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The Exceptions in Documentary Credits in English Law

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The Exceptions in Documentary Credits in English Law

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The Exceptions in Documentary Credits in English Law

by

Lu Lu

A thesis submitted to the University of Plymouth
in partial fulfilment for the degree of

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Abstract

Name : Lu Lu

Title of the Thesis: The Exceptions in Documentary Credits in English Law

The main subject of this thesis is the exceptions in documentary credits in English law. The exceptions were established during the development of the documentary credits system to solve drawbacks of the payment means caused by its distinctive feature of autonomy. A rationale of the research is the current decline of the market share of documentary credits as a recognized means of settlement in international trade. This thesis aims to explore an appropriate and efficient way to apply certain necessary exceptions in documentary credits system. And hopefully, the current high rate of the rejection of the documents by banks by relying on the strict compliance principle can be decreased by the improving of the application of exceptions in documentary credits.

The research centres primary the application of the exceptions in English law. An early study of the original development of the fraud exception will cover both English and American authorities. Because there is no statute law in English law to regulate the exceptions in documentary credits, the thesis will

analyse the exceptions mostly through the case law. The main exceptions analysed in the thesis are the fraud rule, the illegality exception and the nullity exception. The application pattern for the three exceptions will be worked out respectively; the specific application of the injunction rules in applying the fraud rule will be concluded during the analysis of the fraud rule; some common features in the application among the exceptions will also be summarized in the thesis. An effort is made to suggest a prospective development of exceptions, which is in consistent with the autonomy principle. And as the necessary exceptions are applied efficiently, the disputes existing in documentary credits system currently may be settled without the appliance of any explanatory rules.

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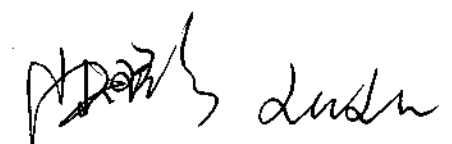
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Author's Declaration

At no time during the registration for the degree of Doctor of Philosophy has the author been registered for any other University award without prior agreement of the Graduate Committee.

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Signed



Date

18/07/2011

Introduction

Documentary credits have been used as the main means of payments in international trade transactions for over 200 years. Despite the advantages of the system, the separation between the documents and the goods, which is the fundamental principle of documentary credits - the autonomy principle - may also cause many problems, such like frauds and the abuse of the credit. The recent decline of the market share of documentary credits as a recognised means of settlement in international trade clearly exposed the negative effect caused by the serious drawbacks within the documentary credits system. According to a survey leading to the UCP600¹ revision, approximately 70% of documents presented under letters of credit were being rejected on first presentation because of discrepancies. The strict compliance doctrine has become the best way for banks to avoid payment. The lack and inefficiency of necessary exceptions may be one of the reasons which caused the high rate of rejection of documents on the basis of strict compliance. The new phenomenon of applying an additional warranty to restrict the beneficiary's title in achieving payment further reflected the necessity of an analysis to the exceptions in documentary credits, which is the core content of the thesis.

¹ The Uniform Customs and Practice for Documentary Credits (UCP) is a set of rules on the issuance and use of letters of credit. The UCP was first published by the ICC (International Chamber of Commerce) in 1933. UCP 600 is the latest version of the UCP.

This thesis is composed of five chapters. The first chapter is generally a background study in the documentary credits system. The main operation process, essential principles, the internal contractual relationships and some other fundamental issues are all discussed in this chapter as an introduction. In the end of chapter one, a comparison among documentary credits and other popular payment types reflects the problems in the current documentary credits system. The rationale of the thesis to analyse the exceptions within the system is further pointed out by the appearance of the application of additional warranties in documentary credits system.

As the first and most important exception in documentary credits, the fraud rule is analysed in both chapter two and chapter three. Chapter two mainly focuses on the establishment and original development of the fraud rule in both American law and English law. Although the root of the fraud rule in England and Wales comes from the old American Case *Sztejn v. J. Henry Schroder banking Corporation*², English courts applied a different test, other than the "material fraud" test of the United States, in identifying the fraud in the application of the fraud rule. A comparison between the two standards of application will also be made in the second chapter. The third chapter begins with research into a different application of the fraud rule at the pre-trial stage in English law. The reasonableness and the different tests for the application are both discussed in this chapter. The special rule for granting an

² *Sztejn v. J. Henry Schroder banking Corporation* (1941) N.Y.S.2d 631.

interlocutory injunction in fraud cases is also one of the main essentials in chapter 3.

Chapter four turns to investigate another established exception in documentary credits in English law, the illegality exception. The necessity of the existence of the illegality exception and the conditions for its practical application are analysed in this chapter. Some other issues which are also relevant to the fraud rule, such like the reliance principle, the crucial time for established evidence, and so on, are discussed in chapter four as well.

Chapter five, which is the last chapter of the thesis, examines the nullity exception, which has not been clearly recognised in English law. The research in this chapter provides strong support for the application of the nullity exception. A narrow application of the nullity exception is justified by the analysis of related English authorities. Some common features among the application of the three exceptions are summarised in the end of the thesis. Finally, the thesis exploits the potentialities of the development of those exceptions in documentary credits. The improvement of the exceptions may also benefit the growth of the documentary credits system.

Chapter One: A Study in Documentary Credits System

Preface:

To start the research in exceptions in documentary credits, it is essential to have a background study in the documentary credit system itself. The first chapter of the thesis starts with an introduction of the documentary credit system, including its general operation, contractual relationships and the two fundamental principles. The study also introduces the main reasons and necessity of the research of exceptions in documentary credits.

1. The Operation of Documentary Credits

A documentary credit is an assurance by the bank that payment will be made to the seller in exchange for the presentation of certain documents which have been specified in the credit. Generally, the documentary credit operates using certain procedures: following the contract which signed between the buyer and the seller, the buyer, as the applicant, requests his bank to issue a credit in favour of the beneficiary seller; according to the instructions of the buyer, the issuing bank then opens the credit and requests a nominated bank to notify the seller the opening of the credit and the terms and conditions in the credits, by issuing the credit, the issuing bank undertakes an absolute obligation to pay against the documents stipulated in the credit; the nominated bank may confirmed the credit if requested by the seller, by confirming the credit, the nominated bank, as the confirming bank, also undertakes an absolute obligation to pay against the documents. At this stage, the documentary credit is established independently from the underlying contract. After the shipment of the goods, the seller presents the stipulated documents to the nominated bank (probably the conforming bank) to ask for the payment. The nominated bank checks the documents according to the terms of the credit, pay against the documents if the documents are complying with the credit. Then the nominated bank sends the documents to the issuing bank for reimbursement, and the issuing bank has to reimburse the nominated bank if the documents conform to the terms of the credit. In the end, the buyer collects the documents from the issuing bank then presents them to the carrier to take the delivery of the goods. The buyer may

reimburse the issuing bank before or after receiving the documents, depending on the arrangement between the parties. Because of the complex operation of documentary credits, the contractual relationships involved in it are even more complicated. The bank plays the essential role in documentary credit transactions. It is the bank who connects the buyer and seller when the payment going through. The security provided by the documentary credit is highly relying on the bank's credit.

2. The Contractual Relationships in Documentary Credits

2.1. The contractual relationship between the buyer and the issuing bank

The underlying contract, which is usually a sales contract, is the basis for the existence of documentary credits. No Documentary credits, by their nature, are separate transactions from the underlying contracts on which they may be based.¹ The process of establishing a letter of credit begins with the buyer requesting the bank to issue a letter of credit in favour of the seller.² After the bank accepts the buyer's application of issuing the credit, the contract between buyer and the issuing bank established. The bank, as the agent of the buyer, then undertakes an obligation to pay the seller against conforming documents according to the terms and conditions agreed in the contract and

¹ See Article 4 of UCP 600. Supra note 1 in "Introduction" section of the thesis.

² Richard King, "Gutteridge and Megrah's Law of Bankers' Commercial Credits" (8th edn, Routledge, 2001), p. 55.

to take "reasonable care"³ in examining the documents before the payment.

Article 7 of UCP 600 specified the undertaking of the issuing bank as follows:

"Article 7 Issuing Bank Undertaking

- a. Provided that the stipulated documents are presented to... the issuing bank and that they constitute a complying presentation, the issuing bank must honour...
- b. An issuing bank is irrevocably bound to honour as of the time it issues the credit..."⁴

The issuing bank's obligation to pay against documents is independent from the underlying contract between the buyer and the seller. He is required to make the decision whether to pay the beneficiary seller solely depending on the documents. The issuing bank owes the applicant buyer a duty of examining the facial conforming of documents. Standard for examination of documents is also specified in UCP 600:

"Article 14 Standard for Examination of Documents

- a. ...the issuing bank must examine a presentation to determine, on the basis of the documents alone, whether or not the documents appear on their face to constitute a complying presentation.
 - b. ...the issuing bank shall each have a maximum of five banking days following the day of presentation to determine if a presentation is complying. This period is not curtailed or otherwise affected by the occurrence on or after the date of presentation of any expiry date or last day for presentation.
- ..."⁵

As long as the issuing bank takes reasonable care and follows the buyer's instruction in examining the documents, it performs its obligation under the contract with the buyer. It is essential, however, that the bank shows that it has carried out, in all their strictness, the buyer's instructions as specified in the contract between the buyer and the bank resulting in the issue of the

³ The term "reasonable care" is used to be in the old version of the UCP until UCP 500. This term was omitted in UCP 600.

⁴ Article 7 of UCP 600, p. 16.

⁵ Ibid, p. 24.

credit.⁶ Otherwise, the issuing bank will not be able to get the reimbursement from the applicant buyer. In the old case of *Equitable Trust Co of New York v Dawson Partner Ltd*⁷, It was held that the bank was not entitled to the reimbursement because the bank accepted a certificate which was not conforming to the requirement of the credit. Lord Sumner said:

"What [the bank] tendered, as one of the documents and as the only certificate of quality, was one issued by only one expert who was a sworn broker, and by nobody else. There is really no question here of waiver or estoppel or of negligence or of breach of a contract of employment to use **reasonable care and skill**. The case rests entirely on performance of the conditions precedent to the right of indemnity, which is provided for in the letter of credit, It is both common ground and common sense that in such a transaction the accepting bank can only claim indemnity if the conditions on which it is authorised to accept are in the matter of accompanying documents strictly observed. There is no room for documents which are almost the same, or which will do just as well. Business could not proceed securely on any other lines. The bank's branch abroad, which knows nothing officially of the details of the transaction thus financed, cannot take upon itself to decide what will do well enough and what will not. If it does as it is told, it is safe; if it declines to do anything else it is safe; **if it departs from the conditions laid down, it acts as its own risk**. The documents rendered were not exactly the document which the defendants had promised to take up. And prima facie they were right in refusing to take them."⁸

Equalled to the obligation of the issuing bank to take a reasonable care to examine the documents, the applicant buyer is obliged to reimburse the issuing bank as long as the issuing bank performed its obligation. And the only obligation which the bank has to perform is to pay reasonable care to examine the documents standardized in UCP 600. In the case of *Gian Singh*

⁶ See Richard King, "Gutteridge and Megrah's Law of Bankers' Commercial Credits", p. 60, supra note 1.

⁷ *Equitable Trust Co of New York v. Dawson Partner Ltd* (1927) 27 Ll.L.R. 49.

⁸ Ibid, 52.

*& Co Ltd v. Banque de L'Indochine*⁹, even though the falsehood of a document was proved, the bank was held entitled to the reimbursement because reasonable care had been showed during the examining of documents. Lord Diplock said during the judgment that:

"In business transactions financed by documentary credits banks must be able to act promptly on presentation of the document, in the ordinary case visual inspection of the actual document presented is all that is called for. The bank is under no duty to take any further steps to investigate the signature of the person named or described in the letter or credit."¹⁰

Lord Diplock's words shows cleared that the obligation of the buyer to reimbursement the bank are independent from any other disputes in the underlying contracts or even in the documents as long as the bank performed its responsibility. And the bank's responsibility is only to pay a reasonable care in examining the conformity documents and made the decision in time. The contractual relationship between the buyer and the issuing bank also reflects the relationship between the issuing bank and the seller beneficiary.

2.2. The contractual relationship between the issuing bank and the seller beneficiary

The contractual relationship established between the issuing bank and the seller when the bank issues the credit and notifies the seller. Although the effect of the contact between the issuing bank and the seller depends upon

⁹ *Gian Singh & Co Ltd v. Banque de L'Indochine* [1974] 2 Lloyd's Rep 1. *Gian Singh* is even a more important case in the research of the fraud exception. See later in Chapter 2, section 5.22.

¹⁰ *Ibid*, 11.

whether the credit is irrevocable or revocable,¹¹ UCP 600 interpreted that "A credit is irrevocable even if there is no indication to that effect."¹² Under an irrevocable credit the issuing bank gives a binding undertaking to the beneficiary that it will pay against documents in compliance with the terms of the credit.¹³ The effect of an irrevocable credit is to substitute the issuing bank for the buyer, as the person who signs the sales contract with the seller, and promises to pay against the shipping documents.¹⁴ In other words, by establishing an irrevocable credit relationship with the seller, the issuing bank undertakes an absolute obligation to pay the seller beneficiary as long as the documents of title presented by the documents are in order, the documents are complying with the credit. The bank's responsibility is independent to the sale contract between the seller and the buyer. The controversy between the seller and the buyer in the underlying contract will not affect the bank's responsibility of payment. As Rowlatt J said in *Stein v. Hambros Bank of Northern Commerce*¹⁵:

"The obligation of the bank is absolute, and is meant to be absolute, that when the documents are presented they have to accept the bill. That is the commercial meaning of it."

However, similar to the buyer's obligation to reimburse the issuing bank, the issuing bank's obligation of payment is also subject to the seller's responsibility of presenting conforming documents. Although the issuing bank

¹¹ See Richard King, "Gutteridge and Megrah's Law of Bankers' Commercial Credits", p.74, *supra* note 1.

¹² See Article 3 of UCP 600.

¹³ In *M.A. Sassoon & Sons Ltd v International Banking Corporation* [1927] AC 711, 724. It was said by Lord Sumner that: "It is not easy to see in what respect [the word 'irrevocable'] would carry the matter further than the word 'contract', used in its strict sense, would have done, for ... the word 'irrevocable' simply closed the door on any option or locus penitentiae, and makes the agreement definite and blinding — in other words, creates a true contract, which will either be performed or be broken."

¹⁴ See *Urquhart Lindsay & Co. Ltd v. Eastern Bank Ltd* [1922] 1 KB 318, 323.

¹⁵ *Stein v. Hambros Bank of Northern Commerce* (1921) 9 Ll.L.R 433, 507. See also Scrutton LJ in *Donald H. Scott & Co Ltd v Barclays Bank Ltd* [1923] 2 K.B. 1 at 14.

cannot refuse payment relying on any defence that may be open to the buyer on the underlying contract, it will still have the right to refuse payment if the documents presented are not complying with the credit. The UCP 600 represents the bank's rights in rejecting nonconforming documents in Article 16 as follows:

"Article 16 Discrepant Documents, Waiver and Notice
a. When ... the issuing bank determines that a presentation does not comply, it may refuse to honour or negotiate.
b. When an issuing bank determines that a presentation does not comply, it may in its sole judgement approach the applicant for a waiver of the discrepancies."¹⁶

The issuing bank's entitlement of rejecting payment is because of the seller's responsibility of representing the conforming documents. As the bank takes the position of the buyer to promise to buy the complying documents, the seller also owes the duty of presenting conforming documents. One of most important reasons why the documentary credit system can work is because the value of the document is standing for the goods in the underlying contract. The documentary credit transaction asks the issuing bank to undertake the obligation of payment, but also offers a security interest to the issuing bank since the bank may be seen as in hold of the contractual goods as long as it holds the conforming documents. Hence, it is not only the obligation which arises from the sale contract for the seller to present the conforming documents; the security interest which is provided by the documentary credit transaction for the bank also requires the bank to present the documents complying to the credit. Otherwise, the bank is entitled to reject the payment. Of course, the bank should be ready to be challenged by the beneficiary

¹⁶ See Article 16 of UCP 600.

seller in the trial for wrongful dishonour if it decides to reject the documents.

2.3. The contractual relationship between the intermediary bank and the issuing bank or seller beneficiary

Documentary credits are more popular in international transactions where the seller and the buyer are located in different countries. In this case, an intermediary bank in the seller's country is usually introduced into the credit contract. This arrangement may provide the seller better security than dealing with a bank in a foreign country. The relationship between the issuing bank and the intermediary bank will depend upon the role which the intermediary bank is playing.

The intermediary bank may merely give the notice of the credit to the beneficiary, in this case, no real contractual liability will arise between the advising bank and the seller. The advising bank only works as agent for the issuing bank and has a limited liability to take reasonable care to check the facial conforming of the documents presented by the seller. However, if the advising bank is unable to establish the apparent authenticity of the documents, it must inform the issuing bank without delay. This is all the obligation the advising bank owes to the issuing bank under UCP 600;¹⁷ but an advising bank may be authorized as the nominated bank, on behalf of the

¹⁷ See UCP 600, Article 9. "... b. By advising the credit or amendment, the advising bank signifies that it has satisfied itself as to the apparent authenticity of the credit or amendment and that the advice accurately reflects the terms and conditions of the credit or amendment received.... e. If a bank is requested to advise a credit or amendment but elects not to do so, it must so inform, without delay, the bank from which the credit, amendment or advice has been received. f. If a bank is requested to advise a credit or amendment but cannot satisfy itself as to the apparent authenticity of the credit, the amendment or the advice, it must so inform, without delay, the bank from which the instructions appear to have been received..."

issuing bank, to pay against the documents. However, unless the nominated bank chose to confirm the payment under the credit, the nominated bank is not bound to pay against the beneficiary's documents. But by authorizing the nominated bank to pay, the issuing bank undertakes the obligation of reimbursement to the nominated bank as long as it pays against the facially conforming documents. Of course, it will be another story if the nominated bank chose to confirm the credit. By confirming the credit, the nominated bank becomes the confirming bank which undertakes the same absolute obligation to pay against conforming documents. The confirming bank's undertaking is specified in Article 8 of UCP 600:

"a. Provided that the stipulated documents are presented to the confirming bank ...the confirming bank must honor...

b. A confirming bank is irrevocably bound to honour or negotiate as of the time it adds its confirmation to the credit..."

Of course, the issuing bank is bound to reimburse the confirming bank as long as the confirming bank pays against conforming documents. In the case of *Byserische Aktiengesellschaft v. National Bank of Pakistan*¹⁸, it was held that the issuing bank was liable to the confirming bank in damages because it failed to reimburse the confirming bank.¹⁹ However, the confirming bank, unlike the mere nominated bank but similar to the issuing bank, also undertakes an obligation to pay the beneficiary seller against conforming documents. In this case, the beneficiary obtains the undertaking from both the issuing bank and the confirming bank. The contractual obligations differed because of the different roles the intermediary bank was playing also introduces another question, which is the types of credit.

¹⁸ *Byserische Aktiengesellschaft v. National Bank of Pakistan* [1997] 1 Lloyd's Rep. 59.

¹⁹ See Jason Chuah, "Law of International Trade"(4th edn, Sweet & Maxwell, 2009), p. 436.

3. Types of the Credit

The UCP has contributed to common usage of language in letters of credit and common meanings for various terms, however, there are different types of letter of credit. "Owing to the absence of any standard form of bankers' commercial credit it is necessary to attempt some kind of classification of the different types of this instrument which are in use in the business world."²⁰ The letter of credit may be classified into different types by different standard. For example, by reference to the method of payment, letters of credit may be classified into a "sight" credit, a "deferred payment" credit, an "acceptance" credit and a "negotiation" credit; by the transferability of the credit, letters of credit may be classified into a "transferable" and a "back-to-back" credit. It might be out of place to discuss the details of the classification of the letter of credit since this chapter is only a background study of documentary credits for the later focus of the exceptions.²¹ However, it may be necessary to discuss further for the most important division in the classification of credits, which is revocable and irrevocable credit since the basic contractual relationships may be totally different between the two types of credits.

Article 3 of UCP 600 states that: "A credit is irrevocable even if there is no indication to that effect." This means the presumption under a documentary credit contract is that the credit is irrevocable if there is no clear stipulation as to the revocability of the credit. In fact, the revocable credit offers the seller so limited security that the buyer may be able to cancel the credit at any time by

²⁰ See Richard King, "Gutteridge and Megrah's Law of Bankers' Commercial Credits" (8th edn, Routledge, 2001), p. 18.

²¹ For further reading for types of letters of credit, See Richard King, "Gutteridge and Megrah's Law of Bankers' Commercial Credits", Chapter 2, p. 17 to 25, *supra* note 1; and Jason Chuan, "Law of International Trade", p. 413 to 422, *supra* note 18.

instructing the issuing bank.²² In this case, the buyer is allowed to terminate the letter of credit and further breach the sale contract with the seller. "The seller is then left with little option but to seek legal redress [under the sale contract], which of course means inconvenience, bad publicity and costs. Revocable credits are therefore not popular in international trade."²³ Hence the credits discussed in the thesis are generally irrevocable credits. An irrevocable credit offers a much better security for the seller beneficiary. It says in Article 10 of UCP 600:

"Article 10 Amendments

a. Except as otherwise provided by article 38, a credit can neither be amended nor cancelled without the agreement of the issuing bank, the confirming bank, if any, and the beneficiary..."²⁴

A confirmed irrevocable credit even means more secure payment for the seller. As has been discussed earlier,²⁵ the seller may prefer to work with a bank in its own country rather than one in a foreign country which is hard to communicate with. It may ask its own bank to add a confirmation of payment to the credit. The seller's bank then as the confirming bank undertakes the obligation of payment against the documents complying with the credit. Actually, confirmed letters of credit have even more advantages than the higher security which they offer to the seller. "Confirming letters of credit have not only the advantage of security as far as the seller concerned, but also of speed. The seller is able to claim payment as soon as documents are presented to his bank."²⁶ Those advantages of letters of credit are essential

²² Although it was not discussed directed in UCP 600, In UCP 500 Article 8(a), it said that a revocable credit may be amended and cancelled by the issuing bank at moment and without prior notice to the beneficiary.

²³ See Jason Chuah, "Law of International Trade", p. 413, supra note 18.

²⁴ See Article 10 of UCP 600.

²⁵ See section 2.3 of this chapter.

²⁶ See Jason Chuah, "Law of International Trade", p. 418, supra note 18.

for the unshakable position of documentary credits as a main method of payment in international trade transactions.

4. The Essential Security Provided by Documentary Credits -- a Comparison between Documentary Credits and Other Payment Types

4.1. The main feature of documentary credits

The main object of a documentary credit is to provide a means to a buyer to pay for goods or services supplied by a seller. Unlike other payment means, a documentary credit has its own feature, which is mainly the high security. The documentary credits system ensured payment to the seller for the contract goods or services on one hand and their delivery to the buyer on the other hand, especially when the dealings are between merchant in different countries. In the operation of documentary credits system, the banks' position is essential. The credit is normally issued by a bank (or other financial facilities) to make a promise to pay against the presentation of stipulated documents in the credit which representing the goods.

The documentary credits system is best suited for transactions in which the contractual parties are not well known to each other. In this case, it can be hard for the seller to trust the strange buyer to pay solely relying on his reputation. A further function of documentary credits is to enable the seller to obtain prompt payment, while allowing the buyer to postpone payment until

the time when he has been able to market the goods. Documentary credits also developed year by year to satisfy the requirements of business.

4.2. The advantages of documentary credits contrasted to other means of payment

Although the documentary credit can also be used in domestic business, it may be seen as much more popular in international business in which parties are not known to each other. The complex procedures of the documentary credit²⁷ provide a high security for the contractual parties. For the seller, the existence of the nominated bank (probably the confirming bank) reduces the risk of the insolvency or non-payment of the international buyer since the nominated bank will pay against documents. The confirmed credit will provide even more security for payment for the seller. And for the buyer, the reimbursement to the issuing bank against the documents provides good evidence that the contractual goods have been shipped. For the banks, the documents also provide comparative security to both the issuing and nominated banks, and more important a good profit as rolling in documentary credit. Documentary credits not only offer security to all the parties, additional terms in different documentary credit contacts may provide better capital liquidity to the parties. For example, a confirming bank may negotiate the documents before the payment is due, and then provide the seller an earlier payment.

²⁷ For the operation of documentary credits, see early this chapter, section 1.

Except for all the advantages, documentary credits also have problems; the high cost of banking settlement may made the buyer choose to use some other payment means to avoid the high expense. The advance payment is one of the more economical payment means. Just as its name implies, advance payment means the part or full of the contractual price is paid in advance for the goods or service. Clearly, advance payment is safe for the seller since the seller may receive the money before the goods being shipped. However, it can be risky for the buyer, who pays the money without anything in hand to make sure the goods will be delivered. What is more, if the insolvency of the seller occurs, the buyer may have difficulty receiving the goods which he has actually paid for. Because of the low security for the buyer, the advance payment is not popular for comparatively higher value business or long distance business. And the advance payment causes a high rate of advance payment fraud in developing areas.²⁸ However, it may be a good choice for some business to save the payment settlement costs as long as the buyer has a good trust in the seller who he is dealing with. Nevertheless, advance payment should not be seen as an eligible replacement to documentary credits.

In contrast to the advance payment, the "open account" may be a much preferred payment means for most buyers. In an "open account" payment, according to the agreement, the buyer may only need to pay for the goods or services provided by the seller within a specific period after the performance of the contract. Compared with a documentary credit, open account saves

²⁸ Olubusola H. Akinladejo in his article "Advance fee fraud: trends and issues in the Caribbean", discussed the high rate of fraud caused by the advance payment in the area of Caribbean and some other developing counties. See [2007] *Journey of Financial Crime*, Vol14, No.3, p. 320-339.

the high cost of a banking commission fee. However, in an open account payment, the seller may have a high risk of suffering the buyer's non-payment. Actually, "open account is quite normal between parties who have been trading with each other for a long time and there is implicit trust between them. It is particularly popular in intra-E.U. Trade."²⁹ It may not be practical in all international trade transactions, especially when the parties are not familiar with each other. The seller may not be able to process action until the buyer fails to pay, at which time the seller has already delivered the goods and may not be able to repossess the goods. Therefore, although the open account payment becomes quite popular, its usage is only limited to certain areas, and mostly to domestic transactions; the documentary credit is still in an unshakable position in international trade transactions.

Of course, the documentary credit system faced problems recently. The high rate of rejection of documents in practice has serious implications for maintaining or increasing its market share as a recognized means of settlement in international trade. "Until two years ago, letters of credit were the dominant payment method for companies, used in over 80 per cent of transactions, but has now dropped to about 15 per cent. Open account trading is now over 80 per cent," Henri de Bellefroid, marketing communication manager at credit insurer Atradius, told the Standard newspaper.³⁰ This negative effect reveals that there are serious drawbacks within documentary credits system itself. To explore the real problems in documentary credits, it may be better to start the research from its main principles – Autonomy & Strict Compliance.

²⁹ Jason Chuah, "Law of International Trade", p. 390, *supra* note 18.

³⁰ See Mark Ford, "Where L/C is weak-and strong",
<http://www.iccbooks.com/Home/LCUse.aspx>.

5. The Autonomy of Documentary Credits

It is a fundamental principle in documentary credits that the contract relating to the documentary credit is autonomous and separate from the underlying sale contract. The autonomy of the documentary credit is reflected in article 4 of UCP 600 as follows:

"Article 4 Credits v. Contracts

a. A credit by its nature is a separate transaction from the sale or other contract on which it may be based. Banks are in no way concerned with or bound by such contract, even if any reference whatsoever to it is included in the credit. Consequently, the undertaking of a bank to honour, to negotiate or to fulfil any other obligation under the credit is not subject to claims or defences by the applicant resulting from its relationships with the issuing bank or the beneficiary. A beneficiary can in no case avail itself of the contractual relationships existing between banks or between the applicant and the issuing bank.

b. An issuing bank should discourage any attempt by the applicant to include, as an integral part of the credit, copies of the underlying contract, proforma invoice and the like."

According to the autonomy principle, the seller is assured of payment as long as he can present documents which are conforming to the credit. "It is not open to anyone (including the buyer) to argue that there has been a breach of the underlying contract of sale and hence, deny the seller payment under the letter of credit."³¹ And the bank is not entitled to reject documents by relying on the underlying contract conflicts. As Hirst J stated in *Tukan Timber Ltd v. Barclays Bank Plc.*³²:

"It is of course very clearly established by the authorities that a letter of credit is autonomous,

³¹ Jason Chuah, "Law of International Trade", p. 422, supra note 18.

³² *Tukan Timber Ltd v. Barclays Bank Plc.* [1987] 1 Lloyd's Rep 171, 174.

that the bank is not concerned in any way with the merits or demerits of the underlying transaction, and only in the most extremely exceptional circumstances should the Court interfere with the payment bank honouring a letter of credit in accordance with its terms bearing in mind the importance of the free and unrestricted flow of normal commercial dealings."

Hirst J's words did not only express the bank's obligation and liability under documentary credits, but also showed that the English courts had traditionally been hesitant to interfere with the operation of documentary credits in respect to the autonomy of credits.³³

The autonomy principle which means a separation of the underlying contract and the letter of credit is the foundation for a smooth operation of documentary credits system. As Professor Jason Chuah said in his book "Law of International Trade"³⁴:

"We should also remember that in many international trade transactions, there are more parties involved than just the buyer or seller. The seller usually had to obtain goods or raw materials from a supplier before he is able to meet the contract made with the buyer. The seller will need to be financed in making payment to their suppliers. That financing comes from the negotiation or discounting of drafts drawn under the documentary credit system. That system of financing would break down completely if a dispute between the seller and buyer was to have the effect of "freezing" the sum in respect of which the letter of credit was opened."³⁵

The autonomy principle isolates the credit from the underlying contract; the document under the credit, consequently, becomes essential in documentary credits transactions. Article 5 of UCP 600 specified that "banks deal with

³³ Also see *Hamzeh Malas & Sons v. British Imex Industrial Ltd.* [1958] 2 Q.B. 127. Details are discussed in Chapter 2 of the thesis, at section 5.1.

³⁴ Jason Chuah, "Law of International Trade", *supra* note 18.

³⁵ Jason Chuah, "Law of International Trade", p. 423, *supra* note 18.

documents and not with goods, services or performance to which the documents may relate."³⁶

In fact, during the operation of documentary credits, not only banks, but all the parties are concerned only with documents. In the old case of *Urquhart Lindsay & Co. Ltd v. Eastern Bank Ltd*³⁷, a letter of credit was opened to secure the payment for an underlying contract of machinery purchase. The underlying contract contained a clause which said the price was to be increased in the event of a rise in wages, cost of materials or transit rates etc., but there was no such clause mentioned in the credit. Later, the bank rejected documents presented by the seller on the ground that items of extra cost of labour were included in the invoice price of the goods. It was held by Rowlatt J that the bank must accept the documents and pay irrespective of any defence under the underlying contracts. For the bank's position under an irrevocable credit, he said:

"...the defendant [the bank] undertook to pay the amount of invoiced for machinery without qualification, the basis of this form of banking facility being that the buyer is taken for the purpose of all questions between himself and his banker, or between his banker and the seller, to be content to accept the invoices of the seller as correct. It seems to me that, so far from the letter of credit being qualified by the contract of sale, the latter must accommodate itself to the letter of credit."³⁸

According to the words of Rowlatt J, the credit may take priority over the underlying contract when there are contradictions between the two. His judgment also established the essential position of documents in documentary credits transactions. Banks can only make the decision of

³⁶ See Article 6 of UCP 600.

³⁷ *Urquhart Lindsay*, [1922] 1 K.B. 318, supra note 13.

³⁸ *Ibid*, 323.

whether paying by examining the stipulated documents in the credit.³⁹ The dominant position of documents also induces the other fundamental principle in documentary credit, which is the strict compliance.

6. The Principle of Strict Compliance

"The idea of strict compliance has developed from the general principle of the law of agency that an agent is only entitled to reimbursement from his principle if he acts in accordance with his instructions."⁴⁰ In documentary credit transactions, banks, who act as the agent of the applicant, are only entitled to reimbursement from the applicant if they pay against documents complying with the condition under the credit. Article 14 of UCP 600 provides the guidance for banks to examine the documents as follows:

"Article 14 Standard for Examination of Documents
a. A nominated bank acting on its nomination, a confirming bank, if any, and the issuing bank must examine a presentation to determine, on the basis of the documents alone, whether or not the documents appear on their face to constitute a complying presentation.

...

d. Data in a document, when read in context with the credit, the document itself and international standard banking practice, need not be identical to, but must not conflict with, data in that document, any other stipulated document or the credit.

..."

Accordingly, banks must determine on the basis of the face of the documents along whether they are in compliance with the terms and conditions under the credit. Banks are obliged to pay against conforming documents, however,

³⁹ See Richard King, "Gutteridge and Megrah's Law of Bankers' Commercial Credits", p. 14, *supra* note 1.

⁴⁰ *Ibid*, p. 181.

they are entitled to reject payment as long as document is not in compliance with the credit. In other words, banks are unable to get the reimbursement if they paid against nonconforming documents. It is interesting that the new version of UCP omits the word of "reasonable care" from UCP 500.⁴¹ This perhaps emphasizes the compliance of documents is the only criterion to determine whether banks are entitled to the reimbursement. A nonconforming document may not be accepted by the applicant simply because the bank has paid reasonable care in examining documents. The strict of the principle was clearly expressed by Lord Summer in the old case of *Equitable Trust Co of New York v. Dawson Partners Ltd.*⁴²:

"It is both common ground and common sense that in such a transaction the accepting bank can only claim indemnity if the conditions on which it is authorised to accept are in the matter of the accompanying documents strictly observed. There is no room for documents which are almost the same, or which will do just as well. Business could not proceed (?) securely on any other lines. The bank's branch abroad, which knows nothing officially of the details of the transaction thus financed, cannot take upon itself to decide what will do well enough and what will not. If it does as it is told, it is safe; if it declines to do anything else, it is safe; if it departs from the conditions laid down, it acts at its own risk."

Of course, facial conformity may not require a word-for-word compliance. Simple typographical errors may not be seen as nonconforming while examining documents. And it is certainly not reasonable for banks to reject documents by relying on very minor defects. However, the strict compliance principle is strict. It is hard to define the sort of discrepancy which can properly be seen as trivial. In *Seaconsar Far East Ltd v. Bank Markazi*

⁴¹ In the previous version of the UCP, UCP 500, the relative article Article 13(a) said: "Banks must examine all documents stipulated in the Credit with reasonable care, to ascertain whether or not they appear, on their face, to be in compliance with the terms and conditions of the credit...".

⁴² *Equitable Trust Co*, (1927) 27 Ll.L.Rep. 49, 52, supra note 6.

*Jomhouri Islami Iran*⁴³, it was stipulated in the credit that that all documents presented to the bank should carry the credit number and the buyer's name. But one of the documents tendered omitted to state the credit number and the buyer's name. It was held by the Court of Appeal that the bank was entitled to reject the documents.⁴⁴ Lloyd LJ said:

"[The plaintiffs] argues that the absence of the letter of credit number and the buyer's name was an entirely trivial feature of the document. I do not agree. I cannot regard as trivial something which, whatever may be the reason, the credit specifically requires. It would not help, I think, to attempt to define the sort of discrepancy which can properly be regarded as trivial. "⁴⁵

According to his words, there is no room for a *de minimis* effect argument. Therefore, banks may feel safer to reject defective documents even they believe the discrepancy is trivial, otherwise they accept them on their own risk.

Furthermore, the bank is not required to have special knowledge to decide the materiality of the discrepancy. In the case of *JH Raynor & Co. Ltd v. Hambro's Bank Ltd*⁴⁶, the beneficiary tendered a bill of lading describing the goods as "machine-shelled ground kernels", while the description in the credit was "Coromandel groundnuts". The Court of Appeal, although admitting the two terms are the same in the specific area, still held that the bank was right to reject the documents because the bank is not required to have the knowledge of the meaning of terms in different industries.

⁴³ *Seaconsar Far East Ltd v. Bank Markazi Jomhouri Islami Iran* [1993] 3 W.L.R. 756 (HL), [1993] 1 Lloyd's Rep. 236 (CA).

⁴⁴ This point was not discussed by the House of Lords. The House of Lords reversed the decision of the Court of Appeal on some other grounds and granted leave to serve the proceedings out of jurisdiction on the defendant bank.

⁴⁵ *Seaconsar Far East*, [1993] 1 Lloyd's Rep. 236, 241, supra note 42.

⁴⁶ *JH Raynor & Co. Ltd v. Hambro's Bank Ltd* [1983] Q.B. 711.

It is reasonable that the bank is not required to know more than the facial meaning of the documents; nevertheless, it is not easy either to define the reasonable knowledge of bank when a possible discrepancy occurs. The judgment of the Court of Appeal in *Glencore International AG & Anor v. Bank of China*⁴⁷ may be a good example. Although *Glencore International* is an important case in the issue of original documents⁴⁸, another pleaded discrepancy relates to the discretion of the origin of the goods was not a simple one. The Court of Appeal reversed the judgment of Commercial Court in this issue, holding that the additional words "Indonesia — Inalum" brand, found in the commercial invoice but not appearing in the description of the origin of the goods in the letter of credit, was not inconsistent with the requirement in the credit. Regarding to bank's knowledge in this issue, MR Bingham said:

"It is, we think, plain that the origin specified in the credit ('any western brand') is expressed in a very broad generic way. A banker would require no knowledge of the aluminium trade to appreciate that there could be more than one brand falling within the genus. ... It seems to us quite plain on the face of the document that the additional words were to indicate the precise brand of the goods, it being implicit that that brand fell within the broad generic description which was all that was required."

¹¹⁴⁹

Bingham MR believed that a banker should have the knowledge that the additional words which was not in the description of the origin in the credit were to indicate a precise brand. However, he did not clearly explain the reason why the bank should be able to understand the function of the

⁴⁷ *Glencore International AG & Anor v Bank of China* [1996] C.L.C. 95.

⁴⁸ The detailed application of the strict compliance principle is not discussing in the thesis. Further reading, see Richard King, "Gutteridge and Megrah's Law of Bankers' Commercial Credits", Chapter 7, p. 179 to 245, *supra* note 1; and Jason Chuan, "Law of International Trade", p. 427 to 436, *supra* note 18.

⁴⁹ *Glencore*, [1996] C.L.C. 95, 119, *supra* note 46.

additional words. It seems hard to define the nature and extent of the bank's duty with regard to the exactness of complying documents. The precise meaning of the phrase "on their face" was even more controversial.⁵⁰ It can be more difficult to identify the compliance of a document when specific issues, such as the originality of documents, different types of documents involved in specific cases. The rule of absolute documentary conformity can lead to harsh results. It is almost impossible to achieve complete standardisation in an area where each letter of credit will normally be adjusted to reflect the parties' concerns and the trade in question.⁵¹ Documentary errors and discrepancies occur all the time. According to R.J. Mann's survey, only 27 percent of documents which presented under letters of credit are complying.⁵² Normally the applicant will waive the discrepancy to obtain the goods because he may not be able to get possession of goods until the credit is paid. However, sometimes he will refuse to waive the discrepancies.⁵³ In that case, the bank may usually choose to reject documents on the ground of the discrepancies to stay in a safer position. What is more, the doctrine of strict compliance can also be abused by the bank by scrutinizing the document and rejecting them technically, if the bank knows that there is a falling market and the buyer wants to get out of the contract. According to the survey of UCP600, approximately 70% of documents presented under letters of credit were being rejected on first presentation because of discrepancies. This situation caused a negative effect on the letter of credit being seen as a means of payment and could

⁵⁰ Janet Ulph, "The UCP 600: documentary credits in the 21st century", (2007) JBL 355, 362.

⁵¹ Ibid, 363.

⁵² R.J. Mann, "The Role of Letters of Credit in Payment Transactions", (2000) 98 Michigan Law Review 2494, 2502, and statistical appendix at 2534.

⁵³ Duncan Sheehan, "Rights of recourse in documentary (and other) credit transactions", (2005) JBL 326, 326.

have serious implications for maintaining or increasing its market share as a recognized means of settlement in international trade.⁵⁴ This is also one of the most important reasons of the recent publishing of the new version of UCP (UCP600). The detailed procedural of documentary credits in UCP 600 is essential in regulating the operation of documentary credits, and solving the problems in recent documentary credit transactions.

7. Exceptions to the Principle of the Autonomy

A new version of UCP may be effective in standardizing the banking practice in documentary credits; it will not be able to solve the controversy within documentary credits system, which was mainly caused by the principle of autonomy. The autonomy principle "imposed upon the banker an absolute obligation to pay, irrespective of any dispute there may be between the parties as to whether the goods are up to the contract or not".⁵⁵ This doctrine no doubt promotes the smooth operation of documentary credits. However, the separation of documents from the actual performance of the underlying contract leaves a space to parties to abuse the system. For this reason, some exceptions⁵⁶, such as the fraud rule, were introduced into the operation of the documentary credits system.

Nevertheless, there are also always arguments in applying exceptions. The most important reason is the existence of exceptions may destroy the fundamental principle of "autonomy". Also, it may put the bank into a reluctant

⁵⁴ See UCP 600, Introduction section.

⁵⁵ *Hamzeh Malas* [1958] 2 Q. B. 127, 129, *supra* note 32.

⁵⁶ The exceptions which are discussed in the thesis are: the fraud rule, the illegality exception and the nullity exception.

situation. It is always hard for banks to make the decision of whether applying exceptions without knowing the underlying contract, which is not the responsibility for banks in documentary credits system. Consequently, to protect the position of "autonomy", the standard of proof in applying those exceptions becomes extremely high in the common law world.⁵⁷ And the inefficiency of the application may also cause buyers or banks to choose a comparatively easy way to avoid payment when they noticed a possible fraud while the evidence was not too clear to them. The buyer may instruct the bank to try to rely on the strict compliance principle to find discrepancies in the document and then reject it, even the defects are really minor. The bank will still get a better chance to avoid the payment. It may be too assertive to say the inefficiency of the application of the exceptions, especially the fraud rule, caused the high rate of the rejection of the documents. But it is certainly essential to improve the efficiency of the fraud rule in documentary credits.

Janet Ulph suggested in her article "The UCP 600: documentary credits in the 21st century"⁵⁸ that:

"One possible method of tacking the risks of fraud is to require the beneficiary to warrant that the documents presented are not forged or otherwise fraudulent. The advantage of such a warranty is that it gives a bank more power to refuse documents because it can rely upon the warranty alone rather than the fraud exception."

The new version UCP does not provide any guidance in the issue of warranty. But the recent decision to the case of *Sirius International Insurance Co v. FAI*

⁵⁷ This issue will be mainly discussed in Chapter 2 of the thesis.

⁵⁸ Janet Ulph, "The UCP 600: documentary credits in the 21st century", at 371, *supra* note 49.

*General Insurance Ltd*⁵⁹ may indicate that English courts are open to accept a warranty although the judgment of the Court of Appeal received lots of criticism.⁶⁰ In *Sirius International Insurance Co*, the Court of Appeal held that a beneficiary under a letter of credit was not entitled to draw upon it because he had agreed to in a separate contract that he will not draw upon the credit unless certain conditions are satisfied. May LJ said in his judgment:

"The present case is in more than one important respect a variant of the more typical. Here the relevant underlying agreement is, not the commercial transaction that the letter of credit was intended to support, as in the typical case the contract of sale or in the present case the retrocession treaties, **but a related agreement regulating as between FAI and Sirius terms on which the letter of credit would be established.** The terms included express contractual restrictions on the circumstances in which Sirius would be entitled to draw on the letter of credit. **To that extent the letter of credit was less than the equivalent of cash and Sirius's security was correspondingly restricted.** Although those restrictions were not terms of the letter of credit, and although the bank would have been obliged and entitled to honour a request to pay which fulfilled its terms, that does not mean that, as between themselves and FAI, Sirius were entitled to draw on the letter of credit if the express conditions of this underlying agreement were not fulfilled."⁶¹

May LJ explained the judgment as the express contractual restrictions restricted the security provided by the credit. He also believed that the restriction is only between the beneficiary and the applicant. In other words, the bank is still obliged and entitled to pay. This explanation is not so convicting. As Christopher Hare argued in his article, the bank may be left in

⁵⁹ *Sirius International Insurance Co v. FAI General Insurance Ltd* [2004] 1 WLR 3251 (HL), [2003] 1 W.L.R. 2214 (CA).

⁶⁰ See Christopher Hare, "Not so Black and White: The limits of the Autonomy Principle" [2004] CLJ 288; Jason Chuah, "Documentary Credit - Principle of Autonomy - Derogation", [2003] 3 JIML 9.

⁶¹ *Sirius International* [2003] 1 W.L.R. 2214, 2225, supra note 58.

an impossible position in this circumstance.⁶² However, since the House of Lords believed it was unnecessary to discuss the point of the autonomy and made the decision on the basis of the correct contextual interpretation of two related documents, it seems that English courts started to be more flexible in applying the autonomy principle in the operation of documentary credits.

Although the applying of warranty can affect of the autonomy of documentary credits, it may be seen as reasonable since the UCP itself is not law. The parties are only obliged to comply with the UCP only if they choose to use documentary credits as the payment means and "the text of the credit expressly indicates that it is subject to these rules"⁶³. Therefore, the UCP is binding on parties as contracts rather than the law. It is common that parties are free to amend any terms of the contract. There is no reason why they are unable to amend the autonomy principle of the UCP in the underlying contract. However, the amendment may only restrict the contractual parties, which normally are the applicant and the beneficiary. In other words, banks, who are not concerned with the underlying contract may not be affected by the amendment even it is about the UCP as long as it was not incorporated into the credit. Hence, the applying of additional warranty may be effective to restrict the beneficiary's title of achieving payment but will not affect the bank's payment obligation under the UCP unless the bank chooses not to pay.

