

# The Fraud Rule in Law of Letters of Credit in the P.R.C.

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This article analyses the fraud rule in the law of letters of credit in the People's Republic of China (P.R.C.) embodied in the Rules of the Supreme People's Court Concerning Several Issues in Hearing Letter of Credit Cases (2005 Rules) issued by the Supreme People's Court of the P.R.C. on November 14, 2005. It consists of five parts. Part I briefly introduces the current use of letters of credit, the 2005 Rules and the content of the article. To facilitate the discussion, Part II introduces the mechanism of the letter of credit and the development of the fraud rule in the law of letters of credit. Part III discusses the historical development of the fraud rule in the P.R.C. Part IV considers in detail the fraud rule in the P.R.C., covering both substantive and procedural matters of the law, including the standard of fraud, parties who can be immune from the application of the fraud rule, parties who can bring an action to the court for the application of the rule and other detailed court procedures. Part V concludes that the fraud rule in the P.R.C. is a comprehensive and unique set of rules, which has filled a legal gap in the P.R.C., and made a significant contribution to the general development of the law of letters of credit in the world.

## I. Introduction

Letters of credit are widely used in international transactions and have been described as "the life-blood of international commerce."<sup>1</sup> The People's Republic of China (P.R.C.) is currently one of the largest users of letters of credit in the world. Its exports and im-

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1. R.D. Harbottle (*Mercantile*) Ltd. v Nat'l Westminster Bank Ltd., [1978] Q.B. 146, 155 (U.K.) (opinion by Kerr, J.).

ports in 2006 exceeded U.S.\$1.76 trillion.<sup>2</sup> It is estimated that around 30 percent of the P.R.C.'s exports and imports are settled through letters of credit,<sup>3</sup> which means that the dollar value was close to U.S.\$600 billion in 2006. The widespread use of letters of credit in international trade with the P.R.C. means that this practice affects not only the interests of the parties at home but also those of its trading partners abroad.

The *raison d'être* of letters of credit is to provide an assurance of payment to the beneficiary when complying documents are presented. The fraud rule in the law of letters of credit allows payment of a letter of credit to be stopped when fraud is involved even though the documents presented are in strict compliance with the terms and conditions of the letter of credit. The fraud rule, therefore, is in direct conflict with the fundamental purpose of the letter of credit and becomes "the most controversial and confused area"<sup>4</sup> in the law governing letters of credit.

The practice of letters of credit, in particular the application of the fraud rule, in the P.R.C., has been a target for criticism over the years. It has been often alleged that the Chinese applicants, banks, and courts have used the fraud rule to avoid payment of letters of credit.<sup>5</sup> Therefore, the application of the fraud rule in the P.R.C. is a hot issue in the use of letters of credit with respect to P.R.C. trade. This is partly because there was no suitable law in the area in the P.R.C. until late 2005, and the practice of the Chinese courts was not consistent.

To fill the legal gap, streamline the judicial and banking practice of letters of credit in the P.R.C., and facilitate the P.R.C.'s international trade, the Supreme People's Court (SPC) promulgated *The Rules of the Supreme People's Court Concerning Several Issues in Hearing Letter of Credit Cases*<sup>6</sup> (the "2005 Rules") on November 14, 2005.<sup>7</sup> The fraud rule

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2. Ministry of Commerce, 2006 Nian 12 Yue Jinchukou Jianshao Qingkuang [Summary of the Imports and Exports of December 2006], available at <http://zhhs.mofcom.gov.cn/aarticle/Nocategory/200701/20070104268607.html>. Throughout this article, Chinese materials, including statutes, cases, and articles, are translated by this author unless otherwise acknowledged.

3. Zhang Yanlin, *Zuo Zai Shijie Sifa Shijie De Zui Qianlie—Xie Zai "Zuigao Renmin Fayuan Guanyu Shenli Xinyongzhen Jiaofeng Anjian Ruogan Wenti De Guiding" Gongbu Shixing Zhisbi* [Leading the Judicial Practice of the World—Paper Written at the Moment when the Rules of the Supreme People's Court Concerning Several Issues in Hearing Letter of Credit Cases Was Promulgated], Int'l Chamber of Commerce, Dec. 30, 2005, available at [http://www.icc-china.org/news/read\\_new.asp?id=137](http://www.icc-china.org/news/read_new.asp?id=137) (on file with author).

4. Note, "Fraud in the Transaction": Enjoining Letters of Credit during the Iranian Revolution, 93 HARV. L. REV. 992, 995 (1980).

5. See, e.g., Int'l Chamber of Commerce, *Special Report on China Trade—The Risk Factor*, ICC Publication No. 548 (1996).

6. *Zuigao Renmin Fayuan Guanyu Shenli Xinyongzhen Jiaofeng Anjian Ruogan Wenti De Guiding* [The Rules of the Supreme People's Court Concerning Several Issues in Hearing Letter of Credit Cases] (promulgated by the Adjudication Comm. of the Supreme People's Court, Oct. 24, 2005, effective Jan. 1, 2006), translated at [http://www.icc-china.org/New\\_Folder/Chinese%20Supreme%20Court%20Provisions%20on%20LC%20cases1.doc](http://www.icc-china.org/New_Folder/Chinese%20Supreme%20Court%20Provisions%20on%20LC%20cases1.doc) (last visited Sept. 4, 2007) (P.R.C.) [hereinafter 2005 Rules]. The 2005 Rules are a set of judicial interpretations. Judicial interpretations are made by the SPC to provide practical guidance to all levels of courts in the P.R.C. for the application of law with respect to a particular issue, a specific statute, or an area of law if no statute exists therein. They are detailed and problem-solving oriented. Although they are not formally called law, they are law in the practical sense because they are cited in court decisions and legally binding. That is, if there is no statute in an area and a judicial interpretation has been made, that judicial interpretation has in fact become the only law in that area.

7. *Id.*

is the major focus of the 2005 Rules, although they cover other areas of the law of letters of credit.

This article discusses the fraud rule in the law of letter of credit in the P.R.C. To facilitate the discussion, it commences in Part II with an introduction to the mechanism of the letter of credit and the rationale for the development of the fraud rule. Part III provides a summary about the development of the fraud rule in the P.R.C. Part IV considers in detail the fraud rule in the law of letters of credit in the P.R.C. embodied in the 2005 Rules. Part V concludes the article.

## II. The Mechanism of the Letter of Credit and the Development of the Fraud Rule

The letter of credit is an instrument issued to a beneficiary, normally by a reputable bank, for the account of the applicant. The issuer promises that it will honor a draft or a demand for payment made by the beneficiary, provided that the terms and conditions specified in the letter of credit are strictly complied with.

A simple example illustrates the operation of a letter of credit. Assume a seller in Shanghai wishes to sell telephone sets to a buyer in New York. The seller and the buyer are strangers. The seller is worried that after going to the expense of loading and shipping the goods, the buyer may become insolvent or refuse to pay upon arrival of the goods in New York. If the buyer does not pay, the seller will have to go to great expense to sue the buyer in a foreign jurisdiction and may also incur the costs of disposing of the goods in an unfamiliar territory. In turn, the buyer is worried that it may not receive the goods if it pays the seller in advance. To assuage the parties' legitimate fears, they agree to conduct the transaction through a letter of credit arrangement.

Under such an arrangement, the buyer procures an irrevocable letter of credit from a bank of good reputation. The bank is committed to pay the seller upon its proper presentation of the draft accompanied by the documents specified in the letter of credit evidencing the seller's performance of the sales contract, which usually include a bill of lading—a document of title signifying the seller's ownership of the goods. The seller thus retains the ownership of the goods until it presents the documents to the bank, at which time the seller is either paid in the case of a sight draft or promised payment at the maturity of the draft by the bank through its acceptance of the draft in the case of a time draft. The buyer knows that its money will not be paid to the seller unless the seller produces documents indicating that the goods have been shipped. The bank pays the seller for the buyer by taking security (a pledge) over the documents to secure the advance made to finance the transaction.

As has been shown, a simple letter of credit transaction involves three parties and three transactions. The three parties are: (1) the buyer, known as the applicant; (2) the seller, known as the beneficiary; and (3) the bank, known as the issuer. The three transactions are: (1) the underlying transaction between the buyer and the seller; (2) the transaction or the application agreement between the buyer and the bank; and (3) the transaction between the bank and the seller, that is, the letter of credit itself.

