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# **Recognized Exceptions to the Autonomy Principle in Documentary Letters of Credit: A Global Analysis**

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## **Abstract**

This thesis was written as part of the LLM in Transnational and European Commercial Law, Banking Law, Arbitration/Mediation at the International Hellenic University.

Documentary letters of credit, have gained, over time, near universal acceptance as means of ensuring the payment process in international sales of goods. The structure and operation of documentary credit transactions is subjected to two fundamental and globally recognized principles, namely the autonomy principle and the principle of strict compliance. Documentary letters of credit rely on the autonomy of the credit as to the underlying contract for their appeal and commercial utility. In principle, insofar as the tendered documents strictly comply with the terms and conditions of the credit, the beneficiary is assured that payment is guaranteed.

The aim of this study is to provide a critical and comparative analysis of the various exceptions to the principle of autonomy of documentary credits; namely, fraud, nullity, unconscionability and illegality. As the analysis will demonstrate, said concepts have received a non-consistent, fragmented treatment among common law jurisdictions, to the detriment of international commerce where certainty and predictability are of utmost value. In appraising these exceptions, the current study argues that the acceptance of the narrow fraud and nullity exceptions shall uphold the commercial utility and viability of the documentary credit system, while limiting interference as to the cardinal autonomy principle. Conversely, this research shall reject the prospective general recognition of the unconscionability and illegality exceptions on the grounds that said concepts utterly erode the independent and irrevocable assurance of payment provided to the beneficiary-exporter under the credit, obliterating the very essence of documentary credits. In balancing the autonomy principle and its exceptions, it is argued that the ICC, considering its expertise in regulating international documentary credit transactions, constitutes the appropriate body to provide the pertinent regulation.

Keywords: documentary letters of credit, fraud, nullity, unconscionability, illegality

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## 1. Introduction

Documentary Letters of Credit have been repeatedly characterized by the English jurisprudence as the “life-blood of international commerce”.<sup>1</sup> This description accentuates their near-universal application<sup>2</sup> and may be attributed to their effectiveness and commercial value as a reliable medium of financing international trade. International commercial transactions are considered to be intrinsically risky, primarily by reason of the geographical allocation of the exporter and the importer.<sup>3</sup> The lack of a prior commercial relationship between the parties located in different jurisdictions further amplifies the ever existing credibility risk with regard to the performance of the contract. Consequently, the exporter under an international sales contract has an interest in assuring advance payment prior to the shipping of the ordered goods; whereas the importer’s interest lies in receiving the goods prior to paying the contract price.<sup>4</sup>

Under a documentary letter of credit, stipulated in the underlying sales contract and opened on the importer’s request, said payment is assumed by the so called issuing bank, typically a bank in the importer’s jurisdiction, and is conditioned entirely on the conforming presentation by the exporter, beneficiary of the credit, of certain pre-agreed upon documents, laid down within the credit.<sup>5</sup> It is common practice that a bank within the beneficiary’s jurisdiction, the advising or correspondent bank, advises the beneficiary and facilitates the proceedings.<sup>6</sup> Additionally, a bank, also usually

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<sup>1</sup> *RD Harbottle (Mercantile) Ltd v National Westminster Bank Ltd* [1978] QB 146, 155; *Intraco Ltd v Notis Shipping Corporation of Liberia (The Bhoja Trader)* [1981] 2 Lloyd’s Rep 256, 257; *United City Merchants (Investments) Ltd v Royal Bank of Canada* [1982] QB 208 (CA), 222; *Hong Kong and Shanghai Banking Corporation v Kloeckner & Co AG* [1989] 2 Lloyd’s Rep 323, 330.

<sup>2</sup> Tareq Al-Tawil, ‘Letters of Credit and Contract of Sale: Autonomy and Fraud’ (2013) 16 Int’l Trade & Bus L Rec 159,160.

<sup>3</sup> Felicity Monteiro, ‘Documentary Credits: The Autonomy Principle and the Fraud Exception: A Comparative Analysis of Common Law Approaches and Suggestions for New Zealand’ (2007) 13 Auckland U L Rev 144, 146-148.

<sup>4</sup> Roy Goode and Herbert Kronke and Ewan McKendrick, *Transnational Commercial Law; Texts, Cases and Materials* (2<sup>nd</sup> edn, Oxford University Press 2015) 321-322.

<sup>5</sup> *Ibid* 322.

<sup>6</sup> M. G. Bridge, *The International Sale of Goods* (3<sup>rd</sup> edn, Oxford University Press 2013) 260.

located in the exporter's jurisdiction, known as the confirming bank, may add its own enforceable independent undertaking to that of the issuing bank. The issuing or confirming bank, acting as the first port of call regarding payment<sup>7</sup>, minimizes the risk of non-payment as to the exporter, by substituting the importer's promise to pay for that of a more reputable and solvent third party; namely a bank, normally within the beneficiary's country.<sup>8</sup> This assurance of payment, dependent solely on a complying tender of specified documents, has led to the documentary letters of credit being considered as equaling "cash in hand".<sup>9</sup> On the other hand, with respect to the importer, by requesting the provision of specific documents, he is in the position to ascertain, for instance, the conformity of the goods to the contract (e.g. quality certificate), verify their shipment (bill of lading) and, effectively, to some degree ensure performance.<sup>10</sup>

The international commercial practice with regard to documentary letters of credit has been harmonized via the Uniform Customs and Practice for Documentary Credits (2007 revision), known as the UCP 600.<sup>11</sup> This set of uniform rules of commercial and banking practice resulted from the codification efforts of the International Chamber of Commerce (ICC).<sup>12</sup> Notwithstanding its voluntary nature, the UCP is nearly globally adopted by way of contractual incorporation into international commercial contracts.<sup>13</sup> The ICC, although is not itself a law-making entity, has rightfully declared

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<sup>7</sup> Roy Goode and Herbert Kronke and Ewan McKendrick, *Transnational Commercial Law; Texts, Cases and Materials* (2<sup>nd</sup> edn, Oxford University Press 2015) 322.

<sup>8</sup> Nicholas P Manganaro, 'About-Face: The New Rules of Strict Compliance Under the Uniform Customs and Practice for Documentary Credits (UCP 600)' (2011) 14 Int'l Trade & Bus L Rev 273, 276.

<sup>9</sup> *Power Curber International Ltd v National Bank of Kuwait SAK* [1981] 1 WLR 1233, 1241; [1981] 3 All ER 607, 612.

<sup>10</sup> Felicity Monteiro, 'Documentary Credits: The Autonomy Principle and the Fraud Exception: A Comparative Analysis of Common Law Approaches and Suggestions for New Zealand' (2007) 13 Auckland U L Rev 144, 147.

<sup>11</sup> Tareq Al-Tawil, 'Letters of Credit and Contract of Sale: Autonomy and Fraud' (2013) 16 Int'l Trade & Bus L Rec 159, 160.

<sup>12</sup> Roy Goode and Herbert Kronke and Ewan McKendrick, *Transnational Commercial Law; Texts, Cases and Materials* (2<sup>nd</sup> edn, Oxford University Press 2015) 324.

<sup>13</sup> Bruno Linden and Gertrud Roos, *Business Contracts in International Markets* (Studentlitteratur AB 2005) 204.

the UCP as the most successful private rules for commerce ever introduced.<sup>14</sup>

## **1.1 Fundamental Principles of Documentary Credits Law**

### **1.1.1 Doctrine of Strict Compliance**

Under common law, the doctrine of strict compliance dictated that the documents tendered by the beneficiary, in line with the documentary credit, must comply precisely with the terms and conditions stipulated in the letter of credit. No documentary discrepancy is tolerated, regardless of how minor. Accordingly, a bank has no obligation to honor a presentation that is not conforming to this standard;<sup>15</sup> otherwise, the bank may be seen as exceeding its mandate, thus, its right to receive reimbursement by the applicant may be forfeited. Similarly, the rejection of documents that, conversely, do comply to this standard, falls outside the bank's duty, thus, bringing about the bank's liability for wrongful dishonor.<sup>16</sup> Traditionally, the American courts have systemically applied the strict standard of documentary compliance.<sup>17</sup>

It is well documented that the strict compliance rule has also long predominated in the English jurisprudence.<sup>18</sup> In *Equitable Trust Co of New York v Dawson Partners Ltd*<sup>19</sup> the court held that the issuing bank was not entitled to reimbursement on the grounds that it accepted a certificate of quality issued by a single expert as conforming presentation, whereas the terms of the credit stipulated for a certificate of quality to

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<sup>14</sup> Roy Goode and Herbert Kronke and Ewan McKendrick, *Transnational Commercial Law; Texts, Cases and Materials* (2<sup>nd</sup> edn, Oxford University Press 2015) 325.

<sup>15</sup> Gabriel Moens and Peter Gillies, *International Trade and Business: Law, Policy and Ethics* (2<sup>nd</sup> edn, Routledge-Cavendish 2006) 314.

<sup>16</sup> Daniel Chow and Thomas Schoenbaum, *International Business Transactions* (Aspen Publishers 2005) 252.

<sup>17</sup> *North Woods Paper Mills Ltd v National City Bank* [1953] 121 NYS (2d) 543; *Corporacion de Mercadeo Agricola v Mellon Bank International* [1979] 608 F (2d) 43; *Beyene v Irving Trust Co* [1985] 762 F (2d) 4; *Hanil Bank v PT Bank Negara Indonesia* [2000] WL 254007 (SDNY).

<sup>18</sup> *English Scottish and Australian Bank Ltd v Bank of South Africa* [1922] 13 LI L Rep 21; *Equitable Trust Co of New York v Dawson Partners Ltd* [1927] 27 LI L Rep 49; *Commercial Banking Co of Sydney Ltd v Jalsard Pty Ltd* [1973] AC 279; *Golodetz & Co Inc v Czarnikow-Rionda Co Inc* [1980] 1 Lloyd's Rep 453; *Fortis Bank SA/NV v Indian Overseas Bank* [2009] EWHC 2303 (Comm).

<sup>19</sup> *Equitable Trust Co of New York v Dawson Partners Ltd* [1927] 27 LI L Rep 49.

be issued by experts. Lord Summers specifically said that “There is no room for documents which are almost the same, or which will do just as well. Business could not proceed securely on any other lines”.<sup>20</sup> Moreover, in *JH Rayner and Co Ltd v Hambros Bank Ltd*<sup>21</sup> the dispute arose from the sale of “Coromandel groundnuts” under a letter of credit. Upon tender of the documents by the beneficiary, the issuing bank deemed discrepant the presented bill of lading that referred to “machine-shelled groundnut kernels”. Although the court recognized that the two terms are “universally” understood in the trade as indicating the same commodity, it was held that “it is quite impossible to suggest that a banker is to be affected with knowledge of the customs and customary terms of every one of the thousands of trades for whose dealings he may issue letters of credit”.<sup>22</sup> The doctrine is further illustrated in *Moralice (London) Ltd v ED and F Man*.<sup>23</sup> In this case, even though the credit provided for a bill of lading for 5,000 metric tons of sugar, the seller’s tendered documents showed shipment of 4,997 metric tons of sugar. As such, the court allowed the bank’s rejection of the presented bill, with the justification that the maxim *de minimis non curat lex* does not apply to documentary credit transactions.<sup>24</sup> It should be noted that, unless the credit dictates precision, Article 30(b) of UCP 600 provides for certain tolerances regarding the quantity of goods.<sup>25</sup>

The UCP 600 rules do not as such stipulate that the standard of compliance must be a strict one. To the extent that documentary credits equal an assurance of payment, the high rejection rate of tendered documents as discrepant is inclined to undermine the

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<sup>20</sup> *Ibid* 52.

<sup>21</sup> *JH Rayner and Co Ltd v Hambros Bank Ltd* [1943] 1 KB 37.

<sup>22</sup> *Ibid* 41; note, however, that in *Banco Espanol de Credito v State Street Bank & Trust Co* [1967] 266 F Supp 106, the Court required banks to have some knowledge of the appropriate sampling technique of the relevant trade.

<sup>23</sup> *Moralice (London) Ltd v ED and F Man* [1954] 2 Lloyd’s Rep 526.

<sup>24</sup> See also *Soproma SpA v Marine & Animal By-Products Corp* [1966] 1 Lloyd’s Rep 367; *Cehave NV v Bremer Handelsgesellschaft mbH (The Hansa Nord)* [1976] QB 44 (CA); *Ficom SA v Sociedad Cadex Lda* [1980] 2 Lloyd’s Rep 118; note, however, that in *Jydske Andels-Foderstofforretning v Grands Moulins de Paris* [1931] 39 Ll L Rep 223, where the shipped goods were slightly in excess regarding their quantity, the maxim *de minimis non curat lex* was implemented; though, it appears that it applied only to the physical duties.

<sup>25</sup> International Chamber of Commerce, ‘Uniform Customs and Practice for Documentary Credits (UCP) 600’ (2006) art 30(b); likewise, according to Article 30(a) thereof, the use of the terms “about” or “approximately” in connection with the quantity and/or price of the goods within the credit allows for a greater margin of tolerance.

documentary credit system, thus, justifying modern endeavours to relax the standard of documentary compliance.<sup>26</sup> Under Article 14(d) of UCP 600, “Data in a document, when read in context with the credit, the document itself and international standard banking practice, need not be identical to, but must not conflict with ... the credit”.<sup>27</sup> It is debatable how far the margin of flexibility or tolerance in the text extends, especially considering how challenging the determination of what amounts to a minor documentary discrepancy is, as opposed to demanding full conformity of the documents.<sup>28</sup> The rules of the UCP 600 are, ultimately, subjected to the judicial interpretation of varying jurisdictions.<sup>29</sup> In any case, it is argued that the strict compliance rule should be implemented in a commercial sensible manner; hence, misspellings and typographical errors, that have no impact on the meaning of the word or phrase in which they transpired, do not result in a non-conforming document.<sup>30</sup>

### *1.1.2 Autonomy of the Credit*

It follows that the commercial utility and appeal of the documentary letter of credit is best ascribed to its function as a provider, to the beneficiary, after the tender of conforming documents, of an irreversible and unconditional claim to payment.<sup>31</sup> In *Ian Stach Ltd v Baker Bosley Ltd*,<sup>32</sup> it was stated that: “The commercial purpose of a banker’s credit is more than a mere method of payment; it creates a direct liability upon the banker that if the seller presents the required documents in the required time, he will receive payment of the contract price”.<sup>33</sup> Accordingly, any claim or complain that may arise out of the performance of the underlying contract, or any other commercial relationship, does not impinge on the bank’s absolute obligation to

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<sup>26</sup> M. G. Bridge, *The International Sale of Goods* (3<sup>rd</sup> edn, Oxford University Press 2013) 277, 278.

<sup>27</sup> International Chamber of Commerce, ‘Uniform Customs and Practice for Documentary Credits (UCP) 600’ (2006) art 14(d).

<sup>28</sup> M. G. Bridge, *The International Sale of Goods* (3<sup>rd</sup> edn, Oxford University Press 2013) 278.

<sup>29</sup> Nicholas P Manganaro, ‘About-Face: The New Rules of Strict Compliance Under the Uniform Customs and Practice for Documentary Credits (UCP 600)’ (2011) 14 *Int’l Trade & Bus L Rev* 273, 288.

<sup>30</sup> Roy Goode and Herbert Kronke and Ewan McKendrick, *Transnational Commercial Law; Texts, Cases and Materials* (2<sup>nd</sup> edn, Oxford University Press 2015) 338.