⁶² See Christopher Hare, "Not so Black and White: The limits of the Autonomy Principle", *supra* note 59, "On the one hand, the bank would be risking its commercial reputation if it did not pay against such documents, but on the other hand, payment would entail the risk of liability for breaching the terms of an injunction."

⁶³ See UCP 600, Article 1, "The Uniform Customs and Practice for Documentary Credits, 2007 Revision, ICC Publication no. 600 ("UCP") are rules that apply to any documentary credit ("credit") (including, to the extent to which they may be applicable, any standby letter of credit) when the text of the credit expressly indicates that it is subject to these rules. They are binding on all parties thereto unless expressly modified or excluded by the credit."

The application of the additional warranty and the high rate of rejection of documents under the strict compliance doctrine showed that both the English courts and the banks are aware of the problems caused by the autonomy principle. Although it is possible to incorporate a warranty to avoid the fraud issues in documentary credits⁶⁴, it would be strange to use any other rules to solve the fraud or other issues while there are exceptions already. Hence, a research in the application of the exceptions in documentary credits becomes more than necessary. It is essential to find a solution to improve the efficiency of the exceptions, such like the fraud rule, in documentary credit. This is also the main rationale for the author to write the current thesis.

⁶⁴ It was suggested by Janet Ulph in her article. See Janet Ulph, (2007) JBL 355, *supra* note 49.

Summary:

The autonomy principle is the essence of documentary credits system. The operation of the unique payment system is based on the application of the autonomy principle. Because of the separation between the documents and underlying contract, banks can only make the decision of whether paying based on the facially complying of the documents. Accordingly, the strict compliance doctrine becomes the best way for the bank to avoid payment especially when a bank suspect a fraud but cannot prove it. The difficulty in the application of the fraud exception may be one of the reasons of the high rate of rejection of documents by the strict compliance. The new phenomenon of the application of additional warranty to restrict the beneficiary's title in achieving payment further shows the problems caused by the inefficiency of the application of the fraud exception. All the discussion in this chapter points out the necessity of a research in the exceptions in documentary credits.

Chapter Two: The Early Development of the Fraud Rule in English and American Law

Preface:

During the operation of documentary credits, all the parties concentrate on and only concentrate on documents themselves. The principle of autonomy is the foundation for the operation of documentary credits system. However, in the American case of *Sztejn v. J. Henry Schroder banking Corporation*, the fraud rule, as an exception in documentary credits system, was established.

Although the fraud rule has been recognized as an exception long ago, it is still a developing area in the law of documentary credits. The reason may mostly be seen as the strong position of the autonomy principle in the documentary credits system. Different jurisdictions may apply the fraud rule by different means. While in the United States, **Article 5 of the Uniform Commercial Code (UCC)**² has recognized the existence of the fraud exception, there is no statutory basis for the fraud rule in English law. The

¹ *Sztejn v. J. Henry Schroder banking Corporation* (1941) N.Y.S.2d 631.

² The Uniform Commercial Code (the UCC) is a collection of model statutes drafted and recommended by the National Conference of Commissioners of Uniform States Laws and the American Law Institute for enactment by the legislatures of the States of the United States. It consists of 11 different Articles, each covering a different aspect of commercial law. Article 5 of UCC is a uniform statutory scheme governing letters of credit and the fraud rule was first recognized in UCC Art.5-114(2) (1972 version). The UCC (1995 version) is the first statutory which regulated the fraud rule as an exception (Article 5-109) in documentary credits. The most recent version is Art-5-109(2004 version).

reorganization of the fraud rule can only be traced from case law.³ Therefore, the United States may be seen as the first country which approved the fraud rule as an extraordinary rule to documentary credits. It is fair enough to trace the root of the fraud rule in the law of the United States.

As the home of the famous case, *Sztejn v. J Henry Schroder Banking Corp*⁴ in which the fraud rule was established, the United States is also the best country to trace the origin of the fraud rule. An analysis of the early development of the fraud exception, before the birth of the fraud rule, in the United States showed the importance of the fraud concept from the very beginning of the existence of the documentary credits system through case law. The seed of the fraud rule had already been planted during the early development of the documentary credits system. Turning the research to the practical application of the fraud rule in the United States, the landmark case *Sztejn* admitted the existence of the fraud rule as an exception to interrupt the payment in documentary credits. However, the most controversial issue, which is the standard of proof for the application, was not clearly settled in this case. As a consequence, even after the expression of the application of the fraud rule in **Article 5-114(2) in UCC 1972**, American courts applied different explanations to define the fraud in different cases during the application of the fraud rule. The different application in different cases only

³ For a leading case in UK which recognizing the fraud rule, see *United City Merchants v. Royal Bank of Canada (The American Accord)* [1983] A.C. 168 (HL); [1982] Q.B. 208 (CA); [1979] 1 Lloyd's Rep 267 (QB).

⁴ *Sztejn v. J Henry Schroder Banking Corp* (1941) 31 NYS 2d 631.

offer a broad way to apply the fraud rule but did not solve the uncertainty of the position of the fraud rule. A clear standard of the application of the fraud rule was not settled until the appearance of Article 5-109 in UCC 1995. The materiality of the fraud was decided as the main test in applying the fraud rule. Nevertheless, from the study of many American cases, it seems that, although the "materiality test" has been applied by American courts, a "material fraud" is always defined as the same as an "egregious fraud", which caused the application of the fraud being very difficult.

Compared with circumstances in the United States, the application of the fraud rule in England and Wales met with more obstacles. English law considered the autonomy principle in an even more important position. Nevertheless, the autonomy principle did not successfully stop the application of the fraud rule in English law. Reasons for the application are discussed during research. Because there is no statute law, similar to the UCC in the United States, to regulate the application of the fraud rule in English law (and the UCP focused on the autonomy principle rather than on the fraud rule), the general application of the fraud rule can only be traced from case law. The early development of the fraud rule in English law approved a very high standard of proof in applying the fraud rule in documentary credits. From the early cases such as *Discount Records*, *Gian Singh*, up to the very famous case *United City Merchants*, the standard of proof of the fraud rule was raised up time by time. The standard of the

application has to be satisfied by several conditions: a clearly proven fraud, the involvement of the beneficiary and the knowledge of the bank. The extremely high standard of proof heavily limited the efficiency of the application of the fraud rule in early England and Wales.

This chapter is generally a background study for the application and development of the fraud rule. By a comparison of the tests being applied to apply the fraud rule between American and English law, the thesis is trying to point out the advantages and the disadvantages of the application in both of the countries. A new thought regarding to the application of the fraud rule is floated at the end of this chapter.

1. The Definition of Fraud

1.1. The definition of "fraud" in documentary credits

Before entering the research of the fraud exception, it may be important to define the concept of "fraud" in the context of documentary credits. It is not easy to give a clear definition to "fraud" since there is even no statute for the common law fraud. In the case of *Edward Owen Engineering Ltd. v. Barclays Bank International Ltd.*⁵, Lord Denning M.R., when expressed the application of the fraud rule in English law, said:

"That case (*Sztejn v. J. Henry Schroder Banking Corporation* (1941) 31 N.Y.S. 2d 631) 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 when there is no right to payment."⁶

A test for an established fraud may be concluded from the above words. This test is also a good guide to define the term of "fraud" in documentary credits. According to the test, fraud in documentary credit transactions may be seen as established under two situations: forged documents are presented and fraudulent request are made. This test is quite similar to the term of "fraud by

⁵ *Edward Owen Engineering Ltd. v. Barclays Bank International Ltd.* [1978] Q.B. 159.

⁶ *Ibid*, 169.

representation" in "Fraud Act 2006"⁷, although it is a criminal law Act:

"Fraud by false representation

- (1) A person is in breach of this section if he—
 - (a) dishonestly makes a false representation, and
 - (b) intends, by making the representation—
 - (i) to make a gain for himself or another, or
 - (ii) to cause loss to another or to expose another to a risk of loss.
- (2) A representation is false if—
 - (a) it is untrue or misleading, and
 - (b) the person making it knows that it is, or might be, untrue or misleading.
- (3) "Representation" means any representation as to fact or law, including a representation as to the state of mind of—
 - (a) the person making the representation, or
 - (b) any other person.
- (4) A representation may be express or implied.
- (5) For the purposes of this section a representation may be regarded as made if it (or anything implying it) is submitted in any form to any system or device designed to receive, convey or respond to communications (with or without human intervention)."

It is an expressed false representation if a false document is presented, and it is an implied false representation if a fraudulent request is made. The payment is the "gain" which is intended to achieve by a false representation. However, the dishonesty may not be strictly required in documentary credits fraud as in criminal fraud. In this sense, the deceit in tort may be more close to a documentary credits fraud.

⁷ Fraud Act (2006), Section 2, Fraud by false representation. The Fraud Act 2006 (2006 c.35) is an Act of Parliament in the United Kingdom, affecting England and Wales and Northern Ireland. It was given Royal Assent on 8 November 2006, and came into effect on 15 January 2007.

In the old case of *William Derry, J. C. Wakefield, M. M. Moore, J. Pethick, and S. J. Wilde v. Sir Henry William Peek, Baronet (Derry v. Peek)*⁸, where the plaintiff bought shares in a company relying on a prospectus which was issued by the directors of the company, stating that they had the right to run trams on steam power. The directors believed the prospectus would be approved by the Board of Trade. However, the Board of Trade rejected it, and later the company was wound up. The plaintiff then brought an action in deceit. The House of Lords held that the deceit was not established. It was explained that, in an action of deceit, the plaintiff must prove actual fraud. Fraud is proved when it is shown that a false representation has been made knowingly, or without belief in its truth, or recklessly, without caring whether it be true or false. And a false statement, made through carelessness and without reasonable ground for believing it to be true, may be evidence of fraud but does not necessarily amount to fraud. Such a statement, if made in the honest belief that it is true, is not fraudulent and does not render the person making it liable to an action of deceit.⁹

For the elements of an establishment of fraud, Lord Herschell, expressed that:

"... fraud is proved when it is shewn that a false representation has been made (1) knowingly, or (2) without belief in its truth, or (3) recklessly, careless whether it be true or false. Although I have treated the second and third as distinct cases, I

⁸ *Derry v. Peek* (1889) L.R. 14 App. Cas. 337.

⁹ *Ibid.*

think the third is but an instance of the second, for one who makes a statement under such circumstances can have no real belief in the truth of what he states. To prevent a false statement being fraudulent, there must, I think, always be an honest belief in its truth. And this probably covers the whole ground, for one who knowingly alleges that which is false, has obviously no such honest belief. Thirdly, if fraud be proved, the motive of the person guilty of it is immaterial. It matters not that there was no intention to cheat or injure the person to whom the statement was made."¹⁰

This judgment had a long-lasting effect in English Law for the definition of fraud in deceit cases. According to this judgment, reckless itself does not amount to dishonesty. But where a person acts recklessly it is open for the court to find that whether the person had believed in the truth of their statement.¹¹ The person cannot be liable for a fraudulent misrepresentation if he believed the statement is true even the statement is actually untrue. In other words, the person who makes a false representation, which he knows it was forged, is liable for a fraudulent misrepresentation even he did not intend to defraud anyone. This principle was confirmed in the case of *Brown Jenkinson & Co. Ltd. v Percy Dalton (London) Ltd.*¹² by the Court of Appeal. In *Brown Jenkinson*, it was held that the shipowners, by making in the bill of lading a representation of fact which they knew to be false, with intent that it should be acted upon were committing the tort of deceit, and that the defendants' promise to indemnify the shipowners against loss resulting from the making of that representation was accordingly unenforceable.

¹⁰ Ibid. 374.

¹¹ See Paul Richards, "Law of contract" (9th edn, Pearson Longman, 2009), p. 224.

¹² *Brown Jenkinson & Co. Ltd. v Percy Dalton (London) Ltd.* [1957] 2 Q.B. 621.

Pearce LJ said during the appeal that:

"...recklessness is sufficient to make a man liable in damages for fraud. Here the plaintiffs intended their misrepresentation to deceive, although they did not intend that the party deceived should ultimately go without any just compensation. In an action based on deceit that state of mind would render them liable, no less than if they had been fraudulent. The plaintiffs' rather haphazard belief that no one would be ultimately defrauded, though it affects their merits, does not in my view improve their legal position in this case."¹³

Morris LJ, in the same appeal, also concluded the elements in deciding the establishment of the fraudulent misrepresentation as follows:

"But in my judgment all the elements were present which made the consideration illegal and the contract unenforceable. Those elements were: (a) the making of a representation of fact, (b) which was false, (c) which was known to be false, (d) with intent that it should be acted upon."¹⁴

Although those elements were expressed during the consideration of an illegal contract, the base of the illegal contract in this case was the fraudulent misrepresentation. According to the judgment of the above cases, especially the elements of the establishment of the fraud misrepresentation which were summarized during the judgments by both Lord Herschell and Morris LJ, the fraud may be defined as follows:

First, there has to be a false representation, this element can be split into two parts: the first is there must be a representation, the second is the

¹³ Ibid, 640.

¹⁴ Ibid, 636.

representation must be false;¹⁵

Secondly, the representor must have the knowledge of the falsity of the representation. In other words, the representor must know that the representation is false or be reckless whether it be true or false. This element, which was established in *Derry v. Peek*¹⁶, made the proving of fraud being very difficult. On one hand, the knowledge of the representor as the internal idea of the representor is not easy to be known; on the other hand, it may be even harder to define the phrase of "reckless whether it be true or false". The term "reckless" is very often regarded as synonymous with negligence, and negligence must never be confused with fraud.¹⁷ Nevertheless, this principle showed an important difference between the criminal fraud and civil fraud. In proving the civil fraud, the motive of the representor who made the false representation is irrelevant.¹⁸

Thirdly, the false representation has to be acted upon. It was summarized by Morris LJ as one of the elements in establishing the fraud that the representor should have the intention that the misrepresentation will be acted upon. This requirement was discussed more clearly in *Standard Chartered Bank v. Pakistan National Shipping Corp and others (No 2)*¹⁹.

¹⁵ A false representation has to be a misrepresentation of fact. For details of the definition of misrepresentation, see Paul Richards, "Law of contract", Chapter 9, *supra* note 11; Jill Poole, "Textbook on Contract Law" (10th edn, Oxford University Press, 2010), Chapter 14.

¹⁶ *Derry* (1889) L.R. 14 App. Cas. 337, *supra* note 8.

¹⁷ Paul Richards, "Law of contract", Chapter 9, p. 224, *supra* note 11.

¹⁸ Also see case *Polhill v. Walter* (1832) 3 B & Ad 114., where defendant was held liable in deceit by make a knowingly false representation although he had no intention making a profit for himself.

¹⁹ *Standard Chartered Bank v. Pakistan National Shipping Corp and others (No 2)* [2003] 1 A.C. 959 (HL), [2000] 1 Lloyd's Rep 218 (CA), [1998] 1 Lloyd's Rep. 684 (QB). The House of Lords reversed the decision of the Court of Appeal on the issue of Mr. Mehra's personal liability, but issues relevant to cognizance of fraud, including the reliance principle, were

Standard Chartered Bank is a documentary credits case involving both fraud and illegality, and in this sense this case is even more important in defining the fraud under the fraud exception. In this case, the plaintiff is a confirming bank(SCB) who sued for damages against shipowner(PNSC) on the basis of a false bills of lading. The fact of the case is unusual because the plaintiff had also claimed repayment from the issuing bank by presenting a false statement that the documents were presented in time. But the issuing bank rejected the documents by reference to other discrepancies without knowing the bill of lading was false and documents were presented out of the expired date. The Court of Appeal allowed the claim of SCB and held that, the fact that the loss might not have occurred but for SCB's decision to attempt to deceive the issuing bank was irrelevant, as SCB had suffered loss as a result of its reliance upon PNSC's false statements. During the judgment, Evans LJ, by reference to the judgement in *Derry v Peek*²⁰, explained the fraudulent representation by the following statement:

"It is not necessary that the maker of the statement was 'dishonest' as that word is used in the criminal law. The relevant intention is that the false statement shall be acted upon by a person to whom it is addressed. If the false statement was made knowingly and that intention is proved, then the basis for liability for the tort of deceit is established. That conduct and state of mind was described as 'dishonest' in *Derry v Peek* and may also be called 'fraudulent'; but that is not necessarily using those words in their criminal sense."²¹

mainly discussed during the appeal.

²⁰ *Derry* (1889) 14 App Cas 337.

²¹ *Standard Chartered Bank* [2000] 1 Lloyd's Rep 218, 224 (CA), supra note 19.

For the issue of the fraudulent of the SCB in the current case, he said:

"Once Mr Thompson admitted in evidence, as he did, that he knew that the letter would be sent to Incombank in the ordinary course of business and that it would contain a statement to the effect that the documents were presented in time, which he knew to be false (even if he thought it to be somehow irrelevant or unimportant) then, in my judgment, a false statement was made by SCB (on whose behalf the letter was signed) which was false to the knowledge of the person who authorised it to be sent (Mr Thompson). In those circumstances, SCB is liable if the remaining elements of the tort of deceit were established....

For these reasons, I would hold on what are mostly undisputed facts that the false statement made by SCB in its letter (dated 10 November) to Incombank that the documents were presented within the period limited by the credit was false to the knowledge of the maker, or was made recklessly, in circumstances which exposed SCB to liability in deceit, if the statement was acted upon by Incombank who thereby suffered loss."²²

The above words from Evans LJ clearly confirmed the required elements for a fraud representation which was established in *Derry v Peek*. And more importantly, besides discussing the essential of the knowledge and intention of the representor, he also pointed out the reliance test in judging a fraud issue. The reliance test is also required in the tort of deceit as the claimant must prove that they acted on the statement to their detriment.²³

In the current case, Evans LJ believed that "SCB relied on the accuracy not only of the bill of lading but also of other documents and upon Mr Mehra's

²² Ibid. 225.

²³ See John Cooke, "Law of Tort" (9th edn, Pearson Longman, 2009), Chapter 22, p. 472.

breach of this undertaking in both respect. It is on that basis that the bank proceeds to consider whether or not the documents are in conformity with the credit". He further explain the detail of the reliance in fraud cases and citing from *Edgington v. Fitzmaurice*²⁴ that "it is not necessary to shew that the [deceitful] misstatement was the sole cause of acting as he did and that it was sufficient for the claimant to show that it 'materially contributed to his so acting'". However, the difficulty in defining the "materiality" may cause some other hazards in defining the reliance and further the fraud. What is clearly established is "in fraud cases, the claimant's negligence is ignored, notwithstanding that it was or may have been a contributory case"²⁵.

According to the above discussion, common law fraud may be defined as a false misrepresentation which is made by a representor who knows the falsity of the representation or be reckless whether it be true or false, and intends to induce other parties to act upon the misrepresentation. For a claimant to claim under the fraud, the reliance between the false misrepresentation and the loss suffered has to be proved. In the context of applying the fraud exception in documentary credits, the fraud could either be in the documents or in the credit itself or the underlying contracts, and the representor, who normally is the beneficiary of the credit, has to have the knowledge of the falsity of the representation. And for the bank who relies on the fraud to reject payment or asks for damages induced by the fraud has to prove the reliance

²⁴ *Edgington v Fitzmaurice* (1885) 29 Ch D 459, 481.

²⁵ [2000] 1 Lloyd's Rep 218 , 226.

between the fraudulent issue and the damages (payment). In other words, the fraud has to be material in inducing the payment. The definition of the fraud is very important since the established fraud is a core requirement in applying the fraud rule in documentary credits. The intention of the beneficiary and the materiality of the fraud are two essentials in establishing a fraud in documentary credits cases. Those issues are discussed later in this chapter.

1.2. The fraud in performance bonds and guarantees

While documentary credits provides a security to the seller for the payment to be paid by the buyer, performance bonds and guarantees could reassure the buyer that the seller will perform his obligation under a contract. The buyer may require the seller to procure a guarantee or promise from a bank or third party to pay certain amount if performance is no made by the seller.²⁶ Typically, the performance bond involves a promise by a third party, which will usually be a bank, that the buyer will be compensated to a specified amount if the goods are not delivered.²⁷ But the seller may also ask for a performance bond from the buyer to rescue the payment under the contract.

In the case of *Edward Owen Engineering Ltd. v Barclays Bank International*

²⁶ Jason Chuah, "Law of International Trade" (4th edn, Seer & Maxwell, 2009), p. 438.

²⁷ Janet Ulph, "Commercial fraud : civil liability for fraud, human-rights, and money laundering" (Oxford University Press, 2006), Chapter 8, p. 510.

*Ltd.*²⁸, Lord Denning while considering the claim on the performance guarantee said:

"All this leads to the conclusion that the performance guarantee stands on a similar footing to a letter of credit. A bank which gives a performance guarantee must honour that guarantee according to its terms. It is not concerned in the least with the relations between the supplier and the customer; nor with the question whether the supplier has performed his contracted obligation or not; nor with the question whether the supplier is in default or not. The bank must pay according to its guarantee, on demand, if so stipulated, without proof or conditions. The only exception is when there is a clear fraud of which the bank has notice."²⁹

It is clear that banks' irrevocable obligation of payment applied similarly to the performance guarantees as to the letters of credit. This obligation applied independent from the underlying contracts between the applicant and beneficiary. But the fraud exception is also applied in the performance guarantees. The general principle remains that, unless fraud is clearly established, the bank should pay and the seller and buyer can sort out their dispute on the underlying contract as a separate matter.

Although the autonomy principle and the fraud rule applied to the performance bonds the same as to the letter of credit, the fraud representation may be harder to be established or even noticed by the bank in a performance bonds case. It is probably because in letters of credit, banks are dealing with the documents, but in the case of performance guarantees,

²⁸ *Edward Owen Engineering Ltd. v Barclays Bank International Ltd.* [1978] Q.B. 159

²⁹ *Ibid*, 169.

banks are dealing with no more than a statement in the form of a declaration to the effect that a certain event or default has occurred.³⁰ It was observed by Lord Denning in *Edward Owen* that:

"So, as one takes instance after instance, these performance guarantees are virtually promissory notes payable on demand. ... the banks will rarely, if ever, be in a position to know whether the demand is honest or not."³¹

It is more difficult for a bank to notice and further prove that a representation is fraudulent when there is a fraudulent demand rather than fraudulent documents, especially if the performance guarantee specified that the buyer could demand payment "without proof or conditions". That is exactly what happened in the case of *Edward Owen*.

Nevertheless, the different expression of the fraud between letters of credit and performance guarantee does not influence the similar application of the fraud exception. Of course, in letter of credits, the fraud is normally documentary fraud, it is the statement in documents is fraudulently made and the beneficiary has the knowledge of the fraud when presenting documents for payment. But in performance bonds cases, the fraudulent issue may just be the request which was made by the beneficiary, and the bank may even be required to pay "without proof or conditions". It is clearly that the proving of the beneficiary's fraudulent intention as making the request is extremely

³⁰ See, Jason Chuah, "Law of International Trade", p. 442, supra note 26: This argument was mentioned during the discussion of the possible different application of the strict compliance principle in performance bonds case rather than in letters of credit.

³¹ *Edward Owen*, [1978] Q.B. 159, 171, supra note 28.

difficult. However, theoretically, there are still situations where the beneficiary is making request for payment by knowing he is not eligible to do it. In those situations, the fraud may be seen as established since the request itself is fraudulent. In this sense, the standard of proof for applying the fraud rule in both documentary credits and performance bonds should be exactly the same. Therefore, the discussion of the detailed application of the fraud rule in later thesis covers both the cases in letters of credit and performance guarantees. And the thesis assumes a similar rule applies to performance guarantees' cases while discussing the application of the fraud rule in letters of credit.

2. The Early Development of the Fraud Exception in the United States Before the Birth of the Fraud Rule

Although *Sztejn*³² is the landmark case of the establishment of the fraud rule in documentary credits, "the idea that fraud upsets the usual rules of credits is an old one"³³. As early as the 1760's, in the case of *Pillans v. Van Mierop*³⁴, the possible influence of the fraud exception to the regular operation of documentary credits system had already been admitted by Lord Mansfield.

³² *Sztejn*, supra note 1.

³³ Professor John F. Dolan, "The Law of Letters of Credits: Commercial and Standby Credits" (4th edition, A.S. Pratt & Sons, 2007), p. 7,

³⁴ *Pillans v. Van Mierop* (1765) 97 Eng Rep. 1035.

*Pillans*³⁵ was not a fraud involved case; the main issue of the case was a rejection of honoring a confirmed draught because of the insolvent of the applicant. White, who was a businessman in Ireland, draw upon a certain amount of money from two businessman, Pillans and Rose (the plaintiffs). He then applied for a confirmed credit from the defendant credit house, Van Mierop and Hopkins, to confirm the money in favor of the plaintiff. Both White and the plaintiffs asked the defendant whether they would agree with the arrangement in writing. And the defendants agreed. However, when the plaintiffs asked the payment from the defendants, they refused to honour the plaintiffs' bills, because White had become insolvent.

On the trial, the judgment was for the defendant. However, on the appeal, the defendant's argument of the appropriation of the underlying transaction was rejected by Lord Mansfield. More importantly, for the issue of the fraud exception, Lord Mansfield said:

"I was then of opinion, that Van Mierop and Hopkins were bound by their letter; unless there was some fraud upon them: for that they had engaged under their hands, in a mercantile action, 'to give credit for Pillans and Rose's reimbursement'." ³⁶

Subsequent to the acknowledgement of the fraud exception, he refused defendant's argument of the involvement of fraud in the current case, said:

"If there was any kind of fraud in this transaction, the collusion and mala fides would have vacated the

³⁵ Ibid.

³⁶ Ibid, 1036.

contract [the credit]. But from these letters it seems to me clear, that there was none... Both the plaintiffs and White wrote to Van Mierop and Company. They answered 'that they would honor the plaintiffs' draughts'. So that the defendants assent to the proposal made by White, and ratify it. And it does not seem at all that the plaintiffs then doubted of White's sufficiency, or meant to conceal anything from the defendant."³⁷

Pillans was decided over two hundred years ago. At that time, documentary credits itself was still developing at a primary stage. It was largely litigated and adjudicated as a case of contract, but not a case of the fraud rule. And the fraud was not established at all. Nevertheless, Lord Mansfield's statement during the appeal made a clear support to the view that fraud may disturb the ordinary operation of documentary credits. What is more, "Pillans demonstrated that fraud had never been tolerated in the letter of credit system, and the seed of fraud rule was planted at a time when letters of credit were barely born."³⁸

Compared to the fraud non-established case *Pillans*, another oft-mentioned case in relation to letter of credits fraud was a more recent decision in *Higgins v. Steinhardter*³⁹. *Higgins* was an early injunction case, in which the plaintiff brought an action to restrain both the beneficiary (the seller) from collection and the issuer of the letter of credit from payment. The alleged fact for the injunction was that the seller has defaulted on the contract by procuring the

³⁷ Ibid, 1038.

³⁸ Gao Xiang, "The Fraud Rule in the Law of Letters of Credit" (Kluwer Law International, 2002), p. 34.

³⁹ *Higgins v. Steinhardter* (1919) 175 NYS 279.

bill of lading falsely stating the shipment date⁴⁰, and the issuer of the letter of credit was also alleged by the plaintiff that he had affirmed the presentation of the facially conforming documents despite the notice of the false statement.

During the hearing, Finch J of the Supreme Court granted the injunction for the plaintiff by the reason that the late shipment date made the credit unusable. He further mentioned the involvement of the false document by rejecting the issuer's argument that it may have become obliged to pay drafts drawn against the credit in any event because of the transfer of such drafts to third parties and said:

"As before stated, plaintiffs authorized payment only on account of a shipment made by a certain date. If defendant Monroe & Co's agent accepted in proof of such shipment a bill of lading which was in fact false as to the time of shipment, then such act of defendants' agent is proximate cause of any risk of loss by the issuance of drafts against the said credits."⁴¹

In *Higgins*, the main issue advanced by the plaintiff was that the seller had defaulted on the contract but not the fraud of the seller; it was only mentioned in the complaint that the bill of lading presented contained a false statement about the date of the shipment. And the decision was also based on the payment against a bill of lading with a false statement would be

⁴⁰ The letter of credit which was used for payment in *Higgins* was subjected to a shipment of walnuts on or before 7th November, 1918. However, it was found the walnuts were not shipped until December 1918. And the bill of lading was falsely stating the shipment was made on 30th October, 1918 by the seller.

⁴¹ *Higgins* (1919) 175 NYS 279, 280, *supra* note 39.

"unauthorized"⁴². However, *Higgins* was decided during the time when the law of letter of credit as a whole was less developed and "the fraud rule in the law of letters of credit was so embryonic at least in the United States that even people in the financial centers like New York did not contemplate its relevance."⁴³ Therefore, both of the plaintiff and the court did not pursue the case in accordance with the fraud rule, but found another way to meet the same result of the fraud rule. It was not difficult to see that the fact of this case was the seller's fraudulent conduct to predate the bill of lading. What have to be mentioned is, the innocent third parties' interests was not protected by the court in this case. It is very important, today, to protect the innocent parties' interests under both the English law and American law while applying the fraud rule.

Another essential case which involved fraud, but did not use the fraud rule as an independent weapon to fight with the fraud, was *Old Colony Trust Co. v. Lawyers' Title & Trust Co*⁴⁴. In *Old Colony*, a letter of credit was issued by the defendant on the benefit of the plaintiff, who advanced a large sum of sugar to a sugar seller. The letter of credit required the drafts to be drawn only against "net handed weights", prior to 30 November 1920, and accompanied by negotiable delivery orders or warehouse receipts. Net landed weight could be ascertained only after the goods had been landed and weighed by customs officials to determine the duty payable on the importation, and

⁴² Ibid.

⁴³ Gao Xiang, "The Fraud Rule in the Law of Letters of Credit", p. 35, supra note 38.

⁴⁴ *Old Colony Trust Co. v. Lawyers' Title & Trust Co* (1924) 297 F 152.

warehouse receipts could not be issued until the goods were in the actual possession of the warehouseman. All shipments did not in fact clear customs until 3 December 1920 at the earliest, but drafts accompanied by facially complying documents were presented for payment prior to the expiry date of the letter of credit. The defendant refused to honour of the drafts on the basis that the documents were not in conformity with the letter of credit. The plaintiffs sued to recover damages for the defendant's breach of contract, but the claim was rejected by the trial court. On appeal, the Second Circuit Court of Appeals affirmed the original judgment and noted:

"As this statement was false, there was failure of compliance with the letter of credit... Obviously, when the issuer for a letter of credit knows that a document, although correct in form, is, in point of fact, false or illegal, he cannot be called upon to recognize such a document as complying with the terms of a letter of credit."⁴⁵

The fact that the document contained a false statement was clear in *Old Colony*, and the judgment was only based on the false document, which according to the above words of the court, is not a conforming document with the terms of a letter of credit even it was facially correct. Therefore, it may be safe to say that *Old Colony* is a strong authority which applied the fraud exception to disturb the ordinary operation of documentary credits but on the basis of the principle of strict compliance principle rather than the fraud rule. Actually, there is always an arguable issue in modern law of whether a

⁴⁵ Ibid, 156-158.

facially conforming document can be rejected by the bank if it contains a false statement, since the bank's duty under documentary credits system was only examining the face conformity of the document. In this sense, *Maurice O'Meara v. National Park Bank*⁴⁶ may be a good example to trace the origin of the application of the fraud rule in modern law.

In *Maurice O'Meara*, the underlying contract was for selling an amount of newsprint paper with certain required quality. The payment against apparently conforming documents was rejected by the defendant issuing bank by the reason of "there has arisen a reasonable doubt regarding the quality of the newsprint paper".⁴⁷ The plaintiff, then, sued the issuing bank for the wrongful dishonour.

The fact of *Maurice O'Meara* was quite similar to those in *Old Colony*, documents presented to the issuer were both conforming documents on the face. The arguable issues were both that the statements in the documents were not complied with the actual conditions of goods. The two litigations were both brought by beneficiaries against issuers. Nevertheless, the decision of *Maurice O'Meara* was totally different from *Old Colony*.

The defence of the low quality of the paper of the defendant issuer was rejected during the appeal by the following statement:

"The bank was concerned only in the drafts and the

⁴⁶ *Maurice O'Meara v. National Park Bank* (1925) 146 NE 636.

⁴⁷ *Ibid*, 639.

documents accompanying them....If the drafts, when presented, were accompanied by the proper documents, then it was absolutely bound to make the payment under the letter of credit, irrespective of whether it knew, or had reason to believe, that the paper was not of the tensile strength contracted for....To hold otherwise is to read into the letter of credit something which is not there, and this the court ought not to do, since it would impose upon a bank a duty which in many cases would defeat the primary purpose of such letters of credit."⁴⁸

The reasoning of *Maurice O'Meara* in the above words is very similar to the thought of determining a documentary credit fraud case in modern law, especially in English law, where the courts normally first focus on the significance of the autonomy principle in documentary credits. And the banks' limited obligations of examining the face of documents with reasonable care may be another emphasis during the hearing. The high standard proof in applying the fraud exception was originated long time ago even before the establishment of the fraud rule.

Of course, disputation arose at the same time even in *Maurice O'Meara*. Cardozo J, while affirming the general rule that the issuing bank had no duty to investigate the performance of the underlying contract, disagreed with the majority judgment said:

"I dissent from the view that, if [the bank] choose to investigate and discovers thereby that the merchandise tendered is not in truth the merchandise which the documents describe, it may be forced by the delinquent seller to make payment of the price

⁴⁸ Ibid.

irrespective of its knowledge."⁴⁹

For the reason he carried on and stated:

"We are to bear in mind that this controversy is not one between the bank on the one side and on the other a holder of the drafts who has taken them without notice and for value. The controversy aroused between the bank and a seller who has misrepresented the security upon which advances are demanded. Between parties so situated payments may be resisted if the documents are false".⁵⁰

Cardozo J took the view that although the obligations of banks under documentary credits were only subject to the face conforming of documents, banks should be free to investigate the internal truth of documents. And if the internal false statement was found, banks should be able to refuse payments because the security interests of banks under documentary credits system may be harmed by the false statement. The security interest in documents was also a liability of sellers to banks.

To disagree to the decision of the current case, Cardozo J further expressed:

"... I cannot accept the statement of the majority opinion that the bank was not concerned with any questions as to the character of the paper. If that is so, the bales tendered might have been rags instead of paper, and still the bank would have been helpless, though it had knowledge of the truth, if the documents rendered by the seller were sufficient on their face."⁵¹

Cardozo J's statement of "the bales tendered might have been rags instead

⁴⁹ Ibid, 641.

⁵⁰ Ibid.

⁵¹ Ibid.

of paper" was suggested as "an invocation to the fraud rule because a misrepresentation might have to go as far as complete non-performance."⁵²

Greg A. Fellingner believed that "Justice Cardozo's dissenting opinion...envision[s] a scenario where there is a total lack of consideration in the underlying sales contract..."⁵³

The study of the historical development of the fraud exception cases in the United States showed a basic concept to the application of the fraud exception during the operation of documentary credits system. From *Pillans* to *Maurice O'Meara*, all the cases above were not adjudicated directly by the fraud rule, since the fraud rule was not well developed before the 1920s, even in the United States. However, a general idea had already been shown by the early fraud related cases, which is "the documents tendered by the beneficiary under a letter of credit had to be both genuine and honest and the issuer accordingly should not be forced to take documents which it knew to be false or fraudulent."⁵⁴ The seed of the fraud rule had already been planted during the early development of the documentary credits system. While the case of *Pillans* pointed out the possibility of the fraud exception to disturb the ordinary operation of documentary credits payment system, both *Higgins* and *Old Colony* provided the support as authorities for the fraud exception to disturb documentary credits. The different approaches in the judgments of

⁵² Gordon B. Graham, and Benjamin Geva, "Standby Credits in Canada", (1984) 9 CAN. BUS. L.J. 180,197.

⁵³ Greg A. Fellingner, "Letters of Credit: The Autonomy Principle and the Fraud Exception", (1990) 1 J. BANKING & FIN.L. & PRAC. 4, 11.

⁵⁴ Gao Xiang, "The Fraud Rule in the Law of Letters of Credit", p. 39, *supra* note 38.

Old Colony and *O'Meara* presented a modern tendency of the application the fraud exception in documentary credits cases in American and English law respectively. And Cardozo J's disagreement to the majority judgment in the case of *O'Meara* may be seen as a historical source of the argument on the banks' discretion in documentary credits during the application of the fraud rule. Of course, no clear principle considering the application of the fraud exception was stated in those cases, and controversial issues relevant to the extent of the exception, such as whether the materiality of the fraud is essential for the application of the fraud exception, or whether the fraudulent activity which was made by a third party but not the beneficiary would be covered by the fraud exception was not concerned deeply. Nevertheless, the historical development of the fraud exception in the United States provided a good source and evidence to the existence of the fraud concept in documentary credits system. It may also be seen as the guidance to the application of the fraud rule in early United States.

3. The Early Application of the Fraud Rule in the United States (Before the UCC 1995)

It is always believed that the United States was the first country which applied the fraud rule as an independent exception to the autonomy principle in documentary credits. One of the main reasons could be the development of

the fraud exception during the "pre-fraud rule" period, which was discussed in the early part of the thesis. However, there is one much more essential reason which is the existence of American case—*Sztejn v. J Henry Schroder Banking Corp.* *Sztejn* is a landmark case for the application of the fraud rule, not only in the United States but also in England (and Wales) and other jurisdictions all over the common law world.

3.1. The landmark case - *Sztejn v. J Henry Schroder Banking Corp.*⁵⁵

In the case of *Sztejn*, the initial contract was a bristles sale contract between Transea Traders Ltd (the seller) and *Sztejn* (the buyer). And Schroder was the issuing bank who was asked by his customer, *Sztejn*, to issue a letter of credit for the payment to the seller, Transea. Transea then drew a draft to the order of a presenting bank, the Chartered Bank. When Chartered Bank presented the draft to the issuing bank for payment, *Sztejn* asked for an injunctive relief from the court to stop the issuer to pay on the ground that the beneficiary of the credit was actually put 50 cases of "cowhair, other worthless material and rubbish with intent to simulate genuine merchandise and defraud the plaintiff".⁵⁶ *Sztejn* also alleged that Charter Bank was only a collecting bank for Transea, but not an innocent holder of the draft for value. Charter bank defended that the presenting bank "is only concerned with the

⁵⁵ *Sztejn*, supra note 1.

⁵⁶ *Ibid.*, 633.

documents and on their face these conform to the requirements of the letter of credit".⁵⁷

During the hearing, Shientag J, followed to the tradition, first acknowledged the principle of Autonomy, said:

"It is well established that a letter of credit is independent of the primary contract of sale between the buyer and the seller. The issuing bank agrees to pay upon presentation of documents, not goods. This rule is necessary to preserve the efficiency of the letter of credit as an instrument for the financing of trade."⁵⁸

To the issue of banks' relationship with the underlying contract, he emphasized that:

"It would be a most unfortunate interference with business transactions if a bank before honouring drafts drawn upon it was obliged or even allowed to go behind the documents, at the request of the buyer and enter into controversies between the buyer and the seller regarding the quality of the merchandise shipped."⁵⁹

However, the judge soon entered into another stage to bring one much more important point of this case stated:

"Of course, the application of this doctrine [the principle of independence] presupposes that the documents accompanying the draft are genuine and conform in terms to the requirements of the letter of credit.

However, I believe that a different situation is

⁵⁷ Ibid, 632.

⁵⁸ Ibid, 633.

⁵⁹ Ibid.

presented in the instant actions. This is not a controversy between the buyer and seller concerning a mere breach of warranty regarding the quality of the merchandise; on the present motion, it must be assumed that the seller has intentionally failed to ship any goods ordered by the buyer. In such a situation, **where the seller's fraud had been called to the bank's attention before the drafts and documents have been presented for payment, the principle of the independence of the bank's obligation under the letter of credit should not be extended to protect the unscrupulous seller...**

Although our courts have used broad language to the effect that a letter of credit is independent of the primary contract between the buyer and seller, that language was used in cases concerning alleged breaches of warranty; no case has been brought to my attention on this point involving intentional fraud on the part of the seller which was brought to the bank's notice with the request what it withhold payment o the draft on this account."⁶⁰

The above words of Shientag J formed the original application of the fraud rule. The judgment of *Sztejn* was that the Chartered Bank's motion for dismissing the plaintiff's complaint was dismissed. And the injunction was granted to the plaintiff on the basis of the allegations that "Transea was engaged in a scheme to defraud the plaintiff..., that the merchandise shipped by Transea is worthless rubbish and that Chartered Bank is not an innocent holder of the draft for value but is merely attempting to procure payment of the draft for Transea's account"⁶¹ was true.

Unlike earlier cases, which decided on the principle of the law of contract,

Sztejn was based on an independent rule under the law of letters of credit --

⁶⁰ Ibid. 634-635.

⁶¹ Ibid, 633.

the fraud rule. It pointed an exceptional way to applicants who have been defrauded by dishonest beneficiaries to protect their interests. Nevertheless, *Sztejn* is a too typical fraud case, in which the fraudulent conduct was assumed to be so clear and serious. The judgment was all established on the basis of the assumption of the allegation of the fraudulent conducts of shipping worthless rubbish on the part of the seller was true. The details of the application of the fraud rule was left as a loophole in *Sztejn*.

However, two additional issues were discussed during the hearing:

One is the bank's security interest, which may be seen as one of the reason for the application of the fraud rule. Shientag J analyzed the possible effect of the fraudulent conducts of the beneficiary to the issuing bank's security interest, said:

"While the primary factor in the issuance of the letter of credit is the credit standing of the buyer, the security afforded by the merchandise is also taken into account. In fact, the letter of credit requires a bill of lading made out to the order of the bank and not the buyer. Although the bank is not interested in the exact detailed performance of the sales contract, **it is vitally interested in assuring itself that there are some goods represented by the documents.**"⁶²

The other one is the possibility of the exemption of a holder in due course during the practical application of the fraud rule. The judge discussed the presenting bank's (the Chartered Bank) position while affirming the

⁶² Ibid. 634-635.

exemption of a holder in due course:

"On this motion only the complaint is before me and I am bound by its allegation that the Chartered Bank is not a holder in due course but is a mere agent for collection for the account of the seller charged with fraud. Therefore, the Chartered Bank's motion to dismiss the complaint must be denied, if it had appeared from the face of the complaint that the bank presenting the draft for payment was a holder in due course, its claim against the bank issuing the letter of credit would not be defeated even though the primary transaction was tainted with fraud."⁶³

The decision of *Sztejn* established the basic principles for the application of the fraud rule: **First**, payment under a letter of credit may only be interrupted in a case of fraud. But the fraud has to be proven or established; mere allegation of fraud should not be an excuse for such an interruption. **Secondly**, the demand of payment from the holder in due course or a presenter with similar status may not be defeated even the fraud is clearly proved.

However, the standard of proof for an approved fraud was left as one of the most controversial arguments in applying the fraud rule. Some commentators believe *Sztejn* sent forth a test of "intentional fraud"⁶⁴ or "egregious fraud"⁶⁵ to justify the fraud in applying the fraud rule. The "egregious fraud" test was even prevailing as a main test for the application of the fraud rule after

⁶³ Ibid.

⁶⁴ E. L. Symons, "Letter of Credit: Fraud, Good Faith and the Basis for Injunctive Relief" (1980) 54 TuL L Rev 338, 340.

⁶⁵ H. Harfield, "Enjoining Letter of Credit Transactions" (1978) 95 BLJ 596, 603.

Sztejn.⁶⁶ This may somehow because of Shientag J's words that "this is not a controversy between the buyer and seller concerning a mere breach of warranty regarding the quality of the merchandise; on the present motion, it must be assumed that the seller has intentionally failed to ship any goods ordered by the buyer...where the merchandise is not merely inferior in quality but consists of worthless rubbish"⁶⁷. However, the *Sztejn* case happened in a special situation, where the fraud has already been proved and there is no doubt that it should be blamed on the beneficiary. The detailed issues relevant to the standard of proof for an established fraud in applying the fraud exception was not necessarily to be discussed in this case. Shientag J when discussed about the autonomy principle in documentary credits also expressed the presupposition that "the documents are genuine", but he did not explain the real meaning of a "genuine document". Is a false document becoming a "genuine document" only because the false statement was not put into the documents by the beneficiary himself? He neither explained the difference between the "alleged breaches of warranty" and an "established fraud" although he believed the alleged breaches of warranty is not an established fraud.

Therefore, Shientag J was possibly only making an adjustment for the *Sztejn* case, where the fraud had already been proved and there was no doubt that it was on the part of the beneficiary. Of course, Shientag J was strongly

⁶⁶ See section 3.2.1 and 3.2.4 of this chapter.

⁶⁷ Ibid.

believed that a bank should not consider the underlying contracts while performing its payment obligation. He said:

"it would be a most unfortunate interference with business transactions if a bank before honouring drafts drawn upon it was obliged or even allowed to go behind the documents, at the request of the buyer and entered into controversies between the buyer and the seller regarding the quality of the merchandise shipped"⁶⁸

The word "allowed" was even against banks' freedom to investigate the possible fraud in the underlying contract. However, he also admitted banks' security interest by saying "although the bank is not interested in exact detailed performance of the sales contract, it is vitally interested in assuring itself that there are some goods represented by the documents." The banks should be, at least, entitled to concern the security interests which is represented by the documents by investigating the true performance of the underlying contract.

For all the above consideration, the thesis is more inclined to agree to Mr Megrah's view that "judgment [in *Sztejn*] does not tell what degree of knowledge of fraud is necessary to justify the issuing bank in refusing to pay"⁶⁹. *Sztejn* may be regarded as the seminal case in the development of the fraud rule, there was no clear answer to the standard of proof to an established fraud. It is even possible that a flexible standard of proof would

⁶⁸ *Sztejn* (1941) 31 NYS 2d 631, 633, supra note 1.

