Chapter 4

The Extent of the Fraud Exception to the Independence Principle

4.1 Introduction

This chapter examines the adequacy of the mechanism currently in place in its various jurisdictional forms under the letters of credit regime allowing for enjoining payment. Courts have introduced a limited exception to the application of the independence principle to address cases of fraud in an attempt to ameliorate the severe injustice and inconvenience that results from payment being made in such circumstances.

Documentary validity, rather than mere documentary compliance, should receive more attention under the letter of credit. As Ronald Mann demonstrated in his seminal piece of field research, in practice there appears to be a persistent disconnection between documents presented under the letter of credit and the goods supplied under underlying contracts. As alluded to previously in chapter 1, this is because documents have lost their real value. Originally, the letter of credit system was based on the integrity of the documents, and the bill of lading is the most important of these documents as it is the title document representing the goods.

With the initiation of container shipments, documents to a great extent no longer represent the goods supplied under the
underlying contract. Prior to container shipping, the carrier had to physically check the goods and put notations on the bill of lading stating the nature of the goods and that the goods were in good condition. Container shipment makes it impossible for the carrier to inspect the goods. However, the carrier still issues the bill of lading — now with anodyne notation such as “condition unknown” or “seller's responsibility” or words to that effect. Thus, although the bill of lading is still considered as a title document, its value has been undermined by container shipping as there is no longer any guarantee that the bill of lading reflects what is in the container.

As the letter of credit system is wholly dependent on the integrity of the documents, it is being undermined by these developments. This chapter advocates that a mechanism must be introduced to safeguard the system against one of the outcomes flowing from these changes — increased fraud.

The only mechanism in place at the moment is the fraud exception but this is inadequate. It is very difficult to invoke because of high thresholds of proof, can only be invoked prior to payment, and involves the difficulty of identifying fraud at an early stage. These inherent problems are exacerbated by lack of, or ambiguity in, bank duties to buyer to investigate possible red flags, and the buyer’s absolute duty to the bank to reimburse. Bank duties are only expressly owed to the seller. Banks have little incentive to identify red flags, and have little incentive to draw the buyer's attention to the associated implications of lack of good faith on the
part of the seller.\(^1\) So the buyer is normally compelled (despite a theoretical right to reject non-complying documents), as a matter of commercial necessity, to take up whatever documents are accepted by the banks to show to the carrier for the purpose of collecting the goods.

The relevant duties of banks should however be expressed in the UCP to be toward the buyer. A bank should, in its exercise of reasonable care in documentary examination, as a duty to the buyer, identify red flags that indicate possible fraud, bad faith, or lack of genuineness of the goods (irrespective of whom was responsible for the defect or lack of genuineness), which should oblige it to examine the underlying transaction for further evidence of the same, and to inform the buyer.

The high standards of proof currently required to invoke the fraud exception in an interlocutory injunction application should further be lowered in order to render such an injunction a viable and achievable option.

An overriding obligation of good faith for all parties should further be incorporated into the UCP, allowing a party to enjoin payment on the basis of lack of good faith, and for this to constitute a separate exception to the independence principle in addition to the fraud exception. A possible model is the *Mannessman Case*

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\(^1\) Note that according to the Official Comment on §5-110, the warranties in respect of the absence of fraud and the accuracy of the documents are only given by the seller to the issuer *after* the letter of credit is honoured, that is, *after* the seller has pocketed the money from the letter of credit transaction, thereby rendering the warranty, in effect, meaningless. American Law Institute, Official Comment of Article 5 (1962 Version) Letters of Credit, 1995, in J. Dolan, *The Law of Letters of Credit: Commercial and Standby Credits*, Warren, A.S. Pratt & Sons; Detroit: 2001 edition, at Appendix A.
(discussed in Chapter 2), in which an English judge applied the principle of good faith as expressed in Swiss law, and which, on the basis of suspected lack of good faith, the court was able to pierce the independence principle and look beyond the surface of the documents into the underlying transaction.

4.2 The Fraud Exception

4.2.1 Revisiting the independence principle

As introduced in Chapter 3, the fundamental principle governing letters of credit is the independence principle. Under the independence principle, the obligation of the issuing bank is to honour a draft on a credit when it is accompanied by documents which on their face are in accordance with the terms and conditions of the credit, which are independent of the performance of the underlying contract for which the credit was issued. This principle is reflected in Articles 3 and 4 of the UCP 500.

Article 13 of the UCP 500 defines a bank’s duty of examination with respect to documentary compliance, which must be made in a manner that is in accordance with international standard banking practice. Application of the independence principle however may create unfair results — exceptions are therefore necessary.

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4.2.2 **The fraud exception**

From about the mid-nineteenth century, the letter of credit system had become a payment mechanism for people who knew each other's business credit well, and it appears from the literature that fraud was not a significant problem in letter of credit transactions until after the end of the Second World War. Unfortunately the increase in the volume of documentary credits has been accompanied by an increase in the incidence of fraud, even though, thankfully, the cases of fraud are relatively rare when compared with the vast volume of international trade. However, for the unfortunate victims, fraud can be devastating.\(^3\) In accordance with the ICC International Maritime Bureau reports, there is little doubt that each year the fraudsters net from their perpetuators hundreds of millions of dollars.\(^4\)

Faced with this harsh reality, the courts have endeavoured to introduce a fraud exception to the independence principle when the letter of credit transaction is tainted with fraud in order to achieve more equitable results. While the history of the fraud exception will be examined further below under section 4.4, the court in *Bank of Nova Scotia v. Angelica-Whitewear Ltd.*\(^5\) succinctly expressed the essence of this exception in the following terms:

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\(^3\) Maria Livanos Cattaui, (Secretary General of ICC), cited in Preface of *Trade Finance Fraud - Understanding the Threats and Reducing the Risk, A Special Report prepared by the ICC International Maritime Bureau, ICC Commercial Crime Services, ICC Publication No 643; Paris: 2002*, at 3.


“An exception to the general rule has been recognized for the case of fraud by the beneficiary of the credit which has been sufficiently brought to the knowledge of the bank before payment of the draft or demonstrated to a court called on by the customer of the bank to issue an interlocutory injunction to restrain the bank from honouring the draft.”

The ICC Banking Commission has also made it clear that irrespective of the independence principle specified in Articles 3 and 4 of the UCP, and the bank’s right of reimbursement in sub-Article 10(d) and 14(a), “there is an exception to these provisions in many jurisdictions, namely abuse of right, or fraud”.6

“The ambit of this exception and the ensuing consequences from the beneficiary and/or the nominated bank may differ from one local jurisdiction to another. It is up to the Courts to fairly protect the interests of all bona fide parties concerned.”7 (emphasis added)

It can be reasoned, therefore, that whatever has been established under the UCP has to be balanced by the fraud exception. It is up to the courts in different jurisdictions to step in to handle the fraud cases in a manner that protects the interests of all concerned parties acting in good faith.

7 Ibid.
The scope and availability in practice of the fraud exception to the independence principle has however raised several questions, as summarised by the court in the Canadian case of *Angelica-Whitewear*,\(^8\) namely (1) whether the fraud exception should only be confined to cases of forged or false documents or should extend to fraud in the underlying transaction;\(^9\) (2) the sufficiency of proof or demonstration of fraud which is required to relieve an issuing bank of its obligation to honour a draft or to warrant the issue of an interlocutory injunction to enjoin the honour; (3) whether the fraud exception is “opposable” (i.e. sustainable) against a holder in due course of a draft; and (4) whether the fraud exception should be limited to the fraud by the beneficiary of the credit, or it should extend to fraud by a third party when the beneficiary is innocent.\(^10\)

Analysis of the cases in England, U.S., Australia and Canada in this chapter demonstrate the differences in approach or emphasis regarding those issues and tension between the following two considerations: the importance of maintaining the independence principle for the sake of certainty and the efficiency of the documentary transaction as a commercial instrument; and the importance of discouraging or suppressing fraud in the letter of credit transaction.\(^11\) As Symons has pointed out, permitting a seller to receive payment from the bank based on admittedly false or forged documents is improper as it serves no justifiable purpose. However, this must be balanced against the benefits of

\(^8\) *Bank of Nova Scotia v. Angelica-Whitewear Ltd.*, op.cit.


\(^11\) Ibid.
maintaining the LC as a commercial instrument. \(^{12}\) It is not the rule in contract law that liability for intentional acts, or even for unconscionable conduct, can be waived. Under the independence principle, seller’s breach of warranty does not affect its right to be paid in a letter of credit transaction, but a seller’s intentional act of deceit should affect his right, as intentional tortious actions are not within the ambit of the original consensual agreement.\(^{13}\) It will be argued further below that a seller’s unconscionable conduct, as well as lack of good faith, should also affect such right.

4.3 Proper Standard of Fraud to be Applied?

4.3.1 Introduction

Two key preliminary questions in respect of the ability to enjoin payment under a letter of credit revolve around (i) the nature of “fraud” that is the subject of the fraud exception, and, (ii) the key threshold issue of the type of conduct that is otherwise sufficient to give rise to an action to enjoin payment.

Both questions are addressed in the course of this section 4.3. For the purpose of the discussion to follow, on a theoretical level, the concepts of fraud in both common law and equity, to the extent possible, will be distinguished. Firstly, for the purpose of a representation upon which it is sought to base an action in deceit (as opposed to remedies flowing therefrom), there is no distinction


\(^{13}\) Angelica-Whitewear, op.cit., at 168.
between legal and equitable fraud. In general, the key elements of an action for deceit are that there has been a statement of what is false or suppression of what is true, fraudulently made, with the intention of inducing another party to rely thereon. The essential component of fraudulent misrepresentation is the element known as scienter, namely, an intention to mislead or deceive. Mere non-belief in the truth is also indicative of fraud. Actual inducement of the misrepresentee and materiality of the misrepresentation are also essential elements for the misrepresentation to draw civil consequences.

In another context however, the term “fraud” has been extended in equity by the concept of “constructive fraud” which includes transactions so opposed to “fair dealing” between the parties that they ought not to be held binding. Fraud in equity has also been extended to encompass unfair and unconscionable bargains, so long as one of the parties has imposed the objectionable terms in a morally reprehensible manner.

4.3.2 Breach of warranty or innocent misrepresentation standard

Some pre-UCC commentators on letters of credit advocated the breach of warranty or innocent representation standard for

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15 Ibid., paras. 757 and 790.
16 Ibid.
17 Ibid., para. 765.
18 Ibid., para. 756, at n. 5.
19 Ibid. para. 673 per Hart v. O’Connor [1985] AC 1000 at 1017, [1985] 2 All ER 880 at 887, PC per Lord Brightman; Multiservice Bookbinding Ltd v Marden [1979] Ch.84 at 110, [1978] 2 All ER 489 at 502 per Browne-Wilkinson J.
enjoining payment.\textsuperscript{20} This standard however fell out of favour in banking circles as it did not allow the beneficiary to reallocate the risk of non-payment to the buyer. The buyer was allowed under this standard to enjoin payment simply because goods may not have complied with what was contracted for.\textsuperscript{21} To the extent that there is absolutely no reallocation of risk, the adoption of such a standard is not really practicable.

4.3.3 Where evidence stops short of demonstrating intentional fraud —particularly serious cases of equitable fraud

In Australia,\textsuperscript{22} as is the case in England,\textsuperscript{23} intentional fraud is the standard, but there are suggestions in case authority that payment can be denied even where evidence of intention is lacking. Young J of the NSW Supreme Court in \textit{Hortico Party Limited v. Energy Equipment Company},\textsuperscript{24} while stating that little short of actual fraud would suffice, stated in obiter that “it may be in some cases [that] ....the unconscionable conduct may be so gross as to lead to [the] exercise of the discretionary power,”\textsuperscript{25} thereby suggesting that serious cases of equitable fraud may be sufficient to injunct payment. In \textit{Inflatable Toy}, Young J of the NSW Supreme Court also held open the possibility of unconscionable conduct falling within the fraud exception while not finding fraud established on

\begin{footnotesize}
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\item \textsuperscript{21} Symons, op. cit. at 3. See for example UCC, Section 5-109, in which a “material fraud” standard is formally adopted, although “fraud” is left undefined.
\item \textsuperscript{22} Contronic Distributors [1984] 3 NSWLR 110, at 116.
\item \textsuperscript{24} [1985] 1 NSWLR 545.
\item \textsuperscript{25} Ibid., at 554.
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the facts of the case. Santow J. of the Supreme Court of NSW, in *Pedna Pty Ltd Trading as Zone Communications v. Sitep Society Per Azioni and Others*, further ruled that “unconscionable conduct, if sufficiently gross, or even complete and utter non-performance under a contract, may constitute exceptions to the general proposition that only actual fraud suffices”. Under such an approach, which shifts the emphasis from the state of mind of the beneficiary to the severity of the effect of the fraud on the transaction, fraud would become easier to establish by evidence because proof of state of mind is notoriously difficult.

A similar approach has been advocated in some US decisions. For example, in *Dynamics Corporation of America v. Citizens & Southern National Bank*, the court held that:

“Fraud has a broader meaning in equity... and intention to defraud or to misrepresent is not a necessary element. Fraud, indeed, in the sense of a court of equity, properly includes all acts, omissions and concealments which involve a breach of legal or equitable duty, trust, or confidence, justly reposed, and

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26 *The Inflatable Toy Company Pty Ltd. v. State Bank of New South Wales Ltd.*, Supreme Court of New South Wales Equity Division Judgment, Young J, No.1010 of 1994, delivered at 23 March 1994, at 9, reported at: (1994) 34 NSWLR 243 (Sup Ct, NSW); 1994 NSW LEXIS 14071; BC9405157.

27 *Pedna Pty Ltd Trading as Zone Communications v. Sitep Society Per Azioni and Others*, Supreme Court of New South Wales, Equity Division, Santow J, Decision 1032 of 1997, delivered on 8 January 1997.


are injurious to another, or by which an undue and unconscientious advantage is taken of another.”

Despite the potential advantage from the perspective of ease of proof, case \(^{31}\) and scholarly endorsement, \(^{32}\) — even in the USA, support for general adoption of the unconscionable standard rather than the legal standard of fraud remains narrow.

4.3.4 Common law fraud requiring scienter

As mentioned above, common law fraud essentially requires absence of an honest belief in the truth of what being represented or an absence of scienter — the intention to mislead or to deceive. Fraud in England and Australia in the context of letters of credit currently appears to be limited to this type of fraud.

The concept of good faith, to the extent that it is part of the fabric of letter of credit law, \(^{33}\) is an essential element of the doctrinal theory underpinning letter of credit law, \(^{34}\) particularly in the US where it is enshrined in §5-109 and §5-102 of the UCC. It is argued that the correct applicable standard of good faith, which is the standard set down under Article 5, is subjective good faith — honesty in fact in the conduct of the transaction concerned. \(^{35}\) The

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31 See also United Bank v. Cambridge Sporting Goods Corp. 360 N.E. 2d 943, at 949.
33 Symons, op. cit., at 339, and UCC §5-109.
34 Ibid.
standard of *objective* good faith set down as applicable to most commercial contracts in §2-103(1)(b) of the UCC — the observance by the merchant of reasonable commercial standards of fair dealing in trade — is not adopted by Article 5.

The rationale for the adoption of the subjective rather than the objective standard is that, because of the separation of the underlying contract of sale from the banks’ obligation to the beneficiary of the letter of credit, the justifiable expectation of the issuer and the customer with regard to the letter of credit is not the absence of breach of contract or negligence, but only the absence of fraud, and that on this basis, good faith is only absent if fraud is present.36

The fraud exception should however at least include the concept of unconscionable conduct as well as common law fraud. Unconscionable conduct could be present in circumstances where intentional fraud is absent. In this sense, equitable fraud as well as common law fraud should both be considered to fall within what is considered to be an absence of subjective good faith. It will be discussed further below whether in the context of letters of credit, the concept of good faith should also encompass fair dealing, thereby rendering “absence of good faith” either as a separate exception to the fraud exception, or alternatively, as an additional requirement to documentary compliance as a precondition to entitlement to payment under a letter of credit.

36 Ibid., Symons, and Official Comment, at Appendix. A-16.
4.3.5 Egregious fraud standard

Cases before the introduction of the UCC are considered to have introduced an “egregious” or “gross” test for fraud, which also incorporated the requirement for intentional fraud. The egregious fraud standard however focused on the severity of the result of the fraudulent conduct as a criterion as to whether the payment should be enjoined. Such conduct would need to have been “outrageous” or “infecting the entire transaction.” Yet, commentators doubt that the egregious fraud standard has any doctrinal validity as its application could conceivably have the result that even though the beneficiary is in breach of its duty of good faith, its conduct could still not be so outrageous as to amount to egregious fraud. This would have the unintended effect of shifting the risk of intentional wrongdoing from the seller to the buyer, and is thus, on this basis, unacceptable.