One of the cornerstones of the law of letters of credit is the principle of independence, where the transactions under a letter of credit arrangement are independent from each other. The obligation of the issuer to pay the beneficiary is direct, primary, and indepen-

dent. The issuer is required to pay the beneficiary regardless of any disputes or claims relating to the underlying transaction between the beneficiary and the applicant. The issuer is entitled to make the payment with full recourse against the applicant, even if the seller's documents turn out to be forgeries or fraudulent. The issuer's only concern is whether the documents tendered conform on their face with the terms and conditions of the letter of credit.<sup>8</sup>

Because of the principle of independence, the beneficiary requiring payment does not have to show the issuer that it has properly performed its duties under the underlying transaction. It needs only to produce documents that conform to the terms and conditions of the letter of credit. This leaves a loophole for unscrupulous beneficiaries to abuse the system and defraud the other parties involved. An extreme example would be a situation in which the seller is paid by the issuer after presenting documents complying on their face with all the requirements set out in the letter of credit, but the buyer does not receive the goods ordered because the documents are in fact pure forgeries. In such a case, an action by the applicant on the underlying contract would normally be ineffectual. Thus, strictly applying the principle of independence can produce harsh and unfair results by operating to unjustly enrich an unscrupulous beneficiary.<sup>9</sup>

To prevent this unfairness, the fraud rule has been developed to balance the "commercial utility of letters of credit against the desire to prevent the inequitable results that flow from fraudulent misrepresentations in individual cases."<sup>10</sup> The fraud rule in the law of letters of credit is recognized as the exception to the principle of independence, allowing the issuer or the court to view the facts behind the face of conforming documents and disrupting payment of a letter of credit. Under the fraud rule, although documents presented are on their face in strict compliance with the terms and conditions of the letter of credit, payment may be stopped if fraud is found to have been committed in the transaction before payment is made, provided the presenter does not belong to a protected

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8. The principle of independence is stated in Articles 3 and 4 of the current version of the Uniform Customs and Practice for Documentary Credits (UCP). (The UCP was first issued by the International Chamber of Commerce [ICC] in 1933 and has since been revised six times. The current version was published in 1993 as ICC Publication No. 500, known as "UCP 500." The most recent version of the UCP is ICC Publication No. 600, known as "UCP 600," which was passed at the ICC Banking Commission meeting on October 25, 2006, and became effective of July 1, 2007. As the UCP 600 was not in force at the time this article was written, all texts referred to in this article are from the UCP 500.) Article 3 of the UCP 500, emphasizing the separateness of the letter of credit from the other transactions, provides:

a. Credits, by their nature, are separate transactions from the sales or other contract(s) on which they may be based and banks are in no way concerned with or bound by such contract(s), even if any reference whatsoever to such contract(s) is included in the Credit. Consequently, the undertaking of a bank to pay, accept and pay Draft(s) or negotiate and /or to fulfil any other obligation under the Credit, is not subject to claims or defences by the Applicant resulting from his relationships with the Issuing Bank or the Beneficiary.

b. A Beneficiary can in no case avail himself of the contractual relationships existing between the banks or between the Applicant and the Issuing Bank.

Article 4 of the UCP 500, emphasizing that the parties to the letter of credit deal in documents and not in goods, provides: "In Credit operations all parties concerned deal with documents, and not with goods, services and/or other performances to which the documents may relate."

9. Note, *Letters of Credit: Injunction as a Remedy for Fraud in U.C.C. Section 5-114*, 63 MINN. L. REV. 487, 490 (1979).

10. Greg A. Fellinger, *Letters of Credit: The Autonomy Principle and the Fraud Exception*, 1 J. BANKING & FIN. L. & PRAC. 4, 6 (1990).

class, such as a holder in due course. The fraud rule is necessary to prevent fraudsters from abusing the letter of credit system, but its scope of application has to be carefully circumscribed so as to maintain the commercial utility of the letter of credit.<sup>11</sup>

### III. The Development of the Fraud Rule in the P.R.C.

#### A. BACKGROUND

The P.R.C. had a highly centralized, planned economy, treated trade as a capitalist vestige, and maintained only marginal contact with the outside world before it embarked on its modernization drive and economic reform in late 1970s. Before it opened up to the world, there was little room for commercial instruments such as letters of credit to be widely utilized. As a result, there were no court cases of letters of credit in the P.R.C. at that time.

The first known letter of credit case in the P.R.C. is *Yuegang Agricultural Resources Development Co. v. Japanese Technology & Science Co.*,<sup>12</sup> which was heard by Zhuhai Intermediate People's Court in 1986. There, the plaintiff, Yuegang Agricultural Resources Development, sued the defendant, Japanese Technology and Science, claiming that the feedstuff machinery delivered was not up to the quality provided in the underlying contract. When filing the action, the plaintiff applied to the court to freeze the payment of ¥216 million under the letter of credit as a measure of property preservation. The Court allowed the application and the payment of the letter of credit was stopped.

To letter of credit experts, the result of the case is stunning and disappointing, as fraud was never mentioned in the case. The dispute was about the quality of goods, which should never trigger the application of the fraud rule. But, this is a true story and a genuine reflection of the approach of a court towards a letter of credit in the P.R.C. at that time.

In the P.R.C., when a plaintiff brings a court action in a civil or commercial case, it may apply to the court for a property preservation ruling to seal-up, distrain, or freeze the assets of the defendant in accordance with the Civil Procedure Law of the P.R.C. ("CPL").<sup>13</sup> The often cited section is Article 93 of the CPL, which provides:

An interested party whose legal rights or interests would, as the result of urgent circumstances, suffer irreparable damage unless immediately applying for property preservation, may, before initiating legal proceedings, apply to a people's court for the

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11. The policy tension behind the fraud rule was well expressed in the leading Canadian case of *Bank of Nova Scotia v. Angelica-Whitewear Ltd.*, [1987] D.L.R. 168 (Can.), in these terms:

The potential scope of the fraud exception must not be a means of creating serious uncertainty and lack of confidence in the operation of letter of credit transactions; at the same time the application of the principle of autonomy must not serve to encourage or facilitate fraud in such transactions.

12. Zhu Zhong Fa Jin Shen Zi Di 23-3 Hao Case No. 23-3 of the Economic Division of the Zhuhai Intermediate People's Court, Oct. 6, 1986 (P.R.C.) (on file with author).

13. Zhonghua Renmin Gongheguo Minshi Sushongfa [Civil Procedure Law of the P. R.C.].

adoption of property preservation measures. The applicant shall provide security; if the applicant refuses to do so, the application shall be rejected.<sup>14</sup>

Upon accepting the application, the people's court must, in urgent cases, make a ruling within 48 hours; when a ruling is made for the application, it shall be executed immediately.<sup>15</sup>

In a case of a letter of credit, when the applicant brings an action against the beneficiary, it often asks the court to join the issuing or confirming bank in the proceeding by listing it as a third party and to stop the payment of the letter of credit by freezing the issuing or confirming bank's account for the payment of the letter of credit as a measure of property preservation against the beneficiary. The courts in the P.R.C., especially in those early days of economic reform, would simply follow the provisions of the CPL and stop the payment of the letter of credit by freezing the bank account concerned, failing to take into consideration the principle of independence and the special nature of the letter of credit, as they knew little about the commercial speciality of the instrument.

Along with the expansion of the Chinese economy and international trade, more and more cases interfering with payment of letters of credit were handed down by Chinese courts, which caused strong reactions and criticisms from foreign parties. In *Yuegang Agricultural Resources Development*, for example, when the payment of the letter of credit was stopped, the defendant seller and the Japanese presenting bank reacted strongly and asked the court to lift the preservation ruling based on the principle of independence in the law of letters of credit.<sup>16</sup> Gradually the practice of the Chinese courts started to draw criticisms from Chinese banks because they began to realize that frequent court interference with the payment of their letters of credit could jeopardize not only the commercial utility of the letter of credit but also their international reputation. They started to complain to the authorities, especially the SPC, when payment of their letters of credit was interfered with.<sup>17</sup>

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14. English translation of the CPL borrowed from *China Laws for Business Regulation—Business Regulation. Civil Procedure Law arts. 92 & 94* (promulgated by the National People's Congress, Apr. 9, 1991, effective Apr. 9, 1991) (P.R.C.) translated in CHINA LAWS FOR BUSINESS REGULATION—BUSINESS REGULATION, paras. 19-201 (CCH Australia Ltd.) [hereinafter CPL].

15. Other relevant sections are Articles 92 and 94. Article 92 provides:

If, as the result of an act of one of the parties to a case or for some other reason, it appears that a judgment may be impossible or difficult to execute, a people's court may, at the request of the other party, issue a property preservation ruling. In the absence of such a request, a people's court itself may also, if deemed necessary, order property preservation measures to be adopted. When taking measures for property preservation, a people's court may order the applicant to provide security. If an applicant fails to provide security, the application shall be rejected. On receiving an application, a people's court must, if the case is urgent, make a ruling within 48 hours. If it rules for the adoption of property preservation measures, execution of these measures shall commence immediately.