⁶⁹ Mr. Megrah, "Risk Aspects of the Irrevocable Documentary Credit", (1982) 24 Ariz L Rev 255, 258.

be approved if the situation in *Sztejn* was different.

3.2. Different test for an established fraud in early case law in the United States

Since *Sztejn* left a loophole to the standard of proof for the application of the fraud rule, the identification of fraud always raise lots of arguments during the application. Different tests were applied in different cases. Although the UCC 1972 used Article 5-114(2)⁷⁰ to express the application of the fraud rule, the details of application was not clear. there were lots of varied tests for an established fraud in American law⁷¹ before the appearance the Article 5-109 in the UCC 1995.

3.2.1. The "egregious fraud" test

"Egregious fraud" is not a term which commonly used by courts in connection

⁷⁰ The UCC (1972 version), Article 5-114(2), unless otherwise agreed when documents appear on their face to comply with the terms of a credit but required document does not in fact conform to the warranties made on negotiation or transfer of a document of title (Article 7-507) or of a certificated security (Article 8-306) or is forged or fraudulent or there is fraud in the transaction: (a) the issuer must honour the draft or demand for payment if honour is demanded by a negotiating bank or other holder of the draft or demand which had taken the draft or demand under the credit and under circumstance which would make it a holder in due course (Article 3-302) and in an appropriate case would make it a person to whom a document of title has been duly negotiated (Article 7-502) or a bona fide purchaser of certificated security (Article 8-302); and (b) in all other cases as against customer, an issuer acting in good faith may honour the draft or demand for payment despite notification from the customer of fraud, forgery or other defect not apparent on the face of the documents but a court of appropriate jurisdiction may enjoin such honour.

⁷¹ Gao Xiang, in his book "The Fraud Rule in the Law of Letters of Credit" classified the standard of fraud in early United States into several catalogues: Egregious Fraud, Intentional Fraud, the Letter of credits Fraud, Constructive Fraud and Flexible Fraud, see supra note 38. The thesis cited part of the classification.

with the fraud in documentary credits.⁷² It was established during the discussion of the application of the fraud rule in cases by judges. Different suggestions for the explanations of the "egregious" were also advocated by many commentators.⁷³ But generally, the test of "egregious fraud" is an extreme or outrageous nature of fraud, in which a simply intent to deceive is not sufficient.⁷⁴

The case which actually mentioned the term of "egregious fraud" was *New York Life Insurance Co. v. Hartford National Bank & Trust Co.*⁷⁵ In this case, there was a mortgage loan agreement between the plaintiff and a real estate company. According to the agreement, the real estate company committed to borrow a certain sum of money from the plaintiff. There was one term in the agreement that the real estate company would pay the plaintiff a sum of money as damages if he failed to borrow the agreed loan. And this term was guaranteed by a standby letter of credit. When the company failed to take up the loan, the plaintiff asked for the damages under the credit by presenting the required documents under the credit. However, the payment was refused, then the plaintiff sued the defendant for a wrongful dishonour. During the hearing, the Supreme Court of Connecticut rejected defendant's several

⁷² Gao Xiang and Ross P Buckley, "A Comparative Analysis of the Standard of Fraud Required Under the fraud rule in Letter of Credit Law", (2003) Oxford U Comparative L Forum 3 at <http://ouclf.luscomp.org/articles/gao-buckley.shtml>. (Last accessed December, 2010).

⁷³ E.g., Henry Harfield, "Enjoining Letter of Credit Transactions", (1978) 95 BANKING LJ 596; Jack B. Justice, "Letters of Credit: Expectations and Frustrations (Pt.1)", (1977) 94 BANKING LJ 424; Jack B. Justice, "Letters of Credit: Expectations and Frustrations (Pt.2)", (1977) 94 BANKING LJ. 493.

⁷⁴ Kerry L. "Macintosh, Letters of Credit: Dishonour When a Required Document Fails to Conform to the Section 7-507(b) Warranty", (1986) 6 J.L. & COM. 1, 6.

⁷⁵ *New York Life Insurance Co. v. Hartford National Bank & Trust Co.* (1977) 378 A 2d 562.

defenses on the basis that none of the defenses involved the plaintiff's fraud.

And the "egregious fraud " was mentioned by the following statement:

"Only in rare situations of **egregious fraud** would ... have justified the issuer, on the facts presented here, in going behind apparently regular, conforming documents; such fraud 'must be narrowly limited to situations of fraud in which **the wrongdoing of the beneficiary has so vitiated the entire transaction** that the legitimate purposes of the independence of the issuer's obligation would no longer be served.'...There is no such evidence in the record of this case, and the [lower] court correctly found that the documentation presented by New York Life complied fully with the terms of the letter of credit."⁷⁶

The above words did not only express the application of the "egregious fraud" as a test in justifying the fraud in the context of the fraud rule, but also explained the term of "egregious fraud" as a fraud "in which the wrongdoing of the beneficiary has so vitiated the entire transaction that the legitimate purposes of the independence of the issuer's obligation would no longer be served". Obviously, "egregious fraud" is an extremely serious fraud, the possibility of the application of the fraud rule would be very rare if the "egregious fraud" would be accepted as the main test to assess the fraud. This test was quite popular to be cited by the courts especially in those cases where no fraud was involved.

In another oft-mentioned case *Intraworld Industries v. Girard Trust Bank*⁷⁷, where the letter of credit was issued in favour of a lessor as the beneficiary to

⁷⁶ Ibid, 567.

⁷⁷ *Intraworld Industries v. Girard Trust Bank* (1975) 336 A. 2d 316.

guarantee a rental payment of the lessee, who was the applicant of the credit. The applicant was attempting to stop the issuer from payment when the beneficiary presented a facially compliant document. The applicant alleged that there were false and fraudulent statements in the document. However, the court found that the fraud did not exist in that case, and the underlying contract indicated that the beneficiary could draw under the letter of credit and terminate the lease if the applicant failed to pay the rent. Therefore, there was no fraud involved at all. But the court, by rejecting the applicant's claim for an injunction, also concluded the reason as follows:

"We think the circumstance which will justify an injunction against honor must be narrowly limited to situations of fraud in which the wrongdoing of the beneficiary has so vitiated the entire transaction that the legitimate purposes of the independence of the issuer's obligation would no longer be served."⁷⁸

Although the term of "egregious fraud" was not mentioned in this case, but the test which the court approved was similar to the meaning of the "egregious fraud" in *New York Life*. The court recognized the existence of the fraud rule but was very reluctant to allow its interference with the payment in documentary credits. Actually, this is also the main attitude in *Sztejn* case. Although *Sztejn* itself is only an example of the application of the fraud rule, it did not establish a clear standard proof for the application, Shientag J suggested his view about the test for an established fraud in another case

⁷⁸ Ibid, 324-325.

one year later.

In the case of *Asbury Park & Ocean Grove Bank v. National City Bank of New York*⁷⁹, the underlying contract was a clothing purchase of which the payment was to be made by letters of credit. The plaintiff issued a letter of credit by the buyers' request to the benefit of the seller. It was then requested by the seller that further letters of credit should be issued by some other banks since the huge amount of money. Therefore, the plaintiff applied the issuing of other letters of credit from the defendant. Later, before the expiration of the credits, the plaintiff found that the seller was holding the documents instead of presenting for payment after the shipment. And the payment was not asked by the seller until the buyer was seemed unable to pay. The plaintiff then requested the defendant to stop further payment under the credits. However, the defendant rejected the plaintiff's requesting and carried on payment on the ground that the documents were in compliance with the terms of the credits. The plaintiff sued the defendant for damages.

Shientag J rejected the plaintiff's allegation of the fraud in this case and observed:

"The authorities...agree that the letters of credit are contracts which are independent of the contract of purchase between the seller and the purchase...unless there was such a fraud on the part of the seller that there were no goods shipped..."⁸⁰

⁷⁹ *Asbury Park & Ocean Grove Bank v. National City Bank of New York* (1942) 35 N.Y.S. 2d 985.

⁸⁰ *Ibid*, 988.

It seems Shientag J, when cited the authority from his own judgment in *Sztejn*, also applied the test of "egregious fraud" which is "there was such a fraud on the part of the seller that there were no goods shipped". He also expressed his own view about the application of the fraud rule by saying "the common law fraud action is one of the most difficult to prove, and the issuing bank cannot be expected to evaluate the soundness of the correspondent bank's claim."⁸¹ Shientag J's reluctant attitude to the application of the fraud rule may be the best reason why the "egregious fraud" test is so popularly applied by the courts in applying the fraud rule in the United States even after the UCC 1995.

3.2.2. The "intentional fraud" test

Although the "egregious fraud" test was applied broadly by the courts in early United States, the arguments for the appropriate test were not stopped. One of the very important test which was suggested by cases in the United States was the "intentional fraud" test.

The idea of "intentional fraud" was raised in the case of *NMC Enterprises v. Columbia Broadcasting System Inc.*⁸². In *NMC*, the underlying contract was for a purchase of stereo. The letter of credit was issued for the payment of the purchase. And an injunction was sought by the buyer (plaintiff) to restrain the seller(defendant) from presenting documents for payment on the ground that

⁸¹ Ibid, 999.

⁸² *NMC Enterprises v. Columbia Broadcasting System Inc* (1974) 14 U.C.C. REP.SERV. 1427.

the technical performance specifications for the receivers was substantially below those specified in brochures. The plaintiff also alleged that the defendant was aware of the non-conformity of documents.

The injunction was granted by the New York Supreme Court, it was stated:

"Where no innocent third parties are involved and where the documents or the underlying transaction are tainted with intentional fraud, the draft need not be honored by the bank, even though the documents conform on their face and the court may grant injunctive relief restraining such honor."⁸³

The above words did not only mention the term of "intentional fraud", but also confirmed the application of the "intentional fraud" test in assessing the fraud in applying the fraud rule. The "intentional fraud" is very similar to common law fraud, which requires: " (1) a false presentation of the fact; (2) knowledge or belief on the part of the defrauder; and (3) an intention to induce the other party to act or to refrain from action in reliance upon the misrepresentation."⁸⁴

Considering that the fraud rule is to stop dishonest beneficiaries from abusing the letter of credit system, the "intentional fraud" test seems to be an appropriate test. Nevertheless, *NWC Enterprises* was a special case in which the beneficiary's knowledge of non-conformity in the documents was proved to the court. In practical operation, the proofing of the fraudster's intention can be extremely difficult, which has already proved by the current application of the fraud rule in English law. The difficulties appeared similarly

⁸³ Ibid, 1429.

⁸⁴ *Derry* (1889) 14 App Cas 337, 347, per Lord Herschell, *supra* note 8.

in the United States, for example, in the case of *American Bell International v. Islamic Republic of Iran*⁸⁵.

The fact of *American Bell* was quite complex. There was a service contract between American Bell and the Ministry of War of the Imperial Government of Iran. According to the contract, American Bell would provide consulting service and telecommunications equipment to the Imperial Government. A down payment was involved, and Bell's liability to return the down payment would be reduced in proportion to the work completed. A bank guarantee was issued by Bank Iranshahr to protect the down payment. And the bank guarantee was subsequently "confirmed" by a standby letter of credit which was issued by Manufacturers Hanover Trust Company. Later, following to a coup, the Imperial Government was replaced by the Islamic Republic in Iran. Then Bank Iranshahr requested for payment of the remaining balance of the down payment under the credit. American Bell asked for a preliminary injunction against the honoring of the credit by alleging that the demand was fraudulent because the contract should be repudiated by the movement of the government in Iran. The application of American Bell was rejected by Macmahon J, the Judge said:

"Even if we accept the proposition that the evidence does show repudiation, plaintiff is still far from demonstrating the kind of evil intent necessary to support a claim of fraud. Surely, plaintiff cannot contend that every party who breaches or repudiates his contract is for that reason culpable of fraud...

⁸⁵ *American Bell International v. Islamic Republic of Iran* (1979) 474 F. Supp. 420.

[T]he evidence is ambivalent as to whether the purported repudiation results from non-fraudulent economic calculation or from fraudulent intent to mulct Bell...On the evidence before us fraud is no more inferable than an economically rational decision by the government to recoup its down payment,..."⁸⁶

Macmahon J, while confirmed the intention is essential for the application of the fraud rule. It is not hard to see the difficulty to reach standard of proof for an intentional fraud, it can be extremely hard to prove the evil intent of the party. However, the intention of the beneficiary has already confirmed as an essential in the application of the fraud rule in English law.⁸⁷

3.2.3. The "equitable fraud" test

While both "egregious fraud" and "intentional fraud" meet difficulty to be applied to test the fraud during the application of the fraud rule⁸⁸, another test, which is the "equitable fraud" test, was suggested in the case of *Dymanics Corp. of America v. Citizens & Southern Nat'l Bank*⁸⁹.

Dymanics Corp. was a case in which politics was involved. The plaintiff (Dymanics) contracted with Indian government to supply some defence-related equipment. The obligation of the supply was guaranteed by a standby letter of credit which was issued by the Citizens & Southern National Bank (the defendant). According to the credit, the defendant promised to pay

⁸⁶ Ibid, 425.

⁸⁷ See the judgment of the House of Lords in the case of *United City Merchants* [1983] 1 A.C. 168 (HL), supra note 3.

⁸⁸ While for "egregious fraud", the standard seems too high, and for "intentional fraud", although it might be reasonable to the purpose of protecting innocent parties, the intention of beneficiaries was so difficult to prove.

⁸⁹ *Dymanics Corp. of America v. Citizens & Southern Nat'l Bank* (1973) 356 F. Supp. 911

Indian Government (a certificate and some relevant documents were required) if the plaintiff failed to do certain obligations under the contract. Later on, a war between Indian and Pakistan broke out. The military equipment supplied became illegal by the announcement of the U.S government. The Indian government presented the required certificate documents to apply for the payment under the credit. The plaintiff then sought for an injunction to prevent the defendant from payment on the ground of the fraud of the Indian government.

The United States District Court for the Northern District of Georgia, while granting the injunction, settled a very rare test for the fraud in the fraud rule:

"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 had broader meaning in equity [than at law] and intention to defraud or to misrepresent in 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 injurious to another, or by which an undue and unconscious advantage is taken of another."⁹⁰

According to the above judgement, "any conduct of the beneficiary that breaks even an equitable duty may lead to the application of the fraud rule".⁹¹

⁹⁰ Ibid, 998 to 999, citing *SEC v. Capital Gains Research Bureau Inc.* (1963) 375 US 180, 193 to 194.

⁹¹ Gao Xiang and Ross P Buckley, "A Comparative Analysis of the Standard of Fraud Required Under the fraud rule in Letter of Credit Law", *supra* note 72.

Looking back to the original purpose of having the fraud exception, which is "the principle of the independence of the bank's obligation under the letter of credit should not be extended to protect the unscrupulous seller..."⁹², the equitable fraud test seems to be too low as a standard of proof in applying the fraud exception in documentary credits system. If the test is set in such a low position, the inherent commercial functions of documentary credits, such like prompt payment, shared security, will be heavily destroyed. "In the commercial world, there are almost limitless ways in which an applicant's bargain with a beneficiary may go sour. When this happens, the applicant will be tempted to use every means to escape from its original bargain; exploitation of the fraud rule may be one of its choices."⁹³ The low standard may become a useful weapon for the applicant to abuse the fraud rule to avoid a letter of credit contract. The utility of documentary credits would be ruined. The purpose of the fraud rule, which was to avoid fraud in documentary credits, will not be satisfied and may cause unfairness in another direction. Therefore, the equitable fraud test may not be proper one in the fraud rule.

3.2.4. Discussion

According to the above analysis, the standard of proof in proofing a fraud was not a settled issue either in the landmark case *Sztejn* or the UCC Article 5 of

⁹² *Sztejn*, at 634, supra note 1.

⁹³ Gao Xiang and Ross P Buckley, , "A Comparative Analysis of the Standard of Fraud Required Under the fraud rule in Letter of Credit Law", supra note 72.

version 1972. The unclear test caused different applications in different cases. Some courts stuck to a strict and restrictive approach and adopted an "egregious fraud" test, while others took a much different approach by adopting an "equitable fraud" test. In comparison to two contradictory standards, the "intentional fraud" test might be in a more reasonable position. Because all the fraud should be intentional in some sense, to avoid the embarrassing situation in approving different tests in justifying the fraud during the application of the fraud rule in documentary credits cases, some neutral ideas of application were raised during the early development of the fraud rule in the United States.

In the case of *United Bank Ltd. v. Cambridge Sporting Goods Corp.*⁹⁴, where the beneficiary, Duck, fraudulently shipped "old, unpadded, ripped and mildewed gloves" instead of "new gloves" which was required in the underlying sale contract with a presentation of facially complying document to ask for payment, an interlocutory injunction to prevent the issuer from payment was granted to the plaintiff purchaser. The issuer, Pakistani Financing Banks, claimed that they "were holders in due course of the drafts and hence were entitled to the proceeds thereof irrespective of any defenses against the beneficiary"⁹⁵. But the petition was rejected by the Court of Appeal. The New York Court of Appeals introduced a flexible test by saying:

"It should be noted that the drafters of section 5-114,

⁹⁴ *United Bank Ltd. v. Cambridge Sporting Goods Corp.* (1976) 392 N.Y.S. 2d 265.

⁹⁵ *Ibid.*

in their attempt to codify the Szejn case and in utilizing the term 'fraud in the transaction', have eschewed a dogmatic approach and adopted a flexible standard to be applied as the circumstance of a particular situation mandate. It can be difficult to draw a precise line between cases involving breach of warranty (or a difference of opinion as to the quality of goods) and outright fraudulent practice on the part of the seller. To the extent, however, that Cambridge established that Duck was guilty of fraud in shipping, not merely nonconforming merchandise, but worthless fragments of boxing gloves, this case is similar to Szejn."⁹⁶

The flexible test may be reasonable in adapting in different cases while applying the fraud rule. The application of different tests in different cases may offer a broader way to apply the fraud rule. However, the range of the flexibility was not solved at the same time. The flexible test was only a wise manner to avoid the embarrassment of the uncertain rule for the application of the fraud rule in earlier United States.

4. The Application of the Fraud Rule after the UCC 1995

After a long period of the unclear application of the fraud rule, Article 5-109 of the UCC in 1995 version first statutorily regulated the fraud rule as an exception in documentary credits.⁹⁷ This article is also applied in the later

⁹⁶ Ibid, 271.

⁹⁷ The most recent version is the UCC (2004 version), SECTION 5-109. FRAUD AND FORGERY.

(a) If a presentation is made that appears on its face strictly to comply with the terms and conditions of the letter of credit, but a required document is forged or materially fraudulent, or honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant: (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

versions of the UCC.⁹⁸

Besides a listing of four types of parties who may be immune from the fraud rule, there is one essential in Article 5-109 that the "material fraud" test has been settled as the test to assess the fraud while applying the fraud rule. And Official Comment on Article 2-109 also offered some explanations for the "material fraud". For commercial letters of credit, it indicated that material fraud "requires that the fraudulent aspect of a document be material to a purchaser of that document or that the fraudulent act be significant to the participants in the underlying transaction"⁹⁹. And for standby letters of credit, the Official Comment states that "material fraud by the beneficiary occurs only when the beneficiary has no colourable right to expect honor and where there is no basis in fact to support such a right to honor".¹⁰⁰

The "material fraud" test made the seriousness of the fraud been the only line

material

fraud, (ii) a confirmer who has honored its confirmation in good faith, (iii) a holder in due course of a draft drawn under the letter of credit which was taken after acceptance by the issuer or nominated person, or (iv) an assignee of the issuer's or nominated person's deferred obligation that was taken for value and without notice of forgery or material fraud after the obligation was incurred by the issuer or nominated person; 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).

⁹⁸ The most recent version is the UCC 2004. The Article relevant to the fraud rule is SECTION 5-109. FRAUD AND FORGERY.

⁹⁹ Official Comment 1, para.2.

¹⁰⁰ Ibid.

to decide the establishment of the fraud. And following to the official explanation the connection between the fraud and the underlying contract becomes the criteria to decide the materiality in commercial letters of credit. A "significant" influence to the underlying transaction was explained as a material connection. The thesis considers the "material fraud" test as a quite reasonable test to assess the fraud in applying the fraud rule. Of course, the "material fraud" test focused on the effect of the fraud rather than the intention of the fraud. But comparing to the confused application in early time in the United States, at least, a unified approving of the material fraud test can make the application of the fraud rule being achievable. And it is not difficult to explain the application of the materiality fraud test in the United States. In the early landmark case *Sztejn*, although the standard of proof for an established fraud in applying the fraud rule was not clearly discussed, the influence of the fraud conduct to the whole documentary credit transaction had already been seen as a main criterion to decide the reasonability of the application of the fraud rule. Although the intention of the beneficiary was mentioned by the judge as a factor which may affect the application of the fraud rule, and the concept of "intentional fraud" was popular in America Law, Shientag J's position was always on the side of "egregious fraud" rather than the "intentional fraud"¹⁰¹. Shientag J's approval of "egregious fraud" was clearly expressed in his judgment in another case *Asbury Park*¹⁰². In other words, traditionally, American courts emphasized the seriousness of the fraud

¹⁰¹ See section 3.1 of this chapter.

¹⁰² *Asbury Park & Ocean Grove Bank* (1942) 35 N.Y.S. 2d 985, supra note 79.

rather than the intention of the beneficiary while considering the application of the fraud rule. However, the materiality issue itself is more like a flexible issue rather than a certain one. The Official Comments expressed clearly that courts must decide the breadth and width of "materiality."¹⁰³ Consequently, the courts' discretion may be essential to the judgment in different cases. According to the two recent cases, the material fraud test was not easy to achieve at all.

In *Mid-America Tire v. PTZ Trading Ltd Import and Export Agent*¹⁰⁴, which happened in 2000, a transaction was financed by a letter of credit, and the quality, quantity and price of the goods were all negotiated and specified in the credit. However, the quality, quantity and price were all failed to match the requirement. The buyer sought an injunction to prevent the payment under the letter of credit on the basis of the fraud. Although the trial court granted the injunction on the ground of the misrepresentation, the decision was reversed by during the appeal, it was decided that the applying of the fraud rule "must be narrowly limited to situations of fraud in which the wrongdoing of the beneficiary has ...vitiating the entire transaction".¹⁰⁵ The material fraud was explained in this case as a fraud which has to vitiate the entire transaction. This test was much higher than that of a significant influence to the underlying transaction. A similar situation was happened in a standby

¹⁰³ Official Comment 1, para.2.

¹⁰⁴ *Mid-America Tire v. PTZ Trading Ltd Import and Export Agent* 2000 Ohio App. LEXIS 5402; (2000) 43 U.C.C. Rep. Serv. 2d (Callaghan) 964. Judgment delivered by Young PJ, Walsh J concurred, Valen J dissented.

¹⁰⁵ Gao Xiang, "The Fraud Rule in the Law of Letters of Credit", p. 87, *supra* note 38.

letter of credit case, *New Orleans Brass v. Whitney National Bank* and the *Louisiana Stadium and Exposition District*¹⁰⁶.

In that case, a standby letter of credit was issued by the Whitney Bank to guarantee the rental payments to the Louisiana Stadium and Exposition District (LSED) from New Orleans brass (Brass). When LSED asked for the payment under the credit by presenting required documents, Brass asked for an injunction from the court to prevent the payment on the ground that there were some false statements in the documents. The request was rejected during the trial. Then Brass appealed. During the appeal, the decision was affirmed by the reasoning of no "material fraud" was found in the case. The "material fraud" was defined during the judgment as the fraud can only be invoked when the 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".

It seems that, in both the commercial letters credit and standby letters credit cases, the "material fraud" was explained by the court as a fraud which vitiated the entire transaction. This explanation is exactly the same as which was made by the Supreme Court of Connecticut in *New York Life*¹⁰⁷, but for the "egregious fraud". Clearly, American courts are still applying the

¹⁰⁶ *New Orleans Brass v. Whitney National Bank and the Louisiana Stadium and Exposition District* (2002) La. App. LEXIS 1764.

¹⁰⁷ See section 3.2.1. of this chapter.

"egregious fraud" test to assess the fraud during the practical consideration for the application of the fraud. This extremely high test left the application of the fraud rule back to the dark again.¹⁰⁸

5. The Early Development of the Fraud Rule in English law

5.1 Reasons of the application of the fraud rule

In English law there is no statute Law specifically admits the existence of the fraud rule. Even in the latest version of the UCP, UCP 600, the fraud exception is not even mentioned while the autonomy principle is in an irreplaceable position.¹⁰⁹ The application of the fraud rule can only be traced in case law. Actually, the old case law also showed a reluctant approach of English Courts to interfere with the operation of documentary credits.

In the old case of *Hamzeh Malas & Sons v. British Imex Industrial Ltd.*¹¹⁰, although it was not a fraud related case, the English Court's approach in interfering in documentary credits cases has been expressed. In *British Imex*,

¹⁰⁸ For more recent relevant cases in the United States, see *Jaffe v. Bank of Am. N.A.*, (2010) U.S. App. LEXIS 18496, also *Sava Gumarska in Kemijska Industrija D.D. v. Advanced Polymer Scis., Inc.*, (2004) Tex. App. LEXIS 958.

¹⁰⁹ The UCP 600, Article 4. Credits v. Contracts a. A credit by its nature is a separate transaction from the sale or other contract on which it may be based. Banks are in no way concerned with or bound by such contract, even if any reference whatsoever to it is included in the credit. Consequently, the undertaking of a bank to honour, to negotiate or to fulfil any other obligation under the credit is not subject to claims or defences by the applicant resulting from its relationships with the issuing bank or the beneficiary. A beneficiary can in no case avail itself of the contractual relationships existing between banks or between the applicant and the issuing bank.

¹¹⁰ *Hamzeh Malas & Sons v. British Imex Industrial Ltd.* [1958] 2 Q.B. 127.

the plaintiff was a buyer who contracted with the defendant seller to buy the steel rods by installments. The payment was arranged by two confirmed letters of credit which were issued by the Midland Bank Ltd. After the payment against the first instalment, the plaintiff sought an injunction to prevent the defendant from asking for payment by alleging that the first instalment was defective.

Jenkins LJ rejected the plaintiff's application for the injunction in the Court of Appeal, and expressed his view on the autonomy of the credit as follows:

"We have been referred to a number of authorities, and it seems to be plain enough that the opening of a confirmed letter of credit constitutes a bargain between the banker and the vendor of the goods, which impose upon the banker an absolute obligation to pay, irrespective of any dispute there may be between the parties as to whether the goods are up to contract or not. An elaborate commercial system has been built up on the footing that bankers' confirmed credits are of that character, and, in my judgment, it would be wrong for this court in the present case to interfere with that established practice."¹¹¹

The above words of Jenkins LJ clearly showed that English courts have traditionally been hesitant to interfere with the operation of documentary credits in respect to the autonomy of credits. A confirmed letter of credit "imposed upon the banker an absolute obligation to pay, irrespective of any dispute there may be between the parties as to whether the goods are up to the contract or not".¹¹² However, English courts' reluctant attitude does not

¹¹¹ Ibid, 129

¹¹² Ibid.

lead to a rejection to the fraud rule in English law. In opposition, Sellers LJ, in the same case after expressing his approval to Jenkins LJ's submission, admits that "there may well be cases where the court would exercise jurisdiction as in a case where there is a fraudulent transaction."¹¹³

In fact, except for the strong principle of autonomy, an acceptance of the fraud rule has sufficient reasonability. On the reverse, a rejection of the fraud rule may cause many problems.

Firstly, according to the autonomy principle in documentary credits, all the parties under a letter of credit are dealing with documents, not goods. If documents tendered appear on their face to be in strict compliance with the terms and conditions stipulated in the credit, the issuer will pay despite any disputes or claims relevant to the underlying transaction. The bank is only responsible to the applicant to take reasonable care to ensure that the documents tendered are on their face complying with the terms and conditions of the credits. This doctrine no doubt promotes the smooth of the operation of documentary credits. The efficiency of documentary credits system is also mainly achieved from this doctrine. Nevertheless, in accordance with the autonomy principle, beneficiaries may not be required to show that they have properly performed their duties under the underlying contract, which is normally to deliver the proper goods or provide the proper service, all they have to do is to present conforming documents. A separation

¹¹³ Ibid, 130.

between documents and the actual performance of the underlying contract leaves a space to those unscrupulous sellers to abuse the system by their fraudulent conducts. "From the criminal point of view, the beauty of documentary fraud is that there is no need to have the correct amount or type of cargo on board the ship before presenting the 'proof' of loading which will enable them to claim payment. In fact, it is not even necessary to have a ship."¹¹⁴ Therefore, to avoid the abuse of the credit, it is necessary to have some rule to restrict the seller's rights when a fraud happens. With the fraud rule in place, the gap between the documentary credits system and fraudulent conduct may be narrowed, though it may not prevent all the possible fraudulent activities that may happen during the operation.

Secondly, the documentary credits system does not only offer the seller a safe environment to do business, it is also crucial to both the applicant and the bank. For the applicant, documents are proof of the performance of the underlying contract of the beneficiary; and for the bank, documents may also be seen, more or less, as security interests. What is more, if there is a chain contract, the genuineness of documents in documentary credits may be more important because of the possible effect on other parties. A serious false statement may cause a total nullity of a document. Because of the central position of documents in documentary credit system, a null document may also heavily influence the utility of the credit.

Thirdly, it is well known that, it is a basic obligation of the beneficiary to

¹¹⁴ Barbara Conway, "the Piracy Business" (Hamlyn, 1981), p. 23-25. See also Barbara Conway, "Maritime Fraud" (Lloyd's of London Press, 1990), p. 8-9.

present complying documents in documentary credits. Banks are only liable to examine the documents on their face. However, according to the historical development of the fraud exception in the United States, it was always being argued that whether a document containing a false statement could be seen as a conforming document, even before the birth of the fraud rule. In the case of *Higgins*, the court made the decision on the basis that payment against a bill of lading with a false statement would be "unauthorized", and believed the credit which contained a false shipment date was an unused credit. A false statement may cause the collapse of a credit. In a later case of *Old Colony*¹¹⁵, the court also made its decision on the basis that fraudulent documents could not be considered as complying documents. "When the issuer of a letter of credit knows that a document, although correct in form, is, in point of fact, false or illegal, he cannot be called upon to recognize such a document as complying with the terms of a letter of credit." The judgment was made in view of the internal fraudulent but not the face incompliance, which means although the facial compliance is a requirement by the documentary credits system, there is a clear support by the court for concerning the inside content of documents before the birth of the fraud rule.

Last but not the least; although a documentary credit contract is separated from the underlying contract, in the end, it is only a means of payment for the underlying contract. The performing of the letter of credit is also a part of the performance of the underlying contract. A false statement or other fraudulent

¹¹⁵ *Old Colony*, (1924) 297 F 152, supra note 44.

issues during the operation of documentary credits is no doubt contrary to the fundamental principle of the underlying contract. The existence of the fraud rule is absolutely crucial to both the underlying transactions and documentary credits.

5.2. The early application of the fraud rule in English law.

5.2.1. The case of Discount Records

By applying the decision of the case of *Sztejn in Edward Owen*¹¹⁶, the fraud exception was accepted in English law as an exception in documentary credits. The most often mentioned case which admitted the judgment of the America case *Sztejn* was *Discount Records Ltd v. Barclays Bank Ltd and Barclays Bank International Ltd*¹¹⁷.

In *Discount Records*, the plaintiffs, Discount Records Ltd., ordered a number of cassettes and gramophone records specified by numbers in accompanying lists from a French company, Promodisc. On May 17, 1974, the plaintiffs signed instructions to the first defendant bank for an irrevocable documentary credit with full cash cover, the credit being made through the second defendant. The beneficiaries of the credit were named as the French company and the credit was for 44,175 francs. The goods were delivered to

¹¹⁶ [1978] Q.B. 159. See section 1.2 of this chapter.

¹¹⁷ *Discount Records Ltd v. Barclays Bank Ltd and Barclays Bank International Ltd* [1975] Lloyd's Rep.444.

the plaintiffs on June 16. It was found by the plaintiff that the goods did not comply with the order and further that the numbers on the boxes had been altered to comply with the specifications. Accordingly, the plaintiff alleged that the French company was guilty of fraud. The plaintiffs therefore instructed the first defendants to reject the payment under the credit. By letter dated June 24, the first defendants stated that there was no way that they could avoid making payment and refused to give an undertaking not to pay since the credit was an irrevocable confirmed credit. Then plaintiffs brought a motion for an interlocutory injunction against both defendants to restrain them from payment.

During the judgment, Megarry J, after emphasizing the fact of the case, mentioned the fraud rule which was established in the case of *Sztejn*, said:

"...there was no English authority directly on the point or anywhere nears it, but he did put before me the case of *Sztejn v. J. Henry Schroder Banking Corporation*, 31 N.Y.S. 2d. series, 613 (1941), a case which is summarized in Gutteridge and Megrah, *The Law of Bankers' Commercial Credits* (4th ed. 1968), pp. 133, 134. There, it was alleged that the seller had shipped rubbish and then passed his draft for collection. At p. 633 Judge Shientag referred to the well-established rule that a letter of credit is independent of the primary contract of sale between the buyer and the seller, so that unless the letter of credit otherwise provides, the bank is neither obliged nor allowed to enter into controversies between buyer and seller regarding the quality of the merchandise shipped. **However, the learned Judge (and I use the phrase as no empty compliment) distinguished mere breaches of warranty of quality from cases where the seller has intentionally failed**

to ship any of the goods ordered by the buyer. In relation to the latter case, at p. 634 the Judge uttered a sentence (quoted in the book) upon which Mr. Pain placed great reliance.

. . . where the seller's fraud has been called to the bank's attention before the drafts and documents have been presented for payment, the principle of the independence of the bank's obligation under the letter of credit should not be extended to protect the unscrupulous seller."¹¹⁸

Although the fraud rule was admitted as itself, and it was proved by the plaintiff that "there were 94 cartons, but of these two were empty, five were filled with rubbish or packing, 25 of the record boxes and three of the cassette boxes were only partly filled, and two boxes labelled as cassettes were filled with records; instead of 825 cassettes, as ordered, there were only 518 cassettes and 25 cartridges. Out of the 518 cassettes delivered, 75 per cent were not as ordered; instead of 112 different records as ordered, only 12 different records were dispatched; and, in total, out of the 8625 records ordered, only 275 were delivered as per order. The rest were not as ordered and were either rejects or unsalable"¹¹⁹, the judge did not apply the fraud rule in this case by relying on that the fraud was not clearly established, he explained the reason as follows:

"However, it is important to notice that in the Sztejn case the proceedings consisted of a motion to dismiss the formal complaint on the ground that it disclosed no cause of action. That being so, the Court had to assume that the facts stated in the complaint were true. The complaint alleged fraud, and so the Court was dealing with a case of established fraud. In the

¹¹⁸ Ibid. 446-447.

¹¹⁹ Ibid, 444, 446.

present case there is, of course, no established fraud, but merely an allegation of fraud. **The defendants, who were not concerned with that matter, have understandably adduced no evidence on the issue of fraud.** Indeed, it seems unlikely that any action to which Promodisc was not a party would contain the evidence required to resolve this issue. Accordingly, the matter has to be dealt with on the footing that this is a case in which fraud is alleged but has not been established."¹²⁰

It can be seen from the above words that the test for the establishment of the fraud applied by the court was quite different from the "materiality fraud" test, which applied in the UCC Article 5 in the United States. The evidence which was proved by the plaintiff showing that a great proportion of the shipment was either rubbish or empty cartons, and the evidence was affirmed by the judge. However, the fraud was still considered as not being established, but merely an allegation of fraud. The reason was because "Promodisc was not a party", and the matter has not been dealt with "on the footing". The involvement of the beneficiary has been seen as a footing requirement for the application the fraud rule in English law. The fraud rule may not be applied no matter how material the fraud is as long as the beneficiary was not involved in the fraud. The test applied in *Discount Records* was similar to the intentional fraud test in early United States, in which the intention of the fraudulent party is concerned as a main condition for the application of the fraud rule.

It is interesting that, the court rejected the plaintiff's petition of the injunction also by considering that "the injunction against the two defendants if granted,

¹²⁰ Ibid. 447.

would not achieve Mr. Pain's avowed purpose, which was to prevent Promodisc from being paid. Promodisc, indeed, may already have been paid by discounting the bill. All that the injunction would do would be to prevent the banks concerned from honouring their obligations".¹²¹ Clearly, the balance of convenience has already been considered by English courts in the early application of the fraud rule, and the bank's independent position under the letters of credits was treasured during the judgement.

5.2.2. The case of *Gian Singh*

A more clear approach of English courts to attach the weight to the bank's autonomy obligation and title under the credit was shown by the case of *Gian Singh & Co. Ltd. v. Banque de L'Indochine Judicial Committee of the Privy Council*¹²².

The facts of the case were as follows:

The plaintiff company requested the defendant bank to open an irrevocable letter of credit in favour of Thai Lung Ship Machine Manufactory of Taiwan (T). The credit was required to meet the purchase price of a fishing vessel to be constructed by the beneficiary. It was a specific condition of the letter of credit that a certificate, which has to be signed by Balwant Singh, holder of Malaysian passport no. E. 13276 and countersigned by the defendant bank, to certify that the vessel had been built according to specifications and was in

¹²¹ Ibid.

¹²² *Gian Singh & Co. Ltd. v. Banque de L'Indochine Judicial Committee of the Privy Council* [1974] 2 Lloyd's Rep. 1.

a fit and proper condition to sail, must be produced to the defendant's agent in Taiwan before payment. The defendants paid T under the credit. The plaintiffs then discovered that the vessel was 14 years old. They, accordingly, sued the defendants by claiming that the defendants had wrongfully debited their account by the following reasons: (i) Balwant Singh's signature to the certificate stating that the vessel had been built according to the specification and was in a fit and proper condition to sail had been forged; and (ii) Balwant Singh's signature ceased to be his signature within the meaning of the credit in view of the fact that he had signed between the rubber stamped words stating the name of the plaintiffs and the word "director".

During the trial, it was held by the Supreme Court of Singapore that the plaintiffs has not clearly established that the signature was a forgery . Then the plaintiffs appealed. On the appeal, the finding that the signature on the certificate was not a forgery was reversed. However, the appeal was still dismissed because the certificate had complied with the terms of the credit. During the appeal, all the judges agreed that the plaintiff company had proved that the signature on the certificate was forged. But the three different judges coincidentally dismissed the appeal for similar reasons.

"...it is the identity of the person who is to certify which is of importance and this requirement must be strictly adhered to.

In my judgment the certificate that was produced complied exactly and strictly with the condition stipulated in the letter of credit and the bank conformed strictly to the instructions it received.

Accordingly I am of the opinion that the trial Judge was right in dismissing the appellant's claim and I would dismiss the appeal with costs." (Wee Chong Jin, C.J.)¹²³

"...the fact that the signature on the certificate was not the genuine signature of Balwant Singh does not avail the plaintiff company as in the circumstances of this case the defendant bank's agent in Taiwan, i.e., the paying bank was in no position to be aware of the forgery.

The crucial question to be decided in this appeal is whether the certificate which was tendered to the paying bank complied with the terms of the letter of credit." (Mr. Justice Tan Ah Tah)¹²⁴

"In my opinion the plaintiff successfully proved that the certificate in question was a forgery but that fact alone is not of much assistance to the plaintiff because the paying bank, i.e., the defendant's agent in Taiwan, had no knowledge of the forgery and it was entitled to assume that the certificate was genuine when there was nothing on the face of it to indicate anything to the contrary. The main issue before the trial Court was, as in this appeal whether the certificate tendered was in accord with the terms of the letter of credit." (Mr. Justice Choor Singh)¹²⁵

The above reasons, which were expressed by different judges during the appeal, cleared showed the court's approaches in dealing with cases where a forgery involved in a letter of credit case: the bank is only obliged to pay reasonable care to examine the facial conformity of the documents; the bank is not liable to examine the inside genuineness of documents, so the bank is in no position to aware of a forgery; the bank is entitled to assume that documents are genuine when there was nothing on the face of the

¹²³ Ibid. 2.

¹²⁴ Ibid. 3.

¹²⁵ Ibid. 4-5.

documents indicating anything of contrary. After all, a document may be seen as a complying document by the bank even there is an inside forgery as long as the forgery was not on the face of the document and was not known to the bank at the time of payment.

The decision of the Court of Appeal was affirmed by the Privy Council later by Lord Diplock. He expressed his point of view after a review of judgments both in the trial and the appeal:

"The fact that a document presented by the beneficiary under a documentary credit, which otherwise conforms to the requirements of the credit, is in fact a forgery does not, of itself, prevent the issuing bank from recovering from its customer moneys paid under the credit. The duty of the issuing bank, which it may perform either by itself, or by its agent, the notifying bank, is to examine documents with reasonable care to ascertain that they appear on their face to be in accordance with the terms and conditions of the credit. The express provision to this effect in article 7 of the Uniform Customs and Practice for documentary credits does no more than re-state the duty of the bank at common law. In business transactions financed by documentary credits banks must be able to act promptly on presentation of the documents. In the ordinary case visual inspection of the actual documents presented is all that is called for. The bank is under no duty to take any further steps to investigate the genuineness of a signature which, on the face of it, purports to be the signature of the person named or described in the letter of credit."¹²⁶

And the final decision of *Gian Singh* was that the forgery of the certificate was

¹²⁶ Ibid, 11.

proved by the evidence, however, the plaintiff was not succeeded in showing the incompletion of the documents and the defendant bank was not liable for the forgery. The appeal was dismissed again in the end.

Gian Singh was a case in which the forgery was clearly proved during the judgment. Although the fraud rule was not clearly mentioned in this case as a separate rule, it may be seen from this case that there is one important condition in applying the fraud exception which is the fraud has to be noticed by the bank. It is not the bank's responsibility to detect the fraud in the transaction or assess inside genuineness of the documents. The bank is only obliged to examine the facial compliance of the document. In another word, the bank is eligible to get the reimbursement from his client even the payment was paid against a forged document or even there is a fraud as long as the face of the document was complying with the credit and the bank was not aware of the forgery or the fraud.

Discount Records and *Gian Singh* showed a clear approach of the application of the fraud rule in English law. In *Discount Records*, the evidence of the nonconforming of the goods was very clear; however, the beneficiary's non-involvement to the fraud led the court to decline the establishment of the fraud in this case. In *Gian Singh*, the fraud was established, but the application of the fraud rule still failed because the bank had no knowledge of the fraud at the time of payment. It might be concluded from the two cases that there were two essentials in applying the fraud rule in English law: the

involvement of the beneficiary and the knowledge of the bank. The decisions of the two cases implied a rough trend for the application of the fraud rule, however, the rule has not been clearly established until the famous case of *United City Merchants Ltd. and Glass Fibres and Equipments Ltd. v. Royal Bank of Canada Respondents*.¹²⁷

5.2.3. United City Merchants

The facts of *United City Merchants* relevant to the issue of the application of the fraud rule was as follows:

In 1975, Glass Fibre and Equipment Ltd (GFE) contracted with a Peruvian buyer to sell a certain amount of glass fibre making equipment. The payment was arranged by an irrevocable letter of credit which was issued by the Banco Continental SA of Peru. The credit was later confirmed by the Royal Bank of Canada (RBC). As the beneficiary of the credit, GFE assigned its rights under the credit to United City Merchants (UCM). The banks were all aware of the assignment. According to the bill of lading, which was one of the most important required documents under the credit the latest shipment date was 15th December 1976. The shipment was then carried out by a broker after GFE sent the goods for a temporary storage to its agent. GFE also told the forwarding agent and the employee of the broker the requirements of the bill of lading, including the latest shipment date. However, the shipment was not completed until 16th of December 1976, while it was stated on the bill of

¹²⁷ *United City Merchants* [1983] 1 A.C. 168 (HL), supra note 3.

lading that the shipment date was 15th of December. At the time of payment, RBC rejected the document on the ground that the shipment date on the bill of lading was not true. GFE then sued RBC for wrongful dishonour. During the trial, it was confirmed by the court that the shipment date on the bill of lading was rendered by the broker without the notice of GFE and its assignee UCM. Mocatta J affirmed the principle that the letter of credit composed the bank an absolute obligation to pay against conforming documents irrespective of any underlying contractual disputes by accepting the exception of "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".¹²⁸

Mocatta J held that the plaintiffs were innocent of the brokers' fraud; the defendants were not entitled to reject the documents by relying on the fraud rule. But the contract and the letters of credit were unenforceable because the contract of sale and purchase was a disguise for exchanging currencies. Then the plaintiffs appealed.

5.2.3.1. Court of Appeal

During the appeal, the court reversed the judgment of the trial court relevant to the application of the fraud rule and held that, fraud such as to entitle a banker to refuse to pay under a letter of credit notwithstanding the strict general rule requiring payment where the documents were in order on their

¹²⁸ *United City Merchants* [1979] 1 Lloyd's Rep 267, 276 (QB), *supra* note 3.

face, included fraud to which the seller or beneficiary was not party and, accordingly, the defendant were right to refuse to pay on the ground that the document presented having been fraudulently completed, did not comply with the terms of the letter of credit.

The Court of Appeal introduced a new concept named "a halfway house" and explained it as "between fraud and accuracy, namely inaccuracy in a material particular".¹²⁹ Stephenson LJ believed, although a simple inaccuracy in the documents may not been seen as a fraud, it may entitled banks to reject payment if the inaccuracy is material to their liability to pay.¹³⁰

During the judgment, Stephenson LJ stated:

"... I do not think that the courts have a duty to assist international trade to run smoothly if it is fraudulent any more than when it violates an international agreement. Banks trust beneficiaries to present honest documents; if beneficiaries go to others (as they have to) for the documents they present, it is important to all concerned that those documents should accord, not merely with the requirements of the credit but with the facts; and if they do not because of the intention of anyone concerned with them to deceive, I see good reason for the choice between two innocent parties putting the loss upon the beneficiary, not the bank or its customer."¹³¹

Stephenson LJ also believed that there was no authority, in English law, "directly deciding that the fraud of a third party, such as the maker of a false

¹²⁹ [1982] Q.B. 208, 231, *supra* note 3.