4.4 Birth and Development of the Fraud Exception

4.4.1 Fraud in the documents or in the underlying transaction: origins of the controversy

The fraud exception is considered as having originally been established under an American Case, Sztejn v J. Henry Schroeder Banking Corporation. In this case, the issuing bank opened an irrevocable credit on Sztejn’s account in favour of Transea Trading

38 Symons, op.cit., at 349.
39 Ibid., at 351.
40 Sztejn v J Henry Schroeder Banking Corporation, 31 N.Y.S. 2d 631 ( S. C.1941), hereafter referred to as the Sztejn Case.
Ltd covering a shipment of bristles. Documents, including bills of lading for bristles, were presented to Transea’s bank and were subsequently forwarded to the bank Schroeders for reimbursement. Before payment, however, Sztejn applied for an injunction restraining payment on the ground that no bristles were in fact shipped, but merely worthless rubbish.

Shientag J stated the independence principle, emphasising that “[i]t could 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 the seller regarding the quality of the merchandise shipped,”41 as it served to deny the very function of the specified documents and the correspondence between the documents and the goods.

However, Shientag J distinguished the case before him as one involving fraud by the beneficiary of the credit as follows:

“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 situation, where the seller’s fraud has been called to the bank’s attention before the draft and documents have been presented for payment, the principle of independence of the bank’s obligation under the letter

41 Ibid., at 633-634.
of credit should not be extended to protect the unscrupulous seller.”

It is clear from the Sztejn opinion that the court was unwilling to use the independence principle in a situation where there is intentional fraud by the beneficiary. It is unfortunate, however, that such decision gave rise to arguments as to whether Sztejn was, or should have been, regarded by the court as a case of false documents or a case of fraud in the underlying transaction.

In another U.S. case, NMC Enterprises Inc. v. Columbia Broadcasting System, Inc., a preliminary injunction was granted to restrain an issuing bank from honouring a draft under a letter of credit. The applicant complained that the beneficiary’s office had misrepresented the quality of the communications equipment and technical assistance and fraudulently induced the applicant to enter into the underlying transaction of sale which the beneficiary knew was false. The court rejected the contention that the fraud exception recognized in Sztejn was confined to “fraud intrinsic to the documents” and did not extend to fraud in the underlying transaction. It held that if the sales contract was tainted with fraud in its inducement, any document required by the letter of credit to be submitted with the draft to show entitlement to payment was equally tainted. It is submitted that this was an early case which equated the legal value of the documents with the actual

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42 Ibid., at 634.
45 Ibid., at 1428.
performance of the underlying contract and indicated clearly that documents represent the beneficiary’s entitlement for payment; if the underlying contract is tainted with fraud, the documents representing the reality of the performance of the contract are equally tainted and therefore not acceptable. Following this line of reasoning, it might not be meaningful to argue whether a fraud is a documentary fraud or an underlying contract fraud.

In *United Bank Limited v Cambridge Sporting Goods Corp.*, the court found the seller was in deceit and held that the fraud exception should be applied as the circumstances of the particular situation allow. In this case, an American buyer entered into a contract with a Pakistani manufacturer for the purchase of boxing gloves. An irrevocable letter of credit was issued in favour of the seller. The gloves which the manufacturer shipped were old, unpadded, ripped and mildewed rather than newly manufactured gloves as agreed upon. The court in this case held that the act of sending not merely non-conforming merchandise, but seriously defective goods, e.g. worthless fragments of boxing gloves, supports the seller’s intention of deceit and should be categorised within the scope of fraud.

It is evident from the above three cases that U.S. courts looked beyond the documents into the facts of the transaction to see whether the information provided in the documents was accurate. If there existed seller/beneficiaries’ deceitful intention, the courts decided to apply the fraud exception to deny the deceitful

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47 Ibid., at 260.
beneficiaries/sellers’ entitlement for the payment under the letters of credit.

These cases however are considered to reflect a less strict view of the fraud exception.48 One commentator has expressed the view that in the case of defective underlying goods, where the seller presents conforming documents, the bank should pay notwithstanding the defect because the seller has complied with the conditions set forth by the bank in the credit. On the other hand, the bank should be entitled to reject any payment demand based on the presentation of defective documents as in such a case the seller has failed to comply with the conditions set forth by the bank.49 The authoritative Chitty on Contracts, Specific Contracts seems to support a documentary fraud approach in stating that “the seller has committed a fraud where he has tendered a forged document or a document which, to the seller’s knowledge, contains a false and fraudulent description of the goods”.50

The Sztejn rule was codified first in §5-114(1) of the UCC (‘62 Code), and later defined in the Revised §5-109 of the UCC (‘95), which states that fraud only includes the beneficiary-seller’s misconduct which is so serious and which has so vitiated the entire transaction that the independence principle can no longer be served.51

49 Goode, op. cit., at 294.
50 23rd ed. (1968), at 231.
51 Also see Intraworld Industries, Inc. v. Girard Trust Bank, 336 A. 2d 316 (Pa. S. C. 1975), in which the court held that "the situation which will justify an injunction against honour must be narrowly limited to situations of fraud in which the wrongdoing of the beneficiary has so
4.4.2 Fraud exception in England — the traditional position

England, as most other countries, does not have legislation dealing with documentary letters of credit. In England, even though the UCP does not have the force of law, 52 it is generally applied and interpreted by courts when the parties have embodied it into their contracts. 53 English courts, which regarded Sztejn as the source of the fraud exception to the issuer’s duty to pay against conforming documents, generally have required “established fraud” before they would issue an interlocutory injunction. 54 Applicants in English courts however had found it difficult to meet such burden of proof as demonstrated in the following case until recent decisions that further developed the law of letter of credit.

The English system had been considered “as having adopted a somewhat strict view of the fraud exception and there has been particular emphasis on the importance to intentional commerce of the principle of the autonomy of documentary credits.” 55 In Malas (Hamzeh Malas & Sons) v. British Imex Industries Ltd, 56 Jenkins LJ. said:

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\text{vitiated the entire transaction that the legitimate purposes of the independence of the issuer’s obligation would no longer be served,} \text{ at 324.}
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56 Malas (Hamzeh Malas & Sons) v. British Imex Industries Ltd, [1958] 1 All ER 262.
“...it seems to be plain that the opening of a confirmed letter of credit constitutes a bargain between the banker and the vendor of the goods, which imposes on the banker an absolute obligation to pay, irrespective of any dispute which there may be between the parties on the question whether the goods are up to contract or not. An elaborate commercial system has been built up on the footing that the 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.”

The courts in England moreover required that the alleged fraud of the beneficiary of a credit must be clearly established to the knowledge of the bank to justify a refusal by the issuing bank to honour a draft under the credit or to warrant an interlocutory injunction to restrain it from doing so. The case of Discount Records Ltd v. Barclays Bank Ltd and another is a good illustration of this restrictive approach. The plaintiffs ordered from a French company ‘Promodisc’ 8,625 discs and 825 cassettes. The credit issued by Barclays Bank (“Barclays”) was an irrevocable confirmed credit. The credit stated the shipment must be made no later than 30th May, 1974. The maturity date under the credit was 20th July 1974. Even though Promodisc made out an invoice for the abovementioned goods which was supposedly shipped before on 20th May, they were actually not shipped until 12th June. The plaintiff had also found that “out of the 8,625

records ordered, only 275 were delivered as per order, the rest were not as ordered and were either rejects or unsalable.” Then the plaintiffs presented this evidence and sought an injunction on July 11th, before the maturity date, alleging fraud.

The counsel for the plaintiffs brought before the court issues such as a lack of correspondence between the documents and the goods, the discrepancies reflected in the bill of lading regarding the delayed shipping date and inflated invoice compared with what actually sent. The counsel for the defendant avoided dealing with the issues raised by the plaintiff and however asserted that “a bill of exchange which has already been accepted by the Discount Bank. That bill may well have been negotiated; it may indeed have passed into the hands of a holder in due course.”

The court denied the applicant’s application for the injunction and held that even if an injunction were granted, it would not prevent the French company from being paid since, as a bill of exchange had been accepted by the Discount Bank, it might already have passed into the hands of a holder in due course.

Megarry J. stated that the reason why the defendant banks, “understandably adduce no evidence on the issue of fraud” was because banks are not concerned with such matters. Even though the court discussed the rule that fraud unravels all, Megarry J. held that this was not a clearly established fraud case and the

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59 Ibid., at 3 of the Lexis version.
60 Ibid., at 5 of the Lexis version.
61 Ibid., at 1 of the Lexis version.
62 Ibid., at 4 of the Lexis version.
court would “be slow to interfere with bankers’ irrevocable credits...unless a sufficiently grave cause is shown”.63

It is doubtful whether the real reason for the court not rendering injunctive relief to the applicant was based on the court’s conclusion that there was no fraud. It seems that the court firstly did not think that it was possible to conclude clearly established fraud without the presence of the beneficiary. Megarry J., when dealing with the issue of allegation of fraud, asserted that “it seems unlikely that any action to which Promodisc (the alleged fraudulent beneficiary) 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.”64 Secondly, it was clear that the court was concerned about the legal effect an injunction would have on a deferred payment credit even though the application was brought before the maturity date of such credit.

Such was the restrictiveness of this position in practice that Ackner L.J. felt obliged to point out in one case, United Trading Corp.65 that an excessively strict requirement with respect to proof of fraud makes it completely impossible for the courts to apply the fraud exception to the principle of independence. The learned Judge gave the following guidance for the degree of proof for establishing fraud:66

63 Ibid.
64 Ibid., at 5 of the Lexis version.
65 United Trading Corp. SA v. Allied Arab Bank Ltd. [1985] 2 Lloyd’s Rep. 554 at 561. (This case concerned a performance guarantee, and not a letter of credit, but where fraud is alleged, the legal issues are the same. Also see E.P. Ellinger, [1985] J.B.L. 232.)
66 Ibid., at 561.
“We could expect the court to require strong corroborative evidence for the allegation, usually in the form of contemporary documents, particularly emanating from the buyer... 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 for fraud.”

The English courts traditionally have also taken rather a restrictive approach as to whether fraud extends not just to fraud on the documents but also fraud on the transaction. As mentioned earlier, Lord Denning M.R. required the correct correspondence between the documents and the seller’s underlying contractual liability in Establishment Esefka International Anstalt v. Central Bank of Nigeria. 67 In the House of Lords decision of United City Merchants, 68 Lord Diplock reasoned that “to this general statement of principle as to the contractual obligations of the confirming bank to the seller, there is an established exception: that is, where the seller for the purpose of drawing on the credit, fraudulently presents to the confirming bank documents that contain, expressly or by implication, material representations of fact that to his knowledge are untrue.” 69 However, he further reasoned that the bank’s right to refuse payment should not depend on information obtained other than by examining the documents themselves. Otherwise, the principle of independence would be violated. If the

69 Ibid., 183.
documents are valid on their face, and the beneficiary-seller is innocent, then the efficacy of the operation of the letter of credit requires that the bank pays.\textsuperscript{70}

\textbf{4.4.3 Australian position — recognising the “uttering” of the documents?}

Australian courts, while recognising the importance of the independence principle, accept the Sztejn Case “as being the law in Australia”.\textsuperscript{71} In \textit{Contronic Distributors Pty Ltd. v. Bank of New South Wales}, which could be described as the first case in which the fraud exception was acknowledged in an Australian court, Helsham J of the NSW Supreme Court granted an injunction on the basis that “a seller can be restrained from presenting a letter of credit for payment or having payment made against [the letter of credit] in the event that the documents which are needed to require payment to be made are false to the knowledge of the seller.”\textsuperscript{72}

The case of \textit{The Inflatable Toy Company Pty Ltd. v State Bank of New South Wales Ltd.}\textsuperscript{73} indicated a willingness to look beyond the documents into the underlying transaction; Young J said: “it is not merely a mechanical exercise of seeing whether the words in the documents are completely true or completely untrue to the knowledge of the seller, the question is really one of considering

\begin{footnotesize}
\textsuperscript{70} Ibid.
\textsuperscript{71} \textit{The Inflatable Toy Company Pty Ltd. v. State Bank of New South Wales Ltd.}, Supreme Court of New South Wales Equity Division Judgment, Young J, No.1010 of 1994, delivered at 23 March 1994, at 9, reported at: (1994) 34 NSWLR 243 (Sup Ct, NSW); \textit{Contronic Distributors Pty. Ltd v. Bank of New South Wales} [1984] 3, NSWLR, 110.
\textsuperscript{72} [1984] 3 NSWLR at 116.
\textsuperscript{73} \textit{The Inflatable Toy Company}, op.cit.
\end{footnotesize}
whether in all the circumstances, the uttering of the documents involves actual fraud.”\(^74\)

Young J. further suggested that:

“There is a possibility that the fraud exception does extend so far as to allow for a case where there has been complete and utter non-performance of the underlying sale of goods contract.”\(^75\)

*The Inflatable Toy Case* thereby indicated that the fraud exception includes not only documentary fraud but also underlying transactional fraud and required that the plaintiff to demonstrate a clear case of actual fraud. In this case, the plaintiff was the applicant-buyer who purchased a considerable quantity of inflatable plastic toys including banana men and inflatable pools. Judge Young stated the independence principle and accepted the judgment of the *Sztejn Case* as the fraud exception to the independence principle. He however also repeated what he said in the *Hortico Case*:

“...the courts have consistently taken a ‘hands off’ approach, and it does not seem to me that anything short of actual fraud would warrant this Court in intervening, though it may be that in some cases... .

\(^{74}\) Ibid., at 18 of the Lexis version.  
\(^{75}\) Ibid.
unconscionable conduct may be so gross as to lead to exercise of the discretionary power.”\textsuperscript{76}

Based on the fact that there had existed evidence of clear communication between the beneficiary-seller and the applicant-buyer about the inconsistency in the numbers of the actual banana men and pools shipped and the numbers indicated on the shipping documents,\textsuperscript{77} and based on the plaintiff’s waiver in writing, (“discrepancies/documents acceptable”\textsuperscript{78}) Judge Young held that “this case does not demonstrate a clear case of actual fraud required by the authorities, thus the plaintiff must fail”.\textsuperscript{79}

This case clearly shows that the intention of the relevant party is an important factor for courts in resorting to the fraud exception. If the parties “know what the commercial reality was and were prepared to accept it”,\textsuperscript{80} there would be no fraud.

The above discussion outlined the general practice in the traditional application of the fraud exception in the U.S., England and Australia. It appears that even in respect of the traditional positions, there was already some divergence in different courts’ understandings of the situations where the fraud exception was applicable. The analysis in the following sections suggests that the fraud exception must be augmented, as in its current state it has proven woefully inadequate to address the challenges that fraud is currently posing to the letter of credit system.

\textsuperscript{76} Ibid., at 15 of the Lexis version, citing In Hortico (Australia) Pty Ltd v. Energy Equipment Co (Australia) Pty Ltd (1985) 1 NSWLR 545, at 554.
\textsuperscript{77} Ibid., Inflatable Toys Case, at 4 of the Lexis version.
\textsuperscript{78} Ibid., at 8.
\textsuperscript{79} Ibid., at 21.
\textsuperscript{80} Ibid.
4.5 Assessing Allegations of Fraud and Investigation of Red Flags

4.5.1 When buyer informs bank of fraud

In practice, most allegations of fraud are brought to the attention of the letters of credit department of a bank by the applicant in order to prevent the bank from honouring the credit or the seller/beneficiary from drawing on it.\textsuperscript{81} The allegation could be that the documents which are about to be presented are forged or fraudulent or that there is fraud in the transaction. Two situations, which may be handled differently, are possible: if a buyer merely complains about inferior quality, the complaint should be ignored. On the other hand, if the complaints are about fraud which is so serious that they will upset the whole purpose of the transaction, or evidence is supplied by the shipowner showing the bill of lading is a forgery, the bank should stop payment.\textsuperscript{82}

The problem here is how a bank is supposed to make judgment in respect of the information, which is provided by the applicant or sometimes by other sources directly to the bank, to determine whether or not such information has constituted clear notice of fraud to a reasonable bank. For instance, if a bank hears an allegation about documentary fraud concerning forged documents or false documents, traditionally the bank had to make a decision as to what constituted clearly established fraud and what was

\textsuperscript{82} Ellinger, op. cit., at 194.
merely an allegation. According to some precedents and legal theories of the law of letter of credit, analysed below, presumably a reasonable bank has to consider the following issues in order to justify its reason for honour or dishonour: (a) Whether an allegation constituted a clear notice of fraud or merely of an underlying contractual dispute; (b) Whether a forgery or false statement was made by a third party; and (c) Whether a presenter of the documents was a holder in due course.