<sup>31</sup> Ricky J Lee, ‘Strict Compliance and the Fraud Exception: Balancing the Interests of Mercantile Traders in the Modern Law of Documentary Credits’ (2008) 5 *Macquarie J Bus L* 137, 160.

<sup>32</sup> *Ian Stach Ltd v Baker Bosley Ltd* [1958] 2 QB 130.

<sup>33</sup> *Ibid* 139.

pay against a compliant presentation,<sup>34</sup> or the ensuing applicant's duty to reimburse the bank. In cases of faulty performance of the underlying contract by the beneficiary, the only remedy available to the applicant is suing the beneficiary on said contract.<sup>35</sup> Conversely, for the bank to honor the credit, it is irrelevant whether the beneficiary can prove proper performance under the contract of sale, considering that the bank is not a party thereof.<sup>36</sup>

This independence of the credit from the underlying commercial transaction between the applicant for the credit and the beneficiary, the relationship between the former and the issuing bank, as well as any other engagement set up around the letter of credit involving differing parties, is known as the autonomy of the credit.<sup>37</sup> This principle has been deemed as the "cornerstone of the commercial validity of the letters of credit",<sup>38</sup> along with "the engine behind the letter of credit".<sup>39</sup> Accordingly, it has been enshrined in both the revised version of the Unified Commercial Code (UCC),<sup>40</sup> one of the principal regimes governing documentary credits under American law,<sup>41</sup> and the UCP 600.<sup>42</sup>

Historically, the autonomy of the credit was incorporated into the documentary credit law via the judicial acceptance of international banking usage.<sup>43</sup> In the American

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<sup>34</sup> Felicity Monteiro, 'Documentary Credits: The Autonomy Principle and the Fraud Exception: A Comparative Analysis of Common Law Approaches and Suggestions for New Zealand' (2007) 13 Auckland U L Rev 144, 147.

<sup>35</sup> Ricky J Lee, 'Strict Compliance and the Fraud Exception: Balancing the Interests of Mercantile Traders in the Modern Law of Documentary Credits' (2008) 5 Macquarie J Bus L 137, 160.

<sup>36</sup> *Lamborn v Lake Shore Banking & Trust Co* [1921] 231 NY 616; 132 NE 911.

<sup>37</sup> Roy Goode and Herbert Kronke and Ewan McKendrick, *Transnational Commercial Law; Texts, Cases and Materials* (2<sup>nd</sup> edn, Oxford University Press 2015) 326.

<sup>38</sup> *Ward Petroleum Corp v Federal Deposit Inc Corp* [1990] 903 F 2d 1299.

<sup>39</sup> J R C Arkins, 'Snow White v Frost White: The New Cold War in Banking Law' (2000) 15(2) J I B L 30, 31.

<sup>40</sup> The American Law Institute and National Conference of Commissioners on Uniform State Laws, 'Uniform Commercial Code (UCC)' (revised version of 1995) art 5.

<sup>41</sup> Richard F Dole, 'The effect of UCP 600 upon UCC Article 5 with Respect to Negotiation Credits and the Immunity of Negotiating Banks from Letter-of-Credit Fraud' (2008) 54 Wayne L Ren 735, 737.

<sup>42</sup> International Chamber of Commerce, 'Uniform Customs and Practice for Documentary Credits (UCP) 600' (2006) art 4 & 5.

<sup>43</sup> Roy Goode and Herbert Kronke and Ewan McKendrick, *Transnational Commercial Law; Texts, Cases and Materials* (2<sup>nd</sup> edn, Oxford University Press 2015) 330.

pioneer case of *Sztejn v J Henry Schroder Banking Corporation*,<sup>44</sup> it was declared that: “It is well established that a letter of credit is independent of the primary contract of sale between the buyer and the seller. The issuing bank agrees to pay upon presentation of documents, not goods. This rule is necessary to preserve the efficiency of the letter of credit as an instrument for the financing of trade”.<sup>45</sup> Likewise, the courts in the United Kingdom have been equally disinclined to interfere in the function of the documentary letters of credit,<sup>46</sup> as was developed through the international customs and traditions of bankers.<sup>47</sup> An early declaration of the autonomy principle in the English jurisprudence can be found in *Hamzeh Malas and Sons v British Imex Industries Ltd*,<sup>48</sup> where Jenkins LJ stated that a letter of credit transaction “imposes upon the banker an absolute obligation to pay, irrespective of any dispute there may be between the parties as to whether the goods are up to contract or not. An elaborate commercial system has been built up on the footing that bankers’ confirmed credits are of that character, and, it would be wrong for this court in the present case to interfere with that established practice”.<sup>49</sup> This position has been consistently reiterated by the English judges in the subsequent case law.<sup>50</sup>

The zealous judicial application of the autonomy doctrine is primarily due to the well-established belief that an undermining of the autonomy of the credit would be particularly detrimental to mercantile confidence with regard to the use of documentary credits, leading to the undermining of trade as a whole.<sup>51</sup> Nevertheless, it has been argued that such absolute application leaves the applicant especially vulnerable against improper and fraudulent demands for payment, undermining the

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<sup>44</sup> *Sztejn v J Henry Schroder Banking Corporation* [1941] 31 NYS (2d) 631.

<sup>45</sup> *Ibid* 633-634.

<sup>46</sup> Rodrigo Thanuja, ‘UCP 500 to UCP 600: A Forward Movement’ (2011) 18 eLaw J 1, 5.

<sup>47</sup> Roy Goode and Herbert Kronke and Ewan McKendrick, *Transnational Commercial Law; Texts, Cases and Materials* (2<sup>nd</sup> edn, Oxford University Press 2015) 324.

<sup>48</sup> *Hamzeh Malas and Sons v British Imex Industries Ltd* [1958] 2 QB 127; see also *Urquhart Lindsay & Co Ltd v Eastern Bank Ltd* [1922] 1 KB 318, 322-323.

<sup>49</sup> *Ibid* 129.

<sup>50</sup> *Discount Records Ltd v Barclays Bank Ltd* [1975] 1 All ER 1071; *Howe Richardson Scale Co Ltd v Polimex-Cekop and National Westminster Bank Ltd* [1978] 1 Lloyd’s Rep 161; *Power Curber International v National Bank of Kuwait SAK* [1981] 1 WLR 1233; [1981] 3 All ER 607; *United City Merchants (Investments) Ltd v Royal Bank of Canada* [1983] 1 AC 168 (HL).

<sup>51</sup> M. G. Bridge, *The International Sale of Goods* (3<sup>rd</sup> edn, Oxford University Press 2013) 295-296.

balance of interests assumed in the letter of credit scheme.<sup>52</sup> Such a position raises several conceptual questions as to how far the autonomy of the credit is open to exceptions, as well as the ambit thereof. Notwithstanding that fraud is generally accepted in the common law world as defense against the strict application of the autonomy doctrine, there is still much controversy over matters related to its application on a practical level.<sup>53</sup> Similarly, the introduction and recognition of other disruptions, such as nullity, unconscionability and illegality, is a matter of considerable debate among scholars and courts, making this area of documentary credits law a contentious one,<sup>54</sup> as our discussion below will demonstrate.

## **2. Fraud Exception to the Autonomy Principle**

### **2.1 General Remarks**

Fraud constitutes a long-lasting, detrimental phenomenon, transpiring within the framework of business and commercial transactions, best described as “a cancer in international trade”.<sup>55</sup> It is true that “as long as there have been commercial systems in place there have been those who have tried to manipulate these systems”.<sup>56</sup> Accordingly, the fraud exception was formulated via the common law jurisprudence as a remedy to counter the unjust benefit that a fraudulent beneficiary may acquire through the strict application of the autonomy principle in the system of documentary letters of credit.<sup>57</sup> Under the exception, where the bank has timely knowledge of the fraudulent action, committed by the beneficiary himself, or through the use of a third party, and the fraud has been established to the required standard, said bank is entitled to refuse payment, irrespective of the apparently complying presentation,

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<sup>52</sup> Xiang Gao, ‘The Identity of the Fraudulent Party Under the Fraud Rule in the Law of Letters of Credit’ (2001) 24 U N S W L J 119, 122.

<sup>53</sup> Roy Goode and Herbert Kronke and Ewan McKendrick, *Transnational Commercial Law; Texts, Cases and Materials* (2<sup>nd</sup> edn, Oxford University Press 2015) 325.

<sup>54</sup> M. G. Bridge, *The International Sale of Goods* (3<sup>rd</sup> edn, Oxford University Press 2013) 297.

<sup>55</sup> *Standard Chartered Bank v Pakistan National Shipping* [1998] 1 Lloyd’s Rep 684, 686.

<sup>56</sup> International Maritime Bureau of the ICC, *Trade Finance Fraud: Understanding the Threats and Reducing the Risk: A Special Report* (ICC Publishing 2002) 9.

<sup>57</sup> Ross P Buckley and Xiang Gao, ‘The Development of the Fraud Rule in the Letter of Credit Law: The Journey So Far and the Road Ahead’ (2002) 23 U Pa J Int’l Econ L 663, 665.

either by exercising its discretionary power or conforming to a court injunction.<sup>58</sup>

Consequently, the fraud exception is an “extraordinary rule”, considering that it amounts to a departure from the autonomy of the credit, the “cardinal” principle of the letter of credit law, allowing the bank or the court to examine facts behind the face of complying documents.<sup>59</sup> The interest in recognizing this rule lies in eliminating the legal gap that the absolute application of the autonomy doctrine has created. Providing the beneficiary with the opportunity to deliberately defraud the bank, and ultimately, the applicant, by presenting forged conforming documents that the bank is not entitled to examine beyond their on face compliance, inevitably minimizes commercial confidence, as well as faith in the operation of documentary letters of credit as a secure financing mechanism in international trade. The application of the fraud exception is considered to maintain and enhance the commercial utility of documentary credits, restoring to some extent trust in the system, that the strict autonomy principle would undoubtedly undermine in such cases.<sup>60</sup>

Even though fraud has been generally admitted as an exception to the autonomy principle, there is still considerable controversy in the common law world over issues relating to the practical application of the rule. Whose fraud is relevant? Does third party fraud, unknown to the beneficiary, suffice for the application of the rule? Does the exception cover only fraud reflected in the documents, or does it extend to the underlying transaction as well? What standard of proof, as well as fraud, must be satisfied for a fraudulent act, capable of disentitling the beneficiary to payment, to be safely deducted? Different common law jurisdictions have developed differing judicial approaches concerning these matters,<sup>61</sup> as will be evidenced by the subsequent analysis of the U.S., English and Canadian approaches to the fraud rule.

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<sup>58</sup> Tareq Al-Tawil, ‘Letters of Credit and Contract of Sale: Autonomy and Fraud’ (2013) 16 Int’l Trade & Bus L Rec 159, 183.

<sup>59</sup> Xiang Gao, *The Fraud Rule in the Law of Letters of Credit: A Comparative Study* (The Hague: Kluwer Law International 2002) 30.

<sup>60</sup> Ross P Buckley and Xiang Gao, ‘The Development of the Fraud Rule in the Letter of Credit Law: The Journey So Far and the Road Ahead’ (2002) 23 U Pa J Int’l Econ L 663, 711.

<sup>61</sup> Roy Goode and Herbert Kronke and Ewan McKendrick, *Transnational Commercial Law; Texts, Cases and Materials* (2<sup>nd</sup> edn, Oxford University Press 2015) 325-326.



## **2.2 The Fraud Exception in the United States of America**

### *2.2.1 Prior to the introduction of the Uniform Commercial Code (UCC)*

With regard to establishing the fundamentals of the debate as to the fraud exception in the field of documentary letters of credit, U.S. case law is accepted as the primary point of reference, considering that the exception was first originated in the United States.<sup>62</sup> In particular, the U.S. pioneer case of *Sztejn v J Henry Schroder Banking Corp*,<sup>63</sup> is widely regarded as the foundational authority on the formulation of the fraud exception rule, as the first ever case where the fraud exception was admitted and applied in practice.<sup>64</sup> It is referred to as having “shaped the fraud rule in virtually all jurisdictions”.<sup>65</sup>

Under the relevant facts of this landmark case, notwithstanding that the presented documents corresponded to the ones stipulated in the letter of credit for the purchase of hog bristles, *Sztejn*, the buyer, applied for a court injunction to be granted, restraining the issuing bank from honoring the credit on the basis of the beneficiary’s fraud. In particular, he evidenced that the seller actually shipped “cow hair, other worthless material and rubbish with intent to simulate genuine merchandise and defraud the plaintiff”.<sup>66</sup> Justice Shientag differentiated the case as one concerning “intentional fraud” committed by the beneficiary, as opposed to involving “a mere breach of warranty”.<sup>67</sup> The court concluded that, where the beneficiary is intentionally fraudulent, and the bank has prior relevant knowledge, the concept of the autonomy of the credit and the independence of the bank’s payment obligation “should not be extended to protect the unscrupulous seller”.<sup>68</sup> Accordingly, the injunction was granted to prevent the fraudulent beneficiary from profiting from his own fraudulent

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<sup>62</sup> See, for instance, *Pillans v Van Mierop* [1765] 97 ER 1035; *Higgins v Steinhardter* [1919] 106 Misc 168; *Old Colony Trust Co v Lawyer’s Title & Trust Co* [1924] 297 F 152.

<sup>63</sup> *Sztejn v J Henry Schroder Banking Corp* [1941] 31 NYS (2d) 631.

<sup>64</sup> Tareq Al-Tawil, ‘Letters of Credit and Contract of Sale: Autonomy and Fraud’ (2013) 16 Int’l Trade & Bus L Rec 159, 213.

<sup>65</sup> Xiang Gao, *The Fraud Rule in the Law of Letters of Credit: A Comparative Study* (The Hague: Kluwer Law International 2002) 32.

<sup>66</sup> *Sztejn v J Henry Schroder Banking Corp* [1941] 31 NYS (2d) 631, 633.

<sup>67</sup> *Ibid* 634.

<sup>68</sup> *Ibid*.

act. The court further established the immunization to the fraud exception rule of the holder in due course.<sup>69</sup>

Consequently, the court's judgement in *Sztejn* laid down the foundation for the definition of the major conditions of the fraud exception rule; namely, that fraud committed by the beneficiary must be successfully established, not merely alleged, and known or notified to the paying bank prior to the honoring of the credit. By contrast, payment should be made, irrespective of the above, if the claim for payment is made by a holder in due course or a presenter of similar status.<sup>70</sup>

### *2.2.2 Following the Introduction of the Uniform Commercial Code (UCC) in 1952*

The principles established in the *Sztejn* case, reflecting the U.S. position on the fraud exception rule, were first codified by introduction of the Uniform Commercial Code (UCC), a comprehensive statutory legislation, in Article 5, Section 5-114(2) thereof.<sup>71</sup> Under said Article, the applicant seeking to restrain the bank from exercising its discretion in good faith and making payment against apparently complying documents, regardless of the notice of fraud, should acquire a court injunction to that effect.<sup>72</sup> Nonetheless, this statutory reiteration of the *Sztejn* principles acted as a mere draft for further development of the rule, considering the lack of any provision as to the standard of fraud required to trigger the exception, as well as the uncertainty as to

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<sup>69</sup> Ibid 634-635; nonetheless, the Court declared that the Chartered Bank, the correspondent or advising bank, presenting the draft for payment, cannot be deemed as a holder in due course, as it is merely an agent of the beneficiary, collecting payment on the latter's behalf.

<sup>70</sup> Ross P Buckley and Xiang Gao, 'The Development of the Fraud Rule in the Letter of Credit Law: The Journey So Far and the Road Ahead' (2002) 23 U Pa J Int'l Econ L 663, 680.

