widely accepted yet, enforcement of punitive awards is likely to confront problems in many countries.

In summary, the forgoing discussion demonstrates that whether arbitrating L/C fraud disputes can be an alternative to litigating depends on a number of factors. Where an international L/C transaction is concerned, it seems that arbitrating a L/C fraud dispute between commercial parties (the buyer and the seller) is possible if an arbitration agreement is reached in the underlying sales contract. After the jurisdiction of the dispute is settled and an arbitral tribunal takes the dispute, it would be preferred that the arbitral tribunal handles the dispute in a proper manner according to widely accepted principles in contract law or tort law. Punitive damages are an attractive tool under the circumstance of fraud. But at the same time, such damages are challenging and risky in court judgments or arbitral awards, as they lead to potential problems (such as being refused) during enforcement. Beside arbitration, are there any other alternatives to resolving L/C fraud disputes?

[1065] Xiao, Hong (2005), 'Refusing Recognition and Enforcement of Foreign Arbitral Awards under Article V (2) of the New York Convention in China: From the Judicial Experience of Europe and USA', *US-China Law Review*, July, Vol. 2, No. 7 (Serial No. 8), p. 51.

[1066] Some distinguish 'public interest' defence from 'public policy', for further discussion see Zhou, Jian (2006), 'Judicial Intervention in International Arbitration: A Comparative of the Scope of the New York Convention in U.S. and Chinese Courts', 15 *Pacific Rim Law and Policy Journal*, June, 403, pp. 448-449.

[1067] Han, Jian (2005), 'Recognition and Enforcement of Foreign Judgments and Awards in Mainland China', *US-China Review*, (Feb.), Vol. 2, No. 2. (Serial No. 3), 20, p. 25.

[1068] Liu, Xin (2002), 'Recognition and Enforcement of Foreign Arbitral Awards in China', *Law and Economics Journal*, published on 05 Mar., available at www.ccmt.org.cn/ss/explore/exploreDetial.php?sId=46, accessed 15 July, 2008.

[1069] Wang, Shengdong (2002).

4.3. ARE DOCDEX RULES SUITABLE FOR RESOLVING L/C FRAUD DISPUTES?

The ICC Rules for Documentary Instruments Dispute Resolution Expertise (DOCDEX) were originally introduced in 1997 in order to establish an expert-based dispute resolution system for L/Cs.[1070] Now its first revision took effect from 15 March, 2002, covering disputes not only about L/Cs, but also over other financial instruments collections and demanding guarantees. Thus, such rules provide an alternative dispute resolution system for international bankers, traders and other parties using UCP 600, URR[1071], URC 522[1072] and URDG 458[1073]. Will such an extra-judicial dispute resolution mechanism provide an alternative to litigating L/C fraud disputes? We will analyse this question by mainly looking at its purpose and procedures.

DOCDEX intend to provide an independent, impartial and prompt expert decision on how the dispute should be solved based on the terms and conditions of each financial instrument contract and the applicable ICC Rules.[1074] Under DOCDEX rules, a panel of three experienced experts will issue an opinion on any given dispute, and the findings of the panel are then reviewed by the Technical Adviser of the ICC Commission on Banking Technique and Practice.[1075] Such a procedure was argued to be able to offer high security to each DOCDEX decision.[1076]

DOCDEX procedure can be initiated upon a request of one of the parties in the dispute, or a joint and single request of more or all parties in the dispute.[1077] DOCDEX procedure is document-based, which means that a DOCDEX decision will be made only on the basis of all documents that parties submitted.[1078] However, unless otherwise agreed, a DOCDEX decision is not binding on the parties and is not intended to follow any legal requirements of an arbitration award.[1079]

DOCDEX are designed to resolve disputes faster than litigation or other forms of dispute resolution; and the average DOCDEX decision is handed down in 2-3 months.[1080] It is said that the key advantage of DOCDEX is that parties stay out of court, and settle the dispute reliably at a low cost. Such advantages may attract more parties to choose DOCDEX to resolve L/C disputes in the future.

[1070] DOCDEX, ICC Publication No. 811, 2002, Foreword.
[1071] The ICC Uniform Rules for Bank-to-Bank Reimbursement under Documentary Credits, ICC Publication No. 525, came in force on 1 July, 1996; now it has a 2008 edition, ICC Publication No. 725, which took effect on 1 October, 2008.
[1072] The ICC Uniform Rules for Collections, ICC Publication No. 522, 1995 Revision.
[1073] The ICC Uniform Rules for Demand Guarantees, ICC Publication No. 458, 1992 edition.
[1074] DOCDEX, article 1.1.
[1075] DOCDEX, article 1.3
[1076] The Insight Interview (1997), 'Winfried Holzwarth on the ICC's New DOCDEX Rules for Settling L/C Disputes', *DCI(ICC)*, Winter, Vol. 3, No. 1, p. 10.
[1077] DOCDEX, article 2.1.
[1078] DOCDEX, article 1.5.
[1079] DOCDEX, article 1.4 and 1.3.
[1080] ICC, 'What is ICC DOCDEX', available at http://www.iccwbo.org/court/docdex/id4493/index.html, accessed 17 Nov., 2009.

However, do such DOCDEX rules suit resolving L/C fraud disputes? We will analyse firstly from the reasons that DOCDEX were initially produced. It was explained that DOCDEX rules were introduced mainly because of the need for a swift and straightforward system concerning disputes of dishonouring L/C payment on the grounds of alleged discrepancies.[1081]

It was stated that this type of dispute concerning discrepancies might be referred to a DOCDEX Panel.[1082] Thus, for L/C disputes, it seems that this type of discrepancy problem is suitable to be resolved by DOCDEX rules.[1083] Furthermore, as DOCDEX article 1.1 states, the disputes available are related to the ICC rules and their applications. In this way, it seems that disputes subject to DOCDEX are to do with technical problems concerning these ICC uniform rules and their interpretations. Being one set of ICC uniform rules, UCP 600 clearly leaves the L/C fraud problem out and looks at the issue subject to national laws. Thus, it can be inferred that L/C fraud disputes are not to be resolved by a DOCDEX Panel.

Secondly, we will analyse the procedure and decision under DOCDEX rules. DOCDEX procedure can be initiated by any party in the dispute, even if the other party does not participate in the proceedings. Therefore it is not necessary for agreement between the parties to have a DOCDEX clause concerning the dispute. Usually after a dispute arises, commercial parties rarely will trust each other any longer. In addition, fraud dispute is a highly sensitive issue. To what extent can one expect commercial disputants to be willing to submit their fraud disputes to an expert Panel? As mentioned above the DOCDEX decision is not binding. So to what extent can one expect commercial disputants to be willing to be bound by an expert decision, if the decision is issued under one party's request? But a bind decision is crucially important to a successful settlement of a L/C fraud dispute. We believe that allegations of L/C fraud seem unlikely to be resolved by such a voluntary-based dispute resolution mechanism.

Following the reasons discussed above, we would conclude that DOCDEX does not provide a viable alternative dispute resolution system to resolve L/C fraud disputes, although DOCDEX may be advantageous for solving other types of L/C disputes.

[1081] Charles del Busto of the ICC's Commission on Banking Technique and Practice explain the problem further: Certain banks had serious problems as to the UCP's application and interpretation, and intended to avoid their irrevocable and independent obligations under L/Cs by rejecting documents based on alleged discrepancies. However, such discrepancies were either due to misinterpretation, or misapplication of the UCP or were merely a fabrication of the discrepancies with their true intention being to delay or refuse to make L/C payment. Such practice was destructive to the integrity of the L/C system, and if it became widespread it would put the L/C system and the international trade system at risk, see Connerty, Anthony (1999), 'Documentary Credits: A Dispute Resolution System from the ICC', *J.I.B.L.*, 14 (3), 65-71, pp. 66-67; see also Bourque, Jean-François, 'A New System of ICC Expertise is being Used to Resolve L/C Disputes', *DCI (ICC)*, Spring, Vol. 2, No. 2, p. 13.

[1082] Connerty, Anthony (1999), p. 67.

[1083] See also the decisions of some disputes (concerning discrepancy) that were handled by the ICC's panel of experts, 'The First DOCDEX Decisions Handled Down by the ICC's Panels of Experts', *DCI (ICC)*, Summer 1998, Vol. 4, No. 3, pp. 2-5.

4.4 OTHER ALTERNATIVES – NEGOTIATION AND MEDIATION

In international commercial dispute resolutions, based on the degree to which the parties have control over the process and the outcome, alternative dispute resolution (ADR) may take different forms.[1084] However, different countries may develop different types of ADR, as different legal systems have their own traditions and practices.[1085] Could L/C fraud disputes be resolved through negotiation or mediation?

Negotiation is always the first method that the parties will turn to if disputes happen in international commercial transactions, as it is the least expensive and the best method for dealing with a dispute. Generally speaking, nowadays mediation is developing as a popular dispute resolution method worldwide[1086], due to its being expense-saving, confidential and flexible. Decisions issued by mediation institutions usually are not binding unless the disputants voluntarily agree to accept.[1087] Both negotiation and mediation do not bar other dispute resolution methods from being used. In contrast, Seul argues that negotiation and mediation often lead to an agreement with the background of litigation.[1088]

In arbitration case *China Everbright Foreign Trade Hubei Branch v. For-Trameyer GmH* (2003)[1089], after the applicant applied to the court to prohibit LC payment and the court granted the order, the four parties (including the applicant, the respondent, the German West LB Bank and Jiaotong Bank Wuhan Branch) signed an agreement[1090] in 1994 after negotiation. The case showed that negotiating a

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[1084] For discussion about ADR in Business, see Wallgren, Carita, 'ADR and Business', in Goldsmith, J.C. & Ingen-House, Arnold & Pointon, Gerald H. (Ed.) (2006), pp. 3-13.

[1085] Bühring-Uhle, Christian (1996), *Arbitration and Mediation in International Business: Designing Procedures for Effective Conflict Management*, The Hague, London, Boston: Kluwer Law International, pp. 261-265; about the design of ADR clauses, see e.g. Trantina, Terry L. (2001), 'How to Design ADR Clauses that Satisfy Clients' Needs and Minimize Litigation Risk', 19 *Alternatives to High Cost Litigation* 137.

[1086] EU generally adopts a positive attitude towards ADR, e.g. the Commission issued a Green Paper on Alternative Dispute Resolution in Civil and Commercial Law, Brussels, 19 04 2002, COM (2002) 196 Final; furthermore, the EU approves mediation Directive (Directive 2008/52/EC of the European Parliament and the Council of 21 May, 2008 on Certain Aspects of Mediation in Civil and Commercial Matters), which encourages the use of mediation for cross-border commercial disputes in the member states of the EU; the UNCITRAL has established a 'Model law on International Commercial Conciliation', and such a resolution was adopted by the General Assembly in the 52nd plenary meeting on 19 Nov., 2002, which may promote the use of conciliation internationally.

[1087] See Várady, Tibor & Barceló III, John J. & Mehren, Arthur T. Von (2006), *International Commercial Arbitration: A Transnational Perspective*, St. Paul, MN: Thomson, 3rd ed., p. 2.

[1088] Seul, Jeffrey R., 'Litigation as a Dispute Resolution Alternative', in Moffitt, Michael L. & Bordone, Robert C. (2005) (Eds.), *The Handbook of Dispute Resolution*, San Francisco: Jossey – Bass A Wiley Imprint, 1st ed., p. 353.

[1089] See 'China Everbright Foreign Trade Applying for Court order to Prohibit the Accepted but Unpaid LC, due to the Seller's Forgery and Anti-dating Bill of Lading' (2002), CCMT, available at http://www.ccmt.org.cn/ss/news/show.php?cId=335, accessed 10 Dec., 2007.

[1090] To be specific, the agreement stated that: the respondent pay the applicant 1,790,000 US dollars to resolve all the claims on damages concerning the past, the current, and the future and the unfinished arbitration; the applicant accepts the contracted goods, and gives up the right of claims on damages regarding the quantity and standard of the goods; the applicant applied to the court to relieve the court order against LC payment, Wuhan Branch would confirm to the German West LB that the court order is relieved; the applicant will give up all rights on claims of damages once the agreement is signed.

L/C fraud case is possible; but negotiation seems to to proceed effectively where a court measure has already been taken.

In England, the use of ADR, which is considered almost the same as mediation, has grown rapidly during the past ten years.[1091] The phenomenon resulted from a radical reform of the Civil Justice system of England. The new Civil Procedure Rules (CPR), which took effect on 26 April 1999, specifies its most important objective is to 'enable the Court to deal with cases justly and with proper proportionality'. The CPR emphasises the adoption of ADR procedures; it not only directs the Courts to encourage parties to use proper ADR procedures, but also implements several pre-action procedures to apply to six different categories of disputes. In the UK, mediation centres such as the Centre for Effective Dispute Resolution (CEDR), also undertake the task of encouraging and developing mediation and other cost effective disputes resolution and prevention both domestically and internationally.[1092] In addition, In addition, the International Mediation Services Alliance (MEDAL) is established with its aim to provide the international business and legal communities with commercial mediation and conflict management services through the cooperation between several leading mediation centres in the world.[1093]

A few court decisions have emphasised the importance of mediation in the civil justice field. Among them, two important cases are worth further discussion. The first case is *Halsey*[1094], which was considered as a landmark decision on mediation. *Halsey* recognised two fundamental advantages of mediation over litigation: firstly, it is usually less expensive than litigation; secondly, it provides the disputants more options on solutions than that in litigation.[1095] The primary issue the court decided was whether it is appropriate to make a cost order against a party who has refused to commence ADR proceedings. The court provided practical and helpful guidance when analysing the factors which could have been relevant to determining the question. The first factor referred to the nature of the dispute; the Court accepted that most cases are appropriate to be mediated, but pointed out that cases such as those involving allegations of fraud are not suitable for ADR.[1096] In *Halsey*, the court clarified the point further by providing some examples unsuitable for mediation. For instance, where a party wants the court to resolve a point of law and a binding precedent would be useful; it may be also inappropriate where an injunctive or other relief is essential for protecting the position of a party.[1097]

[1091] Richbell, David (2000), *The CEDR Mediator Handbook – Effective Resolution of Commercial Disputes*, London: CEDR, p. 2.
[1092] CEDR is also widely recognised as the leader in Europe in the area of mediation and ADR, official website: www.cedr.com; in 2005, 15 percent of 700 settled cases are international, see Annual Review 2005, available at http://www.cedr.com/news/resolutions/Review05.pdf, accessed 17 Dec., 2008.
[1093] Available at www.medal-mediation.com/About.html, accessed 16 Dec., 2008.
[1094] *Halsey v. Milton Keynes General N.H.S. Trust* [2004] 1 WLR 3002 (CA).
[1095] Ibid, p. 3008.
[1096] Ibid, p. 3009; some scholars also point out that where deliberate, bad-faith counterfeiting or piracy is concerned, mediation is not appropriate as cooperation of both sides is required, see Várady, Tibor & Barceló III, John J. & Mehren, Arthur T. Von (2006), p. 3.
[1097] [2004] 1 WLR 3002 (CA), p. 3009.