¹³⁰ *Ibid*, 239.

¹³¹ *Ibid*, 234.

document, is or is not a good defence to a claim to be paid in accordance with the terms of a letter of credit".¹³² He, therefore, decided that a bank should be entitled to reject payment if it knows that any of the documents is forged in a material particular, even the fraud was not on the part of the beneficiary. His decision was somehow based on some American authorities, he further developed the test which was applied in the United states by the following words:

"We should not apply it only to 'situations of fraud in which the wrongdoing of the beneficiary has so vitiated the entire transaction that the legitimate purposes of the independence of the issuer's obligation would no longer be served. [*Intraworld Industries Inc. v. Girard Trust Bank*¹³³]' ... It should also be applied to any fraud which, if known to the issuing or confirming bank, would entitle it to refuse payment. In that situation the bank owes no duty to the beneficiary to pay and, I would say, owes a duty to the customer not to pay."¹³⁴

Stephenson LJ clearly applied the "material fraud" test to assess the fraud in applying the fraud rule. The "material fraud" test was actually established in the UCC in the United States but being applied more like the "egregious fraud" test by American courts.¹³⁵ In this sense, Stephenson LJ's judgment may be seen as a typical case for the application of the "material fraud" test in applying the fraud rule in documentary credits. According to this test, the materiality of the inaccuracy in documents may be seen as a very important

¹³² Ibid, 234.

¹³³ *Intraworld Industries*, (1975) 336 A. 2d 316, 324-325, supra note 77.

¹³⁴ Ibid, 239.

¹³⁵ See section 4 of this chapter.

point to assess an establishment of a fraud. Although a simple inaccuracy may not be seen as a fraud, it may lead an application of the fraud rule if the inaccuracy is material to the underlying contracts.

The "half way house" theory was also accepted by both Ackner LJ and Griffiths LJ during the Court of Appeal. Both of the judges added another essential, which is banks' security interests, to further explain the reason of their decisions.

"Moreover, the bank is prepared to provide finance to the exporter because it holds shipping documents as collateral security for the advance and, if necessary, can take recourse to the buyer as instructing customer and the exporter as drawer of the bill. The bank invariably asks for the delivery of a full set of original bills of lading; otherwise a fraudulent shipper would be able to obtain payment under the documentary credit on one of them and advances from other banks on the security of the other originals constituting the set: see Schmitthoff's, *The Export Trade*, 6th ed. (1975), p. 216. It is therefore of vital importance to the bank not to take up worthless documents." (Ackner LJ)¹³⁶

"What is the position if the bank is presented with documents that appear on their face to be in order but which the bank knows to be forgeries? The bank takes the documents as its security for payment. It is not obliged to take worthless documents. If the bank knows that the documents are forgeries it must refuse to accept them. It may be that the party presenting the documents has himself been duped by the forger and believes the documents to be genuine but that surely cannot affect the bank's right to refuse to accept the forgeries. The identity of the forger is immaterial. It is the fact that the documents are worthless that matters to the

¹³⁶ [1982] Q.B. 208, 247, *supra* note 3.

bank." (Griffiths LJ)¹³⁷

Both of the judges believed that banks should be entitled to refuse forgery documents which may affect their security interests. It's true that the innocent seller who did not do the fraud might not be seen as a fraudulent party in the fraud rule; however, it may also be wield to ask a bank to accept a document which has been known to him as forgery only because the seller is not liable to the document. The protection of an innocent seller should not be satisfied at the sacrifice of bank's security interest.¹³⁸

Generally, the judgment of the court of appeal was based on the "half way house" theory and banks' security interests. Nevertheless, none of the two points was approved by Lord Diplock in the House of Lords.

5.2.3.2. House of Lords

The House of Lords reversed the decision of the Court of Appeal and held that "fraud such as to entitle a banker to refuse to pay under a letter of credit notwithstanding the strict general rule requiring payment when the documents were in order on their face, did not extend to fraud to which the seller or beneficiary was not party, and accordingly, prima facie the defendants should have paid on presentation of the documents."¹³⁹ Lord Diplock started his analysis with a rejection of the "halfway house" theory said:

¹³⁷ Ibid, 247-248.

¹³⁸ Banks' security interests is discussed in details in Chapter 5 of the thesis, where the nullity exception is mainly analysed. See Chapter 5, section 4.2.

¹³⁹ [1983] 1 A.C. 168, 169, supra note 3.

"...for the proposition upon the documentary credit point, both in the broad form for which counsel for the confirming bank have strenuously argued at all stages of this appeal and in the narrower form or "halfway house" that commended itself to the Court of Appeal, there is no direct authority to be found either in English or Privy Council cases or among the numerous decisions of courts in the United States of America to which reference is made in the judgments of the Court of Appeal in the instant case."¹⁴⁰

He believed that the autonomy principle led to an establishment of several autonomous interconnected contractual relationships in documentary credits. Consequently, he confirmed the bank's responsibility to the applicant in documentary credits by the following words:

"It has, so far as I know, never been disputed that as between confirming bank and issuing bank and as between issuing bank and the buyer the contractual duty of each bank under a confirmed irrevocable credit is to examine with reasonable care all documents presented in order to ascertain that they appear on their face to be in accordance with the terms and conditions of the credit, and, if they do so appear, to pay to the seller/ beneficiary by whom the documents have been presented the sum stipulated by the credit, or to accept or negotiate without recourse to drawer drafts drawn by the seller/beneficiary if the credit so provides."¹⁴¹

Lord Diplock accepted the fraud exception but restricted its application to the situation "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

¹⁴⁰ Ibid, 182.

¹⁴¹ Ibid, 184.

knowledge are untrue"¹⁴². He, accordingly, regarded the instant case as not falling within the fraud exception because of the finding that the sellers had been unaware of the inaccuracy of the date.

Lord Diplock also specifically rejected the "material fraud" test and believed the application of this test is to destroy the autonomy principle. He said:

"It is conceded that to justify refusal the misstatement must be "material" but this invites the query: **"material to what?"** The suggested answer to this query was: a misstatement of a fact which if the true fact had been disclosed would have entitled the buyer to reject the goods; date of shipment (as in the instant case) or misdescription of the goods are examples. But this is to destroy the autonomy of the documentary credit which is its *raison d'être*; it is to make the seller's right to payment by the confirming bank dependent upon the buyer's rights against the seller under the terms of the contract for the sale of goods, of which the confirming bank will have no knowledge."¹⁴³

Regarding banks' security interests, Lord Diplock decided, the security interests would not justify the confirming bank's refusal to honour the credit in the instant case. Because the realisable value of goods could not be in any way affected by its having been loaded on board a ship on December 16, instead of December 15th, 1976.¹⁴⁴

There is no defence to Lord Diplock's decision for *United City Merchants*. The "material fraud" test for the fraud rule in English law if English court considers

¹⁴² Ibid, 183.

¹⁴³ Ibid, 185.

¹⁴⁴ Ibid, 186.

the application of the fraud exception as a clear application of the *maxim ex turpi causa non oritur actio*¹⁴⁵. The beneficiary may be deprived from payment if he is not trying to benefit from his own fraud. The security interest was not seriously affected by the forgery in the document either. However, some issues discussed during the judgement may cause arguments.

On one hand, it is true that the bank has no duty to go behind the facial conformity of the documents, but it is arguable that the contractual duty owed by banks to the applicant should be matched by the contractual liability of banks to the beneficiary. Lord Diplock, while discussing bank's responsibility to the applicant also said:

"It would be strange from the commercial point of view, although not theoretically impossible in law, if the contractual duty owed by confirming and issuing banks to the buyer to honour the credit on presentation of apparently conforming documents despite the fact that they contain inaccuracies or even are forged, were not matched by a corresponding contractual liability of the confirming bank to the seller/beneficiary (in the absence, of course, of any fraud on his part) to pay the sum stipulated in the credit upon presentation of apparently conforming documents. Yet, as is conceded by counsel for the confirming bank in the instant case, if the broad proposition for which he argues is correct, the contractual duties do not match. "¹⁴⁶

The contractual relationship among parties in documentary credits has been

¹⁴⁵ The principle of "*ex turpi causa*" was first pointed by Lord Mansfield the case of *Holman v Johnson* (1775) 1 Cowp 341. This principle is discussed in details in section 2.2.1 of Chapter 4.

¹⁴⁶ [1983] 1 A.C. 168, 184 to 185, supra note 3.

clearly regulated by the UCP¹⁴⁷. As between the issuing bank and the applicant, the bank owes the applicant buyer a duty of examining the facial conforming of documents. The bank also owes the applicant a duty of not paying against a facially nonconforming documents. In other words, the issuing bank is not responsible to the internal genuineness of documents; As between the issuing bank and the beneficiary, the issuing bank undertake an absolute obligation to pay the seller beneficiary as long as the documents of title presented by the documents are in order, the documents are complying to the credit. However, the issuing bank's obligation of payment is subject to the beneficiary's responsibility of presenting conforming documents. The bank is obliged to pay the beneficiary against conforming documents but not only facially conforming documents. It is clear that the facial conformity does not equal to conformity. Therefore, the contractual duty owed by banks to the applicant is definitely not matched by the contractual liability of banks to the beneficiary. In this sense, although the bank is not liable to go behind the documents to detect the fraud, it does not follows that the bank is not allowed to go behind the documents to investigate whether there was a fraud.¹⁴⁸ It would be even more irrational to force the bank to pay against facially conforming but internal fraudulent documents.

On the other hand, Lord Diplock, while considering the security interests

¹⁴⁷ UCP 600, Article 3, 7, 9, 14, and 16. For detailed discussion of the relationships among the bank, applicant and beneficiary, see Chapter 1, section 2.1 to 2.3.

¹⁴⁸ See Cardozo J.'s dissent judgment in *Maurice O'Meara*. (1925) 146 NE 636, supra note 46. It was discussed in section 2 of this chapter.

was not affected by the forgery in the document, also said:

"I would not wish to be taken as accepting that the premise as to forged documents is correct, even where the fact that the document is forged deprives it of all legal effect and makes it a nullity, and so worthless to the confirming bank as security for its advances to the buyer. This is certainly not so under the Uniform Commercial Code as against a person who has taken a draft drawn under the credit in circumstances that **would make him a holder in due course, and I see no reason why, and there is nothing in the Uniform Commercial Code to suggest that, a seller/beneficiary who is ignorant of the forgery should be in any worse position because he has not negotiated the draft before presentation.** I would prefer to leave open the question of the rights of an innocent seller/beneficiary against the confirming bank when a document presented by him is a nullity because unknown to him it was forged by some third party; for that question does not arise in the instant case."¹⁴⁹

Lord Diplock suggested that the innocent seller should not be in a worse position than a holder in due course, therefore, he might not be liable for the fraud he did not do even if "document is forged deprives it of all legal effect and makes it a nullity, and so worthless to the confirming bank as security for its advances to the buyer". However, in a normal third party fraud situation, there may be three innocent parties: the seller, the buyer and the banks. The allocation of risk may become a complex issue under this circumstance. The decision of whether the seller or the buyer should take the responsibility may vary in cases. But it is too rash to leave the seller totally out of the responsibility anyway. It is also worthy of consideration whether an innocent

¹⁴⁹ [1983] 1 A.C. 168, 186, supra note 3.

seller should be seen as a holder in due course under the UCC. Stephenson LJ's following statement during the Court of Appeal may be seen as a clear objection to Lord Diplock's "holder in due course" theory:

"Banks trust beneficiaries to present honest documents; if beneficiaries go to others (as they have to) for the documents they present, it is important to all concerned that those documents should accord, not merely with the requirements of the credit but with the facts; and if they do not because of the intention of anyone concerned with them to deceive, I see good reason for the choice between two innocent parties putting the loss upon the beneficiary, not the bank or its customer.

Even though the judge was not able to find that Baker was the plaintiffs' agent in making the bill of lading for presentation to the defendants, the plaintiffs were the innocent party who put him in the position in which he made the bill, and made it fraudulently, and in my judgment it is they rather than the defendants, already impoverished by the dollars remitted to the United States of America, who should bear the loss."¹⁵⁰

The thesis considers Stephenson LJ's analysis through the beneficiary's obligations of presenting truly conforming documents made a strong argument for Lord Diplock's "holder in due course" theory. This issue may be better understood in terms of a study in the nullity exception in documentary credits.¹⁵¹ Actually, Lord Diplock himself also left the question of "the rights of an innocent seller/beneficiary against the confirming bank when a document presented by him is a nullity because unknown to him it

¹⁵⁰ [1982] Q.B. 208, 234-240, *supra* note 3.

¹⁵¹ The issues relevant to the allocation of risks in documentary credits are discussed in Chapter 5, section 4.3 and 5.2.

was forged by some third party"¹⁵² open in his judgment.

United City Merchants left many issues unresolved to the application of the fraud rule. However, the decision of House of Lords in this case was still in a prominent position during the early development the fraud rule in England and Wales. The high standard of proof made the application of the fraud rule being extremely difficult. Firstly, the fraud has to be clearly established; secondly, it has to be proved that the fraud is on the part of the beneficiary, a third party's fraud may not cause an application of the fraud rule; Thirdly, the banks' knowledge of the forgery or fraud has to be proved as well, the fraud rule may not be applied in the case of where the bank did not notice the fraud at the time of payment. The test applied to assess an established fraud by Lord Diplock may be seen as an extensive application of the "intentional fraud" test applied in early United States. While in early United States, the "intentional fraud" test required the fraudulent intention has to be proved, in English law, the "intention fraud" test further required the fraudulent intention has to be proved as from the beneficiary. The most unfortunate situation would be that a bank had to accept a forged document which he knows might cause a total loss of his security interest only because the seller was not liable to the fraud. This could probably be a reason why banks chose to rely on the principle of strict compliance to reject documents all the times.

It is hard to explain the reason why English courts applied a different test in

¹⁵² Ibid.

applying the fraud rule rather than the "material fraud" test of the United States, when the root of the fraud rule in England and Wales was from the America case *Sztejn*.¹⁵³ It may be caused by the dominant position of the autonomy principle in the UCP; in contrast, the fraud rule was not even mentioned in the latest version of UCP.

Lord Diplock's decision in *United City Merchants*, which exempted the third party fraud from the application of the fraud rule expressed the application of the "intentional fraud" test in English law. The beneficiary's fraudulent intention becomes one of the main conditions in applying the fraud rule. Although the high standard of proof made the application of the fraud rule being extremely difficult, the early development of the fraud rule in England and Wales was not too negative. The dawn happened in the case of *Bolivinter Oil S.A. v. Chase Manhattan Bank, Commercial Bank of Syria and General Company of Homs Refinery*¹⁵⁴.

5.2.4. The case of *Bolivinter Oil*

In *Bolivinter Oil S.A.*, the plaintiff, Bolinvinter Oil S.A., made a contract with the third defendant (Homs) to procure the carriage of about 2.38 million tons of Iranian crude oil from Iran to Syria in the summer of 1982. The contract provided for a daily penalty of U.S. \$25,000 in the event of delay during

¹⁵³ Of course, both of the application may be seen as reasonable since the both the materiality of the fraud and the intention of the representor are essential elements in common law fraud. Generally see the section 1 of this chapter.

¹⁵⁴ *Bolivinter Oil S.A. v. Chase Manhattan Bank, Commercial Bank of Syria and General Company of Homs Refinery* [1984] 1 Lloyd's Rep. 251.

performance. The plaintiffs also agreed to furnish Homs with a performance guarantee for U.S. \$1 million. The guarantee was provided by the second defendants (CBS) to Homs; a letter of credit was provided by the first defendants (Chase) in favour of CBS and a counter indemnity and cash deposit was provided by the plaintiffs in favour of Chase. In the event there were delays in the performance of the freight contract and Homs indicated claims of U.S. \$25 million subsequently reduced to between U.S. \$2 million and \$12 million. In November, 1982, the plaintiffs and Homs entered into a second freight contract on similar terms to that of June, 1982, save as to freight and the amount of oil carried. During the currency of the second freight contract Homs withheld freight to the extent of about \$22 million. The plaintiffs then alleged that negotiations followed and it was agreed that Homs would pay the plaintiffs about \$8.5 million, would establish a letter of credit to cover the freight, demurrage and insurance on the final shipment under the second contract, and would establish a further letter of credit of \$4.3 million to cover disputed items. Finally it provided that the guarantee would be released upon the arrival of the last vessel carrying oil to Syria under the second contract.

Shortly after the arrival of the last vessel the plaintiffs notified Chase that the guarantee had been released by agreement with Homs. Chase then sought confirmation from CBS that their letter of credit had been cancelled and that Chase was released from all liability. However, CBS informed Chase that

Homs had demanded \$1 million under the CBS guarantee due to the plaintiffs' breaches of the June, 1982 agreement. On Oct. 31, 1983 the plaintiffs obtained injunctions restraining Hom's from claiming on the CBS guarantee and restraining CBS from paying under that letter of credit.

Stoughton J discharged the injunctions on Nov. 29, 1983. Then the plaintiff appealed. During the appeal, although the Court of Appeal accepted that it was clearly debatable whether Hom's have acted fraudulently in making their claim on the CBS guarantee or whether they have merely acted in breach of their release agreement with the plaintiff, the injunctions affecting Chase and CBS, the two banks, were discharged, the decision of granting an injunction restraining Hom's from demanding was held to continue. The reason of keeping the injunction against Hom's was "there is no appeal against the decision of the learned Judge to grant an injunction restraining Hom's by themselves"¹⁵⁵, but Sir John Donaldson said during the appeal:

"The continuation of the Hom's injunction, because no one has asked us to discharge it, creates a problem. If, as is common in the context of Mareva injunctions, a defendant is enjoined from dealing with moneys standing to the credit of a bank account and the bank has notice of the injunction, it is itself in contempt of Court if it acts on its customers' instructions and thereby aids and abets a breach of the injunction. Where does that leave CBS? The injunction which expressly bound them not to pay under the guarantee has been discharged by the learned Judge and we have affirmed that decision. Is it now to be said that they are indirectly bound to refrain from paying Hom's notwithstanding that the Court has refused any

¹⁵⁵ Ibid, 256.

direct order prohibiting them from so doing?

This point was not brought to the learned Judge's attention or for that matter ours, but, it having occurred to us, we think that we should deal with it. For present purposes it will suffice if, in dismissing the appeal, we make it clear that nothing in the injunction granted by the learned Judge against Homs is in any way to inhibit the freedom of CBS to make payment in accordance with its contractual obligations under the performance guarantee if it is minded so to do."¹⁵⁶

Sir John Donaldson distinguished between interlocutory injunctions which restrained the beneficiary from claiming and *mareva* injunctions which restricted the beneficiary dealing with the money, and expressed that the interlocutory injunction which prevent the beneficiary from claiming may not affect the bank's freedom of making payment. He further illuminated the exceptionality of an injunction to prevent a bank from payment by the following words:

"Before leaving this appeal, we should like to add a word about the circumstances in which an *ex parte* injunction should be issued which prohibits a bank from paying under an irrevocable letter of credit or a purchase bond or guarantee. ...

In requesting his bank to issue such a letter, bond or guarantee, the customer is seeking to take advantage of this unique characteristic. If, save in the most exceptional cases, he is to be allowed to derogate from the bank's personal and irrevocable undertaking, given be it again noted at his request, by obtaining an injunction restraining the bank from honouring that undertaking, he will undermine what is the bank's greatest asset, however large and rich it may be, namely its reputation for financial and contractual probity. Furthermore, if this happens

¹⁵⁶ Ibid, 257.

at all frequently, the value of all irrevocable letters of credit and performance bonds and guarantees will be undermined."¹⁵⁷

Sir John Donaldson pointed the autonomous position of banks under letters of credits or performance bonds, other than the applicants or beneficiaries, which may invoke innovative thinking concerning a different standard of proof in applying the fraud as between different parties, especially in injunction cases. Sir John Donaldson's judgment is very important for the later development of the application of the fraud rule. It indicated the contractual relationships among the parties under letters of credits or performance bonds may influence the courts' decisions in granting interlocutory injunctions in fraud rule cases. An analysis to the application of the fraud rule in injunctions cases may be a good start point to explore the recent development of the fraud rule in English law.

¹⁵⁷ Ibid.

Summary:

The early development of the fraud rule, in both American and English law, presented authorities of the interference of the fraud exception to the ordinary operation of documentary credits payment system, though the standard of proof for applying the fraud rule are not the same in the two common law countries. The reasonability of the existence of the fraud rule had been proved with no doubt. There are advantages and disadvantages in both the "material fraud" test in the United States and the "intentional fraud" test¹⁵⁸ in England and Wales. The "material fraud" test in the United States, which was legalized by the UCC, is the first and probably the only test for the application the fraud rule that was recognized by statute law.

The establishment of the "material standard" pointed out a clear criterion for the application of the fraud rule in the United States. Because the "material fraud" test emphasized on the seriousness of the fraud, the effect of the fraud to the whole underlying contract might be highly considered by the court in the United States. The clear focus may provide a route for the court of the United States to apply the fraud rule reasonably. However, considering the principle autonomy principle in documentary credits, the material standard may have a highly negative impact on the separation of the documents and

¹⁵⁸ Here, the "intentional fraud" refers to the test establish by Lord Diplock in *United City Merchants*, which requires the fraudulent intention has to be further proved as from the beneficiary.

the underlying contract. It is difficult to justify the materiality of the fraud without considering the underlying contract. Actually, the Official Comment on Article 2-109 itself explained the "material fraud" without avoiding the considering the underlying contract.¹⁵⁹ To justify the materiality of the fraud by considering the impact of the fraud to the underlying contract may be reasonable in the sense of business interests, but it may also require the bank to know more about the underlying contract while processing the payment. In other words, the bank has to justify whether the fraud rule should be applied to reject the payment by considering the performance of the underlying contract. The expanding of the bank's obligation to the underlying contract is totally against the basis of the documentary credit payment system, which is a separation of the underlying contract and the documents. In this case, this test applied for the application of the fraud rule in English law may be in a better position.

The juristic basis of the fraud rule in English law is the maxim "*ex turpi causa non oritur actio*", which may be translated in English as "no action can arise from a base cause" or "no action arises from an unworthy cause". The essence of the test in applying the fraud rule in English law is the intention of the beneficiary. To apply the fraud rule to reject payment, the fraudulent intention of the beneficiary has to be proved. Otherwise, as long as the documents are facially complying with the credit, the bank has to pay to the

¹⁵⁹ Official Comment 1, para.2. Also see earlier part of this chapter, section 4.

beneficiary even the bank noticed there is a forgery in the documents. The "intentional fraud" test made the application for the fraud rule most complied with the autonomy principle in documentary credits, the bank need not to investigate the underlying contract at all to justify the reasonability of payment. However, the intentional standard is not that perfect as it intends to be. Firstly, the intention of the beneficiary, as a moral activity, is very hard to prove, especially for the bank without investigating the underlying contract; Secondly, a documentary credit is a functional system for payment in international trade. The benefit for the bank during the operation of documentary credits is highly depending on the security interests provided by the documents. Although the interests of the bank may not be influenced by the performance of the underlying contract as long as the reimbursement is paid by the buyer, the buyer's bankruptcy may cause a totally different situation. When the buyer goes bankrupt, the interests which the bank may receive by operating the documentary credit payment system is nothing comparing with the security interests the bank may lose if the documents lose its value because of an inaccuracy in the documents (most of time, the nullity of the documents is caused by the false statement in the document). It is hard to explain why the loss should be borne by the bank but not the beneficiary. It is even more unreasonable to ask the bank to ignore a false statement only because there is no evidence to prove the fraudulent intention of the beneficiary.

Because the negative issues caused by the "intentional fraud" standard, the

actual efficiency of the fraud rule was not satisfying in early England and Wales. In contrast, the material fraud standard in the United States was more reasonable in considering the security interests of banks. A fraud may not affect the bank's security interest if it is not material enough. But according to the practice in the United States, because of the subjective characteristic of the material standard, the fraud rule was not that efficient in early America either. American courts seem to explain the "material fraud" the same as the "egregious fraud" during the practical consideration for the application of the fraud.

Nevertheless, the injunction case *Bolivinter Oil* provided a fresh guidance to considering the application the fraud rule in English law. And actually, new approaches of applying the fraud rule emerged from 1990s in England and Wales.

Chapter Three: The Application of the Fraud Rule at the Pre-trial Stage in English Law

Preface:

As an exception to the general rule in documentary credits, the fraud rule was born in *Sztejn v. J Henry Schroder Banking Corp*¹ in the United States. The application of this new exception in the United States was developing by both case law and the UCC. After lengthy deliberation, a standard of proof which depends on the materiality of the fraud² was established in UCC Article 5. However, the clear expressed standard was not as efficient³ as it was supposed to be in the legal practice in the United States. In many cases, an "egregious fraud" standard was still dominant.⁴ The conflict between the fraud rule and the autonomy principle of documentary credits is the main reason for the difficulties in applying the fraud rule in documentary credits.

¹ *Sztejn v. J Henry Schroder Banking Corp* (1941) 31 NYS 2d 631. *Sztejn* is the leading case which recognizing the fraud rule in the United States, and the first case in the world.

² Official Comment on Article 2-109 explained the concept of the "material fraud". For commercial letters of credit, it indicated that material fraud "requires that the fraudulent aspect of a document be material to a purchaser of that document or that the fraudulent act be significant to the participants in the underlying transaction".

³ Article 5-109 of the UCC 1995 applied the "material fraud" as the main standard of proof in applying of the fraud rule in the United States, however, the materiality issue itself is more like a flexible issue rather than a certain one. See Chapter 2 section 4.

⁴ Generally, "egregious fraud" is an extremely serious fraud, in which a simply intention is not enough. As a standard of proof in applying the fraud rule, the effect of the "egregious fraud" has to be a vitiation of the entire transaction, and the legitimate purposes of the independence of the issuer's obligation would no longer be served. See *New York Life Insurance Co. v. Hartford National Bank & Trust Co.* (1977) 378 A 2d 562. Also see Chapter 2 section 3.2.1.

Compared with the application of the fraud rule in the United States, the fraud rule was even more limited in the English law. English courts were very reluctant to intervene in a documentary credit transaction. The autonomy principle takes an extremely important place in every version of the UCP. In contrast, the fraud rule has never been even mentioned in the UCP. The application of the fraud rule as an independent exception in documentary credits in English law can only be traced in case law. The American case *Sztejn* is also the origin of the fraud rule in England and Wales.⁵

From the very beginning of the establishment of the fraud rule in England and Wales, the standard of proof for the application was very high.⁶ In general, the early development of the fraud rule restricted its application at the trial stage in English law to three conditions:

First, the fraud has to be clearly established; a mere allegation of fraud is not sufficient;

Secondly, the bank is only obliged to examine the facial compliance of the document, it is not the bank's responsibility to examine whether there is a fraud in the underlying transaction. The bank is eligible to get the reimbursement from his client even the payment was paid against a forgery

⁵ It is hard to explain why are the US courts not convinced by the autonomy arguments, and arguments for security of banks, that impress the English courts. The UCP may not be the proper answer since it is also adopted by the American banks. However, the difference of the legal practice between England & Wales and the United States may be a possible reason. Revocable credits are common in the US, or at least were until recently. Perhaps there, the security aspect of the transaction is less important.

⁶ See *Discount Records Ltd v. Barclays Bank Ltd and Barclays Bank International Ltd*. [1975] Lloyd's Rep. 444. But the high standard proof is applied at the trial stage for the application of the fraud rule.

document and the fraud was later proved, as long as the face of the document was complying with the credit and the bank was not aware of the fraud;

Thirdly, the intention of the beneficiary is also one of the essentials for the application of the fraud rule. This condition does not only mean that a lack of intention may cause a failure of establishment of a fraud itself. In English law, even a fraud is clearly established, the fraud rule may still not be applied if the beneficiary was not a party of the fraud.⁷ In other words, a fraud caused by a third party may not lead to an application of the fraud rule.

Those three conditions made the successful application of the fraud rule in documentary credits at the trial stage extremely difficult in English law. However, from the late 1990s, English courts started to consider details of the application of the fraud rule, and some different tests were applied by English Courts at the pre-trial stage. This chapter will focus on the different application of the fraud rule at the pre-trial stage.

⁷ This principle was established in *United City Merchants* [1983] 1 A.C. 168, by Lord Diplock. See Chapter 2, section 5.2.3, for a detailed discussion of this case.

1. The Recent Application of the Fraud Rule at the Pre-trial Stage

The early development of the fraud rule in England and Wales, which was discussed in the second chapter, was totally based on English case law. There was no statute law which admitted the fraud rule as an independent exception in documentary credits system. Similar to the prior situation, the recent application also appeared and developed in the case law. Therefore, the analysis of the pre-trial application of the fraud rule is also relying on a series of examples of cases, which include both interlocutory injunction cases and summary judgment cases.

1.1. The case of United Trading Corp

Although the first case, in which the judgment clearly applied a different approach in applying the fraud rule, was *Themehelp Ltd v. West*⁸, the case of *United Trading Corp SA v. Allied Arab Bank Ltd*⁹ in 1985 had already showed some new trends for the application of the fraud rule.

In *United Trading Corp*, the plaintiff was trading with an Iraq State Establishment corporation ("Agromark") for foodstuffs' supply. By the request of Agromark, the plaintiffs, through its own bank Allied Arab Bank Ltd.

⁸ *Themehelp Ltd v. West* [1996] Q.B. 84.

⁹ *United Trading Corp SA v. Allied Arab Bank Ltd* [1985] 2 Lloyd's Rep 554 (CA).

("Allied"), acquired a performance bond from Rafidain Bank ("Rafidain") in favour of Agromark. Because of some disagreements relevant to performance of the contracts, Agromark made demands on the performance bond. The plaintiffs feared that, if their own accounts came to be debited against the demanding, they would have no hope of recovering the equivalent sums from Agromark or its banker, Rafidain. Therefore the plaintiffs sought injunctions to restrain the Allied Bankers from payment by alleging that the demands which made by Agromark on the performance bonds was fraudulent.

The decision of this case was not different from the old cases in applying the fraud rule in English law. It was held that no injunctions was granted because there was no clear fraud on the side of Agromark to Allied Bankers' knowledge. However, Ackner LJ said during the judgment:

"Have the plaintiffs established that it is seriously arguable that, (arguable) on the material available, the only realistic inference is that Agromark could not honestly have believed in the validity of its demands on the performance bonds?"¹⁰

The above words provided a different standard of proof in injunction cases in applying the fraud rule, which is **to establish a seriously arguable fraud on the part of beneficiary**. This standard is obviously lower than the one which was established in *Edward Owen Engineering Ltd. v. Barclays Bank*

¹⁰ Ibid, 561.

*International Ltd.*¹¹ The previous one was that "The evidence of fraud must be clear, both as to the fact of fraud and as to the [guarantor's] knowledge. The mere assertion or allegation of fraud would not be sufficient"¹². Although the new standard of proof did not lead to an application of the fraud rule in *United Trading Corp*, it heavily influenced decisions of later cases in applying the fraud rule.

1.2. The case of *Themehelp*¹³

Themehelp Ltd. v. West was also a case about the enforcement of a performance guarantee. In this case, the plaintiff was a buyer who agreed to purchase the defendant seller's business under a contract which provided the payment by three separate instalments. The third and also the largest instalment was secured by a third party by a performance guarantee. After the first instalment had been paid the buyers brought an action for rescission, alleging fraudulent misrepresentation by the seller, who denied the allegation and proposed to give notice to the guarantors to enforce the guarantee. The buyers applied for an interlocutory injunction to restrain the sellers from giving notice to the guarantors, who were not a party to the action, until trial. The judge granted the injunction on the basis that the evidence was sufficient to

¹¹ *Edward Owen Engineering Ltd. v. Barclays Bank International Ltd.* [1978] Q.B. 159.

¹² There was no clear explanation for the difference between the "seriously arguable fraud" and a "clearly proved fraud". But literally, the "seriously arguable fraud" may be understood as there is sufficient evidence for the plaintiff to argue that there is a fraud, this is lower than a "clearly proved fraud" in which the evidence has to be sufficient to establish a fraud.

¹³ *Themehelp* [1996] QB 84, supra note 8.

raise a seriously arguable case that the only reasonable inference that could be drawn from the circumstances was that the sellers had been fraudulent. The seller then appealed.

During the appeal, Waite LJ distinguished two different legal circumstances for granting an interlocutory injunction in the performance guarantee cases by applying the fraud rule. One is where at the date of the application there has already been a claim under the guarantee by the beneficiary, the other is where a default has occurred but the beneficiary has not yet claimed under the guarantee. He admitted, as for the first circumstance, letters of credit, performance bonds and guarantees are all subject to the general principle that they must be treated as autonomous contracts, whose operation is not to be interfered with by the court on grounds extraneous to the credit or guarantee itself.¹⁴ However there is a sole exception for the guarantor to refuse to pay, which is the fraud on the part of the beneficiary. And a performing party may apply for an injunction to restrain enforcement of a performance guarantee by the beneficiary if he can prove fraud on the part of the beneficiary.¹⁵ But "the evidence of fraud must be clear, both as to the fact of fraud and as to the [guarantor's] knowledge. The mere assertion or allegation of fraud would not be sufficient".¹⁶ Nevertheless, for the second

¹⁴ Ali Malek, David Quest, Jack Raymond and Jonathan Davies-Jones, "Jack, Documentary credits: the law and practice of documentary credits including standby credits and demand guarantees" (4th edn, Tottel Pub., 2009).

p. 220-226, paras. 9.28-9.3.

¹⁵ *Edward Owen* [1978] Q.B. 159, supra note 11; *Bolivinter Oil S.A. v. Chase Manhattan Bank N.A.* [1984] 1 W.L.R. 392.

¹⁶ *Bolivinter Oil S.A.* [1984] 1 W.L.R. 392, supra note 15.

circumstance, Waite LJ believed that there was "no authority stating the principles to be applied when, as in this case, the party in default under the main contract seeks, without involving the guarantor in the proceedings at all, to restrain the beneficiary from taking any step to enforce the performance guarantee."¹⁷ He then agreed with Mr. Maurice Kay Q.C in the Queen's Bench Division, that the present case was exceptional, in that here the relief was sought at an earlier stage, that is to say a restraint against the beneficiary alone in proceedings to which the guarantor is not a party, to prevent the exercise by the beneficiary of his power to enforce the guarantee by giving notice of the other party's alleged default in discharging the liability which was the subject-matter of the guarantee.¹⁸ Therefore, the judge had the power to grant an injunction to restrain the demanding without proof of fraud as between the defendant and the banks, and the standard of proof of fraud should be the establishment of an arguable prospect of satisfying the court at trial that the only realistic inference to draw is that of fraud. For the issue of destroy the autonomy of the performance guarantee, he said:

"In a case where fraud is raised as between the parties to the main transaction at an early stage, before any question of the enforcement of the guarantee, as between the beneficiary and the guarantor, has yet arisen at all, it does not seem to me that the slightest threat is involved to the autonomy of the performance guarantee if the beneficiary is enjoined from enforcing it in proceedings to which the guarantor is not a party. One can imagine, certainly, circumstances where the

¹⁷ *Themehelp* [1996] QB 84, 91-92, *supra* note 8.

¹⁸ *Ibid*, 97.

guarantor might feel moved to express alarm, or even resentment, if the buyer should obtain, in proceedings to which the guarantor is not a party, injunctive relief placing a restriction on the beneficiary's rights of enforcement. But in truth the guarantor has nothing to fear. There is no risk to the integrity of the performance guarantee, and therefore no occasion for involving the guarantor at that stage in any question as to whether or not fraud is established."¹⁹

Although Evans LJ disagreed with Waite LJ by relying on the ordinary view to the application of the fraud rule in English law, it did not influence the decision of this case. From *Themehelp*, one of the different approaches to the application of the fraud rule may be stated: **where there is a case for granting an interlocutory injunction between the buyer and the beneficiary, in another words, where the bank or the guarantor is not involved in the injunction, the standard of proof for applying the fraud rule may be lowered as a seriously arguable case of fraud, other than a clearly proved fraud.**

This different approach is not hard to explain. It is well known that one of the most important reasons for the strictness of applying the fraud rule in documentary credits may be the conflict between the fraud rule and the autonomy principle. And the bankers' independent position in documentary credits is always one of the most essential expressions of the autonomy principle. The elaborate commercial system was built up on the footing that a confirmed letter of credit constituted a bargain between the banker and the

¹⁹ Ibid, 98-99.

vendor of the goods, which imposed upon the banker an absolutely obligation to pay, irrespective of any dispute there might be between the parties whether or not goods were up to contract, bankers were not expected to have the knowledge of the underlying contract, or to be aware of whether there are any fraudulent issues during the business process. The obligation to pay against documents is rooted from its interests during the operation of documentary credits, and it is also an expression of the banker's reputation. The fraud rule is exceptional because according to it, the conflicts in underlying contractions which should not affect banks' payment obligation may entitle a bank to reject payment if the conflict is a fraud on the part of the beneficiary. It is an exceptional situation which allows the bank to breach his obligation of payment under documentary credits. However, where the applicant is asking for an injunction to prevent the beneficiary from payment by relying on the fraud rule, the bank is not involved in the action or involved in the application of the fraud rule, and the documentary credits system may not be disturbed at all. In other words, the obligations of all the parties in documentary credits may not be varied even if the demanding for payment is prohibited by the courts. In such circumstances, where the autonomy principle has not been involved in, the plaintiff does not have to establish that the payment enjoined would constitute a breach of contractual duty owed to the plaintiff by the bank; the plaintiff only has to show that his legal rights are threatened by the fraud of the beneficiary.²⁰

²⁰ *Czarnikow-Rionda Sugar Trading Inc. v. Standard Bank London Ltd.* [1999] 2 Lloyd's Rep.

Therefore, the standard of proof in applying the fraud rule for granting an injunction between the application and the beneficiary to restrain the beneficiary from demanding payment may be the establishment of a seriously arguable case of fraud on the part of the beneficiary rather than a clearly proved fraud. Although there are still some arguments about this exception,²¹ the thesis argues that this new approach is reasonable, and that the decision in *Themehelp* may be seen as a good example which relaxed the strictness of the standard of proof for the application of the fraud rule, while avoiding interrupting the autonomy principle under documentary credits. However, the unique situation of an injunction, which normally happens before the exact trial, is an essential condition of applying the lower standard. The general law in granting an interlocutory injunction has already provided a lower requirement for evidence in English law; there is no reason why the standard of proof should be increased only because the case involving the application of the fraud rule in documentary credits.²²

Themehelp is a very important case on the application of the fraud rule in documentary credits. It is the first case which relaxed the standard of proof in applying the fraud rule in English law. The decision of *Themehelp* shows a big possibility for the development of the fraud rule in documentary credits.

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²¹ Evans LJ disagreed with Waite LJ since the ordinary view of applying the fraud rule in *Themehelp*. Also in *Group Josi Re v. Walbrook Insurance Co. Ltd.* [1996] 1 W.L.R. 1152, 1162. Staughton LJ disagreed to the decision of *Themehelp* by saying the effect on the lifeblood of commerce will be precisely the same whether the bank is restrained from paying or the beneficiary is restrained from asking for payment.

²² The general rule in interlocutory injunction cases is analysed in section 2 of this chapter.

1.3. The case of *Solo Industries*

While in both the *United Trading Corp* and *Themehelp*, the approach of applying a lower standard of proof in applying the fraud rule was approved in interlocutory injunction cases, the case of *Solo Industries UK Ltd v. Canara Bank*²³ reflected a broader application of the lower standard of proof.

In *Solo Industries*, the claimant was the beneficiary of a performance bond issued by the defendant bank. On the claimant's application for summary judgment in proceedings on the bond, the bank sought to avoid the claim on the ground that the issue of the performance bond was induced by fraudulent conspiracy or misrepresentation to which the claimant was a party. The judge held that the "cash principle" whereby performance bond obligations were to be treated like promissory notes, bills of exchange or cash had no application where the challenge was to the validity of the bond, rather than to the propriety of any demand under it. Although the evidence did not clearly establish fraud, he refused summary judgment on the ground that the bank had a real or reasonable prospect of success in justifying avoidance of the bond.

During the appeal, Mance LJ applied Sir John Donaldson M.R's dictum in

²³ *Solo Industries UK Ltd v. Canara Bank* [2001] 1 W.L.R 1800.

Bolivinter. "the first task of any judge faced with an application for interim injunctive relief was to 'ask whether there was any challenge to the validity of the instrument' and 'if there is not or if the challenge is not **substantial**, prima facie no injunction should be granted'".²⁴ Mance LJ then explained "substantial" in modern terms as it must have a "real prospect".²⁵

He took the view that the cash principle, which means that "any claim that a bank may acquire against a beneficiary making a fraudulent demand must be pursued separately and subsequent to payment, and cannot normally be used as a defence or set-off to avoid payment", is only applied on the assumption of "the integrity of the instrument that the bank has issued";²⁶ and accordingly:

"It does not follow that banks accept the risk that the instrument itself has been induced by conspiracy between, or misrepresentation by, their customers and the beneficiaries. The mere appearance of a valid instrument cannot commit a bank. Take the case of a forgery. The bank must be able to advance a defence with a real prospect of success that an instrument relied upon is a forgery by the beneficiary.

...

The problems inherent in Solo's case can be illustrated: if, on an application for summary judgment, the court were to apply the principle for which Solo contends and to give judgment upon a demand because the invalidity of the bond was not sufficiently 'established' at that stage, the bank or other issuer of the instrument could still continue with proceedings to establish that it had in fact validly avoided the instrument."²⁷

²⁴ Ibid, 1813.

²⁵ Ibid.

²⁶ Ibid, 1814.

²⁷ Ibid.

Mance LJ applied the "real prospect of establishing fraud", which is the ordinary civil test, as the standard of proof to justify the bank's claim of avoiding the credit. He extended the application of the lower standard of proof into the summary judgment cases where the alleged fraud affected the validity of the credit. According to his decision, **a bank may not be forced to pay by a summary judgment as long as it has a real prospect of success to claim that there was a misrepresentation by the beneficiary directed at persuading the bank to enter into the letter of credit.**

The application of the lower standard of proof is also based on the non-involvement of the autonomy principle. It is well known that the autonomy principle is applied specifically to documentary credits, so it exists only when there is a valid letter of credit²⁸. Banks are one of the main parties in documentary credit transactions; their participation is essential for the validity of the credit. If the bank was induced to enter into a credit by misrepresentation then rescission would render the credit invalid from the very beginning, which could mean that there was no longer any valid the letter of credit at all. It follows that there is no autonomy principle either. Thus, the bank cannot be forced to perform its obligations under the letter of credit. The bank is also entitled to avoid the instrument, which can be either a letter of credit or performance bond, by relying on the invalidity of the instrument. In this circumstance, where the beneficiary is asking for a summary judgment to

²⁸ Similar for performance bonds or guarantees.

force the bank to pay, the general rule for the standard of proof in summary judgment cases should be applied. The bank may not be enforce to payment as long as he has a "real prospect of success in proving his claim"²⁹, which is the invalidity of the letter of credit. Furthermore, a letter of credit is also a contract which is constructed by law between the issuing bank and the beneficiary. The law has developed the cash principle and the limited fraud exception in response to perceived commercial need.³⁰ There is no reason why the establishment of the letter of credit can be inconsistent with the general contractual principle.

The decision of *Solo* is not only essential for the development of the different approaches in applying the fraud rule; Mance LJ's position of applying general contractual principles in invalid letter of credit cases may also be seen as a basis for the illegality exception in documentary credits.

During the judgment, Mance LJ also mentioned the decision of another case, *Safa Ltd. v. Banque Du Caire*³¹. He applied part of the judgment in *Safa* to support his decision. However, he was reserved in extending the application of the lower standard of proof to the application of the fraud rule under some other circumstances.

²⁹ This is according to CPR r 24.2(a) (ii). The general rule for granting a summary judgment is discussed in the case of *Safa Ltd. v. Banque Du Caire* [2000] 2 Lloyd's Rep.600. See section 1.4 of this chapter.

³⁰ *Solo* [2001] 1 W.L.R 1800, 1815, supra note 23.

³¹ *Safa Ltd. v. Banque Du Caire* [2000] 2 Lloyd's Rep.600.

1.4. The case of *Safa Ltd.*

While in *Solo*, the lower standard of proof is restricted to apply in the sole situation that the letter of credit is invalid because of the beneficiary's fraud, the decision of *Safa Ltd. v. Banque Du Caire*³² may be seen as a big extension in applying the lower standard of proof in summary judgment cases .

In *Safa*, the plaintiffs were assignees of two letters of credit. Under the two letters of credit, the bank was obliged to pay against the presentation of a financial insurance guarantee. And the bank was involved in the establishment of the financial insurance guarantee. When the plaintiff asked for payment under the letters of credit, the bank refused to pay by alleging that the beneficiary was acting fraudulently in establishing the financial insurance guarantee. The plaintiffs claimed they were entitled to the entire proceeds under the letters of credit and applied for a summary judgment to force the bank to pay. The summary judgment was rejected by the court, then the plaintiffs appealed. During the appeal, Waller LJ first mentioned CPR 24.2 which is the rule for giving summary judgment:

"The Court may give summary judgment against a defendant on the whole of claim if

(a) it considers that -

(ii) that defendant has no real prospect of successfully defending the claim. . .; and

(b) there is no other reason why the case or issue

³² Ibid.

should be disposed of at a trial.." ³³

Then he pointed out that in documentary credits cases, the summary judgment should be refused "if the bank can raise an actual defence with a real prospect of success as opposed to a counterclaim, and/or if it appears as it might in exceptional circumstances that there is a compelling reason why there should be a trial of the issue of liability on the letter of credit or bill of exchange" ³⁴

Waller LJ believed, in the current case, the bank was trying to raise a fraud defence to against the summary judgment application while he has no clear evidence of fraud at the time of the presentation of documents. ³⁵ He decided the issue is similar to that in *Balfour Beatty Civil Engineering Ltd. v. Technical & General Guarantee* ³⁶. *Balfour Beatty* was concerned with a performance bond and an allegation that the beneficiary had made a fraudulent demand, albeit it was common ground that on any view the surety had no evidence of the same as at the date of the demand. Waller LJ affirmed his own opinion in *Balfour Beatty* that it would absurd for a court to be forced to grant a summary judgment to force a bank to pay a fraudulent beneficiary because the bank had no sufficient knowledge of the fraud at the time of the demand, though the fraud was clearly proved at the time of hearing. He believed the bank should have its own remedy directly against the fraudulent beneficiary

³³ Ibid, 605.