<sup>71</sup> Menachem Mautner, "Letter of Credit Fraud: Total Failure of Consideration, Substantial Performance and the Negotiable Instrument Analogy" (1986) 18 Law & Pol'y Int'l Bus 579, 594.

<sup>72</sup> The American Law Institute and National Conference of Commissioners on Uniform State Laws, 'Uniform Commercial Code (UCC)' (1952 version) art 5, Section 5-114(2); according to the Article: "Unless otherwise agreed, when documents appear on their face to comply with the terms of a credit but a required document ... is forged or fraudulent in the transaction: (a) the issuer must honor the draft or demand for payment if honor is demanded by ... a holder in due course; and (b) an issuer acting in good faith may honor the draft or demand for payment despite notification ... of fraud ... but a court of appropriate jurisdiction may enjoin such honor."

whether the rule extends to fraud in the underlying transaction.<sup>73</sup>

In particular, the phrase “fraud in the transaction”,<sup>74</sup> as was employed in the codification of the fraud exception rule within the original version of the UCC, became the focal point of an extensive judicial debate as to its given scope; namely, whether it indicated the credit transaction per se, solely as to the tender of false documents,<sup>75</sup> or also encompassed the underlying contract, where it becomes apparent that the actual merchandise does not comply with the contract specifications.<sup>76</sup> Proponents of the narrow approach argue that the *Sztejn* case introduced the fraud exception rule as to the documents, considering that the tendered documents were fraudulent, misrepresenting the underlying transaction. Similarly, those in favor of the wide approach invoke *Sztejn* as the relevant authority, as fraud was established within the underlying transaction since the buyer would ultimately acquire worthless rubbish, as opposed to the contracted goods.<sup>77</sup> Nevertheless, it is observed that fraud in the underlying transaction generally entails an element of fraud within the tendered documents, as a false documentary representation is required in such cases to induce the issuing bank to honor the credit, thus, pay the beneficiary. In turn, the establishment of fraud in the documents may necessitate recourse to the circumstances of the underlying transaction,<sup>78</sup> rendering the distinction between the two concepts as de facto inconsequential. The narrow approach alone would effectively cover all such fraudulent cases. Moreover, Justice Shinetag rationalized his

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<sup>73</sup> Ricky J Lee, ‘Strict Compliance and the Fraud Exception: Balancing the Interests of Mercantile Traders in the Modern Law of Documentary Credits’ (2008) 5 *Macquarie J Bus L* 137, 164.

<sup>74</sup> The American Law Institute and National Conference of Commissioners on Uniform State Laws, ‘Uniform Commercial Code (UCC)’ (1952 version) art 5, Section 5-114(2).

<sup>75</sup> See, for instance, *Shaffer v Brooklyn Park Garden Apartments* [1977] 250 NW 2d 172; *Bossier Bank & Trust Co v Union Planters National Bank* [1977] 550 F 2d 1077; *O’ Grady v First Union National Bank* [1978] 250 SE 2d 587; *FDIC v Bank of San Francisco* [1987] 817 F 2d 1935.

<sup>76</sup> See, for instance, *NMC Enterprises Inc v Columbia Broadcasting System Inc* [1974] 14 UCC Rep 1427; *Rockwell International Systems Inc v Citibank* [1983] NA 719 F 2d 583; *United Bank Ltd v Cambridge Sporting Goods Corp* [1976] 392 NYS 2d 265; *Itek Corporation v First National Bank of Boston* [1982] 730 F 2d 1344.

<sup>77</sup> Felicity Monteiro, ‘Documentary Credits: The Autonomy Principle and the Fraud Exception: A Comparative Analysis of Common Law Approaches and Suggestions for New Zealand’ (2007) 13 *Auckland U L Rev* 144, 154-155.

<sup>78</sup> See, for instance, *Shaffer v Brooklyn Park Garden Apartments* [1977] 250 NW 2d 172, 180 where the court held that the “fraud alleged must be in respect to the documents” and then proceeded to examine the underlying contract to ascertain if the documents are indeed fraudulent; similarly, see *O’ Grady v First Union National Bank* [1978] 250 SE 2d 587.

decision on the grounds that “the application of this doctrine [the autonomy principle] presupposes that the documents accompanying the draft are genuine and conform in term to the requirements of the letter of credit”.<sup>79</sup> Consequently, it is apparent that Szejn introduced the narrow documentary fraud rule to prevent the dishonest beneficiary from demanding payment on the basis of apparently complying, yet fraudulent documents. The latter cannot be regarded as conforming to the credit. Additionally, it was further considered that the fraudulent documents fail to serve as security for the bank, as guarantor of payment, in case of the applicant’s non-payment or insolvency.<sup>80</sup> The extension of the exception to fraud confined exclusively in the underlying transaction falls outside this rationalization, as the beneficiary does not utilize the documentary presentation to carry out his fraudulent action. Accordingly, insofar as the documents genuinely represent the goods called for, the bank’s security interests, provided by said documents, are not frustrated.

Regarding the level of fraud capable of inducing the application of the fraud exception rule, the lack of a clear authority in this area led to the judicial development of various relevant standards. Accordingly, the standard of constructive fraud was formulated, as encompassing any conduct on behalf of the beneficiary that constitutes “a breach of a legal or equitable duty”.<sup>81</sup> However, the threshold of this broad standard was criticized as being too low,<sup>82</sup> making it susceptible to abusive claims of fraud as defense against payment. Subsequently, the concept of intentional fraud was introduced, as the proper standard of fraud, requiring a knowing misrepresentation by the beneficiary, with the purpose of inducing the other party to rely thereon.<sup>83</sup> Additionally, under the standard of egregious fraud, “the wrongdoing of the beneficiary has so vitiated the

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<sup>79</sup> Szejn v J Henry Schroder Banking Corp [1941] 31 NYS (2d) 631, 633.

<sup>80</sup> Ibid 635; where Justice Shinetag, in recognizing the fraud exception, took into consideration, as a supporting factor, the issuing bank’s security interest on the goods, as the bank “is vitally interested in assuring itself that there are some goods represented by the documents”; whereas in this case it would be left with worthless rubbish, if the applicant failed to reimburse the bank, had the latter proceeded with payment under the credit.

<sup>81</sup> Dynamics Corp of America v Citizens & Southern National Bank [1973] 356 F Supp 991, 998-999.

<sup>82</sup> Xiang Gao and Ross P Buckley, “A Comparative Analysis of the Standard of Fraud Required Under the Fraud Rule in Letter of Credit Law” (2003) 13 Duke J Comp & Int’l L 293, 309.

<sup>83</sup> NMC Enterprises Inc v Columbia Broadcasting System Inc [1974] 14 UCC Rep 1427; see also American Bell International v Islamic Republic of Iran [1979] 474 F Supp 420; West Virginia Housing Development Fund v Sroka [1976] 415 F Supp 1107.

entire transaction that the legitimate purposes of the independence of the issuer's obligation would no longer be served".<sup>84</sup> This narrow approach as to the fraud exception calls for a serious misconduct on behalf of the beneficiary, precluding him from having any bona fide claim to payment.<sup>85</sup>

### *2.2.3 Following the Revision of the Uniform Commercial Code (UCC) in 1995*

After the redraft of the UCC in 1995, the fraud rule was embodied in the new version of Article 5, under Section 5-109 thereof. Following this revision, the language of the Article was modified to proclaim that the issuer, acting in good faith, has the discretion to honor or dishonor a documentary presentation, while the court may enjoin payment under a letter of credit, if "a required document is forged or materially fraudulent, or honour of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant".<sup>86</sup>

Accordingly, the U.S. position as to the required standard of fraud was determined as "material fraud". The Article, however, provides no explicit definition with respect to the meaning of the term "material".<sup>87</sup> Instead, the Official Comment on Section 109 gives an explanation to facilitate the understanding of the term, as such, that fraudulent conduct should be material "to a purchaser of the [fraudulent] document or ... the participants in the underlying transaction", depriving the beneficiary of any "colourable right to expect honor", while, "there is no basis in fact to support such a

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<sup>84</sup> *Intraworld Industries Inc v Girard Trust Bank* [1975] 336 A 2d 316, 324-325; see also *New York Life Insurance Co v Hartford National Bank & Trust Co* [1977] 378 A 2d 562; *First Arlington National Bank v Stathis* [1980] 413 NE 2d 1288; *Foreign Ventures LP v Chemical Bank* [1977] 399 NYS 2d 114.

<sup>85</sup> Tareq Al-Tawil, 'Letters of Credit and Contract of Sale: Autonomy and Fraud' (2013) 16 *Int'l Trade & Bus L Rec* 159, 219.

<sup>86</sup> The American Law Institute and National Conference of Commissioners on Uniform State Laws, 'Uniform Commercial Code (UCC)' (revised version of 1995) art 5, Section 5-109; it, further, provides a list of four parties immune to the fraud rule: (i) a nominated person who has given value in good faith and without notice of forgery or material fraud; (ii) a confirmer who has honoured its confirmation in good faith; (iii) a holder in due course of a draft drawn under a letter of credit which was taken after acceptance by the issuer or nominated person and; (iv) an assignee of the issuer's nominated person's deferred obligation that was taken for value and without notice of forgery or material fraud after the obligation was incurred by the issuer or nominated person.

<sup>87</sup> Tareq Al-Tawil, 'Letters of Credit and Contract of Sale: Autonomy and Fraud' (2013) 16 *Int'l Trade & Bus L Rec* 159, 220.

right to honor”.<sup>88</sup> Within its explanation, the Official Comment, further, indicated, what up to this point has been characterized as “egregious fraud”,<sup>89</sup> as an expression of “material fraud”.<sup>90</sup> This position on the standard of fraud by the revised Article 5 has been assumed by the subsequent case law,<sup>91</sup> where “material fraud” was interpreted within the meaning of “egregious fraud”. It is apparent that the focus of this standard concentrates on the seriousness of the fraud and the effect of its severity,<sup>92</sup> providing for a clear criterion that may facilitate the reasonable application of the fraud rule. However, considering the difficulty in justifying the materiality of the fraud without recourse to the underlying contract,<sup>93</sup> this standard may have a highly negative effect on the autonomy principle. Accordingly, the consideration of the impact of the fraud as to the transaction, albeit reasonable from the perspective of business interests, especially the bank’s security interests in the goods, requires said bank to know more with regard to the underlying contract while processing payment. In other words, the bank has to justify the application of the fraud rule by considering the performance under the underlying contract. Nevertheless, the latter constitutes an intrinsic element of the fraud rule as an exception to the autonomy principle.

With regard to the scope of the fraud exception, whereas the language prior to the UCC revision led to an open question,<sup>94</sup> the revised Article 5 expressly states that

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<sup>88</sup> Official Comment to UCC Article 5 Letters of Credit, UCC§5-109 Forgery and Fraud, Official Comment 1.

<sup>89</sup> *Intraworld Industries Inc v Girard Trust Bank* [1975] 336 A 2d 316, 324-325; see also *New York Life Insurance Co v Hartford National Bank & Trust Co* [1977] 378 A 2d 562; *First Arlington National Bank v Stathis* [1980] 413 NE 2d 1288; *Foreign Ventures LP v Chemical Bank* [1977] 399 NYS 2d 114.

<sup>90</sup> Official Comment to UCC Article 5 Letters of Credit, UCC§5-109 Forgery and Fraud, Official Comment 1.

<sup>91</sup> See, for instance, *New Orleans Brass v Whitney National Bank and the Louisiana Stadium and Exposition District* [2002] LA App LEXIS 1764; *Mid-America Tire v PTZ Trading Ltd Import and Export Agents* [2002] 43 UCC Rep Serv 2d 964.

<sup>92</sup> Ross P Buckley, ‘The 1993 Revision of the Uniform Customs and Practice for Documentary Credits’ (1995) 6(2) *J Banking & Fin L & Prac* 77, 97.

<sup>93</sup> See Official Comment to UCC Article 5 Letters of Credit, UCC§5-109 Forgery and Fraud, Official Comment 1; which reads that “The courts must examine the underlying transaction when there is an allegation of material fraud, for only by examining that transaction can one determine ...whether the fraud was material”.

<sup>94</sup> The American Law Institute and National Conference of Commissioners on Uniform State Laws, ‘Uniform Commercial Code (UCC)’ (1952 version) art 5, Section 5-114(2).

payment may be restrained, both in the case of “materially fraudulent” documents, as well as in the case of any other “material fraud by the beneficiary on the issuer, or applicant”.<sup>95</sup> Consequently, the matter is explicitly settled as encompassing fraud established in the underlying transaction. This wider approach as to the notion of fraud within the fraud exception rule obliterates the independence of the commercial instrument, allowing for a high degree of judicial interference, making the operation of the commercial instrument slow and cumbersome; hence, in no way equal to “cash in hand”.<sup>96</sup> It further exceeds the rationale behind the development of the fraud rule under US law, as articulated in *Sztejn* by Justice Shinetag.<sup>97</sup> Nonetheless, it can be largely attributed to the focus of the U.S. courts on suppressing fraud,<sup>98</sup> as opposed to prioritizing the efficacy of the documentary credits and the needs of commerce, a position adopted by the English courts. Regardless, it is not for the banks to act as international policemen for the prevention of the proliferation of fraud.

### ***2.3 The Fraud Rule in the United Kingdom***

The fraud exception rule, although firmly recognized under the English common law system,<sup>99</sup> has rarely been successfully established in practice, as the English courts have been traditionally very reluctant to intervene in the function of the autonomy of the credit.<sup>100</sup> Fraud is referred to as “the most controversial and confused area”,<sup>101</sup> as it affects the autonomy principle in the international operation of the letters of credit.

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<sup>95</sup> The American Law Institute and National Conference of Commissioners on Uniform State Laws, ‘Uniform Commercial Code (UCC)’ (revised version of 1995) art 5, Section 5-109.

<sup>96</sup> *Power Curber International Ltd v National Bank of Kuwait SAK* [1981] 1 WLR 1233, 1241; [1981] 3 All ER 607, 612.

<sup>97</sup> *Sztejn v J Henry Schroder Banking Corp* [1941] 31 NYS (2d) 631.

<sup>98</sup> See for instance *Dynamics Corp of America v Citizens & Southern National Bank* [1973] 356 F Supp 991, 1000; where Edinfeld J held that “There is as much public interest in discouraging fraud as in encouraging the use of letters of credit”.

<sup>99</sup> *Discount Records Ltd v Barclays Bank Ltd* [1975] 1 All ER 1071; *RD Harbottle (Mercantile) Ltd v National Westminster Bank Ltd* [1978] QB 146; *Edward Owen Engineering Ltd v Barclays Bank International Ltd* [1978] QB 159; *United City Merchants (Investments) Ltd v Royal Bank of Canada* [1983] 1 AC 168 (HL); *United Trading Corp SA v Allied Arab Bank Ltd* [1985] 2 Lloyd’s Rep 554; *Themehelp Ltd v West* [1985] 4 All ER 215; *Czarnikow-Rionda Sugar Trading Inc v Standard Bank London Ltd* [1999] 2 Lloyd’s Rep 187; *Turkiye Is Bankasi AS v Bank of China* [1998] 1 Lloyd’s Rep 250.

<sup>100</sup> Rodrigo Thanuja, ‘UCP 500 to UCP 600: A Forward Movement’ (2011) 18 eLaw J 1, 5.

<sup>101</sup> Ross P Buckley and Xiang Gao, ‘The Development of the Fraud Rule in the Letter of Credit Law: The Journey So Far and the Road Ahead’ (2002) 23 U Pa J Int’l Econ L 663, 663.