Case authority concerning (a) is ambiguous on what constitutes a clear notice of fraud. In Society of Lloyd’s v. Canadian Imperial Bank of Commerce and Others,83 the defendant banks had been provided with information which its customers alleged to have amounted to a sufficient case of fraud as to entitle the defendant banks to decline to honour the drafts that had been presented under the letters of credit. The banks, however, for the avoidance of doubt, did not allege fraud against the plaintiff. The banks believed that it was not necessary to plead and establish fraud provided that they could satisfy the court that the material upon which they relied would either amount to notice to a reasonable banker of clear fraud by the beneficiary, or would lead a reasonable banker to infer fraud by the beneficiary.84

The court, however, was not ready to accept this as a defense believing that this would put the court in an “awkward” position. The court reasoned that it would not be right if the court was persuaded at trial that the material provided to the bank did

84 Ibid.
amount to a clear notice of fraud to a reasonable banker and, in the meantime, the beneficiary was able to establish that in fact there was no fraud. Alternatively it would not be right for the beneficiary to bear the burden of proving the absence of underlying fraud because such was “entirely inconsistent with the fraud provisions of the Uniform Customs and Practice for Documentary Credits which were incorporated into the letters of credit”.

The result of such decision is that the concept of “a clear notice of fraud” was left undefined and consequently, that a bank is left to its own devices as to whether or not to honour, unless the bank possesses sufficient evidence and enough legal knowledge to determine there has been an actual fraud.

It is dubious as to which “fraud provision” the court was referring to with regard to the fraud issue in the UCP because the UCP does not deal with fraud. The line of reasoning of the court indicated a reluctance to define what would amount to a clear notice of fraud and whether a defendant bank had met the reasonable bank standard, which could justify a bank’s refusal of payment to the beneficiary. Furthermore, the court, contrary to the court in Bank of Nova Scotia v. Angelica-Whitewear Ltd., was clearly unwilling to look into the situation as to whether there was actual fraud.

The Canadian Supreme Court in Angelica-Whitewear considered the sufficiency of a bank’s knowledge of the fraud which could

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85 Ibid., at 581.
relieve the bank of its obligation of payment.\textsuperscript{87} The court used the test laid down in \textit{Edward Owen Engineering},\textsuperscript{88} that is, whether a fraud case is clearly demonstrated by the applicant to the knowledge of the issuing bank before payment of the draft is made. The court was trying to impose a heavier onus of proof on an applicant which had to establish that a draft was improperly paid by the issuing bank after notice of the alleged fraud committed by the beneficiary. In this case, the court concluded that the information provided by the applicant to its bank could not be considered to have constituted evidence of clear or obvious fraud to the bank.\textsuperscript{89}

4.5.2 Third party fraud and the issue of nullity

\textbf{(a) The baggage of UCM}

The second issue that a reasonable banker must consider when dealing with an allegation of fraud in order to justify its reason for honour or dishonour is whether the seller himself or a third party made a forgery or false statement. The third party fraud issue was dealt with in an English case, \textit{United City Merchants v. Royal Bank of Canada}.\textsuperscript{90} In this case, the letter of credit in question required a bill of lading evidencing shipment no later than on December 15, 1976. In fact, shipment of the goods took place on December 16, a day later than the limit specified in the credit. The shipping agent

\begin{footnotesize}
\footnote{\textsuperscript{87} Ibid., at 177.}
\footnote{\textsuperscript{88} \textit{Edward Owen Engineering Ltd. v Barclays Bank Int'l Ltd.} [1978] 1 All E.R. 976.}
\footnote{\textsuperscript{89} \textit{Bank of Nova Scotia v. Angelica-Whitewear Ltd.}, op.cit., at 177.}
\footnote{\textsuperscript{90} \textit{United City Merchants v. Royal Bank of Canada} [1979] 1 Q.B. 267, hereafter referred as \textit{the United City Merchants Case} or \textit{the UCM Case}.}
\end{footnotesize}
falsely backdated the bill of lading as December 15, 1976. The confirming bank, to whom the documents were submitted, refused to pay because it had discovered through its own sources that the date on the bill of lading was false. The sellers, who presented the documents, claimed that they had no knowledge of the shipping agent’s falsification.

Mocatta J, who ruled that there was no fraud by the plaintiffs because they did not know the date on the bill of lading to be false when they presented the documents, decided this case at first instance. The case then went on to the Court of Appeal. Griffith L.J. said:

“It may be said 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 bank.”

Griffith L.J. arguably raised the question of validity of the documents, that is, in this case, the validity of the bill of lading. Under the common law, the correct dating of the bill of lading is a matter of great importance with regard to three legal relationships: in the contract of carriage, in the contract of sale, as well as in

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91 The UCM Case, op.cit., at 270. (Queens Bench - Mocatta J.)
92 Ibid., at 267.
93 The UCM Case (Court of Appeal) [1981] 3 W.L.R.169.
94 Ibid., at 173.
relation to the banks if payment is paid under a letter of credit. The correct date of a ‘shipped’ bill is the date when all the goods are loaded and it must not be dated earlier. The seller/shipper, under the contract of carriage, is entitled to demand that the bill of lading is dated correctly. If the master or any agent of the carrier negligently misdates the bill, they are liable in damages because there is an implied obligation that due care should be exercised in the dating of the bill. Accordingly, for example, the Court in *Standard Chartered Bank v. Pakistan National Shipping Corporation* held that PNSC was liable to the SCB, which relied upon the antedated bill of lading as being accurate, in damages for the tort in deceit in respect of any loss they suffered. Therefore, it is clear that the legal requirement for the accuracy of the date of a bill of lading determines that a bank is not obliged to and should not accept a bill of lading wrongfully dated. The innocent seller/shipper is entitled to claim damages from the ship-owner or carrier. Furthermore, “the tender of a wrongly dated bill of lading by the seller qualifies, at least in a c.i.f. contract, as a breach of condition and entitles the buyer to reject the bill and to treat the contract as repudiated, even if the goods are in fact shipped within the contract time”.

In the present case, the issuer of the bill of lading deliberately backdated it in order to make the date conform to the shipment

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95 Schmitthoff’s Export Trade, op. cit., at 186 (15-035).
98 Standard Chartered Bank v. Pakistan National Shipping Corporation [2000] 1 Lloyd’s Rep. 218, parties hereafter referred to respectively as “SCB” and “PNSC”.
time under the letter of credit. One should logically expect that such document would be considered as invalid and unacceptable under the law of letter of credit in order to be in line with the law of international sales of goods as well as law relating to carriage of goods by sea. Hence, Stephenson L.J. ruled that he was dealing with a clearly established case of fraud, that the documents were intentionally misleading and were not genuine documents against which the bank could be required to pay. He acknowledged that the courts had a duty to assist the smooth functioning of international trade, but not to the extent of assisting established and admitted fraud.100

The House of Lords however overruled the Court of Appeal and decided that, relying on the principle *ex turpi causa non oritur actio*, that the fraud exception to the independence principle did not extend to fraud where beneficiary-seller is not a party, and that accordingly, the bank is obliged to make payment in the face of third party fraud.101 Lord Diplock argued the proposition that a bank would be justified in refusing payment where the effect of a material inaccuracy in the documents, innocent or otherwise, would be to undermine the whole foundation of the letter of credit.102

It is not surprising that “the United City Merchants decision caused unease in banking circles.”103 Schmitthoff commented on the decision of the House of Lords that “it is contrary to the common

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100 *The United City Merchants* (Court of Appeal), at 173.
102 Ibid., at 774.
103 Schmitthoff, op.cit., at 11-041.
sense of the ordinary banker to pay under a credit if he knows that he tendered documents, though apparently correct on their face, are in fact fraudulent or forged.”104

Goode was less reserved in his criticism of Lord Diplock’s conclusion:

“In the first place, a document which by reason of forgery is a nullity cannot by any stretch of imagination be described as conforming to the credit. What the buyer bargains for in his contract of sale and the bank requires as a condition of payment are documents which are genuine, not worthless pieces of paper conferring no rights of any kind. The UCP certainly protects the bank against paying in good faith against forged documents which appear on their face to be genuine after reasonable examination; it is quite another thing to say that the beneficiary who in good faith tenders, say, a bill of lading not issued by the shipping company by which it purports to be issued or a certificate of insurance which purports to incorporate the conditions of a non-existent policy tenders conforming documents. Such a proposition extends the autonomy of a credit ad absurdum and reduces letter of credit law to a mockery.”105

104 Ibid, at 11-042.
105 Goode, op.cit., 231.
It is obvious that the reasoning made by Ackner L.J. and Griffith L.J. in the Court of Appeal was more logical. They both viewed the matter as not being covered by previous authority, and preferred to decide with reference to first principles. The bank’s duty and obligation was to pay only against genuine documents. The documents in question, although not forged and not fraudulently prepared by the beneficiary-seller, nonetheless were not conforming documents and the bank was therefore entitled to refuse payment. This decision was in line with the theory that the cardinal feature of a documentary credit transaction is the performance by the tender of the documents specified by the buyer in the application form and by the bank in the documentary credit. The object of the bank’s documentary credit is to ensure that the seller-beneficiary of the credit gets paid for the goods he sells and the buyer receives, in the shape of the relative documents of title, the goods which the seller has contracted to deliver to him.

(b) Bank’s Right of Refusal of Forged or False Documents

If, under the law of the letters of credit, without regard to the fact that documents are forged or false and invalid, and, as reflected in the UCM case, banks are obliged to accept such documents, banks may be placed under an unreasonable burden to honour a credit and accept fraudulently completed documents, unless they

are aware that the documents were also fraudulently completed by the seller/beneficiary itself.

One may legitimately question, however, whether a bank has the capacity or even the time to discover whether the actor of the fraud is the beneficiary-seller himself or the third party. The status of documents as bank security is also a concern as raised by Griffith L.J. who stated in the Court of Appeal of the UCM case:

“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... If the documents presented are fraudulently false, they are not genuine conforming documents and the bank has no obligation to pay.”108

Allowing the acceptance of forged or false documents by the banks has served to shift risk from the seller to the buyer/applicant, as well as also cause obvious confusion to banks. This was illustrated in the recent Singaporean case of Mees Pierson NV v Bay Pacific (S) Pte Ltd & Ors109 (“Mees Pierson”). In this case, the defendants were trading a cargo of wheat flour to a buyer in Vietnam. To cover the sale to the buyer in Vietnam, the Industrial & Commercial Bank of Vietnam (‘Vietincombank’) issued an

108 The United City Merchants (Court of Appeal), at 178.
irrevocable letter of credit in favour of the defendants for US$497,420. At the first defendants’ request, the plaintiff bank added its confirmation to the letter of credit. When the defendants presented the documents to the plaintiff, the plaintiff found some discrepancies and returned them to the defendants. After amendment and upon resubmission, the documents were accepted by the plaintiff, which discounted the bill of exchange and sent the documents to the Vietincombank. Vietincombank rejected the documents purportedly for certain discrepancies.

The plaintiff disputed the claim of discrepancies and commenced an action against Vietincombank. In the course of the proceedings, it discovered that the Health Certificate presented by the defendants was in fact a forgery, and that the bill of lading presented by the first defendant was antedated. The plaintiff immediately withdrew its action against Vietincombank and then instituted the proceedings against the defendants alleging that the defendants knew, at the time they presented the documents to the plaintiff, that the Health Certificate was a forgery and the bill of lading contained material misrepresentations of fact.

The Singapore High Court dismissed the plaintiff’s claim and stated that even though the Health Certificate was a forgery and therefore a nullity and such tender would have been an “incomplete tender”, the Court found the presenter of the forged documents was innocent and the confirming bank had no knowledge of such forgery when making the payment. Therefore the Court ruled that “so long as the document tendered is, on its face, compliant with the requirements of the credit, the confirming
bank is entitled to make payment under the credit and obtain reimbursement from the issuing bank, which in turn is entitled to obtain reimbursement from the applicant for the credit."

Therefore, despite the fact that the issuer Vietincombank had first rejected the documents based on some discrepancies and it was only later discovered that there was a forgery and misrepresentation of the bill of lading, presumably Vietincombank would not have been entitled to reject such documents based on any of these reasons. This decision, which forced Vietincombank to pay over fraudulent documents to the confirming bank, which obviously did not expect such reimbursement after the discovery of the fraud has the effect of straining the relationship not only between banks but also between the issuing bank and the applicant. Both the *UCM* and *Mees Pierson* cases wrongly neglect the bank’s duty to reject the forged or false documents on behalf of its applicant — a duty articulated by Ackner L.J. in the *UCM Case* (Court of Appeal decision): “if the signature on the bill of lading had been forged, a fact of which the sellers were ex hypothesi ignorant, but of which the bank was aware when the document was presented, I can see no valid basis upon which the bank would be entitled to take up the drafts and debit their applicants.”

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110 Ibid., at 13.

111 *The United City Merchants*, (Court of Appeal), op. cit., at 173.
(c) Beneficiary recklessness in respect of documents fabricated by a third party

As Lord Herschell set out in the seminal case of *Derry v. Peek*, Common law fraud requires proof that the maker of a statement made it either (a) knowing it to be false; or (b) recklessly, not caring whether it is true or false. Such fraud is notoriously difficult to prove as it requires evidence of a state of mind. On top of this factor, at common law, the state of mind is hardest to detect.”^{112}

The second head can constitute a basis for banks to reject fraudulent documents even through they were not fabricated by the beneficiary. As early as 1957 in the English case of *Brown, Jenkinson & Co Ltd v. Percy Dalton (London) Ltd*,^{113} Pearce L.J. had set down 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 just compensation.”

This was underlined by the recent English case *KBC Bank v. Industrial Steels (UK) Ltd*, David Steel J. looked into the beneficiary’s state of mind even though the beneficiary contended that at all material times he believed that the statement and the

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^{112} *Derry v. Peek* [1889] 14 App.Cases. 337:374 (Eng.) (per Lord Herschell).

certificates were correct. However, Steel J. ruled that when the documents were discrepant, they did not conform with the letter of credit and the beneficiaries were reckless as regards the content of the beneficiary’s certificate in the sense that they did not care whether it was true or false — the beneficiaries were therefore liable in deceit.

*KBC Bank* fits in well with the above-mentioned second head of fraud, i.e. recklessly not caring whether the material representation is true or false. *Lambias (Importers & Exporters) Co Pte Ltd v. Hong Kong & Shanghai Banking Corporation*, is another case on point, in which Goh Phai Cheng JC ruled that:

“Where the seller-beneficiary, while neither a direct nor deliberate perpetrator of the fraud or forgery, was nonetheless in some way clearly responsible for the turn of events that led to the perpetration of the fraud or forgery, and where no money has been paid out under the credit, there is no obligation on the part of the issuing bank or its agent to make any payment under the credit.”

Here the court had clearly required that “care and circumspection be taken in the tender of documents by a beneficiary.”

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115 Ibid., para. 46 at 10 of the Lexis version.


118 Ibid., at 765.
Goh further stated that “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.”\textsuperscript{119}

It is alarming to note the fact in the \textit{KBC Case} that the beneficiary supplied “an unstamped and undated Certificate of Origin simply because this is administratively convenient”.\textsuperscript{120} The beneficiary obviously did not foresee the consequence of such casual practice, which under the law had made the beneficiary liable in deceit.

Schmitthoff believed that the rule “fraud unravels all” should apply even when the fraud is committed by a third party, e.g. a forwarder or loading broker, and when the beneficiary himself was unaware of this fraud.\textsuperscript{121} The court in \textit{Sztejn} also referred to the rule of “fraud unravels all”.\textsuperscript{122} In practice, the beneficiary is given many chances by the banks to amend the documents for discrepancies, whether the discrepancy was the fault of the beneficiary, shipmaster or freight forwarder, until the documents comply with the terms and conditions of the credit. There exists no system to guarantee all alterations are done in a legally permitted manner or to restrain such practice. As shown in the \textit{United City Merchants Case}, when the documents first presented did not conform with the shipping date requirement yet honestly stated the truth, they were rejected with a request for amendment. Then fresh bills of lading

\begin{footnotesize}
\begin{enumerate}
\item[119] Ibid
\item[121] \textit{Schmitthoff’s Export Trade}, op.cit., at 11-041.
\end{enumerate}
\end{footnotesize}
were prepared for the purpose of being considered as facially complying documents.\textsuperscript{123} Such practice can produce the consequence that such documents are conforming on their face and therefore acceptable to the banks, yet dishonest and illegal.