³⁴ Ibid, 606.

³⁵ Ibid.

³⁶ *Balfour Beatty Civil Engineering Ltd. v. Technical & General Guarantee* [2000] C.L.C. 252, but the judgment was delivered on 14 October 1999.

in such circumstances. He summarised his own views in *Balfour Beatty* as follows: if the evidence of fraud was "powerful", but not sufficient to justify summary judgment, the bank could in his view seek either a stay of execution in respect of its liability on the instrument or a deferral of any judgment on the instrument until after trial of its counterclaim; if, on the other hand, the evidence was less than powerful, the bank would simply be left to pursue a claim or counterclaim against the beneficiary for reimbursement or its remedy against its customer.³⁷

Back to *Safa*, Waller LJ accepted the submission that a seriously arguable case which a fraudulent demand has been made with a real prospect of success would entitle the bank to resist an application for summary judgment. In other words, where the beneficiary claims summary judgment, he will fail if the claim can be shown to be fraudulent at any time up to the time of judgment. This is simply an application of "*ex turpi causa non oritur actio*".

Furthermore, he took the view that there was not a big different between the words "the powerful evidence" and "real prospect of success". Therefore, "where the bank can raise a set-off as a defence the question whether it has a 'real prospect of success' is the appropriate test"³⁸ in applying the fraud rule in this case.

³⁷ *Safa* [2000] 2 Lloyd's Rep. 600, 607, supra note 31.

³⁸ *Ibid.*

By referring to several other authorities³⁹, Waller LJ expressed his own view in the current case and said:

"Gathering the threads from the above authorities and adapting them to the circumstances of this case, my view is as follows:

1. The principle that letters of credit must be treated as cash is an important one, and must be maintained.
2. It is however unusual for a bank which has opened a letter of credit to be involved in the related transaction to the extent this bank was.
3. When a bank is involved in the related transaction it may be unjust for that bank to be forced to pay on a summary judgment where it has a real prospect of succeeding by reference to a claim on the underlying transaction, and particularly if that claim is a liquidated claim, the court should not give summary judgment either because a set-off has a reasonable prospect of success or because there is a compelling reason to have a trial of the letter of credit issue.
4. If a bank can establish a claim with a real prospect of success, either that the demand was fraudulent even if it had no clear evidence of fraud at the time of demand, or that there was a misrepresentation by the beneficiary directed at persuading the bank to enter into the letter of credit, it may also be unjust to enter summary judgment against the bank either because the bank has a reasonable prospect of succeeding in a defence of set-off or because there is a compelling reason for a trial of the letter of credit issue."⁴⁰

Waller LJ's analysis broke the old idea of applying the fraud rule in English law; it brought many new situations in applying a lower standard of proof in applying the fraud rule.

³⁹ Including: *Hong Kong and Shanghai Banking Corp v. Kloeckner & Co AG* [1990] 2 QB 514. and *Clovertogs Ltd v. Jean Scenes Ltd* (unreported) 5 March 1982; Court of Appeal (Civil Division) Transcript No 566 of 1982

⁴⁰ *Balfour Beatty* [2000] 2 Lloyd's Rep. 600, 608, *supra* note 36.

First of all, when a bank is involved in the related underlying transaction, it may not be forced to pay on a summary judgment as long as the bank can establish a claim that it has a real prospect of succeeding by reference to a claim on the underlying transaction.

Secondly, a bank may not be forced to pay by a summary judgment if it can establish a claim with a real prospect of success that the demand was fraudulent even if it had no clear evidence of fraud at the time of demand.

Thirdly, a bank may not be forced to pay by a summary judgment as long as it has a real prospect of success to claim that there was a misrepresentation by the beneficiary directed at persuading the bank to enter into the letter of credit.

However, except for the third point, which was later confirmed in *Solo*, the other two points both caused arguments in English law.

For example, Mance LJ, in the case of *Solo*, while discussing the second point above said:

"I would not consider that this low test can be justified on the basis that the *Safa* case concerned the relationship between bank and beneficiary, rather than between customer and bank or between the parties to the underlying commercial relationship. If instruments such as letters of credit and performance bonds are to be treated as cash, they must be paid as cash by banks to beneficiaries."⁴¹

⁴¹ *Solo* [2001] 1 W.L.R 1800, 1812, supra note 23.

Before a discussion of Mance LJ's view above, it may be necessary to recall the bank's title and obligation to the beneficiary under a letter of credit since all the new approaches established in *Safa* are applied between the bank and beneficiary.⁴² By issuing an irrevocable letter of credit, the bank undertakes an absolute obligation to pay the seller beneficiary against the presentation of conforming documents under the credit. The autonomy principle requires the bank to make the decision of whether paying totally relying on the conformity of documents. The bank is not required to concern the disputes in the underlying contracts between the applicant and beneficiary. The bank has to pay against conforming documents, in other words, the bank cannot reject payment by relying on conflicts in the underlying contract. The fraud rule is exceptional because it entitles the bank to reject documents where there is a fraud on the part of the beneficiary even the fraud is in the underlying contract.⁴³ According to the fraud rule, the bank is entitled and also obliged (to the applicant) to reject to pay a fraudulent beneficiary as long as the fraud has been known to the bank. In this sense, it seems unreasonable to consider the bank's participation in the underlying transaction as a significant point in applying the lower standard of proof when applying the fraud rule. The bank may have other contractual relationships besides those under the letter of credit, with both the applicant and the

⁴² The contractual relationships under documentary credits are mainly discussed in Chapter 1, section 2.1 to 2.3. Only several involved issues are mentioned here.

⁴³ See *Sztejn* (1941) 31 NYS 2d 631, 634-635, *supra* note 1: "where the seller's fraud had been called to the bank's attention before the drafts and documents have been presented for payment, the principle of the independence of the bank's obligation under the letter of credit should not be extended to protect the unscrupulous seller".

beneficiary, if he is involved in the underlying contracts. However, under the principle of autonomy, the bank is not allowed to reject documents by relying on any disputes in the underlying contracts (except to the fraud rule). This should not change merely because the bank is involved in the underlying contract. The bank's obligation under the letter of credit cannot be influenced by its other title or obligations under the underlying contracts. This is a simple application of the autonomy principle. It would be questionable to applying a lower standard of proof in a summary judgment case to the application of the fraud rule solely because the bank was involved in the underlying transactions in documentary credits. The bank is not entitled to reject payment by relying on any disputes between itself and the beneficiary although its involvement in the underlying contracts may offer it separate defence against the beneficiary. The only possible explanation may be that, the bank is comparatively better able to find the evidence of fraud as one of the parties in the underlying contract. But it is not clear whether this explanation is strong enough to support the application of a lower standard of proof.

However, referring to another new approach established in *Safa*, under which a bank may not be forced to pay by a summary judgment if it can establish a claim with a real prospect of success that the demand was fraudulent even if it had no clear evidence of fraud at the time of demand, it seems that the bank's participation in the underlying transaction is not important or even

necessary to apply the lower standard of proof in a summary judgment case between the bank and beneficiary. According to the judgement of *Safa*, the bank is only required to prove a seriously arguable case of fraud to defend the beneficiary's summary judgment application, even he is not involved in the underlying transaction. This is also the new approach which gave rise to many arguments. Mance LJ thought the different relationship between the bank with beneficiary, and the applicant with bank, cannot justify the reasonableness of the new approach. However, the thesis respectfully disagrees.

It is true that the letter of credit and performance bonds are treated as cash according the autonomy principle in documentary credits; however, the different contractual relationships between different parties certainly will affect every party's title and obligation under the credit. Where a beneficiary is asking for a summary judgment to force a bank to pay, it must follow that the bank is in breach of obligations to the beneficiary by not paying. Under a letter of credit, the bank is obliged to pay against conforming documents. But the fraud rule also entitles the bank to reject payment by relying on the fraud of the beneficiary. Of course, the fraud rule does not require the bank to go behind the document to detect the fraud. But it does not mean that the bank is not allowed to go behind the document to find the fraud if he suspected a possibility of fraud. The bank cannot reject payment by relying on any conflicts in underlying contracts unless the conflict is a fraud of the beneficiary.

Certainly, the bank is liable for damages to the beneficiary because of a wrongful dishonour if the fraud is not clearly proved at the trial. However, before the trial, where the beneficiary is asking for a summary judgment from the court to force the bank to pay, the bank is entitled to not being forced to pay by a summary judgment as long as it can establish a claim with a real prospect of success that the demand was fraudulent. This is a simple application of the general rule for summary judgment. And the bank's right to reject the documents against a fraudulent beneficiary is given by the fraud rule, which is an exception in documentary credits. Therefore, bank's rejecting of payment by relying on the fraud rule cannot be seen as a breach of obligations under documentary credits transactions. The application of the lower standard of proof in this case is because of the specific contractual relationship between the bank and beneficiary. To apply the general rule for granting a summary judgment in such a situation does not contradict to the fraud rule, nor the autonomy principle in documentary credits. The situation would be totally different if the action was between the applicant and bank, for example, where an applicant is asking for an injunction to prevent the bank from payment by alleging there is a fraud on the beneficiary. One of reasons is that, by asking for the injunction, the applicant is asking a court to force the bank to breach its obligation of payment to the beneficiary under the credit. The general rule for granting an interlocutory injunction can be an essential issue which has to be considered in this situation.

Actually, the above cases, which involved in the application of the lower standard of proof in applying the fraud rule, are either summary judgment cases or injunction cases. While the application of the general rule for granting a summary judgment in documentary credits cases has been discussed in *Safa*⁴⁴, it is still not clear that how the general rule of granting an interlocutory injunction is applied in documentary credits cases, essentially the fraud rule cases.

2. The Application of the General Interlocutory Injunction Rule in Fraud Documentary Credits Cases.

2.1. The general rule in granting an interlocutory injunction in English law

It is well known that the purpose of an interlocutory injunction is to maintain the "status quo" pending trial.⁴⁵ "Status quo" or, more fully, "status quo ante," means in Latin "the existing state of things", exists before a particular point of time.⁴⁶ It is common ground that the courts can only intervene by way of injunction to prevent the alleged breach of a legal duty owed by the defendant to the plaintiff, or by way of ancillary relief required by a party to proceedings

⁴⁴ *Balfour Beatty* [2000] 2 Lloyd's Rep. 600, 605, supra note 36.

⁴⁵ Adrian A.S. Zuckerman, "Interlocutory injunctions on the merits", [1991] Law Quarterly Review 196, 196-197.

⁴⁶ *Alfred Dunhill Limited and Another v. Sunoptic S.A. and Another* [1979] F.S.R. 337, 376.

who asserts a cause of action against the other party.⁴⁷ Although the test for an interlocutory injunction tends to be flexible, the most frequently used approach to injunctions before 1975 was that in the House of Lords decision in *J. T. Stratford & Son Ltd v. Lindley*²³, whereby a plaintiff must establish that he or she had a prima facie case against the defendant to succeed in obtaining an interlocutory injunction. This is actually a test of merits which focuses on testing the strengths of the parties, and quite a difficult hurdle to mount successfully.

However, in the House of Lords in *American Cyanamid Co. Appellants v. Ethicon Ltd. Respondents*⁴⁸ in 1975, Lord Diplock rejected the previous high test for granting an interlocutory injunction said:

"... there is no such rule. The use of such expressions as 'a probability', 'a prima facie case', or 'a strong prima facie case' in the context of the exercise of a discretionary power to grant an interlocutory injunction leads to confusion as to the object sought to be achieved by this form of temporary relief. The court no doubt must be satisfied that the claim is not frivolous or vexatious, in other words, that there is a serious question to be tried."⁴⁹

He then emphasized on the essential of the principle of "balance of convenience" by saying:

"... unless the material available to the court at

⁴⁷ *Siskina, The* (H.L.) [1978] 1 Lloyd's Rep. 1, 6. Lord Diplock said: "The right to obtain an interlocutory injunction is merely ancillary and incidental to the pre-existing cause of action . . ."

⁴⁸ *American Cyanamid Co. Appellants v. Ethicon Ltd. Respondents* [1975] A.C. 396.

⁴⁹ *Ibid.* 407.

the hearing of the application for an interlocutory injunction fails to disclose that the plaintiff has any real prospect of succeeding in his claim for a permanent injunction at the trial, the court should go on to consider whether the balance of convenience lies in favour of granting or refusing the interlocutory relief that is sought."

He also added that the "balance of convenience" only arises "where there is doubt as to the adequacy of the respective remedies in damages available to either party or to both".

Lord Diplock's decision gave rise to the notion that at the interlocutory stage the courts are only concerned with whether the plaintiff has an arguable case and not with whether the plaintiff's case is stronger than that of the defendant. And once a plaintiff could establish that there was a serious question to be tried, the court has to move on to examine whether, if the plaintiff were to succeed in the end, he or she would be compensated by adequate damages. Clearly, the balance of convenience becomes the central issuing in interlocutory injunction cases.

There was much argument on the principles of "the adequacy of damages" and "balance of convenience" in granting interlocutory injunctions during three decades after the guidance had been ruled out by Lord Diplock in *American Cyanamid*⁵⁰. Recently, Laddie J even interpreted *American*

⁵⁰ The decision in *American Cyanamid* has been quite heavily criticised (see Gray C., "Interim injunctions since *American Cyanamid*", (1981) 40. Cambridge Law Journal at 307; Zuckerman, A., "Interim Injunctions on the merits", (1991) 107. Law Quarterly Reports at 197; I.R.Scott, 'Re-assessing *American Cyanamid*', (2002) 21. Civil Justice Quarterly 190.). There are also many cases which did not follow the rules of *American Cyanamid* (e.g. *NWL Ltd v. Woods* [1979] 1 WLR 1294, *Cambridge Nutrition Ltd v. BBC* [1990] 3 All ER 523; *Series 5 Software v. Clarke & Ors* [1996] 1 All ER 853.).

Cyanamid as meaning that Lord Diplock "did not intend to exclude consideration of the strength of the cases in most applications for interlocutory relief"⁵¹. Lord Diplock himself, in the case of *N.W.L. Ltd v Woods*⁵², also admitted that there are exceptional cases in which the interlocutory injunction will be the final stages. **In other words, the court should consider the respective merits of parties in deciding injunction cases in which the decision will be decisive and the matter will not go to a final trial.** There are also other exceptions which are concerned in English case law.⁵³ Essentially, an exception concerning the fraud issue was mentioned in *Alfred Dunhill Ltd v. Sunoptic S.A.*⁵⁴. The court allowed an appeal for applying an interlocutory injunction, although on the basis of the principle established in *American Cyanamid*, said that **it would be proper to consider the respective merits of the parties' cases in interlocutory cases if there was no substantial disputes as to the facts, in particular as to the allegation of fraud.** This case is certainly important in considering the application of the general rule of injunction in fraud cases. However, it may not be followed by an application of the "prima facie" test in injunction cases to the application of the fraud rule in documentary credits.

⁵¹ *Series 5 Software Ltd v Clarke & Ors* [1996] 1 All E.R. 853, 865.

⁵² *N.W.L. Ltd v Woods* [1979] 1 W.L.R. 1294.

⁵³ For example: *De Falco v. Crawley BC* [1980] 1 Q.B. 460 (CA); *Leisure Data v. Bell* [1988] F.S.R. 367; *Cambridge Nutrition Ltd v. BBC* [1990] 3 All E.R. 523 at 534 (CA); *Douglas v. Hello Ltd* [2001] Q.B. 967. *Emmanuel Francis v. The Royal Borough of Kensington and Chelsea* [2003] WL 933 (CA). For detailed discussion of examples see J. Martin, Hanbury and Martin's Modern Equity, (17th edn, Sweet & Maxwell, 2005), at p. 784-790; Andrew Keay, "Whither American Cyanamid? : interim injunctions in the 21st century", [2004] Civil Justice Quarterly, volume 23, 132, 138.

⁵⁴ *Alfred Dunhill Ltd v. Sunoptic S.A.* [1979] F.S.R. 337, supra note, 46.

2.2. An analysis to the application of the general injunctions rule in the fraud rule cases

According to the above research, the general rule itself for granting an interlocutory injunction is not so clear in English law. The application of the *American Cyanamid* principle is still a matter of argument, and the "prima facie" test is still being applied by the judges in many cases. Therefore, to understand the test for granting an interlocutory injunction in the fraud rule cases, it may be useful to consider the recent judgments of the fraud rule cases which are concerned with those essential tests.

2.2.1. The "*prima facie* test"

The "prima facie test" is actually a test of merits which focuses on testing the strengths of the parties. In the fraud rule cases, the prima facie test may be a test of whether the defendant can make a seriously arguable case of fraud on the part of beneficiary.

In *United Trading Corp*, Ackner LJ, while discussing the standard of proof in the current case, said:

"Have the plaintiffs established that it is **seriously arguable** that, on the material available, the only realistic inference is that Agromark could not honestly have believed in the validity of its demands on the performance bonds?"⁵⁵

⁵⁵ *United Trading* [1985] 2 Lloyd's Rep. 554, 561, supra note 9, see previous this chapter, section 1.1.

In *Themehelp*, Balcombe LJ also considered the standard of proof in applying the fraud rule "between the buyer and seller" as "whether the buyers had established that it was **seriously arguable** that on the material available the only reasonable inference was that the sellers were fraudulent in relation to the share sale agreement".

In both of the injunction cases, the courts applied the seriously arguable case of fraud as the standard of proof in applying the fraud rule. Consequently, it may be right to say that the "prima facie test" is considered by the courts as a main principle in granting an interlocutory injunction by applying the fraud rule in documentary credits. However, the application of the "prima facie test" may not be seen as a breach of "the balance of convenience" test which was established in *American Cyanamid* according to the following research.

2.2.2. The test of "balance of convenience"

The "balance of convenience test", which was established by Lord Diplock in *American Cyanamid*, only required the plaintiff to establish that "there was a serious question to be tried", but asked the courts to focus on considering the "the adequacy of damages" to the parties to make the decision of whether granting an interlocutory injunction. This test is comparatively a lower test to the "prima facie test". Although the seriously arguable case fraud had been mainly applied as the standard of proof in the injunction cases while applying the fraud rule, the "balance of convenience test" was not ignored according to

most of the judgments. Waite LJ said in *Themehelp*:

"It is unnecessary for the purposes of this appeal to decide whether the 'sole realistic inference' test propounded by Ackner LJ in *United Trading Corporation S.A. v. Allied Arab Bank Ltd.*⁵⁶ involves a more burdensome standard of proof than the standard generally applied to proof of fraud, namely that fraud must be established on the balance of probabilities after weighing the evidence with due regard to the gravity of the particular allegation; or to decide whether the judge was right to have treated the former test, rather than the latter, as applying in this case. That is because Mr Craig for the buyers has not sought to argue in this appeal, though he would reserve the right to do so in another case, that the judge adopted too stringent a test of fraud."⁵⁷

It seems that Waite LJ was trying to avoid the question of whether it is reasonable to apply the "prima facie test" in the current case. He believed it was unnecessary to make a decision on this point because this issue was not argued by the buyer. He only mentioned the test applied in *United Trading* as involving a more burdensome standard of proof than the general law, but he did not say the test was wrong. However, he concluded in his judgment that "the judge was entitled, in my judgment, to take all this into account in reaching his conclusion that the buyers had satisfied the onus of showing, for the purposes of interlocutory relief, that they had an arguable case at trial that fraud was the only realistic inference",⁵⁸ then turned to discuss "the appropriateness of relief by way of injunction". In the end, he granted the

⁵⁶ *Ibid.*

⁵⁷ *Themehelp* [1996] QB 84, 100, *supra* note 8.

⁵⁸ *Ibid.*

injunction on the basis of otherwise the plaintiff might be in peril of being forced to indemnify the guarantor and of then being unable to recover its outlay from the fraudulent beneficiary even if fraud was ultimately proven at trial.

Waite LJ's decision of granting the injunction is the same as Balcombe LJ's; however, his judgment was clearly relying on the test of "balance of convenience". In this sense, his decision may also be seen as an application of the test of "balance of convenience" in fraud rule injunction cases. It is interesting that, in *Themehelp*, the same conclusion can be made by applying a different test. It is even more interesting that the test of "balance of convenience" was also considered by Ackner LJ in *United Trading Corp.*

Following to the conclusion that the plaintiff did not establish "a good arguable case that the only realistic inference is that the demands were fraudulent", Ackner LJ cited Kerr J's "insuperable difficulty theory" from *R. D. Harbottle Ltd. v. National Westminster Bank Ltd.*⁵⁹ as follows:

"The plaintiffs then still face what seems to me to be an insuperable difficulty. They are seeking to prevent the bank from paying and debiting their account. if the threatened payment is in breach of contract, which the plaintiffs' writs do not even allege and as to which they claim no declaratory relief, then the plaintiffs would have good claims for damages against the bank. In that event the injunctions would be inappropriate, because they interfere with the bank's obligations to the Egyptian banks, because they might cause greater damage to the bank than the plaintiffs could pay on

⁵⁹ *R. D. Harbottle Ltd. v. National Westminster Bank Ltd.* [1978] Q.B. 146.

their undertaking as to damages, and because the plaintiffs would then have an adequate remedy in damages. **The balance of convenience would in that event be hopelessly weighted against the plaintiffs.**"⁶⁰

Ackner LJ agreed with Kerr J's opinion that where an applicant is "seeking to prevent the bank from paying and debiting their account", "the balance of convenience would in that event be hopelessly weighted against the plaintiffs". He further explained this opinion in the current case by the following words:

"...even given the injunctions they seek, they are bound to experience difficulties in raising further sums from their own bank or from other banks to whom they would have to disclose their potential liabilities arising from the performance bonds issued on their instructions.

The grant of an injunction would not be upon the basis that they had established fraud, but only on the basis that on the available evidence it was seriously arguable that fraud had occurred. Such a finding does not indicate success in the final action, nor does the failure to obtain an interim injunction predicate failure when the case is ultimately heard."⁶¹

The above words are a clear consideration of the test of "balance of convenience". Although Ackner LJ applied the "seriously arguable fraud" as the standard of proof in applying the fraud rule, he did not consider it as the only factor for justifying the reasonability of granting the injunction. In contrast, he further expressed that the injunction may not be granted even if the plaintiff can establish a good arguable case because of the issue of

⁶⁰ Ibid, 151.

⁶¹ *United Trading* [1985] 2 Lloyd's Rep. 554, 565 to 566, supra note 9.

balance of convenience:

"Thus, even if we had concluded that the plaintiffs had established a good arguable case on the issue of liability and had decided this appeal purely on the issue of the balance of convenience, we would have found against the plaintiffs in the result."⁶²

Ackner LJ's judgment clearly shows that the test of "balance of convenience" is a crucial test for granting an interlocutory injunction. An injunction may not be granted even if the applicant can satisfy the "prima facie test" by establishing a seriously arguable case of fraud, as long as the balance of convenience is weighted against the plaintiff. This point was further proved by the decision of *Tukan Timber v. Barclays Bank Plc.*⁶³ It was held that the plaintiffs were not entitled to an injunction to restrain a bank making payments under an irrecoverable letter of credit on the ground of fraud because they could not show that a further fraudulent demand would be made notwithstanding that fraudulent demands had already been made. In this case, the plaintiff was seeking an injunction to prevent his own bank to pay under a letter of credit, and the bank had already twice rejected a demand on the ground of forgery. The courts believed there was a heavy burden of proof on the plaintiff to show that there was fraud on the part of the beneficiary, in other words, the plaintiff had proved much more than a seriously arguable case of fraud; however the injunction was rejected on the ground that the damage the bank might sustain to its reputation could not be

⁶² Ibid, 566.

⁶³ *Tukan Timber v Barclays Bank Plc.* [1987] 1 Lloyd's Rep. 171.

properly compensated by the plaintiff if the injunction should not have been granted.

Tukan Timber was a typical example of applying the "balance of convenience test" for granting an interlocutory injunction in documentary credits. At this stage, it may be concluded: "a seriously arguable case of fraud" may only be seen as a lower standard of proof in applying the fraud rule in injunction cases. Where there is an application for granting an interlocutory injunction in documentary credits transactions, which may relevant to the appliance of the fraud rule, the standard of proof in applying the fraud rule may be lowered to that of "a seriously arguable case of fraud" rather than "a clearly proved fraud". However, the applying of the fraud rule does not necessarily lead to a result of granting an interlocutory injunction. The "balance of convenience test" is still a decisive test to grant an interlocutory injunction in documentary credits cases.

Nevertheless, the application of the "balance of convenience test" in documentary credits may not be seen as a simple application of *American Cyanamid*. While *American Cyanamid* was being seen as a decision which relaxed the high test of the "prima facie case" for granting an interlocutory injunction, the application of "the balance of convenience test" in documentary credits increased the difficulty to achieve an interlocutory injunction. The plaintiff, who is seeking an injunction by alleging a fraud under documentary credits, can only win this case by satisfying both the fraud rule

and "the balance of convenience test". It does not appear that the courts would grant an injunction simply by considering the balance of convenience in documentary credit cases in which the application of the fraud rule is essential⁶⁴. In other words, although the lower standard of proof is applied in injunction cases to apply the fraud rule, the injunction can still be very difficult to achieve because both the "prima facie test" and the "balance of convenience test" have to be satisfied. But even if the courts only applied the "balance of convenience test" in considering granting an injunction in documentary credits cases, the "the balance of convenience would in that event be hopelessly weighted against the plaintiffs"⁶⁵. *Themehelp* is one of these exceptional cases. In that case, a default had occurred before the beneficiary claimed under the guarantee. And there was no authority stating the principles to be applied in this situation, where the guarantor was not involved in the proceedings at all, to restrain the beneficiary from taking any step to enforce the performance guarantee.⁶⁶ Hence, there was no risk to the integrity of the performance guarantee to grant an injunctive relief to restrict the beneficiary's rights of enforcement between the applicant and the beneficiary. Although Waite LJ granted the injunction by relying on the test of "balance of convenience", the judgment may not be seen as an indication of the courts will grant an injunction simply by considering the balance of

⁶⁴ Of course, there will be injunction applications in documentary credits cases which are pleading on other exceptions rather than the fraud rule. In this case, the applicant will be required to prove the relative issues rather than the fraud. For examples, see *Group Josi Re v. Walbrook Insurance Co. Ltd.* [1996] 1 W.L.R. 1152. Also see Chapter 4, section 5 and Chapter 5, section 4 and 5 for detailed discussion of this issue in illegality and nullity exceptions.

⁶⁵ *R. D. Harbottle*, [1978] Q.B. 146, 151, *supra* note 59.

⁶⁶ *Themehelp* [1996] QB 91-92, *supra* note 8.

convenience in ordinary documentary credits cases.

Nevertheless, there is another exceptional case, *Kvaerner John Brown Ltd v. Midland Bank plc*.⁶⁷ In this case, Cresswell J refused to discharge a pre-trial injunction restraining Midland Bank from making payment under a letter of credit on the ground of the beneficiary's manifest fraud in certifying to the bank the giving of a required notice to the plaintiff when it had not done so. Cresswell J's decision was arrived at without a consideration of the balance of convenience.⁶⁸ But Cresswell J said at the same time in this case:

"the courts would refuse to grant an injunction to restrain a bank from paying in the case of a first demand bond or standby credit, save where there was clear and obvious fraud of which the bank had."⁶⁹

The thesis wonders whether this case could be seen simply as being contradictory to the application the "balance of convenience test"?

First, the courts believed that there was clear and obvious fraud to the bank's knowledge, and accordingly there would be a breach of obligation to the applicant for the bank to pay the fraudulent beneficiary. Secondly, there will be no appreciable risk that the claim of fraud cannot be wholly satisfied since it has already been satisfied. Thus there will be no possibility for the bank to claim any damage from the applicant as the result of having to delay payment; in contradiction, it may cause many more trials since the applicant will

⁶⁷ *Kvaerner John Brown Ltd v. Midland Bank plc* [1998] C.L.C. 446.

⁶⁸ *Czarnikow-Rionda*, [1999] 2 Lloyd's Rep. 187, 190, *supra* note 20.

⁶⁹ *Kvaerner John Brown*, [1998] C.L.C. 446, *supra* note 67.

certainly reject reimbursement to the bank by relying on the fraud rule if the injunction is discharged. Last but not the least, the thesis wondered whether this case could be justified as one of exceptional cases in which the interlocutory injunction will be the final stages.⁷⁰

If the above analysis is correct, *Kvaerner John* then may be seen as an exceptional case which deviated from *American Cyanamid* with reasons. In fact, *Kvaerner John* was also an unusual case because the applicant had a clear cause of action to achieve an injunction against the bank. Ordinarily, the cause of action is a stumbling block in the way of the applicant to seek an interlocutory injunction to prevent a bank from paying or debiting their account.

2.2.3. A cause of action

According to "the Siskina principle"⁷¹, the plaintiff has to have a cause of action against the defendant to ask an injunction against it. This rule has also been applied widely in injunctions in documentary credits while considering the application of the fraud rule.

In *United Trading*, Ackner LJ believed that an injunction could only be granted in aid of a cause of action against the enjoined party. He, subsequently,

⁷⁰ Lord Diplock himself, in the case of *N.W.L. Ltd v Woods*, supra note 51, admits that there are exceptional cases in which the interlocutory injunction will be the final stages. See section 2.1 of this chapter.

⁷¹ See *Siskina*, The (HL) [1978] 1 Lloyd's Rep. 1, 6, supra note 47. Lord Diplock said: "The right to obtain an interlocutory injunction is merely ancillary and incidental to the pre-existing cause of action . . ."

analysed three potential causes of action for the plaintiff before the discussion of other essential issues, such like the "prima facie test" and "balance of convenience test".⁷² The cause of action was also pointed out by Kerr J in the case of *R. D. Harbottle Ltd. v. National Westminster Bank Ltd.*⁷³ as one of the crucial issues in considering to grant interlocutory injunctions against the bank:

"They [the plaintiffs] are seeking to prevent the bank from paying and debiting their account. It must then follow that if the bank pays and debits the plaintiffs' account, it is either entitled to do so or not to do so. To do so would either be in accordance with the bank's contract with the plaintiffs or a breach of it. If it is in accordance with the contract, then the plaintiffs have no cause of action against the bank and, as it seems to me, no possible basis for an injunction against it."⁷⁴

It is clear that there are no exceptions in applying "the Siskina principle" in documentary credits while considering granting an interlocutory injunction by relying on the fraud rule. For instance, where an applicant is asking for an injunction to prevent the bank from payment, it has to prove its own cause of action. In another word, the applicant has to prove the bank is in breach of his mandate to the applicant as paying against the document or demanding. Otherwise, it is not entitled to the injunction. This is also one of the reasons

⁷² *United Trading Corporation*, [1985] 2 Lloyd's Rep. 554, 560, supra note 9. The cause of action was approved by the courts as the bank is threatening to commit a breach of a duty owed to the plaintiff in tort. This decision was based on *Anns v. Merton London Borough Council* [1978] A.C. 728. But it is doubtful whether such an argument would be accepted today since the further developments in the law of negligence. Also see *Czarnikow-Rionda* [1999] 2 Lloyd's Rep. 187, 199, supra note 20.

⁷³ *R. D. Harbottle*, [1978] Q.B. 146, supra note 59.

⁷⁴ *Ibid*, 155.

why, in *Czarnikow-Rionda Sugar Trading Inc. v. Standard Bank London Ltd*,⁷⁵ an injunction of restraining a bank from giving instructions for payment under three letters of credit was discharged by Rix J. In fact, *Rionda* is also the most important case in considering the reasonability of applying a lower standard to apply the fraud rule in both injunctions and summary judgments cases.

Previous to an intensive study to the new approaches in applying the fraud, it is essential to make a conclusion to the rules for granting an interlocutory injunction in documentary credits relevant to the fraud rule.

The above analysis shows: the general rules for granting interlocutory injunctions are basically applied in the fraud rule cases. Nevertheless:

The "**Siskina principle**" is applied equally in the fraud rule cases for granting an interlocutory injunction. The plaintiffs are unable to obtain an interlocutory injunction unless they can prove there is a clear cause of action against the defendants. In other words, the plaintiff has to prove that the defendant would be in breach of mandate to the applicant if the injunction is not granted.

The "**balance of convenience test**" is also applied similarly in the fraud rule cases. The courts are always considering the balance of convenience for granting an interlocutory injunction by applying the fraud rule in documentary credits. To obtain an interlocutory injunction by relying on the fraud rule, the plaintiff first has to prove there is an arguable case of fraud by the beneficiary.

⁷⁵ *Czarnikow-Rionda* [1999] 2 Lloyd's Rep. 187, supra note 20.

And once a plaintiff could satisfy the requirement, the court has to examine whether, if the plaintiff were to succeed in the end, he or she would be compensated by adequate damages. The "balance of convenience test" is a central issue for granting an injunction in the fraud rule cases as which in normal injunction cases. However, the "balance of convenience test" may not reduce difficulties for the applicant to achieve an interlocutory injunction in the fraud rule cases as it does in normal injunction cases. Because even the "balance of convenience test" was passed, the plaintiff is still required to satisfy the "prima facie test".

The "**prima facie test**" is applied, in addition to the "balance of convenience test", in the fraud rule cases. Although there are arguments against abandoning the "prima facie test", it is not the general rule for the courts to consider the strength of the cases in injunction cases in English law since *American Cyanamid*. Therefore, the application of the "prima facie test" in the fraud rule cases may be exceptional. Actually, this application is reasoning from the high standard of proof for applying the fraud rule in normal documentary credits cases. The standard proof to apply the fraud rule has been lowered from "a clearly proved fraud" to "a seriously arguable case of fraud" in injunction cases.

After all the standard of proof to obtain an interlocutory injunction in the fraud rule case is much higher than which in ordinary injunction cases. This is proved more clearly by the following study.

3. An Intensive Study to the Application of the Fraud Rule at the Pre-trial Stage in Documentary Credits

The previous research in this chapter suggests that a lower standard of proof regarding the demonstration of fraud may be applied in injunction or summary judgment cases in considering the application of the fraud rule. The case law specified several situations of the application as follows:

First of all, in applying for an interlocutory injunction at the pre-trial stage to restrain the beneficiary from demanding payment, the applicant is required to prove a seriously arguable case of fraud rather a clearly proved fraud on the part of the beneficiary to apply the fraud rule in documentary credits. This application was established in *Themehelp*, and based on reasoning from the non-involvement of the bank or guarantor at the early stage.

Secondly, a bank may not be forced to pay the beneficiary by a summary judgment as long as it has a claim with a real prospect that there was a misrepresentation by the beneficiary when directing or persuading the bank to enter to the letter of credit. This exception was established in *Safa*, and then confirmed in *Solo*. The court believes that a bank is allowed to avoid a bond by relying on the invalidity of the bond.

Thirdly, a bank may not be forced to pay by a summary judgment if it can establish a claim with a real prospect of success that the demand

was fraudulent even if it had no clear evidence of fraud at the time of demand. This application is established in *Safa* case and based on reasoning from the bank's own "*ex turpi causa*" defence against the fraudulent beneficiary. This exception includes the situation of the bank was involving in the underlying contract. However, the thesis argues that a bank's underlying transaction claims should not be accounted in considering the application of the fraud rule.⁷⁶

3.1. "The trial test" and "the pre-trial test"

It is interesting that all the three exceptions in applying the lower standard of proof were at the pre-trial stage for either an injunction or a summary judgment. In this sense, Rix J's following words in the case of *Rionda*⁷⁷ may be very important:

"This case [*United Trading*] is also the locus classicus for the elucidation of the standard of proof required to make good a case of fraud, both at trial and at the stage of requesting a pre-trial injunction (at p. 561)."⁷⁸

At trial the test is this:

If the Court considers that on the material before it the only realistic inference to draw is that of fraud, then the seller would have made out a sufficient case of fraud.

At the pre-trial stage the test therefore becomes: Have the plaintiffs established that it is seriously arguable that, on the material available, the only

⁷⁶ For detailed discussion, see section 1.4 of this chapter.

⁷⁷ *Czarnikow-Rionda* [1999] 2 Lloyd's Rep. 187, supra note 20.

⁷⁸ *United Trading Corporation*, [1985] 2 Lloyd's Rep. 554, 561, supra note 9.

realistic inference is that [the beneficiary] could not honestly have believed in the validity of its demands on the performance bonds?"⁷⁹

Rix J classified the standard of proof in applying the fraud rule into two catalogues by the timing. Of course the "prima facie case test" may not be restricted to the validity of its demands on the performance bonds. When the issue of standard of proof comes to the court at the trial, the court would consider the test as whether there was a clear case of fraud. However, when the same issue comes to the court at the pre-trial stage, the test might be amended as whether there was a seriously arguable case of fraud. The former is the traditional test for the standard of proof while applying the fraud rule in English law; the latter is an exceptional test for the same issue at the pre-trial stage.

According to this classification, the new approaches in applying the fraud rule in documentary credits may be summarised into one sentence: At the pre-trial stage, it has to be proved that there was a seriously arguable case of fraud on the part of the beneficiary in applying the fraud rule in documentary credits. Of course the general rule for granting an interlocutory injunction or a summary judgment should be considered separately in each case.

3.2. Banks' knowledge of the fraud

⁷⁹ *Czarnikow-Rionda*, at 200, *supra* note 20.

The issue of the banks' knowledge was always a controversial issue in applying the fraud rule. English court is always considering banks' knowledge as a crucial requirement in applying the fraud rule in documentary credits. In *R. D. Harbottle*⁸⁰, Kerr J said, the courts will leave the merchants to settle their disputes under the contracts by litigation or arbitration **unless the banks have noticed clear cases of fraud**;⁸¹ In *Edward Owen*⁸², the Court of Appeal also recognized the fraud exception as that "the bank ought not to pay under the credit **if it knows that** the documents are forged or that the request for payment is made fraudulently in circumstances where there is no right to payment"⁸³; In *Gian Singh*⁸⁴, the bank was held not liable to pay against a forgery documents even the forgery was proved during the trial, because **the bank had no knowledge of fraud** at the time of payment.

Therefore, it seems that the new approach of not considering the knowledge of the bank at the time of demanding as an essential issue is totally contrary to the ordinary approach of applying the fraud rule. Banks' knowledge of fraud was not discussed specifically either in *Themehelp* or in *Solo*. But things are not that simple.

In the case of *Czarnikow-Rionda Sugar Trading Inc. v. Standard Bank London Ltd.*⁸⁵, which was decided a year earlier than *Safa*, an injunction

⁸⁰ *R. D. Harbottle*, [1978] Q.B. 146, supra note 59.

⁸¹ *Ibid*, 155 to 156.

⁸² *Edward Owen Engineering Ltd. v. Barclays Bank International Ltd.*, [1978] 1 Lloyd's Rep. 166.

⁸³ *Ibid*, 171.

⁸⁴ *Gian Singh & Co. Ltd. v. Banque de l'Indochine* [1974] 2 Lloyd's Rep. 1.

⁸⁵ *Czarnikow-Rionda* [1999] 2 Lloyd's Rep. 187, supra note 20.

against a bank to pay was discharged, and one of the reasons was the lack of notice of the bank on the time of demand. In a more recent case, *Banque Saudi Fransi v. Lear Siegler Services Inc*⁸⁶, the courts also held that a bank's notice of the fraud is a consistent requirement imposed by the courts to apply the fraud rule. Both of the two cases did not follow the view of the new approach that the knowledge of the bank on the time of demand was not necessary. To understand this confused situation, it is important to research more deeply *Czarnikow-Rionda Sugar Trading Inc. v. Standard Bank London Ltd*.⁸⁷

In *Rionda*⁸⁸, the plaintiffs (Rionda) sought to maintain a pre-trial injunction against the first defendant (Standard) to prevent it from paying out to two Swiss banks, United European Bank (UEB) which confirmed two of the letters of credit, and Banque Cantonale de Geneva (BCGe) which confirmed the third, at maturity the proceeds of the three letters of credit which Standard had opened at the request of its customer Rionda. The application of the injunction was based on the fraud exception. Rionda claimed that the beneficiary of the credit (Dine Group) was fraudulent.

Rionda is an important case on the new approaches in applying the fraud rule. The judgment was against the plaintiffs, and the injunction restraining Standard from giving instructions payment out under the three letters of credit

⁸⁶ *Banque Saudi Fransi v Lear Siegler Services* [2006] 1 Lloyd's Rep 273. (QB); [2007] 2 Lloyd's Rep. 47 (CA).

⁸⁷ [1999] 2 Lloyd's Rep. 187.

⁸⁸ *Ibid.*

was discharged. But Rix J considered the "prima facie test", the "balance and convenience" and the cause of action during the judgment, which made *Rionda* being a clear example of the application of the general injunction rule in the fraud rule cases. More importantly, Rix J analysed "the knowledge of the bank"⁸⁹ particularly during the discussion of the cause of action, and said:

"...at any rate the possibility of an injunction, however exceptional, is contemplated where it is proved that the bank knows that a demand for payment is fraudulent"⁹⁰

"The interest in the integrity of banking contracts under which banks made themselves liable on their letters of credit or their guarantees is so great that not even fraud can be allowed to intervene unless the fraud comes to the notice of the bank."⁹¹

"The formulation of the fraud exception, to the extent that it requires the timely knowledge of the bank and not merely that of the beneficiary (who, ex hypothesis knows of his own fraud), emphasizes the distinctiveness of this rule."⁹²

He believed the fraud rule exception is limited under one condition, which is the bank's knowledge or notice of the fraudulent demand. He even made a fresh explanation to the doctrine of "fraud unravels all" by the following words:

"It would be less pithy but more accurate to fill out the dictum by saying that fraud unravels the bank's obligation to act on the appearance of documents to be in accordance with a credit's requirements provided that the bank knows in time

⁸⁹ Ibid, 199.

⁹⁰ Ibid.

⁹¹ Ibid, 202.

⁹² Ibid.

of the beneficiary's fraud."⁹³

Rix J expressed the essential requirement of the banks' knowledge in applying the fraud rule. However, the conclusion was made on the basis of the fact of the current case. In *Rionda*, the applicant was seeking to maintain a pre-trial injunction against a bank to prevent it from payment. According to "the Siskina principle", the applicant has to prove a cause of action against the bank, which means it has to prove that the bank would be in breach of mandate to make the payment. In a case relevant to the application of the fraud exception, the applicant then has to prove that the bank is in breach of mandate to pay a fraudulent beneficiary. In accordance with the fraud rule, the bank is not in breach of mandate by paying a fraudulent beneficiary unless the fraud comes to the notice of the bank. Consequently, the applicant may not have a cause of action against the bank to prevent the bank to pay unless the bank's knowledge of fraud is proved.

Rix J did not try to extend the requirement of the bank's knowledge to all the fraud exception cases. In the judgment, he accepted *Themehelp v. West* as "either a genuine distinction, based on the fact that the claim against the beneficiary alone was brought at an early stage, well before the question of enforcement of the guarantee arose; or the decision must be regarded as undermined by the concession there that a claim against a beneficiary, as distinct from a claim against a bank, was not covered by prior authority"⁹⁴.

⁹³ Ibid, 199.

⁹⁴ Ibid, 202.

Consequently, it was reasonable in *Themehelp*⁹⁵ not to consider the banks' knowledge of fraud as a condition in granting the injunction against the beneficiary between the applicant and the beneficiary. Rix J also suggested in the judgment:

"If the source of the power to injunct were purely the law's interest in preventing the beneficiary from benefiting from his own fraud, I do not see why there should be the added requirement that the fraud be patent to the bank."⁹⁶

Rix J's suggestion seems particularly apposite to the case where a beneficiary is asking for a summary judgment to force the bank to pay. In this circumstance, in applying the fraud rule, the bank is only required to establish a claim with a real prospect of success that, by rejecting the payment, it is "preventing the beneficiary from benefiting from his own fraud". Therefore, there should be no "added requirement that the fraud be patent to the bank".

After an analysis of *Rionda*, it may be concluded that the banks' knowledge of fraud is very important in applying the fraud rule in documentary credits. According to the fraud rule, fraud unravels the bank's payment obligation to pay against the complying documents; but fraud only unravels the applicant's obligation to reimburse the bank who paid against facially complying documents provided that the bank knows the beneficiary's fraud before or at the time of payment. The courts may not grant an injunction at a pre-trial

⁹⁵ The banks' knowledge was not mentioned during the judgment in *Themehelp*, the injunction was granted to restrain the demanding without proof of fraud as between the defendant and the banks. See section 1.2 of this chapter.

⁹⁶ *Ibid.*

stage to prevent the bank from payment as long as the bank does not notice the fraud; but the courts may not grant a summary judgment, either, to force a bank to pay against a fraudulent beneficiary on a pre-trial stage simply because the bank has no knowledge of the fraud.

Summary:

The new approaches of applying the fraud rule appeared in the 1990s may also be seen as exceptions within the context of the fraud exception. Despite the difference of the causes of action and involved parties among those exceptions, all of them were applied under a certain stage by English courts, the pre-trial stage. And the exceptional issues of those exceptions were also similar: An application of a lower standard of proof while applying the fraud rule. It has to be mentioned here, the lower standard of proof, which is a seriously arguable case of fraud on the part of beneficiary, is only the standard of proof in applying the fraud rule at the pre-trial stage. The general rule for granting an interlocutory injunction or a summary judgment has to be considered separately in each case as well. The analysis to the application of the general injunctions rules in fraud documentary credits cases shows that the standard of proof to obtain an interlocutory injunction in the fraud rule cases is much higher than which in ordinary injunction cases. The importance of banks' knowledge of fraud for applying the fraud rule, in different cases, may vary in accordance with the different contractual relationships among parties under the credit.