However, it is argued that it is an old idea and there are many examples of fraud cases being resolved successfully through mediation.[1098] The fact that a party commits fraud does not prevent one from negotiating and reaching a settlement of the dispute related to fraud, although in some circumstances an injunction to freeze assets might be necessary as a preliminary step.[1099] Some experienced mediators further argued that there are good reasons for why such cases are to be handled by mediation rather than in court.[1100] Moreover, for the cases where urgent resort to the court (such as seeking interim relief) is necessary, mediation may be a very effective dispute resolution method thereafter.[1101]

The case *Couwenbergh v. Valkova*[1102] in 2004 provides a good example. The CA had recognised in principle that mediating a dispute involving allegations of forgery is no longer an issue; and urged the parties to undertake the mediation. In the L/C fraud dispute case *Standard Chartered Bank v. Pakistan National Shipping Corporation and others*, the carrier PNSC, who committed fraud by issuing a false date BL, reached a final settlement with Standard Chartered Bank, before the hearing by the HL.

In China ADR is popular, and mediation is the most widely used ADR form.[1103] Mediation has been considered quite a successful means of settling commercial disputes between foreign and Chinese parties. In practice the terms mediation and conciliation are often used interchangeably. The Peking Conciliation Centre was established by the China Council for the Promotion of International Trade (CCPIT), which has also set up more than 40 mediation centres in other main cities in China. In addition, some joint mediation centres were established by Peking Conciliation Centre together with overseas conciliation centres, in order to meet with the need for resolving international commercial disputes. For example, the Peking-Hamburg Conciliation Certre[1104] was established in 1987, the U.S. China Business Mediation Certre was founded in 2004. CCPIT also continues to work with CEDR on the UK China Mediation Centre to promote the use of mediation in cross-border commercial disputes between European and Chinese businesses.[1105]

[1098] Newmark, Christopher C. & Dahlberg, Andrea (2004), 'New English ADR Principles Advance Law, Raise New Questions', 22 *Alternatives to High Cost Litigation* 146, p. 163.
[1099] Ibid.
[1100] Kallipetis, Michel & Ruttle, Stephen, 'Chapter 9 Better Dispute Resolution – The Development and Practice of Mediation in the United Kingdom between 1995 and 2005', in Goldsmith, J.C. & Ingen-House, Arnold & Pointon, Gerald H. (Ed.) (2006), *ADR in Business – Practice and Issues across Countries and Cultures*, The Netherlands: Kluwer Law International, p. 218.
[1101] Ibid.
[1102] [2004] C.P. Rep. 38, CA (Civil Division), judgement was delivered on 27 May, 2004.
[1103] Zheng Rungao, 'ADR in P.R. China', available at http://www.softic.or.jp/symposium/open_materials/11th/en/RZheng.pdf , accessed 21 Nov., 2007.
[1104] The detailed rules and procedures of the Beijing-Hamburg Conciliation Certre are discussed in academic articles; see, Trappe, Johannes (2003), 'Beijing-Hamburg Conciliation', Vol. 19, No. 3, *Arbitration International*, 371.
[1105] CEDR, Annual Review 2007, available at http://www.cedr.com/news/resolutions/Review07.pdf, accessed 17 Dec., 2008.

However, mediating fraud cases seems to proceed more effectively where the court is involved[1106] than merely under mediation centres. We will take a few cases as examples. In 1997 Company A (buyer) in China concluded a contract with Company B (seller) in a foreign country with L/C as the payment method, but it turned out that Company B did not deliver the goods under the bills of lading. Thus Company A applied for a court order to prohibit the L/C payment, and claimed damages. During the civil proceedings, Company A and Company B reached an agreement under the court's mediation. In this agreement, the liability of L/C payment was released permanently, Company B agreed to pay the direct damages, and either party would not pursue any other liability in this business and would not take any measure to damage the other party's business reputation.[1107] From this case, it can be identified that the force of legal measures and a party's business reputation are important factors urging parties to reach an agreement.

Another case concerns a L/C fraud dispute between a buyer in China and a seller in England. The seller colluded with the carrier and produced a BL which contained a false description of the goods. The buyer applied for a court order on the grounds of discrepancy of documents and fraudulent documents. The seller and the issuing bank threatened that they would submit to arbitration concerning L/C payment dispute and bring litigation against the buyer concerning contractual dispute. The buyer applied for mediation through the Hebei Mediation Centre in order to avoid further conflict.[1108] Under the agreement of both parties, the mediator invited experts on L/C, shipping and goods inspection and judges to assess the situation.[1109] After several mediation meetings, both parties reached a settlement: the seller agreed to reduce the price by 200, 000 US dollars and paid for part of the costs of dealing with the goods after arrival; the buyer applied to the court to release the previous order and paid for the costs of mediation and experts.[1110]

Interestingly, a similar case concerned a court order applied by Zhongji Company in 2003.[1111] In a sale transaction with the Miedun Company, Zhongji being the buyer applied a L/C from the Bank of China, Ningbo Branch. Later the applicant found out that the seller and carrier anti-dated BL and applied for

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[1106] For further discussion on mediation system under court in China, Liao, Zhonghong (2006), *Civil Procedure Law*, Xiamen: Xiamen University Press, pp. 206-207; see also Chang, Yi (2008), *Civil Procedure Law*, Peking: China Legal Publishing House, 1st ed., pp. 324-326; for proposals of improving the system, see e.g. Yan, Qingxia (2008), *On Court Mediation System*, Peking: China People Public Security University Press, pp. 216-239.

[1107] Sun, Dingjie (Chief Ed.) (1999), pp. 213-214.

[1108] Liu, Debiao & Yu, Youyan (2003), pp. 128-130.

[1109] Ibid, the results of the investigation were that: the seller and carrier were at fault in producing unclean and untrue BL, and this could be considered as a breach of contract or tort; but such a document did not constitute substantial discrepancy, and it was not fraud; the buyer employed an improper legal remedy. Thus, the mediator proposed that both parties deal with goods promptly so as to avoid further losses.

[1110] Ibid.

[1111] Case Name: Zhongji Company (Ningbo City, Zhejiang Province) Applying for Stop-payment Order under LC Payment Dispute, Application of Property Preservation Order before Litigation, in database http://www.lawyee.net/.

a court order on grounds of substantial LC fraud. The court granted this order and eventually both parties reached an agreement under the court's mediation.

From these specific case examples, we understand that the reach of a final settlement requires efforts from several players, including the disputants (the most important players in settling a dispute), mediator or court. Two factors, including the force of legal measures and a party's business reputation seem to have great influence on the mediation process where fraud allegations are concerned in disputes. Certainly there would be other influential factors in settling L/C fraud disputes, but they are at the moment difficult to discover through only looking at a few cases. In addition, it may be impractical to conduct an empirical study to answer this question, as mediation mainly evolves from practice and it is confidential.

As we can observe, English court cases have confirmed the possibility of mediating fraud disputes; and several practical case have showed that L/C fraud disputes could be resolved by mediation (usually after a legal measure is taken or under court mediation). We argue that L/C fraud disputes can be resolved by negotiation or mediation or both or a combination with other dispute resolution mechanisms; court procedures can be used as a strategy to urge the other party to reach a dispute settlement.

4.5 SUMMARY

From the previous sections, we suppose that in theory L/C fraud disputes can be resolved alternatively through arbitration, negotiation and mediation. Arbitration, with its binding decision and enforcement mechanism protected by the New York Convention seems to offer commercial parties a comparatively better alternative for resolving L/C fraud disputes.

However, it can be seen from the above discussions that dealing with L/C fraud disputes through arbitration is not a simple alternative. Several remarks have to be made clearly. Firstly, it relates to the jurisdiction problem; national courts may be required to determine the issue of whether or not an arbitral tribunal has the jurisdiction of handling L/C fraud disputes. The court's decision in the first instance is normally allowed appeal, which obviously slows the process of dealing with such disputes through arbitration, and makes the dispute resolution procedure complex.

Secondly, such an alternative requires an arbitration agreement between the relevant parties. There may be no difficulty for international sales contract parties (the buyer and the seller) to agree on arbitration and have an arbitration clause concerning fraud disputes in sales contracts. Then, in theory it is possible for commercial parties to deal with L/C fraud disputes under the sales contractual relationship through arbitration according to contract law or tort law.

However, as for arbitrating L/C fraud disputes in which a bank is a party, obstacles still exist in practice. As we know, usually the L/C application (made

between the buyer/applicant and the bank) and the L/C contract (made between the bank and the seller/beneficiary) have been developed in standard forms by banks. The dispute resolution clause in such standard forms usually states that any dispute shall be subjected to exclusive jurisdiction of a particular court. Thus, due to the almost non-negotiable dispute resolution clause in a contract where a bank is a party, the occurrence of arbitrating a L/C fraud dispute seems very unlikely.

Arbitrating fraud disputes concerning an international sales contract in which L/C is the payment method between international commercial parties seems preferable than litigating for several reasons. Firstly, it seems that there is no obstacle in theory to arbitrate fraud disputes concerning commercial contracts. Secondly, the arbitration clause may be simply placed in a sales contract between the buyer and the seller. Especially, where the arbitration clause stipulates that "any dispute arising out of or in connection with this contract", the scope of such a clause is wide enough to apply to not only contract issues but also to tort issues which are related to the contract.[1112] Furthermore, the possibility of enforcing arbitral awards internationally due to the New York Convention may make the arbitration method look attractive. However, whether the fraud allegations will lead to some difficulty (e.g. violation of public policy) during the enforcement process is not a clear-cut matter; although the provisions about refusing to recognise and enforce arbitral awards in the New York Convention do not include such ground.

DOCDEX, being a kind of expert determination mechanism, does not exactly suit the resolving of L/C fraud disputes. Although negotiation is the best dispute resolution method, serious disputes such as fraud may not be easily negotiated. Similarly, mediation provides flexibility and the possibility of resolving L/C fraud disputes. However, either negotiation or mediation seem to proceed better when a court or legal measure has been taken or with the background of litigation.

Fraud is a sensitive and delicate issue in most countries and a L/C fraud dispute has its unique features. Accordingly, I would make the following proposals based on all the preceding discussions. Firstly, when one commercial party is able to find sufficient evidence that another party is involved in fraudulent action in either a L/C transaction or an underlying sales transaction, a court order such as an injunction or stop-payment order to prohibit the bank from paying out should be applied for. The L/C fraud exception rules have been developed mainly through judicial practice by courts in different countries. Since such court orders usually require high standards of evidence, the party has to do careful assessment about the likelihood of success of such an application. Another relief freezing order should also be considered to be applied for from the court under urgent circumstances.

Secondly, court orders such as an injunction or freezing order merely deal with L/C fraud dispute in a certain short period. In order to resolve disputes the disputants have to solve their problems by turning to specific contracts. Four main options may be available: either through civil litigation, arbitration, media-

[1112] Moses, Margaret L. (2008), p. 42.

tion or negotiation. The most optimal method for parties to resolve their disputes is negotiation. If this is not possible then mediation would be the next best thing.

Alternatively, arbitration offers some advantages to international commercial parties when compared to litigation. However, enforcement issues particularly associated with fraud allegations have to be considered. It is recommendable for a party to cautiously choose appropriate claims in arbitral disputes. Claiming compensatory damages or liquidated damages from another party on the basis of breach of contract or tort (deceit, or fraud) seems more realistic than alleging punitive damages based on the fraud, as punitive damages may not be eventually recognised or enforced.

Thirdly, each method is not completely exclusive, thus one may be combined with another. When litigation or a court measure has been initiated, negotiation or mediation (including mediation under mediation centres or under court mediation) can also be used. Even the procedure of arbitration will not prevent the disputants from employing negotiation or mediation. Which method to employ and when to use it depends on specific circumstances.

After considering different alternatives to litigating L/C fraud disputes, we would like to touch upon the preventive and proactive approach towards L/C fraud. Such an approach considers L/C fraud as a business risk; and business enterprises may place L/C fraud in a whole framework of enterprise risk management so as to effectively manage it.

5 L/C Fraud Risk Management

5.1 THEORY OF FRAUD RISK MANAGEMENT

5.1.1 Terminology of Risk and Enterprise Risk Management

Risk basically means uncertainty[1113]; and enterprise risk management (ERM) may be simply defined as managing risks associated with the business objectives of an organisation.[1114] In the context of ERM, risk refers to "the potential for loss caused by an event (or series of events) that can adversely affect the achievement of a company's objectives".[1115]

In order to manage risk, it is essential to clearly identify the elements around risk, including drivers, controls, possible events, and possible outcomes.[1116] Both risk drivers and controls[1117] are factors influencing the outcome.[1118] Events simply mean the things that happen and the importance of "events" in terms of enterprise risk management can be illustrated as follows: firstly, events are evidence of the presence of risk; secondly, managers can learn from those events; thirdly, events have consequences, which are to be avoided; fourthly, an outcome will be preceded after events, thus it is possible to take measures to influence the eventual outcome.[1119] In order to deal with risk, several logical steps might be followed: risk identification, risk measurement, and risk evaluation and re-evaluation.[1120] However, standard risk self-assessment methodologies are criticised for contrib-

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[1113] For further explanation, see Crockford, Neil (1980), *An Introduction to Risk Management*, Cambridge: Woodhead-Faulkner Limited, 1st ed., pp. 11-12; for further discussion on some key problems of risk, see e.g. Singleton, W. T. & Hovden, Jan (1987), *Risk and Decisions*, New York: Jonh Wiley & Sons, pp. 3-8.

[1114] Monahan, Gregory (2008), p. 1; this concept is also discussed in Olson, David L. & Wu, Desheng Dash (2008), *Enterprise Risk Management*, Series: Financial Engineering and Risk Management – Vol. 1, Singapore: World Scientific Publishing Co. Pte. Ltd., pp. 3-13; this book approaches risk management from five perspectives: financial, accounting, supply chains, information systems, and disaster management.

[1115] Monahan, Gregory (2008), *Enterprise Risk Management: A Methodology for Achieving Strategic Objectives*, New Jersey: John Wiley & Sons, Inc, p. 4.

[1116] Monahan, Gregory (2008), p. 4.

[1117] For further explanation on risk control, see e.g. Young, Peter C. & Tippins, Steven C. (2001), pp. 125-168.

[1118] But it is necessary to distinguish between risk drivers, which simply exist as a fact, that are factors increasing uncertainty and controls, which are those factors intended to reduce uncertainty or measures taken to mitigate the probability or severity of an adverse outcome, see Monahan (2008), pp. 5-7.