Accordingly, under the rationale of safeguarding the integrity of the documentary credit and banking system, as well as promoting international trade,<sup>102</sup> the English position on the application of the fraud exception has been consistently a restrictive one, even to the point of negating the purpose for which the exception was initially recognized.<sup>103</sup>

One of the earliest English cases that referred to the fraud exception was *Discount Records Ltd v Barclays Bank Ltd*,<sup>104</sup> where the buyer sought to obtain an injunction enjoining the defendant bank from making payment on the seller's draft, on the grounds that the latter fraudulently shipped only a small quantity of the ordered goods in accordance with the contract requirements. Megarry J referred to the American *Sztejn* case, on the basis of which, for the fraud exception to apply, the existence of "established fraud" is required, as opposed to mere allegations. Nevertheless, the court regarded the buyer's inspection certificate, evidencing the incompliance and obtained in the presence of a representative of the issuer, as insufficient to successfully establish the beneficiary's fraud. It held that judicial interference can only be justified, if a "sufficiently grave cause is shown".<sup>105</sup> This case, illustrating the difficulty in satisfying the high standard of proof necessitated by the English courts as to the fraud exception, has been criticized as rendering the acquisition of injunctions in such cases practically infeasible.<sup>106</sup>

The leading English authority with regard to the fraud exception rule is the decision of the House of Lords in *United City Merchants (Investments) Ltd v Royal Bank of Canada*.<sup>107</sup> In this case, which concerned the sale of glass fibre making equipment under an irrevocable letter of credit, a loading broker, not acting as the seller's agent, fraudulently backdated the tendered bill of lading to reflect the shipment date provided for in the credit. Subsequently, upon presentation, the confirming bank

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<sup>102</sup> *RD Harbottle (Mercantile) Ltd v National Westminster Bank Ltd* [1978] QB 146, 155-156.

<sup>103</sup> Xiang Gao, *The Fraud Rule in the Law of Letters of Credit: A Comparative Study* (The Hague: Kluwer Law International 2002) 50.

<sup>104</sup> *Discount Records Ltd v Barclays Bank Ltd* [1975] 1 All ER 1071.

<sup>105</sup> *Ibid* 1075.

<sup>106</sup> Ross P Buckley and Xiang Gao, 'The Development of the Fraud Rule in the Letter of Credit Law: The Journey So Far and the Road Ahead' (2002) 23 *U Pa J Int'l Econ L* 663, 691.

<sup>107</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada* [1983] 1 AC 168 (HL).

refused to pay on the grounds of fraud, having evidence that the shipment actually took place on a later date. In his judgement, Lord Diplock restricted the application of the fraud exception to cases where the seller, with the intention of claiming payment under the credit, fraudulently presents documents that encompass “expressly or impliedly, material representations of fact that to his knowledge are untrue”.<sup>108</sup> This knowledge of the material fraud by the beneficiary constitutes the decisive factor that can bring about his liability in the case of third party fraud.<sup>109</sup> Accordingly, on the facts of the case, the House of Lords concluded that the confirming bank was not entitled to refuse payment against documents that it knew to be fraudulent, considering that the fraud was committed by a third party, while the beneficiary genuinely had no relevant knowledge.<sup>110</sup> That the document was fraudulent in a material fact, to the knowledge of its issuer and the bank, did not matter insofar as the seller himself did not act fraudulently, or was privy to the third party fraud.<sup>111</sup> The critical time as to the beneficiary’s knowledge of fraud is the time of presentation. Any subsequent awareness of the falsity of the document does not override his claim to payment.<sup>112</sup> It should be noted, at this point, that, the House of Lords then proceeded to examine the backdated document within the context of the nullity concept,<sup>113</sup> as will be analyzed further along.

This judgement, reflecting the English approach as to the beneficiary’s liability in case of third party fraud, has been criticized on the grounds that a fraudulently fabricated bill of lading does not constitute a complying document, merely by reason of the fraud having been committed by a third party.<sup>114</sup> This position seems to be in line with the view of the Court of Appeal in the *United City Merchants* case; namely, that the conformity of the document is determined on the basis of its character, as opposed to its origin. Consequently, said court focused on the nature of the document as

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<sup>108</sup> *Ibid* 183.

<sup>109</sup> Eliahu Peter Ellinger and Dora Neo, *The Law and Practice of Documentary Letters of Credit* (Hart Publishing 2010) 142.

<sup>110</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada* [1983] 1 AC 168 (HL), 184.

<sup>111</sup> M. G. Bridge, *The International Sale of Goods* (3<sup>rd</sup> edn, Oxford University Press 2013) 305.

<sup>112</sup> *Group Josi Re v Wallbrook Insurance Co Ltd* [1996] 1 WRL 1152 (CA), 1161.

<sup>113</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada* [1983] 1 AC 168 (HL), 187.

<sup>114</sup> Roy Goode, “Reflections on Letters of Credit – I” [1980] J Bus Law 291, 294.

fraudulent, not on the identity of the fraudster,<sup>115</sup> as did, conversely, the House of Lords.<sup>116</sup> Nonetheless, it seems more accurate to regard the person knowingly making the false statement as fraudulent, rather than the documents in and of themselves or the party innocent of said falsity. The requirement of the beneficiary's established fraudulent action, or knowledge thereof, provides a needed element of causality, justifying the detrimental consequences that the application of the fraud exception will undoubtedly bring about as to the beneficiary.

Under English law, the standard of fraud requiring "material misrepresentation", as stated by Lord Diplock,<sup>117</sup> reflects the "intentional fraud" standard developed within the U.S. jurisprudence, rather than the U.S. adopted standard of "material fraud", as it focuses primarily on the beneficiary's fraudulent intention or knowledge.<sup>118</sup> Without the latter, the fraud rule cannot be applied, no matter the materiality of the fraud's effect on the transaction.<sup>119</sup> However, considering that the letter of credit constitutes a functional payment system in international trade, the seriousness of the fraud's impact is highly relevant to the bank's security interests in the goods, provided by the documents. In that regard, the U.S. standard of "material fraud" may be regarded as more reasonable in considering the latter, as a fraud may not impair the bank's security interests if it is not material enough. Additionally, another issue arising out of the "intentional fraud" standard is that it requires proof of the beneficiary's "evil" intent which, as a state of mind, is extremely difficult to establish;<sup>120</sup> especially without recourse to the circumstances surrounding the underlying transaction. Nonetheless, insofar as the fraud rule was developed to prevent the dishonest beneficiary from abusing the documentary credit system,<sup>121</sup> the "intentional fraud" test appears to be an appropriate one to justify the rule's application.

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<sup>115</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada* [1981] 1 Lloyd's Rep 604, 628-629.

<sup>116</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada* [1983] 1 AC 168 (HL) 183-184.

<sup>117</sup> *Ibid* 183.

<sup>118</sup> Tareq Al-Tawil, 'Letters of Credit and Contract of Sale: Autonomy and Fraud' (2013) 16 *Int'l Trade & Bus L Rec* 159, 219-221.

<sup>119</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada* [1983] 1 AC 168 (HL).

<sup>120</sup> Eliahu Peter Ellinger and Dora Neo, *The Law and Practice of Documentary Letters of Credit* (Hart Publishing 2010) 142.

<sup>121</sup> *Sztejn v J Henry Schroder Banking Corp* [1941] 31 NYS (2d) 631, 634.

Regarding the scope of the fraud rule, Lord Diplock's statement that the exception refers to *documents* that encompass "material representations of fact that to [the beneficiary's] knowledge are untrue",<sup>122</sup> is generally accepted as a succinct summary of the fraud exception in documentary letters of credit under English law.<sup>123</sup> This narrow approach; namely, the restriction of the rule to fraud manifested in the documents, allows the autonomy principle to be disturbed in the least possible cases while, concurrently, protecting the applicant from the beneficiary's fraudulent documentary presentations under the credit. Accordingly, it reflects the contractual allocation of risk as between the parties, when selecting to trade by way of an irrevocable device as payment method. The parties to such a transaction accept that payment is guaranteed as long as the documents strictly conform with the credit. Hence, the applicant takes on the risk of a fraudulent beneficiary; the only exception being that said applicant would not expect the bank to pay against apparently complying but clearly fraudulent documents, as the latter in no way constitute a conforming presentation.<sup>124</sup>

As a practical matter, the way for the buyer to prevent payment on the grounds of fraud, normally provided that the bank does not adhere to his request to voluntarily dishonor the credit, is primarily by pursuing an interlocutory injunction whereby, either the bank is enjoined from making payment, or the seller is restrained from claiming under the letter of credit. From a practical point of view, it is immensely difficult and infrequent for an interim injunction to be granted, initially, on account of the buyer's inability to satisfy the high level of proof required under English law,<sup>125</sup> demanding "clear cases of fraud of which the banks have [clear and obvious] notice".<sup>126</sup> It is not for a bank to carry out its own enquiries when an allegation of fraud is

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<sup>122</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada* [1983] 1 AC 168 (HL), 183.

<sup>123</sup> Rodrigo Thanuja, 'UCP 500 to UCP 600: A Forward Movement' (2011) 18 eLaw J 1, 7.

<sup>124</sup> *Sztejn v J Henry Schroder Banking Corp* [1941] 31 NYS (2d) 631, 633; see previously *Higgins v Steinhardt* [1919] 106 Misc 168; *Old Colony Trust Co v Lawyer's Title & Trust Co* [1924] 297 F 152.

<sup>125</sup> M. G. Bridge, *The International Sale of Goods* (3<sup>rd</sup> edn, Oxford University Press 2013) 303.

<sup>126</sup> *Edward Owen Engineering Ltd v Barclays Bank International Ltd* [1978] QB 159, 171; *RD Harbottle (Mercantile) Ltd v National Westminster Bank Ltd* [1978] QB 146, 155. Although both cases concerned performance guarantees, the approach in the common law world is that demand guarantees and letters of credit, both abstracts payment undertakings, autonomous

brought to its attention.<sup>127</sup> Accordingly, the pertinent time at which fraud must be clear to the bank is the time of payment; any subsequent knowledge of fraud has no impact on the bank's right to reimbursement.<sup>128</sup> In *United Trading Corp SA v Allied Arab Bank Ltd*,<sup>129</sup> Ackner LJ formulated a more explicit test, requiring, by way of strong confirmatory evidence, mostly contemporary documents originated from the buyer, the establishment of a "seriously arguable case that the only realistic inference is fraud".<sup>130</sup> This approach manages to strike a balance by setting a standard that is neither too low, utterly eroding the autonomy principle, nor too high, thus, unattainable in practice. Accordingly, it is evident that English law relaxed its standard of proof, becoming more consistent with the rest of the common law world.<sup>131</sup> It shows the potential for the development of the fraud rule in documentary letters of credit credits.

Apart from the high standard of evidence required in the case of fraud, the difficulty in acquiring an injunction is further demonstrated by the equitable requirement that the balance of convenience should be in favor of granting the injunction.<sup>132</sup> In deciding, the court needs to weight the damage that granting or refusing the injunction will generate as to the plaintiff and the defendant respectively.<sup>133</sup> In *RD Harbottle (Mercantile) Ltd v National Westminster Bank Ltd*,<sup>134</sup> Kerr J addressed the matter by pointing out that damages constitute an adequate remedy in favor of the applicant, for any breach of duty committed by the bank. Accordingly, the harm incurred by the bank that dishonors its international obligations, by large outweighs any harm likely to be

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and documentary in character, are treated similarly as to the autonomy principle and the fraud exception, see Roy Goode and Herbert Kronke and Ewan McKendrick, *Transnational Commercial Law; Texts, Cases and Materials* (2<sup>nd</sup> edn, Oxford University Press 2015) 325-326.

<sup>127</sup> *Turkiye Is Bankasi AS v Bank of China* [1998] 1 Lloyd's Rep 250.

<sup>128</sup> *Credit Agricole Indosuez v Generale Bank* [1999] 2 All ER 1009, 1015.

<sup>129</sup> *United Trading Corp SA v Allied Arab Bank Ltd* [1985] 2 Lloyd's Rep 554.

<sup>130</sup> *Ibid* 561.

<sup>131</sup> See for instance *Themehelp Ltd v West* [1985] 4 All ER 215; where the standard of a "seriously arguable case that the only realistic inference is fraud" was successfully applied, resulting in the granting of the injunction, preventing payment being made on the performance guarantee.

<sup>132</sup> M. G. Bridge, *The International Sale of Goods* (3<sup>rd</sup> edn, Oxford University Press 2013) 304.

<sup>133</sup> Tareq Al-Tawil, 'Letters of Credit and Contract of Sale: Autonomy and Fraud' (2013) 16 Int'l Trade & Bus L Rec 159, 199.

<sup>134</sup> *RD Harbottle (Mercantile) Ltd v National Westminster Bank Ltd* [1978] QB 146.

incurred by the applicant, whose application for an injunction has been rejected. As such, the latter faces an “insuperable difficulty”, in that the balance of convenience as to the injunction is, in such cases, “hopelessly weighted” against the applicant seeking to restrain payment.<sup>135</sup> Such strict requirements reassign the contractual allocation of risk as among the parties by solely allocating them on the applicant. Under this approach, obtaining an injunction to enjoin payment has become practically infeasible in most English cases, notwithstanding the courts’ claims that they “will not allow their process to be used by a dishonest person to carry out a fraud”.<sup>136</sup> Accordingly, it has been criticized as reducing the fraud rule to a merely theoretical concept.<sup>137</sup>

#### **2.4 The Fraud Rule in Canada**

Canadian courts, in recognizing and applying the fraud exception rule, relied primarily on the cases of *Sztejn*<sup>138</sup> and *Edward Owen Engineering*,<sup>139</sup> an American and English case respectively, on the basis of which an established case of fraud is required; in particular, clear or obvious fraud, as well as the bank’s knowledge thereof.<sup>140</sup> However, as the subsequent case law evidences, said courts were more inclined to apply the fraud rule by adopting the more flexible standard of a “strong prima facie case of fraud”, as formulated and successfully applied in *C.D.N. Research & Developments Ltd v Bank of Nova Scotia*.<sup>141</sup>

Under Canadian law, the leading authority in this area is the judgement in *Bank of Nova Scotia v Angelica-Whitewear Ltd*.<sup>142</sup> In this case, before payment was made, *Whitewear Manufacturing Co Ltd*, the applicant, notified the issuing bank, *Bank of Nova Scotia*, of the signature on the tendered inspection certificate being forged and, accordingly, requested the payment under the letter of credit to be restrained.

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<sup>135</sup> *Ibid* 155.

<sup>136</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada* [1983] 1 AC 168 (HL), 184.

<sup>137</sup> Yeliz Demir-Araz, ‘International Trade, Maritime Fraud and Documentary Credits’ (2002) 8(4) *Int’l Trade L & Reg* 128, 133.

<sup>138</sup> *Sztejn v J Henry Schroder Banking Corp* [1941] 31 *NYS* (2d) 631.

<sup>139</sup> *Edward Owen Engineering Ltd v Barclays Bank International Ltd* [1978] *QB* 159.

<sup>140</sup> Ross P Buckley and Xiang Gao, ‘The Development of the Fraud Rule in the Letter of Credit Law: The Journey So Far and the Road Ahead’ (2002) 23 *U Pa J Int’l Econ L* 663, 694; see for instance *Aspen Planners Ltd v Commerce Masonry & Forming Ltd* [1979] 100 *DLR* 3d 546.

<sup>141</sup> *C.D.N. Research & Developments Ltd v Bank of Nova Scotia* [1980] 18 *CPC* 62.