In *Safa* and *Solo*, the courts believe that a bank is allowed to avoid a bond by relying on the invalidity of the bond. In both cases, the possible invalidity was

caused by a beneficiary's misrepresentation in directing or persuading the bank to enter into the letter of credit, which was a fraud issue. However, invalidity is not necessarily caused by a fraud, it may cause by some other issues, such like illegality. The illegality exception in documentary credits is the key content of the next chapter.

Chapter Four: The Illegality Exception in Documentary Credits

Preface:

The autonomy principle, which is a cornerstone of documentary credits, counteracted the development of the fraud rule both in American and English law since the birth of the fraud rule. Traditionally, in English law, the standard of proof in applying the fraud rule is extremely strict. First, the fraud has to be clearly established, a mere allegation of fraud arguing nothing for an application of the fraud rule; secondly, the fraud has to be on the part of the beneficiary, the beneficiary has to be involved in the fraud and a third party fraud was rejected as one of the fraud in applying the fraud rule in the famous case of *United City Merchants*¹; Lastly, it is likely that the fraudulent facts have to be known to banks at the time of payment.² These three high standards made the application of the fraud rule very difficult, even more difficult than the material standard in the United States, although the material

¹ *United City Merchants v. Royal Bank of Canada (The American Accord)* [1983] A.C. 168 (HL); [1982] Q.B. 208(CA).

² This principle was established in the case of *Gian Singh & Co. Ltd. v. Banque de L'Indochine* [1974] 2 Lloyd's Rep. 1, 11 per Lord Diplock, where the action was between the applicant and the bank, and the judgment was for the paying bank because the bank was unaware of the forgery although the forgery was proved by the plaintiff. See Chapter 2, section 5.2.2. However, this principle may vary while the cause of action changed. This point will be discussed later in this chapter, section 5.3.1.

standard is not so effective itself in the United States³.

Because of the importance of the existence of the fraud rule, English courts have been aware of the inefficacy of it and made some efforts recently to improve the efficacy of the fraud rule. From the 1990s, many new approaches toward applying the fraud rule appeared in English law. Generally, those approaches applied a lower stand of proof, a strong arguable case of fraud instead of clearly established fraud, under certain conditions. The lower evidential standard can be strongly justified in terms of its reasonableness⁴. Other issues such as the necessity of the knowledge of the bank were not in a firm position either. Chapter four will continue researching in the reasonableness of those new approaches, and the study will start with the illegality exception in documentary credits.

³ See Chapter 2, section 3 and 4.

⁴ Generally see Chapter 3 of the thesis.

1. The Background of Other Exceptions

Although the fraud rule has been established for over half a century since the case *Sztejn v. J. Henry Schroder Banking Corporation*⁵, the standard of proof is still unclear in English law. The conflicts between new approaches and the one which was determined in the case of *United City Merchants (Investments) Ltd. v. Royal Bank of Canada*⁶ cause lots of arguments, which had already been discussed in the earlier part of the thesis⁷. However, problems are not easy to be solved, and the contradiction is mainly between the exception itself and the famous autonomy principle in documentary credits. Therefore, other possible exceptions, the illegality exception and the nullity exception⁸, arose from recent cases and may be worth analysing for a better understanding of the fraud rule.

Both of the two possible exceptions are contradictory to the autonomy principle, just as is the fraud rule; however, attitudes of whether they should be accepted as an independent exception are not the same in English law. While the nullity exception was largely rejected in the case of *Montrod Ltd. Grundkötter Fleischvertriebs GmbH*, the illegality exception was admitted in *Mahonia Ltd v. JP Morgan Chase Bank*⁹ by Colman J. The application of the

⁵ *Sztejn v. J Henry Schroder Banking Corp* (1941) 31 NYS 2d 631.

⁶ *United City Merchants*, supra note 1.

⁷ See Chapter 2, section 5.2.3 of the thesis.

⁸ The nullity exception will be discussed in the next chapter, Chapter 5.

⁹ *Montrod Ltd v. Grundkötter Fleischvertriebs GmbH* [2001] EWCA Civ 1954, [2002] 1 W.L.R. 1975.

¹⁰ *Mahonia Ltd v. JP Morgan Chase Bank* (No.1) [2003] EWHC 1927 (Comm); [2003] 2

illegality exception in English law may be a good starting point.

2. The Nature of Illegality

2.1. Definition

To discuss the illegality exception, the first point which should be analysed is the illegality itself. Illegal conduct means conduct which does not conform to the law, or is even prohibited by the law. Professor Nelson Enonchong wrote in his book "Illegal Transactions" that "A transaction is illegal or at least affected by illegality if the transaction or some aspect of it is prohibited by law."¹¹ An illegal transaction may either involve the commission of a legal wrong (criminal or civil) or conduct which is illegal as contrary to public policy although it may not be prohibited by the law. Consequently, illegal transactions, which may cause illegality, should be classified into two categories. The first type of illegality may be caused by illegal transactions which are prohibited by legislation; the other illegality may not be literally prohibited by law but contrary to public policy. However, in practice the establishment of an illegality transaction is not as easy as the literal definition.

For illegality which is caused by a statutory prohibition, the court will have to

Lloyd's Rep 911 and (No.2) [2004] EWHC 1938 (Comm).

¹¹ Professor Nelson Enonchong, "Illegality Transactions" (Lloyd's of London Press, 1998), p. 2.

consider the intention of the Act to decide the effect of illegality. Statutory illegality was explained in the American case of *Yango Pastoral Co. Pty. Ltd v. First Chicago Australia Ltd*¹² as follows:

"Generally a transaction will be illegal as being in contravention of a statute if (a) the transaction is to do something which the statute forbids, or (b) the transaction itself is one which the statute forbids, or (c) the transaction, although lawful in itself, is made for a purpose which in the statute is unlawful, or (d) the transaction, although lawful in itself, is intended to be performed in a manner which the statute prohibits."

The statutory illegal transactions may thus be classified into two types: one is the transaction of which the making is prohibited by the statute law; the other is the transaction of which the purpose is prohibited by the statute law. It needs to be mentioned here that the statutory illegal transaction may not be restricted to what was expressly prohibited by the statute; a transaction involving conduct in breach of the terms of a statute may be illegal even though it is not expressly prohibited by the statute, as long as it is impliedly prohibited by the statute.¹³ This means the intention of the statute is still the fundamental criterion to decide whether there is a statutory illegality. Although, similar to the intention of fraud in the fraud rule, the intention of the legislation is to prohibit a conduct when there is no express provision.

The other category of illegality consists of transactions contrary to public

¹² *Yango Pastoral Co. Pty. Ltd v. First Chicago Australia Ltd* (1978) 139 C.L.R. 410, 413, per Gibbs A.C.J.

¹³ In the case of *Cf. Johnson v. Moreton* [1980] A.C. 36, 37, Lord Simon of Glaisdale concluded that for a transaction which is impliedly prohibited by statute is just as illegal as one which is expressly prohibited.

policy. In the case of the public policy illegality, the definition and cognizance of public policy would be the essential issue. In the case of *Gray v. Barr*¹⁴, it was stated that public policy "is a method which the courts use where there is conduct which the public disavow"¹⁵. Public policy has many characteristics, such as its flexibility and regionality. Those characteristics make the reorganization of public policy very difficult. To make a decision on whether conduct is contrary to public policy, the judge has to weigh competing interests or policies; he is not interpreting the law but also making the law in some sense. Therefore, the subjective view could affect the decision as well.¹⁶ To minimize the weight of any subjective views of the judge, English courts put a quite heavy border on the cognizance of which conduct is contrary to public policy. The House of Lords has insisted that a court will hold that a transaction is illegal as contrary to public policy only where "the harm to the public is substantially incontestable".¹⁷ It is even said that the courts should not declare a contract contrary to public policy unless "the contract is incontestable and on any view inimical to the public interest".¹⁸ In any event, the harm must be substantial enough to outweigh the public interest objective expressed in the specific rule of law which otherwise would have governed

¹⁴ *Gray v. Barr* [1971] 2 Q.B. 554.

¹⁵ *Ibid*, 561.

¹⁶ Of course, all the cases in common law follows a similar idea that the subjective view of different judges affect the judgment in different cases, not only in the public policy cases.

¹⁷ *Fender v. St. John Mildmay* [1938] A.C. 1, 12, per Lord Atkin. As Donaldson LJ put it in *Cheall v. A.P.E.X* [1983] 1 Q.B. 126, 147,, before a court declares a contract or a provision in it to be contrary to public policy the court must be "satisfied that any reasonable person would agree" that the enforcement of the contract or provision would be harmful thing.

¹⁸ *Monkland v. Jack Barclay* [1951] 2 K.B. 252, 265, per Asquith LJ For public policy to be invoked there must be "a discernible public interest" to protect: *J v. S-T (Formerly J) (Transsexual)* [1997] 1 F.L.R. 402, 437, per Ward LJ.

the matter.

Interestingly, the harshness of the assessment of acts contrary to the public policy is so similar to the application of the fraud rule in documentary credits. This may be explained in that the fraud rule was rooted from public policy to some extent. There is no necessity to analyse too much the issue of the cognizance of the illegality, or what especially in contrary to public policy. However, it may be worth discussing the effects of an illegal transaction in English law, since it may be a fundamental principle to apply an illegality exception. More importantly, the effects of an illegal transaction to different parties, especially for the innocent party, may bring some inspiration for applying the illegality exception; and furthermore, for the application of the fraud rule. The discussion is based on Law Commission paper LC 320, CP 189 and CP 154¹⁹. Although CP 189 and CP 154 are only consultation papers, and hence do not state the law, they show an aspiration of the approaches of the law in area of the illegality. This thesis considers the central idea that the

¹⁹ LC 320 is the final report published by the Law Commission to conclude a long-running review of the illegality defence, which has considered how the defence applies to the law of contract, unjust enrichment, tort and trusts. The final report followed most of the recommendations in the 2009 consultative report CP 189. CP 189 is the most recent consultation paper published by the Law Commission to discuss "the illegality defence". The effect of illegality was discussed as one of the main issues in illegality in CP 189. However, the analysis of this issue in CP 189 was highly depending on the old paper of CP 154, which was published in 1999 and entitled "Illegal transactions: the effect of illegality on contracts and trusts". The central proposal put forward in CP 154 was that, in general, a court dealing with a transaction tainted by illegality should have discretion whether to enforce it. The discretion would be "structured" by setting out the factors that the court should take into account (such as the seriousness of the illegal purpose, whether refusing to enforce the transaction would tend to deter illegality of that kind, and so on). This thesis organized the research of the effect of illegality on the basis of CP 154 ,2.3 to 2.31 <http://www.lawcom.gov.uk/docs/cp154.pdf>; the relevant sections in CP 189 are 3.3 to 3.49 <http://www.lawcom.gov.uk/docs/cp189.pdf>; the relevant sections in LC320 are 3.1 to 3.47 <http://www.lawcom.gov.uk/docs/lc320.pdf>.

discretion of judges in different illegality cases is quite reasonable.²⁰

2.2. Effects of an illegal transaction in English law

One of the essential issues relating to the effect of illegality is whether illegality renders a contract void or merely unenforceable. There is in the authorities "some inconsistency in determining whether [illegal contracts] are void, voidable or unenforceable".²¹ The uncertain situation led some judges to attempt to say that illegality renders an agreement both "void and unenforceable".²² However, there is a very important difference between a contract which is void and one which is only unenforceable. A contract which is void is one which gives rise to no rights and duties, which means the contract is null. But a contract which is merely unenforceable may still have a legal formation. Some rights, like property rights, may be legally enforceable. In English law, unlike some other systems of law, an illegal contract can be effective to transfer property rights. Most of the cases proceed on the footing that an illegal agreement is only "unenforceable".²³ Thus, it may be safe to say that under English law an illegal contract is in general unenforceable, not

²⁰ Most of the responses to CP 154 supported the proposal that the court should be given discretion whether to enforce a contract tainted by illegality. However, a minority of respondents raised concerns to some ideas in CP 154.

²¹ *Aratra Potato Co. v. Taylor Johnson Garrett* [1995] 4 All E.R. 695, 708. See N Enonchong, "Effects of Illegality: A Comparative Study in French and English Law" (1995) 44 ICLQ 196, 198-199.

²² *Haseldine v. Hosken* [1933] 1 K.B. 822, 836.

²³ *Cleaver v. Mutual Reserve Fund Life Association* [1892] 1 Q.B. 147, 152; *Bennett v. Bennett* [1952] 1 K.B. 260; *Aratra Potato v. Taylor J. Garrett* [1995] 4 All E.R. 695.

void. When a contract is unenforceable, the contract does come into existence, but the courts will refuse to assist in its enforcement.²⁴

2.2.1. The reliance principle

Actually, contracts involved fraud or illegality are both unenforceable according to the principle of "*ex turpi causa*". The policy of "*ex turpi causa*" was first explained by Lord Mansfield in 1775 in *Holman v. Johnson*²⁵ as "No court will lend its aid to a man who founds his cause of action upon an immoral or an illegal act." And this principle was further explained by the House of Lord in the case of *Tinsley v. Milligan*²⁶ by the following words:

"In my judgment the time has come to decide clearly that the rule is the same whether a plaintiff founds himself on a legal or equitable title: he is entitled to recover if he is not forced to plead or rely on the illegality, even if it emerges that the title on which he relied was acquired in the course of carrying through an illegal transaction."²⁷

The above words have since been applied as the "**reliance principle**". Under this principle, the claimant is able to enforce his or her equitable interest notwithstanding any illegality in the arrangement, provided that the claimant does not need to plead or lead evidence of the illegality to prove the interest.²⁸ Although the Law Commission explained that "outside the context of proprietary claims, the reliance principle is by no means the universal rule

²⁴ *In re Mahmoud and Ispahani* [1921] 2 K.B. 716; *Marles v. Philip Trant & Sons* [1954] 1 Q.B. 29, 38.

²⁵ *Holman v. Johnson* (1775) 1 Cowp 341.

²⁶ *Tinsley v. Milligan* [1994] 1 AC 340.

²⁷ *Ibid.*, 376.

²⁸ See LC 320, section 2.2, *supra* note 19.

that is used to determine whether illegality should have any effect on the civil claim",²⁹ it seems that the "reliance principle" has been broadened by the case law all the time.³⁰

In the recent case of *Stone & Rolls Ltd v. Moore Stephens*³¹, Lord Phillips rejected "the idea that 'the reliance principle' should operate in a mechanical fashion"³² said:

"I do not believe that it is right to proceed on the basis that the reliance test can automatically be applied as a rule of thumb. It is necessary to give consideration to the policy underlying the *ex turpi causa* in order to decide whether this defence is bound to defeat [Stone & Rolls'] claim."³³

He further subdivided "*ex turpi causa*" into two principles in relation to contractual obligations as follows:

"(i) The court will not enforce a contract which is expressly or impliedly forbidden by statute or that is entered into with the intention of committing an illegal act. (ii) The court will not assist a claimant to recover a benefit from his own wrongdoing."³⁴

Those two principles also represent the two types of act which may not be enforced by the courts: illegality and fraud. The court will not assist a claimant to recover benefit from his own fraud, which means the claimant will not be able to enforce a contract by relying on his own fraud. This is a simple

²⁹ See LC 320, section 3.2, *supra* note 19.

³⁰ For example, *Cross v. Kirkby* [2000] All ER (D) 212, *Hewison v. Meridian Shipping Services PTE Ltd* [2003] ICR 766.

³¹ *Stone & Rolls Ltd v. Moore Stephens* [2009] 1 A.C. 1391.

³² See LC 320, section 3.28, *supra* note 19.

³³ *Stone & Rolls* [2009] 1 A.C. 1391, 1453, *supra* note 31.

³⁴ *Ibid*, 1452.

application of "the reliance principle" in fraud. However, Lord Phillips it seems, did not restrict the explanation of the principle as to illegality to the reliance test. On one hand the courts will never entertain a claim if the claimant has to rely on his own illegality to establish the claim;³⁵ on the other hand, the court will also refuse to lend its aid to enforce an illegal contract even where the claimant is not pleading on the illegality³⁶. The later explanation may also be a better rationale for the application the illegality exception in documentary credits.³⁷ It may not be conclusive to say that English courts have applied a flexible approach to the illegality defence; however, Lord Phillips' opinion to the application of the reliance principle is not isolated in English law.

Lord Hoffmann also represented a similar view in another recent case of *Gray v. Thames Trains Ltd*³⁸:

"The maxim *ex turpi causa* expresses not so much a principle as a policy. Furthermore, that policy is not based upon a single justification but on a group of reasons, which vary in different situations."

Those recent cases at least showed an approach that English courts started to relax the strict application of the reliance test to the defence of illegality. As what was stated in LC 320:

"It is difficult to anticipate what precedent, if any, *Stone & Rolls* will set regarding the illegality defence. Though there was a majority verdict, there was no majority reasoning, with all their Lordships

³⁵ Ibid, 1453.

³⁶ See *United City Merchants*, supra note 1.

³⁷ Further discussion, see section 3.2 of this chapter.

³⁸ *Gray v. Thames Trains Ltd* [2009] 1 AC 1339, 1370.

reaching different conclusions on how the defence should be applied. However there was no general endorsement of the view that the illegality defence should always be applied so as to defeat a claim founded on an illegal act we are encouraged by the references made by their Lordships to the importance of considering the policies that underlie the application of the illegality defence."³⁹

2.2.2. The position of the innocent party and the seriousness of illegality

The possible flexible approach in applying the "reliance principle" to illegality also causes arguments in the position of the innocent parties in illegal contracts. It is clear that the defence of fraud is based on the fraudulent intention of the party. In other words, the innocent party who has no intention to commit a fraud may still be able to obtain assistance from the court to enforce a contract involving fraud.⁴⁰ But it is unclear whether an innocent party who has no knowledge of the illegality should be able to enforce an illegal contract. The analysis of this question was divided into two categories by CP 189⁴¹: cases where the illegality was caused by the statutory law and cases where the illegality was caused by common law.

³⁹ See LC 320, section 3.32, *supra* note 19.

⁴⁰ Before *United City Merchants*, it was not clear whether the fraud of anyone apart from the beneficiary would be sufficient for applying the fraud rule. Lord Diplock restricted the application of the fraud rule to the beneficiary's fraud during the House of Lord in *UCM*. See Chapter 2, section 5.2.3.2.

⁴¹ In Law Commission 189, 3.2, page 18, it was stated that: "We consider, first, cases in which illegality may act as a defence to a claim for contractual enforcement because of the provisions of a statute or other legislation. These are frequently referred to as cases of 'statutory illegality'. Next we consider cases where the claim may be unenforceable because of the doctrine of illegality at common law. Also in CP 154 page 12: "It is difficult to extract the various principles applied by the courts and some of the decisions are hard to reconcile. The case law draws a distinction between contracts which are rendered unenforceable by statute (that is where the statute expressly or impliedly provides that a contract which involves the breach of one of its provisions should be unenforceable by either or both parties) and those which are rendered unenforceable by common law."

On one hand, for cases in which the illegality was caused by the statutes, either by expressed provisions or implied provisions, CP 189 suggested that "A statute (or other legislation) may expressly provide what should be the consequences for a contract that involves the contravention of one of its provisions. However, in many other cases the legislation is silent on the point. Then it will be necessary for the court to interpret the relevant provisions in the ordinary way to determine whether the legislation impliedly renders the contract unenforceable by either or both parties."⁴² Therefore, it is always an unclear issue "whether a contract that is impliedly prohibited by statute is always unenforceable by both parties, or whether there are circumstances in which only one party will be affected."⁴³ In many cases, the affected contract was assumed to be unenforceable by both parties, even by the innocent party.⁴⁴ However, there were other cases which suggested that in certain circumstances only the guilty party's contractual claim will be affected by the illegality and the innocent party may be left to his or her usual contractual remedies.⁴⁵ CP 189 did not make a clear approach on this issue; it only suggested that "It might, therefore, be better if, instead of deciding whether the contract is 'illegal', the court were to ask whether the statute renders the claim being made by the particular claimant unenforceable"⁴⁶.

⁴² The Law Commission CP 189, 3.3, p. 18, *supra* note 19.

⁴³ *Ibid.*, 3.8, p. 20.

⁴⁴ *Ibid.* Also see *Phoenix General Insurance Co of Greece SA v. Halvanon Insurance Co Ltd* [1988] QB 216, 268. by Kerr LJ: "It is settled law that any contract which is prohibited by statute, either expressly or by implication, is illegal and void".

⁴⁵ *Ibid.*, 3.9, page 20. See *Anderson Ltd v. Daniel* [1924] 1 KB 138, 147, and *Marles v. Phillip Trant & Sons Ltd* [1953] 1 All ER 645. (reversed but not on this point: See [1954] 1 QB 29).

⁴⁶ *Ibid.*

On the other hand, for cases in which the illegality was caused by being contrary to common law, the Law Commission seems to be even less rigid when determining issues. There are also three different situations where the illegality happened. First, where the terms of the contract require the commission of a legal wrong, it is often stated that the contract is illegal and unenforceable by either party. And in theory, the seriousness of the unlawful conduct should not be considered at all. However, CP 189 pointed out the difference between the theory and the practice and suggested that the contract is only unenforceable by either party when a serious crime involved in. In another word, in contracts where there are only trivial illegal issues involved, the knowledge of the parties may be considered during the judgment.⁴⁷ Secondly, where the purpose of the contract is to facilitate the commission of a legal wrong, a party with an unlawful purpose will not be able to enforce the contract. It is not clear whether the knowledge of claimant of the unlawful purpose is important during the judgment.⁴⁸ Although CP 189 argues that the innocent party will not be prevented from enforcing the contract, the acknowledgement of the innocence is a confusing issue.⁴⁹ Thirdly, where the contract is performed in an unlawful manner, it was suggested in CP 189 that the mere commission of an unlawful act in the

⁴⁷ The Law Commission CP189, section 3.14 to 3.17, page: 22, supra note 19.

⁴⁸ CP 189 used two examples to explain the unclear issue. In *Waugh v. Morris* (1872-73) LR 8 QB 202, Blackburn J decided that in order to avoid a contract which can be legally performed it is necessary to show that there was a "wicked intention" to break the law. In contrast, in *J M Allan (Merchandising) Limited v. Cloke* [1963] 2 QB 340, despite the innocence of the claimant, his attempt to recover the rent under the contract failed because of the illegal purpose of the contract. The Law Commission CP 189, section 3.20 and 3.21, p. 23-24, supra note 19.

⁴⁹ CP 189. 3.22. P. 24, supra note 19.

course of carrying out a contract would not at common law affect enforcement. The example which was taken is the case *Wetherell v. Jones*⁵⁰, in which the plaintiff succeeded in an action for the price of goods delivered, despite his unlawful performance in providing an irregular statutory invoice. However, a party who intends to perform the contract in an unlawful manner from the outset will not be able to enforce the contract. In other words, the intention of the parties again becomes the essential point to decide whether the contract is enforceable.⁵¹

It seems that for the effect of an illegal transaction, the Law Commission suggests that, under English law, the enforceability of an illegal contract to different parties is not very clear, especially when the party is an innocent party, in both the statutorily illegal and the common law illegal situations. In statutory illegality cases, it will be necessary for the court to interpret the relevant provisions in the ordinary way to determine whether the legislation impliedly renders the contract unenforceable by either or both parties;⁵² and in common law illegality cases, the innocent party's position is even less rigid.⁵³ Although, in common law practice, as Lord Goff said in *Tinsley v. Milligan*, the common law rules on illegality do not distinguish "between degrees of iniquity"⁵⁴ and the seriousness of the illegal issue should not be taken into account in judging the effect of illegality among cases, in the case

⁵⁰ *Wetherell v. Jones* (1832) 3 B & Ad 221; 110 ER 82.

⁵¹ CP 189. 3.29 to 3.32, p. 26-27, *supra* note 19.

⁵² See above, the second paragraph of 2.1 (B).

⁵³ See the above paragraph.

⁵⁴ *Tinsley v. Milligan* [1994] 1 AC 340, 362, *supra* note 26.

of a contract to commit a serious crime, such as murder, the contract is clearly unenforceable by either party even one of the parties has no intention to do anything unlawful.⁵⁵ CP 189 also suggests that it seems questionable that any contract which necessarily requires the commission of such a minor offence is unenforceable by either party. LC 320 also suggests there are exceptions to the general rules for the enforceability of illegal contracts "where the illegality involved is of a minor or trivial nature or one of the contracting parties was unaware of the other's illegal intent"⁵⁶. **Thus it may be right to say that the seriousness of the illegality may at least affect the decision of the court in considering the effect of the illegality in common law practice** though there is no rule on this issue. In other words, unlike in fraud, the innocent party who has no intention of the illegality can still be affected by the illegality in common law. But the innocent party may be entitled to enforce an illegal contract if the illegal issue is trivial. However, the definition of a "trivial illegality" becomes another difficult issue in common law.⁵⁷

Of course, CP 189 is only a consultation paper; even the final report of LC 320 is not the law for the effect of illegality. But as a review of Law

⁵⁵ *J M Allan* [1963] 2 QB 340, supra note 48. Where neither party realised that the conduct was unlawful it may be that, following the House of Lords' decision in *Kleinwort Benson v. Lincoln City Council* [1999] 2 AC 349, the contract will be void for mistake. Contrast this with the position in relation to contracts that are unlawfully performed. Here, it seems, a party will only be denied contractual remedies if he or she knew that the relevant performance was unlawful (and possibly participated in it). See CP189, 3.27 to 3.46, supra note 19.

⁵⁶ See LC 320, section 3.3, supra note 19.

⁵⁷ In the case of *Mahonia Ltd*, see supra note 10, Colman J suggests that the impregnability of letters of credit may not be affected by a "relatively trivial illegality" of the underlying contract. For further discussion, see later this chapter, section 4.3.

Commission in the area, it provides guidance for the approaches of the development of the law. As Lord Walker of Gestinghorpe said in the case of *Stone & Rolls Ltd v Moore Stephens*:

"The Law Commission is well advanced, ... These proposals, if enacted by Parliament, would introduce more flexibility into this area of the law (although without reintroducing a general 'public conscience' discretion)." ⁵⁸

The approach suggested by the Law Commission may also bring some inspirations in the research of the innocent party's position in applying the illegality exception, even the fraud rule.

3. Arguments about the Existence of the Illegality Exception in Documentary Credits

Since the effect of unenforceability of a contract, which may be caused by an illegality in an illegal transaction, the argument of whether there should be a similar effect of unenforceability when the illegality occurs in a letter of credit transaction was brought into consideration under the background of the recognition of the fraud rule as an exception in documentary credits. To understand the illegality issue in documentary credits, a classification should be made first to the possible illegality in a letter of credit transaction.

⁵⁸ *Stone & Rolls* [2009] 1 A.C. 1391, 1481, supra note 31.

3.1. Letter of credit itself illegal

When there is an illegal issue in a letter of credit transaction, the simple circumstance could be that the letter of credit itself is illegal. In other words, it could be either that the issue of the letter of credit itself is prohibited by the law or that the enforcement of the letter of credit is prohibited by the law. According to the discussion in the Law Commission reports and the case law, an illegal transaction should be unenforceable in English Law. Therefore, a letter of credit may be unenforceable if the issue or performance of the letter of credit is prohibited by law.

3.2. Illegality in underlying transactions

The controversial issue of the illegality of a letter of credit was not the situation of the self-illegal letter of credit but the circumstance when the illegality happens in the underlying contract which relates to the issue of the letter of credit. To put it another way, the most debatable issue in applying an illegality exception is whether the letter of credit will be unenforceable because of the illegality of underlying transactions.

The first reason why there are views that there should not be an illegality exception in documentary credits is a simple one: the illegality exception will be contrary to the autonomy principle of letter of credits. If the enforcement of

the letter of credit is to be affected by the illegality of the underlying contract, the principle of autonomy would be destroyed. There is exactly the same argument as when the fraud rule is applied as an exception in documentary credits. And the autonomy principle was not successful in counteracting the application of the fraud rule. One of the most important reasons was that the fraud rule has a clear basis in the "*ex turpi causa non oritur actio*" principle. This maxim may be translated in English as "no action can arise from a base cause" or "no action arises from an unworthy cause". Actually, "fraud" is one of the "unworthy causes", the other one is "illegality". Therefore, it is reasonable to argue that if the maxim "*ex turpi causa non oritur actio*" could be helpful for the fraud rule to withstand the rigorous of the autonomy principle, why the application of the illegality exception should be barred by the autonomy. What is more, as Professor Nelson Enonchong suggested in his article, "The Autonomy Principle of Letter of Credit"⁵⁹, the wrong doing of fraud is against a private interest⁶⁰, but the wrong doing of illegality is against a public interest. He further stated that "If fraud against the private interest of a bank is weighty enough to displace the principle of autonomy, then illegality against the wider public interest should have the same potent effect".⁶¹

Secondly, it was clearly suggested in the Law Commission CP 189 that a

⁵⁹ Professor Nelson Enonchong, "The Autonomy Principle of Letters of Credit: An Illegality Exception?" [2006] Lloyd's Maritime and Commercial Law Quarterly 404.

⁶⁰ Most time is the bank, but also the applicant when the applicant is not involved in the fraud.

⁶¹ Professor Nelson Enonchong, [2006] Lloyd's Maritime and Commercial Law Quarterly 404, 412, *supra* note 59.

party who enters into a contract with the intention of using it for the commission of a legal wrong or carrying out conduct which is otherwise contrary to common law, will not be able to enforce it. Such guilty intent might involve the use of the subject matter of the contract for the commission of a legal wrong, or even the use of the contractual documentation for such a purpose.⁶² An illegal purpose of a contract would always be rendered unenforceable by the responsible party. In the case of a letter of credit, when the issue of the letter of credit was for execution of an illegal underlying contract, in other words, the purpose of the establishment of the letter of credit was illegal; there is no reason why the issue should be legal just because it was a letter of credit. Although a letter of credit contract has its own special principles as a security contract, the essence of its being a contract will not be changed because of its autonomy. Therefore, when the purpose of the letter of credit contract is illegal, the letter of credit should be unenforceable, just as would be any other contract. Furthermore, it will be a breach of public policy for a court to assist a claimant to enforce a letter of credit if the letter of credit is essential for the enforcement of the underlying illegal contract.⁶³

Besides the anxiety about the contradiction between the illegality exception and the autonomy principle, another argument against applying the illegality exception is that the exception may counteract the normal running of the

⁶² The Law Commission CP 189, Page 27, *supra* note 19.

⁶³ The court will refuse to lend its aid to enforce an illegal contract. See *supra* note 34-37.

documentary credits system. However, this issue may totally depend on how the illegality exception is applied in documentary credits system. The application of the fraud rule could be good pattern to apply the illegality exception. How could the duties and security of banks not be disturbed by application of necessary exceptions? That was always a question for English courts. And new approaches⁶⁴ toward the application of the fraud rule were a very good attempt. The current attitude of English courts to the application of the illegality exception is also worth analysing.

4. The Approach of the Application of the Illegality Exception in English Law

Because of the solidity of the autonomy principle in documentary credits system, similar to the fraud rule, there is no statutory regulation for the application of the illegality exception in English law. The development of the approach for applying the illegality exception in documentary credits may only be traced in case law. However, unlike the fraud rule, the argument for whether applying the illegality principle as an exception separate from and in addition to the fraud rule was not so ardent. There were not many cases which mainly discussed the application of the illegality exception in English Law. Nevertheless, the illegality exception was not really a new consideration

⁶⁴ The new approaches were mainly discussed in Chapter 3 of the thesis.

in English Law, since the approach of accepting the illegality exception occurred so long ago as *United City Merchants (Investments) Ltd. v. Royal Bank of Canada*⁶⁵, which restricted the application of the fraud rule in England and Wales.⁶⁶

4.1. The case of *United City Merchants*

Although, in *United City Merchants* the application of the fraud rule was rejected by Lord Diplock because of the lack of fraudulent intention on the part of the beneficiary, the judgment in the case was also affected by the illegality issue. In this case, the illegality issue was called "the Bretton Woods Point" during the judgment. The Bretton Woods point arose from the agreement between the buyers and the seller collateral to the contract of sale of the goods between the same parties that out of the payments in U.S dollars received by the seller under the documentary credit in respect of each installment of the invoice price of the goods, they would transmit to the account of the buyers in America one half of the U.S. dollars received.

However, the Bretton Woods Agreements Order in Council 1946, made under the Bretton Woods Agreements Act 1945, gives the force of law in England to article VIII section 2(b) of the Bretton Woods Agreement, which is in the

⁶⁵ *United City Merchants*[1983] 1 A.C. 168, supra note 1.

⁶⁶ The decision of the House of Lord in *United City Merchants* excluded the third party's fraud from the application of the fraud rule, which made the application of the fraud rule even more difficult. Details discussed in Chapter 2, section 5.2.3.

following terms:

"Exchange contracts which involve the currency of any member and which are contrary to the exchange control regulations of that member maintained or imposed consistently with this agreement shall be unenforceable in territories of any member..."

During the hearing, after the analysis of the probably illegal issue under the Bretton Woods Agreements, Lord Diplock agreed to Lord Denning M.R. in his judgment in the *Terruzzi*⁶⁷ case at p. 714 that the court in considering the application of the provision should look at the substance of the contracts and not at the form. And he continuing stated:

"The question whether and to what extent a contract is unenforceable under the Bretton Woods Agreements Order in Council 1946 because it is a monetary transaction in disguise is not a question of construction of the contract, but a question of the substance of the transaction to which enforcement of the contract will give effect."⁶⁸

For the instance case, he believed that "it was not a contract to exchange one currency for another currency but a contract to pay currency for documents which included documents of title to goods"⁶⁹, and that "there is no difficulty in identifying the monetary transaction that was sought to be concealed by the actual words used in the documentary credit and in the underlying contract of sale."⁷⁰ Therefore, although the contract between the sellers and the confirming bank constituted by the documentary credit fell altogether outside

⁶⁷ *Wilson Smithett & Cope Ltd. v. Terruzzi* [1976] Q.B. 683.

⁶⁸ *United City Merchants* [1983] 1 A.C. 168, 189, supra note 1.

⁶⁹ *Ibid.* 189-190.

⁷⁰ *Ibid.* 190.

the Bretton Woods Agreement, "Payment under the documentary credit by the confirming bank to the sellers of that half of the invoice price ... was an essential part of that monetary transaction and therefore unenforceable ..."⁷¹ Thus, in the end of *United City Merchants*, although the fact was not felt into the fraud exception, the seller lost half the installments because of the illegality issue. It was true that the illegality issue has not been recognized as an independent exception under documentary credits, but it was not difficult to see the illegal conduct cannot be protected because it's under the umbrella of documentary credits system. And this case may be seen as the first case accepting the illegality exception as a distinct exception, separate from and in addition to the fraud rule.

4.2. The case of *Group Josi Re*

Following the judgment in *United City Merchants*, *Group Josi Re v. Walbrook Insurance Co. Ltd.*⁷² may be the first case in which illegality has been considered as affecting payment under a letter of credit. In that case, a reinsurance company, Group Josi, which was not authorised to carry on business in the United Kingdom under the Insurance Companies 1974, or subsequently under the Insurance Companies Act 1982,⁷³ entered into a

⁷¹ Ibid, 190.

⁷² *Group Josi Re v. Walbrook Insurance Co. Ltd.* [1996] 1 W.L.R. 1152.

⁷³ Insurance Companies Act 1982, s.2: "(1)... no person shall carry on any insurance business in the United Kingdom unless authorised to do so under ...".

number of reinsurance contracts with the defendant insurance companies through the agency of Weavers. And the reinsurers procured an opening of letters of credit in favour of the reassured companies. The reinsurers subsequently brought proceedings against Weavers and the reassured companies to restrain them from drawing down under the letter of credit, and claimed that the contracts of reinsurance were void on the ground their own illegality in carrying on insurance business in the United Kingdom without statutory authorization.⁷⁴ In the trial, Clarke J set aside those *ex parte* injunctions⁷⁵ on the ground that although the reinsurance contracts were illegal and void, the letters of credit were not be tainted by the illegality of the underlying contracts. Group Josi then appealed. During the appeal, Staughton LJ, after a review of the previous judgment, divided the case into eight issues:

"(1) Do the reinsurers have a cause of action sufficient to justify an injunction? (2) Can the reinsurers bring this action when it involves asserting their own illegality? (3) What is the level of proof required for the grant of an interim injunction in a letter of credit case? (4) Has there been non-disclosure sufficient to justify avoidance of the reinsurance contracts, or misrepresentation? (5) If so, would a claim on the letters of credit be clearly fraudulent? (6) Can a letter of credit be affected by illegality of the underlying transaction? (7) Is there illegality of the

⁷⁴ After the claim was dismissed, The reinsurers amended their pleadings to allege that the reinsurance contracts had been avoided pursuant to section 18 of the Marine Insurance Act 1906 for non-disclosure of a material circumstance, namely that overriding commission payable under the reinsurance contracts which should have been paid to the assured companies had been misappropriated by three directors of the underwriters to whom the placing, administration and handling of the reinsurance had been delegated.

⁷⁵ The plaintiff obtained *ex parte* injunctions in July 1993 restraining the defendants from drafting on the letter of credits. Id 18, 1156

reinsurance contracts in this case? (8) Is there a constructive trust, and do the reinsurers have a proprietary right? I shall consider those issues in turn, although in the event it is not necessary to reach a conclusion on all of them."⁷⁶

There were three issues above which were directly or indirectly related to the illegality issue. The first one is issue (2) in his judgment. "Can the reinsurers bring this action when it involves asserting their own illegality?"⁷⁷ Staughton LJ admitted the well-established principle which cited from the speech of Lord Jauncey of Tullichettle in *Tinsley v. Milligan*⁷⁸ that "... a party is not entitled to rely on his own fraud or illegality in order to assist a claim or rebut a presumption"⁷⁹, but believed that the reinsurers did not seek to rely on their own illegal conduct of unauthorised insurance business for either of those purpose.

"They do not ask the court to order the defendants, or for that matter the bank, to do anything illegal. On the contrary they seek to prevent something happening which they say would be illegal, that is to say the payment of moneys due under illegal reinsurance contracts."⁸⁰

Therefore he decided that the reinsurers were entitled to bring the action although there were their own illegalities in the assertion. The view of Staughton LJ in this issue was not directly related to the illegality exception. However, it did imply that the illegal conduct was, and always was, prohibited by English courts because of public policy, especially when the guilty party

⁷⁶ *Group Josi*, [1996] 1 W.L.R. 1152, 1159, supra note 72.

⁷⁷ Ibid.

⁷⁸ *Tinsley v. Milligan* [1994] 1 A.C. 340, supra note 26.

⁷⁹ Ibid.

⁸⁰ *Group Josi*, 1160, supra note 72.

tries to assist his own claim of illegality.⁸¹ Of course, the autonomy of documentary credits was not mentioned here.

The other two issues, which were clearly related to the illegality exception, were pointed to by Staughton LJ as the issue (6) and issue (7). For the question of whether a letter of credit can be affected by the illegality of the underlying transaction, although Staughton LJ considered that "the Bretton Woods" point was not an indication that illegality generally is a defence under a letter of credit, he believed it did show that established fraud is not necessarily the only exception. He insisted there must be cases when illegality can affect a letter of credit⁸² He even took an example of a contract for the sale of arms to Iraq under a letter of credit. And he made an assumption to the current case:

"If the reinsurance contracts are illegal, and if the letters of credit are being used as a means of paying sums due under those contracts, and if all that is clearly established, would the court restrain the bank from making payment or the beneficiary from demanding it? In my judgment the court would do so. That would not be because the letter of credit contracts were themselves illegal, but because they were being used to carry out an illegal transaction."⁸³

Staughton LJ's opinion on this issue is very essential for the discussion of the illegality exception. Although in the end of the case, the illegality was not

⁸¹ *Group Josi*, 1159, see supra note 72, Staughton LJ cited the speech of Lord Jauncey of Tullichettle in *Tinsley v. Milligan*, see supra note 26, to support this view.

⁸² *Group Josi*, 1164, supra note 72.

⁸³ *Ibid.*

proved in the reinsurance contract by his decision, at least, the possibility of the application of the illegality exception was accepted. Unlike the conclusion of Clark J that the letter of credit may not be tainted by the illegality underlying contract, Staughton LJ admitted the effect of the illegality on a letter of credit, which means that the autonomy principle of documentary credits may be affected by the illegality underlying contract. Also the Bretton Woods Point from *United City Merchants* was affirmed again.

The standard of proof for applying the illegality exception was not discussed in depth in this case, Staughton LJ only implying his opinion that the illegality should be clearly established and known to the bank. He said in his judgment that:

"Would illegality, like fraud, have to be clearly established and known to the bank before it could operate as a defence or a ground for restraining payment by the bank? That is not an altogether easy question, but I am inclined to think that it would. If the legality of the payment is merely doubtful, it may be that the bank would not be restrained. But whether in a *United City Merchants* type of case, if illegality were clearly proved at trial, it would be a defence that it was not clear at the time when the documents were presented for payment is even more of a problem."⁸⁴

Group Josi is the first case in English Law which considered illegality as affecting the payment under a letter of credit. Although the decision was not held under an illegality exception base because the illegality of the underlying

⁸⁴ Ibid.

contract was not established in the end, the illegality, besides the fraud rule was first mentioned as a separately factor which may affect the enforcement of the letter of credit under the principle of autonomy. This case also pointed out the different approaches of English law in applying an illegality exception contrasted to the United States and Canada.⁸⁵ And the points made by Staughton LJ relating to the illegality exception may be summarised as follows:

First of all, prior to a discussion in the scope of documentary credits system, illegal conduct was and always was prohibited by English law because of public policy, especially when the guilty party tries to assist his own claim of illegality. Staughton LJ decided in *Group Josi* that the reinsurers were entitled to bring the action although there were their own illegalities in the assertion. Because they were seeking "to prevent something happening which they say would be illegal" rather than "ask the court to order the defendants, or for that matter the bank, to do anything illegal".

Secondly, considering with the Bretton Woods point in *United City Merchants*, Staughton LJ believed that "there must be cases when illegality can affect a letter of credit". He took a view that although there might not be an indication in *United City Merchants* that illegality generally was a defence under a letter

⁸⁵ According to Article 5 under UCC, the fraud rule is the only exception to the autonomy in the letter of credit in the United States; and in Canada. It was held in *Morguard Bank of Canada v. Reigate Resource Ltd and Canada Trust Co.* (1985) 40 Alta 1. R (2d) 77, that the letter of credit was a separate and distinct agreement and was not tainted by the illegality of the underlying contract. For the details of the position in the United States and Canada in applying the illegality exception, see Professor Nelson Enonchong, "The Autonomy Principle of Letters of Credit: An Illegality Exception?" [2006] LMCQ 404, 408-409, *supra* note 59.

of credit, it, at least, showed that fraud was not necessarily the only exception.

Thirdly, unlike the conclusion of Clark J that the letter of credit may not be tainted by illegality in the underlying contract, Staughton LJ admitted the effect of the illegality on a letter of credit. He believed that the autonomy principle of documentary credits may be affected by the illegality of the underlying contract.

Lastly, regarding to the detailed standard of applying the illegality exception, Staughton LJ made a comparison between the fraud rule and illegality exception and took a view that the illegality had to be clearly established and known to the bank.

4.3. The case of *Mahonia v. JP Morgan*

While *Group Josi* is the first case in English law in which illegality has been considered as affecting payment under a letter of credit, the case which most clearly shows the judicial opinion of English law recognizing illegality as an exception to the autonomy principle in documentary credits is *Mahonia Ltd v. JP Morgan Chase Bank*⁸⁶. This case arose out of the collapse of the erstwhile mighty Enron Corporation. West LB AG, a German bank with offices in London, New York and elsewhere, issued a letter of credit for the benefit of

⁸⁶ *Mahonia Ltd v. JP Morgan*, supra note 10.

Mahonia on the request of Enron. The letter of credit was issued to support a swap transaction between Enron North American Corporation (ENAC⁸⁷) and Mahonia. Enron's financial difficulties began to come to light shortly after the letter of credit was issued, Enron then went into Bankruptcy. Under the letter of credit Enron's bankruptcy was an event of default which entitled Mahonia to make a demand. That demand was made for the amount due under the credit (about US \$165 million). However, West Bank refused to pay by the reason of the letter of credit was unenforceable for illegality. West Bank alleged that although the document presented for payment was in conformity with the letter of credit, the purpose of the underlying swap transaction was to provide Enron with a disguised loan to enable Enron improperly to manipulate its account, which was in breach of US Generally Accepted Accounting Principles (GAAP) and the Securities Exchange Act 1934.⁸⁸ Therefore, the claimant (Mahonia Ltd) applied to strike out the illegality defence and for summary judgment to enforce the defendant bank to pay.

During the hearing, Colman J, after introduced the fact of the case, first pointed out the main issue of illegality in the current case by saying:

⁸⁷ ENAC was a subsidiary of Enron.

⁸⁸ The allegation was that this illegal purpose emerged when the swap transaction was seen together with two other related swap transactions: one between Mahonia and Chase and the other between ENAC and Chase. The swaps provided for fixed and floating payments in opposite directions. Chase paid a sum of \$350 million (less than arrangement fee of \$1 million) to Mahonia under Chase/Mahonia swap and Mahonia paid it to ENAC under the ENAC/Mahonia swap. Also, under the ENAC/Chase swap the fixed payment which ENAC agreed to pay Chase was \$356 million. The effect of the three swap transactions was that \$350 million was paid by Chase to Mahonia and by Mahonia to Enron and Enron was obliged approximately six months later to pay approximately \$356 million to Chase. As the floating payments were exactly the same in each of the three swap transactions, the ultimate effect of the transaction was to provide Enron with \$350 million (less the arrangement fee) for a period of six months, for which it was obliged to pay a figure which equated to repayment of a loan of \$350 million with an effective annual interest rate of 3.44%.