Article 94 provides: "Property preservation shall take the form of sealing up, confiscation, the freezing of assets or other methods prescribed by law. If deciding that assets are to be frozen, a people's court shall immediately notify the party whose assets are to be frozen.

16. The High People's Court of Guangdong Province, *Gengdan Xinyongzhen Sifabaoquan [Judicial Preservation over Documentary Credits]*, Document No. 9 presented at the National Forum on Adjudication of Economic Cases (Nov. 1998) (on file with author).

17. The Chinese banks not only started to complain to the SPC when payment of their letters of credit was interfered with by a Chinese court but also tried with every means to have the freezing order lifted, even in

## B. 1989 SUMMARY

The gradual appreciation of the special nature of the letter of credit and the complaints by Chinese banks made the SPC realize that it was not proper for courts to treat letter of credit cases as ordinary commercial cases and unduly interfere with the payment of letters of credit. Accordingly, when the National Forum on the Adjudication of Economic Cases Relating to Foreigners and People from Hong Kong and Macao in the Coastal Region was held in December 1988, one of the focuses of the conference was to curb the frequent interference with the payment of letters of credit.

After the conference, the SPC, on June 12, 1989, issued the Summary of the National Forum on the Adjudication of Economic Cases Relating to Foreigners and People from Hong Kong and Macao in the Coastal Region<sup>18</sup> (the "1989 Summary"), which contains a section establishing the basis for the development of the fraud rule and serving in some sense as the fraud rule in the P.R.C. for almost twenty years. Paragraph 3(4)(ii) of the 1989 Summary, entitled "Regarding the Freezing of Payment of a Letter of Credit," states:

A letter of credit is a documentary transaction independent from the underlying sales contract, under which the issuing bank is obliged to pay the seller within the prescribed time as long as the seller presents the required documents on their face conforming with the terms of the letter of credit . . . . The letter of credit and the sales contract belong to two different legal relationships. Generally payment of a letter of credit should not be frozen without serious consideration merely because there is a dispute over the foreign-related sales contract; otherwise the reputation of the Chinese bank can be jeopardised. In view of the practice at home and abroad, if sufficient evidence shows that the seller is using the underlying contract defrauding the buyer, and the Chinese bank has not paid within a reasonable time, a people's court may freeze the payment of the letter of credit upon the request of the buyer. However, a people's court should not freeze the payment of an acceptance credit when a time draft presented thereunder has already been accepted by the Chinese bank, as the obligation of the Chinese bank in such a situation has become unconditional under the law of negotiable instruments. Hence a people's court taking such measures must proceed with caution, should first contact the Chinese bank, and seek advice from

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cases where blatant fraud was involved. Moreover, to persuade, or in some sense to educate or to put pressure on the Chinese courts, Chinese banks used nearly all their means to express their concerns and frustration. For example, in early 1995, the Bank of China organized a special conference and invited letter of credit specialists from a number of organizations, including judges from various levels of courts, to express its concern over decisions where payment of its letters of credit had been frozen. In January 2000, the Banking Commission of ICC China organized a special meeting in Beijing between judges of the SPC and representatives of all then fourteen major Chinese banks to express the banks' concern over the issues arising from the courts' interference with the payment of their letters of credit, and urged the SPC to promulgate the 1998 Draft as soon as possible. (For details about the 1998 Draft, see *infra* note 25 and its accompanying text. Documents produced at both of the meetings are on file with the author.) In the course of the drafting of the 2005 Rules, Chinese banks also played a very important role, not only by actively commenting on the drafts, but also by pushing it through the process.

18. Zuigao Renmin Fayuan Quanguo Yanhai Diqu Shewai Shegang'ao Jinji Shenpan Gongzuo Zuotanhui Jiyao [Summary of the National Forum on the Adjudication of Economic Cases Relating to Foreigners and People from Hong Kong and Macao in the Coastal Region].

higher courts when necessary. A people's court should follow the same steps mentioned when it receives an application from a Chinese foreign arbitration agency for the freezing of the payment of a letter of credit.<sup>19</sup>

The 1989 Summary served two important functions in the development of the fraud rule in the law of letters of credit in the P.R.C. First, it told the Chinese courts that the letter of credit was a special commercial instrument, emphasized the paramount importance of the principle of independence in the law of letters of credit, and restrained the surge of cases where courts interfered with the payment of the letter of credit. Secondly, it for the first time set forth the basic elements of the fraud rule in the law of letter of credit in the P.R.C.:

1. A court can interfere with the payment of a letter of credit if sufficient evidence has shown that the beneficiary is making use of the underlying contract to defraud the applicant; and
2. A court cannot interfere with the payment of a letter of credit if the payment under a letter of credit has been made, or the draft presented has already been accepted, even if fraud is involved in the transaction.

Following the publication of the 1989 Summary, Chinese courts, especially those at the higher levels and those with more opportunities to deal with letter of credit cases, took the special nature of letters of credit into account when asked to exercise property preservation measures in letter of credit cases. But in some cases, in particular those decided by courts with less experience and knowledge of the law of letters of credit, the 1989 Summary was not well observed<sup>20</sup> because it was only a policy statement from the SPC and nonbinding on the Chinese courts.

### C. OTHER DOCUMENTS

The SPC made numerous efforts over the years to refrain the Chinese courts from unduly interfering with the payment of letters of credit, not only monitoring individual cases but also constantly calling on relevant courts to follow the guidelines set forth in the 1989 Summary. In addition, it formally considered the issue in an additional two conferences and issued documents afterwards. The first was a conference organized by the then Transport and Communication Division of the SPC<sup>21</sup> in May 1995. A short summary was published following the conference, saying:

In accordance with the legal characteristics of letters of credit, maritime courts generally should not consider ordering a property preservation ruling over the proceeds of

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19. *Id.*

20. See, e.g., XIANG GAO, *THE FRAUD RULE IN THE LAW OF LETTERS OF CREDIT—A COMPARATIVE STUDY* 175-178 (Kluwer Law Int'l 2002).

21. The Transport and Communication Division was merged in 2000 with the foreign-related group of the Economic Division to form the No. 4 Civil Division, a division of the SPC responsible for all foreign-related commercial and maritime cases.



a letter of credit unless the bill of lading is antedated or forged and the applicant requests such a ruling.<sup>22</sup>

The second conference was the National Forum on the Adjudication of Economic Cases organized by the Economic Division of the SPC in November 1998. At the conference, Justice Guoguang Li, then vice president of the SPC, stated:

In recent years, the freezing of payment of letters of credits by courts in our country has caused great concern in the circles of law and finance in the world. The improper freezing of payment of letters of credit by some of our courts has already caused damages to both the international reputation and the property of the banks of our country. . . . Dealing with matters of this kind, we must first stick to the principle of independence. Payment of a letter of credit cannot be stopped because there is a dispute over the international sales contract or other types of underlying contract. Secondly, payment of a letter of credit can only be stopped when sufficient evidence has shown that the seller (or the beneficiary) has used the letter of credit to defraud or has presented false documents, and when the applicant has made such an application and furnished proper security. Thirdly, even if the conditions mentioned in the second point are met, a ruling to stop the payment of a letter of credit is still not allowed if [the draft drawn under] the letter of credit has been accepted and transferred, or has been negotiated.<sup>23</sup>

The most important step taken by the SPC to solve the problem was to attempt to issue a special judicial interpretation on the fraud rule in November 1998 following the conference by introducing the draft of Provisions Concerning Certain Issues on the Ruling for the Stopping of Payment of a Letter of Credit<sup>24</sup> (the "1998 Draft"), which reads:

1. In accordance with the long and widely used [Uniform Customs and Practice for Documentary Credits (UCP)] by the International Chamber of Commerce, a letter of credit is a documentary transaction independent from the underlying transaction. It forms a different contractual relationship from that of the underlying contract. Unless fraud is involved in a letter of credit, a claimant cannot apply to a people's court for a ruling to stop the payment of a letter of credit on the ground that there is a dispute over the underlying contract.
2. A claimant may apply for a ruling to stop the payment of a letter of credit if one of the following occurs:
  - (a) A document presented by the beneficiary is forged or fraudulent;
  - (b) The beneficiary has committed material fraud against the applicant in the underlying transaction; or

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22. The influence of this summary is much less than the 1989 Summary because: (1) it has never been widely published; (2) its content is far less comprehensive; and (3) its distribution was only limited to maritime courts. Therefore, it has seldom been mentioned by commentators in the literature (on file with author).