<sup>142</sup> *Bank of Nova Scotia v Angelica-Whitewear Ltd* [1987] 36 *DLR* 4<sup>th</sup> 161.

Nonetheless, the credit was honored and the applicant's account was debited. The issuing bank then proceeded with an action against Whitewear for the balanced owed. The applicant claimed that the bank was not entitled to reimbursement as it had prior knowledge of the beneficiary's fraud. Le Dain J, of the Canadian Supreme Court, differentiated the standard of proof required for the applicant to obtain an interlocutory injunction against the bank to withhold payment, where the strong prima facie test applies, from the standard needed in cases of disputes between the issuer and the applicant, following the honoring of the credit, to establish improper payment by the bank after being informed of the beneficiary's fraud. In the latter case, where the bank exercised its discretion as to honor the credit, Le Dain J required the standard set in *Edward Owen Engineering*; namely, established, clear or obvious fraud to the knowledge of the bank,<sup>143</sup> a stricter test, harder to satisfy.<sup>144</sup>

Before reaching its conclusion, the court considered three pertinent issues as the application of the fraud exception rule. In particular, it held that the fraud rule should not be restricted to fraud manifested in the presented documents, but should, further, encompass fraud in the underlying contract, of such a character as to make the claim for payment under the credit a fraudulent one. Subsequently, it reaffirmed the position that the fraud exception does not extend to third party fraud, as to which the beneficiary is entirely innocent, while declaring its non-applicability against a holder in due course.<sup>145</sup> On the facts of the case, the argument based on fraud was rejected on the grounds of the fraud not being sufficiently obvious to the bank that paid against apparently conforming documents.<sup>146</sup> Notwithstanding that this case is regarded as "a lucid and comprehensive judgement, setting out the Canadian position to the exception",<sup>147</sup> the relevant issue of the standard of fraud required to apply the

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<sup>143</sup> *Ibid* 177.

<sup>144</sup> Felicity Monteiro, 'Documentary Credits: The Autonomy Principle and the Fraud Exception: A Comparative Analysis of Common Law Approaches and Suggestions for New Zealand' (2007) 13 *Auckland U L Rev* 144, 158.

<sup>145</sup> *Bank of Nova Scotia v Angelica-Whitewear Ltd* [1987] 36 DLR 4<sup>th</sup> 161, 176-177.

<sup>146</sup> *Ibid* 184.

<sup>147</sup> Greg Fellinger, 'Letters of Credit: The Autonomy Principle and the Fraud Exception' (1990) 1 *J Banking & Fin L & Prac* 4, 21.

exception was barely considered.<sup>148</sup>

## **2.5 Legal Basis of the Fraud Exception**

### *2.5.1 Maxim ex turpi causa non oritur actio*

In the English landmark case of *United City Merchants (Investments) Ltd v Royal Bank of Canada*,<sup>149</sup> Lord Diplock articulated the legal justification for the recognition and application of the fraud exception rule in the common law world; namely, the maxim *ex turpi causa non oritur actio*, or otherwise known as “fraud unravels all”.<sup>150</sup> The literal meaning of the maxim is “no action arises from an unworthy cause”. Accordingly, it was emphasized that the courts will not allow a deceitful person to avail himself of their process to carry out a fraud.<sup>151</sup> Within the context of this dictum, the U.S. pioneer *Sztejn* case had first communicated the justification of the fraud exception in terms of preventing the unscrupulous seller from benefiting from the documentary credit system, as the autonomy of the bank’s obligation under the letter of credit should not be of such extent as to facilitate said fraudulent seller.<sup>152</sup>

It has been argued that the rationale of “fraud unravels all” is contradictory to the generally narrow English approach, whereby the fraud exception is strictly restricted to fraud in the documents. If fraud unravels all, namely the bank’s independent and irrevocable obligation to pay against apparently complying documents, there appears to be no valid reason for distinguishing between fraud evidenced in the documents and fraud in the underlying transaction. Therefore, there exists an internal inconsistency in expressing the absolute condemnation of fraud committed or known to the beneficiary, while concurrently limiting said condemnation in practice, to only

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<sup>148</sup> Ross P Buckley and Xiang Gao, ‘The Development of the Fraud Rule in the Letter of Credit Law: The Journey So Far and the Road Ahead’ (2002) 23 U Pa J Int’l Econ L 663, 698.

<sup>149</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada* [1983] 1 AC 168 (HL).

<sup>150</sup> *Ibid* 184; similarly, in *Bank of Nova Scotia v Angelica-Whitewear Ltd* [1987] 36 DLR 4<sup>th</sup> 161, Le Dain J, in supporting the inclusion of the fraud exception under Canadian law, based said rule on the *ex turpi causa non oritur actio* maxim, scrupulously following the English approach on the matter.

<sup>151</sup> *Ibid*.

<sup>152</sup> *Sztejn v J Henry Schroder Banking Corp* [1941] 31 NYS (2d) 631, 634.

fraud manifested in the documents, with no sufficient justification.<sup>153</sup> Consequently, this dictum has been invoked as a supportive argument for the expansion of the fraud rule to also fraud in the underlying contract within the English law.<sup>154</sup> In the same vein, it could be argued that since “fraud unravels all”, the fraud of the loading broker in United City Merchants would have been capable of enjoining payment. However, Lord Diplock explicitly restricted this maxim to fraud perpetrated by, or known to, the beneficiary.<sup>155</sup> Hence, it is more accurate to say that only some fraud unravels all. So why not only fraud manifested in the documents? It is apparent that the dictum was never intended as an absolute statement. Accordingly, the rationale behind the fraud rule was never the absolute condemnation of fraud, but rather achieving the right balance between the prevention of fraudulent calls under the credit and the support of the commercial utility of the letter of credit as a guarantee of payment. Thus, the rule must be confined strictly to its reason.

#### *2.5.2 Implied Term in the Contract as a matter of Ordinary Contract Principle*

The legal basis as to the fraud exception rule was further considered in the English case of *Czarnikow-Rionda Sugar Trading Inc v Standard Bank London Ltd*.<sup>156</sup> In particular, Rix J, when contemplating an application for an injunction against the issuing bank to restrain payment and, subsequently, the need to find a substantive cause of action against the defendant, held that Lord Diplock’s reference to the *ex turpi causa* maxim “may appropriately be viewed as an authoritative expression of the source in law of the implied limitation on a bank’s mandate”.<sup>157</sup> Accordingly, from the perspective of ordinary contract law, he accepted the existence of an implied term within the contract between the applicant and the issuing bank, whereby the latter is obliged to withhold payment when faced with a clear case of fraudulent tendered documents. If

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<sup>153</sup> Felicity Monteiro, ‘Documentary Credits: The Autonomy Principle and the Fraud Exception: A Comparative Analysis of Common Law Approaches and Suggestions for New Zealand’ (2007) 13 *Auckland U L Rev* 144, 150.

<sup>154</sup> Tareq Al-Tawil, ‘Letters of Credit and Contract of Sale: Autonomy and Fraud’ (2013) 16 *Int’l Trade & Bus L Rec* 159, 222-223.

<sup>155</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada* [1983] 1 AC 168 (HL), 183-184.

<sup>156</sup> *Czarnikow-Rionda Sugar Trading Inc v Standard Bank London Ltd* [1999] 2 *Lloyd’s Rep* 187.

<sup>157</sup> *Ibid* 211.

the bank fails to do so, on the basis of this reasoning, it violates its mandate,<sup>158</sup> thus, is liable against the applicant for damages.<sup>159</sup>

Although this implied term conceptualization seems to be in contrast with the documentary and comprehensive nature of the credit, so does the fraud exception itself, recognized in almost all common law jurisdictions as an exception to the autonomy principle.<sup>160</sup> Additionally, it has been regarded as being in line with the domestic banking law with respect to the bank's duty of care as to its customer when proceeding to payment. It should be, further, noted that, by this formulation, it is irrelevant whether the beneficiary has knowledge of the fraud, considering that it is the relationship between the bank and the applicant that is pertinent, not the origin of the fraud. As such, the implied term approach has been consistently rejected by the subsequent jurisprudence.<sup>161</sup> Most remarkably, in *Montrod Ltd v Grundkotter Fleischvertriebs GmbH*,<sup>162</sup> the court stated that "the fraud exception to the autonomy principle recognized in English law ... should remain based upon, the fraud or knowledge of fraud on the part of the beneficiary",<sup>163</sup> thus, rejecting the implied term approach that requires no such awareness.<sup>164</sup> In any case, the problem of fraud and its adulteration of financial systems guarantees that it cannot be regarded as solely an issue of private right. The law has its own interest in suppressing fraud.<sup>165</sup>

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<sup>158</sup> *Ibid* 207.

<sup>159</sup> Felicity Monteiro, 'Documentary Credits: The Autonomy Principle and the Fraud Exception: A Comparative Analysis of Common Law Approaches and Suggestions for New Zealand' (2007) 13 *Auckland U L Rev* 144, 151.

<sup>160</sup> M. G. Bridge, *The International Sale of Goods* (3<sup>rd</sup> edn, Oxford University Press 2013) 303.

<sup>161</sup> Felicity Monteiro, 'Documentary Credits: The Autonomy Principle and the Fraud Exception: A Comparative Analysis of Common Law Approaches and Suggestions for New Zealand' (2007) 13 *Auckland U L Rev* 144, 151.

<sup>162</sup> *Montrod Ltd v Grundkotter Fleischvertriebs GmbH* [2002] 1 *WLR* 1975.

<sup>163</sup> *Ibid* 1991.

<sup>164</sup> Felicity Monteiro, 'Documentary Credits: The Autonomy Principle and the Fraud Exception: A Comparative Analysis of Common Law Approaches and Suggestions for New Zealand' (2007) 13 *Auckland U L Rev* 144, 152.

<sup>165</sup> M. G. Bridge, *The International Sale of Goods* (3<sup>rd</sup> edn, Oxford University Press 2013) 303.

## **2.6 International Legal Instruments and the Fraud Exception**

### **2.6.1 The UCP Rules**

The Uniform Customs and Practice for Documentary Credits, currently UCP 600, has traditionally maintained an absolute silent attitude as to the issue of fraud and the fraud exception rule, deferring the regulation of said matters to the national jurisdiction of states and under national law.<sup>166</sup> This position has been rationalized on the grounds that the UCP rules constitute “rules of best banking practice, not rules of law...”, whereas fraud is traditionally regarded as “the province of the applicable law of the courts of the forum ...”.<sup>167</sup> Therefore, it is apparent that, while the drafters of the UCP are plainly aware of the fraud problem,<sup>168</sup> they have intentionally omitted its regulation from the UCP provisions.<sup>169</sup> Many scholars have applauded this passive approach on the basis that any attempt by the ICC to develop a uniform fraud rule is not only redundant but, further, most likely to fail, considering the sensitivity of the fraud rule to various national laws and the diverse national approaches to it. They, further, maintain that said approach motivates national jurisdictions to regulate the issue in a commercially favorable manner, not detrimental to the market position of the letters of credit as a medium of financing international trade.<sup>170</sup>

Nonetheless, the UCP’s silent position has not escaped criticism. It is argued that the virtually universal application of the UCP rules and general success have elevated them to *de facto* law,<sup>171</sup> thus, bringing about the necessity of providing security and predictability to the trading community so as to promote commerce, a quality found in every “good” commercial law. By leaving the issue of fraud as to the documentary

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<sup>166</sup> Ross P Buckley and Xiang Gao, ‘The Development of the Fraud Rule in the Letter of Credit Law: The Journey So Far and the Road Ahead’ (2002) 23 U Pa J Int’l Econ L 663, 700.

<sup>167</sup> Roy Goode, ‘Abstract Payment Undertakings and the Rules of the International Chamber of Commerce’ (1995) 39 St Louis U L J 725, 727.

<sup>168</sup> John F Dolan, ‘Commentary on Legislative Developments in Letter of Credit Law: An Interim Report’ (1993) 8 Banking & Fin L Rev 53, 63.

<sup>169</sup> Ross P Buckley and Xiang Gao, ‘The Development of the Fraud Rule in the Letter of Credit Law: The Journey So Far and the Road Ahead’ (2002) 23 U Pa J Int’l Econ L 663, 700.

<sup>170</sup> John F Dolan, ‘Commentary on Legislative Developments in Letter of Credit Law: An Interim Report’ (1993) 8 Banking & Fin L Rev 53, 63.

<sup>171</sup> Ross P Buckley, ‘The 1993 Revision of the Uniform Customs and Practice for Documentary Credits’ (1995) 28 Geo Wash J Int’l L & Econ 265, 267-268.

letters of credit to be dealt with exclusively under the non-harmonized, thus, differing, even sometimes vague, national approaches, the UCP rules, conversely, enhance the ever existing uncertainty encountered by those involved in international trade. Moreover, the ICC's experience and expertise in the field of documentary letters of credit, especially when compared to the national judges that are called upon to regulate the issue,<sup>172</sup> defines it as the most appropriate body to provide guidance as to the fraud in the area of documentary credits.<sup>173</sup> When left to the national courts to formulate the relevant rules, the lack of a commercial background or relevant experience may lead to detrimental results as to the efficacy and commercial utility of documentary letters of credit. Consequently, due to the proliferation of fraudulent practices, the call for pertinent regulation by the UCP rules has escalated over the years.<sup>174</sup>

#### *2.6.2 The UNCITRAL Convention on Independent Guarantees and Standby Letters of Credit*

As opposed to the UCP rules, the UNCITRAL Convention on Independent Guarantees and Standby Letters of Credit strived to tackle the issue of fraud in the relevant field, constituting the first such international attempt.<sup>175</sup> Although its scope is restricted to international standby letters of credit and independent guarantees, it may, further, apply to international commercial letters of credit, as a matter of choice, if it is expressly stipulated in the latter.<sup>176</sup> Otherwise, its application is generally dependent on the existence of a requisite link to a contracting State.<sup>177</sup> Notwithstanding that the convention omitted the use of the term fraud from its text, primarily by reason of preventing the confusion generated by the various interpretations of the word found

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<sup>172</sup> Ross P Buckley and Xiang Gao, 'The Development of the Fraud Rule in the Letter of Credit Law: The Journey So Far and the Road Ahead' (2002) 23 U Pa J Int'l Econ L 663, 701.

<sup>173</sup> Xiang Gao and Ross P Buckley, "A Comparative Analysis of the Standard of Fraud Required Under the Fraud Rule in Letter of Credit Law" (2003) 13 Duke J Comp & Int'l L 293, 335.

<sup>174</sup> Ross P Buckley and Xiang Gao, 'The Development of the Fraud Rule in the Letter of Credit Law: The Journey So Far and the Road Ahead' (2002) 23 U Pa J Int'l Econ L 663, 701-702.

<sup>175</sup> Ibid 710.

<sup>176</sup> United Nations Commission on International Trade Law, 'United Nations Convention on Independent Guarantees and Standby Letters of Credit' (1995) art 1(2).