[1119] Outcomes mean the consequence of events, and can be controlled depending on the impact or effectiveness of controls, see Monahan (2008), p. 9;

[1120] This point is associated with the risk analysis approach; for further explanation, see Hertz, David B. & Thomas, Howard (1983), *Risk Analysis and Its Applications*, New York: John Wiley & Sons, pp. 11- 17.

uting little to identifying loopholes in fraud controls.[1121] Furthermore, three basic procedures of managing risks have been identified: ban an activity that will bring forth risks, reduce such activity, carry out a comprehensive risk/benefit analysis to identify all factors involved in such activity.[1122]

It is argued that risk management should become an integral part of business.[1123] Among all the risks in the context of enterprise risk management, the risk of fraud is difficult to discover and manage. A significant fraud may never occur, but clearly good fraud risk management is more likely to make an enterprise stay one step ahead of the fraudsters. How should fraud, presenting itself as a risk, be managed properly by an enterprise?

5.1.2 Fraud Risk Management

It is said that in practice many enterprises fail to put the fraud inside in the ERM frame.[1124] With regard to risk and risk management, it is suggested that fraud should be put in the centre stage.[1125] Both large and small enterprises need to take fraud as being a serious issue due to the significant cost involved and impact on business reputation. The less serious attitude an organisation takes regarding fraud, the greater the fraud risk will be, and larger potential costs will result. In a company, weak controls, negligent managers, unclear responsibility for company resources, and dishonest employees can make a company vulnerable to attack by fraud.

To have formal systems and procedures in place to prevent, detect, and respond to fraud is necessary for each company due to the serious harm fraud can cause. Even though no system provides complete protection against fraud, some measures or controls can be taken to deter fraud. Fraudsters are sophisticated in indentifying possible victims by investigating which companies are careless in their controls; by using professional advisors to find out in which jurisdictions there is a lack of police or law enforcement resources they can protect themselves from prosecution.[1126]

In particular, it is recommended that enterprises adopt a four-star success model. The first point is to have good corporate ethics and a sound anti-fraud policy; the second aspect is to conduct fraud awareness training, including training in fraud response, what is involved in supporting a formal investigation and so forth; the third is to educate staff to be alert and proactive so as to identify

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[1121] Samociuk, Martin (2006), *Fraud Risk Management*, Hibis Consulting Pty Limited, p. 1, available at http://www.hibis.com/pdf/fraud_risk_management.pdf, accessed 28 April, 2009.
[1122] For further explanation, see Crouch, Emmund A.C. & Wison, Richard (1982), *Risk/Benefit Analysis*, Cambridge & Massachusetts: Ballinger Publishing Company, pp. 195-201.
[1123] Carey, Anthony & Turnbull, Nigel, 'The Boardroom Imperative on Internal Control', in Pickford, James (Ed.) (2001), *Mastering Risk – Volume 1: Concepts*, Edinburgh: Pearson Education Limited, 1st ed., pp. 11-14.
[1124] Pickett, K.H. Spencer (2006), *Enterprise Risk Management - A Manager's Journey*, Hoboken, NJ: John Wiley & Sons, Inc., p. 103.
[1125] Ibid.
[1126] For a full analysis of the fraudster's perspective concerning financial instrument fraud, see ICC Commercial Crime Services (2002a), *Preventing Financial Instrument Fraud – The Money Launderer's Tool* (A Special Report prepared by ICC Commercial Crime Bureau), Essex: ICC Publishing, ICC Publication No. 648, pp. 23-40.

problems that indicate that fraud is taking place or could take place; and the final part is to conduct self-assessment to make sure potential problems are solved before real fraud happens.[1127]

By taking fraud seriously and having sound anti-fraud policies in place means that an enterprise to some extent may not so easily become a target as those that have not made any anti-fraud efforts. But for an anti-fraud strategy to be effective, four key elements must be in place: prevention, detection, deterrence and response.[1128]

In combating fraud, fraud prevention and detection must operate hand in hand. Therefore, when designing a strategy to manage fraud risk, enterprises must take both aspects into account. Prevention begins with effective internal controls, which help reduce exposure to financial risks and build systems for detecting fraud. To prevent fraud measures to reduce motivation, limit chances and restrict the ability of offenders to commit fraud have to be taken.[1129] Proactive fraud prevention has to be conducted, and it covers good division of responsibilities, supervision of staff, monitoring work performance, and all those measures intended to ensure dishonest people cannot access the system, or even if the system is accessed that a proper control is in place.[1130] Further factors that help to prevent fraud can be anti-fraud policies, procedures, training and fraud awareness.[1131] Nevertheless, preventive measures may require some investment in advance, and cannot provide complete protection. Concerning deliberate fraud, preventive controls are intended to decrease opportunities and eliminate attraction from potential perpetrators.

However, even dedicated controls can be abused by fraudsters. Thus, a fraud detection strategy (designed to detect fraud)[1132], including noticing or analysing strange trends or inconsistencies, looking out for red flags that indicate something may be going wrong and a reporting system need to be adopted.[1133] In addition, managers also need to assess the controls regularly, and know the latest fraud issues and what new scams exist.[1134]

Fraud deterrence, deterring potential fraudsters from attempting fraudulent activity, is linked closely with the response of an enterprise to fraud.[1135] It is sig-

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[1127] Pickett (2006), pp. 120-122.
[1128] AICPA (2009), 'The Basics of Fraud Risk Management', *Business Brief*, Vo1. 1, 4, available at http://fmcertre.aicpa.org/NR/rdonlyres/33E55856-1A41-4D02-BBA8-CD5B51724E4C/0/Fraud_Risk_Management_Business_Brief.pdf, accessed 28 April, 2009.
[1129] Ibid.
[1130] The Committee of Sponsoring Organizations of the Treadway Commission (COSO) (2004), *Enterprise Risk Management – Integrated Framework: Application Techniques*, NJ: COSO, pp. 93-104.
[1131] Coburn, Niall F. (2006), 'Corporate Investigations', *Journal of Financial Crime*, Vol. 13, No. 3, 348, pp. 365-366.
[1132] For detecting forged documents, it has been indentified that document examiners usually conduct a three-step process: examination (or analysis), comparison, and evaluation. Such document examination can be equally applied to civil and criminal cases, see Tytell, Peter V., 'The Detection of Forgery and Fraud', in Jan van den Berg, Albert (Ed.) (2003), *International Commercial Arbitration: Important Contemporary Questions*, The Hague: Kluwer Law International, p. 315; this paper further discusses what an attorney or a counsel should do when asked to deal with questioned documents.
[1133] AICPA (2009).
[1134] Pickett (2006), p. 120.
[1135] AICPA (2009).

nificant if a consistent and comprehensive response to suspected and detected events of fraud is in place. A few response methods have been proved to be effective, such as conducting thorough investigations, allocating individual personnel liable through internal, civil or criminal action, preserving evidence for prosecution, and reviewing existing systems to investigate system gaps.[1136]

Therefore, in fraud risk management, essentially preventive measures against fraud are required so that the harmful consequences can be controlled or prevented before fraud actually happens; and a good response plan is required so that people know what to do and what not to do.

5.1.3 Preventive and Proactive Approach

The ideas of the preventive proactive approach are obvious and understandable, and it would be helpful if the preventive and proactive approaches were properly applied in legal and commercial fields. An integrated preventive and proactive approach is required to mitigate risk by enterprises. The following question is going to be considered: how can the theory of fraud risk management be applied combining the principal ideas of preventive and proactive approaches to the area of L/C fraud risk management?

5.2 L/C FRAUD RISK MANAGEMENT

Based on the theory of fraud risk management and principles of preventive and proactive approaches, where the L/C payment instrument is involved in a business transaction, L/C fraud risk management essentially includes L/C fraud prevention and L/C fraud response. In this part, we will firstly consider L/C fraud prevention by exploring preventive measures those commercial parties in L/C transactions (buyers, sellers, banks, and lawyers) can take. Then we will look at how enterprises can respond to L/C fraud in a concise manner.

5.2.1 L/C Fraud Prevention

Two significant features of preventive legal practice have been recognised. First, it prospectively deals with fact patterns that may arise in the future; second, in preventive legal practice, the final decision-maker is the client, who follows the advice of a lawyer.[1137]

Applying such principles to fraud prevention in L/C transactions could work in the following way: first, earlier types or patterns of fraud in L/C transactions could be examined; furthermore, potential L/C fraud types in the future could be predicted and assessed. By recognising these past and potential L/C fraud types, the trading parties would be able to consider those vulnerable aspects where they are likely to be defrauded and accordingly seek preventive measures.

[1136] Ibid.

[1137] Gruner, Richard S., Lesson 1, 'What is Preventive Law', Cyber Institute, available at http://www.cyberinstitute.com/preventivelaw/week1.htm, accessed 2 Feb., 2007.

Second, trading parties play the most important role in fraud prevention in L/C transactions. Even if they can consult a lawyer or professional organisations in particular regarding fraud-related questions, it is the commercial parties who do the business and decide what and how to deal with specific problems. In addition, a systematic method has been summarised to help promote preventive and proactive thinking.[1138] If such a method and thinking were applied when dealing with L/C transactions, the possibilities for fraud would be reduced.

The next section will discuss the preventive and proactive methods in L/C transactions. During the dissuasion, economic analysis is employed where necessary. It is argued that efforts to prevent fraud can generally be justified only if the cost of those efforts is less than the likely expenses.[1139] In other words, the merits of preventive efforts should be carefully considered. A full understanding of preventive costs will help a trading party sensibly decide how much preventive effort is justified. In current international L/C frauds, most of the victims are buyers. Thus, we will firstly examine the measures that buyers can take in order to prevent L/C fraud risk.

What Preventive and Proactive Measures Can Buyers Take?

Check Credibility of Seller

Before a buyer concludes a sales contract with the other party, the buyer should collect as much information as possible about the credibility of the seller.[1140] It is possible for the buyer to learn the history and current state of the seller's business. More importantly, contacting local banks in the seller's place of business to determine their credit history can be of great help to the buyer.[1141]

From an economic point of view, it is true that checking credibility involves some information costs; compared to the potential cost that would be involved if fraud were to occur, it would definitely be worthwhile carrying out thorough search. In fact, it is significant for the buyer to choose a trustworthy partner in international sales transactions.

Check Capacity and Location of Contractual Ship

Apart from carefully checking the credibility of the seller beforehand, the buyer must cautiously choose suitable trade terms which allocate the risk of goods,

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[1138] For detailed steps, see Barton, Thomas D., 'Thinking preventively and proactively', in Wahlgren, Peter (2006), p. 84.

[1139] Gruner, Richard S., Lesson, 9, 'How to Use Preventive Law Principle to Develop New Preventive Law Applications', Cyber Institute, available at http://www.cyberinstitute.com/preventivelaw/week36.htm, accessed 2 Feb., 2007.

[1140] Demir-Araz, Yeliz (2002), p. 133; see also Xinqing, Yuantao (2007), 'L/C Fraud and Prevention in International Trade', *Group Economy*, April (2nd Issue) (Sum. No. 227), 312, pp. 313-314; Li, Yang (2007), 'L/C Fraud and Prevention', *Industrial & Science Forum*, Vol. 6, No. 6, 51, p. 52; Wei, Juan (2009), 'L/C Fraud Exception', *Popular Business*, No. 8 (General No. 104), 223, p. 224.

[1141] For some other methods to get to know the creditability of a business partner, see Sun, Dingjie (Chief Ed.) (1999), p. 185-187, see also Meng, Yuqun & Chen, Zhenying (1999), pp. 313-314; Ma, Huanhuan (2006), 'Preventive Measures of LC Fraud by Buyers', *Contemporary Manager*, Vol. 2, 65, p. 66; Li, Qiuhong (2008), 'L/C Fraud and Prevention', *HLJ Foreign Economic Relations & Trade*, No. 7 (Serial No. 169), 71, pp. 72-73.

cost and liability between buyer and seller in different ways.[1142] It is particularly advantageous to grasp the knowledge of shipping[1143] and to choose the FOB term rather than the CIF term in a sales contract to ensure that the buyer has control over the shipped goods.[1144]

It is also recommended that in an underlying sales contract buyers are required to include terms concerning name of ship and time of shipment.[1145] Such clauses give the buyer a chance to confirm the availability of the ship. The standard Lloyd's information can tell whether a vessel is able to take the contractual quantity of goods; and Lloyd's Shipping Intelligence can show the current location of the ship, and thus it is possible to estimate when the ship will arrive at the specified port.[1146]

Use Independent Inspectors

In international trade, different methods of payment allocate different risks to different parties. The L/C payment instrument places the risk mainly on the buyer. The payment will be made merely against the documents from the seller; and this provides a seller the opportunity to engage in fraudulent conduct.

In order to seek added security, it is suggested that a buyer gets an independent judgment from a third party on inspection certificates in L/C transactions.[1147] Independent inspectors, as a third party, would employ their resources to determine the quality and quantity of goods, to inspect whether the goods have been loaded and so forth.[1148] In such a way the risk of fraud, to some extent, could be alleviated.

Certainly, this method involves additional costs. However, sometimes the division of costs depends on the bargaining power of the traders, and it may be possible to allocate costs to different parties through negotiation.

[1142] Gu, Xiaorong & Ni, Ruiping (Eds.) (2005), p. 237; see also Sun, Dingjie (Chief Ed.) (1999), pp. 188-190; Cai, Lei & Liu, Bo (1997), pp. 325-326; Sun, Qian (2004), 'Causes and Preventive Measures of L/C Fraud', *Journal of South-Central University for Nationalities (Humanities and Social Science)*, Vol. 24, April, 65, p. 66.

[1143] See e.g. Li, Jingsheng & Zhang, Yunke & Ge, Liming (2007), 'On the Fraud from the L/C Beneficiary', *Journal of Shijiazhuang University of Economics*, April, Vol. 30, No. 2, 109, p. 111.

[1144] Fung, King Tak, 'Legal Issues with Letters of Credit in China and Hong Kong', speech and material in the 2nd Annual International Conference on Letters of Credit, 28 May, 2008; see also Gu, Xiaorong & Ni, Ruiping (Eds.) (2005), p. 237; Yang, Zhengming (Ed.) (1999), p. 216; Meng, Yuqun & Chen, Zhenying (1999), pp. 314-315; Wang, Ruiting & Du, Yunqing (2005), 'Study on Countermeasures of L/C Fraud', *Market Modernisation*, Dec. (2nd Issue) (Sum. No. 452), 217, p. 218.

[1145] Gu, Xiaorong & Ding, Muying (2000), p. 216; see also Yao, Liwei & Xia, Jie (2008), 'L/C Fraud and Prevention', *Law and Commerce*, No. 5, 168.