It is submitted therefore that the application of the rule that “fraud unravels all” should be insisted upon in such situations in order for such documents to be rendered unacceptable, therefore to be in line with buyer’s right to repudiate his contract with the seller if the bill of lading is forged or false, as well as the ship-owner’s responsibility to provide such documentation under the common law. This is in line with a decision made in an unreported case, \textit{Bank Russo-Iran v. Gordon Woodroffe & Co Ltd},\textsuperscript{124} where the court reasoned that the identity of the forger is immaterial.

Arguably, the beneficiary in the \textit{UCM Case} could be considered as having a “cavalier attitude”\textsuperscript{125} and therefore acting recklessly as regards the date of the bill of lading. The decision in the \textit{United City Merchants} might have had the effect of actually encouraging sellers not to inquire into the possibility of fraudulent activities of third parties, such as carriers, freight forwarders and any other parties who are required to provide documents. The fact that the bill of lading was forged so as to be a conforming document on its face is to the beneficiary’s benefit and any knowledge of any wrongdoing would jeopardise the beneficiary’s chances of being paid. It is easy to come to the conclusion here that a beneficiary, therefore, would never admit that he has noticed any illegality of

\begin{itemize}
\item \textsuperscript{123} \textit{The UCM Case} [1979] 1 Q.B. 267, at 270.
\item \textsuperscript{124} \textit{Bank Russo-Iran v. Gordon Woodroffe & Co Ltd} The Times, October 4th, 1972.
\item \textsuperscript{125} \textit{KBC Bank v. Industrial Steels (UK) Ltd}, para. 46 at 10 of the Lexis version.
\end{itemize}
any action from the document providers even though it has been suggested\textsuperscript{126} that a beneficiary who takes the documents from those who issue them surely is in a much better position to check their authenticity than is a buyer in a foreign country. And, as discussed in Chapter One, in recent times, due to the trend of banks taking various types of security from applicants, the fact that the documents are worthless in such circumstances may matter little to the bank.

(d) Rejection of documents on the basis of nullity?

Are banks entitled to, or even obliged, to reject a tender of documents on the basis that they are false? Rejection on the basis that a document is a nullity, which has little support in English authority, derives some support in the form of a 1993 Singapore High Court decision of \textit{Lambias}.\textsuperscript{127} In \textit{Lambias}, Goh Phai Cheng JC stated that a forged document is a document that was a nullity \textit{ab initio} and that the bank was entitled to reject it even if the seller was not a party to the forgery. In the case of \textit{Lambias}, the issuer was the Hong Kong & Shanghai Banking corporation ('HSBC'), which requested the seller/beneficiary Lambias to provide a Quality and Weight Inspection Certificate ('QWI'). There was a specific requirement for such QWI to be signed by a specified person called “YAU” which however had been signed by an impostor. The court held that the QWI was a discrepant document and a nullity. The learned judicial

\textsuperscript{127} \textit{Lambias (Importers & Exporters) Co Pte Ltd v. Hong Kong & Shanghai Banking Corporation} (1993) 2 SLR 751.
commissioner analysed the basic requirement of a QWI certificate saying that, first of all, the document has to be issued by the party required by the letter of credit. Secondly, it has to state the necessary particulars to relate it to the goods which are the subject of the letter of credit. Thirdly, it has to contain the necessary statement as to the quality or weight of the goods ostensibly inspected. Without meeting all above requirements, the QWI was a nullity *ab initio*.128

Stephenson L.J. in the *UCM Case*, in addition to Griffiths L.J., expressed the opinion that the fraud exception was not confined to fraud by the beneficiary-seller.129 Reflecting this line of reasoning, as early as 1983, in *Bolivinter Oil SA v. Chase Manhattan Bank*,130 Sir John Donaldson MR and Griffiths L.J. had expressed the possibility of using the principle of “fraud unravels all” and they urged judges to get to the fundamental issue of the validity of the letter of credit or bond or guarantee itself when considering an injunction restraining payment by a bank.

The Singapore High Court dealt with the question of nullity again in *Mees Pierson*131 in which it considered that the House of Lords in the *United City Merchants Case* had left the nullity issue open. The Court raised the question of differentiating forged documents from false documents. In the former situation, where the documents in question are forged, “the confirming bank who is aware of the forgery may refuse payment under the credit even if

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129 *United City Merchants*, (Court of Appeal), op. cit., at 169.
130 *Bolivinter Oil SA v. Chase Manhattan Bank* [1984] 1 All ER 351.
131 *Mees Pierson NV v Bay Pacific (S) Pte Ltd & Ors*, op. cit.
the presenter of the documents was innocent of the forgery and had no knowledge of the same, on the ground that the documents tendered are not complete."\textsuperscript{132} The latter situation, which was dealt with in the \textit{UCM Case}, was where “the documents, on their face conform to the credit, but contain a statement of fact that is inaccurate, so the confirming bank is not entitled to reject those documents unless there is some culpability on the part of the presenter of the documents, who has fraudulently presented the documents with knowledge of the material misrepresentations of fact.”\textsuperscript{133} This analysis appears to represent one more step along the path towards resolving the practical problems plaguing the documentary letters of credit transaction, that is, how to make documents with minor discrepancies acceptable as long as they do not contain material misrepresentations. However, it is doubtful whether the courts as well as lawmakers will be able to establish any kind of consistency in determining the threshold of materiality for a misrepresentation of fact, especially for statements on the bills of lading for which accuracy is considered crucial for international sales of goods.\textsuperscript{134} It is also doubtful whether such a change will assist the system to combat fraudulent activities as it will necessarily entail making a confirming bank’s knowledge a precondition for the rejection of any forged document.

\textsuperscript{132} Ibid., at 2 of the Lexis version.
\textsuperscript{133} Ibid.
\textsuperscript{134} \textit{Schmitthoff’s Export Trade}, op.cit, Chapter 15.
4.5.3 Bank obligation of enquiry, and of duty of care to the applicant

(a) Issuer interest in and liability for payment over/investigation into potentially forged or false documents

In court decisions, there is some indication of a line of reasoning which may in due course gather the support necessary to engender a change in banks’ rather carefree attitude towards acceptance of non-genuine documents. For instance, in the UCM Case, Ackner L.J. expressed\textsuperscript{135} the view that the issuer owed the applicant a duty of care. However, as the letter of credit system generally refuses to admit that there is any contractual relationship under the credit itself between the issuer and the applicant, and in the general absence of a substantive duty of care of an issuer toward an applicant, there is no basis for the applicant to sue the issuer for knowingly making payment over alleged fraudulent documents. An issuer therefore bears little risk of being found liable to the applicant for wrongful payment.

The “general rule with respect to fraud is that a bank is not responsible for payment against forged or false documents which appear on their face to be regular”.\textsuperscript{136} This is also indicated in Article 15 of the UCP 500, which provides in part:

\begin{quote}
“Banks assume no liability or responsibility for the forms, sufficiency, accuracy, genuineness, falsification
\end{quote}


or legal effect of any documents(s)...”

Accordingly, when a bank is informed of fraud, it “is not obliged actively to ascertain whether the alleged fraud can be proved. It may adopt a passive attitude and only evaluate the evidence placed before it by the buyer.”

In an article in the ICC publication *Insight*, N.D. George, Head of Trade Finance at the National Bank of Fujairah, Dubai stated that while banks take full account of their interest in the business of documentary credit, they are unconcerned about what the applicants/buyers receive at the end of the day:

“The letter of credit thrives on that dynamic, because it fosters payment; the hallmark of the letter of credit that it will yield payment even when the parties are contesting rights and liabilities in the underlying transaction... Bank issuers, moreover, are unlikely to risk their reputation as credit issuers in order to protect their customers.”

The test of documentary compliance is said to be “international banking practice” under Article 13 of the UCP 500. In *KBC Bank v. Industrial Steels (UK) Ltd*, in which the court upheld the paying bank KBC’s right to sue the beneficiary in deceit because the

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137 Schmitthoff, op.cit., at 11-042.
140 *KBC Bank v. Industrial Steels (UK) Ltd*, op. cit.
beneficiary had provided a document with misstatement, David Steel J. took a dim view of the assertions of the beneficiary ISL as supported by an expert from the trade finance department of Credit Agricole Indosuez, that “a non-negotiable document in the context of the certificate of origin would include one that was not stamped, signed or dated.”

Justice Steel requested full disclosure of documents relating to this practice and in coming to his view of the incredibility of the beneficiary’s assertions, emphasised “the value of full and proper disclosure or more particularly, the potential for suppression of the truth in selective and partial disclosure”. By requesting the relevant party to disclose actual practice to the court, and by requesting expert opinions from both parties, it is evident that the claimants (the beneficiaries) and the expert from Credit Agricole Indosuez felt unable to give any credence to “their own opinion, which clearly constituted a mere assertion unsupported by any reasoning in contrast to the report of the opposing expert”.

It is commonly assumed that if the credit is opened under the UCP, Article 15, which provides that banks assume no liability in respect of the genuineness and falsification or legal effect of any documents, will protect the bank’s position. However, as indicated in Angelica-Whitewear, “the legal position remains doubtful”. The Canadian Court of Appeal in Angelica-Whitewear considered

141 Ibid., para. 29 at 7 of the Lexis version.
142 Ibid., para. 44 at 9 of the Lexis version.
143 Ibid.
144 Bank of Nova Scotia v. Angelica-Whitewear Ltd., op.cit. Note that Le Dain J did not agree with such reasoning and held that there was no reason for the bank to make any inquiry or to act on any assumption concerning the shipment covered by invoice 0014 by reason of what it had been informed concerning the shipment covered by a previous invoice merely for the words “the amount claimed on the invoice 0014 was not correct”, ibid., at 179-180.
145 Schmitthoff’s Export Trade, op.cit., at 11-042.
that the bank had been put on inquiry. As such, without taking steps to inform itself sufficiently as to whether there had been fraud by the beneficiary of the letter of credit, the bank had breached its duty of care.\footnote{Bank of Nova Scotia v. Angelica-Whitewear Ltd., op.cit., at 179-180.}

\( (b) \) \textit{Customer's right of recovery against the bank}

The Canadian Supreme Court in \textit{Angelica-Whitewear} delineated the theory of the customer's right against an issuing bank — where the bank has debited the applicant’s account pursuant to an improper payment — a draft under a letter of credit could be made the subject of an action for recovery of the amount of the debit. The basis of right of recovery is that the customer was not obliged to reimburse the issuing bank because the bank, by reason of the fraud exception if it applied, or by reason of documentary non-compliance with the terms and conditions of the credit, should not have accepted the document and paid the draft.\footnote{Ibid., at 195.}

The Supreme Court referred to \textit{Chitty on Contracts} (25th ed. 1983) vol. II, at 324:

“\textit{If a tender of documents does not strictly comply with the requirements of the commercial credit, the banker is entitled to reject it. It does not matter whether the discrepancy is significant or minute. The rule \textit{de minimus non curat lex} does not apply in commercial credit transactions. Moreover, the person to whom the}
documents are tendered is entitled to raise any lawful objections against the documents even if in fact his objection is purely technical and the true motive for his rejection of the documents is to be found in a falling market. The fact that he does not, at the time of the rejection of the documents, realise all the defenses available to him does not preclude him from setting up all of them at the trial.”

The court found in this case a discrepancy on the face of the bills of lading and held that the bank was not obliged and was not authorized to accept the documents and pay the draft of invoice 0014. In doing so, the court held, the bank was in breach of its agreement with the applicant, Whitewear.\textsuperscript{148} This court reasoned that the fact that Whitewear may not have been prejudiced by the discrepancy, in the sense that its loss was not directly attributable to it, is immaterial. This line of reasoning is also followed by the case of \textit{Midland Bank, Ltd. v. Seymour},\textsuperscript{149} which held that the buyer’s real reason or motives for invoking documentary non-compliance are immaterial.

Therefore, the Supreme Court held that the applicant was entitled to the amount which was improperly paid and debited from its account because of the documentary non-compliance with the terms and conditions of the letter of credit and agreed with the decision of the court of appeal which held that the acceptance of the goods by the applicant did not constitute a waiver of the right to

\textsuperscript{148} \textit{Bank of Nova Scotia v. Angelica-Whitewear Ltd.}, op.cit., at 193.
\textsuperscript{149} \textit{Midland Bank, Ltd. v. Seymour} [1955] 2 Lloyd’s Rep. 147 (Q. B.), at 151.
invoke irregularities affecting the documents accompanying the draft of invoice 0014.

(c) Possible liability of a bank for contributory negligence for turning a blind eye to a discrepancy

If documents do not conform to the conditions of the letters of credit, they should not be acceptable. Further, dishonesty in stating the actual situation should potentially render a bank liable for contributory negligence.

In *Standard Chartered Bank v. Pakistan National Shipping Corporation & Others*,¹⁵⁰ the plaintiff, Standard Chartered Bank ("SCB"), in order to claim reimbursement from the issuing bank, Incobank, issued a false statement claiming that the documents required under the letter of credit had been presented by the beneficiary on time. As Incobank refused payment to SCB on the basis of entirely unrelated discrepancies, the court decided that SCB would have been liable if the issuing bank had based its rejection on SCB’s dishonesty in stating the truth. Therefore, as PNSC had not refused payment on this basis, PNSC was unsuccessful in getting the damages payable to SCB reduced on the grounds of contributory negligence.¹⁵¹

According to Ronald J. Mann's study, out of the 343 discrepant

¹⁵⁰ *Standard Chartered Bank v. Pakistan National Shipping Corporation & Others*, op. cit.
files he reviewed, the beneficiary presented documents late in 48 files (14%). This provides an idea of the frequency in which documents are being accepted on expired letters of credit. Presumably, the confirming bank or other paying bank in such a situation had misled the issuing bank and the buyer about the reality of the submission.

The court has indicated clearly that such behaviour is not tolerable. Lord Justice Ward referred to SCB’s false statement as:

“scandalous attempts to deceive the issuing bank on the basis of a false statement that the documents were presented to them in time.”

He further expressed his “distaste for the bank’s conduct” and said that “they have brought dishonour upon themselves and upon the City.”

**(d) Can exemption clauses relieve the bank of liability?**

According to the Supreme Court in *Angelica-Whitewear* which considered this question, the answer was a definitive no. The court considered the exemption clause in the agreement between the bank and Whitewear which read as follows:

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153 *Standard Chartered Bank v. Pakistan National Shipping Corporation & Others* (No.3) [2000] 2 All ER (Comm) 948.

154 Ibid.
“All users of the Credit shall be deemed to be agents for the Undersigned and neither the Bank nor its agents or correspondents shall be responsible for the negligence or fraudulence of any user of the Credit... and the Bank shall not be in any way lessened or affected if any bill or document accepted, paid or acted upon... is...invalid, insufficient, fraudulent or forged or if any bill or document does not bear a reference or sufficient reference to the Credit ...”

The court held that such exemption clause would not relieve the bank of liability of the payment of the draft that is accompanied by the documents which are not in accordance with the terms and conditions of the letter of credit, and, therefore, would not oblige the customer to reimburse the bank. The court was of the opinion that such an intention was contrary to the fundamental principle of documentary credits and the stipulated obligation of reimbursement by the customer to the bank under Article 8 of the UCP 400.155

(e) Limiting duty of care to the applicant under the UCC

§5-103(c) of the UCC states that [a] term in an agreement or undertaking generally excusing liability or generally limiting remedies for failure to perform obligations is not sufficient to vary obligations prescribed by this article. The Official Comment of §5-103 however states that the restriction of a general disclaimer is

based on procedural unfairness rather than substantive unfairness and as far as the obligations of the issuer are concerned, the law recognises that the issuer and the applicant may agree to almost any provision, even a reimbursement agreement stating that an issuer will not need to check any documents.

It is submitted that the official commentator is clearly advising banks to explicitly disclaim its duties to achieve the same purpose as a general disclaimer. Secondly, these commentators also know that the applicants will have virtually no say as to whether an unfair term will end up being in the agreement between the issuer and the applicant, and that such terms would be upheld by courts as negotiated between two parties. If courts understand the basic function of the documents and their importance to the interest of applicant-buyer, it is submitted that they should question why applicants often take up all the risks, and why issuers can effectively have all their duties and obligations disclaimed. If the terms of such agreement are the result of negotiation and bargain, where is there any manifestation of the applicant’s interests?