<sup>177</sup> Ibid art 1(1); namely, either the place of business of the guarantor/issuer at which the undertaking is issued must be in a contracting State, or the rules of private international law lead to the application of the law of a contracting State.

in different jurisdictions,<sup>178</sup> it condensed the majority of the aspects with regard to the fraud exception rule as developed, over time, under the national judicial or legislative systems.<sup>179</sup>

In particular, Article 19(1) entitles the guarantor/issuer, when in good faith, to restrain payment against the beneficiary where it is “manifest and clear” that (a) any document is false, or (b) payment is not due, or (c) “judging by the type and purpose of the undertaking, the demand has no conceivable basis”.<sup>180</sup> Article 19(2) in four subparagraphs clarifies, by way of illustrative practical examples, the meaning of “no conceivable basis”; including, for instance, the beneficiary’s “wilful misconduct” in preventing the underlying obligation’s fulfilment.<sup>181</sup> Additionally, Article 20 stipulates the provisional court measures and respective conditions that can be pursued by the applicant, when having “immediately available strong evidence” as to the “high probability” of the existence of one of the circumstances under Article 19(1).<sup>182</sup>

Accordingly, the Convention provides elaborate and useful guidelines to both the letters of credit users and the courts.<sup>183</sup> It enumerates the types of misconduct capable of evoking the application of the fraud rule;<sup>184</sup> stipulates the kind of measures the victims of fraud may seek, namely the issuer’s rejection of the presentation,<sup>185</sup> and the applicant’s right to a court injunction restraining payment by the issuer;<sup>186</sup> denotes the standard of proof required, namely “manifest and clear”<sup>187</sup> fraud by way of “immediately available strong evidence”;<sup>188</sup> indicates that the fraud rule applies to

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<sup>178</sup> Xiang Gao, *The Fraud Rule in the Law of Letters of Credit: A Comparative Study* (The Hague: Kluwer Law International 2002) 126.

<sup>179</sup> Ross P Buckley and Xiang Gao, ‘The Development of the Fraud Rule in the Letter of Credit Law: The Journey So Far and the Road Ahead’ (2002) 23 U Pa J Int’l Econ L 663, 709-710.

<sup>180</sup> United Nations Commission on International Trade Law, ‘United Nations Convention on Independent Guarantees and Standby Letters of Credit’ (1995) art 19(1).

<sup>181</sup> *Ibid* art 19(2).

<sup>182</sup> *Ibid* art 20.

<sup>183</sup> Ross P Buckley and Xiang Gao, ‘The Development of the Fraud Rule in the Letter of Credit Law: The Journey So Far and the Road Ahead’ (2002) 23 U Pa J Int’l Econ L 663, 710.

<sup>184</sup> United Nations Commission on International Trade Law, ‘United Nations Convention on Independent Guarantees and Standby Letters of Credit’ (1995) art 19(1).

<sup>185</sup> *Ibid*.

<sup>186</sup> *Ibid* art 19(3).

<sup>187</sup> *Ibid* art 19(1).

<sup>188</sup> *Ibid* art 20(1).

both fraud manifested in the documents, and fraud solely evidenced in the underlying transaction;<sup>189</sup> and, finally, administers necessary guidance to courts as to the application of the fraud rule.<sup>190</sup>

Nevertheless, from a critical perspective, it fails to identify the parties that should be immune to the fraud rule, a crucial issue for the protection of innocent third parties. Most importantly, the limited scope of application of the Convention, as designed to directly regulate only standby letters of credit and independent guarantees, diminishes its sphere of influence as to the fraud rule in the area of commercial letters of credit.<sup>191</sup> This is, further, illustrated by the fact that so far the Convention has entered into force in only eight states, not including major international trade players and letter of credit users, such as the United Kingdom, Canada or the United States; although the latter is a signatory since 1997.<sup>192</sup> Nonetheless, it is considered a positive and encouraging development with regard to regulating the fraud rule at an international level.<sup>193</sup>

### **3. Other Recognized Exceptions to the Autonomy Principle**

#### ***3.1 The Nullity Exception***

##### *3.1.1 Definition*

Contrary to the fraud exception rule, the matter of documentary nullities may only arise in those cases where the beneficiary lacks all pertinent knowledge as to the null nature of the apparently conforming, tendered document. Notwithstanding that documentary nullities surely contain false data and may be forged, merely the fact that the presented document encompasses a false statement, even of material fact, or has

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<sup>189</sup> Ibid art 19(1)(a) & (c).

<sup>190</sup> Ibid art 20.

<sup>191</sup> Ross P Buckley and Xiang Gao, 'The Development of the Fraud Rule in the Letter of Credit Law: The Journey So Far and the Road Ahead' (2002) 23 U Pa J Int'l Econ L 663, 710.

<sup>192</sup> UNCITRAL, 'Status; United Nations Convention on Independent Guarantees and Stand-by Letters of Credit (New York, 1995) <[http://www.uncitral.org/uncitral/en/uncitral\\_texts/payments/1995Convention\\_guarantees\\_status.html](http://www.uncitral.org/uncitral/en/uncitral_texts/payments/1995Convention_guarantees_status.html)> last accessed 15 February 2018.

<sup>193</sup> Ross P Buckley and Xiang Gao, 'The Development of the Fraud Rule in the Letter of Credit Law: The Journey So Far and the Road Ahead' (2002) 23 U Pa J Int'l Econ L 663, 710.

been forged, does not suffice for its characterization as a nullity.<sup>194</sup> Accordingly, Lord Diplock in *United City Merchants*<sup>195</sup> interpreted the documentary nullity as lacking legal effect, due to the falsity contained within, and distinguished between forged documents that constitute nullities and forged documents that do not. The backdated bill of lading, although forged as to a material fact, was held to belong in the latter category as it still performed all functions as bill of lading; namely, as a receipt, a document of title to the goods and as evidence of the terms of the contract of carriage; thus, was deemed as “far from nullity”.<sup>196</sup> In that regard, various scholars have suggested possible definitions, concentrating primarily on whether the falsity contained eliminates “the whole or essence of the instrument”.<sup>197</sup> Such an approach is in line with Lord Diplock’s judgement with respect to a simply misdated bill of lading,<sup>198</sup> as it defines nullity in restrictive terms, requiring, for the application of the nullity exception, documents that amount to worthless paper.

### 3.1.2 Legal Recognition

Although Lord Diplock chose not to comment on the bank’s obligation to pay against documents that constitute nullities, leaving the issue open for resolution,<sup>199</sup> Potter LJ in *Montrod Ltd v Guundk Otter Fleischvertriebs GmbH*,<sup>200</sup> rejected the recognition of a general nullity exception under English law on the basis of “sound policy reasons”;<sup>201</sup> the latter will be analysed under the subsequent section. The *Montrod* case concerned an inspection certificate that, although, under the terms of the credit, was supposed to be signed by *Montrod*, a third party as to the underlying contract, liable to reimburse the issuing bank if payment was made under the credit; it was ultimately signed by the seller on behalf of *Montrod*, acting in good faith, as he was persuaded by the buyer that he was entitled to proceed to said action. The court held that, where there is no

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<sup>194</sup> M. G. Bridge, *The International Sale of Goods* (3<sup>rd</sup> edn, Oxford University Press 2013) 298-298-299.

<sup>195</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada* [1983] 1 AC 168 (HL).

<sup>196</sup> *Ibid* 187.

<sup>197</sup> Ali Malek and David Quest, *Jack: Documentary Credits* (4<sup>th</sup> edn, Tottel Publishing 2009) 250.

<sup>198</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada* [1983] 1 AC 168 (HL), 187.

<sup>199</sup> *Ibid*.

<sup>200</sup> *Montrod Ltd v Guundk Otter Fleischvertriebs GmbH* [2002] 1 WLR 1975.

<sup>201</sup> *Ibid* 1992.

fraud, the exception to the autonomy principle does not extend to encompass cases of nullity, as no such exception should be recognized.

Contrary to the English position, the Singapore courts have recognized and successfully applied the nullity exception in *Beam Technologies v Standard Chartered Bank*.<sup>202</sup> In this case, according to the terms of the credit that was subject to the UCP 500, payment was to be made against presentation of air waybills issued by freight forwarders, Link Express (S) Pte Ltd. Nevertheless, the confirming bank was subsequently notified that there was no such entity as Link Express (S) Pte Ltd and, accordingly, rejected the tendered air waybills as forgeries. The Singapore Court of Appeal differentiated between the *Montrod* case, as concerning merely an unauthorized document, and the case at hand that concerned a true documentary nullity. Such a forged document does not constitute a complying one, but rather equals a blank piece of paper; thus, the confirming bank was entitled to reject the documentary presentation. The scope of the nullity exception, as formulated under the case, is a limited one, requiring the bank to have established within the seven-day period, provided for the examination of the documents under the UCP 500, that a material document required under the credit is forged and null and void, while relevant notice has been given to the beneficiary within the same time limit.<sup>203</sup>

### *3.1.3 Arguments Against the Recognition of a General Nullity Exception*

Uncertainty and lack of clarity generated by the difficulty in formulating a precise nullity definition constitute the foundational basis for the rejection of the nullity exception.<sup>204</sup> Accordingly, Potter LJ, in *Montrod*, assessed that a general nullity exception was not “susceptible of precision”, thus, “making undesirable inroads into the principle of autonomy”.<sup>205</sup> This argument was discarded in *Beam Technologies* on the grounds that, although an explicit general nullity definition is indeed infeasible, it is

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<sup>202</sup> *Beam Technologies v Standard Chartered Bank* [2003] 1 SLR 597.

<sup>203</sup> *Ibid* par 36.

<sup>204</sup> Eliahu Peter Ellinger and Dora Neo, *The Law and Practice of Documentary Letters of Credit* (Hart Publishing 2010) 173.

<sup>205</sup> *Montrod Ltd v Guundk Otter Fleischvertriebs GmbH* [2002] 1 WLR 1975, 1992.

common practice for the courts to determine what is reasonable in each case.<sup>206</sup> Moreover, this exercise may be facilitated by way of adopting the restricted approach towards the defining of a nullity,<sup>207</sup> limiting the exception to documents that amount to mere scraps of paper. Taking as a point of reference Lord Diplock's assertion with regard to a merely misdated bill of lading,<sup>208</sup> the determination of whether a document still performs the functions associated with it, can be perceived as a useful guideline in that regard. Accordingly, an inspection certificate signed by the wrong person in honest error as to his authority, as was the case in *Montrod*,<sup>209</sup> may still be regarded as performing its function as an inspection certificate in appropriate cases. On the contrary, a forged bill of lading, issued by a non-existing entity,<sup>210</sup> or referring to a non-existent shipment is no more than a worthless piece of paper as it embodies none of the functions associated with a genuine bill of lading; similarly, an insurance certificate incorporating the terms of a non-existent policy.

Potter LJ, further argued that the introduction of such an exception "would place banks in a further dilemma as to the necessity to investigate facts which they are not competent to do and from which UCP 500 is plainly concerned to exempt them".<sup>211</sup> The same applies as to the UCP 600.<sup>212</sup> Nevertheless, under the nullity exception, as recognized and applied in Singapore, the bank must have clear knowledge of the documentary nullity before payment is made. The bank itself is by no means required to investigate into the tendered documents.<sup>213</sup> In cases where payment is made with due care, the bank is entitled to reimbursement, even if it failed to detect the documentary nullities;<sup>214</sup> but that cannot necessarily mean that it had a duty to pay in the first place against tendered documents that it clearly knew to be nullities. In any case, there appears to be no valid reason to differentiate the position of the bank

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<sup>206</sup> *Beam Technologies v Standard Chartered Bank* [2003] 1 SLR 597, par 36.

<sup>207</sup> Ali Malek and David Quest, *Jack: Documentary Credits* (4<sup>th</sup> edn, Tottel Publishing 2009) 250.

<sup>208</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada* [1983] 1 AC 168 (HL), 187.

<sup>209</sup> *Montrod Ltd v Guundk Otter Fleischvertriebs GmbH* [2002] 1 WLR 1975.

<sup>210</sup> *Beam Technologies v Standard Chartered Bank* [2003] 1 SLR 597.

<sup>211</sup> *Montrod Ltd v Guundk Otter Fleischvertriebs GmbH* [2002] 1 WLR 1975, 1992.

<sup>212</sup> International Chamber of Commerce, 'Uniform Customs and Practice for Documentary Credits (UCP) 600' (2006) art 34.

<sup>213</sup> *Beam Technologies v Standard Chartered Bank* [2003] 1 SLR 597, par 34.

<sup>214</sup> International Chamber of Commerce, 'Uniform Customs and Practice for Documentary Credits (UCP) 600' (2006) art 14(a) & 34.

towards facts extraneous to the documents under the nullity exception and the recognized fraud rule.<sup>215</sup>

An additional argument raised by Potter LJ concerned the unfairness that such an exception is likely to entail as to the “beneficiaries participating in a chain of contracts in cases where their good faith is not in question”.<sup>216</sup> Where the documentary nullity does not preclude the bank from making payment, it is the buyer that will bear the loss by repaying the bank. Conversely, where the nullity hinders payment, the loss will be incurred by the seller. Accordingly, such a reasoning seems weak in principle as either way will be unfairly detrimental to the other party. Nonetheless, it has been argued that, considering that the function of the letter of credit is to provide the beneficiary with an assurance of payment, all pertinent risks ought to be assumed by the buyer. Otherwise, confidence in the documentary credit system as medium of financing international trade will be undermined.<sup>217</sup> However, such a statement may be refuted on the grounds that, as between innocent parties; namely, the beneficiary the applicant and the banks, “the risk is to be taken by the beneficiary as banks trust the beneficiary to present honest documents”.<sup>218</sup> The tender of genuine documents constitutes an implied contractual obligation under the letter of credit contract. It is the seller’s duty to be careful and vigilant as to the tendered documents, especially when produced by third parties, so that, in turn, the documents, when apparently conforming, can be safely presumed as genuine. As such, the position of the innocent beneficiary may not be equated to that of a holder in due course.<sup>219</sup> It is, further, argued that the beneficiary is the only party in a position to verify the validity of the documents issued by third parties.<sup>220</sup> The presentation of a void ab initio document, even when in good faith, constitutes a breach of said duty, justifying the ensuing loss if payment is prevented.

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<sup>215</sup> Nelson Enonchong, *The Independence Principle of Letters of Credit and Demand Guarantees* (Oxford University Press 2011) 153.

<sup>216</sup> *Montrod Ltd v Guundk Otter Fleischvertriebs GmbH* [2002] 1 WLR 1975, 1992.

<sup>217</sup> Kieran Donnelly, ‘Nothing for nothing: A Nullity Exception in Letters of Credit?’ (2008) 4 J Bus L 316, 317.

<sup>218</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada* [1982] QB 208 (CA), 246.

<sup>219</sup> Roy Goode, “Reflections on Letters of Credit – I” [1980] J Bus Law 291, 294.

<sup>220</sup> Kieran Donnelly, ‘Nothing for Nothing: A Nullity Exception in Letters of Credit?’ (2008) 4 J Bus L 316, 318.

### 3.1.4 Arguments in Favor of Recognizing a General Nullity Exception

In principle, the beneficiary's payment entitlement is solely contingent on a strictly complying documentary tender.<sup>221</sup> Nonetheless, it has been argued that documentary nullities, when amounting to valueless pieces of paper, conferring no rights of any kind, "cannot by any stretch of imagination be described as conforming to the credit, ... as such a proposition extends the autonomy of a credit ad absurdum and reduces letter of credit law to a mockery".<sup>222</sup> Such documents constitute a violation of the implied term under the letter of credit contract that the documents presented must be genuine. A breach of such an essential obligation gives rise to the bank's entitlement to dishonor its duty to pay under the credit. The purpose of the rule whereby the bank is obliged to pay against an on its face complying documentary presentation, determined as such with reasonable care, is to protect the banks that, despite displaying due care, failed to identify the falsity.<sup>223</sup> This is based on the assumption that the apparently conforming documents are indeed true and genuine. However, when there is conclusive and timely evidence to the contrary, refuting this assumption, the documents cannot be deemed as conforming, thus, preventing the bank from making payment. Accordingly, to accept that the beneficiaries have a right to payment against documentary nullities extends to the latter a benefit designed exclusively to protect the banks as intermediaries, having a purely mechanical role.<sup>224</sup> In that regard, the materiality of the document, an abstract concept in and of itself, appears to be an unnecessary requirement found in *Beam Technologies v Standard Chartered Bank*.<sup>225</sup> If any of the documents requested under the credit constitutes a nullity, hence, is non-complying, the bank should have the right to reject the pertinent presentation. Insofar as a minor discrepancy is sufficient to enjoin payment, so is a seemingly menial, void

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<sup>221</sup> Eliahu Peter Ellinger and Dora Neo, *The Law and Practice of Documentary Letters of Credit* (Hart Publishing 2010) 172.