[1146] Meng, Yuqun & Chen, Zhenying (1999), pp. 254-255.

[1147] Nelson, Carl A.(2000), *Import Export: How to Get Started in International Trade*, Blacklick, OH, USA: McGraw-Hill Professional Book Group, p. 115; see also Gu, Xiaorong & Ding, Muying (2000), p. 216; Wei, Tianping (2006), 'Introducing Supplementary System to Prevent L/C Fraud in International Trade', *Group Economy*, Nov. (2nd Issue)(Sum. No. 212), 281, p. 282.

[1148] See e.g. Wang. Zhuilin (2006), pp. 227-229; for example, one of the world's leading inspection, verification, testing and certification companies is SGS, which provides services such as loading supervision, pre-shipment inspection, quality assurance and quality control inspection, available at www.sgs.com, accessed 1 June, 2009.

Use Time Drafts rather than Sight Drafts

In order to collect the proceeds of the documentary L/C from the paying bank through forged documents, the fraudsters have to do that before the goods are inspected so that their fraud is not detected before obtaining payment. Thus, it is recommended that a buyer chooses to use time drafts (usance drafts) instead of sight drafts (payable when presented)[1149] concerning L/C payment method in international trade.[1150] Where a sight draft is used in the L/C mechanism, payment shall be done immediately when the draft is presented. However, where a time draft is used, payment can be made some days after acceptance. Thus, it is possible to discover fraud after the goods arrive but before the date of payment. A similar suggestion is to insert a provision that allows payment in a certain period after the beneficiary's presentation, and the purpose of such provision is also to allow a period for verifying some facts.[1151]

The case *United Bank Limited v. Cambridge Sporting Goods Corp*[1152] in the US is a good example for illustrating the effect of using a time draft. In this case, the seller in Pakistan was to deliver boxing gloves to the buyer in New York, under the term of L/C calling for payment ninety days after acceptance of the draft. After the goods arrived at New York, an inspection was conducted, showing the boxing gloves were old, unpadded, ripped and mildewed. Then the buyer applied for an injunction against payment, and the court granted the injunction on the ground of fraud. If a sight draft had been chosen, the bank would have to pay immediately. In such circumstances, no opportunity for inspection of goods would have been available for the buyer before the bank pays out; and then the fraud might have already been successful.

Use Law: Sale of Goods "on approval"

A further proposal is to insert a term of sale of goods on approval.[1153] Under the sales on approval, the property in the goods does not pass to the buyer until the buyer approves of the goods.[1154] Originally the term of sales on approval was created so as to ensure the quality of goods. However, if such terms are included and used, the condition of the goods, including the situation where no goods exist at all, would be found out during the examination of goods for approval. Then

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[1149] Draft is defined as "an unconditional order in writing, signed by a person (drawer) such as a buyer, and addressed to another person (drawee), typically a bank, order the drawee to pay a stated sum of money to yet another person (payee), often the sellers, on demand or a at fixed or determinable future time"; the most common two types are sight drafts and time drafts, which are payable at a future fixed date or a determinable (such as 30, 60 or 90 days) date, see Hinkelman, Edward G. (2003), p. 36.

[1150] Murray, Daniel E. (1993), 'Letters of Credit and Forged and Altered Documents: Some Deterrent Suggestions', *Commercial Law Journal*, Winter; 98, 4; p. 509; see also Guo, Yuanyuan (2004), 'L/C Fraud and How to Remedy and Prevent', published 12 Jan., available at www.ccmt.org.cn/ss/explore/exploreDetial.php?sId=540, accessed 15 July, 2008; Wang, Saisai (2007), 'Discussion on LC Independence Abstract Principle', *Times Finance*, Vol. 7, p. 32; Zhao, Xiaoyan (2006), 'L/C Fraud and Prevention', *Policy & Management*, No. 21, 13, p. 14.

[1151] See Zhou, Ying (2003b), 'Documentary L/C Fraud: Dilemma in Prevention', *Economist*, Vol. 5, 46, p. 48.

[1152] (1976) 41 NY. 2d 254, 392 N.Y. S. 2d 265, 360 N.E 2d 943, 20 UCC Rep. Serv. 980.

[1153] Murray, Daniel E. (1993), p. 510.

[1154] For example, the Sale of Goods Act (SGA) 1979 in England provides the availability of such a term; Sects.5-040 and SGA s.18, Rule 4, see Guest, A. G. (Ed.) (2002).

the buyer may have valid ground for preventing the bank from payment under L/C. A counter argument for this proposal may claim that such terms would run against the purpose of L/C, which is independent from the underlying sales contract. However, from the buyer's viewpoint, it would be an effective strategy for defeating fraud in L/C transactions.

Confirm Issuance of BL

It is recommended that buyers ask for copies of the documents presented under the L/C to be emailed, couriered or faxed to them before presentations to banks, which will allow them time to make independent investigations to verify whether some key documents such as BL are authentic.[1155] A common-sense approach can be to call the issuer to check the authenticity of the key document BL.[1156] It is recommended that the telephone conversation be taped legally when telephoning the issuer; and if possible, the buyer must conduct its own search of the carrier and contacting number.[1157]

Require Carrier to Send BL to Banks

Normally in a L/C transaction the carrier will send the original BL to the seller (shipper) of the goods, and the seller then presents the original BL or accompanying copies as required to the paying bank. Such a way of delivering BL from sellers to banks opens the door for forgery. Some carriers may even deliver BL in blank forms to their shippers long before the shipment; in such circumstances, it seems nothing can be done to prevent dishonest sellers from filling in the blank forms and then signing the names of authorised carrier's agents.[1158]

Therefore, it is proposed that a buyer may require that carriers deliver the original BL to paying banks, as the L/C is not honoured without receiving the BL.[1159] It is believed that in this way the opportunities for forgery by sellers are reduced. However, this is not an absolute safeguard, as it is still difficult for the buyer to prevent fraud where the seller conspires with the carrier and delivers a false BL to the bank.[1160]

Use Performance Guarantees

Using a performance guarantee might be the best method for the buyer to be protected from fraud by the seller.[1161] By issuing such a performance guarantee with the buyer as beneficiary, the seller provides a guarantee to carry out their contractual obligations. Deficient behaviour might obligate the issuing bank to pay the stipulated amount to the buyer, solely upon a demand by the buyer. The use of performance guarantees might make the transactions more complex and increase costs due to a service charge at the bank. However, such a guarantee

[1155] Mukundan, Pottengal (2008), speech and material, Vienna Conference; see also Gu, Min (2000), p. 207.
[1156] Murray, Daniel E. (1993), p. 512.
[1157] Ibid.
[1158] Murray, Daniel E. (1993), p. 511.
[1159] Ibid.
[1160] Ibid.
[1161] Demir-Araz, Yeliz (2002), p. 134; see also Gu, Min (2000), p. 208; Sun, Dingjie (Chief Ed.) (1999), p. 188.

provided by a seller with an unconditional undertaking by a bank could reduce the likelihood of fraud to the lowest level.

Take Insurance and Export Credit Insurance

Insurance is a traditional method of transferring relevant risk to an insurance company under insurance contracts. Insurance plays a large role in most risk management practice.[1162] Unfortunately, insurance normally does not cover the fraud risk in L/C transactions. In practice, some insurance companies may agree to cover such risks but with a high premium, or require the customer to have a series of transactions rather than a single transaction to be insured by the same company. However, it is difficult to predict how insurance markets will respond to fraud risk in L/C transactions.

Export credit insurance plays a basic and vital role in international trade and it essentially supports both the buyer and the seller. There are various institutions, including government and private agencies, (e.g. in the UK, it is Export Credits Guarantee Department), that insure import, export and foreign investment risks. Usually export credit insurance covers the risks as follows: firstly, commercial and business risk, such as buyer's insolvency, unwillingness to pay, failure of adequately performing contract; secondly, political and related risks; and thirdly, financial and currency risks.[1163]

Covering the risk on failure to adequately perform a contract is important for our subject matter. If the non-existence of goods paid by L/C is due to the seller's failure to fulfil the contract, then it can be covered by an export credit insurance contract. However, as for the understanding of the failure of adequately performing a contract, it most probably depends on the scope defined by the export credit insurance agency and may vary from one to another.

What Preventive and Proactive Measures Can Sellers Take?

Choose a Credible Partner

Choosing a credible trading partner is the best way of avoiding fraud or falling into a harmful situation. A well-known L/C expert pointed out that the buyer who employs L/C to pay should be very careful and must clearly know who the trading party is.[1164] This suggestion is also relevant to the seller.

A common channel by which to investigate the credibility of new customers is through the bank and those professional institutions that provide credibility investigation.[1165] If the trading partner is a middleman, then it is much more

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[1162] Young, Peter C. & Tippins, Steven C. (2001), *Managing Business Risk: An Organization-Wide Approach to Risk Management*, New York: American Management Association, p. 324.
[1163] Van Houtte, Jan (2002), pp. 285-287.
[1164] Yang, Liangyi (1998), p. 172; see also Zhou, Xianshun & Liang, Lan (2006), 'Risk Prevention Measures of Exporters Under L/C', *Science Information*, Vol. 4, 176.
[1165] Gu, Xiaorong & Ni, Ruiping (Eds.) (2005), p. 237; see also Zhou, Qinghua (2001), 'Discussion on Preventive Measures and Judicial Remedy to L/C Fraud', *Contemporary Law Review*, No. 12. 68, pp. 68-69; Cheng, Songliang & Xiao, Xiao (2008), 'Discussion on L/C Fraud', *Pioneering with Science & Technology Monthly*, No. 8, 131, p. 132.

important to find out its credibility including its economic strength and its past record of implementing contracts.[1166]

Draft International Sales Contract Carefully

Usually L/C clauses in a L/C agreement are essentially based on an underlying international sales contract. Therefore, the whole sales contract, especially contracting clauses on the various documents should be drafted as clearly as possible.[1167] It would be preferable if the various required documents including BL, insurance policy, commercial invoice, inspection certification, certificate of origin and other possible documents are stipulated clearly in the sales contract. If contingent conditions in the future are possible to predict and are stipulated in the sales contracts, then the possibility of inserting soft clauses into L/C agreements would be reduced.

Check L/C after it is Received

The seller needs to carefully and promptly check the L/C after it is received, so as to leave sufficient time if any amendment is necessary and to avoid the failure of not having the conforming documents.[1168] There are two main aspects requiring attention when the L/C is checked. Firstly, the seller needs to check the validity of the L/C itself, including the credibility of the issuing bank, the terms of honouring payment, and the appropriateness of period of validity.[1169] Secondly, the seller needs to check whether the L/C terms comply with the clauses of the sales contract.[1170]

Once the seller identifies soft clauses in the L/C, the seller must immediately require the applicant to amend; at the same time, the seller sets forth the time limit for the buyer to amend or provide other guarantees, and clearly points out that the buyer should extend the validity of the L/C due to the delay of amendment.[1171] If the buyer refuses to amend the L/C afterwards, the seller may claim that the contract is terminated and can require the buyer to provide a valid guarantee, and further preserves the right to claim for compensation as the buyer breaks the sales contract due to the failure of opening the L/C.

[1166] Sun, Dingjie (1999), *Financial Fraud and Legal Countermeasures*, Peking: People's Court Publishing House, p. 176; see also Yang, Zhengming (Ed.) (1999), p. 215.

[1167] Gu, Xiaorong & Ding, Muying (2000), p. 213-214; see also Cai, Lei & Liu, Bo (1997), pp. 323-325; Shi, Donglian (2005), 'L/C Fraud and Risk Prevention of Exporters', *Market Modernisation*, Sep. (2),No. 444, 90, p. 91. Zhu, Min (2006), 'The Causes and Risk Prevention of L/C Soft Clauses', *Finance and Accounting Journal (Integrated)*, No. 3, 35, p. 36; Hong, Tao (2009), 'L/C Fraud and Preventive Measures in International Trade', *Modern Business*, No. 11, 89, p. 91.

[1168] Li, Xiaoyong (1998), *Financial Crime and Prevention*, Hangzhou: Hangzhou University Press, 1st ed., p. 17; see also Bai, Jianjun (1994), p. 31; this is only one small part in managing documentary credits on the side of exporters; for a detailed discussion see 'Vincent O'Brien with Some Personal Tips for Exporters who Receive an L/C', *DCI (ICC)*, Autumn 1997, Vol. 3, No. 4, pp. 21-22.

[1169] Wang, Haizhi & Ma, Youxin (2000), p. 213; this point is also closely related to the prevention of L/C soft clauses, see Li, Xiaoyong (1998), p. 176.

[1170] Hu, Yuexiu (2007), 'Soft Clause of L/C and Risk Prevention', *Market Modernisation*, No. 512, August (Second), p. 296; concrete contractual terms that need to be checked, see also Li, Xiaoyong (1998), p. 176.

[1171] See e.g. Lu, Jingsheng (2003), *Legal Security Study and Measures in Business Operations*, Peking: China Economy Press, p. 299; see also Chen, Zhenhang (2007), 'The Risk and Its Prevention In International Letter of Credit Transactions by Exporters', *Science and Educational Innovation*, March, No. 6, 220, p. 221.

Establish a Set of Effective Criterion of Soft Clauses

The key of preventing soft clause problems in L/C transactions is to establish a set of effective criterion that could help to identify various L/C soft clauses.[1172] Through such criterion, when one soft clause is in a L/C, it is possible to identify which type of soft clause it is, what effect it can bring to the seller, and what protective measures can be taken. Unfortunately, there is no standard criterion for it as L/C soft clauses are different and variable. Preventing soft clause becomes feasible, if the seller is aware of possible soft clauses in each stage of a L/C transaction.[1173] Before solving the problem of L/C soft clauses in a L/C, the seller must not impatiently ship the goods in order to avoid more loss.

Concerning problematic soft clauses in a L/C, on the one hand, we emphasise preventing including such clauses; on the other hand, we recommend the sellers make use of contractual provisions to protect themselves.

Cooperate with Internal Units and Banks

It is important for the seller to make efforts to cooperate between different units inside the company and cooperate with banks.[1174] It is clear that sellers need to have sufficient knowledge not only of their business but also of L/C transactions. L/C is in itself complicated and risky, thus once a L/C transaction is involved, it is essential not only for each unit of a company to do its own work well, but also to cooperate with each other through effective communication. In addition, the seller must cooperate with the advising bank in its home country[1175] by seriously taking on board the bank's advice on some terms in the L/C.

However, it should be noted that the preventive and proactive approaches not only involve efforts from international trading parties, but also efforts from various other parties, such as banks, lawyers and some organisations. The legal health of the L/C system in general, and decreased fraud in L/C transactions in particular, might be achieved through cooperation between these parties. Therefore, the possible preventive and proactive measures that other parties can take will be discussed and reviewed.