The Official Comment of §5-108 permits the issuer to have its liabilities for discovering discrepancies freed or reduced by an “agreement” or by “custom”, which thus will not be considered as violating the terms of §5-108 (a) and §5-103(c), under which liabilities of the issuer cannot be modified by agreement. Even though the term “in some circumstances” is used, because it is not specific about the situations under which such exemption of liability is permitted, it follows that the Official Comment of §5-108 has created an opportunity for the issuer to impose virtual liability-free
agreements on the applicants without risk of violating §5-108 (a) and §5-103(c). One must wonder however whether such agreement can be considered as violating the concept of “good faith” under §5-102(7). It would have easily been considered as violating the concept of “fair dealing in the transaction”, which unfortunately has been taken out of the definition of “good faith” concept which was incorporated in Article 5 (62’).

Interestingly, under Article 3 of the UCP as well, an undertaking of a bank to pay or “to fulfil any other obligation under the credit is not subject to claims or defenses by the applicant resulting from his relationships with the issuing bank or the beneficiary”. According to ICC Publication No 511, Article 3 of the UCP 500 “deters” an applicant’s demand that payment should be stopped because of the beneficiary’s breach of his contractual obligations to the applicant. Unfortunately, neither the text of the UCP itself nor the ICC chairman’s explanation refers to the degree or character of the breach.

(f) Extending enquiry beyond the documents and identification of an absence of good faith

— Enquiry beyond the documents and case authorities

As mentioned above, a number of authorities suggest looking outside of the documents to determine whether there has been fraud in the transaction. In this context, identification of manifest lack of good faith in the transaction could be of assistance in uncovering the necessary scienta to constitute fraud, and
disqualifying relevant parties from reliance on the independence principle.

Under the independence rule, the bank is only concerned with the apparent good order of the documents, not with the goods themselves, and its duty to pay is not conditioned on the performance of the underlying contract by the beneficiary-seller. Therefore, the law of the letter of credit has rarely permitted any claim by the applicant that the seller has shipped goods which are unmerchantable or short in quantity. However, the court in Angelica-Whiteware decided that “the fraud exception to the autonomy of documentary letters of credit should not be confined to cases of fraud in the tendered documents by the beneficiary; it should include fraud in the underlying transaction of such a character as to make the demand for payment under the credit a fraudulent one.” Lord Denning M.R. in Edward Owen Engineering moreover had already stated clearly:

“...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.”

This suggests that the fraud exception is not limited to documentary fraud. As stated by Le Dain J., the fraud exception to

158 The Edward Owen Case, op. cit.
the autonomy of a documentary credit should extend to any act of
the beneficiary of the credit, otherwise the effect would be to
permit the beneficiary to obtain the benefit of the credit as a result
of fraud.\footnote{Bank of Nova Scotia v. Angelica-Whitewear Ltd., op.cit., at 174.}

While the consideration of the underlying transaction in order to
detect whether the beneficiary has a colourable right to demand
payment is supported by some judges as indicated above, it might
be difficult to decide whether the underlying contract has been
performed in such a manner that the beneficiary has no right to
payment under the credit. One of the early cases dealing with this
issue is \textit{Maurice O’Meara Co. v National Bank of New York}.\footnote{Maurice O’Meara Co. v National Bank of New York 146 N. E. 636 (1925).}
This case involved the shipment of paper of a certain stated weight
or strength. The bank refused to pay against apparently
conforming documents because there arose a reasonable doubt
regarding the quality of the newsprint paper. The court pointed out
that the buyer had remedies at law for any alleged defect in
quality, and that to hold for the defendant would impose a duty on
the bank which could defeat the central purpose of the credit.\footnote{Ibid., at 638.}

\textquote{The [defendant] bank was concerned only with the
drafts and the documents accompanying them. This
was the extent of its interest. If the drafts, when
presented, were accompanied by the proper
documents, then it was absolutely bound to make the

\footnotesize
\textfootnote{Bank of Nova Scotia v. Angelica-Whitewear Ltd., op.cit., at 174.}
\textfootnote{Maurice O’Meara Co. v National Bank of New York 146 N. E. 636 (1925).}
\textfootnote{Ibid., at 638.}
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.”

The decision in *Maurice O’Meara* seemed to demonstrate a strict adherence to the documentary fraud exception and the court refused to look to the underlying transaction to see whether there was clear intention of deceit by the beneficiary and imposed a duty for the defendant bank to pay even though it was clear both to the bank and the court that the beneficiary might not honestly perform the contract.

One is to wonder whether the commercial purpose of the goods should have been considered here by the court to infer bad faith. If the low quality paper was sent and the entire contractual purpose of the buyer was upset, trying to obtain the payment for high quality paper which has not been sent might not be easily categorised as a beneficiary acting in good faith. Sellers and buyers know their industry better than courts and banks. If the seller cannot be said to have honestly believed that it deserves the payment of the price indicated in the invoice or draft, it might easily fall into the circumstances Lord Denning described where the request for payment is made fraudulently because the beneficiary has no right to payment. Therefore, the court’s decision in *Maurice O’Meara*, which based its reasoning on the fact that that the paper was not worthless and did have a certain value on the market in general, might not be a convincing one with which to

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162 Ibid., at 639.
163 *Edward Owen Case*, op. cit.
reject the application of the fraud exception.

In *Rockwell International Systems. Inc. v. Citibank, N.A.*, the court, referring to *Sztejn* and *Cambridge Sporting Goods*, said that it must look to the circumstances surrounding the transaction to determine whether there had been an “outright fraudulent practice” where a beneficiary of a credit has acted in such a manner as to prevent the performance of the underlying contract and to attempt to reap the benefit of the credit.

It is submitted that if there is clear indication of the seller’s intention of deceit, even if the complaint only concerns the quality of goods (rather than documentary compliance), courts should enjoin a bank from its obligation to pay. This would serve to bring justice to the letter of credit system and thwart any fraudulent intention of taking advantage of the independence rule, thereby protecting the interests of bona fide parties. If a seller can easily receive payment despite defective goods, this would naturally result in an undermining of the buyer’s position through a proliferation of sellers taking advantage of this opportunity. Furthermore, the shipment of valueless goods arguably vitiates the documents. If the holder discovers the fraud, he can hardly transfer the bill of lading for value without facilitating a fraud. Moreover, irrespective of other options implemented by banks to take security from applicants, it should not be forgotten that the documents, under the law of credit, are the bank’s primary security for the advances to the seller. A bank should not be required to pay money against such worthless security, even if the documents are not forged.

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Therefore, attempts to label the authority of the Szteijn Case as only dealing in fraudulent documents proves to be illogical because it is hard to say a bill of lading is a document of value if no goods are shipped at all. This point was also clearly spelt out by Young J's judgment in Inflatable Toys.\textsuperscript{165}

— Adding good faith as a required precondition to receive payment

Originally, the beneficiary's right of payment was based only on demonstrating facially conforming documents, as determined by banks. Now it appears that a new precondition has been added to facial compliance, which is evident in the Santander Case,\textsuperscript{166} namely, the beneficiary's good faith. As discussed in chapter 3, good faith as a concept is very well entrenched in the civil law system and is also creeping into common law jurisprudence. The effect of Santander, which is discussed in more detail under section 4.8, was to make good faith of the beneficiaries a precondition for payment under the letter of credit. As admitted by Santander, it was felt in the industry that it was safe to discount credits and that “banks, or at least discounting banks, are not concerned with the bona fides of the beneficiary.”\textsuperscript{167}

The independence principle limits banks' responsibilities of checking the documents to their face only and endorses the right of payment to the beneficiary as long as they provide facially

\textsuperscript{165} Inflatable Toys Case, op. cit.
conforming documents. Banks had rarely been asked to bear the risk of beneficiary’s fraudulent performance of the underlying transaction and the risk has always been shifted to the applicants. Santander could have won this case easily if the Court simply applied, as usual, the independence principle under which the court refrained from examining what lay beyond the documents.

By asserting itself to be a holder in due course, never identified clearly in the letter of credit transaction yet frequently resorted to by banks as a defense, the confirming bank claimed to be immune from any fraud claim. Furthermore, Santander was aware that the courts have been leaving letter of credit issues to banks to determine for fear of tampering with or even destroying the system underpinning international business transactions. Santander also claimed that discounting the deferred letter of credit was a “customary practice” for banks, which supposedly “facilitates international trading by assisting the beneficiary’s cash flow”.

This case demonstrated a new resolve on the part of the courts that beneficiaries would have no right of payment if they did not act with good faith, and that even with facially conforming documents, a bank cannot claim itself as having “holder in due course” status in order to be insulated from the fraud even though it is a confirming bank under the deferred letter of credit; as well as the fact that good faith is the fundamental principle courts are willing to use to analyse complex legal situations. The court in this case suggested that the beneficiary’s right to be paid does not derive from the application of the independence principle and the strict compliance rule, which limits the beneficiary’s duty to the
presentation of facially conforming documents — the basis of this right to payment is actually the good faith of the beneficiary. If the beneficiary acted in bad faith, it had no right to be paid. Under such circumstances, this decision demonstrated that the confirming bank should not have greater rights to payment than the beneficiary. In application of the good faith principle, the court in effect pierced the veil of the independence principle where it was serving to facilitate a fraud.

— Good Faith and Article 5 of the UCC

“Good faith” is defined in §5-102 of the Revised UCC as “honesty in fact in the conduct or transaction concerned”. “Observance of reasonable standards of fair dealing” has been removed from the concept of good faith in Article 5 (62’) of the UCC. The reason for doing so was given as for providing greater certainty in respect of the bank’s obligation to pay, for the purpose of speed and cost-saving, and to provide U.S. letters of credit with “continuing vitality and competitiveness in international transactions” and is consistent with the independence principle.168

Dolan has expressed the view that courts should read the good faith requirement of Article 5 with regard to that body of law, “which make allowance for the independent nature of the obligation, for the exigencies of the document examination process, and for the

169 Ibid., at 4-9.
170 Ibid.
low cost of letters of credit”. He further states that “it is not helpful for courts to succumb, for instance, to the temptation to second-guess bank document examiners, clerks who must make decisions on short notice and without benefit of legal briefs and oral arguments.”

Under the present system of letters of credit under the umbrella of the UCP, bad faith and unfair dealings appear to be tolerable as they are not overtly prohibited. Beneficiaries get paid without fulfilling their duties of performing their underlying contract. These are bad faith and unfair dealings. Banks only have to exercise an artificial duty on the examination of documents without having to exercise substantial reasonable care. Even with all responsibilities exempted, banks can still get reimbursement from the applicant’s account.

The question here is whether a system should be framed so as not to deal with or even to accommodate such practice, or should it be perfected to prohibit such bad faith activities by incorporating good faith in every stage of such transaction and imposing on all parties a duty to act in good faith? It seems clear that the Revised Article 5 adopts the former approach. It is submitted that whereas Article 5 (62’) was drafted under the influence of the general principles of the UCC which incorporated the concept of good faith in designating the rights and duties of all parties involving in the letters of credit transactions, the subsequently revised version of Article 5 have taken a step backward in this aspect. By following the UCP, which Article 5 accepts as a codification of banking practices, in the writer’s opinion, Article 5’s function and credibility
as the law governing letters of credit has been damaged.

Under Article 5, even though the buyer/applicant might seek injunctive relief to enjoin the bank from paying when possessing belief of the seller/beneficiary’s fraud, a bank acting in good faith may still choose to make payment irrespective of the applicant’s allegation and still be entitled to its right to be reimbursed by the applicant-buyer. The power to render injunction is vested in the court. It is submitted, however, that Article 5, by imposing the duty of payment on the bank against an applicant’s allegation of fraud, might be considered as limiting the court’s judicial power of enjoining payment. If a bank can decide and choose to make payment to a possible fraudster in the name of making the payment in good faith while still being entitled to reimbursement from the buyer/applicant, this, in effect, rules out the right of court intervention under the letter of credit in enjoining payment against the payment to the fraudster and renders the applicant-buyer as a victim unless there is a system in place under which the applicants have the right of recovery of the money paid by the issuing bank under mistake of fact or against such bank for wrongful dishonour. Banks in turn should have a right of action against a deceitful beneficiary which has received payment under the mistake of fact.

171 § 5-109 of the UCC.
172 Edward Owen Case, op. cit., at 979.
4.6 Documentary Examination as a Tool to Protect Bank Interests

4.6.1 Banking interests also under threat

The ICC International Maritime Bureau advises that the documentary credit system can be used as a cover for many activities that banks are led to believe are trade based.\textsuperscript{173} Notwithstanding the duty of checking the presented documents under UCP 500, “it is in the banks’ own interests to ensure that they know precisely what activities their clients are asking them to finance. The way to do this is for banks to make independent checks into the transactions, i.e. to authenticate the bills of lading and other documents presented under the documentary credit system. It is only through these independent checks that banks can be sure they are financing what their clients are declaring to them, and it is the only way that some of the early warning signs of a long-term fraud against the bank will be detected.”\textsuperscript{174}

According to an ICC International Maritime Bureau report, a government trading organisation involved in the purchase of 20,000 metric tones of sugar, which was to be financed through a letter of credit negotiated by a bank in Jordan, was faced with such a situation. The bank staff had rich experience in dealing with shipments of sugar and knew what the letterheads and signatures

\textsuperscript{173} Trade Finance Fraud - Understanding the Threats and Reducing the Risk, op.cit., at 29. Also see P. Mukundan, “Trade Finance Fraud: When Buyers and Sellers Collude”, Vol. 9, No. 1, Insight, Jan-March 2003: 1.

\textsuperscript{174} Trade Finance Fraud - Understanding the Threats and Reducing the Risk, at 28; Such checks can even be undertaken free of charge by an organisation such as the CCS Bureaux for their banking members, at 29.

\textsuperscript{175} Ibid., at 11.
on the documents looked like. When the letter of credit misspelled the name of the surveyors who were to attest to the quality and quantity of the sugar loaded on board, the fraudster knew that in order to get paid they needed to produce documents which exactly complied with the terms of the letter of credit. When the documents with the misspelt name of the surveying company were produced, the staff was immediately alerted. It was discovered that the goods were not loaded on the vessel at all. The bank therefore refused payment.\textsuperscript{175}

\textbf{4.6.2 The bill of lading and the potential for forgery}

By mercantile custom,\textsuperscript{176} and by case law,\textsuperscript{177} “a bill of lading is a formal receipt by the shipowner acknowledging that goods alleged to be of the stated species, quantity and condition are shipped to a stated destination in a certain ship...”\textsuperscript{178} Possession of the bill is in many respects equivalent to possession of the goods and the transfer of the bill of lading has normally the same effect as the delivery of the goods themselves.\textsuperscript{179}

As discussed in chapter 1, with the rise of container transport, however, there has existed “many unsolved legal problems”.\textsuperscript{180} When a container bill of lading is issued, the goods packed by the seller or shipper are not and cannot be ascertained or checked by

\textsuperscript{176} Schmitthoff's Export Trade, op.cit., at 15-038.
\textsuperscript{177} The quality of such document as a document of title was first recognised by the courts in Lickbarrow v. Mason (1794) 5 T.R. 683.
\textsuperscript{178} Schmitthoff's Export Trade, op.cit., at 15-019.
\textsuperscript{179} Ibid., at 15-038.
\textsuperscript{180} Ibid., at 16-001.
the ship-master. It is doubtful whether such bill of lading still has
the same value and security provided by a traditional bill of lading
which was labelled as “currency of trade”181 because it might not
have any goods to support it at all.

The ICC International Maritime Bureau warns that there is no
physical control over blank books of bills of lading and they are
given away to the freight forwarders and other sub-contractors; a
fraudulent seller does not need to go back to the ship-master for
stamp and signature. Therefore, a bill of lading can be reproduced
without great difficulty. Furthermore, banks have no way to verify
the stamp or signature of a bill of lading.

Sometimes, a beneficiary can present an ostensibly clean bill of
lading to a bank which has been obtained illegally. When cargoes
are loaded on board and the ship-master discovers such cargoes
in a damaged condition, which will entitle the buyer to reject the
goods, the Master has to put a clause on the bill of lading to reflect
that. However, the shipper/seller knows that such bill of lading is
not a conforming document under the letter of credit and will insist
that the Master issue a clean bill of lading. The shipper/seller thus
will make a promise that should any claim be made arising from
the condition of the cargo by the buyer, the shipper will indemnify
the ship-owner.182 However, such practice is illegal under English
law,183 and it “is tantamount to a conspiracy to defraud the buyer
into paying the full value of goods, based upon the clean bill of

181 Scrutton, Charterparties and Bills of Lading (1996), cited in Schmitthoff’s Export Trade,
op.cit, at 268, n. 93.
182 Ibid, at 42. Also see Schmitthoff’s Export Trade, op.cit., at 15-039.
lading.”