23. Li Guoguang, *Quanbao Shifa Gongzhen, Jiaqiang Duiwu Jianshi, Jingyibu Tuijin Jinji Shenpan Gongzuo De Quanmian Fazhan* [To Ensure Judicial Fairness, to Strengthen Personnel Construction, to Further the Overall Development of Economic Trials 16 JINJI SHENPAN ZHIDAO YU CANKAO [CIVIL & COMMERCIAL TRIAL REV.], (1999).

24. *Zuigao Renmin Fayuan Guanyu Caiding Jinzhi Zhifu Xinyongzheng Xiangxia Kuanxiang De Ruogan Wenti De Guiding* [Provisions Concerning Certain Issues on the Ruling for the Stopping of Payment of a Letter of Credit] (on file with author).

- (c) The beneficiary has colluded with the applicant or the applicant's agent to defraud the issuing bank, and the issuing bank asks for such a ruling.
3. After receiving an application for a ruling to stop the payment of a letter of credit, the people's court should carefully examine the application according to the law, and make a ruling to stop the payment if the following conditions are met:
- (a) The evidence submitted by the claimant is sufficient to show that the fraud mentioned in Article 2 exists;
  - (b) On the basis of the information submitted to the court, the claimant is more likely than not to succeed in the lawsuit;
  - (c) The beneficiary has no other property to be taken in custody in China; otherwise property preservation measures should be taken against the beneficiary's other property first; and
  - (d) Adequate security has been provided by the claimant.
4. Although the conditions provided in Article 2 are met, in order to protect the interest of innocent third parties, a people's court should not make a ruling to stop the payment of a letter of credit if:
- (a) The paying, confirming or negotiating bank nominated in the letter of credit has already paid or incurred the obligation to pay in accordance with the terms of the letter of credit, unless the bank itself is a party to the fraud or knew of the fraud before making the payment or incurring the obligation to pay; or
  - (b) In case of an acceptance credit, the issuing bank has indicated its acceptance on the draft or through fax, or the rights and obligations under the letter of credit has already been discounted or transferred.
5. After a ruling to stop payment of a letter of credit has been made by a people's court, if the issuing bank, the nominated bank, the beneficiary, the holder of drafts drawn under a letter of credit or an assignee of proceeds of the letter of credit raises an objection to the ruling and applies for a review, the court at the immediate higher level should accept the application and make a review ruling within 30 days. If the original ruling is found to be in violation of Articles 3 and 4 or other good reasons have been provided by the applicant, the original ruling should be reversed promptly.
6. If, during the hearing of a case involving a letter of credit, a people's court has found that the parties are, by using the letter of credit, undertaking illegal financing or other fraudulent activities amounting to criminal offences, the people's court should hand over the case to the authority of public security; for those cases in which laws or rules have been violated, the people's court should timely provide judicial opinions with regard to those violations to the relevant authorities.
7. When handling criminal cases, if an authority of public security, procuratorate or state security finds it necessary to stop the payment of a letter of credit, the relevant authority should make an application to the intermediate people's court where the issuing bank is domiciled; when an arbitration tribunal receives an application to stop the payment of a letter of credit, it should transfer the application to the intermediate people's court where the issuing bank is domiciled, and the relevant applicant should provide security to the court. The court having received the application should examine it in accordance with This Provision and make a ruling to stop the payment if the conditions are met.

Compared with the 1989 Summary, the 1998 Draft was a greatly improved document, which covered in detail nearly every aspect with regard to the application of the fraud rule. Unfortunately it has never been published. It became a dead letter soon after it was drafted.<sup>25</sup>

#### D. DRAFTING OF THE 2005 RULES

In order to meet demands on further economic reform and challenges brought by the P.R.C.'s accession to the WTO, a special division, No. 4 Civil Division (the "Division"), was formed by the SPC in August 2000 to deal with foreign-related commercial and maritime matters. One priority of the Division is to make necessary rules to provide guidance for courts of the country dealing with foreign-related commercial and maritime cases. A survey in early 2001 found that 25 percent of the foreign-related commercial cases heard by the Division were related to letters of credit.<sup>26</sup> Following the survey, it was decided that a judicial interpretation concerning letters of credit was to be formulated. After more than four years of drafting and extensive consultation, the document was finally promulgated on October 24, 2005.<sup>27</sup>

### IV. The Fraud Rule Under the 2005 Rules

The fraud rule in the law of letters of credit in the P.R.C. provided under the 2005 rules is detailed and comprehensive. It covers both substantive and procedural matters of the law, including the standard of fraud, parties who can be immune from the application of the fraud rule, parties who can bring an action to the court for the application of the rule, and other detailed court procedures.

#### A. STANDARD OF FRAUD

The fraud rule is developed to prevent fraudsters from using letters of credit to unjustly enrich themselves. It is applied when fraud is found in the transaction, so the first and foremost important question for formulators of the fraud rule and courts hearing letter of credit fraud cases to decide is what is fraud under the law of letters of credit or what kind

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25. I have been told by one of former my colleagues at the SPC that the reason for its unfortunate fate is the provision of Article 7 that provides that other government departments, including the authorities of public security, procuratorate, and state security, were required to make an application to an intermediate people's court where the issuing bank was domiciled if they found it necessary to stop payment of a letter of credit when handling criminal cases, and these departments could not accept the provision. These departments argued that applying to a court for a ruling would hinder and delay the process of preventing criminals from transferring illegal money through letter of credit facilities; therefore, it was rejected shortly after it was drafted.

26. Data on file with the author.

27. For more details about the background and the drafting process of the 2005 Rules, see *Zuigao Renmin Fayuan "Guanyu Shenli Xinyongzhen Jiaofeng Anjian Ruogan Wenti De Guiding" De Shuoming [Explanatory Notes by the Supreme People's Court to the Rules Concerning Several Issues in Hearing Letter of Credit Cases]*; Jin Saibo, *Xinyongzheng Sifa Zhidu De Cuoxin—"Guanyu Shenli Xinyongzhen Jiaofeng Anjian Ruogan Wenti De Guiding" Yiyi Jiqi Chutai Beijing [The Innovation of the Legal System of Letters of Credit—the Significance and the Background of the Rules Concerning Several Issues in Hearing Letter of Credit Cases]* ZHONGGUO CHENGXIANG JINRONG BAO [CHINA CITY AND RURAL FINANCIAL DAILY], Jan. 5, 2006.

of fraud can invoke the fraud rule in the law of letters of credit. This has proven to be the most challenging issue in some jurisdictions because: (1) the letter of credit is a commercial speciality; and (2) fraud is an "inherently pliable concept."<sup>28</sup> Some take the view that the fraud rule must be applied in a strict fashion or in cases where only "egregious" fraud is involved.<sup>29</sup> Others favor a more flexible approach to the concept.<sup>30</sup> The divergent views expressed with respect to the kind of fraud that can invoke the fraud rule reflect the tension between two different policy considerations: "the importance to international commerce of maintaining the principle of the autonomy of documentary credits . . . and the importance of discouraging or suppressing fraud in the letter of credit transaction."<sup>31</sup>

On the one hand, if fraud is defined too widely or the standard of fraud is set too low, the fraud rule may be abused by the applicant who does not want the issuer to pay simply because it will not profit from the underlying transaction. If obstruction of payment of a letter of credit is repeated too often, business confidence in letters of credit as effective performance assurances will be destroyed.<sup>32</sup> On the other hand, if fraud is defined too narrowly or the standard of fraud is set too high and the fraud rule cannot be applied in cases where it should be applied, the effectiveness of the fraud rule will be compromised, which may encourage the growth of fraudulent conduct by beneficiaries, discourage the use of letters of credit by applicants, and ultimately harm the commercial utility of letters of credit.<sup>33</sup> Therefore, it was always one of the major tasks in the minds of the drafters of the 2005 Rules to set up a proper standard of fraud to balance the competing interests in a letter of credit transaction.

In the P.R.C., fraud is defined under Article 68 of the Interim Opinions of the Supreme People's Court Concerning the Implementation of the General Principles of the Civil Law of the P.R.C.<sup>34</sup> (IOGPCL) as "one party intentionally telling the other party a lie or

28. Gerald T. McLaughlin, *Letters of Credit and Illegal Contracts: The Limits of the Independence Principle*, 49 OHIO ST. L.J. 1197, 1203 (1989).

29. E.g., "Only in rare situations of *egregious fraud* would § 42a-5-114 have justified the issuer, on the facts presented here, in going behind apparently regular, conforming documents; such fraud 'must be narrowly limited to situations . . . in which the wrongdoing of the beneficiary has so vitiated the entire transaction that the legitimate purposes of the independence of the issuer's obligation would no longer be served.'" *N. Y. Life Ins. Co. v. Hartford Nat'l. Bank & Trust Co.*, 378 A.2d 562, 567 (Conn. 1977) (emphasis added) (quoting *Intraworld Indus., Inc. v. Girard Trust Bank*, 336 A. 2d 316, 324-25 (Pa. 1975)). See also Henry Harfield, *Enjoining Letter of Credit Transactions*, 95 BANKING L.J. 596, 603 (1978).