[1172] Xu, Donggen (2005), p. 310; see also Wang, Xiaodong (Ed.) (2006), p. 79; Jin, Xiaohua & Zheng, Shuhua (2005), 'Analysis of L/C Soft Clauses', *Market Modernisation (Academic)*, No. 7, 70.

[1173] There are several stages such as the stage of LC taking effect, inspecting goods, shipping goods and accepting goods, Liu, Zhiyong (2006), 'Analysis of LC Fraud', *Academic Journal of Shanxi Provincial Committee Party School of C.P.C.*, Vol. 29, No. 3, June, 107, pp. 108-109; see also Wu, Renbo (2009), 'Identification and Prevention of L/C Soft Clauses', *Practice in Foreign Relations and Trade*, No. 8, 56, p. 57.

[1174] See Wang, Xiaodong (Ed.) (2006), p. 81; see also Li, Xiaoyong (1998), p. 176; Bai, Jianjun (1994), p. 32; cooperation with banks may prevent the false L/C, ensure the creditability of the issuing bank, avoid L/C soft clause fraud, transferring L/C fraud, and so forth, see Yang, Zhengming (Ed.) (1999), pp. 216-217; Xie, Ying & Zhu, Zhiyong (2003), 'Discussion on L/C Fraud and Prevention', *International Economics and Trade Research*, Vol. 19, No. 5, Oct., 41, p. 44.

[1175] Wu, Cuihua (2005), 'Risk and Avoidance of Soft Clauses in L/C', *Economy Forum*, No. 12, p. 33; similarly, establishing a platform for exchanging information for business enterprises and banks is also recommended, see Zhang, Xianglan (1999), 'Discussion on L/C Fraud and Countermeasures', *Law Review (Bimonthly)*, No. 2 (Sum. No. 94), 78, p. 82.

What Preventive and Proactive Measures Can Banks Take?

The UCP provides that banks deal with documents, not goods, services or performance to which the documents are related. On the one hand, this provision facilitates international sales transactions; on the other, it makes fraud simpler. Currently, the bankers' single duty is to examine the documents at their face value to determine whether they conform to the requirements of the documentary L/C. Therefore, current rules and practices regarding the bank's responsibility of processing L/C transactions that contribute to L/C fraud need to be criticised, and should be changed; strong criticism has been made by Shiao-Lin Kuo, who argues that extending the bankers' duty must be seriously considered in order to prevent fraud in banking and trade.[1176]

Optional "Super Service"

The suggestion of having a bank "super service" in L/C transactions was discussed and reviewed early in the 1980s. A bank "super service" in a sense means to impose some obligation on the part of the paying bank to undertake any sort of investigation into the validity, genuineness, or accuracy of the documents before paying out under a L/C.[1177]

However, it can be criticised as being impractical for banks to check the authenticity of any documents or the signatures on such documents, due to the large number of shipping companies and agents in the world and the vast number of documents presented to banks in L/C transactions.[1178] It is also doubtful whether a safeguard can be provided as expected, even if the paying bank conducted some investigation, because it may be possible for the paying bank to check the existence of the ship and the seller, but it may not be possible to determine whether the goods were loaded on that ship and the nature or quality of the goods.[1179] Thus, it was further suggested that banks carry out investigations on some documents on an ad hoc basis; but such an approach did not seem to be a satisfactory answer.[1180]

Furthermore, increasing the checking of documents requirement would increase costs in terms of time and money. Therefore, it is further recommended that such a super service be optional with an additional fee charged by paying banks.[1181] Whether such a super service is available in a bank depends on whether a bank has the necessary resources to be able to perform this function. The function of a super service at least requires the establishment of lines of communications between banks and inspection agencies.[1182] Some developed market economy countries have already established sophisticated communication networks, which provide an advantageous position for the paying bank located in

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[1176] Demir-Araz, Yeliz (2002), p. 134.
[1177] UNCTAD Report, prepared by the UNCTAD secretariat, 'Review and Analysis of Possible Measures to Minimize the Occurrence of Maritime Fraud and Piracy', TD/B/C.4/AC.4/2, 21 September, 1983, para. 112, p. 32.
[1178] UNCTAD Report (1983), para. 114, p. 33.
[1179] Ibid, para. 115, p. 33.
[1180] Ibid, para. 122, p. 35.
[1181] Ibid, para. 124, p. 36.
[1182] Ibid, para. 132, p. 38.

such developed countries. The banks in developing countries do not have to have any new or sophisticated facilities in order to meet with customers' applications of this type. To arrange a L/C to be handled by another bank which provides super-service is probably enough.[1183]

In addition to the capability of a bank, such a super service also depends on the customers' demands. In cases where the buyer is confident of the creditability of the seller, such a service may be not necessary. Then unnecessary cost of extra checking is avoided and most L/C transactions will still be processed in a normal manner. It seems that buyers in developing countries are more likely to use such a service. The Bank of China has developed its services in the field of creditability investigation of foreign parties, and in investigating the loading of ships.[1184] The service of creditability investigation offered by the Bank of China includes providing commercial creditability reports through cooperating with creditability investigation companies in foreign countries or through its overseas branches.[1185] Through the report offered by this service, the customer can get to know a foreign partner's background, credit status, solvency capability, history record and so forth. The latter service refers to investigating the information of the carrier, the name of the ship, loading port, the condition of the goods and so forth by cooperating with organisations of the International Maritime Bureau and Lloyds.[1186] Through this service, the bank helps the customer confirm the authenticity of BL and follow the process of delivery of the goods, thus preventing the potential fraud risk to a great extent.

Thus, a bank's super service does not change its duty to examine documents at their face value. Whether such a service will be provided by a bank depends on its resources and its markets' needs. Moreover, such a service is optional, so that customers can choose whether to take advantage of it or not.

Investigate further where Fraud is Suspected

Besides the banks' optional "super service", banks may take some particular measures where a suspicion of fraud arises concerning documentary L/C transactions. It is preferable for banks to be aware of the importance of making more efforts where fraud is suspected.[1187] A bank may not bear any legal responsibility according to applicable rules and current law. Nevertheless, if the buyer (applicant) suffers loss from a successful fraudulent L/C transaction, the buyer's potential insolvency may endanger the bank's interest for receiving sufficient reimbursement from the applicant. Where the victim targets in L/C fraud schemes are banks[1188] (buyers and sellers colluding to defraud banks), banks can be faced with a large amount of financial losses. Under such circumstances, it is truly in

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[1183] Ibid, para. 132, p. 39.
[1184] Bank of China, www.boc.cn/cn, accessed 09 September 2008.
[1185] Ibid.
[1186] Ibid.
[1187] Xu, Junke (2007), pp. 111-112.
[1188] It is a different situation when fraudulent buyers intend to obtain shipping documents or goods, but do not intend to pay the bank; for further discussion see Todd, Paul (1996), 'Can Banks Protect themselves against Buyers' Fraud?', *DCI (ICC)*, Autumn, Vol. 2, No. 4, pp. 15-16.

the banks' interest to ensure that they know the real trading background of the customers and know exactly what activities their customers are asking them to finance by making independent checks into the transactions.[1189]

Where fraud is suspected, when banks examine L/C documents, banks may change their previous practice and take a more prudent approach. In particular, banks can examine carefully the presented documents under L/C by making further enquires and carrying out a close investigation of documents to prevent fraud occurrence.[1190] The banks might then identify the discrepancies in the documents presented by the seller, which might be critical signals of fraud.

Making more enquires to some extent requires more time and work on the part of bank personnel, thus potentially increasing the costs of the documentary L/C. However, this would be helpful for both the banks and the customers for preventing further loss from fraudulent circumstances.

Prudent Approach in Daily Business

In addition, it is recommended that banks take a prudent approach and follow several measures in order to prevent fraud risk in daily business. Firstly, an education programme for banks in preventing L/C fraud was proposed.[1191] In particular, it is suggested that banks do activities in their daily L/C transactions as follows[1192]:

> 1. emphasise the need for buyers and sellers to make enquiries to satisfy themselves on the standing and integrity of the parties involved;
> 2. advise buyers of possible protection (e.g. requiring independent checking of goods);
> 3. convince shippers that they will not be completely innocent parties if they imprudently accepted cut-price cargos or other advantages;
> 4. stress that payment is made against documents, and it is better if a buyer does not enter any transaction with a trading party whose credibility is not satisfactory;
> 5. highlight the facts of life – if something sounds too good to be true, it most probably is not true;
> 6. pay attention to the activities of national and international trade facilitation organisations in standardising documents and simplifying their production, as sometimes such practices may have security risks. If banks follow such advice in a consistent way in everyday business life, some progress towards prevention of L/C fraud will be achieved.

Secondly, banks need to fully examine the creditability of the L/C applicants, such as the reputation, the accounting situation, and solvency capability.[1193] Thirdly, a

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[1189] Tu, Weijuan & Huang, Wei (2004), 'Analysis of LC Fraud Risk and Preventive Measures by Banks', *Finance & Economics*, May (Supplement), 47.
[1190] Gu, Xiaorong & Ni, Ruiping (Eds.) (2005), p. 238; see also Kuo-Ellen, Lin S. (2002b), 'UCP and Fraud', *Journal of Money Laundering Control*, Winter, Vol. 5, No. 3, p. 261; Liu, Zhenduo (2006), 'Risk and Prevention of Bank under L/C', *Market Modernisation*, Feb. (2nd Issue), Vol. 459, 21.
[1191] Wang, Xiaodong (Ed.) (2006), p. 80; see also Yang, Zhengming (Ed.) (1999), p. 216; Wang, Chao & Xu, Yang (2003), 'Study on the Precautions of L/C Fraud', *Journal of Harbin University of Commerce*, No. 4 (Serial No. 71), p. 20.
[1192] Kuo-Ellen, Lin S. (2002a), p. 201.
[1193] See e.g. Liang, Shuxin & Wang, Hongyan (2006), *Letters of Credit Operation in Practice*, Peking: University of International Business and Economics Press, p. 119; also Zhou, Qisan (2002), 'L/C Fraud and Prevention', *Lawyer World*, No. 8, 19, p. 20.

random check on bills of lading presented to banks among good but not so well known clients is suggested.[1194] In addition, it is suggested that banks strengthen internal controls, follow standard operation in L/C business, strengthen the research on L/C fraud, increase scientific and technological input and collaboration, and enhance international cooperation.[1195] Finally, it is suggested that banks properly employ L/C fraud exception rules to prohibit L/C payment when they know about the fraud before paying out.[1196]

To sum up, to extend banks' duty of checking documents at their face value and to place more responsibility on banks in general in uniform customary rules seems neither necessary nor practical. It would be preferable if additional services are optional to both banks and customers. Then banks can make their decision as to whether to make a "super service" available based on their facilities and markets; and customers can decide whether or not to pay additional costs to employ such a service. Furthermore, where fraud is suspected, banks that do examination of documents under L/C are advised to conduct a closer investigation, for both the clients and banks' interests. Finally, banks need to take a prudent approach in their daily L/C transaction business.

What Preventive and Proactive Measures Can Lawyers Take?

The role of lawyers in preventive law and the proactive approach has been actively discussed. The traditional role that lawyers play in advocacy and litigation is still important. However, it seems that future lawyers will be multi-dimensional in their roles, skills and mentality.[1197] Future lawyers are also required to have the necessary skills and strategy to consider and handle legal problems preventively and proactively.[1198] Moreover, they are required to be able to compare different legal cultures and mentalities when dealing with cross-border issues; and they are increasingly needed to play a role in business cooperation and avoiding disputes.[1199]

[1194] Mukundan, Pottengal (2008), Executive Director of the ICC Commercial Crime Services, 'Fraud with L/Cs – latest modi operandi', speech and material in the 2nd Annual International Conference on Letters of Credit, organized by ICC Austria, Vienna, 29 May, 2008.

[1195] Dai, Xiaofang (2006), 'How Does Bank Prevent LC Fraud', *Jiangsu Business Consultation*, Vol. 2, 162, pp. 162 -163.

[1196] Liang, Shuxin & Wang, Hongyan (2006), p. 120; see also Gao, Yunsheng (2006), 'Risk Control of Issuing Bank Concerning L/C Fraud', *Journal of Shanghai Lixin University of Commerce*, Sep., Vol. 20, No. 5, 65, p. 68; Huang, Xia (2005), 'L/C Fraud, Prevention and Remedy', *Wuhai Finance*, Vol. 5 (Sum. No. 65), 16, p. 17; but such protection is limited due to several conditions, see Wen, Xuwu (2008), 'L/C Fraud and Bank Risk Prevention under UCP 600', *Economist*, No. 1, 258, p. 259.

[1197] 'The Multi-dimensional Lawyer and the Legal System', National Certre for Preventive Law, available at http://www.preventivelawyer.org/main/default.asp?pid=multi-dimentsional.htm, accessed 5 Feb., 2007.

[1198] Goldblatt, Michael & Hardaway, Robert & Scranton, Robert, 'Establishing the Mindset of Practicing Preventively', National Certre for Preventive Law, available at http://www.preventivelawyer.org/main/default.asp?pid=essay/goldblatt.htm , accessed 6 Feb., 2007; see also Taskinen, Tommi K. J., 'Some thoughts on Proactive Counselling and Legal Mentality', in Wahlgren, Peter (2006), p. 227.

[1199] Nystén-Haarala, Soili, 'Preventive Law – Some Theoretical and Practical Aspects', National Certre for Preventive Law, available at http://www.preventivelawyer.org/main/default.asp?pid=essays/nysten-haarla.htm, accessed 5 Feb., 2007.

Frequently lawyers adopt preventive and proactive approaches both in contract planning and in contractual risk management.[1200] Contractual risk management is becoming an integral part of the enterprise risk management framework. Good contractual risk management clarifies the allocation of tasks and costs, minimises problems and disputes and improves the efficiency of business transactions.[1201] It is said that contractual risk management is not a matter merely for lawyers as it is not just about contract drafting tactics, but requires collaboration between all members of the enterprise who have an interest in the implementation of the contract.[1202] In addition, a good contract must be able to answer the questions of what if and what if not, contain provisions that predict the possibility of a breach by the other party or by itself and clarify abilities and remedies, and provide procedures by which any problems or potential disputes are handled.[1203]

Based on the aforementioned ideas, concerning fraud prevention in documentary L/C transactions, several points require lawyers' attention, depending on which parties the lawyer gives advice to. Let us suppose that a lawyer provides legal services to the buyer in international trade involving the L/C payment method. Firstly, the lawyer can provide an analysis of the risk of fraud in L/C transactions and make suitable suggestions to the buyer to manage such risk properly. Secondly, when checking a contract, the lawyer is required to be capable of identifying some definite terms[1204] in international sale contracts which might be tricky or signals of fraud. Third, the lawyer is required not only to know the relevant legal rules and legal culture of the other trading party's country, but also to make them clear to the buyer.[1205] Last but not least, the lawyer is required to be able to predict potential disputes, and discuss different resolutions to different types of disputes with the buyer.[1206] Similarly, when a lawyer provides legal services to a seller in L/C transactions, it is important that the lawyer keeps L/C

[1200] Rudanko, Matti, 'Preventive law and International trade', National Certre for Preventive Law, available at http://www.preventivelawer.org/main/default.asp?pid=essay/rudanko.htm, accessed 5 Feb., 2007; concerning contractual risk management, see Keskitalo, Petri (2000), *From Assumptions to Risk Management*, Helsinki: Helsinki Kauppakaari Oyi.