A seller may forge a bill of lading in an attempt to compensate for unwelcome events of shipping reality, such as “delays in the arrival of the vessel at the load port, port congestion, delays in the production of the cargoes, and delays to the transport/arrival of the cargoes at the load port, etc.” A seller would forge a bill of lading with the required shipping date or ask the carrier to pre-date a bill of lading in order to make sure the documents are complying on the face with the terms and conditions of the letter of credit.

As Schmitthoff states, “the date of the bill of lading is material in three legal relationships: in the contract of carriage, in the contract of sale, and in relation to the banks if payment is arranged under a letter of credit.” Bills of lading issued after this date will not be acceptable under the letter of credit. If goods are loaded after the final date of shipment permitted under the letter of credit, and the bills of lading correctly reflect this date, the seller will have to request that its buyer extends the final date of shipment in the letter of credit. Such a request could result in the buyer renegotiating the price or other terms of the contract. An easier option for the unscrupulous seller rather than disturbing the letter of credit, is to exert pressure on the shipping agent to pre-date the

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184 Note that an indemnity given to the carrier by the buyer in order to induce the delivery of the shipped good without presentation of the bill of lading, however shocking, is considered valid and enforceable by the carrier, see Sze Hai Tong Bank v. Rambler Cycle Co Ltd.[1959] A.C. 576; The Delfini [1990] 1 Lloyd’s Rep. 252; and The Houda [1994] 2 Lloyd’s Rep. 541.

185 Trade Finance Fraud - Understanding the Threats and Reducing the Risk, A Special Report prepared by the ICC International Maritime Bureau, op.cit., at 17.

186 Ibid., at 13.


188 Trade Finance Fraud - Understanding the Threats and Reducing the Risk, op.cit., at 13.
bill of lading, thus ensuring that its documents comply with the terms of the credit.\textsuperscript{188}

An important piece of collateral within the trade transaction is the bill of lading consigned to the bank.\textsuperscript{189} If all else fails, through the bill of lading a bank should be able to get its hands on the cargo and thus recover some of its losses. However, if that document itself is false, the bank has no collateral and may be financing a transaction worth millions of dollars based upon nonexistent cargo.\textsuperscript{190} Hence the need of banks to check whether or not documents presented are genuine. Even taking into account banks’ own credit insurance policies, which are intended to protect customers against unforeseen losses and fraud, these do cover situations where the bill of lading itself has been fraudulently issued or a genuinely issued bills of lading contains wrong description of the contents, date of shipment, and the name of vessel.\textsuperscript{191}

The ICC International Maritime Bureau has warned that documents used in a trade finance transaction have few security measures built into them and therefore none of these documents are immune from forgery, especially given the sophistication of scanners, colour copiers and laser printers today. A fraudster only

\textsuperscript{188} As stated by Cyril Eden of the International Trade Services Department of Bank Leumi (UK) plc, London, “the value of bills of lading is being eroded. As a bank very actively engaged in trade finance, we may well be looking to goods as security, apart from looking after our customers’ interests. We are sure that we are not alone in the trade finance world with regard to our worries concerning the worth of a document of title that may not be strictly accurate in its content.” He concludes that “We have in fact reached a point where we may hold a document of title but our reliance on it will be uneasy. We fear that the situation may get worse with the introduction of electronic bills of lading” – C. Eden: “International Bulletin: Country Correspondent Reports: United Kingdom”, Vol. 7, No. 3, \textit{Insight}, July-Sept. 2001: 16.

\textsuperscript{189} \textit{Trade Finance Fraud - Understanding the Threats and Reducing the Risk}, op. cit., at 29.

\textsuperscript{190} Ibid., at 32.
has to satisfy the examination by the trade finance department of a bank, “whose obligation is to ensure that the document complies with the terms of the letter of the credit, not to ensure that the document is genuine and properly issued by the inspection company.”

In the case of the Certificate of Origin and Phytosanitary Certificate, it is said that “such a certificate usually has no special features that prevent forgery. In fact, in many countries, one could get a genuinely issued certificate of origin for a non-existent cargo.”

4.6.3 Letters of indemnity

Normally, the beneficiary is required to present a whole set of documents in accordance with the terms and conditions of the letter of credit before it gets paid. Some banks reportedly separate this submission stage into two parts: provisional submission for 90% of the letter of credit value, and 10% for the subsequent submission. A beneficiary can obtain payment after submitting merely an invoice and a letter of indemnity. A letter of indemnity provided by a beneficiary is to guarantee that the beneficiary will submit the required bill of lading, certificate of quality and other documents at some later stage after being paid. The letter gives the bank the right to negotiate documents and credit the proceeds.

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192 Ibid., at 15.
193 Ibid.
195 Ibid., at 5.
to the beneficiary’s account under reserve. In this way the bank assists the beneficiary by paying out in advance of the actual date of payment before all the documents are presented.

Paying out the beneficiary under such circumstances raises serious issues under the general rules of documentary letters of credit. This is because the beneficiary’s right of payment should in theory only be derived from the submission of all required documents which have to meet all conditions of the letter of credit. Banks should ideally not make any payment to the beneficiary until all documents are submitted before the expiry date of the credit and all conditions are met. In paying out the beneficiary, a bank in effect may be assuming that the beneficiary will, in addition to being able to submit all documents at a subsequent stage before the letter of credit expires, be able to submit such documents which are definitely complying with the credit conditions.

Problems thus arise if the documents subsequently submitted are not conforming and have uncorrectable discrepancies. According to an explanation of the ICC Banking Committee, the issuing bank in such a situation is not expected to raise any discrepancies in the shipping documents presented, as the credit has been fully utilised by the presentation of the invoice and the letter of indemnity.\(^{196}\) As a result, banks would presumably have to obtain a waiver from the applicant in respect of discrepancies. The ICC’s explanation clearly indicates that, at least as far as it is concerned, the risk of accepting discrepant documents which the beneficiary may eventually present would be shifted to buyers. It is not clear

\(^{196}\) Ibid.
whether courts will subscribe to this point of view, especially where a buyer has raised the fraud defense.

This practice also leaves an opportunity for fraudulent activities. A paid beneficiary could easily run away with the money without actual underlying performance. Therefore, if the genuineness of the documents is not guaranteed and insisted upon by banks and the bank's good faith is not required, questions are raised about such practices — questions that suggest that they could easily be used as a facade for fraudulent activities.

4.7 Interlocutory Injunctions and their Role

4.7.1 Role of and criteria for granting interlocutory injunctions to enjoin payment where fraud is alleged in connection with the underlying contract

There is no mention of fraud in the UCP. This was evidently because of the differing treatment by national courts of fraud under documentary credits. At any rate, on a strict construction of UCP 500, fraud would not be a relevant consideration in the examination of documents. This arguably is to an extent counter-balanced by the doctrine of strict compliance in UCP Articles 13 and 14, under which banks are obliged to refuse payment in case of documentary discrepancy. However, as drawn out by our discussion of documentary examination in Chapter 3 and as indicated by Mann's research demonstrating the apparent

\[\text{Note that there are some experts that advocate the inclusion of fraud in UCP 600 – See, for example, R. Langerich, "Expert Commentary: UCP Should Not Deal with Fraud. Right? Wrong, Says Rienhard Langerich", Vol. 6., No. 3, Insight, Summer 2000, 9-10.}\]

\[\text{Articles 3 and 4, UCP.}\]
proliferation and tolerance of discrepancies, the doctrine of strict compliance is of itself not a sufficient safeguard. Indeed, as mentioned above, the ICC Banking Commission in an opinion has acknowledged that there is an exception to the doctrine of strict compliance in many jurisdictions, namely for abuse of right or fraud, and that it is up to the courts to fairly protect the interests of all bona fide parties concerned.

Notwithstanding the fact that documents may on their face be strictly compliant with the terms of the credit, payment can be refused by a bank or enjoined on the application of the buyer to a court under the fraud exception where (1) there was clear evidence of fraud; (2) the bank has clear notice of this evidence of fraud; and (3) the bank’s awareness of the fraud was timely. In the context of the interlocutory injunction, there is a fourth element that needs to be satisfied — that the balance of convenience is in favour of granting an injunction restraining payment, bearing in mind, according to established doctrine, that the fraud exception will operate to stop payment only in “exceptional circumstances”.

In respect of the last requirement — the balance of convenience —

199 Mann, op.cit.
202 In American Cyanamid Co v. Ethicon [1975] 1 All ER 505, the House of Lords laid down various tests for the grounds of pre-trial (or interim/interlocutory) injunction. These included (1) if a claimant were to succeed in establishing its right to a permanent injunction at trial, could it be adequately compensated in damages for refusal of an injunction? If not (2) if the defendant was to succeed, could it be compensated in damages for the grant of a pre-trial injunction? (3) If there is doubt as to the adequacy of the respective remedies in damages, where does the balance of convenience lie, having regard to the general prudence of preserving the status quo?
normally the courts would view such balance as being in favour of
the bank. Where the applicant has a claim against the bank, it
would normally be considered by the court to have an adequate
remedy in damages; even where the court could grant such
injunction, it would be restrained by the perception (as examined in
Chapter 2) that maintaining the integrity and autonomy of banking
commitments would outweigh the demands of the allegedly
defrauded claimant, whom at any rate could obtain Maree
relief against the alleged fraudster.\textsuperscript{204}

The threshold for invoking the fraud exception as a basis for
enjoining the issuing bank’s payment of the letter of credit is
therefore high; there have only been two reported cases in the
U.K. where injunctions have been granted in inter-party
proceedings in such circumstances, which the courts clearly
regarded as exceptional.\textsuperscript{205}

4.7.2 Examination of key criteria in invoking the fraud exception in
an interlocutory injunction application

(a) Relevant date for establishing knowledge of fraud —
timeliness of the bank’s awareness of fraud.

Traditionally courts held that the only relevant time at which the

\textsuperscript{204} See Rix, J. in Czamikow-Rionda Sugar Trading Inc., op.cit. Note however that the
Maree may not be satisfactory from the buyer’s point of view where it has to immediately
reimburse the bank or if there are competing creditors for the assets of the seller.
\textsuperscript{205} Themehelp v. West [1995] 4 All E.R 215; Kvaerner John Brown Limited v. Midland Bank
plc [1998] CLC 446. In the former case, there was a concession that there was a difference
between a grant of an injunction against a bank and a grant of an injunction against a
fraudulent beneficiary. In the latter case, there was no consideration of the balance of
convenience.
state of knowledge of an issuer of a letter of credit might be considered was when payment was made. Sir John Donaldson MR and Griffiths L.J. stated in *Bolivinter Oil SA v. Chase Manhattan Bank*\(^{206}\) that the state of knowledge of a letter of credit issuer only falls to be considered when demand for payment is made. They qualified this by saying that if the underlying principle was that “fraud unravels all”, the timing should not be restricted to the time of payment. The issue of whether a relevant fraud has occurred has to be decided according to the facts then known to the court and it is irrelevant that an earlier stage the fraud was unknown to the bank.\(^{207}\) On the other hand, in *United Trading Corp. v. Allied Arab Bank Ltd.*,\(^{208}\) the court held that the bank’s knowledge of the fraud as on the date of payment has to be established by the plaintiff.

(b) **Standard of proof for bank’s knowledge**

The alleged fraud of the beneficiary of a credit must be clearly established to justify a refusal by the issuing bank to honour a draft under the credit or to warrant an injunction to restrain it from doing so.\(^{209}\) The meaning of “established” was delineated by Kerr J. in *Harbottle*, who held that the courts would not interfere with the irrevocable obligations of banks except in *clear* cases of fraud in

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\(^{207}\) Ibid, at 256.

\(^{208}\) *United Trading Corp v. Allied Arab Bank* [1985] 2 Lloyd’s Rep 554.

which the banks had notice.\textsuperscript{210} In Edward Owen Engineering, the expressions used to characterise the nature and proof of the fraud required to relieve a bank of its obligation under a letter of credit were “obvious fraud to the knowledge of the bank”, clear fraud of which the bank has notice”, fraud that is “very clearly established”, and “fraud that is very clear to the bank.” In United Trading, the court stated that to meet such standard of fraud, the evidence must be clear in respect of the fact of fraud and the bank’s knowledge of such fraud. A mere assertion or allegation of fraud would not be sufficient.\textsuperscript{211} The only realistic inference for the court, taking into account the standard of a hypothetical reasonable banker is possessing all of the relevant facts, must be that the seller could not have reasonably believed in the validity of the documents that he submitted — there could be no other explanation except for fraud.

In contrast to the English courts which have taken “established fraud” as the appropriate test, in Canada, a line of cases appear to adopt a test of a strong \textit{prima facie} test of fraud which was regarded as less onerous and more appropriate on an application for an interlocutory injunction than the test of clearly established fraud.\textsuperscript{212} Such a standard interestingly was the precursor to the currently used general standard of proof for interlocutory injunctions, which is that the material available to the court at the hearing of the application must disclose that the plaintiff has real

\textsuperscript{210} Harbottle, op.cit., per Kerr J., at 155-156.

\textsuperscript{211} A bank is not obliged to investigate mere allegations of fraud to ascertain whether such allegations are founded — per Waller J. in Turkiye Si Bankasi AS v. Bank of China [1996] 2 Lloyd’s Rep. 611.

prospects for succeeding in its claim for a permanent injunction at trial.\textsuperscript{213}

\textbf{4.7.3 Recent refinements to the required standard of proof – the Solo Case}

In England a standard roughly equivalent to a strong \textit{prima facie} standard has been applied in the context of the fraud exception, but only in circumstances where a misrepresentation has been made by a beneficiary to induce the opening of a letter of credit, as such an act would constitute a challenge to the validity of the letter of credit. One would assume the reason for the apparent dilution of the virtually sacrosanct established fraud standard was because a challenge to the validity of the instrument was considered an “exceptional circumstance”.

Even if there is no clear evidence of fraud at the time of the demand, so long as there is a “real prospect” of this being established at trial, meaning an arguable case with a real prospect of success, the claimant could still succeed.\textsuperscript{214} Accordingly, in \textit{Solo}, Lord Justice Mance reasoned that although the evidence in front of him could not be regarded as clearly establishing fraud and the defendant bank did not seem to have a strong case, the issuer need only demonstrate that it “had a reasonable prospect of success” in justifying its dishonour because “the principle whereby performance bond obligations are treated like promissory notes,


\textsuperscript{214} \textit{Safa Ltd. v. Banque Du Caire} [2000] 2 Lloyd’s Rep. 600, per Waller J.
letters of credit, bills of exchange or cash ("the cash principle") has no application in situations where the challenge is to the validity of the bond.\textsuperscript{215}

Underpinning this conclusion, which was (citing Bolivinter) with reference to "the present situation as distinct and falling outside the principles of Harbottle and Edward Owen",\textsuperscript{216} and with the purpose of avoiding the result that the independence principle imposes on banks the risk of being misled into entering the instrument,\textsuperscript{217} Lord Justice Mance presumably had in mind Lord Diplock’s underlying principle that the court should not lend its process to assist fraud and that "fraud unravels all". As his Lordship emphasised in relation to the situation before him, "no question arises in this context of the grant of injunctive relief or of any requirement for that purpose to have a cause of action. It would affront good sense, and probably general principles relating to illegality, if courts were obliged to give judgment in favour of a beneficiary now shown to be acting fraudulently."\textsuperscript{218}

Accordingly, the court in Solo cautioned against overstating the burden of proof under the fraud exception, implying that the rule

\textsuperscript{215} Solo Industries UK Ltd v. Canara Bank [2001] EWCA Civ 1059, retrieved on 23 October 2001 at http://lexis.com, at para 5 of the Lexis version. Note however Lord Justice Mance’s comments at para. 32 of the text at 10 in the Lexis version of Solo at which he was obviously at pains to avoid being seen to endorse a dilution of the “established fraud” standard generally: “If and so far as that defense is limited to the time when demand was or payment should have been made, but the court will still refuse judgment if by the time of judgment fraud is established, again there would seem to be little room for considering whether there is an “arguable case” or “real prospect” of establishing fraud. On any view, as Rix J observed (in United Trading), the court should be careful not to allow too extensive a dilution of the presumption in favour of the fulfillment of independent banking commitments.”

\textsuperscript{216} Ibid., para. 33, at 10 of the Lexis version.

\textsuperscript{217} Ibid., para. 36.