<sup>222</sup> Peter Cane and Jane Stapleton (ed), *Essays for Patrick Atiyah* (Oxford University Press 1991) 231.

<sup>223</sup> International Chamber of Commerce, 'Uniform Customs and Practice for Documentary Credits (UCP) 600' (2006) art 14(a) & 34.

<sup>224</sup> Roy Goode, *Commercial Law* (3<sup>rd</sup> edn, Penguin UK 2004) 996.

<sup>225</sup> *Beam Technologies v Standard Chartered Bank* [2003] 1 SLR 597.

ab initio document.<sup>226</sup>

Moreover, the tendered documents that constitute documents of title, act as security for the bank against the possibility of the applicant's non-payment or insolvency.<sup>227</sup> Additionally, under the letter of credit, the buyer trusts that he is provided with assurance as to the contracted goods and the seller's performance of the underlying contract, in the form of the relative documents of title, as well as the other documentary requirements under the credit.<sup>228</sup> As such, it is irrational to oblige a bank that has timely and clear knowledge of the documentary nullity, to consciously proceed to payment against documents that to its knowledge are worthless and, thus provide neither security to the bank, nor assurance of proper performance to the buyer.<sup>229</sup> The innocent beneficiary's protection should not be pursued to the detriment of the bank's security interests. It is, further, argued that the recognition of a general nullity exception enhances the integrity of the letter of credit and banking system as it prevents the circulation of null documents within letter of credit transactions.<sup>230</sup> Conversely, the rejection of a nullity defense to payment may be regarded as a policy of tolerance with respect to said circulation. Trust constitutes the foundational basis of international trade. There should be mechanisms that guarantee that commercial parties are able to transact with confidence and certainty. Therefore, there is a strong case for recognizing a general nullity exception that defines nullity in a restrictive manner, encompassing sham pieces of paper, as opposed to merely unauthorized documents and documents comprising misstatements.<sup>231</sup>

### **3.2 Unconscionability**

While a precise definition is elusive, primarily by reason of its amorphous nature;

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<sup>226</sup> Deborah Horowitz, *Letters of Credit and Demand Guarantees: Defences to Payment* (Oxford University Press 2010) 56.

<sup>227</sup> Dora Neo, 'A Nullity Exception in Letter of Credit Transactions?' [2004] *Sing J Legal Stud* 46, 60.

<sup>228</sup> Eliahu Peter Ellinger, 'Documentary Credits and Fraudulent Documents' [1983] *Sing Int'l Bus L Series* 185, 189.

<sup>229</sup> Eliahu Peter Ellinger and Dora Neo, *The Law and Practice of Documentary Letters of Credit* (Hart Publishing 2010) 170.

<sup>230</sup> Tareq Al-Tawil, 'Letters of Credit and Contract of Sale: Autonomy and Fraud' (2013) *16 Int'l Trade & Bus L Rec* 159, 196.

<sup>231</sup> M. G. Bridge, *The International Sale of Goods* (3<sup>rd</sup> edn, Oxford University Press 2013) 300.

unconscionability, is generally accepted as referring to circumstances where the beneficiary's claim to draw under the letter of credit or bank guarantee is so tainted with bad faith and unfairness, that a court in equity would prevent the bank from making payment, in absence of fraud or forgery.<sup>232</sup> Under Singaporean law, the concept of unconscionability as defence against payment was initially, implicitly introduced in *Royal Design Studio Pte Ltd v Chang Development Pte Ltd*,<sup>233</sup> where an injunction was granted, restraining payment, on the grounds that the beneficiary's call for payment under the performance bond was based on delays in construction generated by their own default in failing to adhere to certain terms of the underlying contract.<sup>234</sup> Nevertheless, unconscionability, as a separate exception to the autonomy principle in addition to the fraud rule, was explicitly recognized in *Dauphin Offshore Engineering & Trading Pte Ltd v The Private Office of HRH Sheikh Sultan bin Khalifa bin Zayed Al Nahyan*.<sup>235</sup> The case concerned a bank guarantee for the repayment of the first instalment in case of default under a contract for the construction of a yacht, payable in instalments. On the facts, the call on the guarantee was held as not unconscionable, as it was based on a repudiatory contractual breach. Nonetheless, the Court expressly held that the beneficiary's unconscionable conduct within the context of the underlying contract may constitute valid ground for the granting of injunctive relief against payment, if strong prima facie evidence of unconscionability is provided.<sup>236</sup> It, further, underlined that, other than the general indicator of lack of bona fides, unconscionability should be determined on a case by case basis, as

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<sup>232</sup> Eliahu Peter Ellinger and Dora Neo, *The Law and Practice of Documentary Letters of Credit* (Hart Publishing 2010) 169.

<sup>233</sup> *Royal Design Studio Pte Ltd v Chang Development Pte Ltd* [1990] 1 SLR 1116.

<sup>234</sup> See also *Kvaerner Singapore Ltd v UDL Shipbuilding (Singapore) Pte Ltd* [1993] 3 SLR 350, where an injunction was granted, restraining payment as to the beneficiary whose call on the performance bond was based on a breach induced by their own default.

<sup>235</sup> *Dauphin Offshore Engineering & Trading Pte Ltd v The Private Office of HRH Sheikh Sultan bin Khalifa bin Zayed Al Nahyan* [2000] 1 SLR 657. An earlier case that addressed the issue in explicit terms was *Bocotra Construction Pte Ltd v Attorney General (No 2)* [1995] 2 SLR 733, 747. The court expressed the view that, in general, the sole considerations with regard to the granting of an interlocutory injunction restraining payment under a bank guarantee are either fraud or unconscionability.

<sup>236</sup> *Ibid* 672; see also, *GHL Pte Ltd v Unitrack Building Construction Pte Ltd & Anor* [1999] 4 SLR 604, 614-616; note, however, that in the previous case of *Bocotra Construction Pte Ltd v Attorney General (No 2)* [1995] 2 SLR 733, 744 the Court required the establishment of a "clear case" of unconscionability, as "a high degree of strictness applies", whereas a "mere allegation is not enough".

opposed to developing an overall definition.<sup>237</sup>

This vagueness as to the concept of unconscionability constitutes the pivotal element that makes it an undesirable notion in an area of law where clarity and certainty are of the utmost value.<sup>238</sup> Similarly to the nullity exception, the scope of such concepts should be explicitly confined, so that their application not to depend solely on the discretionary power of courts and, thus, possibly allow unacceptable inroads into the autonomy principle. With respect to the nebulous unconscionability concept, however, any attempt at an explicit restriction, other than general indicators, is inherently infeasible. Additionally, the Singapore example has evidenced that the recognition of such an exception, being intrinsically vague and insufficiently defined, will undoubtedly lead to a high number of legal claims against the beneficiary's right to payment under the credit,<sup>239</sup> delaying the latter, thus, eroding the attractiveness of documentary credits as a speedy and secure financing tool that has been equated to "cash in hand".<sup>240</sup>

Based on the relevant jurisprudence,<sup>241</sup> the main area of application as to the unconscionability exception comprises of demand guarantees, as opposed to commercial letters of credit. Although both autonomous in nature, the primary function of commercial letters of credit is that of a medium of payment as to the

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<sup>237</sup> See also *Hiap Tian Soon Construction Pte Ltd v Hola Development Pte Ltd* [2003] 1 SLR 667.

<sup>238</sup> Nelson Enonchong, *The Independence Principle of Letters of Credit and Demand Guarantees* (Oxford University Press 2011) 170.

<sup>239</sup> *Dauphin Offshore Engineering & Trading Pte Ltd v The Private Office of HRH Sheikh Sultan bin Khalifa bin Zayed Al Nahyan* [2000] 1 SLR 657; *Electro International Pte Ltd v CGH Development Pte Ltd* [2000] SGCA 51; *Samwoh Asphalt Premix Pte Ltd v Sum Cheong Piling Pte Ltd* [2001] SGCA 79; *McConnell Dowell Constructors (Aust) Pty Ltd v Sembcorp Engineers and Constructors Pte Ltd* [2002] 1 SLR 199; *Anvar v Teo Hee Lai Building Construction Pte Ltd* [2002] SGCA 51; *JBE Properties Pte Ltd v Gammon Pte Ltd* [2010] SGCA 46.

<sup>240</sup> *Power Curber International Ltd v National Bank of Kuwait SAK* [1981] 1 WLR 1233, 1241; [1981] 3 All ER 607, 612.

<sup>241</sup> *Royal Design Studio Pte Ltd v Chang Development Pte Ltd* [1990] 1 SLR 1116; *Kvaerner Singapore Ltd v UDL Shipbuilding (Singapore) Pte Ltd* [1993] 3 SLR 350; *Bocotra Construction Pte Ltd v Attorney General (No 2)* [1995] 2 SLR 733; *Min Thai Holdings Pte Ltd v Sunlabel Pte Ltd* [1999] 2 SLR 368; *GHL Pte Ltd v Unitrack Building Construction Pte Ltd & Anor* [1999] 4 SLR 604; *Dauphin Offshore Engineering & Trading Pte Ltd v The Private Office of HRH Sheikh Sultan bin Khalifa bin Zayed Al Nahyan* [2000] 1 SLR 657; *Hiap Tian Soon Construction Pte Ltd v Hola Development Pte Ltd* [2003] 1 SLR 667; *JBE Properties Pte Ltd v Gammon Pte Ltd* [2010] SGCA 46.

contract price; whereas demand guarantees basically constitute securities for the performance of the underlying contract, thus, their payment obligation is secondary or collateral to said contract.<sup>242</sup> Considering that in the case of demand guarantees the bank is called upon to pay only if the principal defaults on the underlying contract, the issue of unfair or unconscionable calls is peculiar to these commercial devices and, thus, should not be subject to the same rules as commercial letter of credit, where it is set from the outset that the bank constitutes the first port of call for payment. Accordingly, an unconscionability exception recognized as to demand guarantees should not automatically and without relevant justification, be considered as applying to commercial letters of credit.

Most notably, unconscionability relates solely to the beneficiary's conduct as to the performance of the underlying contract, whereas it is a fundamental principle of letter of credit law that banks only deal with documents.<sup>243</sup> Contrary to the narrow fraud and nullity rules, where some falsity exists in the documents, even as apparently complying, unconscionability solely relates to purely contractual issues as between the buyer and the seller. Although recourse to the circumstances surrounding the underlying transaction is an intrinsic aspect of an exception to the autonomy principle, to the extent that there is no element of defect contained in the complying documents, justifying said recourse, it seems that such an exception takes matters too far, utterly destroying these independent commercial devices.

### **3.3 The Illegality Exception**

Illegality may arise by virtue of either a breach of a statutory prohibition, or a public policy infringement.<sup>244</sup> Within the framework of documentary letters of credit, insofar as it solely relates to the underlying transaction, as opposed to the relevant letter of credit contract, it is ambivalent whether said illegality overrides the bank's obligation

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<sup>242</sup> Roy Goode and Herbert Kronke and Ewan McKendrick, *Transnational Commercial Law; Texts, Cases and Materials* (2<sup>nd</sup> edn, Oxford University Press 2015) 326-327.

<sup>243</sup> International Chamber of Commerce, 'Uniform Customs and Practice for Documentary Credits (UCP) 600' (2006) art 5.

<sup>244</sup> Alavi Hamed, 'Illegality as an Exception to Principle of Autonomy in Documentary Letters of Credit: A Comparative Approach' (2016) 20 *Kor U L Rev* 3, 7.

to pay under the autonomous credit transaction.<sup>245</sup> Under English law, the issue was considered at length in *Mahonia Ltd v JP Morgan Chase Bank*.<sup>246</sup> The case concerned a letter of credit, issued on the request of Enron Corporation and in favour of Mahonia, that acted as security in relation to the underlying contract. Upon presentation of conforming documents, following Enron's default, the issuing bank refused to pay Mahonia on the grounds that the underlying contract, a series of swaps transactions, provided Enron, with a disguised loan, allowing the latter to improperly manipulate his accounts in violation of U.S. securities laws. Notwithstanding that, no illegality was found as to the underlying transaction, Cooke J, the trial judge, on a hypothetical basis, commented that, based on the *ex turpi causa non oritur actio maxim*, or "no action arises from an unworthy cause" and under certain circumstances; namely, a clearly established, serious case of illegality, as well as the beneficiary's intention or knowledge thereof, the underlying contract's illegality may taint the letter of credit, being used to carry out an illegal transaction, and thereby render it unenforceable, despite its autonomous nature.<sup>247</sup> Consequently, the enforceability of the illegality exception is a matter of degree, contingent on the extent to which a letter of credit is connected to and, thus, tainted by the underlying transaction.<sup>248</sup>

Although the English jurisprudence indicates an inclination towards the recognition of an illegality exception,<sup>249</sup> the relevant statements merely constitute *obiter dicta*, as

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<sup>245</sup> M. G. Bridge, *The International Sale of Goods* (3<sup>rd</sup> edn, Oxford University Press 2013) 300.

<sup>246</sup> *Mahonia Ltd v JP Morgan Chase Bank (No 2)* [2004] EWHC 1938 (Comm); An earlier case where the issue arose was *Group Josi Re v Walbrook Insurance Co Ltd* [1996] 1 WLR 1152 (CA). Although, on the relevant facts, the underlying reinsurance contracts were found as not illegal, Staughton LJ accepted that a letter of credit could be tainted by an illegal underlying transaction; thus, a court could restrain payment as the documentary credit was conditional payment under, and would have been used to carry out, an illegal transaction. Illegal shipments of arms to Iraq was cited as an example.

<sup>247</sup> Note that, under English law, the preponderant view is that an illegal contract is regarded as unenforceable, as opposed to void or voidable; see, for instance, *Cleaver v Mutual Reserve Fund Life Association* [1892] 1 QB 147, 152; *Bennett v Bennett* [1952] 1 KB 249, 260; *Pau On v Lau Yiu Long* [1980] AC 614, 634-635; *O'Sullivan v Management Agency & Music Ltd* [1985] QB 428, 447, 448, 469; thus, the court will refuse to assist in their enforcement; see, for instance, *Marles v Philip Tram & Sons* [1954] 1 QB 29, 38; *Tinsley v Milligan* [1993] 3 All ER 65, 82, 85.

<sup>248</sup> M. G. Bridge, *The International Sale of Goods* (3<sup>rd</sup> edn, Oxford University Press 2013) 301.