30. E.g., "The law of 'fraud' is not static and the courts have, over the years, adapted it to the changing nature of commercial transactions in our society . . . [I]n a suit for equitable relief—such as this one—it is not necessary that plaintiff establish all the elements of actionable fraud required in a suit for monetary damages . . . . Fraud has a broader meaning in equity [than at law] [sic] and intention to defraud or to misrepresent is not a necessary element. Fraud, indeed, in the sense of a court of equity properly includes all acts, omissions and concealments which involve a breach of legal or equitable duty, trust, or confidence, justly reposed, and are injurious to another, or by which an undue and unconscientious advantage is taken of another." *Dynamics Corp. of Am. v. Citizens & Nat'l Bank*, 356 F. Supp 991, 998-99 (N.D. Ga. 1973) (quoting *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 193-94 (1963)).

31. *Bank of Nova Scotia v. Angelica-Whitewear Ltd.*, [1987] 36 D.L.R. (4th) 161, 168 (Can.).

32. Robert J. Gavigan, *Wysko Investment Company v. Great American Bank: A New Attack on the Usefulness of Letters of Credit*, 14 N.W. J. INT'L L. & BUS. 184, 202 (1993).

33. Cf. Stephen J. Leacock, *Fraud in the International Transaction: Enjoining Payment of Letters of Credit in International Transactions*, 17 VAND. J. TRANSNAT'L L. 885, 899 (1984).

34. *Zuigao Renmin Fayuan Guanyu Guanche Zhibing*"Zhonghua Renmin Gongheguo Minfa Tongze" *Ruogan Wenti De Yijian (Shixing)*, issued by the SPC on April 2, 1988.

concealing the truth of a fact in order to induce the other party to come to a decision that it otherwise would not come to.”<sup>35</sup> This is the test generally used in civil and commercial cases to determine if fraud is involved in the P.R.C. Having learned from the experience of other jurisdictions with respect to the issue and, more importantly, taking into consideration the special nature of letters of credit and the practice of the Chinese courts in the past twenty years, the drafters of the 2005 Rules have not taken the easy step of merely adopting the provision of Article 68 of the IOGPCL but have taken another route by enumerating the circumstances that can cause the fraud rule to apply in Article 8, saying:

Any of the following shall be considered as letter of credit fraud:

- (i) The beneficiary has forged documents or presented documents containing fraudulent information;
- (ii) The beneficiary has intentionally failed to deliver goods or delivered goods with no value;
- (iii) The beneficiary has conspired with the applicant or a third party and presented fraudulent documents whereas there is no actual underlying transaction; or
- (iv) Other circumstances that constitute letter of credit fraud.<sup>36</sup>

The above provisions are similar to those provided in Article 2 of the 1998 Draft, but they are more refined. Moreover, the 2005 Rules have introduced the concept of “letter of credit fraud” to indicate that the fraud in the law of letters of credit is not entirely the same as that in general civil and commercial cases. The standard of fraud provided here has clearly limited the types of fraud that can invoke the fraud rule in the law of letters of credit in the P.R.C. to the following circumstances:

(1) Documents presented by the beneficiary are forged or fraudulent. This covers two types of situations: one is that the document does not exist at all but is simply forged by the beneficiary; the other is that the document exists but the information contained therein is fraudulent. Presentation of either of types of documents will be considered as fraud under the 2005 Rules. There was a debate over situations such as whether the pre-dating of a bill of lading should be treated as fraud in the drafting process. Some took the view that presenting a set of predated bill of lading might not cause substantive damages to other parties involved in the transaction, therefore mere pre-dating of a bill of lading should not be treated as fraud that could invoke the fraud rule. But others took the view that a letter of credit was a documentary transaction and that any fraud in the documents should be covered under the fraud rule. The current provision has adopted the second view. Therefore, any fraud in the documents can now invoke the fraud rule in the P.R.C.

(2) Goods have not been delivered or delivered but without any value. There is an overlap between subsection (i) and subsection (ii), as the documents presented will be either forged or fraudulent if goods have not been delivered or have been delivered but without any value. Subsection (ii) has simply addressed the fraud problem from another perspective and offered the defrauded party another set of arguments in court. It also has its own practical bearing. It sends a message to parties of letters of credit, lawyers, and

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35. It is similar to the meaning of common law fraud or the standard of intentional fraud espoused in cases such as *NMC Enters., Inc. v. CBS, Inc.*, 14 U.C.C Rep. Serv. 1427 (N.Y. Sup. Ct. 1974) and *Am. Bell Int'l v. Islamic Republic of Iran*, 474 F. Supp. 420 (S.D.N.Y. 1979).

36. 2005 Rules, *supra* note 6, art. 8.

courts involved in a letter of credit fraud action that the standard of fraud invoking the fraud rule in the P.R.C. is very high: only non-delivery of goods or goods delivered with no value will be treated as fraud; other situations, such as goods delivered of low quality or short of some quantity, cannot be treated as letter of credit fraud under Chinese law. In other words, disputes over quality or quantity of goods cannot invoke the fraud rule at all in the P.R.C., and cases like Yuegang Agricultural Resources Development<sup>37</sup> will never happen again in the P.R.C. under the 2005 Rules.

(3) No genuine underlying transaction. From time to time, cases are reported in the P.R.C. that the beneficiary and the applicant are in collusion to defraud state-owned banks or to avoid the rules of foreign exchange control by making false contracts. Subsection (iii) is drafted to address this particular problem, which was also mentioned in Article 2(c) of the 1998 Draft.<sup>38</sup> It clearly tells those who are using or may want to use the letter of credit system to avoid the law of foreign exchange control or to cheat the banks for funds that otherwise cannot be obtained that payment will be stopped by courts if their true intention is discovered.<sup>39</sup>

Concerned that some types of fraudulent conduct may not be covered by subsections (i), (ii), and (iii), subsection (iv) was added to serve as a catch-all clause. The advantage of this clause is that it can serve as a safety valve to prevent any fraudulent acts from leaking through the net. There is, however, a danger that this provision may be used by some parties to interrupt the normal operation of a letter of credit given the history of the development of the fraud rule in the P.R.C. The real effect of this subsection remains to be seen.

## B. PARTIES IMMUNE FROM THE FRAUD RULE

As mentioned, the fraud rule is not always applied when fraud is found in a letter of credit transaction. It cannot be applied when the party seeking payment belongs to a protected class such as a holder in due course.

The rationale for some parties being immune from the fraud rule is to maintain the commercial utility of the letter of credit. The widespread use of the letter of credit is due to its commercial functions. One of the functions of letters of credit is to raise credit for the applicant and the beneficiary,<sup>40</sup> which is partly achieved by allowing third parties, normally intermediary banks, to participate in the payment process of a letter of credit. These third parties may negotiate, purchase, or discount the beneficiary's drafts or demands for payment under a letter of credit or arrange other means to finance the underlying transaction such as making loans to the beneficiary by taking the right to the proceeds of the letter of credit as security, relying on the undertaking and creditworthiness of the issuing bank. When a letter of credit transaction is tainted with fraud and recourse for fraudster often turns out to be ineffective, the loss caused by the fraud tends to be borne by the innocent parties, including the issuer as well as the applicant and the third party.

37. For details, see *supra* note 12 and its accompanying text. .

38. 2005 Rules, *supra* note 6, art. 2(c).

39. *Id.*

40. For a good discussion of the functions of letters of credit, see JOHN F. DOLAN, *THE LAW OF LETTERS OF CREDIT: COMMERCIAL AND STANDBY CREDITS* Ch. 3 (Warren Gorham & Lamont rev. ed. 2003 & Supp. I 2006).

To protect the commercial interests of the innocent third parties, it has been well recognized that some presenters should be immune from the application of the fraud rule. This has been provided in Article 10 of the 2005 Rules as follows:

A people's court shall make a ruling to suspend the payment or a judgement to permanently stop the payment under a letter of credit when fraud is established, unless one of the following has happened:

- (i) The nominated person or the person authorised by the issuing bank has paid in good faith in accordance with the instructions of the issuing bank;
- (ii) The issuing bank or its nominated or authorized person has accepted the draft under the letter of credit in good faith;
- (iii) The confirming bank has paid in good faith; or
- (iv) The negotiation bank has negotiated in good faith.<sup>41</sup>

Accordingly, the fraud rule cannot be applied in four types of situations in the P.R.C. even if fraud is found in a letter of credit transaction.