"For the purposes of the present applications only, the parties are agreed that the facts which I have set out as constituting the relevant illegality or unenforceability should be assumed to be true."⁸⁹

4.3.1. Foreign and domestic illegality

He then expressed the unenforceable effect of illegality and said:

"If the relevant contract were entered into by the claimant for an unlawful purpose and the unlawfulness contemplated was English, rather than foreign, there is strong authority that the claimant could not enforce the contract."⁹⁰

The words of "the unlawfulness contemplated was English" pointed out one of the important issue during the judgment which is the effect of an illegal contract when breaches a foreign law. To analyse this point, Colman J took the case *Regazzoni v. K.C. Sethia Ltd (1944) Ltd.*⁹¹ as an example. In that case, the claim was proposed by the buyer for wrongful repudiation of the seller in a contract of sale of jute bags CIF Genoa. This contract was, in the end for the purpose of re-selling the goods for shipment to South Africa. And both parties were aware that such a large of quantity of jute bags could not be obtained from anywhere except India; however, Indian law prohibited the export of goods to South Africa. It was held that although on the face of it the contract provided neither for the shipment of goods from India nor their delivery into or sale to South Africa, the action must fail because the

⁸⁹ *Mahonia Ltd v. JP Morgan*, [2003] 2 Lloyd's Rep 911, 914, supra note 10.

⁹⁰ Ibid.

⁹¹ *Regazzoni v. K.C. Sethia Ltd (1944) Ltd.* [1958] A.C. 301.

enforcement of the contract would be contrary to public policy.

According to the decision of *Regazzoni*, Colman J believed the contract was unenforceable if both the claimant and the defendant knew the immoral or illegal purpose under internal or foreign law. However the present case was different from *Regazzoni v. Sethia*, since the purpose of Enron in procuring the letter of credit which was to affect a breach of United States law was entirely unknown to the defendant bank.

To justify this situation, Colman J cited Scott LJ's judgment in *Alexander v.*

Rayson:

"It is settled law that an agreement to do an act that is illegal or immoral or contrary to public policy, or to do any act for a consideration that is illegal, immoral or contrary to public policy, is unlawful and therefore void. But it often happens that an agreement which in itself is not unlawful is made with the intention of one or both parties to make use of the subject matter for an unlawful purpose, that is to say a purpose that is illegal, immoral or contrary to public policy. The most common instance of this is an agreement for the sale or letting of an object, where the agreement is unobjectionable on the face of it, but where the intention of both or one of the parties is that the object shall be used by the purchaser or hirer for an unlawful purpose. In such a case any party to the agreement who had an unlawful intention is precluded from suing upon it. *Ex turpi causa non oritur actio*. The action does not lie because the Court will not lend its help to such a plaintiff."⁹²

By relying on the above words of Scott LJ's judgment, Colman J took the view

⁹² *Alexander v. Rayson* [1936] 1 K.B. 169,182.

that there is strong authority that the claimant could not enforce the contract if the relevant contract were entered into by the claimant for an unlawful purpose and the unlawfulness contemplated was English, rather than foreign. Therefore, after cited another decision of Court of Appeal in *Scott v. Brown, Doering, McNab & Co.*,⁹³ Colman J concluded that:

"If a claimant enters into a contract lawful on its face for the purpose of using the subject-matter to be derived from the contract or the very existence of the contract or the consequence of its being performed for an unlawful purpose he will not be permitted to enforce it. To permit him to do so would be contrary to public policy as offending against the *ex turpi causa* principle. That the defendant was ignorant of the purpose when the contract was entered into is irrelevant."⁹⁴

Colman J stated that where both the claimant and the defendant knew the illegal purpose of the underlying contract, and the defendant was ignorant of the underlying illegality, the court would not enforce the contract which is legal on its face but in fact immoral or illegal under the law. He then asked: "Does it make any difference that the purpose was unlawful, not under English law, but under the law of a foreign friendly state?"⁹⁵ He continued:

"In my judgment, it does not. It must logically be just as contrary to public policy to enable the claimant to enforce a contract which has been entered

⁹³ *Scott v. Brown, Doering, McNab & Co.* [1892] 2 Q.B. 724, In this case, a plaintiff claimed to recover money paid to the defendant stockbrokers through whom he had purchased shares in a company on the grounds that the contract should be rescinded on the grounds that the brokers had used their own shares to satisfy his instructions and had not purchased shares on the open market. However, the court rejected the claim on the grounds that the contract was entered into and the money under it paid to the defendant for the unlawful purpose of rigging the market in those shares.

⁹⁴ *Mahonia*, [2003] 2 Lloyd's Rep 911, 918, *supra* note 10.

⁹⁵ *Ibid.*, 919.

into for an illegal purpose know only to himself as to enable him to enforce such a contract the purpose of which is known to both parties to it"⁹⁶

The above analysis clearly expressed Colman J's opinion for the effect of an illegal contract which breaches foreign law. He believed an illegal contract is unenforceable no matter the breached law is internal or international. The reason is simply the enforcement of an illegal contract is contrary to public policy.

4.3.2. Illegality and letters of credit

Since the one even more controversial issue in the case of *Mahonia Ltd v. JP Morgan*, other than the enforceability of the illegal foreign contract, is the conflict between the illegality and the autonomy of principle in documentary credits, Colman J then focused his discussion on enforceability of the letter of credit when an illegal underlying contract is involved.

After the analysis of the development of the fraud exception in English law and the case of *Group Josi*, he went back to the present case of *Mahonia* and justify the transaction in this case similar to "one in which the underlying contract is illegal to the knowledge of both parties and therefore unenforceable by either and where one of the parties to procures an innocent third party to provide to the other a bond which pays against a certificate that

⁹⁶ Ibid.

the underlying contact has not been performed"⁹⁷. And he decided the innocent third party could rely by the way of defence on the underlying illegality. However, the problem in his discussion was whether it makes any difference that "the security was provided by means of a documentary letter of credit confirmed by a bank innocent of the illegality of the underlying transaction, but which has clear evidence of that illegality at the time when it ought otherwise to pay"⁹⁸? In other words, does the policy of no permitting the autonomy of a letter of credit to be used to obtain fraudulent benefits extend to a case where there was an illegal purpose during the letter of credit was procured?

Although he did not support Staughton LJ's view on the case of *United City Merchants*,⁹⁹ he agreed with Staughton LJ that it is incredible for a party to an unlawful arms transaction to be permitted to enforce a letter of credit which was an integral part of that transaction even if the relevant legislation did not on its proper construction render ancillary contracts illegal. In the end he concluded:

"If a beneficiary should as a matter of public policy (*ex turpi causa*) be precluded from utilizing a letter of credit to benefit from his own fraud, it is hard to see why he should be permitted to use the courts to enforce part of an underlying transaction which would have been unenforceable on grounds of its

⁹⁷ Ibid, 926.

⁹⁸ Ibid.

⁹⁹ During the appeal of the case of *Group Josi*, see supra note 72, Lord Justice Staughton justified the *bretton woods* point in the case of *United City Merchant* was a kind of approving the illegality exception, however, Colman J alleged that was only an example of a letter of credit which because of its cosmetic purpose was directly rendered unenforceable by legislation.

illegality if no letter of credit had been involved, however serious the material illegality involved. To prevent him doing so in an appropriately serious case such as one involving international crime could hardly be seen as a threat to the lifeblood of international commerce."¹⁰⁰

Colman J's conclusion on the issue of illegality and the letter of credit provided a clear support to the existence of the illegality exception in documentary credits. He further discussed the position that "the claimant seeks the court's assistance in enforcing the letter of credit which has been opened pursuant to a contract which would be unenforceable on the grounds of public policy due to its unlawful purpose, that purpose being known to the claimant, but not to the bank until long after the demand for payment had been presented to the bank."¹⁰¹ In other words, neither at the time when the document was presented to the bank under the letter of credit nor at the deadline for making payment under it was the bank aware of the illegal purpose of the underlying contract. Colman J explained that because the bank is protected by the doctrine of "*ex turpi causa*"¹⁰², he is also protected at trial if it is proved the claimant is attempting to use the court's process to benefit from the illegality. Thus "the bank did not have clear evidence of such illegality at the date when payment had to be made would not prevent it having a good defence on that basis if such clear evidence were to hand when the Court was called upon to decide the issue."

¹⁰⁰ *Mahonia*, [2003] 2 Lloyd's Rep 911,927, supra note 10.

¹⁰¹ *Ibid*, 919.

¹⁰² The "reliance test" to the principle of "*ex turpi causa*" was established in the case of *Holman v Johnson*, see supra note 25, by Lord Mansfield CJ, "No court will lend its aid to a man who founds his cause of action upon an immoral or an illegal act." For details, see earlier this chapter, section 2.2.1.

Although in the end of the *Mahonia* case, after a full trial, Colman J found that there was no illegality in the underlying transaction since Enron's accounting was not in breach of US Security law and the beneficiary, Mahonia, was not privy to any unlawful purpose, having no knowledge of any element of wrongful accounting.¹⁰³ Consequently, it was not necessary for the court to decide what would have been the effect of illegality in the swap transaction on the enforceability of the letter of credit. But Colman J arrived at the same conclusion as Stoughton LJ on the illegality issue that "the autonomy of a letter of credit does not prevent it from being tainted by the illegality of the underlying transaction." In other words, illegality in the underlying transaction could constitute a defence to the enforcement of a letter of credit.¹⁰⁴ The public policy arguments that are operable at the underlying contract level apply equally where the documentary credit is "being used to carry out an illegal transaction"¹⁰⁵. To the extent that illegality prevents enforcement of the underlying contract, it should also prevent documentary credits "being used to carry out an illegal transaction".

The case of *Mahonia* was almost the most important case on the issue of applying an illegality exception in English law. That was the first time the illegality exception was accepted as a distinct exception to the autonomy principle under documentary credits. However, there are still many problems

¹⁰³ *Mahonia* (No.2), *supra* note 10.

¹⁰⁴ Professor Nelson Enonchong, [2006] *Lloyd's Maritime and Commercial Law Quarterly* 404, 410, *supra* note 59.

¹⁰⁵ See *Group Josi* [1996] 1 W.L.R. 1152, 1164, *supra* note 72.

about the application of the illegality exception, which were not clearly solved in this case. For example, the issue of **"the seriousness of the illegality"**¹⁰⁶. Colman J mentioned "there is much to be said for the view that the public policy in superseding the impregnability of letters of credit where there is an unlawful underlying transaction defence may not be engaged where the nature of the underlying illegal purpose is relatively trivial, at least where the purpose is to be accomplished in a foreign jurisdiction."¹⁰⁷ However, he did not try to explain the criterion of assessing the "relatively trivial illegality". Also, emphasizing the issue of the foreign jurisdiction issue seems to be contrary to his earlier point that an illegal contract is unenforceable no matter the breached law is internal or international.

Nevertheless, this case may be a good beginning for the illegality exception to grow up in the earth of English law. The discussion which was made by Colman J in this case may also be seen as an extension of the discussion regarding to the illegality exception in *Group Josi*. Colman J's detailed discussion regarding to the application of the illegality exception also made some implications for the conditions of this new exception in documentary credits.

¹⁰⁶ This issue was discussed in section 2.2.2 of this chapter. It was concluded that the seriousness of the illegality may affect the decision for an illegality defence.

¹⁰⁷ *Mahonia*, [2003] 2 Lloyd's Rep 911,927, supra note 10.

5. Conditions for Applying the Illegality Exception in Documentary Credits under Current English Law

After over 50 years' development, the conditions of the application of the fraud rule are still not settled. Problems such like the standard of proof remain in. Therefore, it may be too early to set certain conditions for the appliance of new exceptions, such as illegality. However, the scant few cases which related to the illegality exception in documentary credits did bring some implication, or at least discussion, to conditions of the application.

5.1. The approved conditions

First, for the question of the establishment of an illegality exception, a clearly established illegal fact would be an indubitable condition. This is a same condition for the application of the fraud rule. When, in the fraud rule exception, the fraudulent conduct has to be clearly established, a mere allegation of fraud is not enough, in the illegality exception, the illegal fact also has to be clearly established. It was expressed by Staughton LJ in the case of *Group Josi Re v. Walbrook Insurance Co. Ltd*¹⁰⁸

"It seems to me that there must be cases when
illegality can affect a letter of credit...
Would illegality, like fraud have to be clearly

¹⁰⁸ See *Group Josi* [1996] 1 W.L.R. 1152, 1164, supra note 72.

established and known to the bank before it could operate as a defence or a ground for restraining payment by the bank? This is not an altogether easy question, but I am inclined to think that it would. If the illegality of the payment is merely doubtful, it may be that the bank would not be restrained."

Not only in *Group Josi*, but also in *Mahonia*, "an established illegality" was the basis for the discussion of the application of this doctrine.¹⁰⁹ Therefore, it is a condition that the illegality has to be clearly established. A mere suspicion of illegality is not enough. The court may not grant an injunction restraining payment if the underlying contract is only arguably illegal. And like the well-known fact that because of the difficulty of satisfying the high standard of proof, most of the fraud rule pleading were failed, the high standard also made the proof of the illegality exception very difficult. But the high standard of proof will also be useful to avoid the abuse of the illegality exception by applicants in letter of credits transactions. Also "the high standard of proving illegality will ensure that the exception does not become an easy excuse for banks to refuse to honour their obligation under a letter of credit."¹¹⁰

Secondly, according to the *Mahonia* and *Group Josi*, the participation of the beneficiary is also a condition for the application of the illegality exception in documentary credits. This issue was discussed in case *Mahonia* during the discussion of the cognizance of an illegal contract. Colman J referred to Lord

¹⁰⁹ In *Mahonia*, during the discussion [2003] 2 Lloyd's Rep 911, 926., Colman J alleged that: "The transaction is therefore similar in many ways to one in which the underlying contract is illegal to the knowledge of both parties and therefore unenforceable by either and where one of the parties to it procures an innocent third party to provide to the other a bond which pays against a certificate that the underlying contract has not been performed."

¹¹⁰ Professor Nelson Enonchong, [2006] Lloyd's Maritime and Commercial Law Quarterly 404, 414, *supra* note 59.

Justice Sankey's opinion in *Foster v. Driscoll*¹¹¹ that: "If the question is one of illegality under our law, the contract is unenforceable if the defendant knew that the goods or money or other consideration were to be used for a purpose immoral or illegal under our law."¹¹²

And for an opposite situation, in *Group Josi*, since the illegal issue of the unauthorised contract of insurance was not known to the assured companies, it was held that reinsurance contracts were rendered unenforceable by the reinsurers but not by the assured companies. In a letter of credit case, the participation of parties may be represented by an intention or knowledge of one party or both parties that the letter of credit was issued for performance of an illegal contract. In other words, if the purpose of the letter of credit is itself illegal or the purpose is for an illegal underlying contract, and the purpose was known to the party, the illegality exception applies, and the party will not be permitted to enforce the letter of credit. But the illegality exception will not be applied to defeat a party's title to enforce a letter of credit if the illegal purpose of the letter of credit is not known to the party. This is also the reason why in *Mahonia* (No. 2)¹¹³, the defence of the illegality exception was not approved.¹¹⁴ However, does this condition apply in all the cases in applying the illegality exception? The earlier research of Law Commission reports¹¹⁵

¹¹¹ *Foster v. Driscoll* [1920] 2 K.B. 287.

¹¹² *Mahonia*, [2003] 2 Lloyd's Rep 911,917, supra note 10.

¹¹³ *Mahonia* (No.2), at 430, supra note 10.

¹¹⁴ In the end, the illegality defence was not succeeding because the beneficiary of the letter of credit was not aware of the illegal purpose of the letter of credit.

¹¹⁵ CP 154; CP 189 and LC 320. For details, see earlier this chapter, section 2.2, supra note 19.

brings some new thoughts to the thesis. If the innocent party is not always able to enforce an illegal involved contract, then accordingly, the participation of the party may not be a condition for the unenforcement of the illegal contract to take effect. In other words, under some circumstance, the innocent party may not be able to enforce a contract whose purpose was illegal. In a letter of credit case, under certain circumstances, the beneficiary may not be entitled to payment where the underlying transaction is illegal even he has no knowledge of the illegality.¹¹⁶

5.2. Some other possibilities

There are also some possible conditions, such as the seriousness of the illegality, and the connection between the illegality and the letter of credit, were suggested by academic authorities.¹¹⁷

Of course, the seriousness of illegal conducts may affect the judges' discretion in accepting the illegality exception. The illegal issue in *Mahonia* was not that serious in English Law. The situation may change if the illegal purpose of the underlying contract was too serious. For example, if the purpose of the underlying contract is to violate the criminal law, such like

¹¹⁶ The seriousness of the illegality may affect the enforcement of an illegal contract by an innocent party. See section 2.2.2. of this chapter. For example, *J M Allan, supra note 48*.

¹¹⁷ Professor Nelson Enonchong approved the seriousness of the illegality and the degree of connection as two conditions for the application of the illegality exception in his article, [2006] LMCLQ 404, *supra note 59*.

murder, or for some more serious commercial purpose, such like trading with the enemy during the wartime. In those circumstance, English courts may not enforce the credit even none of the parties has knowledge of the illegality.¹¹⁸

As Scrutton LJ said in *Re Mahmoud v. Spahani*¹¹⁹:

"In my view the Court is bound, once it knows that the contract is illegal, to take objection and to refuse to enforce the contract, whether its knowledge comes from the statement of the party who was guilty of the illegality, or whether its knowledge comes from outside sources. The Court does not sit to enforce illegal contracts."

However, the seriousness of the illegality is rather a simple factor to be considered for a cognisance of an illegal contract than a separate condition for the appliance of the illegality exception in documentary credits.¹²⁰

And for the idea of seeing the connection between the illegality and the letter of credit as a condition, there is no clear rule of what is a sufficiently close connection between the letter of credit and the illegality of the underlying transaction. The only reasonable suggestion was that in *Mahonia*. Colman J said that if it had been established that the underlying transaction had the unlawful purpose alleged and if the beneficiary had been a party to that unlawful purpose, he would have accepted the connection that the letter of

¹¹⁸ In Law Commission CP 189, 3.15 to 3.16, see supra note 19, it was suggested at page 22 that: In theory the common law rules do not explicitly take into account the seriousness of the unlawful conduct at all. However it must be doubtful whether the law is really this rigid. There is a vast amount of statutory regulation creating numerous statutory offences which maybe committed without any guilty intent and involve misconduct of a fairly trivial nature. To suggest that any contract which necessarily requires the commission of such a minor offence is unenforceable by either party seems questionable".

¹¹⁹ *Re Mahmoud v. Spahani* [1921] 2 KB 716, 729.

¹²⁰ See supra note 93.

credit was sufficiently connected to the illegal purpose of the underlying transaction as to be tainted by it. However, if the sole factor, which is the knowledge of the beneficiary, should be used to determine whether the illegality is sufficiently connected to the letter of credit, it may not be necessary to have a separate requirement that there has to be a connection between the letter of credit and the illegal underlying contract. The knowledge of the beneficiary, like the involvement of the beneficiary in the illegality, has already been a requirement for the application the illegality exception.

Therefore, basically, the illegality exception in documentary credits has been applied in English law but under two conditions according to the current case law, which are a clearly proved illegal fact and the involvement of the beneficiary.

5.3. Several unclear issues

However, since the limited development of the illegality exception in English case law, there are still some issues which have not been discussed clearly. One of the main issues is the knowledge of the bank when applying the illegality exception.

5.3.1. Banks' knowledge of the illegality

In the case of *Gian Singh*¹²¹, the application of the fraud rule was rejected by the court because of the bank's unawareness of the forgery. Although the banks' knowledge has not been discussed in the current application of the illegality exception, it should not be ignored. If, in applying the fraud rule, the bank is entitled to the reimbursement even there's a clearly proved fraud as long as the bank has no knowledge of the fraud at the time of the payment, it is hard to see why the same principle will not be applied while applying the illegality exception. However, is the bank's knowledge always a condition in applying the fraud rule? According to the early research on the issue of banks' knowledge in applying the fraud rule, the court may not grant an injunction at a pre-trial stage to prevent the bank from payment as long as the bank does not notice the fraud, but the court may not grant a summary judgment to force a bank to pay against a fraudulent beneficiary on a pre-trial stage simply because the bank is not able to prove he has the clear evidence of the fraud.¹²² Since both the application of the fraud rule and the illegality exception share the same basis of "*ex turpi causa*", it may be concluded that the bank's knowledge principle applies similarly in the illegality exception. In other words, it is true that the applicant has to pay the reimbursement to the bank as long as the bank has no knowledge of the involved fraud or illegality, but it is difficult to see why the bank's knowledge should be so important

¹²¹ *Gian Singh & Co. Ltd. v. Banque de L'Indochine* Judicial Committee of the Privy Council [1974] 2 Lloyd's Rep. 1, see Chapter 2, section 5.2.2.

¹²² See section 3.2 of Chapter 3.

where the beneficiary is asking for a summary judgment to enforce the bank to pay under the credit, or applicant is applying for an injunction to restrain the beneficiary from demanding. Under those circumstances, banks' knowledge of the illegality may not be seen as a condition in applying the illegality exception.

5.3.2. The crucial time for the evidence of illegality

Actually, the issue of the knowledge of banks may be relative to another issue which was discussed both in *Group Josi* and *Mahonia*, "the crucial time of the establishment of the evidence".

In *Group Josi*, during the hearing, Staughton LJ pointed out this difficult question and said:

"If illegality were clearly proved at trial, it would be a defence that it was not clear at the time when the documents were presented for payment is even more of a problem."¹²³

He analysed this problem and stated his own view in the following words:

"....would the court restrain the bank from making payment or the beneficiary from demanding it? In my judgment the court would do so. That would not be because the letter of credit contracts were themselves illegal, but because they were being used to carry out an illegal transaction."¹²⁴

A similar decision was made by Colman J in *Mahonia* that the bank was

¹²³ *Group Josi* [1996] 1 W.L.R. 1152, 1164, supra note 72.

¹²⁴ *Ibid.*

entitled to rely on the evidence of illegality at the date of the trial even though it did not have that evidence at the date when the payment was made.¹²⁵ However, those two similar decisions did not come from a similar analysis. During the judgment, the similar time issue in the fraud rule was discussed. And in both cases the application of the fraud rule from *Sztejn* by *United City Merchants (Investment) Ltd. v. Royal Bank of Canada*¹²⁶ was cited as a beginning of the discussion. However, a different understanding was achieved. While, in *Group Josi*, Staughton LJ believed the decision of *United City Merchants* shows that "it is nothing to the point that at the time of trial the beneficiary knows, and the bank knows, that the documents presented under the letter of credit were not truthful in a material respect. **It is the time of presentation that is critical** When that reasoning is applied to an interlocutory application to restrain a bank from making the payment, the same result follows. The bank is entitled and bound to pay on presentation of apparently conforming documents, unless the demand of the beneficiary is clearly fraudulent. ... The effect on the lifeblood of commerce will be precisely the same whether the bank is restrained from paying or the beneficiary is restrained from asking for payment."¹²⁷ In *Mahonia*, Colman J believed the implication in *United City Merchants* to be that "the fraudulent claimant will not be entitled to remedy if the bank, having clear evidence of fraud, declines

¹²⁵ *Mahonia*, at 923, supra note 10, "As long as there is before the court evidence which establishes fraud by the beneficiary there is evidence sufficient to establish a straight defence based on *ex turpi causa*. For this purpose, I agree with Lord Justice Waller that the strength of the fraud case has to be tested on the evidence available at the hearing of the summary judgment application, as distinct from the time of demand."

¹²⁶ *United City Merchants* [1983] 1 A.C. 168, supra note 1.

¹²⁷ *Group Josi* [1996] 1 W.L.R. 1152, 1161-1162, supra note 72.

to pay at the time when the documents are presented."¹²⁸, and was not saying that "the claimant who, at trial, is proved to be fraudulent will nevertheless be entitled to recover from the bank if it did not have clear proof of fraud at the time of the presentation of documents"¹²⁹. Colman J believed that **"If the bank is protected by the doctrine of *ex turpi causa* when it has clear evidence of fraud at the time of presentation it must, inescapably, also be protected if, at trial, it is demonstrated that the beneficiary is attempting to use the court's process to benefit from his own fraud."**¹³⁰

It may not be reasonable just to admit one of the two different understandings. However, if Staughton LJ was right, that while applying the fraud rule, it is "the time of presentation is crucial", and the bank's knowledge "at the time of trial" is "nothing", then why would a totally different principle apply to the illegality exception, which is also based on the doctrine of "*ex turpi causa*"? Furthermore, if the principle of "the time of presentation is critical" is followed in applying the fraud rule, then the beneficiary might be able to achieve a summary judgment to force the bank to pay as long as the bank had no clear evidence of fraud at the time of presentation. "But what happens if, in the meantime and, before the application for summary judgment is heard, the bank acquires clear evidence of fraud? Is the beneficiary still entitled to judgment? Has the bank lost the "*ex turpi causa*" defence which would have been available to it if it had acquired that clear evidence at the time when it

¹²⁸ *Mahonia*, at 922, *supra* note 10.

¹²⁹ *Ibid.*

¹³⁰ *Ibid.*

was called upon to pay?"¹³¹ An even less reasonable result may be that the beneficiary will be able to claim damages from the bank even the fraud is clearly proved at the time of trial as long as the bank did not have the clearly evidence of the fraud at the time of presentation. It would be ridiculous for the court to assist a fraudulent beneficiary to claim for benefits by relying on his own fraud. This will be clearly in breach of the "reliance principle" to "*ex turpi causa*", which was established in the case of *Holman v Johnson*¹³², by Lord Mansfield CJ "no court will lend its aid to a man who founds his cause of action upon an immoral or an illegal act."¹³³

In this sense, the conclusion in *Mahonia* may be more proper. Colman J decided that "the surety should have a direct defence on the basis of *ex turpi causa* at whatever stage in the proceedings prior to the hearing of the summary judgment application he can adduce the evidence necessary to establish fraud". In other words, the time of presentation may be the crucial time for the evidence of fraud or illegality if the applicant is applying for an interlocutory injunction to restrain a bank from payment or the bank is claiming for reimbursement from the applicant; but in situations where the beneficiary is asking for a summary judgment to force the bank to pay, the strength of the fraud or illegality case has to be tested on the evidence available at the hearing of the summary judgment application, as distinct from the time of the presentation.

¹³¹ Ibid, 921.

¹³² (1775) 1 Cowp 341, 343, see supra note 25

¹³³ For further discussion of "the reliance principle", see earlier this chapter, section 2.2.1.

The above discussion may also benefit the understanding of one of the new approaches in applying the fraud rule, that a bank should not be forced to pay by a summary judgment if it can establish a claim with a real prospect of success that the demand was fraudulent, even if it had no clear evidence of fraud at the time of presentation.¹³⁴ In this circumstance, it is the time of trial that is crucial. By considering the strength of the evidence of fraud, the court should give the bank a chance to prove the fraud if the bank, at the time of hearing the summary judgment, have a real prospect of success in proving the fraud at the later trial. The beneficiary cannot achieve a summary judgment to force the bank to pay by relying on the bank having no clear evidence of fraud at the time of presentation.

¹³⁴ This approach was established in the case of *Safa Ltd. v. Banque Du Caire* [2000] 2 Lloyd's Rep. 600. For detailed discussion of this new approach, see Chapter 3, section 1.4.

Summary

The illegality exception is an essential part of the development of documentary credits system. The illegality exception, like the fraud rule, provides a safe and stable environment for the documentary credits practice. The same basis of the principle of "*ex turpi causa*" between the fraud rule and illegality exception clearly shows the reasonableness and necessity of applying the illegality exception. The research of the detailed application of the illegality exception is not only useful in explaining the illegality exception as a new exception in documentary credits system; it also benefits the understanding of the fraud exception, especially the new approaches which emerged during the 1990s. However, exceptions in documentary credits developed much more quickly than could be expected. Another possible exception, the nullity exception, appeared first in Singapore, starting to affect the English Law only recently. The last chapter of the thesis will be mainly discussing the application of the nullity exception in English law.

Chapter Five: The Nullity Exception in Documentary Credits

Preface

Unlike the other exceptions, the fraud rule and illegality exception, the nullity exception has not been accepted by English law as an independent exception which may impact the ordinary operation of documentary credit system. The case of *Montrod Ltd. v. Grundkötter Fleischvertriebs GmbH*¹ is mainly seen as the clear authority that rejects the nullity exception. However, the Singapore Court of Appeal in *Beam Technologies v. Standard Chartered Bank*² departed from the English position and applied that there is a nullity exception separated from the established fraud exception. This is probably the first time that the nullity exception was applied in common law jurisdiction. This chapter, which is also the last chapter of the thesis, will focus on a discussion of the possibility and restriction in applying a nullity exception in English law. The research may also benefit the early study of the fraud rule and illegality exception.

¹ *Montrod Ltd v. Grundkötter Fleischvertriebs GmbH* [2001] EWCA Civ 1954, [2002] 1 W.L.R 1975.

² *Beam Technologies v. Standard Chartered Bank* [2002] 2 SLR 155, [12]; aff'd [2003] 1 SLR 597.

1. The Nature of the Nullity Exception Contrasted to the Fraud Rule

It is well known that the fraud rule and illegality exception are both established on the application of the principle of "*ex turpi causa*". As the first and most important exception in documentary credits, the fraud rule was developed in *United City Merchants*.³ Lord Diplock restricted the application of the fraud rule to the situation where "the seller, for the purpose of drawing on the credit, fraudulently presents to the...bank documents that contain, expressly or by implication, material representations of fact that to his knowledge are untrue." The rationale for this application is that the principle of "*ex turpi causa*" will not allow the court to help a dishonest person to carry out a fraud. According to the decision of *United City Merchants*, the beneficiary's knowledge of fraud becomes an essential condition in applying the fraud rule. Thus, a beneficiary may still receive payment by presenting forged documents, as long as he has no knowledge of the fraud. In other words, banks are obliged to pay against documents which they know involved fraud because the beneficiary is "innocent".⁴

The decision of Lord Diplock may be seen reasonable on the judicial basis of

³ Before *United City Merchants*, it was not clear whether the fraud of anyone apart from the beneficiary would be sufficient for applying the fraud rule. Even during the Court of Appeal of *United City Merchants*, Mocatta J called the fraud exception as "established or obvious fraud to the knowledge of the bank" [1979] 1 Lloyd's Rep 267, 276 (col 2).

⁴ See K Donnelly, "Nothing for Nothing: a Nullity Exception in Letters of Credit?" [2008] J.B.L 316, 322.

"*ex turpi causa*" since the fraud rule operates as to prevent proven fraudsters from claiming payment. However, it may also cause the circulation of forged documents in international trade. And forged documents is always being seen as "a cancer in international trade"⁵. In this circumstance, an application of a nullity exception may be attractive because it does not require the knowledge of the beneficiary as a condition. The nullity exception, unlike the fraud rule, is based on the attributes of the documents tendered. Therefore, the operation of a nullity exception may not be disturbed by the conduct of the beneficiary.⁶ The nullity exception, if established, will prevent the beneficiary to achieve payments by presenting forged documents which are null no matter whether the beneficiary is innocent to the fraud. Further speaking, according to the nullity exception, the bank will be entitled to refuse payment solely on the null of documents even if there is no fraud involved at all. In the sense, the nullity exception can be useful in solving the problems caused by the limit of the fraud rule. This is also one of main reasons why the application of the nullity exception in documentary credits is so attractive.

2. The Nullity Exception in Singapore

Possibly the first and only official admission of the nullity exception so far is

⁵ See *Standard Chartered Bank v. Pakistan National Shipping Corpn. (No. 2)* [1998] 1 Lloyd's Rep. 684, 686 (QB). See Chapter 2, note 19.

⁶ See Professor Paul Todd, "Non-genuine Shipping Documents and Nullities" [2008] L.M.C.L.Q 547-573, 552.

Beam Technologies v. Standard Chartered Bank in Singapore. This case may be a good start point to discuss the prospective application in English law. The fact of *Beam Technologies* was as follows:

Beam Technology Pte Ltd made a contract of selling electronic components with an Indonesian buyer, PT Mulia Persada Permai. The buyer obtained a letter of credit from the issuing bank, PT Bank Universal HO Jakarta in favour of the seller as the beneficiary.⁸ The credit was then confirmed by Standard Chartered Bank. According to the credit, a full set of clean air way bills was required to be issued by the seller's freight forwarders, "Link Express(S) Pte Ltd". During the time of presentation, the conforming bank, Standard Chartered Bank, rejected the document and refused to pay the seller on the basis of the finding that the seller's freight forwarders, "Link Express(S) Pte Ltd" did not exist at all. The confirming bank believed that there was a forgery in the air way bills.

On this basis, the Court of Appeal of Singapore held that the bank was entitled to reject the forgery. It accepted a nullity exception and took the view that:

"[The] confirming bank is not obliged to pay if it has established within the seven-day period that a material document required under the credit is forged and null and void and notice of it is given within that period."⁹

⁷ *Beam Technologies*, 2003] 1 S.L.R 597, supra note 2.

⁸ The letter of credit was subjected to the terms of UCP 500.

⁹ *Beam Technologies*, 610, supra note 2.

The decision of this judgment was quite on the basis of the facts of the case. In this case, the nullity was clearly established and it was decided that the bank was not obliged to pay against the null documents as long as the nullity can be proved in time. However, a general application of the nullity exception may face more hazards in different cases.

2.1. The identification of nullity in nullity exception

In *Beam Technologies*, the non-existence of the seller's freight forwarders was a straightforward situation of nullity. The air way bill was not only forged but clearly null. However, in applying a nullity exception, it is always a difficult question to determine whether a document is null. There could be lots of confusion between the cases. For example, a misdated bill of lading was decided by Devlin J as "valueless but not a complete nullity"¹⁰ in case *Kwei Tek Chao v. British Traders and Shippers*;¹¹ in contrast, in the case of *Egyptian International Foreign Trade Co v. Soplex Wholesale Supplies*¹², Leggatt J described a misdated bill of lading which includes a misstatement of the vessel's as a "sham piece of paper"¹³. Although it was suggested in "Benjamin's Sale of Goods" that a document in which the forgery destroys the

¹⁰ *Kwei Tek Chao v. British Traders and Shippers* [1954] 1 QB 459, 476.

¹¹ *Ibid.*

¹² *Egyptian International Foreign Trade Co v. Soplex Wholesale Supplies* [1984] 1 Lloyd's Rep 102.

¹³ *Ibid.*, 116.

"whole or essence of the instrument"¹⁴ would be considered as a null document, the concept of "a null document" was not clear.

In *United City Merchants*, Lord Diplock said:

"[T]he bill of lading with the wrong date of loading placed on it by the carrier's agent was far from being a nullity. **It was a valid transferable receipt for the goods giving the holder a right to claim** them at their destination ... and was evidence of the terms of the contract under which they were being carried."¹⁵

It seems Lord Diplock explained nullity from the legal right provided by documents against the carrier. In other words, a document is null if it can not provide any legal rights to the holder against other people. For a bill of lading, the nullity will make the documents given no legal right to the holder to claim against the carrier. Kieran Donnelly understands this explanation as similar to the approach of "destruction of the whole or essence of the instrument"¹⁶. Accordingly, a bill of lading that has been fraudulently backdated is not a nullity, it does not render the bill of lading as being without legal effect. And, in *Heskell v. Continental Express Ltd*¹⁷, the bill of lading issued was decided as a nullity by Devlin J because the cargo had been left behind.

¹⁴ Professor Michael Bridge, edits, "Benjamin's Sale of Goods", (10th edn, Sweet & Maxwell. 2010), para 19-034.

¹⁵ *United City Merchants* [1983] 1 A.C. 168, 188.

¹⁶ For further reading, see Kieran Donnelly, "Nothing for Nothing: a Nullity Exception in Letters of Credit?" [2008] J.B.L.316, 317-321; Professor Michael Bridge, edits, "Benjamin's Sale of Goods", (10th edn, Sweet & Maxwell. 2010)¹⁶; *Heskell v. Continental Express Ltd* (1950) 83 Ll L Rep 438, 455 (col 2).

¹⁷ *Heskell v. Continental Express Ltd* [1950] 1 All England 1033.

However, it is not easy to define nullity during practice, for example, Devlin J while citing *Kreditbank Cassel GmbH v. Schenkers Ltd*,¹⁸ as the authority of forged signature will usually render a document a nullity, also decided a forged signature need not render the document a nullity if it is not central to the imposition of liability. Therefore, "whereas a test based on deprivation of all legal effect is reasonably certain, the essence of a document to one party might differ from its essence to another."¹⁹

The issue may be more complex when it comes to the nullity exception in documentary credits. In *Montrod*, the forged signature was in an inspection certificates, and an unauthorized signature would have deprived it of all legal effect. But the Court of Appeal implied that a document signed by the beneficiary in honest error as to its authority would not be a nullity. The unclear identification of the concept of "nullity" will no doubt cause difficulty in applying a nullity exception in documentary credits.²⁰

2.2. The materiality of the document

While the application is between the bank and the beneficiary, the identification of nullity is probably depending on the security interests provided by the document to the bank. However, the weight of security

¹⁸ *Kreditbank Cassel GmbH v. Schenkers Ltd* [1927] 1 KB 826, 835, per Bankes LJ.

¹⁹ Professor Paul Todd, "Non-genuine Shipping Documents and Nullities", *supra* note 6.

²⁰ L. Chin and Y. Wong, "Autonomy A Nullity Exception at Last?" [2004] L.M.C.L.Q. 14, 17.

interests in documents may also vary by the type of the document. This is probably also the reason why the Court of Appeal of Singapore mentioned the materiality of documents as a main issue in applying the nullity exception.

For instances, a null certificate, which was proved in *Gian Singh and Montrod*, may not affect the bank's security interest very much. However, if the null document was an insurance document, the bank's security interests may be reduced or even destroyed by the null document. The most serious demolition to banks' security interests on documents may caused by a null bill of lading. While it is possible that other documents can also be documents of title, the only document about which this can always be said with certainty is the shipped bill of lading.²¹ A delivery of the bill of lading can be seen as a transfer of the goods. Banks usually take the bill of lading as their main security in documents. A null bill of lading means a total destruction of the banks' security interests. If the required shipping document is a bill of lading, and the bill of lading is so defective that it cannot be regarded as being a bill of lading at all; the extreme case could be that a document appearing to be a bill of lading is produced, conforming on its face with the terms of the credit, but both ship and cargo are invented. In that case, whatever this piece of paper looks like, on no reasonable definition can it be described as a bill of lading"²², it will offer no security to the bank if it is not a bill of lading. It is unreasonable to force a bank to pay against a document, especially a bill of

²¹ Professor Paul Todd, "Bills of Lading and Bankers' Documentary Credits", (4th edn, Informa Law, 2007), p. 106.

²² Professor Paul Todd, [2008] L.M.C.L.Q 547-573, 554, *supra* note 6.

lading, which is known to the bank as a piece of paper provided no security. The different security interests provided by different kinds of documents may cause more difficulties in defining the concept of nullity.

What is more? The materiality itself is a complex issue for the application of the nullity exception. A similar issue was pointed out by Lord Diplock in *United City Merchants*. Regarding to the submission that the bank is entitled to reject payment if there was a material misstatement in the document, Lord Diplock asked the question: "material to what?". He then rejected the suggested answer of "a misstatement of a fact which if the true fact had been disclosed would have entitled the buyer to reject the goods" and explained the reason as "this is to destroy the autonomy of the documentary credit".²³ Of course, a material misstatement may not affect the buyer's obligation under a letter of credit according to the autonomy principle. However, the bank may not be forced to pay if it knows there is a material inaccuracy in documents which may affect its ability to pay. Actually, this view, which was first mentioned by Stephenson LJ during the Court of Appeal of *United City Merchants*,²⁴ was not rejected by Lord Diplock either. Lord Diplock said in the House of Lords:

"if this were so, **the answer** to the question: "to what must the misstatement in the documents be material?" **should be: "material to the price which the goods to which the documents relate would fetch on sale if, failing reimbursement by the buyer, the bank should be driven to realise its security."** But this would not justify the confirming bank's refusal

²³ See *United City Merchants*, at 185, *supra* note 15.

²⁴ See *United City Merchants* [1982] Q.B. 208, 239.

to honour the credit in the instant case; the realizable value on arrival at Callao of a glass fibre manufacturing plant made to the specification of the buyers could not be in any way affected by its having been loaded on board a ship at Felixstowe on December 16, instead of December 15, 1976."²⁵

Lord Diplock, though believed the forged date in the document was not material enough to affect the bank's security interests, did not clearly suggest the bank's position when the forgery in the document was material enough to affect the bank's security interests. In this sense, banks' discretion to reject a forgery document which is material enough to affect its ability of payment should not be seen as to destroy the autonomy in documentary credits. The distinctive relationship between the bank and the beneficiary was also an essential for the application of the nullity exception in the Singapore case.

2.3. The distinctive cause of action

In *Beam Technologies*, the action was between a confirming bank and the seller who was the beneficiary of the letter of credit. In that case, the bank chose to go behind the face of the document and found the nullity. However, banks were not under an obligation of examining any issues besides whether documents are facially conforming under UCP 500.²⁶ The relevant provisions

²⁵ See *United City Merchants*, at 186, supra note 15.

²⁶ See UCP500, Article 13a: "Banks must examine all documents stipulated in the Credit with reasonable care, to ascertain whether or not they appear, on their face, to be in compliance with the terms and conditions of the Credit. Compliance of the stipulated documents on their face with the terms and conditions of the Credit shall be determined by international standard banking practice as reflected in these Articles. Documents which appear on their face to be inconsistent with one another will be considered as not appearing

in UCP 600 are Articles 7(a) and 8(a)²⁷. In this case, the authority of Singapore in applying a nullity exception may only be seen as restricted between the bank and the beneficiary. And the bank choose to reject the null documents by relying on its security interests under the letter of credit and took the risk of being sued by the beneficiary. Thus, one question may be proposed here: What is the situation if the bank chose to accept the document by its facially conforming, would the buyer in this case be able the make a defence on the nullity exception? This was just what happened in the English case *Montrod Ltd v. Grundkotter Fleischvertriebs GmbH*²⁸.

3. The Facts and Judgment in the Case of Montrod

Although the nullity exception was approved by the Singapore authority, it was generally rejected by English courts in *Montrod Ltd v. Grundkotter Fleischvertriebs GmbH*²⁹. *Montrod* was also the first case which clearly considered and discussed the possible application of the nullity exception as a separate exception in documentary credits in English law.

on their face to be in compliance with the terms and conditions of the Credit. Documents not stipulated in the Credit will not be examined by banks. If they receive such documents, they shall return them to the presenter or pass them on without responsibility."

²⁷ UCP 500, Article 7(a) "[Issuing Bank Undertaking] [p]rovided that the stipulated documents are presented to the issuing bank and they constitute a complying presentation, the issuing bank must honour if the credit is available by..."; Article 8(a) "[Confirming Bank Undertaking] [p]rovided that the stipulated documents are presented to the confirming bank or to any other nominated bank and that they constitute a complying presentation, the confirming bank must..."

²⁸ *Montrod*, supra note 1.

²⁹ Ibid.

In *Montrod*, there was a CIF contract between a German company and Russian entity, for the sale of a large consignment of frozen pork. The transaction was financed by a documentary credit issued by the third defendant bank (SCB), at the request of the second defendant (Fibi), on the application of the claimant (Montrod). One of the documents required under the credit was a "certificate of inspection issued and signed by Montrod at his discretion on the goods quality and quantity in good order before shipment" which should be presented by the beneficiary of the credit, GK. Montrod had the intention that this stipulation of certificate would allow them to delay payment until they themselves were put in funds. GK was unaware of this intention though. GK presented the certificate, which was actually signed by GK himself (GK believed he had Montrod's authority to do so), to SCB for payment. And SCB claimed reimbursement against Fibi. In turn Fibi claimed a similar reimbursement from Montrod. Montrod refused reimbursement and claimed that SCB should have refused payment on the ground that the certificate was a nullity. Montrod's claim was dismissed by the judge. Then Montrod appealed and GK started a cross-appeal.³⁰

During the hearing of the appeal, Potter LJ, after explaining the fact of the case, first pointed to the possible nullity exception and said:

"The formulation of the so-called "nullity exception" as advanced before the judge was as follows:

³⁰ There were actually two claims arose by Montrod: one was on the ground of the nullity of the certificate, and the other one was that GK had acted negligently and in breach of fiduciary duty in presenting the certificate. The second claim was also rejected by the court.

'If, by the time of full payment (or the time when a bank irrevocably commits itself to a third party who has taken in good faith, if earlier), the only reasonable inference is that one (or more) of the documents ... presented under the credit is not what it appears on its face to be, but is a nullity, then the bank is not obliged to make payment under the credit.'"³¹

Then Potter LJ brought the decision of early judgment into discussion by an analysis of UCP500 Articles which is to the autonomy principle and banks' duties under documentary credits.³² He emphasized on the issue of the liability of the bank under the credit stated:

"Leaving aside for a moment the exception of fraud on the part of the beneficiary (which the judge held not to exist) the liability of SCB to make payment under the UCP 500 terms is clear.

...Neither as a matter of general principle, nor under UCP 500, is an issuing bank obliged to question or investigate the genuineness of documents which appear on their face to be documents the nature and content of which comply with the requirements of the credit."³³

He took the words of Lord Diplock in case *Gian Singh & Co Ltd v Banque de l'Indochine*³⁴ as an example:

"The fact that a document presented by the beneficiary under a documentary credit, which otherwise conforms to the requirements of the credit, is in fact a forgery does not, of itself, prevent the issuing bank from recovering from its customer money paid under the credit. The duty of the issuing bank, which it may perform either by itself, or by

³¹ *Montrod*, at 1983, supra note 1.