[1201] Xu, Lanying & Li, Xiangmin (2003), 'The Ways of Preventing Risks Through Contract Management', *Commercial Research*, No. 15 (General No. 275), 37; see also Wang, Jiansheng & Zhang, Dongxiang (2002), 'How to Strengthen Enterprise Contract Management', *Economist*, No. 7, 294.

1202 'Contractual Risk Management: Not just a Matter for Lawyer!', available at http://ifnews.if.fi/en/latest-topics/liability-newsletter/contractual-risk-management--not-just-a-matter-for-lawyers-.html, accessed 07 December, 2007.

[1203] Ibid.

[1204] For discussion on the importance of identifying invisible contract terms, see Haapio, Helena (2004), 'Invisible Terms in International Contracts', *Contract Management*, July, 32-35.

[1205] Dauer, Eduard A., 'The Role of Culture in Legal Risk Management', in Wahlgren, Peter (2006), p. 93; see also Wang, Zhuilin (2006), *International Commercial Rules and Techniques*, Wuhan: Wuhan University Press, pp. 227-228.

[1206] Forrest S., 'Managing and Preventing Disputes', National Certre for Preventive Law, Mosten, available at http://www.preventivelawer.org/main/default.asp?pid=essays/mosten.htm, accessed 6 Feb., 2007; for further discussion on how to design a dispute or conflict resolution system, see e.g. Ury, William L. & Brett, Jeanne M. & Goldberg, Stephen B. (1988), *Getting Disputes Resolved: Designing Systems to Cut the Cost of Conflict*, San Francisco: Jossey-Bass Publishers, 1st ed., pp. 1-84; Costantino, Cathy A. & Merchant, Christina Sickles (1996), *Designing Conflict Management Systems: A Guide to Creating Productive and Healthy Organizations*, San Francisco: Jossey-Bass Publishers, 1st ed.

soft clauses in mind, cooperates with the seller to make sure sales contracts are drafted carefully and that the L/C is checked promptly after it is received.

Therefore, in general it is essential for lawyers to think about legal problems and disputes preventively and proactively and to cooperate closely with their clients, thus properly managing fraud risk in contracts and L/C transactions. It is then hoped that L/C fraud could be prevented through cooperation between all the relevant parties; and thus a sound legal and commercial environment would be achieved at a general level and in particular a healthy L/C market would be maintained and facilitated.

5.2.2 L/C Fraud Response

In case the preventive measures fail to work, the victim enterprises must be able to respond to L/C fraud promptly and have remedial measures in place. It is recommended that firstly the enterprise must identify and look for suspected signals, and endeavour to find out the truth of the case as soon as possible through various means, such as a foreign bank, shipping agency, cargo agency, shipping broker, International Maritime Organisations, Lloyds and so forth.[1207] Then, if possible, the victim enterprise can send a special working group to investigate on the spot, or employ a foreign lawyer to bring a lawsuit against the fraudster, or apply for a property perseveration order from the court after investigating the fraudster's financial status, such as banking deposit or assets, or report to the local police promptly.[1208] In a word, enterprises need to respond to L/C fraud promptly and effectively; and have systematic steps to follow so as to reduce or recover potential losses.

5.3 WILL ELECTRONIC L/C PROTECT ITSELF FROM FRAUD?

Trade documentation in L/C transactions has remained mainly paper-based in the past, which has caused inefficiency, fraud and international lawsuits.[1209] The topic of electronic L/C is not new, and the discussion in the literature started in the 1980s. It is argued that digitisation may reduce the occurrence of fraud, as the documents would be better controlled and the means of verification would be quicker and easier.[1210] A similar argument maintains that moving to an electronic transaction carries a natural benefit, which is the reduction of the ability to conduct a fraudulent transaction, because authenticating messages contained in the underlying electronic record or digital signatures and other cryptographic

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[1207] Meng, Yuqun & Chen, Zhenying (1999), *Shipping Fraud and Legal Countermeasures*, Peking: People's Court Publisher, p. 312.
[1208] Meng, Yuqun & Chen, Zhenying (1999), p. 313.
[1209] Reinbach, Andrew (1997), 'Bringing Trade Documentation into the 20th Century', 23 *Bank Systems & Technology*; Feb 1997; 34, 2; ABI/INFORM Global, p. 23.
[1210] Kozolchyk, Boris (1992), pp. 89-92; see also 'Christiaan van der Valk Explains the Basics of Digital Signatures and Certification', *DCI (ICC),* Spring 1997, Vol. 3, No. 2, pp. 11-12; Gu, Xiaorong & Ding, Muying (2000), p. 221.

techniques offers greater safety than that on paper.[1211] However, before accepting this argument, we must be aware that it will take time to prove its correctness, and there will be extensive opportunities for fraud in electronic systems.[1212]

Until now several platforms allowing operation of electronic L/C have been established. However, to a large extent the current legal and technical infrastructure has far from been sufficient to support the wide application of electronic L/C environment. This section will assess whether L/C can be effectively adapted to paperless trade and discusses to what extent the operation of electronic L/C can reduce the possibility of fraud.

5.3.1 Arrangement of Electronic L/C

For L/C transactions to operate electronically, electronic operation[1213] of the creation, communications, and documentary exchanges under different contractual arrangements must be made possible.[1214] As introduced in Chapter 1 previously, a typical L/C transaction involves at least three interconnected, but also independent contracts. We will look at the electronic operability of each arrangement.

Contract Between Applicant and Issuing Bank

It can be said that a contract for the issuance of L/C concluded electronically is considered as having all the same legal qualities as a contract concluded on paper in many jurisdictions.[1215] Nowadays, it is common for banks in developed countries to make online application of L/C available to their customers. Some banks may maintain systems open for all potential applicants for L/C applications on the Internet, whereas others may have closed systems that merely open to banks and certain customers.

Contract Between Issuing Bank and Correspondent Bank

Similarly, a contract between the issuing bank and correspondent bank can be concluded in any legally available way, such as on paper or in electronic form. Communications between banks concerning L/C instructions and L/C-related information have been conducted electronically for a long time through the Society

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[1211] Collyer, Gary (2003), 'Will Online Letters of Credit Rule?', *Trade Finance London*, Sep., p. 1; see also Slowther, Valerie (1998), the Insight Interview, 'Valerie Slowther Explains the ICC's Electronic Commerce Project', *DCI (ICC)*, Winter, Vol. 4, No. 1, p. 7.

[1212] Laryea, Emmanuel T. (2001), 'Payment for Paperless Trade: Are there Viable Alternatives to the Documentary Credit?', 33 *Law and Policy in International Business* 3, Fall, p. 19; Nilson, Åke argues that the amount of fraud by electronic means is smaller than the equivalent for paper-based commerce, in terms of the proportion, see Nilson, Åke (1998), 'Åke Nilson Reacts to the ICC's Recent Conference on Electronic Commerce', *DCI (ICC)*, Winter, Vol. 4, No. 1, p. 9; Liu, Yideng & An, Guangji (2007), 'Electronic L/C Problems and Theory', *Group Economy*, Jan. (1st Issue) (Vol. 217), 273.

[1213] For further discussion on the difference to the conventional form of operation, see e.g. Lipton, Jacqueline D. (1999), 'Documentary Credit Law and Practice in the Global Information Age', 22 *Fordham International Law Journal* 1972, pp. 1984-1989.

[1214] For further about electronic variants of the traditional documentary credit procedure, see Maduegbuna, Samuel O. (1994), 'The Effects of Electronic Banking Techniques of the Use of Paper-based Payment Mechanisms in International Trade', *Journal of Business Law*, (July), 338-362, pp. 345-349.

[1215] Whitaker, David R. (1991), p. 1781.

for Worldwide Interbank Financial Telecommunications (SWIFT)[1216]. SWIFT is a computerised telecommunications network for transmitting messages and it is nowadays widely accepted by the major banks in the world, which proves such electronic messaging of L/C through SWIFT is effective. The safety of the SWIFT system is guaranteed by a complex set of security devices (such as "log in" procedures, application-selection procedures, message numbering, error checking, and control of access at processors and system control centres, encryption and authentication), which have been effective in preventing outsiders from entering the system.[1217]

The liability of a fraudulent transmission is allocated between SWIFT and its users. A key principle and a number of corollaries guide SWIFT's liability. The key principle is that the SWIFT is not responsible for any section of the teletransmission not directly under its control.[1218] A number of corollary principles have been identified, but only two of them relate to fraud. The first is that SWIFT is not liable for an unauthorised transmission unless the victim establishes that SWIFT could not reasonably have believed the validity of the transmission.[1219] The second is that SWIFT is liable for fraud by its employees, subcontractors, and third parties when acting within the part under SWIFT control and if such fraud is proved, SWIFT only bears responsibility for the users' "direct" losses or damages.[1220] Regarding third-party fraud, SWIFT is only liable if it could not have reasonably supposed the validity of the message or if the fraud occurred due to the SWIFT's failure to follow its security procedures.[1221] Thus, the liability of SWIFT concerning fraud is basically limited; and the users of such a system mainly bear a large part of the liability and losses if fraud occurs.

Contract Between Correspondent Bank and Beneficiary

Commutations between the correspondent bank and beneficiary are sometimes still paper-based. It seems that the electronic form is becoming popular as banks are encouraging the electronic use of advising credits to beneficiaries by using dedicated interfaces or Internet-based systems.[1222] Due to the benefit of saving time and costs, banks that have proper electronic systems prefer to advise credit

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[1216] Nilson, Åke (1996), 'Åke Nilson Asks some Pointed Questions about the Role of Banks in Handling Electronic Credits', *DCI (ICC)*, Autumn, Vol. 2 No. 4, pp. 16-17.

[1217] In particular, encryption refers to the process of encoding or scrambling a message in order to make the message unintelligible for those who are unauthorised to see without decoding or unscrambling (which is decryption), and this minimises the possibility of being altered or interfered with; to authenticate means to validate a message by using an algorithm or mathematical formula that calculates the contents of a message from header to trailer; being part of the process of validating a message, SWIFT checks if authentication is required by the message type; the issuing bank and receiving bank can conduct additional authentication checks by looking at whether the messages received by both the receiving and issuing bank match; if the messages do not match, it is possible that the system is being used fraudulently or without authorisation, see Kozolchyk, Boris (1992), pp. 48-49.

[1218] See SWIFT Rule 21.5.1.

[1219] SWIFT Rule 23.1.

[1220] SWIFT Rule 23.4.2.

[1221] Kozolchyk, Boris (1992), 'The Paperless Letters of Credit and Related Documents of Title', 55 *Law and Contemporary Problems* 39, Summer, p. 56.

[1222] Whitaker, David R. (1991), p. 1781.

electronically. A lack of acceptable electronic interfaces between banks and their customers seems to be the main problem.[1223]

Problem of Presentation of Documents Electronically

Theoretically speaking, the L/C as a payment mechanism can operate electronically without major problems. However, in the current L/C practice, electronic presentation of documents is still not common.[1224] Paper documents are dominant in international L/C transactions. It has been shown that nowadays the operation of the electronic L/C is mainly limited to the stages of opening and advising the L/C; but the electronic L/C has not been implemented in the key stages such as presentation and examination of documents under L/C.[1225] The failure to present documents electronically can be explained by a number of reasons.

Firstly, the question concerns whether all the documents regarding the whole L/C transaction can be submitted electronically. A complete L/C transaction is always connected with an underlying contract, and other contracts such as a contract of carriage and contract of insurance. There seems to be no legal difficulties in concluding an international sales contract electronically. However, it will not be simple to make a bill of exchange electronically.[1226] Furthermore, an electronic insurance contract can pose minor legal problems. However, it is argued that the major obstacle to an electronic L/C transaction is the absence of a generally accepted electronic BL system.[1227]

A study has been done in order to investigate the potential for an internet-based, third-party internet service provider providing electronic bills of lading and shipping documents services.[1228] This study adopted an exploratory attitude by conducting a survey targeted at BL users, traders, middlemen, and the shipping industry. However, the electronic BL is not considered secure and its legal status is not clear[1229], although it can offer several advantages, such as speedier documentation, better management information and savings on postage.[1230]. Furthermore, extensive training is needed through state support or partnerships with internet-based third-party internet service providers so as to build infrastructure, knowledge, confidence and trust among potential users. Although this

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[1223] Ibid.

[1224] Railas, Lauri (2004), *The Rise of the Lex Electronica and the International Sale of Goods: Facilitating Electronic Transactions involving Documentary Credit Operations*, Helsinki: University of Helsinki, p. 355.

[1225] Chen, Yuan & Li, Chen (2006), 'The Application of Electronic L/C in International Trade Settlement', *Business Times*, Vol. 10, 70, p. 72.

[1226] Nilson, Åke (1997), 'The Implications of the S.W.I.F.T/Bolero Joint Venture', *DCI (ICC)*, Winter, Vol. 3, No. 1, p. 17.

[1227] Whitaker, David R. (1991), 'Electronic Documentary Credits', 46 *Business Law*, 1781, p. 1781; American President Lines (APL) has developed a comprehensive shipping information resource on the web, under which registered shippers can have APL electronic bills of lading; for further explanation see 'Åke Nilson on How Internet Security is being Improved', *DCI (ICC)*, Autumn 1997, Vol. 3, No. 4, p. 12; also Todd, Paul (1994), 'Dematerialisation of Shipping Documents', *Journal of International Banking Law*, 9(10), 410-418, pp. 411-412.

[1228] See Mei, Zhiliang & Dinwoodie, John (2005), 'Electronic Shipping Documentation in China's International Supply Chains', *Supply Chain Management: An International Journal*, 10/3, pp. 198 – 205.

[1229] Ibid.