First, the fraud rule cannot be applied when payment has already been made by "the nominated person" or "the person authorised by the issuing bank" in accordance with the instructions of the issuing bank.<sup>42</sup> It should be noted that "the nominated person" and "the person authorised by the issuing bank" are the same person in letter of credit practice, as a nominated person is an authorized person by the issuer under the law of letter of credit or in accordance with Article 10(b)(i) of UCP 500, which provides:

Unless the Credit stipulates that it is available only with the issuing bank, all Credits must nominate the bank (the Nominated Bank) which is authorised to pay, to incur a deferred payment undertaking, to accept Draft(s) or to negotiate. In a freely negotiable Credit, any bank is a Nominated Bank.<sup>43</sup>

Second, the fraud rule cannot be applied if the issuing bank or the nominated or authorized person has accepted the draft drawn under the letter of credit in good faith. This is inherited from the 1989 Summary, different from the position stated in Justice Guoguang Li's speech in 1998 and that taken by Article 4(b) of the 1998 Draft.<sup>44</sup> It has greatly narrowed the generally accepted fraud rule in the law of letter of credit. As we know, a letter of credit can be either paid immediately upon presentation when it is a payment letter of credit or later when it is a usance one. We also know that the fraud rule can only be applied before payment has been made. If the letter of credit is a payment one, it is difficult for the fraud rule to be applied, as payment is made immediately upon presentation of documents. If the letter of credit is a usance one, it is possible for the fraud rule to be applied, as under such an arrangement, the issuer first accepts the draft when documents are presented and then makes payment when the mature date of the draft arrives. The fraud rule may be applied if fraud is found after the acceptance but before the payment. Under Article 10(ii) of the 2005 Rules, the likelihood for the application of the fraud rule is greatly reduced because payment of the letter of credit cannot be stopped the

41. 2005 Rules, *supra* note 6, art. 10.

42. *Id.*

43. The Uniform Customs and Practice for Documentary Credits, ICC Publ. No. 500 art. 10(b)(i) (ICC Publishing S.A. 1993).

44. See *supra* notes 21-22 and their accompanying texts.

moment the draft is accepted.<sup>45</sup> Thus, the only chance for the fraud rule to apply now in the P.R.C. is to start the action before documents are presented. In this author's view, the current wording of Article 10(ii) is unfortunate because it immunizes all parties holding an accepted draft from the application of the fraud rule. In other words, even if the accepted draft is still in the hands of the fraudulent beneficiary, the fraud rule cannot be applied, which obviously defeats the whole purpose of the fraud rule.

Third, the fraud rule cannot be applied when the confirming bank has made payment under a letter of credit in good faith. A confirming bank is usually a bank located at the beneficiary's place and authorized by the issuing bank to honor the presentation under a letter of credit. A confirmation of a letter of credit constitutes a definite undertaking of the confirming bank, in addition to that of the issuing bank, to pay or to accept and pay the draft drawn under the letter of credit when conforming documents are tendered. As against the beneficiary and third-party presenters, the confirming bank stands in the same position as the issuing bank as the paymaster under the law of letters of credit.<sup>46</sup> Like the issuing bank, acting in good faith, the confirming bank "may honor or dishonor a presentation" when fraud is alleged<sup>47</sup> and, reciprocally, it should be entitled to take the advantage of all defences available to the issuer. As long as the confirming bank has paid, it is protected under the 2005 Rules.

Fourth, the negotiation bank is immune from the fraud rule if it has negotiated in good faith. Negotiation banks play a very important role in the payment of a letter of credit. They are normally the nominated persons to whom the documents are presented and those involved in the performance of the financing function of the letter of credit. In practice, a court applying this provision often needs to do more than just listen to the bank claiming that it is the negotiation bank and needs to find out whether the bank has indeed negotiated the draft. Article 10(b)(ii) of UCP 500 provides that negotiation means: "[G]iving of value for Draft(s) and/or document(s) by the bank authorised to negotiate. Mere examination of the documents without giving of value does not constitute a negotiation."<sup>48</sup> Despite the clear requirement for the giving of value for negotiation under the UCP, different banks in the banking community, in practice, have interpreted the term differently. For example, in the United States, when some banks say "negotiation" in the context of a letter of credit, they merely mean that they offer to examine the beneficiary's documents and ask for payment from the issuing bank or confirming bank on the beneficiary's behalf when they find the documents to be facially conforming. Then, if after tendering the documents they are paid by the issuing bank or confirming bank, they pass the money to the beneficiary and charge a fee.<sup>49</sup> For some other banks, when they claim to be "negotiation" banks, they offer to collect payment under the letter of credit and to

45. 2005 Rules, *supra* note 6, art. 10(ii).

46. See U.C.C. § 5-107 cmt. 1 (2002) ("A confirmer has the rights and obligations identified in Section 5-108 [Issuer's Rights and Obligations]. Accordingly, unless the context otherwise requires, the terms 'confirmer' and 'confirmation' should be read into this article wherever the terms 'issuer' and the 'letter of credit' appear.")

47. U.C.C. § 5-109(a)(2) and U.C.C. § 5-109 cmt. 2 (2002). See also *Lustrelon, Inc. v. Prutscher*, 428 A.2d 518, 527 (N.J. Super. Ct. App. Div. 1981).

48. BROOKE WUNNICKE & DIANE B. WUNNICKE, UCP 500 AND STANDBY LETTERS OF CREDIT: SPECIAL REPORT (Wiley Law Publications 1994) (emphasis added).

49. Boris Kozolchik, *The UNIDROIT Principles as a Model for the Unification of the Best Contractual Practices in the Americas*, 46 AM. J. COMP. L. 151, 162 (1998).



give the beneficiary a “provisional credit”<sup>50</sup> or to pay the beneficiary “under reserve.”<sup>51</sup> All these so-called “negotiation” banks do not give value in law, so they should not be taken as having “negotiated” or as genuine negotiation banks. It follows they should not be protected under the fraud rule, as stopping payment of the letter of credit will not cause any harm to them. Therefore, in the P.R.C., when banks claim that they are negotiation banks or have negotiated under the letter of credit, Chinese courts require them to show that they have in fact paid or given value.<sup>52</sup>

Under Article 10 of the 2005 Rules, anyone immune from the fraud rule must act in “good faith.”<sup>53</sup> Under Chinese law, good faith denotes that the person acquiring an item of personal property is not aware of the transferor’s defective title in that property.<sup>54</sup> In the context of a case of letter of credit fraud, the term good faith should be interpreted as “without notice of the fraud.” In other words, in accordance with Article 10 of the 2005 Rules, a person who may be immune from the application of the fraud rule must accept the draft or pay the beneficiary without notice of the fraud involved.<sup>55</sup> Accordingly, if fraud is alleged and the negotiation bank has been notified of the fraud before it negotiates but subsequently negotiates the draft of the beneficiary, the negotiation bank should not be protected, as it has negotiated the presentation with notice of the fraud involved in the transaction.

But, if the same interpretation of the phrase good faith applies to all subsections of Article 10, unfairness can arise when a confirmer is involved. As mentioned, a confirmer stands in the same position as the issuer as against the beneficiary and other presenters, and it must honor its obligation when presentation is made and the documents are in compliance with the terms and conditions of the letter of credit. If fraud is alleged before the confirmer pays and the confirmer refuses to honor its obligation under the letter of credit because of that allegation, it can be sued by the presenter. This is different from the situation where presentation is made to other nominated banks or negotiation banks because the negotiation bank can refuse to negotiate but does not have to be involved in any litigation, as it is not obligated to negotiate under the law of letter of credit when fraud is alleged before a negotiation bank negotiates. Therefore, if fraud is alleged before the confirmer honors, the confirmer may still honour the presentation if it chooses to do so, and it should be protected under the fraud rule due to its special position under the law of letter of credit. In other words, when a confirmer pays in good faith, the term should be interpreted as “without collusion” with the fraudster. Otherwise, confirmers will be forced into litigation or will no longer be willing to be involved in the confirmation of letters of credit.

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50. DOLAN, *supra* note 40, § 8-5.

51. Boris Kozolchyk, *The Immunization of Fraudulently Procured Letter of Credit Acceptances: All Services Exportacao Importacao Comercio, S.A. v. Banco Bamerindus Do Brazil, S.A. and First Commercial v. Gotham Originals*, 58 BROOK. L. REV. 369, 402-03 (1992).

52. A good example is *Sichuan Ermei Shan Import & Export Co v Shibo Co. of South Korea*, Min Si Zhong Zhi Di 28 Hao (2001) (Case no. 28 of 2001 of No. 4 Civil Division of the SPC), decided by the SPC, Sept. 28, 2004 (on file with author).

53. 2005 Rules, *supra* note 6, art. 10.