\textsuperscript{218} Ibid., para. 21.
“fraud unravels all” had not been allowed full play in dealing with letter of credit fraud. As his Lordship, approvingly citing trial judge Mr Justice Neill, stated,

“it cannot be in the interests of international commerce or of the banking community as a whole that this important machinery that is provided for traders should be misused for the purposes of fraud…. Moreover, we would find it an unsatisfactory position if, having established an important exception to what had previously been thought an absolute rule, the Courts in practice were to adopt so restrictive an approach to the evidence required as to prevent themselves from intervening. Were this to be the case, impressive and high-sounding phrases such as ‘fraud unravels all’ would become meaningless.”219

The lower standard of proof for interlocutory applications adopted by the Court of Appeal in Solo, should, it is submitted, not merely be applied where the validity of the instrument is threatened. It should be applied more broadly. Returning to the position as articulated by Le Dain J. in Angelica-Whitewear more than a decade before Solo, a similar threshold for the application of an interlocutory injunction — that “a strong prima facie case of fraud would appear to be a sufficient test on an application for an interlocutory injunction”220 — was advocated, except that it was expressed to apply generally to interlocutory injunction

219 Ibid., para. 13.
applications in place of the “established fraud” standard. As suggested in Angelica-Whitewear, the test applied by the court in respect of the interlocutory injunction should be the “strong prima facie” (equivalent to a “real chance of success”) test.”

There are many instances in which a bank receives clear notice of fraud (often through detection of “red flags”) but is unable to satisfy itself that fraud has been established. Owing to diverse decisions and opinions on these issues, there is no guarantee that banks, when facing fraud allegations, can confidently determine when established fraud exists and thereby withhold payment. Obviously they are often faced with questions as to whether the alleged fraud suffices as an established fraud or merely an allegation. How then, in the absence of a clearly applicable and recognisable threshold of fraud, can banks, though their staff of highly pressured (and usually relatively junior) document-checking personnel, accurately determine such a delicate and thorny issue in the course of their day-to-day business when efficiency is at a premium?

A bank has three options — to inform the buyer of the possibility of fraud, and for the decision to be left to the buyer to initiate

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221 Highly pressured document checkers are becoming less “knowledgeable” (see “Troublesome LC Trends, Part II”, Vol. 6, No. 5, Documentary Credit World, May 2002: 3) and less familiar with their customers through bank restructuring that has led to geographical separation with customers and their businesses (Vol. 6, No. 3, Documentary Credit World, Summer 2000: 14 at 15.). Also see the article reporting on the court’s dim view of the conduct of Standard Chartered Bank in the case Standard Chartered Bank v. Pakistan National Shipping Corporation [2000] 1 Lloyd’s Rep. 218, in which the Cresswell J. of the Queens Bench found that the three document checkers were under qualified and over-worked on a repetitive task – Raymond Jack J., “Judge Raymond Jack on a Case which Raises Disturbing Questions about Banks that Accept Presentation of Late Documents”, Vol. 6, No. 2, Insight, Spring 2000, 4 at 5.
interlocutory injunction proceedings; to determine that established fraud exists, withhold payment and in justification demonstrate to the court that there was a clear notice of established fraud, thereby leaving the risk to the bank itself if the beneficiary is eventually proven innocent; or to proceed to pay out under the credit irrespective of the fraud allegation, and if there is subsequently proven to be fraud, bear the risk of being sued by the customer.

Note that, as set out earlier, the concept of clear notice to a bank is not defined and therefore it is difficult for banks to establish the sufficiency of such notice to justify refusal of payment to the beneficiary under the first option. Moreover, banks do not like to put themselves in the position of defendant if the beneficiary brings a claim for payment unless a bank has clear evidence of such fraud. As Goode has pointed out, a bank which has to decide that the evidence of fraud is compelling is placed in a difficult position, for if its assessment is wrong it not only breaches its duty to the beneficiary but damages its commercial reputation, hence one would not reasonably expect a bank to withhold payment in the absence of an injunction — all that can be reasonably expected of the bank is that it act in good faith.222

The second option is, under the present regime of the letter of credit law, therefore a much less burdensome choice for banks as once a bank has paid out the beneficiary, the burden is assumed by the applicant-buyers to pursue their rights under the sales contract. The third option is where the bank is unable to confidently determine that fraud has been established, to inform

222 Goode, op.cit, at 234.
the buyer of the possibility of fraud, and to allow the customer a short time to apply for an injunction to restrain payment. Given the difficulty of determining established fraud, a bank is likely to elect for one of the two latter options.

The third option — to leave the decision to the applicant as to whether to seek an injunction — represents prudent banking practice where the banks are unsure, but there is no guarantee that such practice is being uniformly implemented, and it would seem, given the extent of protection of banks under the UCP, that it would make more sense for banks to pay out under the credit under such circumstances. Where some suspicion of fraud exists, a bank should be obliged to inform the buyer of the suspicion and of its right to seek an injunction. In seeking an injunction, the buyer helps to solve the bank’s dilemma, because if no fraud is proven, the buyer — and not the bank — has to pay the costs for the litigation. Buyers which are prone to make casual allegations of fraud (because, for example, of a falling market in certain goods) are careful in their accusations if they are required to raise them in court. If the banks ask the buyer to bring an action for an injunction, and the latter refuses to do so, it can reasonably be assumed that the accusation is not to be taken seriously.

223 Ibid.
224 Ellinger, op. cit., at 196.
225 This is so serious that it has prompted one commentator to state “the bankers, with their differing and varied interpretations of the provisions of the UCP, have contributed to damaging the traders’ confidence in the letter of credit system and must accept the blame for this shift (to open account trade). These interpretations vary from country to country and sometimes we come across practices that are contrary, not only to the provisions of the UCP, but also against international standard practices (italics added). Sadly, standards seem to be declining worldwide. With the current UCP now in force for more than eight years, one would have thought that the current understanding of the rules would have been much more settled. On the contrary, the number of issues raised with the ICC Banking Commission, both with respect to dispute resolution and educational queries, suggest that all is not well with
It is submitted that allowing banks to proceed to pay out over the credit in the face of notice of fraud or red flags without being obliged to inform the customer is harmful to the letter of credit system as it gives rise to the appearance of banks acting in bad faith. Only if the system is such that a bank’s position is neutral in face of honour and dishonour can a bank exercise, and be seen to exercise, good faith to ensure the system is of benefit to both beneficiaries-sellers and applicant-buyers. Given the ambiguity (or even the decline) of the standards of document examination and the extensive exclusions from liability of banks incorporated into the UCP, the inherent difficulty of the customer to succeed in a claim on the bank for not exercising reasonable care in its examination of the documents, issuing banks would naturally be inclined towards payment in order to avoid being sued by the beneficiary in the knowledge that the applicant would have to resort to the underlying contract to recover payment.

Applying the position of Le Dain J. in *Angelica-Whitewear*, in the event that the applicant does decide to seek an interlocutory injunction, the court entertaining such an application should not be required to use the established fraud standard applicable to the

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determination of the banks. The courts should only be required to apply the standard generally used in interlocutory injunctions, namely the “real chance of success” test. This would bring English law in line with standard applied under the UCC §5-109, which requires an applicant to demonstrate that it would be “more likely than not to succeed under its claim of forgery or material fraud”.

Apart from the justification given by Le Dain J. in the quotation above, it is submitted that such an approach would inject a degree of sorely needed equity into the system for applicants. Imposition of the requirement of demonstrating clearly established fraud at the stage of application for an interlocutory injunction in effect might be preventing the courts from rendering justice. Accumulating evidence to satisfy the established fraud standard is so onerous and takes so long as to render an ultimate judgment in favour of the applicant virtually meaningless as, short of being a deferred credit, the issuing bank would have proceeded to pay out under the credit in the meantime. Reducing the standard applicable by the court in considering the interlocutory application would address this problem of timing, thereby rendering it conceivable that applicants could succeed in their attempts to secure interlocutory relief. Such an approach would not undermine the reputation of banks, as they would be obliged to proceed with payment unless they determine that established fraud exists or are subject to an interlocutory injunction. And applicants, though still required to establish fraud at the ultimate hearing for a permanent injunction, will have the comfort that, in the meantime, the alleged fraudster will not be able to disappear with the money.
4.7.4 The UCC position

The UCC §5-109(2) provides for the possibility of the injunction against payment by stating that “when a required document... is forged... a court of appropriate jurisdiction may enjoin... honour of the draft or demand for payment.” However, securing such injunction is not as straightforward as might appear from a cursory reading of the section.

The Official Comment of §5-109 elaborates ways “to prohibit injunctions against honour”. The Official Comment suggests to work on the concept of “honour”, firstly, to define honour “in the particular letter of credit” to occur upon acceptance and without regard to later payment of the acceptance and secondly, to agree explicitly that the applicant has no right to an injunction after acceptance — whether or not the acceptance constitutes honour. Clearly the wording “in the particular letter of credit” in the Comment refers to the deferred payment letter of credit. That is to say, if the issuer’s promise to pay is conditioned on the expiry of 180 days, either from the date of acceptance of the documents or from the date of a bill of lading, even if fraud is discovered before the payment date, the applicant will not be able to stop the payment through an interlocutory injunction if the acceptance of documents is defined to be “the honour”. Courts would be obliged to accept such concept of acceptance as it would have been incorporated in the letter of credit contract. Therefore the issuer could easily make payment over fraudulent or forged documents even if the beneficiary clearly “has no colourable right to expect
That the Official Comment can afford to set out such method of applying the process of honour is clearly based on the drafters' belief of the viability of inclusion of such notion of acceptance and honour into agreements between the issuer and the applicant, and a certain confidence presumably derived from courts routinely upholding such agreements. It appears that concepts of “good faith” and “fair dealing in the transaction” have not been brought into consideration even though, as set out in Chapter 2, little freedom of choice or bargaining power is truly exercised by the applicant in the process of entering such agreement. The banking industry forcefully asserts to courts that they should accept such a system per se. The consideration of any extrinsic factor which might affect bank’s honour has been considered by banks to be a direct challenge to the independence principle upon which the entire letter of credit system is supposedly based. Accordingly, so far as the logic goes, the court should have the “same hostility to” any form of relief and “the court should not allow the sacred cow of equity to trample the tender vines of letter of credit law”. The Official Comment therefore appears to further reflect the results of a process of manipulation of the definitions of the concepts involved in the letter of credit to ensure that honour can occur without court interruption. It is also submitted that in application of these concepts, the issuer may be able to effectively put the interlocutory injunction against honour out of reach of the

227 Ibid.
applicant, thereby stymieing the court’s ability to address fraud in the letter of credit transaction.

4.8 Assignment of Proceeds and Negotiation Credits: their Role in Facilitating Fraud

4.8.1 Assignment: its Potential Impact on Fulfilment of Underlying Duties of the Seller

The practice of assignment of proceeds serves to recognise the beneficiary’s right to payment in the future from a bank or third party before it has fulfilled its duty of shipping the goods to the buyer. It is permissible under UCP Article 49. The seller is essentially paid out in advance of the maturity of the credit subject to presentation of all of the required conforming documents. The practice most commonly occurs under deferred payment letters of credit. There is a well-established market (known as the forfaiting market) for the sale and purchase of the rights created by such credits, where a party independent of the credit (referred to as a forfaiter) engages in the trade of paper by purchasing the obligations that such paper represents.228

The documents the beneficiaries present to the issuing bank should honestly reflect fulfilment of the beneficiary’s duty to ship the goods it has contracted to sell to the buyer. Accordingly, an issuing bank should have no duty to pay and the beneficiary should have no right to receive the amount of money indicated in

the draft or/invoice unless the beneficiary has truly performed such duty. In allowing such system of assigning the proceeds, banks may conceivably be permitting a practice where a beneficiary feels absolved from performing its underlying duty to ship the contracted goods to the buyer — so long as the beneficiary prepares facially regular documents for presentation, it will obtain payment by assigning the proceeds of the credit to a bank or third person. Where the underlying transaction is a sham, the buyer-applicants have to suffer the consequences of not being able to obtain delivery of the goods they contracted for while still paying the full price. Further, assignees may be able to shield themselves by the protection accorded to a holder in due course where they have negotiated the credit.

4.8.2 Negotiation credits and their impact on the rights of the buyer

The concept of negotiation stipulated in the credit in accordance with the relevant UCP 500 definition in Sub-Article 10(b)(ii) enables the beneficiary to be paid before the maturity date through the discount of complying draft(s) and/or document(s) at the nominated bank, subject to the nominated bank’s agreement to effect the negotiation, or by negotiation of the complying draft(s) and/or document(s) with a third party which then presents them, in its turn, to the nominated bank or issuing bank. A nominated bank which advises to the beneficiary a letter of credit available by negotiation, and states as well, at the same time, its agreement to

229 Sub-Article 10(b)(ii) defines negotiation as the action of giving value to draft(s) and/or document(s) by the bank authorised to negotiate. The sub-Article emphasizes that “mere examination of the documents without giving value does not constitute a negotiation. Article 10 further extends the definition of the nominated bank authorised to negotiate, by stating that “in a freely negotiable credit, any bank is the nominated bank”.

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negotiate the credit, becomes liable by this action and undertakes toward the beneficiary the same obligation as a confirming bank — to pay without recourse against stipulated complying documents.230

The confirming bank, as mentioned above, does not provide any warranty to the issuing bank or to the applicant for the accuracy or validity of the documents it receives. In the context of a system that imposes only limited risk for the acceptance of documents which may be suspicious, a confirming bank would naturally feel inclined to proceed to make payment and claim reimbursement from the issuer. In First Union National Bank v. Paribas,231 when the beneficiary presented the required documents to the confirmer in advance of the maturity date, the confirmer discounted the presentations, relying on the obligation of the issuers to reimburse on maturity. The issuers disputed their liability to reimburse the confirming bank claiming that the latter knew of, or deliberately turned a blind eye toward, the fraudulent activity before they discounted the letters of credit. It naturally raises the question as to the possibility of a confirmer turning a blind eye to fraud if they are allowed to, i.e., discounting without assuming any risks.232

The problem here is that there is much confusion, even within banking circles, as to what constitutes a negotiated credit and the

circumstances in which a party that has purported to having “negotiated” obtains the benefit as a holder in due course.\textsuperscript{233} There is much vagueness associated with the term “negotiation”.\textsuperscript{234} This may be due in part to UCC §5-109 which provides for an exception to the fraud defense in favour of a correspondent bank which discounts its own credit obligation. Indeed, this may have been behind the spirited yet unsuccessful argument of Santander in the recent case of Santander that it, as an innocent assignee and a holder of a deferred credit undertaking, should be accorded protection as a holder in due course on the basis of custom or general industry expectation, which was dismissed by Waller L.J. of the English Court of Appeal. The confusion surrounding negotiation can be used to the advantage of those banks that portray themselves to buyers as negotiating banks when in fact they are not. At any rate, it is important for buyers to be aware of the consequences of negotiation and the assumption of fraud risk by the buyer that this could entail.

Article 9(b) of the UCP provides that a confirmation of an irrevocable credit by another bank (the confirming bank) upon the authorisation or request of the issuing bank, constitutes a definite undertaking of the confirming bank, in addition to that of the issuing bank, to pay. Dolan has pointed out that this provision contains ambiguities in its language by stipulating in part (a)(iv) that the issuer of a negotiation credit must “pay ... documents” and in part (b)(iv) that a confirming bank to “negotiate ... documents.” He believes that the use of such language is a deliberate attempt

\textsuperscript{234} Karni and Turner, op.cit., at 19.
to make it clear that even the absence of a negotiable draft or a negotiable bill of lading will not relieve the confirming bank of the duty to give value to the presenter.\textsuperscript{235}

At least as far as English law is concerned, such ambiguity has been clarified by two recent English cases. Firstly, in \textit{Banque Nationale de Paris v. Credit Agricole Indosuez},\textsuperscript{236} the English High Court endeavoured to identify the clear notion of a negotiation credit and the issuing bank’s obligation to pay in the face of fraud allegation under a negotiation credit and a deferred payment credit. On 20 March 1999, Credit Agricole Indosuez (‘CAI’) was asked to establish a letter of credit for US $1,333,600 in favour of a Singapore company, Amerorient. The credit stated that the payment was “available against presentation of drafts at 180 days from the date of negotiation by deferred payment”. The confirming bank, BNP advised and confirmed the credit, “negotiated” the documents and made payment to Amerorient on 26th of March. Shortly before the maturity date of the credit, CAI advised BNP not to make any payment owing to a serious fraud suspicion. However BNP had already paid out and therefore sued CAI for reimbursement.