[1230] Generally about the advantages of electronic BL, see e.g. Faber, Dinan (1996), 'Electronic Bills of Lading', *LMCLQ*, (May), Part 2, pp. 242-243.

study focused on BL users in Shanghai, China, it may be just in saying that for the electronic BL to operate widely in developing countries will take a long time.[1231]

In commercial L/C transactions, many documents required to be presented have to be in a paper or the original form so that it is convenient for the applicant to obtain goods from carriers or to pass some governmental tests for import.[1232] The electronic form of some commercial documents is simply not available in the current market; government-generated documents, which are produced by governments for export, import, or approval, are still a principal challenge, although many governments have made great efforts to remove paper impediments to international trade in their regulations.[1233]

Secondly, the problem touches on verification of the authenticity of electronic documents.[1234] Thirdly, the secure links between the issuer and the beneficiary are not available, which can lead to further impediments.[1235] In brief, it is without doubt that electronic documents can provide a large amount of savings, especially in high-value transactions. However, making the main documents under L/C transactions in electronic form available still comes up against practical hurdles in the real world. Thus, a world of entirely electronic L/C transaction cannot be expected any time soon.

5.3.2 Bolero Platform

There are several providers who are eager to design innovations in trade finance, such as Bolero[1236], @GolbalTrade[1237], TradeCard[1238]. We will particularly examine the Bolero platform as an example in order to understand further the operation of electronic L/C transaction. Bolero, a London-based trade industry organisation, aims to provide secure electronic delivery of trade documentation on a worldwide basis.[1239] Bolero attempts to make an electronic BL and title transfer, electronic payment, delivery and shipping available and offers encrypted security tools to combat fraud or forgery.[1240] A legal infrastructure for dealings between participants is governed by the Bolero Rule Book.

An electronic BL system is the essential system of the Bolero platform. Electronic BL under Bolero operates through a registry, which is a centrally held database holding the status of each Bolero BL.[1241] The system of Registry Record in

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[1231] See Cai, Lei & Liu, Bo (1997), p. 321; see also He, Ziheng,& Sun, Yang (2009), 'L/C Fraud under New Environment and Function of UCP 600 in Preventing Fraud', *Market Forum*, No. 5 (General No. 62), 49, p. 51.
[1232] Barnes, James G. & Byrne, James E. (2001a), 'E-Commerce and Letter of Credit Law and Practice', 5 *Int'l Law*. 23 Spring, p. 25.
[1233] Ibid, p. 26.
[1234] A number of related questions can be raised, such as whether it is truly produced by the proper person**,** see Whitaker, David R. (1991), p. 1785.
[1235] Barnes, James G. & Byrne, James E. (2001a), p. 25.
[1236] Official website, www.bolero.net.
[1237] Official website, www.cceweb.com.
1238 Official website, www.tradecard.com.
[1239] Corporate Overview, available at www.bolero.net/company/corporate_overview.html, accessed 19 Feb., 2009.
[1240] Biederman, David (1998), 'Who Benefits from Bolero?', 17 *Traffic World*; Nov 16; 256, 7; ABI/INFORM Global, p. 17.
[1241] Railas, Lauri (2004), p. 403; for further discussion on the Bolero bill of lading, see pp. 410-412.

this database replaces the endorsement chain in paper form. The central registry also contains the encrypted electronic "signatures" of participating companies.[1242] It was commented that if this project succeeds, documentary trade transaction will be facilitated and frauds will be reduced, as the data relating to the transaction will be inter-related and integrated, and the authentication of messages will be conducted through digital means.[1243]

However, it is still difficult for buyers and sellers to abandon the paper-based processes they have relied on for centuries.[1244] The operation of such an electronic system requires all parties in a L/C transaction, such as the seller, buyer, bank, carrier, and cargo insurer to participate in the Bolero platform[1245]; otherwise, the commercial value of such a system will be narrow.[1246]

5.3.3 Development of eUCP

The first version of eUCP created by ICC came into effect on 1 April 2002.[1247] Along with the new UCP 600, the eUCP has been updated, but continues to be a supplement to the UCP. The eUCP is applicable when the L/C indicates expressly that it is subject to the eUCP.[1248] The eUCP can be applicable to electronic presentations and a mix of paper documents and electronic presentation; and provides the necessary rules to allow both sets of rules to work together.[1249]

It seems that the eUCP assumed that electronic messages could be more securely protected against unauthorised alterations by authenticating systems than messages contained in paper documents.[1250] It is further argued that the reliability of authenticating systems can be improved by technological developments, although the electronic presentation of documents is possible to falsify by unique means in the electronic environment.[1251]

To sum up, although the system of electronic L/C has several advantages, it takes time for it to operate in practice. The analysis of the process of authenticating electronic messages through SWIFT shows the great possibility for preventing fraud. However, such an advantage can only be taken when messages are sent between banks. The electronic L/C is unable to be put in use entirely though, due

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[1242] Biederman, David (1998), p. 17.
[1243] UNCTAD Report (1996), 'Documentary Risk in Commodity Trade', p. 87, available at http://www.unctad.org/en/docs/itcdcommisc31_en.pdf, accessed 03 April, 2009.
[1244] Hawser, Antia (2006), 'Crossing Boundaries', 14 *Global Finance*, Sep.; 20, 8, p. 14.
[1245] UNCTAD Report (1996), p. 91.
[1246] Gamble, Richard H. (2001), 'Beyond Letters of Credit: Innovations in Trade Finance', 16 *Business Credit*, Nov/Dec; 103, 10: ABI/INFORM Global, p. 22.
[1247] For further discussion on eUCP, see Lacoursière, Marc (2002-2003), 'Designing an Electronic Documentary Credit for Small and Medium – Size Enterprises', 18 *Banking & Finance Law Review* 155, pp. 174-179; also Bergami, Roberto (2004), 'eUCP: A Revolution in International Trade', 8 *Vindobona Journal of International Commercial Law & Arbitration*' 23; Ellinger, E.P. (2004), 'Use of Some ICC Guidelines', *Journal of Business Law*, (Nov.), 704-709, pp. 706-708.
[1248] UCP 600, article e 1 Scope of the eUCP, c.
[1249] UCP 600, article e 1 Scope of the eUCP, a; for further discussion of the problems of electronic L/C in international trade, see Zhang, Xiuqin (2009), 'Certain Problems of Electronic L/C Application in International Trade', *Practice in Foreign Relations and Trade*, No. 11, 58, pp. 59-61.
[1250] Takahashi, Koji (2004), 'Original Documents in Letters of Credit in the Era of the High-Quality Photocopiers and Printers', 121 *Banking L.J.* 613 (July/August), p. 624.
[1251] Ibid.

to both banks and beneficiaries not having the same communication platforms, and the barriers to presenting documents electronically, especially electronic BL. Furthermore, it is difficult for any electronic trading platform to foresee fraudulent behaviour and it is therefore impossible to completely exclude potential fraudsters from its market place. Therefore, the idea of relying on electronic L/C to prevent L/C fraud does not appear safe.

5.4 SUMMARY

An enterprise needs to place fraud risk at the centre of its enterprise risk management framework, due to the huge potential harm that fraud may cause. According to fraud risk management theory, the key aspects of effectively managing fraud are fraud prevention, and in case fraud prevention fails, proper and effective response to fraud needs to be in place. Accordingly, L/C fraud risk management essentially includes L/C fraud prevention and L/C fraud response. However, in this chapter we have highlighted the aspect of L/C fraud prevention, and focused on examination of what preventive and proactive measures that parties involved in L/C transactions can take. Keeping in mind international L/C fraud types and features, particular measures that can be taken by buyers, sellers and banks have been worked out and examined. Lawyers, who play a critical role in preventing L/C fraud, need to cultivate their preventive and proactive mentality and design proper customer-tailored solutions by cooperating closely with their clients. Finally, electronic L/C provides certain advantages, but it cannot totally protect L/C transactions from the abuse of fraud.

6 Conclusions

The L/C plays a significant role in international commercial transactions, and the L/C itself has its customary rules which have been widely accepted by the international commercial world. Unless a commercial system has been designed to have a function of combating fraudulent conduct, fraud can happen in that system. Thus, the documentary L/C fraud issue will inevitably be encountered in international commercial transactions.

What are the approaches to resolving the international documentary L/C fraud issue? This is the question posed in this doctoral dissertation. The body of the dissertation paints a comprehensive picture of different approaches to resolving the L/C fraud issue in international commercial transactions and points out the potential problems of each approach based on rational analysis. The approaches include not only a legal approach (criminal legal remedy and civil legal remedy), which provides the basic protection to commercial parties, but also include a business approach, which is mainly considered from the perspectives of potential victims and is recommended to be an important part of business practice for commercial parties who might be involved in L/C transactions. Therefore, the research adopts an inter-disciplinary and multi-levelled approach.

Commerce is by its nature international and globalisation has made international commerce even more important than before. Along with the increase in international business transactions, commercial and relevant law-making activities have been enormously active. Two assumptions have been generally accepted: firstly, an efficient system protecting property rights and facilitating transactions is crucial to commerce; secondly, differences in commercial law indicate inefficiency, thus commercial law should be harmonised. Commercial law seems to have been the most harmonised field, with plenty of legal transplants or legal adaptations.

To provide a high degree of certainty so as to promote international commerce, many nations have harmonised rules concerning contract terms, usages and customs. The harmonised law offers the advantage of promoting legal predictability and security and thus making the international legal business easier, in spite of different harmonisation processes. By avoiding the possibility of applying private international law and foreign substantive law, unified law reduces the legal risks in international business, and relieves the anxiety of the businessmen conducting international transactions, and of the judges resolving potential disputes.

However, national systems of commercial law still differ in many aspects, and there are always difficulties in harmonising some issues. In such situations, specific law has to be turned to. Fraud in the international documentary L/C is such an issue. Thus, when legal approaches to L/C fraud are concerned, besides international rules, rules at the national level have to be considered.

6.1 LEGAL APPROACH: CRIMINAL LEGAL REMEDY VS. CIVIL LEGAL REMEDY

L/C fraud is a difficult and subtle issue, as it does not necessarily fall into a certain legal field and it is not certain whether L/C fraud is a criminal or a civil matter. Even if L/C fraud is handled as a civil matter, it is difficult to distinguish and decide whether a dispute involved is a fraud or only a breach of contract. Criminal legal remedy is important to commercial parties. In Chapter 2, we have limited ourselves only to studying the relevant rules that deal with L/C fraud in England and China briefly, and have not performed a case law study. Certainly, differences can be seen in the particular rules in criminal law for tackling L/C fraud in England and China. English laws dealing with fraud are scattered at different statutes and case law, firstly because England has its common law system and secondly probably because the problem of L/C fraud in England is not so serious. Chinese law has a specific provision on L/C fraud, probably because the situation of L/C fraud under the criminal law context in China is serious. The seriousness of L/C fraud combined with other types of international financial crimes, has the possibility of endangering the Chinese national economy.

However, such rules in both systems have been uncertain and unspecific, and leave much discretion and room in judicial practice. Large scale and various types of international L/C fraud do require that different countries address the issue in a serious manner and improve the cooperation of the prosecutions of criminals and enforcement of criminal judgment, which has been discussed generally at the international and EU level. In Chapter 2 we have showed that the availability of such a legal remedy in different nations has provided the essential confidence for the commercial parties to undertake business transactions and some guarantee against crime; however, such a legal remedy can be ineffective in judicial practice due to procedural problems.

In general, we have not conducted a deep comparative analysis in Chapter 2, as criminal legal remedy is not the focus of our research. But it remains an interesting topic in the future to explore further how the comparative study would be conducted concerning criminal law field on the topic of L/C fraud.

The civil legal remedy to L/C fraud disputes has been examined in Chapter 3. The examination of L/C fraud exception rules is the focus of this research. In a way, to examine L/C Fraud Exception Rules is to study to what extent L/C is independent from underlying transactions. To deal with whether to apply L/C fraud exception rules in L/C fraud disputes is the process of balancing between the L/C fraud exception and L/C independence principle.

Two commercial principles have played a significant role in the development of the L/C fraud exception rules. Firstly, certainty is required for parties employing the L/C instrument. To ensure the smoothness of international commerce, parties engaged in large value transactions need to know exactly the legal consequences of using such a financial instrument, the risks they are going to bear and the remedies that are available. Secondly, trust is the foundation of any successful

commercial system. In the L/C payment system, parties engaged in such transactions suppose that different participants in transactions are trustworthy, and usually do not allocate the risk of fraud between them. Thus, legal principles or rules should be developed on the understanding that trust is the basis of commerce.

Therefore, where fraud is involved, the fraud exception is recognised as a limitation to the independence principle. Courts have acknowledged that the L/C fraud exception is necessary considering the intention of the commercial parties using the L/C and the fulfilment of their intended commercial purpose.

Nonetheless, it is not an easy task to reconcile certainty, trust and the commercial intentions of different parties with the international L/C system. As a general exception, the established fraud is widely accepted as an exception to the independence principle of L/C. To maintain certainty and trust in the L/C system, a three-step analysis must be considered when examining whether a L/C fraud exception is applied. Firstly, what are the defences (L/C fraud) that are or should be recognised? Secondly, what are the circumstances of immunisation of the L/C fraud exception? Thirdly, at what stage is the defence being placed, at an interlocutory injunction stage, or at a final stage before a trial court?

In the history of commercial law in England, several features of commercial transactions have been distinguished: (1) the principle is to encourage commerce, thus it is the law that follows commerce; (2) party autonomy in contracting is highly respected, thus flexibility and adaptability remain; (3) certainty is preferred to fairness in individual cases, only minimal protection for the weak or the ignorant is available.[1252] These features are also reflected in the approach of the English courts towards the L/C fraud exception rules. English courts have expressed the view that the enforceability of the L/C instrument depends on commercial practice so as to essentially protect commercial certainty in the L/C system. The L/C fraud exception rules in England are developed within a narrow scope and with high limitations, which means the L/C independence principle is strictly adhered to. However, we believe that the failure of providing an effective remedy to L/C fraud when dealing with the L/C fraud exception issue can also unfortunately undermine the certainty which the courts declared to protect.

The process of developing the L/C fraud exception rules by Chinese courts has not been smooth. At the beginning, there was no such legal concept as "L/C fraud exception" in Chinese law and judicial practice. The Chinese courts dealt with L/C fraud disputes according to available rules that were relevant (such as the general Principles of civil law, contract law), simple guidance issued by the SPC, and sometimes international practice. After the SPC confirmed the concept of "L/C fraud exception" in a particular case, other lower courts followed suit in using the idea to deal with L/C fraud disputes. At the same time, the procedural instrument – preservation order was criticised as not being suitable for prohibiting L/C payment in L/C fraud disputes. When the SPC aimed to establish the provisions dealing with L/C fraud, it studied the different models of many countries, looked at foreign judicial experiences, invited comments from scholars

[1252] Foster, Nicholas HD, in Örücü, Esin & Nelken David (2007) (Eds.), p. 271.

and practitioners domestic and abroad, and learned ideas from others. Finally, the provisions on dealing with L/C fraud disputes were established based on the Chinese courts' previous judicial practice, the laws that are available, widely accepted principles or ideas about L/C fraud exception rules in other countries. In particular, the provisions adapted common law countries' legal instrument of "injunction" to a new procedural instrument "stop-payment order" in China so as to establish rules and procedures that are best suitable for China's own situation.