54. WANG LIMING, WU QUAN FA LU (PROPERTY LAW) (rev. ed., 2003).

55. 2005 Rules, *supra* note 6, art. 10.

## C. COURT REMEDIES

Article 9 of the 2005 Rules provides that “[t]he applicant, the issuing bank or any other interested party may apply to a competent people’s court for a ruling to suspend the payment under the letter of credit if they have found out that the circumstances [of fraud] set out in Article 8 . . . have happened and will cause them irreparable damage.”<sup>56</sup> This is based on Articles 93 and 94 of the CPL but is not identical. Under the CPL, an “interested party . . . may . . . apply to a people’s court for the adoption of property preservation measures,”<sup>57</sup> which “shall take the form of sealing up, confiscation, the freezing of assets.”<sup>58</sup> This means that under the CPL a party may apply for a ruling for property preservation, normally in the form of a ruling for freezing people’s assets, but cannot apply for a ruling to stop people from doing things that may harm its interests. No remedies, such as restraining orders or injunctions in common law jurisdictions, are provided under the CPL, which has left a legal gap in the law of the P.R.C. This gap caused problems to Chinese banks in letter of credit fraud cases in the past. That is, before the 2005 Rules were issued, when a party applied for “property preservation” in a letter of credit fraud case, a Chinese court could only issue a ruling to freeze the issuing or confirming bank’s account for the payment of the letter of credit in accordance with the CPL. When the ruling was issued and a Chinese bank observed that ruling and stopped payment of the letter of credit, foreign presenters went to foreign courts to bring actions against the Chinese bank arguing that the bank should be able to pay because it could do so from other accounts of the bank that were not frozen. The 2005 Rules have filled the gap and solved the problem in relation to cases of letters of credit. Now, the Chinese courts can issue a ruling to suspend the payment under a letter of credit, a remedy similar to a restraining order or a preliminary injunction available in common law jurisdictions.

Article 15 of the 2005 Rules provides that “[a]fter the trial of the case, the people’s court shall render a judgement to permanently stop the payment under the letter of credit if fraud has been established and there are no circumstances as set out in Article 10 hereinbefore,” which means another kind of remedy, “judgement to permanently stop the payment,” is available.<sup>59</sup> It is similar to that of a permanent injunction in other jurisdictions. This remedy is only available after a full trial of the case. After a full trial, if fraud is established and no innocent parties listed in Article 10 are involved in the transaction, the court will use the way of judgement, rather than ruling, to declare a permanent stop on the payment of the letter of credit.

In summary, two forms of remedies are available in cases of letter of credit fraud under the 2005 Rules: (1) a ruling to suspend the payment; and (2) a judgement to permanently stop the payment. The former is an interim measure used before initiating the proceedings or during the course of the proceedings; the latter is a permanent measure used when fraud is established after a full trial of the case.

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56. Emphasis added.

57. CPL, *supra* note 14, art. 93.

58. *Id.* art. 94.

59. 2005 Rules, *supra* note 6, art. 15.

#### D. PARTIES APPLYING FOR COURT REMEDIES

Article 9 of the 2005 Rules lists the parties that can seek remedies from the court, providing that “the applicant, the issuing bank or any other interested party may apply to a competent people’s court for a ruling to suspend the payment under the letter of credit.”<sup>60</sup> There is no doubt that the applicant should be the party applying to the court to stop the issuer or confirmer from paying the beneficiary or other presenters if fraud is involved in the transaction. But during the consultation process for the 2005 Rules, there was a debate over whether the issuing bank should be spelled out as an applicant for a court ruling to stop payment if fraud was involved. Some argued that it was unnecessary to do so because: (1) it is widely recognized that the issuer is entitled to refuse payment when fraud is found in the transaction; (2) it is much more efficient and economical for the issuer to refuse payment than going to a court and applying for a ruling to stop payment; and (3) nobody can stop a bank from going to the court to make such an application even if it is not spelled out in the 2005 Rules. But others argued that the issuer should also apply to the court for a ruling in order to stop payment of a letter of credit. This kind of argument was strong and surprisingly came from Chinese banks. Their reason was that banks should be concerned with their reputation and should not refuse payment themselves even if fraud was found in the transaction. If they did not want to honor their payment obligation under a letter of credit, they should go to the court and apply for a ruling to stop them from doing so. The 2005 Rules have adopted the argument from the second line of reasoning.

To this author, the position of the 2005 Rules sounds strange and illogical, as it is not easy to follow the argument that the issuer’s refusal of payment will damage its reputation but its application to a court for a ruling for it to stop payment will not.

#### E. JURISDICTION

Article 9 of the 2005 Rules further provides that “[t]he applicant, the issuing bank or any other interested party may apply to a competent people’s court for a ruling to suspend the payment under the letter of credit.”<sup>61</sup> It requires the applicant to go to a competent court for the remedy. But what is a competent court?

In the P.R.C., letter of credit cases are classified as a type of foreign-related commercial cases for jurisdiction purposes. Jurisdiction over foreign-related commercial cases has been specially allocated by the SPC to a limited number of courts since March 1, 2003. This special arrangement is set out by a special judicial interpretation known as the Rules of the Supreme People’s Court Concerning Several Issues Over the Jurisdiction Over Foreign-related Commercial Cases,<sup>62</sup> under which only the following courts can hear foreign-related commercial cases or are competent courts that can hear letter of credit cases:

- a). People’s courts of the Economic and Technological Development Zones approved by the State Council;

60. *Id.* art 9.

61. *Id.*

62. *Zuigao Renmin Fayuan Guanyu Shewai Minshuangshi Anjian Susong Guanxia Ruogan Wenti De Guanding*, issued by the SPC, Feb. 25, 2002, effective Mar. 1, 2003.

- b). Intermediate people's courts of the capital cities of provinces, autonomous regions and municipalities directly under the control of the Central Government;
- c). Intermediate people's courts of the Special Economic Zones and Municipalities financially directly report to the Central Government;
- d). Other intermediate people's courts specially designated by the SPC for the jurisdiction of foreign-related commercial cases; and
- e). High people's court.<sup>63</sup>

Currently, all letter of credit cases in the SPC are under the jurisdiction of the No. 4 Civil Division. Nationwide letter of credit cases are under the jurisdiction of those divisions specially set up as the corresponding department to the No. 4 Civil Division of the SPC in high or intermediate people's courts.

#### F. CONDITIONS FOR THE REMEDIES

Article 11 of the 2005 Rules provides:

A people's court shall accept the application by a party for a ruling to suspend the payment of a letter of credit prior to the filing of the action when the following conditions are met:

- (i) The people's court receiving the application has the competent jurisdiction over the case;
- (ii) The evidence rendered by the applicant has established the existence of the circumstances set out in Article 8 hereinbefore;
- (iii) The applicant will suffer irreparable damage if a ruling to suspend the payment is not issued;
- (iv) The applicant has provided effective and adequate security; and
- (v) The circumstances set out in Article 10 hereinbefore do not exist.<sup>64</sup>

As can be seen, Article 11 is also formulated on the basis of the CPL.<sup>65</sup> Five conditions should be met for the granting of the remedies to stop the payment under a letter of credit. Since the conditions mentioned in subsections (i) and (v) have already been considered, the discussion here will be focused on those listed in subsections (ii), (iii) and (iv).

Article 11(ii) provides that the applicant applying for the application of the fraud rule must provide the court with sufficient evidence to establish that the fraud listed in Article 8 of the 2005 Rules has occurred.<sup>66</sup> This normally requires the presentation of written evidence, such as a letter from an independent third party showing that the ship has never turned up to the loading port or its arrival at the port is certain days later than claimed in the documents presented. It will be very difficult for a Chinese court to accept a mere oral allegation in order to apply the fraud rule.

Article 11(iii) provides that the fraud rule can only be applied when the applicant will suffer irreparable damages caused by the fraud involved in the transaction.<sup>67</sup> Due to the

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63. *Id.*

64. 2005 Rules, *supra* note 6, art. 11.

65. See *supra* note 14 and its accompanying text.

66. 2005 Rules, *supra* note 6, art. 11(ii).

67. *Id.* art. 11(iii).

special nature of the letter of credit, the application of the fraud rule or stopping payment of a letter of credit should be the last resort. The fraud rule should only be applied when no other choices are available. For example, if the defendant is a multi-national corporation or a person with assets in the jurisdiction sufficient for the measure of property preservation to be taken, the Chinese court should not apply the fraud rule to interrupt the payment of a letter of credit.