³² UCP 500 Article 3, 4, 9, 13, 14, and 15, were cited during discussion.

³³ *Montrod*, [2001] EWCA Civ 1954, 1985 to 1986, supra note 1.

³⁴ *Gian Singh & Co. Ltd. v. Banque de L'Indochine* Judicial Committee of the Privy Council [1974] 2 Lloyd's Rep. 1

its agent, the notifying bank, is to examine documents with reasonable care to ascertain that they appear on their face to be in accordance with the terms and conditions of the credit."

To discuss the banks' liability when the application of exceptions involved in, Potter LJ cited Rix J's decision in *Czarnikow-Rionda Sugar Trading Inc v Standard Bank London Ltd*.³⁵

"The fact that the rationale of the fraud exception is the law's prohibition on the use of its process to carry out fraud (per Lord Diplock in *United City Merchants (Investments) Ltd v Royal Bank of Canada*) may appropriately be viewed as an authoritative expression of the source of law of the implied limitation on a bank's mandate... If the source of the power to injunct were purely the law's interest in preventing the beneficiary from benefiting from his own fraud, I do not see why there should be the added requirement that the fraud be patent to the bank"

Potter LJ also made a support to Lord Diplock's view on "halfway house" that the intention of beneficiary was crucial for applying the fraud rule in *United City Merchants*.³⁶:

"I consider that the judge was correct in the decision to which he came. The Fraud Exception to the autonomy principle recognised in English law has hitherto been restricted to, and it is in my view desirable that it should remain based upon, the fraud or knowledge of fraud on the part of the beneficiary or other party seeking payment under and in accordance with the terms of the letter of credit. It should not be avoided or extended by the argument that a document presented, which conforms on its face with the terms of the letter of the credit, is none

³⁵ *Czarnikow-Rionda Sugar Trading Inc v Standard Bank London Ltd* [1999] 2 Lloyd's Rep 187, 203.

³⁶ *United City Merchants*, supra note 15.

the less of a character which disentitles the person making the demand to payment because it is fraudulent in itself, independently of the knowledge and bona fides of the demanding party."³⁷

And for the words of Lord Diplock that "I would prefer to leave open the question of the rights of an innocent seller/beneficiary against the confirming bank when a document presented by him is a nullity because unknown to him it was forged by some third party; for that question does not arise in the instant case."³⁸, Potter LJ explained:

"While he left open the position in relation to a forged document where the effect of the forgery was to render the document a 'nullity", there is nothing to suggest that he would have recognised any nullity exception as extending to a document which was not forged (i.e. fraudulently produced) but was signed by the creator in honest error as to his authority; nor do I consider that such an exception should be recognised."³⁹

After all the discussion, Potter LJ made a decision in the current case and stated:

"I do not consider that the fact that in this case it was the seller/beneficiary himself who created the document said to be a nullity should of itself disentitle him to payment, assuming (as the judge found) that such creation was devoid of any fraudulent intent..."⁴⁰

He also made a clear expression about the appliance of the nullity exception and gave the reason as follows:

³⁷ *Montrou*, [2001] EWCA Civ 1954, 1991, *supra* note 1.

³⁸ *United City Merchants*, at 188, *supra* note 15.

³⁹ *Montrou*, at 1991-1992, *supra* note 1.

⁴⁰ *Ibid*, 1992.

"In my view there are sound policy reasons for not extending the law by creation of a general nullity exception ... The creation of a general nullity exception, the formulation of which does not seem to me susceptible of precision, involves making undesirable inroads into the principles of autonomy and negotiability universally recognised in relation to letter of credit transactions."⁴¹

However, after the conclusion of "there should be no general nullity exception based upon the concept of a document being fraudulent in itself or devoid of commercial value"⁴² Potter LJ added an idea that there might be possibility that **"the conduct of a beneficiary in connection with the creation and /or presentation of a document forged by a third party might, though itself nor amounting to fraud, be of such character as not to deserve the protection available to a holder in due course"**.⁴³

To make the above idea clear, he cited the decision of the High Court of Singapore in *Lambias (Importers and Exporters) Co Pte Ltd v. Hong Kong and Shanghai Banking Corp*⁴⁴. In this case, the defendant bank rejected documents tendered under a letter of credit which included a quality and weight inspection certificate required to be countersigned by a named individual. The court held that the certificate contained discrepancies which entitled the bank to refuse the documents tendered and went on to find that the inspection certificate was in any event a nullity by the following words:

⁴¹ Ibid.

⁴² Ibid.

⁴³ Ibid, 1992-1993.

⁴⁴ *Lambias (Importers and Exporters) Co Pte Ltd v. Hong Kong and Shanghai Banking Corp* [1993] 2 SLR 751.

"The law cannot condone actions which, although not amounting to fraud per se, are of such recklessness and haste that the documents produced as a result are clearly not in conformity with the requirements of the credit. The plaintiffs in the present case are not guilty of fraud, but they were unknowingly responsible for having aided in the perpetration of the fraud. In such a case where the fraud was discovered even before all other documents were tendered, I think it is right and proper that the plaintiffs should not be permitted to claim under the letter of credit."⁴⁵

While the Singapore High Court's decision argued against a rejection of the nullity exception, Potter LJ's took a narrow view of it:

"While such a finding was not necessary to the outcome of the case, it fell within the reservation of Lord Diplock in the *United City Merchants* case and has certain attractions. However, it is not necessary for us to decide in this case whether it is correct. This is a case where the judge found neither recklessness, haste, nor blame in the conduct of GK. Furthermore, in the *Lambias* case the bank rejected the documents as non-compliant, whereas in this case SCB accepted the documents as compliant, having raised Montrod's observations and reservations with Fibi before it did so. Fibi in turn accepted the documents when sent to them, making clear to Montrod that payment would be made unless a court order to prevent it were obtained."

4. Arguments for Applying the Nullity Exception

Although *Montrod* rejected an application of the nullity exception. The

⁴⁵ Ibid. 765-766.

decision was not approved by some commentators⁴⁶. The mandate of banks under a letter of credit became a complex issue and was discussed in many articles.

4.1. The mandate of the bank to the applicant

A strong dissent arose from the bank's position as agent of the applicant. It was argued that besides the title of receiving reimbursement from the applicant, the bank must also act within the mandate to the applicant. And no applicant would authorize a bank to accept and pay out on tendered documents that, to the bank's knowledge, involve nullity, because the applicant will ultimately be obliged to reimburse the bank and therefore bear the loss resulting from acceptance of such documents. Therefore, where the bank knows that the documents tendered are fraudulent or a nullity it is arguably entitled to, and required to, withhold payment on the basis that to accept and pay on such documents would fall outside its mandate from the applicant.⁴⁷

However, the thesis argues **the above proposition is strongly unpersuasive.**

First, according to the UCP, banks' obligations under documentary credits may

⁴⁶ E.g. L. Chin and Y. Wong, "Autonomy: a Nullity Exception at Last" [2004] M.C.L.Q. 14; Neo "A Nullity Exception " [2004] Singapore Journal of Legal Studies 46; and Kieran Donnelly, " Nothing for Nothing: a Nullity Exception in Letters of Credit?" [2008] J.B.L.316; etc.

⁴⁷ Kieran Donnelly, [2008] J.B.L.316, 322, *supra* note 5.

be split into two sides. On one hand, the bank owes a duty to the applicant to examine the stipulated documents in the credit before payment; on the other hand, the bank owes a duty to the beneficiary to pay as long as the documents are conforming. In another words, a bank is not only working as an agent of the applicant, the bank itself has a connection with the beneficiary. Accordingly, a bank's mandate may not be limited to the obligation of an agent of the applicant. It is also obliged to perform the obligation of payment against conforming documents to the beneficiary, which is one of the core mandates of bank under documentary credit system.

Secondly, it is the bank's mandate to follow the instructions from the applicant to examine documents under the credit, however, this mandate only requires the bank to examine the face conformity of documents with reasonable care. As long as the bank examined the face conformity of the documents, the bank had completed its obligation to the applicant. It is unreasonable to ask the bank to bear any loss caused by the fraud or nullity even it did exist but the bank did not realize the issue. The bank's responsibility is only to examine the facially conformity of documents. In fact, to the bank, even the application of the fraud rule to refuse the payment is "extra-contractual"⁴⁸. It is . What is more, the underlying contract provides alternative actions to the parties to it, in respect of the matters already considered. For example, if the beneficiary of a credit is in breach of the sale contract, the applicant can sue for damages, it is not necessary to ask to

⁴⁸ See *Bolivinter Oil S.A. v. Chase Manhattan Bank N.A.* [1984] 1 Lloyd's Rep. 251, 257; also see *Czarnikow-Rionda*, [1999] 2 Lloyd's Rep. 187, 199, *supra* note 35.

bank to refuse the payment to the beneficiary of a credit because the beneficiary is in breach of the underlying contract. Actually, it would be against the autonomy principle of documentary credits to ask the bank to consider the performance of the underlying contract. Accordingly, the bank is entitled to pay against facially conforming documents and get reimbursement. Banks are not in breach of their mandate to pay against apparently conforming documents even the documents is forged or null as long as they examined documents strictly complying with the credit. Banks are not liable for the damages caused by the forgery or nullity of the documents, and are entitled to get the reimbursement from the applicant.⁴⁹

4.2. Banks' security interests based on documents

The documents, which are essential for both the documentary credits contract and the underlying contract, may also have a close connection with the bank. The system of international trade which is financed by documentary credits requires banks to look to the applicant for reimbursement after paying on the credit. Banks will, therefore, generally seek to strengthen their position by taking security from the applicant for protection in case of the applicant is unable to pay.⁵⁰ And documents which are in the control of the bank before reimbursement may contain a very important security interest for the bank. A

⁴⁹ The decision of *Gian Singh*, supra note 34, was based on a similar principle.

⁵⁰ Neo "A Nullity Exception" [2004] Singapore Journal of Legal Studies 46, 58.

forged especially null document may cause a disaster for banks' security interests. Choo Han Teck JC held in the case of *Beam Technologies v. Standard Chartered*⁵¹ that a forged document is not a "document" at all and is indistinguishable from a "blank piece of paper", which implies that such a document is commercially worthless, offering no security.⁵² Accordingly, it is unreasonable to force a bank to pay against a document, especially a bill of lading, which is known to the bank as a piece of paper provided no security interests at all.

Professor Paul Todd, while discussing the decision in *Gian Singh*, pointed the distinction of the nullity issue arose between bank and beneficiary and said:

"Even though a bank which pays against a document which is a nullity should be entitled to reimbursement, a bank which is aware, at time of presentation, that a document tendered is a nullity, thereby according it no security, should be entitled to refuse it."⁵³

The importance of the banks' security interest was also discussed by Ackner LJ in the Court of Appeal in *United City Merchants*.⁵⁴ Unlike Lord Diplock in the House of Lords, Ackner LJ took the view that the bank was entitled to reject the facially conforming documents. He expressed his view of the important of the bank's security interests and said:

⁵¹ *Beam Technologies*, supra note 2; L Y Chin and Y K Wong, [2004] L.M.C.L.Q 14, supra note 46.

⁵² Seer R Hooley, "Fraud and Letters of Credit: Is There a Nullity Exception?" [2002] C.L.J 379, 380; Professor Paul Todd, "Non-genuine Shipping Documents and Nullities", supra note 6.

⁵³ Professor Paul Todd, "Non-genuine Shipping Documents and Nullities" at 554, supra note 6.

⁵⁴ *United City Merchants* [1982] Q.B. 208, supra note 24.

"Moreover, the bank is prepared to provide finance to the exporter because it holds shipping documents as collateral security for the advance and, if necessary, can take recourse to the buyer as instructing customer and the exporter as drawer of the bill. The bank invariably asks for the delivery of a full set of original bills of lading; otherwise a fraudulent shipper would be able to obtain payment under the documentary credit on one of them and advances from other banks on the security of the other originals constituting the set: see Schmitthoff's, *The Export Trade*⁵⁵, 6th ed. (1975), p. 216. It is therefore of vital importance to the bank not to take up worthless documents."⁵⁶

Although the decision of the Court of Appeal was rejected by Lord Diplock in the House of Lords, the thesis believes the security interests should not be ignored when nullity issue arises in a documentary credit case. In fact, nullity was not established in *United City Merchants*. Ackner LJ himself said during the appeal that "a bill of lading on which the date of shipment has been forged is not a nullity, since such a forgery would not go to the essence of the document, the primary purpose of which is to evidence a contract of affreightment and to enable the buyer to remove the goods from the ship."⁵⁷ Thus, the decision of Lord Diplock, which rejected the application of the fraud rule in this case, could not be seen as an authority rejected the nullity exception in documentary credits. Actually, Lord Diplock, when deciding that fraud by a third party could not be acknowledged as an established fraud for the application of the fraud rule, pointed out a possible different application

⁵⁵ The current edition is Carole Murray, Leo D'Arcy, Barbara Cleave, Giles Dixon and Daren Timson-Hunt, *Schmitthoff's Export Trade, The Law and Practice of International Trade*, (11th edn, Sweet & Maxwell, 2007), p. 221.

⁵⁶ *United City Merchants* [1982] Q.B. 208, 247, *supra* note 24.

⁵⁷ *Ibid.*

which is a nullity issue arose between an innocent beneficiary and the bank by the following words:

"I would not wish to be taken as accepting that the premise as to forged documents is correct, even where the fact that the document is forged deprives it of all legal effect and makes it a nullity, and so worthless to the confirming bank as security for its advances to the buyer. . . . **I would prefer to leave open the question of the rights of an innocent seller/beneficiary against the confirming bank when a document presented by him is a nullity because unknown to him it was forged by some third party;** for that question does not arise in the instant case."⁵⁸

Lord Diplock did not only admit the possibility of applying a nullity exception between the bank and innocent beneficiary but also emphasized the documents as "the security for its advances to the buyer ". It seems that Lord Diplock himself saw banks' security interests as the rationale of the application of a nullity exception between the bank and beneficiary. In fact, banks' security which was emphasised by both Ackner LJ and Griffiths LJ during the Court of Appeal, was not rejected by Lord Diplock as an essential in documentary credits cases. But Lord Diplock alleged this would not justify the confirming bank's refusal to honour the credit in *United City Merchants*, because the realisable value of the goods could not be affected by its having been loaded on board one day late.⁵⁹ Banks' security interests, in anyway, should not be ignored in documentary credits system. It may be considered

⁵⁸ *United City Merchants* [1983] 1 A.C 168, 188, supra note 15.

⁵⁹ *Ibid*, 186. Of course, Lord Diplock also discussed the beneficiary's position as a holder in due course. This issue is discussed later in section 4.2.2, this chapter.

as a essential defence for banks to reject payment against the beneficiary when the document presented is null. Of course, issues regarding to the justification of a null document or the materiality of a documents can be another difficult problem.

4.3. The beneficiary's liability by presenting null documents

This is no doubt that under a letter of credit the bank is only obliged to examine the face of the document but actual performance of the underlying contracts. Therefore, the bank takes no responsibility by paying against a forged or null document as long as the document is in facial conformity. However, there must be a difference between the bank's responsibility of examining documents and the beneficiary's obligation of presenting conforming documents. Under Arts 7(a) and 8(a) of the UCP 600, the bank's obligation of payment is against "a complying representation", and Arts 2 defined the "complying representation" as complying presentation as one that is in accordance with the terms and conditions of the credit. Accordingly, UCP 600 does not say that the beneficiary's obligation of presenting complying documents can be satisfied by presenting documents only in facial conformity. In fact, the beneficiary, who was also a party of the underlying contract, was supposed to have the knowledge of the underlying contract. At least, the beneficiary should have a common sense that the document relevant to the

underlying contract must not be forged. It is reasonable to rely on the beneficiary to check the authenticity of documents before he hands in them to the bank. What is more, in single transactions it is arguable that the beneficiary is the only party in a position to police the validity of the documents produced by third parties and, accordingly, that he should bear the burden of any loss associated with presented documents that are a nullity.⁶⁰ The position of an innocent beneficiary in the illegality exception cases was even less clear. CP 189 itself admits that it is not clear from the case law whether an illegal contract is always unenforceable by both parties, or whether there are circumstances in which only one party will be affected in both the statutory illegal and common law illegal cases.⁶¹ In some cases, the innocent party had already been prohibited to enforce the contract which was tainted by an illegal purpose.⁶² When comes to the fraud rule, the seller beneficiary may not be seem as liable to present a forged document because it was not the beneficiary who forged it. However, it will be hard to see why the beneficiary should not be liable for the loss of the commercial value of a null document.

In the Court of Appeal in *United City Merchants*, Stephenson LJ said:

"Banks trust beneficiaries to present honest documents; if beneficiaries go to others (as they have to) for the documents they present, it is important to all concerned that those documents

⁶⁰ Kieran Donnelly, [2008] J.B.L.316, 338, supra note 5.

⁶¹ See CP 189, 3.8 to 3.32. Also see section 2.1.2 in Chapter 4 of the thesis.

⁶² For example, see *J M Allan (Merchandising) Limited v. Cloke* [1963] 2 QB 340, the claimant's attempt to recover rent under the agreement failed in despite of his innocence.

should accord, not merely with the requirements of the credit but with the facts; and if they do not because of the intention of anyone concerned with them to deceive, I see good reason for the choice between two innocent parties putting the loss upon the beneficiary, not the bank or its customer."⁶³

Stephenson LJ's above word showed a clear support to the view that the beneficiary should be liable to present null documents and further bare the damages caused by the null documents. The innocent of the beneficiary may not be seen as the reason of transferring the damages to either the bank.⁶⁴ Kieran Donnelly also believed "the beneficiary should bear the risk that a document presented might be a nullity on the basis that it is the beneficiary who has the obligation to present conforming documents which are genuine and valid"⁶⁵.

If the above analysis is correct, then it may be concluded that when the nullity issue arose between the applicant and beneficiary without the involvement of the bank, the applicant may be entitled to prevent the beneficiary from demanding by relying on the nullity of the document. However, the situation can be different when the nullity issue arose between the applicant and bank. The contractual relationship between the applicant and beneficiary, is different to which between the applicant and bank similarly in the application of the fraud rule.⁶⁶

⁶³ *United City Merchants* [1982] Q.B. 208, 234, supra note 24.

⁶⁴ However, Lord Diplock may disagree to Stephenson LJ because he believed that the innocent beneficiary should be in the same position as a holder in due course. [1983] 1 AC 168, 187 to 188. See section 4.2 of this chapter for further discussion.

⁶⁵ Kieran Donnelly, [2008] J.B.L.316, 338, supra note 5.

⁶⁶ See different decision between *Themehelp Ltd. v. West* [1996] QB 84 and *Consolidated Oil Ltd v. American Express Bank Ltd* [2002] CLC 488.

After the discussion of the arguments above, the thesis argues an application of the nullity exception is quite reasonable according to banks' security interests and the beneficiary's obligation regarding to documents. However, English Courts seems not being attracted by the new exception according to the decision in *Montrod*. Therefore, it may be necessary to analyse English authorities relevant to the application of the nullity exception.

5. An Analysis to English Authorities related to the Nullity Exception

Although *Montrod* was the first case which clearly considered and discussed the possible application of the nullity exception as a separate exception in documentary credits in England and Wales, nullity is not a totally fresh issue in English law; it was mentioned and discussed in many cases during the application of the fraud rule.⁶⁷

5.1. The decision in *Gian Singh*

Similarly to the fraud rule and illegality exception, the most serious obstacle

⁶⁷ E.g. see *Gian Singh & Co. Ltd. v. Banque de L'Indochine* [1974] 2 Lloyd's Rep. 1; *United City Merchants Ltd. and Glass Fibres and Equipments Ltd. v. Royal Bank of Canada* [1983] 1 A.C. 168(HL).

for the application of a nullity exception is the autonomy principle in documentary credits. The autonomy principle leads a separation between the bank's letter of credit contract with applicant or beneficiary and the underlying contract. Accordingly, a bank is entitled to pay a beneficiary and to get the reimbursement from the applicant as long as a facially complying document is presented.⁶⁸ The autonomy principle requires the parties to a documentary credit to assume that the bank will neither wish nor be able to concern itself with disputes under the underlying transaction, and that the seller's assured right to payment should be independent of such disputes.⁶⁹ An earlier approach in nullity issues in documentary credits was showed by the case of *Gian Singh & Co. Ltd. v. Banque de l'Indochine*.⁷⁰

In that case, it was proved that the signature in a document was a forgery, and accordingly the document, which was a certificate, was also a forgery. In other words, the certificate was null. However, the decision of both the Court of Appeal and the House of Lords were both in favour of the bank because the forged signature was made in personal capacity and the certificate therefore complied with the term of the credit. Although the nullity exception was not discussed in this case, *Gian Singh* is an early case which implied English court's approach in the apply of a nullity exception in documentary

⁶⁸ UCP 600 - Article 7 a. "Issuing Bank [u]ndertaking a. Provided that the stipulated documents are presented to the nominated bank or to the issuing bank and that they constitute a complying presentation, the issuing bank must honour..."; c. "An issuing bank undertakes to reimburse a nominated bank that has honoured or negotiated a complying presentation and forwarded the documents to the issuing bank..."

⁶⁹ Professor Paul Todd, "Non-genuine Shipping Documents and Nullities" at 554, *supra* note 6.

⁷⁰ [1974] 2 Lloyd's Rep. 1.

credits. A certificate which contained a forged signature was a clearly null document. Nevertheless, the nullity did not prevent the bank from getting a reimbursement from his client.

However, It can only be concluded from *Gian Singh* that there is no nullity exception exists as between the issuing bank and the applicant for the credit, and presumably the same principle would operate as between the banks.⁷¹ The essential view in the judgment was that the duty of the bank "is to examine documents with reasonable care to ascertain that they appear on their face to be in accordance with the terms and conditions of the credit", and "the bank is under no duty to take any further steps to investigate the genuineness of a signature which, on the face of it, purports to be the signature of the person named or described in the letter of credit."⁷² Therefore, the bank is entitled to get reimbursement from the applicant as long as the documents was conforming on the face even if it was clearly a null document. But there is no discussion in whether a null document will entitle the bank to refuse to pay against the beneficiary. Therefore, *Gian Singh* should not be seen as an authority which was contrasted to the application of Singapore court.

⁷¹ Professor Paul Todd, "Non-genuine Shipping Documents and Nullities" at 555, *supra* note 6.

⁷² *Gian Singh* [1974] 2 Lloyd's Rep. 1, 11, *supra* note 34.

5.2. The judgement in *United City Merchant*

5.2.1. "Matching duties"

In the case of *United City Merchant*⁷³, Lord Diplock though rejected the application of the fraud rule kept neutral in discussing the possible nullity issue arose between an innocent beneficiary and the bank by saying:

"...I would prefer to leave open the question of the rights of an innocent seller/beneficiary against the confirming bank when a document presented by him is a nullity because unknown to him it was forged by some third party; for that question does not arise in the instant case..."⁷⁴

Lord Diplock did not reject the possibility of having a nullity exception between the bank and the beneficiary. But his later analysis in bank's discretion of accepting forged the document seems implied that he is not in favor of considering the difference between the duty of the bank to the applicant and what to the beneficiary. He said:

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

⁷³ *United City Merchants* [1983] 1 A.C 168, supra note 15.

⁷⁴ *Ibid*, 188.

confirming documents."⁷⁵

If Lord Diplock was right in the above words that the contractual relationship between the bank and the applicant is equ to the what between the bank and the beneficiary, then it would be no reason why the nullity exception which does not exit between the bank and applicant should exit between the bank and the beneficiary. However, it seems quite clear that the two relationships can not be the same. On one hand, banks' payment obligation of paying against conforming documents to the beneficiary does not equal to bank's responsibility of not paying against document which are facially nonconforming. On the other hand, bank's payment obligation against conforming documents is even more different to bank's title of get the reimbursement from the applicant as long as he is payment against apparently conforming documents.⁷⁶

It is true that the bank is entitled to pay against facially conforming documents, and receive reimbursement when the document appears on its face to conform, but it goes too far to say that the bank is obliged to make payment against non-conforming documents.⁷⁷ In fact, the distinction between "the contractual duty assumed by the bank under the letter of credit and the availability to a beneficiary of a remedy for breach of that duty" has already

⁷⁵ Ibid.184-185.

⁷⁶ For detailed discussion of the relationships among the bank, applicant and beneficiary, see Chapter 1, section 2.1 to 2.3.

⁷⁷ Hooley [2002] CLJ 379, 280, supra note 52; see also Roy Goode and Ewan McKendrick, "Commercial Law", (4th edn, Penguin, 2009), p. 1008-1009, for detailed discussion see section 2.2 of this chapter.

been discussed in the case of *Mahonia*⁷⁸. Also banks' discretion to refuse to pay, and to take the risk of being sued by the beneficiary had already been analysed during the discussion of the new approaches in applying the fraud.⁷⁹ Therefore, there is no reason why there could not be a different application of the nullity exception between the bank and the beneficiary other than between the applicant and the bank. As between the bank and the beneficiary, the bank is free to choose to reject the null document by relying on its security interests. Of course, similar to the application of the fraud rule or illegality exception, the bank should be ready to take the risk for being sued by the beneficiary for a wrongful dishonour.

5.2.2. "Holder in due course"

One of the main arguments for an application of the nullity exception during the early discussion was that the beneficiary should bear the risk by presenting a nullity because it is the beneficiary's obligation to present conforming documents which are genuine and valid.⁸⁰ However, Lord Diplock's view that an innocent beneficiary may be seen in the same position as the holder in due course may be a big challenge for the above argument.

"This is certainly not so under the Uniform Commercial Code as against a person who has taken a draft drawn under the credit in circumstances that

⁷⁸ *Mahonia Ltd v. JP Morgan Chase Bank* (No.1) [2003] 2 Lloyd's Rep 911, 922. See Chapter 4, section 4.3.

⁷⁹ See *Balfour Beatty Civil Engineering v. Technical & General Guarantee Co Ltd* (1999) 68 Con LR 180, cited with approval in *Safa Ltd v. Banque du Caire* [2000] 2 Lloyd's Rep 600. For a detailed discussion in the necessity of banks' knowledge see Chapter 3, section 3.2 and Chapter 4, section 5.3.1.

⁸⁰ See section 2.3 of this chapter.

would make him a holder in due course, and I see no reason why, and there is nothing in the Uniform Commercial Code to suggest that, a seller/beneficiary who is ignorant of the forgery should be in any worse position because he has not negotiated the draft before presentation."⁸¹

Lord Diplock alleged that an innocent seller/beneficiary who was ignorant of the forgery was in the same position of a holder in due course. But the thesis does not think this view is so convictive. How could be a seller of a contract, who actually had duties of doing a genuine performance to the buyer and providing security to the bank, under the same protection as a holder in due course who has nothing to do with the performance of the contract? The idea of the seller should not be seen as the holder in due course was also supported by Professor Roy Goode, who expressed in his Article "Reflections on Letters of Credit - I"⁸² as follows:

"Is a plaintiff who seeks to enforce a letter of credit affected by forgery of the documents or other fraud in the transaction if he himself acted in good faith? There is a remarkable dearth of authority on this question. Let us start with the beneficiary. He himself has a duty to tender documents which are in order, and the fact that he acted in good faith in tendering forged documents is thus irrelevant. This fundamental point appears to have been overlooked by Mocatta J in the [*United City Merchants* case⁸³] when he held that the beneficiary was entitled to collect payment despite the insertion of a fraudulent shipping date on the bill of lading, since the fraud had been committed by the loading broker who was the agent of the carrier, not of the

⁸¹ *United City Merchants* [1983] 1 A.C 168, 187 to 188, *supra* note 15.

⁸² Professor Roy Goode, "Reflections on Letters of Credit - I", [1980] JBL 291, 294. This was also mentioned by Stephenson L.J during the Court of Appeal in *United City Merchants* [1982] Q.B. 208, 238.

⁸³ [1979] 1 Lloyd's Rep 267.

seller/beneficiary. But this, with respect, is not to the point. The beneficiary under a credit is not like a holder in due course of a bill of exchange; he is only entitled to be paid if the documents are in order. A fraudulently completed bill of lading does not become a conforming document merely because the fraud is that of a third party."

Professor Roy Goode's words clearly expressed the view that the seller/beneficiary's position in documentary credits might not be seen as that of a holder in due course. The duty of tendering documents "in order" keeps the seller out of the position of holder in due course and makes the view that the beneficiary should bear the risk of a nullity document fair enough. Therefore, in the thesis, *United City Merchant* may not be seen as a clear authority which successfully in rejecting the nullity exception.

5.3. Discussion of the decision of *Montrod*

As the most important case for the nullity exception in English law, The *Montrod* case gave rise to many arguments. The decision rejecting a nullity exception in documentary credits was not approved by some commentators.⁸⁴ Nevertheless, *Montrod* may not be seen as authority of a total rejection of a nullity exception.

According to the decision of *Montrod*, although the bank's obligation should

⁸⁴ L Y Chin and Y K Wong, [2004] L.M.C.L.Q 14, supra note 46; Neo "A Nullity exception", supra note 50, and Kieran Donnelly, [2008] J.B.L.316, 338, supra note 5; etc. See section 2 of this chapter for the discussion of arguments for applying the nullity exception.

not be affected by a pure nullity exception, there may be other situations where applying a nullity exception may be reasonable. This view was implied in the case of *Montrod* by a comparison between *Montrod* and the Singapore case *Lambias*⁸⁵.

"Furthermore, in the *Lambias* case the bank rejected the documents as non-compliant, whereas in this case SCB accepted the documents as compliant, having raised Montrod's observations and reservations with Fibi before it did so. Fibi in turn accepted the documents when sent to them, making clear to Montrod that payment would be made unless a court order to prevent it were obtained."⁸⁶

Here, although Potter LJ did not clearly say that there would be a possible nullity exception if the bank decided to reject the document, it was admitted that bank's choice might affect decisions in cases. It is well known that the bank is an intermediate party in the documentary credits system. On one hand, the bank works for his client, who is normally the applicant of a credit. The bank has to take reasonable care to examine documents stipulated in the credit, and does not make a payment until the facially conforming documents are handed in. On the other hand, the bank also works for the beneficiary of the credit. The bank has an obligation to pay the beneficiary as long as the beneficiary presents conforming documents. Therefore, the bank almost stays in the middle of the line between the applicant and the beneficiary. This position may also create a dilemma for the bank. There may be, on one side, the applicant is claiming that the document was not actually

⁸⁵ *Lambias v. Hong Kong and Shanghai Banking Corp* [1993] 2 SLR 751, see supra note 44.

⁸⁶ *Montrod*, [2001] EWCA Civ 1954, 1993, supra note 1.

conforming; but on the other side, the beneficiary is insisting on the payment. The dilemma of the bank is not only a hazard for the bank, but may also stop the smooth process of documentary credits system. Thus, both the UCP and English courts provided a comparative protection to the bank. The UCP only requires the bank to pay upon taking reasonable care during the examination of documents. And the criterion for a conforming document becomes comparatively easier to achieve for the bank, given that only facial conformity is required. English courts' approach of protecting the bank was clearly shown in *Gian Singh & Co. Ltd. v. Banque de l'Indochine*.⁸⁷ This is also the main view that the decision of *Montrod* was based on.

A limitation of banks' obligation under documentary credits does not only help the bank to avoid a dilemma, but also upholds the ordinary operation of the documentary credits system. It may also be seen as an embodiment of the autonomy principle of documentary credits. The bank keeps a connection with both the beneficiary and the applicant according to the credit, but is not involving in the underlying contract between the beneficiary and the applicant. In *United City Merchants*, it was clear that documentary credits are contractually based⁸⁸. Therefore, all the parties' obligations should be subject to the contracts which were involved. If the action is between a bank and an applicant of the credit, the bank's obligation is to examine the face conforming of

⁸⁷ See *Gian Singh*, supra note 34, also see early discussion in section 3.2.

⁸⁸ *United City Merchants* [1983] 1 A.C 168, 182–183, supra note 15. The contract between confirming bank and beneficiary must be unilateral, since (typically at least) no undertaking is entered into by the beneficiary.

the documents, the applicant is obliged to pay the reimbursement to the bank as long as the bank fulfilled its obligation;⁸⁹ conversely, if the action is between a bank and a beneficiary, although the bank should pay against conforming documents under the contract between the bank and the beneficiary, ignoring the underlying contract between the applicant and beneficiary, the bank may be entitled to reject the documents because of its security interests.⁹⁰ Nevertheless, the nullity exception applying between the bank and beneficiary will not prevent the bank from getting a reimbursement from the applicant. In other words, The nullity exception applying restrictively between the bank and beneficiary will not alter the bank's obligation in documentary credits. This view was also expressed by Professor Paul Todd in his article⁹¹:

"As between bank and beneficiary, it can be argued that, even though a bank which pays against a document which is a nullity should be entitled to reimbursement, a bank which is aware, at time of presentation, that a document tendered is a nullity, thereby according it no security, should be entitled to refuse it."

After the above analysis, it may be concluded that Potter LJ's decision of rejecting the nullity exception is only applied between the applicant and the bank. The reason why Potter LJ rejected the nullity exception was mostly based on the limited liability of the bank. He expressed that "neither as a

⁸⁹ The situation will be similar on the contract between the banks if there is more than one bank (as of course there will always be with a confirmed credit), See Professor Paul Todd, "Non-genuine Shipping Documents and Nullities" at 554, *supra* note 6.

⁹⁰ For the issue of bank's security interest, see section 2.2.

⁹¹ See Professor Paul Todd, "Non-genuine Shipping Documents and Nullities" at 556, *supra* note 6.

matter of general principle, nor under UCP 500, is an issuing bank obliged to question or investigate the genuineness of documents which appear on their face to be documents the nature and content of which comply with the requirements of the credit"⁹², and "the bank assumes no liability or responsibility for the genuineness or legal effect of any such document."⁹³ Accordingly, it would be wrong to place the loss caused by the nullity on the bank. However, he did not reject the possibility of a nullity exception if the bank decided to reject the documents as a nullity because of its security interests. In other words, the security interests may give the bank a powerful defence against the beneficiary who presents a null document. To express it more clearly, **A bank is entitled to reject to pay the beneficiary against a null document as long as the bank has realized the nullity before the payment.** However, a buyer is not entitled to reject the reimbursement to the bank on the basis of a nullity as long as the document was conforming on its face to the credit. Generally, the establishment of a nullity exception in the above situation is on the basis of the beneficiary's obligation to provide the security interests to the bank by presenting stipulated documents in the credit.

Following to Potter LJ's view of the bank should not be liable for the damages caused by a null document, there would be either the beneficiary or the buyer to suffer the loss. Actually, the below analysis of Potter LJ's in *Montrod* was

⁹² *Montrod*, [2001] EWCA Civ 1954, 1993, *supra* note 1.

⁹³ *Ibid*.

even more attractive.

Potter LJ implied in his judgment though he literally rejected a nullity exception that "in an individual case, the conduct of a beneficiary in connection with the creation and/or presentation of a document forged by a third party might, though itself not amounting to fraud, be of such character as not to deserve the protection available to a holder in due course."⁹⁴ And to explain the connection, he cited the decision of the High Court of Singapore in *Lambias*⁹⁵, in which the bank was entitled to reject a certificate which contained discrepancies because the inspection certificate was in any event a nullity and the nullity was a kind of cause by the fraudulent countersignatory who was introduced to the bank by the beneficiary. This explanation of the "connection" led to many possibilities. One of them, for example, is a circumstance where under a CIF contract, in which the responsibility of arranging the transport is on the side of the seller, the carrier who was choose by the seller fraudulently made the bill of lading and the seller had no knowledge of the fraud. Does the seller have an enough close connection with the fraud in such a case? The author would think so according to the decision of *Lambias*. If the fact the seller introduced the fraudulent party to the bank was qualified for the "connection", an arrangement of the transport by hiring a fraudulent carrier should be in no doubt qualified for the "connection". In other words, the connection is easy to be established as long

⁹⁴ Ibid, 1992 to 1993.

⁹⁵ *Lambias* [1993] 2 SLR 751, *supra* note 44.

as the seller has a relationship with the fraudulent party.

If the above analysis of the "connection" was right, another possibility of applying a nullity exception may be seen as implied by Potter LJ. Because a beneficiary is not in the position of holder in due course, the buyer/applicant of the credit may also have a defence against the beneficiary to demand the payment as long as the applicant is able to prove the allocation of the risk should be on the beneficiary when there is an established nullity in the documents. Of course, the issue has to be raised before the enforcement of the letter of credit arose as between the beneficiary and the bank. In the case of *Themehelp Ltd. v. West*⁹⁶, which was a fraud case, it was held by the Court of Appeal that although a performance guarantee was an autonomous contract not to be interfered with on grounds extraneous to the guarantee itself, where fraud was raised between the parties to the main transaction before any question of enforcement of the guarantee arose as between beneficiary and guarantor, to grant an injunction restraining the beneficiary's rights of enforcement did not amount to a threat to the integrity of the performance guarantee; and that, accordingly, the judge had jurisdiction to entertain the application for an injunction. And the standard of proof of the fraud in that circumstance was also reduced from a clearly established fraud to a seriously arguable case of fraud. The test applied by the court for granting an interlocutory injunction in *Themehelp* is believed as an

⁹⁶ *Themehelp Ltd v. West* [1996] Q.B. 84.

application of the general rule for injunctions.⁹⁷

The decision of *Themehelp Ltd.*, in accession to the allocation of risk defence of the buyer to the beneficiary may be strong enough to lead to another possible application of the nullity exception, **which is when there is a nullity in the documents and the nullity was raised before the enforcement of the letter of credit arose as between the beneficiary and the bank, the buyer is entitled to prevent the beneficiary from demanding the payment as long as he can prove the beneficiary have a closer connection to the nullity than the buyer.** However, it does not follow that the applicant can ask an interlocutory injunction to prevent the bank from payment by claiming on the nullity exception. Where an injunction is sought by the applicant to prevent payment, he will succeed if he can show, not only that the bank would be acting in breach of its mandate by making payment, but also that an interlocutory injunction is an appropriate remedy.⁹⁸

6. The Exceptions and Documentary Credits

According to the discussion and authorities, the thesis may get a conclusion that although the nullity exception was not established clearly by any of English cases, the nullity exception was not totally rejected in English law. It

⁹⁷ See Section 2.2.2, Chapter 3 of the thesis. The application of the injunction rule in *Themehelp* was before the stage in which the autonomy of the performance guarantee involved in.

⁹⁸ See Professor Paul Todd, "Non-genuine Shipping Documents and Nullities" at 556, *supra* note 6.

is still reasonable to have a nullity exception in documentary credits in certain circumstances. The decision of the case of Montrod is very conducive to the development the nullity exception in English law. The present main hazard to apply a nullity exception was similar to the application of the fraud rule and the illegality exception that exceptions may destroy the autonomy of documentary credits; especially baffle the bank's performance of payment under the credit.

However, all the exceptions were established based on the assumption of the reasonable defence. While the fraud rule and the illegality exception shared the same the doctrine of *ex turpi causa*, the nullity exception, when applying between the bank and beneficiary , was based on the bank's defence of its security interests. A nullity exception may also be applied between the applicant and beneficiary before the enforcement of the letter of credit arose as between the beneficiary and the bank, in this circumstance, the buyer's cause of action is that the beneficiary is in breach of his mandate as presenting null documents and according should bear the loss caused by the nullity.

Clearly, all three exceptions are applied without in contradiction to banks' autonomous obligation in letters of credit or performance guarantee. Both the fraud rule and the illegality exception may not be applied if the fraud or illegality was not to banks' knowledge at the time of payment. Banks are entitled to get reimbursements from the applicant by paying against facially

conforming documents or requests. The nullity exception is applied even more narrowly. It can only be applied between the bank and beneficiary when the bank chose to reject documents by relying on its security interests or between the applicant and beneficiary before the enforcement of the letter of credit or performance guarantee arose as between the beneficiary and the bank. Banks have not obligation to the applicant to check the value of documents, accordingly, the applicant has no cause of action to prevent the bank to pay against nullity documents even the nullity has been noticed by the bank.

A narrow but efficient application of the exceptions subject to banks' autonomous responsibility in documentary credits system is very essential for documentary credits as a main means of payment in international trade. A clear application of certain exceptions can provide both the applicant and bank effective and conventional remedies to solve the problems caused the separation of the credit and underlying contracts in documentary credits without contradicting to the autonomy principle. The effective application of certain exceptions in documentary credits may also be effective in avoiding the abuse of strict compliance principles during banking practice. The high rate of rejection of documents by relying on the strict compliance principle in practice had already seriously impacted the market share of documentary credits as a recognized means of payment in international trade.⁹⁹ By relying

⁹⁹ See Chapter 1, section 4.

on those exceptions, banks are not necessary to rely on the strict compliance principle to avoid payments when certain issues, such like fraud, were noticed before the payment. As the necessary exceptions are applied efficiently, the disputes existing in documentary credits system currently may be settled without the appliance of any explanatory rules. Consequently, the documentary credits system will be able to develop while maintaining its featured advantage of autonomy as a main payment means in international trade transactions.

Summary:

Although the nullity exception has not been applied clearly by English law as an independent exception, alike the fraud rule and illegality exception, in documentary credits, the research in this chapter provides a strong support to the application of the nullity exception. Unlike most commentators who propose a general application of the nullity exception, the thesis argues the application of the nullity exception will be restricted between either the bank and beneficiary or the applicant and beneficiary. The nullity exception should not be applied between the bank and applicant to tolerate the ordinary operation of documentary credits. More importantly, the analysis of the case of *Montrod* provides an essential support for a prospective application of the nullity exception.

Conclusion

This thesis mainly aims to explore an appropriate and efficient way to apply certain necessary exceptions in documentary credits system:

- The autonomy principle is the essence of documentary credits system. The separation between the documents and underlying contract requires banks to make the decision of whether paying solely based on the facially complying of the documents. Accordingly, the strict compliance doctrine becomes the best way for the bank to avoid payment especially when a bank suspect a fraud but cannot prove it. The difficulty in the application of the fraud exception may be one of the reasons of the high rate of rejection of documents by the strict compliance. The high rate of rejection of documents by relying on the strict compliance principle in practice has serious implications for maintaining or increasing its market share as a recognized means of settlement in international trade. The new phenomenon of the applying of additional warranty to restrict the beneficiary's title in achieving payment shows the problems caused by the inefficiency of the application of the fraud exception. The serious drawbacks within documentary credits system revealed by the research further pointed out the necessity of a research in the exceptions in documentary credits. (Chapter 1)
- The research of the early application of the fraud rule in both English law and American law reflects the difficulty in applying the exception in

practice. A comparison of the standard of proof in applying the fraud rule between English law and American law shows, both English courts and American courts are reluctant to disturb the autonomous operation of documentary credits because of the strong position of the autonomy principle in documentary credits. In this circumstance, banks prefer to choose a comparatively easy way by relying on the principle of strict compliance to reject payment to avoid the high standard of proof for the application of the fraud rule. The importance of improving the efficiency of the fraud rule in documentary credits has been reflected during the analysis.(Chapter 2)

- The different application of the fraud rule appeared in the 1990s may also be seen as exceptions within the context of the fraud exception. Despite the difference of the causes of action and involved parties among those exceptions, all of them were applied under a certain stage by English courts, the pre-trial stage. Generally, the different approach is an application of a lower standard of proof in applying the fraud rule at the pre-trial stage. The reasonability and application pattern of the different approaches have both been concluded through the analysis of the case law. More importantly, the special rule for granting an interlocutory injunctions in fraud documentary credits case has been worked out during the research.(Chapter 3)
- The application of the illegality exception is an essential achievement in

the development of documentary credits system. The illegality exception, similar to the fraud rule, provides a safer and stable environment for the documentary credits practice. The same basis of the principle of "*ex turpi causa*" between the fraud rule and illegality exception clearly shows the reasonability and necessity of applying the illegality exception. The research of the detailed application of the illegality exception does not only useful in explaining the illegality exception as a new exception in documentary credits system, it also benefits the understanding of the fraud exception, and especially the new approaches emerged during 1990s. (Chapter 4)

- Although the nullity exception has not been applied clearly by English law as an independent exception, unlike the fraud rule and illegality exception, in documentary credits, the research in this chapter provides a strong support to the application of the nullity exception. Unlike most commentators who propose a general application of the nullity exception, the thesis argues the nullity exception should be applied narrowly in certain circumstances and between certain parties. Although most commentators criticized the decision in the case of *Montrod Ltd v. Grundkötter Fleischvertriebs GmbH*¹ which rejected the nullity exception in English law, the thesis argues that the analysis of the case of *Montrod* during the judgment provides an essential support for a prospective

¹ *Montrod*, [2001] EWCA Civ 1954, supra note 1.

application of the nullity exception. In the end the thesis, some common features among the application of the three exceptions are summarized. A prospective development of the documentary credits system has also been suggested in the last chapter.(Chapter 5)

- In summary, all three exceptions were established based on the assumption of the reasonable defence. While the fraud rule and the illegality exception shared the same the doctrine of *ex turpi causa*, the nullity exception, when applying between the bank and beneficiary, was based on the bank's defence of its security interests. All the exceptions are applied without in contradiction to banks' autonomous obligation in letters of credit or performance guarantee. Both the fraud rule and the illegality exception may not be applied if the fraud or illegality was not to banks' knowledge at the time of payment. The nullity exception is applied even more narrowly. It can only be applied between the bank and beneficiary when the bank chose to reject documents by relying on its security interests or between the applicant and beneficiary before the enforcement of the letter of credit or performance guarantee arose as between the beneficiary and the bank. The thesis considers that a narrow but efficient application of the exceptions subject to banks' autonomous responsibility in documentary credits system will relieve the current disputes existing in documentary credits system.

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