To consider such a process from the perspective of legal transplant, China being an importer of L/C fraud exception rules, drew inspiration from multiple sources (not only individual legal systems but also rules at the international level), made proper adjustments based on its own legal experience and procedure. Thus, we consider that the formulation of the L/C fraud exception rules in China is a phenomenon of legal transplant or more properly legal adaptation.

In comparative studies, one important and practical question is whether legal transplant will have the expected function.[1253] Thus we would be expected to evaluate the new provisions on L/C fraud exception rules in China. Considering the relation of such new rules to pre-existing law, the new rules replaced the previous flawed and unsystematic rules, integrated the previous proper rules into new ones, and filled the gaps of rules dealing with L/C fraud disputes in China.

In addition, we consider that the approach of legal transplant in the Chinese L/C fraud exception rules is more contextualised, because the Chinese drafters realised the different features of China' own legal rules, procedure and judicial practice from other countries when establishing such rules. After the new L/C fraud exception rules came into effect, very few court judgements concerning L/C fraud disputes have been officially reported; and L/C fraud exception rules have been rarely exercised. We probably can assert that the enhanced standard of proof of L/C fraud and the more strict conditions of obtaining stop-payment order in the new rules have successfully discouraged litigating normal L/C contractual disputes as L/C fraud disputes; thus to some extent maintaining and supporting the integrity of the L/C instrument in international trade.

To some extent, L/C fraud exception rules should be dealt with in a similar way in different countries. The development of a highly integrated system of international commerce requires such kind of commonality between national legal systems. Thus, it is recommendable for more countries to adopt a framework similar to Article 19 of the UNCITRAL Convention or join the UNCITRAL Convention.

From the comparative study perspective, it can be identified that there are similarities concerning L/C fraud exceptions between England and China. In both countries' approach towards L/C fraud exception rules, fraud in documents is recognised: there must be evidence proving fraud (allegation is certainly not sufficient), the beneficiary must have the knowledge of fraud, and the paying banks must notice fraud before making payment. The immunisation of L/C fraud exception rules apply in both approaches. Court orders which intend to prohibit

[1253] Foster Nicholas, Chapter 4, in Harding, Andrew & Örücü, Esin (Eds.) (2002), n. 55 above, p. 57.

payment under L/C have to meet with strict conditions in order to be granted.

Nevertheless, the general economic environment, legal cultures, and other factors result in differences, which demonstrate that it is necessary to consider the context approach when developing certain rules in a country. England is a developed country with an advanced market economy system, and has rich and long experience of the L/C system. England also intends to maintain the status of London as an international financial centre, and even compete with others such as New York. Thus, English courts would highlight and place priority on the independence principle of L/C and limit the application of L/C fraud exception as much as possible. However, China only has a short period (around 30 years) of experience of the L/C system. The commercial parties need time to get familiar with the L/C instrument, and the Chinese courts need time to develop the L/C fraud exception rules in judicial practice. The existence of real L/C fraud in L/C disputes and the problem of increasing L/C fraud allegations more likely to be contractual disputes necessitates the establishment of provisions of the L/C fraud exception. Thus, China needs to respect and emphasise the independence principle of L/C so as to maintain the reputation of the L/C system in China in international trade. But at the same time, China needs to deal with L/C fraud in the context of civil litigation for commercial parties. The proper balance between the L/C independence principle and L/C fraud exception do need to be carefully weighted.

In Chapter 3, we have applied the comparative approach by providing comparative analysis of English and Chinese L/C fraud exception rules. We have chosen the comparative approach because it has demonstrated itself indeed a powerful and significant approach in legal studies. A wide range of model solutions for resolving a particular problem can be found and examined through the comparative approach. By considering the complexity of the real world, this approach has the advantage of discarding narrowness of the local view and establishing different models of law towards particular legal issues. In addition, we can see that the comparative approach has been of significance for a law reform in developing countries, and for the improvement of one's legal system. It is argued that adopting a particular foreign solution to a problem depends not on nationality, but usefulness and need.[1254]

The comparative approach has helped this research clarify the L/C fraud problem, identify different solutions towards the L/C fraud issue at both the national and international level, and further discover the method of searching for a solution for where relevant legal rules are inefficient or inappropriate. From the process of creating new provisions of the L/C fraud exception rules in China, we identify that the main approach of reforming law in China is to study different model solutions in other countries and international rules, learn ideas from different models, and adapt such rules to its own context. We think it is a proper approach and thus recommendable for a country which is looking for a solution to legal problems or intending to improve its own rules.

[1254] Zweigert, Konrad & Kotz, Hein (1998), p. 17.

However, it is not possible to simply state which model rules of L/C fraud exception are better or the best. This issue has to be considered under the context of different situations, which would in a way of justifying each model. In dealing with the rule of L/C fraud exception, the legislators and the courts of national jurisdictions must address the balance concerning the objective of facilitating international trade and the purpose of protecting against fraud. To facilitate international trade, the independence rule of the L/C must be highly respected and the rule of fraud exception must be restrained to narrowly limited circumstances in order to preserve the integrity and efficiency of the L/C as a method of financing international transactions. To discourage fraud, the rule of fraud exception needs a broader interpretation by national legislators and courts. A broader interpretation of the L/C fraud exception requires consideration of the issue of whether or not there is alleged fraud in the performance of an underlying contract; and such a consideration and practice may slow the speed and decrease the efficiency of L/C payment transaction. Which model of the fraud exception rule is exercised depends on which objective is preferred, and how the balance of different objectives is weighted.

Moreover, we propose using a freezing order in appropriate circumstances during L/C fraud disputes. The willingness of the courts to grant a freezing order in the circumstance of fraud suggests that the freezing order seems more useful than interlocutory injunctions. The new instrument of the stop-payment order in China does not in theory prohibit the employment of the previous procedural instrument – the freezing order.

Finally, with regard Chinese law reform in the future, we would propose that the procedural instrument stop-payment order be included in Chinese Procedural Law. In the current Provisions of the Supreme Court in the adjudication of L/C cases, such a procedure seems merely to be used to deal with L/C fraud cases, and whose function is quite narrow. If such a procedure were to be used in Chinese Procedural Law, it would have official legal status and it could be applied to other cases if necessary.

6.2 CIVIL LEGAL REMEDY: LITIGATION VS. ALTERNATIVE DISPUTE RESOLUTION

The procedural instruments (such as interlocutory injunction, stop-payment) used to remedy L/C fraud in civil litigation is usually at the interlocutory stage. The court decision at this stage usually does not resolve the commercial parties' disputes. Whether a permanent injunction or stop-payment order will be issued has to be decided after the trial concerning the substantive issues.

There is no international court for the resolution of commercial disputes and it seems not likely to be established in the near future. Thus litigating international L/C fraud disputes has to be conducted in the national courts of some countries. Furthermore, it is also recognised that in any international litigation several na-

tional legal systems can be involved and thus legal complexities, uncertainty and transaction costs relating to litigation would be increased on the whole.

The high transaction costs of litigation in an international L/C fraud dispute make it worthwhile to look at other alternatives for litigating such disputes. Chapter 4 has provided some indication of the alternatives (such as arbitration, mediation, and negotiation) to resolving L/C fraud disputes. However, what has been said should not be construed as implying that court litigation is dead. Court litigation in the national courts sometimes may be the only realistic choice available to commercial parties depending on the particular facts of the case. Other alternatives only offer complementary methods for settling disputes according to their respective features. International L/C fraud disputes should be resolved through the application of procedures and measures that are the most suitable for addressing the particular dispute between commercial parties.

Arbitrating international L/C fraud disputes between commercial parties is possible in theory. In Chapter 4, we have mainly discussed the issue of the arbitrability of the fraud issue, the independence principle of the arbitration agreement and interim measures in arbitration proceedings in order to explore the option of arbitrating international L/C fraud disputes. The research findings have shown that if commercial parties clearly state that a L/C fraud issue be handled by arbitration in the arbitration agreement, arbitrating an international L/C fraud dispute is possible. Besides confidentiality and a binding-decision, arbitration further provides the advantage of the arbitral awards being enforced under the New York Convention.

However, arbitrating L/C fraud disputes between parties in which one is a bank may have several practical difficulties. First, there is a general negative attitude towards arbitration concerning financial matters in the banking community. Second, arbitrating L/C disputes does not seem popular in the real world worldwide. Third, with regard international L/C transactions, in contracts provided by a bank, the dispute resolution clause usually states about court litigation, rather than providing flexible options. Therefore, it seems that an arbitration agreement between a bank and another commercial party would be difficult to reach.

Furthermore, the punitive damages issue has been discussed in detail, and the discussion demonstrated that legal attitudes and rules are diverse in different countries either under the civil litigation procedure or under arbitration, which may present a potential problem for enforcing a court judgment or arbitral awards where punitive damages are involved. Nevertheless, we observe the encouraging role that punitive damages may play in the situation where fraud has occurred during international commercial transactions, and propose that the legal and arbitral world adopt an affirmative attitude towards the application of punitive damages in exceptional circumstances such as fraud.

The ICC DOCDOX rules seem to be unsuitable for resolving L/C fraud disputes. Negotiating or mediating an international L/C fraud dispute seemed possible both in theory and in practice. However, case examples in practice have shown

that that negotiation or mediation is likely to be more effective when combined with some legal measures than being employed alone.

In addition, international dispute resolution is both a comparative and interdisciplinary field, thus a transnational approach to international legal problems would be desirable. Where there is no choice and national rules have to be applied to resolve international commercial disputes, we propose that courts and arbitrators consider an international interpretation of those national rules.

By shedding new light on the possibilities of other alternatives, the thesis will stimulate ADR amongst the dispute resolution methods that are available to the international business community concerning international L/C fraud disputes.

6.3 LEGAL APPROACH VS. PREVENTIVE AND PROACTIVE APPROACH IN BUSINESS PRACTICE

The legal approach is a common perspective in dealing with a legal problem and it uses the criminal legal remedy and civil legal remedy. The business approach represents the perspective of businessmen, which has been presented in Chapter 5. In this research, the business approach to the L/C fraud problem mainly refers to the preventive and proactive approach, under which the commercial parties adopt preventive measures and work proactively to prevent L/C fraud in daily business.

In Chapter 5, by considering the potential victims and different types of L/C fraud, from the perspective of risk management and prevention, we have worked out a number of specific measures which buyers, sellers, and banks in international L/C transactions can take in business. The option of banks providing additional services of checking further the validity or authenticity of some documents under the L/C by charging additional prices has reflected the needs of some business parties. However, it has been proposed that this be optional rather than compulsory for banks. The lawyers can also play an important role by adopting preventive legal mentality to help and provide advice to different parties in applying the preventive and proactive approach. More importantly, it is recommended that buyers or sellers maintain close cooperation with their banks and lawyers in implementing preventive and proactive measures.

The possibility of preventing L/C fraud by employing electronic L/C has further been examined. The analysis has revealed that electronic L/C cannot totally prevent L/C fraud, the system of presenting L/C electronically may still be a great obstacle for electronic L/C to operate widely, and types of L/C fraud can be developed differently in the electronic environment.

Business reports and case analysis of international L/C fraud in real life, and legal cases concerning international L/C fraud disputes before national courts in judicial practice over the years have clearly showed that the costs can be expensive if L/C fraud occurs and if L/C fraud is disputed under the legal approach. Some business parties may take limitless amounts of time, energy, and resources

to deal with L/C fraud or resolve L/C fraud disputes, or may not be able to stand for the losses or the costs involved and go bankrupt. In this dissertation, the analysis about the advantages and disadvantages of the legal approach has confirmed findings on the meaningfulness of the preventive and proactive approach to L/C fraud. The practice and theory have shown that L/C fraud is mostly likely to be prevented either early before entering an international transaction or when there are some signals of fraud.

From the previous discussions concerning the approaches to resolving the L/C fraud issue, which is a specific problem, we may generalise that to examine approaches for resolving a legal problem in international trade, it is recommended that both the legal approach and business approach are included.

6.4 FINAL CONCLUSION AND FUTURE RESEARCH

An efficient and effective L/C payment mechanism is essential in international trade. In other words, the commercial utility of L/C determines the function of L/C in international commercial transactions. The customary rules of L/C transactions have been created and updated in UPC. Fraud in international L/C transactions will not go away as long as there is opportunity for criminals to have economic gain. Fraud disputes in international L/C transactions will not disappear either as long as business parties utilise L/C as a financial and payment instrument in international commercial transactions.

The delicate balance between L/C fraud exception rules and the independence principle of L/C that national courts have endeavoured to make demonstrates the conflict between certainty, trust, and different commercial parties' interests. After all, the L/C system is not designed to be fraud-proof, thus we do not propose any changes to the L/C system itself. However, it is justifiable for courts to deal with disputes and to construe the law in a manner that does not contribute to fraudulent behaviours. The way of national jurisdictions and courts addressing L/C fraud under the criminal legal remedy and the L/C fraud exception rule under civil legal remedy will influence the use of L/C in international commercial transactions in the future. Prevention of fraud is a legitimate commercial policy; thus, it is sound and recommendable for business enterprises to conduct business in a manner that does not contribute to fraud.

To conclude, it seems clear that the L/C being an important international financial instrument may continue to be frequently utilised to facilitate international trade, so long as the L/C fraud issue can be tackled by different approaches properly at different stages.

Interestingly, there are several avenues open to future research. First, examination of other countries' practices (such as the USA) concerning L/C fraud exception rules will present a broad vision on this issue. However, this topic may deserve its own research, including the statutes and cases. Second, the theme of procedural rules concerning instruments (such as injunction and stop-payment

order) is also meaningful, and such research remains to be done. The perspective of procedural rules complements the perspective of substantial rules on L/C fraud exception, thus offering a comprehensive picture of the international legal framework of the L/C fraud issue. Third, a close in-depth study on the system of punitive damages in litigation and arbitration fields in different countries would be interesting and valuable. Fourth, the electronic L/C system is promising and challenging, thus this issue deserves continual attention in the future along with technologies as economies at the worldwide level develop.

Finally, we hope the overall findings of the research prompt researchers to carry out further research in the area; and encourage practitioners to develop the preventive and proactive approach in legal and commercial fields.

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Yanan Zhang

Approaches to Resolving the International Documentary Letters of Credit Fraud Issue

This research is about different approaches towards the international documentary letters of credit fraud issue. The documentary letter of credit is an important payment method and financial instrument in international trade. However, the usage has been challenged by the occurrence of fraud. There are two perspectives of looking at the issue: legal perspective and business perspective.

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