The High Court reasoned that if the credit were a deferred credit, CAI would not be liable to reimburse BNP as the beneficiary was only entitled to be paid at the maturity date and here, the fraud was discovered prior to maturity. Although the Court referred to the

\textsuperscript{236} \textit{Banque Nationale de Paris v. Credit Agricole Indosuez}, 2000-4 SLR 254.
\textsuperscript{237} See \textit{Banco Santander SA v. Bayfern Limited and others}, op. cit., which was heard on appeal in \textit{Banco Santander SA v. Banque Paribas}, op. cit.
case *Banco Santander SA v Bayfern* 237 under which the confirming bank, which had discounted prior to the maturity date of the credit, bore the risk of the fraud, it however held that the credit issued by CAI was a negotiation credit and BNP was immune from the fraud. The decision was appealed to the Court of Appeal which construed the credit in the same manner, that is, to apply the principles on the construction of contract in general rather than only examine the provision of the document in the light of the applicable UCP rules. 238 The decision of the Court of Appeal makes it clear that a negotiation credit is a credit under which the issuing bank has extended its engagement to third parties which negotiate or purchase the beneficiary’s drafts. Without such undertaking, it is only a financial arrangement between the issuing bank and the beneficiary even if there is a general reference to the word of “negotiation”. An advising/confirming bank cannot by its unilateral action extend the commitment the issuing bank. 239 The Court of Appeal has also made it clear that the drafts under the letter of credit are not bills of exchange because they fail to satisfy the requirement for certainty. Furthermore, BNP was only the payee of the bill and not the endorsee. Therefore, it was not a holder in due course of a valid bill of exchange which is entitled to payment on the bill irrespective of fraud that is subsequently discovered. 240

Secondly, in *KBC Bank v. Industrial Steels (UK) Ltd*, 241 the letters of credit provided that KBC was called a “negotiating” bank, which

238 See the decision of *Credit Agricole Indosuez v. Banque Nationale de Paris*, 2001-2 SLR 1, retrieved on 23 June 2001 at [http://lexis.com](http://lexis.com)
239 Id.
240 Ibid., para. 47-49, at 13 of the Lexis version.
241 *KBC Bank v. Industrial Steels (UK) Ltd*, op. cit.
242 Ibid., para. 8 at 3 of the Lexis version.
should “negotiate” against documents presented by the beneficiary, Industrial Steels Ltd (“ISL”), in full compliance with the letters of credit without “recourse” to the beneficiary ISL. When the beneficiary’s deceit was apparent and the issuing banks refused reimbursement, KBC brought a claim in deceit against ISL on the ground that the statement contained in the Beneficiary’s Certificate was false and that ISL either knew that it was false or was reckless as to its truth. This case indicates clearly that a “negotiating” bank might not be immune from fraud even though it had “negotiated” the documents, and that the beneficiary was not relieved from its documentary obligation to provide conforming documents, and that evidence can be raised against the beneficiary even though the “negotiating” bank had already made payment.

It was clear that KBC Bank should not have been called a negotiating bank at all. More accurately, it was an advising bank which had committed itself to the beneficiary for making payment without recourse in the absence of the issuing bank’s clear instruction. Therefore, it is logical that David Steel J. did not deny KBC’s right of recourse against the deceitful beneficiary, therefore, in effect, making the non-recourse agreement useless.

These two cases are significant because they clarified the way the word “negotiation” is used in practice can be misleading even to some judges as indicated in *Banque Nationale de Paris v. Credit Agricole Indosuez* where the letter of credit actually had not been
negotiated at all in a legal sense. After these cases, it would reasonable to expect that an advising bank or confirming bank will refrain from having any agreement for any payment without recourse to the beneficiary under a documentary credit without the issuing bank’s clear authority.

4.8.3 Forfaiting market, deferred credits, and the issue of “authorisation”

Forfaiting has its origin on the European Continent. London has become an important forfaiting market with forfaiting transactions undertaken by most London banks engaged in international finance. It involves the purchase of a debt expressed in a negotiable instrument, such as a bill of exchange or a promissory note, from the creditor on a non-recourse basis, that is, the forfaiter will undertake to waive (to forfait) its right of recourse against the creditor if he cannot obtain satisfaction from the debtor. However, this is only done when the forfaiter is given security by a bank with good standing. Rights to payment under letters of credit are routinely accepted as security on forfaiting deals. The documentation from such trades provides for the forfaiter to obtain an assignment from the beneficiary of its own rights under the credit and that the forfaiter will give notice that it has done so to the banks whose obligations it has bought. The forfaiter’s rights to receive payment are embodied in the assignment, as it is not a

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244 Schmitthoff’s Export Trade, op.cit., at 13-008.
245 Ibid., at 13-008.
party to the credit itself.\textsuperscript{246} It is said that “in an export transaction, forfaiting is to help the cash flow of the exporter which has allowed the overseas buyer credit”.\textsuperscript{247}

The forfaiting arrangement has to be agreed between the seller and the buyer in the contract of export sale.\textsuperscript{248} The bank’s non-recourse clause in the forfaiting contract with the seller does not protect the seller if he fails to deliver the goods to the buyer without legal excuse.\textsuperscript{249}

\textit{Banco Santander Sa, v. Banque Paribas},\textsuperscript{250} a decision of the English Court of Appeal, is important in relation to deferred payment letters of credits and how the fraud exception affects such credits. In this case, Santander (London) advised and confirmed a letter of credit issued by Paribas (Paris) on the behalf of Bayfern for the value of up to approximately US$20 million. This was a deferred payment 180 days from the bill of lading date. Santander received facially complying documents and paid a few days later to the beneficiary the discounted value of its deferred payment obligation after deducting its fees up to about $US 641,000 and taking an assignment of beneficiary’s rights under the letter of credit. A week later, the issuer was notified that the documents were false. The issuer refused reimbursement to the confirmer, Santander.

\textsuperscript{247} Ibid. at 13-009.
\textsuperscript{248} Schmitthoff’s \textit{Export Trade}, op.cit., at 13-010.
\textsuperscript{249} Ibid., at 13-011.
\textsuperscript{250} \textit{Banco Santander SA v. Bayfern Limited and others}, op. cit., and \textit{Banco Santander SA v. Banque Paribas}, op. cit.
Santander pointed out that it is routine banking practice for a bank to discount its own future payment obligation at the request of the party to whom the obligation is owed. This practice operates both generally and in the specific context of deferred payment letters of credit and acceptance letters of credit. The discounting of deferred payment undertakings and acceptance credits facilitates international trading by assisting beneficiary cash flow. Santander further contended that it was on implied authority from the issuing bank, Paribas, that Santander should act on this authority to discount the further payment to the beneficiary and that Paribas was aware of the practice.251

One might wonder what the outcome would have been had Santander obtained Paribas’ agreement for the discounting. According to the general reasoning of this case, Santander would have been considered as having acted within the mandate given by Paribas. Therefore Paribas would have had to reimburse Santander. On the basis of the fundamental philosophy of “maxim ex turpi causa non oritur actio”, i.e., “fraud unravels all”,252 the argument that implied authorisation was obtained should be dismissed. It would have been illogical for the court to force the issuer to make reimbursement to the confirming bank in the face of clear fraud. This case also did not provide a solution as to what the issuer should do in the event that it has to reimburse and whether the issuer has the right of recourse to the beneficiary in such situation.

Traditionally, fraud risk rarely fell on the banks because banks would obtain payment as long as the documents complied on their face. Banks did not have to be concerned with the *bona fides* of the beneficiaries. However, Santander constitutes a warning for confirming banks which have habitually discounted beneficiary’s documents. It is suggested that confirming banks enter into an agreement with the beneficiary regarding the confirming bank’s right of recourse in case of fraud, at least in deferred payment credit transactions.

4.9 *Banks’ Cause of Action Against Fraudulent Beneficiary*

4.9.1 Against beneficiary for deceit

In *KBC Bank v. Industrial Steels (UK) Ltd*, David Steel J. upheld the paying bank KBC’s right to sue the beneficiary in deceit and ruled against the beneficiary ISL for reason of the inconsistency of the Beneficiary’s Certificate with the certificates of origin. David Steel J. stated that:

“It is common ground that, by reason of the inconsistency of the Beneficiary’s Certificate with the certificates of origin, the documents were discrepant and did not conform with the letters of credit. Further, it is common ground that SBT and PNB (the issuing banks) were in the circumstances entitled to reject them. KBC (the paying bank) accordingly claims

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253 *KBC Bank v. Industrial Steels (UK) Ltd*, op. cit.
The court ruled that a beneficiary who is in deceit has no right to be paid, and a paying bank has a right against the deceitful beneficiary even if the letter of credit provides that the payment is made based on negotiation and the bank has no recourse to the beneficiary in the event of rejection of the documents by the issuing bank or applicant.

The court in the *Balfour Beatty Case* also ruled that in the event that the applicant is successful in establishing fraud, the banks should have a cause of action against the beneficiary for fraudulent misrepresentation if they have already made the payment.255

As far as bank recourse against the seller is concerned, the bank has a good cause of action against the seller in deceit. It can hardly be argued that the fraudulent seller should be allowed to raise as a defense that the bank could obtain payment from the buyer. In a practical sense, payment to a fraudulent beneficiary would probably not be recoverable because of the physical inaccessibility of the seller and his assets. This is ironic in the sense that underlying the legal system governing letters of credit is the assumption that it is sufficient for the applicant-buyer to seek a remedy through litigation against the beneficiary-seller located in a different country, or even a totally different legal and economic system, yet an issuing bank which normally either has its own

254 Ibid., para. 8, at 3 of the Lexis version.
255 Cited in *Solo*, op. cit., para. 19 at 8 of the Lexis version.
branch located in the country where the beneficiary is situated, or at least has a long-standing business relationship with the advising bank, has no way to recover the money paid out to the beneficiary.

As early as 1968, Gutteridge and Megrah, after discussing the problem which banks faced with a holder in due course, stated that these exceptions in respect of a holder in due course, however, “do not apply where the draft and documents, or the documents if tendered alone, are tendered by the beneficiary himself. He is the drawer of the draft, not a holder, and if the documents are false, the banker paying bona fide against them may recover the money as paid under a mistake of fact. The seller is also in all probability in breach of his contract with the banker.”256 Here Gutteridge and Megrah clearly indicated that providing genuine documents with true information is the contractual obligation of the beneficiaries' and breach of this by the beneficiary will entitle the issuing bank to dishonour and bring a law suit against such beneficiary.

English judges were already seriously considering such a theory decades ago. In Bank-Russo-Iran v. Gordon, Woodroffe & Co. Ltd., Browne J. stated that a fraudulent beneficiary would be liable to repay money paid in mistake of fact.257 This decision was however not welcomed by some scholars. It was suggested that it would damage the value of the irrevocable credit if money paid in ignorance of a false tender was always recoverable from a

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beneficiary. Furthermore, according to Harfield, an issuing bank, by issuing an irrevocable letter of credit, has committed itself to a certain liability – that without the beneficiary’s consent, the bank cannot change the terms and conditions of the credit. This means that from the time the beneficiary is informed by the advising and/or issuing bank itself, it has entered into a contract. The beneficiary’s presentation of documents which, on their face, are in conformity with the terms and conditions of the credit, will trigger the issuer’s obligation to pay. The question here is whether one can accept a falsely tendered document as a conforming document which meets the terms and conditions of a letter of credit.

In the Queen’s Bench decision of *KBC v. Industrial Steels (UK) Ltd*, where the beneficiary knowingly presented documents, which were non-conforming, to the nominated bank, the nominated bank was held to have the right to recover from the deceitful beneficiary on the basis that a issuing bank’s obligation was only to pay against genuine documents. With the certificate of origin being discrepant, the court held that the beneficiary was liable for the misrepresentation based on the theory of deceit. If the deceived bank furthermore has an action for damages or restitution against the beneficiary, it is difficult to see how one could deny it the ability to reject a false document, if the bank discovers in time the deception of which it risks being a victim. One must add that it would be unwarranted to deny the bank the right to reject a document that it knows to be false, when the fraud

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258 Ibid.
259 *KBC Bank v. Industrial Steels (UK) Ltd*, op. cit.
in question undermines the security interest over the shipped merchandise that it is acknowledged to possess.\textsuperscript{260} It is submitted that the court in the *KBL Case* correctly shifted the burden of providing conforming documents to the beneficiary. Providing conforming documents in the legal sense requires the beneficiary to look into the accuracy of all statements included in the documents. If the beneficiary acts recklessly as regards the content of the documents, such beneficiary should be held liable in deceit.

The confirming bank in *KBL* relied on the judgment of Goh Joon Seng J in *Standard Chartered Bank v Sin Chong Hua Electric & Trading Pte Ltd & ors*,\textsuperscript{261} that a bank is always entitled to recover moneys paid under a mistake of fact. Banks should not be compelled to pay against the documents if documents do not constitute security for the transaction. This point was also expressed in the case of *Edward Owen Engineering* as follows:\textsuperscript{262}

“If the documents are presented by the beneficiary himself, and are forged or fraudulent, the bank is entitled to refuse payment if the bank finds out before payment and is entitled to recover the money as paid under a mistake of fact if it finds out after payment.”\textsuperscript{263}


\textsuperscript{262} *Edward Owen Case*, op. cit., at 979.

\textsuperscript{263} Ibid. This paragraph was also quoted by Craig J. in an Canadian case, *Rosen et al. v. Pulen et al.*, 126 D.L.R. (3d) 62; 1981 D.L.R. LEXIS 3818.
In *Edward Owen Engineering*, the two situations were handled separately. If bank has not yet made payment and discovers the fraudulent documents, the bank has the right to dishonour; if the bank discovers such fact after the payment, such payment is made based on the mistake of fact, the bank should recover the money from the beneficiary.

### 4.9.2 Damages

In *KBC Bank v. Industrial Steels (UK) Ltd.*, David Steel J. stated that “the relevant principles were recently reviewed in *Smith New Court Ltd v Scrimgeour Vickers*, [1997] AC 254. They can be summarised as follows: (i) The measure of damages is that which puts the claimant in the position it would have been in if no false representation had been made to him. (ii) The wrongdoer is liable for all the loss directly flowing from the representation whether or not it was reasonably foreseeable. (iii) For the loss to be direct, it is not necessary to show that the false statement was the sole cause of the loss: it is sufficient to demonstrate that it made a material contribution to it. (iv) By the same token, contributory negligence is no defense.”

### 4.10 Conclusion

The Secretary General of the ICC has stated that “it is unfortunately the case that fraud, like other forms of crime, is encouraged in the environment that remains unaware and hence

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Recourse and availability of injunctive relief should be permitted to be effective ways to deter fraud. It is submitted that an extreme interpretation of the independence rule has resulted in a narrow application of the fraud exception in the letter of credit mechanism. Such interpretation ignores the beneficiary’s duty under a letter of credit to provide documents representing the contracted goods. It is, with respect, questionable whether some courts and merchants are aware that a letter of credit does not constitute payment itself and only offers a means of obtaining payment. Without fulfilling his duty strictly by providing conforming documents according to the terms and conditions of a letter of credit and acting in good faith, a seller/beneficiary should not expect to be paid. A bank should not be forced to pay against forged or false documents irrespective of whether the seller/beneficiary himself has committed the fraud or not.

It is submitted that whenever an allegation of fraud is brought to the attention of a bank or a court, the independence rule should never be an obstacle for the courts to bring about justice and apply the rule of fairness and, therefore, restrain activities undertaken in bad faith. It is entirely consistent with the independence principle to say that a beneficiary who practices fraud on the applicant or the issuer is not entitled to the payment under the credit and it is also consistent with the strict compliance rule to say that a beneficiary who presents fraudulent or false documents has not

265 Maria Livanos Cattaul, (Secretary General of ICC), cited in Preface of Trade Finance Fraud - Understanding the Threats and Reducing the Risk, op.cit., at 3.
complied with the credit.

The grant of an injunction is made in the exercise of the court’s inherent power to prevent injustice arising as a result of fraud. The one true option for the buyer/applicant to try to prevent payment of the credit once fraud is discovered is to appeal to a court for preliminary or interlocutory injunction prohibiting the bank from paying out under the credit. The law perhaps should protect banks from being sued by the beneficiary when an applicant is applying for an injunction and the court is considering such application. That is to say, the law should ideally give the issuer the right to suspend the payment pending the decision of injunction. If a buyer/applicant is making an unfounded allegation and the court does not think the applicant has a reasonable chance to succeed, the applicant should bear costs and interest in respect of any delay in payment that has incurred. Such an allocation of financial burden on the applicant for casual accusations of fraud, when facing a falling market in certain goods, can play an important role in constituting a disincentive to taking advantage of such system and of making sure that most such allegations are serious ones.

Only when applicants are given the opportunity to raise viable and achievable defenses against payment through injunction will the courts be able to play a role in the battle against the proliferation of fraudulent transactions, thereby ensuring that justice is allowed to assume place in the letter of credit system. Otherwise, the letter of credit system will remain insulated from meaningful court intervention and from the benefits in the form of justice and equity that such intervention could bring.