Article 11(iv) of the 2005 Rules provides that the applicant claiming the application of the fraud rule must provide the court with effective and adequate security.<sup>68</sup> Generally, in the P.R.C.:

When a people's court adopts a property preservation measure before the initiating of the legal proceedings or during the legal proceedings according to Articles 92 and 93 of the Civil Procedure Law and requires the applicant to provide security, the amount of the security provided should be equal to the amount applied for preservation.<sup>69</sup>

When the 2005 Rules were drafted, there were two kinds of views with respect to the issue. One was to follow the position of the Opinions of the Supreme People's Court on the Application of the Civil Procedure Law of the People's Republic of China (OACPL) and require the applicant to furnish a security equal to the amount of payment that was requested to be stopped under the letter of credit. The other was that, given the special features of cases of letters of credit, in particular when the damage might not be as big as the amount of the payment to be stopped, the value of the security provided was not necessarily to be as large as the payment to be suspended or stopped. The security that should be provided was to ensure that the damages caused by the action to other parties were properly compensated if the action was wrongly taken. The 2005 Rules have adopted the latter view and require the security provided to be effective and adequate.

#### F. COURT'S ACTION UPON RECEIVING THE APPLICATION

Article 12 of the 2005 Rules provides:

A people's court must make a ruling within 48 hours after an application for the suspension of a payment under a letter of credit has been received. The ruling shall be effective the moment it is rendered if it is to suspend the payment.

The ruling to suspend the payment under the letter of credit shall clearly list the details of the applicant, the respondent and the third party.<sup>70</sup>

The first paragraph of Article 12 requires the court dealing with the application to act quickly, which is not only in agreement with the provisions of the CPL but also reflects the practical requirement for the dealing of a case of letter of credit fraud.<sup>71</sup> If the court

68. *Id.* art. 11(iv).

69. *Zuigao Renmin Fayuan Guanyu Shiyong "Zhonghua Renmin Gongheguo Minsbi Susongfa" Ruogan Wenti De Yijian* [Opinions of the Supreme People's Court on the Application of the Civil Procedure Law of the People's Republic of China, "OACPL"] (promulgated by the Sup. People's Ct., July 14, 1992, effective July 14, 1992), art. 98, ChinaLawInfo (P.R.C.).

70. 2005 Rules, *supra* note 6, art. 12.

71. *Id.*

does not act swiftly, payment of the letter of credit will be delayed and the commercial utility of the letter of credit will be affected. The court's quick action can further save the issuer from being involved in a difficult situation: unwillingly paying the presenter who may be a fraudster as being afraid of damaging its reputation or damaging its reputation by refusing to pay the presenter who may not be fraudulent as claimed by the applicant.

The second paragraph of Article 12 is also a reflection of the practice of the Chinese courts.<sup>72</sup> In court proceedings of letter of credit fraud cases in common law jurisdictions, the applicant normally brings an action against the issuing or confirming bank for an injunction or a restraining order, preventing it from paying the presenter or against the beneficiary for an injunction or a restraining order preventing it from presenting for payment. The procedures in the P.R.C. are different. There, if the applicant claims that fraud is involved in a letter of credit transaction, it normally brings an action of tort against the beneficiary and at the same time asks the court to list or join the issuing or confirming bank as a third party so that the court can freeze the account for the payment of the letter of credit held in the issuing or confirming bank as a property preservation measure in accordance with the CPL. This practice is also restated in Article 14 of the 2005 Rules, which provides:

When hearing a letter of credit fraud case, a people's court can hear the dispute arising out of the letter of credit transaction and that arising out of the underlying transaction together when it is necessary.

A people's court may list the issuing bank, the negotiating bank or any other interested party under the letter of credit as a third party where a party files an action on the ground of fraud in the underlying transaction; a third party may apply for joining in the proceedings, and the people's court may notify the third party to join in the proceedings.<sup>73</sup>

As can be seen, the general procedures remain the same under the 2005 Rules as those provided in the CPL. The difference is that the applicant now merely asks the court to make a ruling to suspend the payment rather than to freeze the letter of credit account in the issuing or confirming bank. Parties of letters of credit have so far never brought any separate action against the bank to suspend or stop the payment of a letter of credit in the P.R.C.

#### H. OBJECTION TO COURT RULING

Article 13 of the 2005 Rules provides:

A party may apply to the people's court at the next higher level for a reconsideration of the ruling by a people's court for the suspension of the payment under a letter of credit within 10 days upon its delivery if it has an objection. The higher level court shall make a ruling within 10 days upon its receipt of the application for reconsideration.

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<sup>72</sup> *Id.*

<sup>73</sup> *Id.* art. 14.

The execution of the original ruling shall not be affected during the course of the reconsideration.<sup>74</sup>

This is formulated on the basis of Article 99 of the CPL, which provides that “[i]f a party concerned is not satisfied with a ruling for property preservation or execution, it may apply for a reconsideration of the ruling once. The execution of the ruling shall not be affected during the course of the reconsideration.”<sup>75</sup> But changes have been made to meet the special needs of the case of letter of credit fraud. Under Article 99 of the CPL, if a party is not satisfied with a ruling for property preservation, it can apply to the court that has made that ruling for reconsideration.<sup>76</sup> But under Article 13 of the 2005 Rules, a party who has an objection to the ruling for the suspension of the payment under a letter of credit can and should apply to the court at the next higher level for a reconsideration of the ruling.<sup>77</sup> By so providing, the SPC actually has raised the level of the court dealing with the case of letter of credit fraud on the consideration of the complexity of the type of the case. Further, while the court reconsidering a ruling for property preservation in an ordinary case uses a resolution to reply to the application for the reconsideration, Article 13 of the 2005 Rules requires the court to reply to the objecting applicant by issuing a ruling upon its receipt of the application for reconsideration, which is more formal than a resolution under Chinese law.<sup>78</sup>

## V. Conclusion

The P.R.C. is an old country with a young modern legal system that began its development in the late 1970s when it started opening up to the world. The law of letters of credit in the P.R.C. was almost blank, let alone the fraud rule, when it started its economic reform and modernization drive. But along with the overall rapid development of its economy and modern legal system and after almost twenty years of good efforts, the P.R.C. published the 2005 Rules containing the fraud rule in the law of letters of credit in late 2005.

The current fraud rule in the law of letters of credit in the P.R.C. provided under the 2005 Rules is comprehensive and unique. It is comprehensive because it covers almost all the aspects of the law with respect to the application of the fraud rule, whether substantively or procedurally, including the standard of fraud, parties who can be immune from the application of the fraud rule, parties who can bring an action to the court for the application of the rule and other detailed court procedures. Parties and courts dealing with letter of credit fraud can find almost all the provisions for such a case in one place.

The P.R.C. fraud rule is unique because it is different from any of the existing rules. In terms of procedural matters, for instance, under the CPL, a party applying for a ruling for property preservation in a general civil or commercial case can only ask the court to freeze the assets of the defendant and cannot apply for remedies such as restraining orders or injunctions to stop the defendant from doing things that may harm its interests. Under

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74. *Id.* art. 13.

75. CPL, *supra* note 14, art. 99.

76. *Id.*

77. 2005 Rules, *supra* note 6, art. 13.

78. *Id.*

the fraud rule provided under the 2005 Rules, however, it can apply for a ruling to suspend or stop the payment under a letter of credit. In terms of substantive issues, for example, the standard of fraud provided under the 2005 Rules is different from the general standard of fraud set out in Article 68 of the IOGPCL in the P.R.C. or the standard of fraud in the law of letter of credit in other jurisdictions, such as that under Article 5 of the Uniform Commercial Code (U.C.C.) in the United States.<sup>79</sup> By so providing, it has not only introduced the unique concept of "letter of credit fraud" into the law of letters of credit but, more importantly, made the job of courts, lawyers, or other parties dealing with these cases much easier. It is clear and certain for those involved to know what kind of acts can invoke the fraud rule in the P.R.C. They do not have to worry about the interpretation of the generic standard of fraud in individual cases, which can be challenging in many instances.

In summary, in the words of Professor Byrne, one of the leading experts in the law of letters of credit, "[t]he new Chinese LC Rules are a significant contribution to letter of credit jurisprudence."<sup>80</sup> The P.R.C. "LC Rules" cannot be discussed without mentioning the fraud rule embodied in them.

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79. For the standard of fraud in the law of letters of credit in the United State, see U.C.C. § 5-109 (2002). For a comparative study on the standard of fraud under the fraud rule in the law of letters of credit in a number of jurisdictions, see Xiang Gao & Ross P. Buckley, *A Comparative Analysis of the Standard of Fraud Required under the Fraud Rule in Letter of Credit Law*, OXFORD UNIV. COMPAR. L. FORUM 3 (2003), available at <http://ouclf.iuscomp.org>.

80. NEW CHINESE LC RULES PART 1 CD-ROM (IBLP Webinars, published by the Institute of International Banking Law and Practice).