<sup>249</sup> *Group Josi Re v Walbrook Insurance Co Ltd* [1996] 1 WLR 1152 (CA); *Mahonia Ltd v JP Morgan Chase Bank (No 2)* [2004] EWHC 1938 (Comm); *Oliver and Anor v Dubai Bank of Kenya* [2007] EWHC 2165 (Comm); *Lancore Services Ltd v Barclays Bank Plc* [2008] EWHC 1264.

opposed to *ratio decidendi*.<sup>250</sup> Additionally, none of the pertinent cases concerned commercial letter of credit, but rather referred to standby ones.<sup>251</sup> Those concepts have significant differences, thus, should not be used interchangeably. Both instruments are subjected to the autonomy principle; notwithstanding, standby letters of credit and demand guarantees, insofar as their primary context of use is to coax the other party into performance of his obligations under the underlying contract, may be considered as “less independent”, being more closely linked to said contract.<sup>252</sup> Accordingly, the argument that the illegality exception, a concept dependent on the degree of connection between the commercial instrument and the underlying contract, should apply to commercial letters of credit in a similar manner as to standby ones, without regard as to their fundamental differences, is an arbitrary one, lacking validity.<sup>253</sup>

Moreover, considering that the interests affected by illegality are public ones, as the parties are benefiting at the cost of society, it has been argued that it would be more appropriate, not to mention effective, for said interests to be protected by statute. A statute prohibiting the illegal transaction itself, and/or its financing, irrespective of the latter’s method, constitutes a much more efficient medium of protection than a general, poorly defined and highly controversial illegality exception.<sup>254</sup> If the letter of credit itself is illegal its unenforceability is undisputed and the autonomy principle is by no way affected. Conversely, illegality solely in the underlying contract, as a situation purely related to said contract and in no way reflected in the actually complying documents, fundamentally erodes the cardinal autonomy principle and, subsequently, the efficacy of the independent commercial letters of credit.

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<sup>250</sup> Liao Zhixiong, ‘Illegality in the Underlying Transaction: A Defence to Dishonouring Letters of Credit’ (2015) 23 *Waikato L Rev* 34, 48.

<sup>251</sup> *Group Josi Re v Walbrook Insurance Co Ltd* [1996] 1 WLR 1152 (CA); *Mahonia Ltd v JP Morgan Chase Bank (No 2)* [2004] EWHC 1938 (Comm).

<sup>252</sup> Charles Debattista, ‘Performance Bonds and Letters of Credit: A Cracked Mirror Image’ [1997] *J B L* 289, 303.

<sup>253</sup> See *Potton Homes Ltd v Coleman Contractors Ltd* [1984] 28 BLR 19 (CA), 27, where Eveleigh LJ held that “In attributing to the bond many similarities to a letter of credit, I do not regard Lord Denning as saying that one should approach every case upon the basis that the bond is a letter of credit and to have no regard to the circumstances which brought it into existence”.

<sup>254</sup> Liao Zhixiong, ‘Illegality in the Underlying Transaction: A Defence to Dishonouring Letters of Credit’ (2015) 23 *Waikato L Rev* 34, 50-51.

#### 4. Comparative and Critical Analysis

It is often suggested that the marketability of the documentary letter of credit is heavily attributed to the fact that it seemingly provides equivalent security to both the importer-buyer and the exporter-seller. In particular, the simultaneous application of the autonomy and strict compliance principles appears to balance the contradicting interests of the parties, facilitating international commerce. Nonetheless, it often fails to deliver the promised mutually secure outcome, as the overly rigid application of the autonomy principle creates a loophole, allowing the abuse of the system by way of presenting apparently complying but fraudulent or forged documents. Accordingly, the system favors the exporter, as the strict compliance doctrine does not provide adequate protection in such cases.<sup>255</sup> As with any commercial device, the attractiveness of the letter of credit derives from the faith of its users. An approach that benefits one party at the expense of the other undermines the viability of the commercial instrument. As such, restitution of mercantile confidence as to the letter of credit scheme required the development of a unique set of rules.

Notwithstanding that the fraud exception rule has been widely accepted as an exception to the autonomy principle, in an effort to restore the aforementioned balance; domestic legal systems have defined the rule differently.<sup>256</sup> Whereas under English law its scope is traditionally restricted to documentary fraud,<sup>257</sup> under U.S. and Canadian law the rule further extends to fraud manifested in the underlying transaction.<sup>258</sup> To the extent that fraud in the underlying contract will undoubtedly result in documentary fraud, by way of a false representation to induce payment,<sup>259</sup> it is the opinion of the author of the thesis that documentary fraud alone covers the

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<sup>255</sup> Ricky J Lee, 'Strict Compliance and the Fraud Exception: Balancing the Interests of Mercantile Traders in the Modern Law of Documentary Credits' (2008) 5 *Macquarie J Bus L* 137, 159.

<sup>256</sup> Felicity Monteiro, 'Documentary Credits: The Autonomy Principle and the Fraud Exception: A Comparative Analysis of Common Law Approaches and Suggestions for New Zealand' (2007) 13 *Auckland U L Rev* 144, 144.

<sup>257</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada* [1983] 1 AC 168 (HL), 183.

<sup>258</sup> The American Law Institute and National Conference of Commissioners on Uniform State Laws, 'Uniform Commercial Code (UCC)' (revised version of 1995) art 5, Section 5-109; *Bank of Nova Scotia v Angelica-Whitewear Ltd* [1987] 36 DLR 4<sup>th</sup> 161, 176-177.

<sup>259</sup> See for instance *Sztejn v J Henry Schroder Banking Corp* [1941] 31 *NYS (2d)* 631.

majority of the fraudulent cases encountered within the documentary credit system. Generally speaking, recourse to the circumstances surrounding the underlying transaction is an inherent element of any concept that constitutes an exception to the autonomy principle. Nonetheless, this narrow approach tethers the fraud inquiry into the beneficiary's performance under the underlying contract to a falsity contained in the documents. Accordingly, insofar as it precludes consideration of fraud that did not, in some way, taint the documents, it causes the least interference with the cardinal autonomy principle. Hence, it best serves both the prevention of fraudulent calls under the credit and the support of the commercial utility of the letter of credit as a guarantee of payment.<sup>260</sup>

The significance of the separation between fraud in the documents and fraud in the underlying transaction can only be envisaged in the exceptional cases where the fraud is solely contained in the underlying contract, while the tendered documents truthfully and accurately describe the goods represented thereunder.<sup>261</sup> This type of fraud does not impair the security interests of the bank in the goods, as guarantor of payment, provided by the documents. Moreover, to the extent that it allows purely contractual issues to defeat the letter of credit, it takes the exception too far. Accordingly, it appears to fall outside the scope of the rationale behind the fraud rule, that was never the absolute condemnation of fraud, but rather the prevention of the exploitation of the documentary credit system by a dishonest beneficiary.<sup>262</sup> A documentary misrepresentation with the intention of inducing payment is an intrinsic element of the latter. It is worth mentioning that the applicant, by arranging for a letter of credit to finance his commercial relationship with the beneficiary, knowing its irrevocable nature, assumes all the risks that such a payment method entails, including the risk of a fraudulent beneficiary. The sole exception to this statement is that the applicant would not expect the bank to pay against apparently conforming, yet clearly

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<sup>260</sup> See for instance *Dynamics Corp of Amer v Citizens & Southern Nat Bank* [1973] 356 F Supp 991, 1000; where Edinfeld J held that "There is as much public interest in discouraging fraud as in encouraging the use of letters of credit".

<sup>261</sup> Such an example would be a fraudulent misrepresentation that induced the other party's entry into the underlying contract; see Peter Cane and Jane Stapleton (ed), *Essays for Patrick Atiyah* (Oxford University Press 1991) 234.

<sup>262</sup> *Sztejn v J Henry Schroder Banking Corp* [1941] 31 NYS (2d) 631, 634; *United City Merchants (Investments) Ltd v Royal Bank of Canada* [1983] 1 AC 168 (HL), 183.

fraudulent documents, as it has been established that the latter is certainly not what is required by the credit.<sup>263</sup> Hence, the ambit of the fraud exception should be restricted accordingly to reflect both the rationale behind the introduction of the rule, as well as the contractual allocation of risk as between the parties; whereas the wider approach would have the unfortunate effect of exceeding the former, while reassigning the latter.

With regard to the controversial issue of third party fraud within the documentary credit system, the general consensus among the common law world is that the fraud exception rule is strictly confined to fraud committed or known to the beneficiary.<sup>264</sup> This approach has been criticized on the grounds that a fraudulently fabricated document does not constitute a conforming one, merely due to a third party having committed the fraud.<sup>265</sup> Accordingly, one should focus on the consequences and existence of the fraud, as opposed to the identity of the perpetrator.<sup>266</sup> Nevertheless, the fraud exception rule, as initially recognized within the American *Sztejn* case<sup>267</sup> and subsequently accepted into the English<sup>268</sup> and Canadian<sup>269</sup> jurisprudence, has been legally rationalized on the *ex turpi causa non oritur action maxim*; otherwise known as “no action arises from an unworthy cause”. On the basis of this maxim, a person may not pursue a cause of action, if the latter arises out of his own fraudulent act.<sup>270</sup> Conversely, “if a person makes a misrepresentation in the truthfulness of which he honestly believes, he is obviously not guilty of a fraud”.<sup>271</sup> In essence, the fraud

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<sup>263</sup> *Sztejn v J Henry Schroder Banking Corp* [1941] 31 NYS (2d) 631, 633; see previously *Higgins v Steinhardter* [1919] 106 Misc 168; *Old Colony Trust Co v Lawyer’s Title & Trust Co* [1924] 297 F 152.

<sup>264</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada* [1983] 1 AC 168 (HL), 183; The American Law Institute and National Conference of Commissioners on Uniform State Laws, ‘Uniform Commercial Code (UCC)’ (revised version of 1995) art 5, Section 5-109; *Bank of Nova Scotia v Angelica-Whitewear Ltd* [1987] 36 DLR 4<sup>th</sup> 161, 176-177.

<sup>265</sup> Roy Goode, “Reflections on Letters of Credit – I” [1980] J Bus Law 291, 294.

<sup>266</sup> Kieran Donnelly, ‘Nothing for Nothing: A Nullity Exception in Letters of Credit?’ (2008) 4 J Bus L 316, 322.

<sup>267</sup> *Sztejn v J Henry Schroder Banking Corp* [1941] 31 NYS (2d) 631, 634.

<sup>268</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada* [1983] 1 AC 168 (HL), 184.

<sup>269</sup> *Bank of Nova Scotia v Angelica-Whitewear Ltd* [1987] 36 DLR 4<sup>th</sup> 161.

<sup>270</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada* [1983] 1 AC 168 (HL), 184; *Sztejn v J Henry Schroder Banking Corp* [1941] 31 NYS (2d) 634.

<sup>271</sup> Eliahu Peter Ellinger, *Documentary Letters of Credit: A Comparative Study* (University of Singapore Press 1970) 193.

exception was formulated to fill a gap within the letter of credit law; namely, to prevent the dishonest beneficiary from abusing the documentary credit system.<sup>272</sup> Consequently, insofar as it constitutes an extraordinary rule as an exception to the fundamental autonomy principle, it should be applied cautiously and restricted strictly to its purpose, so as to preserve the commercial utility and efficacy of the letter of credit. Hence, the bona fide beneficiary falls outside the scope of the fraud rule and, thus, under the protection of the autonomy principle.

Accordingly, where the fraud is that of a third party, the nullity exception, being based on the attributes of the tendered documents, may provide a complementary mechanism to eliminate the gap caused by the limit of the fraud rule. Nonetheless, documentary nullities should be strictly construed as referring solely to documents whose defect deprived them of all legal effect.<sup>273</sup> It is only documents of such nature, being commercially worthless, that may erode the bank's security interests.<sup>274</sup> *Beam Technologies v Standard Chartered Bank*,<sup>275</sup> has provided the groundwork for the further development of a general nullity exception. The line of reasoning behind said concept is the beneficiary's duty to provide, as well as the bank's obligation to pay against, a conforming presentation.<sup>276</sup> The latter implicitly requires the tendered documents to be genuine and accurate.<sup>277</sup> A document amounting to a worthless piece of paper is in no way what is required under the credit, as mere facial conformity does not equal actual one. At first glance the nullity concept may be deemed as another restriction to the autonomy principle that hinders the commercial utility of documentary credits. Nevertheless, in a world where trust among commercial parties is of utmost value, said concept, similar to the fraud rule, insofar as it ensues the

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<sup>272</sup> *Sztejn v J Henry Schroder Banking Corp* [1941] 31 NYS (2d) 631, 634; *United City Merchants (Investments) Ltd v Royal Bank of Canada* [1983] 1 AC 168 (HL), 183.

<sup>273</sup> *United City Merchants (Investments) Ltd v Royal Bank of Canada* [1983] 1 AC 168 (HL), 187.

<sup>274</sup> See for instance *United City Merchants (Investments) Ltd v Royal Bank of Canada* [1983] 1 AC 168 (HL), 186; where Lord Diplock held that a merely misdated bill of lading in no way affects the bank's security interests in the goods, provided by the documents, as the realizable value of the goods "could not be in any way affected by them having been loaded on board a ship at Felixstowe on December 16, instead of December 15, 1976".

<sup>275</sup> *Beam Technologies v Standard Chartered Bank* [2003] 1 SLR 597.

<sup>276</sup> International Chamber of Commerce, 'Uniform Customs and Practice for Documentary Credits (UCP) 600' (2006) art 2, 7(a) & 8(a).

<sup>277</sup> *Sztejn v J Henry Schroder Banking Corp* [1941] 31 NYS (2d) 631, 633.

circulation of documents of value within documentary credit transactions, upholds the sanctity and integrity of the international banking system, allowing the parties to transact with confidence and certainty. Most notably, both the narrow fraud and nullity exceptions relate to a falsity contained in the documents, as opposed to purely contractual issues. The autonomy principle, while designed to shield the beneficiary from defences generated from the underlying contract, does not signify that said beneficiary should also be shielded from defences related to the documents themselves.<sup>278</sup>

By contrast, the unconscionability and illegality concepts relate solely to circumstances surrounding the underlying contract, while the documents themselves are, apart from apparently complying, intrinsically true and genuine. To the extent that banks deal exclusively with documents alone,<sup>279</sup> in the opinion of the author of this study, any exception to the autonomy principle should at the very least maintain a degree of connection to said documents, as the applicant mandates the bank to pay upon a conforming documentary presentation. Hence, the rejection of these two exceptions as defences against payment under the credit may be justified practically on the basis of the banks' purely mechanical role of ensuring the strict compliance of the tendered documents with the credit.<sup>280</sup> Contrary to the narrow fraud and nullity exceptions, to argue that the presented documents are tainted and, hence, non-complying based on the illegality of the underlying contract, would extend the meaning of documentary non-conformity ad absurdum. Accordingly, banks are not qualified to evaluate neither the beneficiary's unconscionable conduct under the underlying contract, a nebulous concept in and of itself, nor the possible illegal nature of said contract. To assume such a role would render documentary credit transactions slow and cumbersome. Additionally, as the pertinent jurisprudence evidences, the unconscionability<sup>281</sup> and

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<sup>278</sup> Dora Neo, 'A Nullity Exception in Letter of Credit Transactions?' [2004] Sing J Legal Stud 46, 67.

<sup>279</sup> International Chamber of Commerce, 'Uniform Customs and Practice for Documentary Credits (UCP) 600' (2006) art 5.

<sup>280</sup> Ibid art 2, 7(a) & 8(a).

<sup>281</sup> Royal Design Studio Pte Ltd v Chang Development Pte Ltd [1990] 1 SLR 1116; Kvaerner Singapore Ltd v UDL Shipbuilding (Singapore) Pte Ltd [1993] 3 SLR 350; Bocotra Construction Pte Ltd v Attorney General (No 2) [1995] 2 SLR 733; Min Thai Holdings Pte Ltd v Sunlabel Pte Ltd [1999] 2 SLR 368; GHL Pte Ltd v Unitrack Building Construction Pte Ltd & Anor [1999] 4 SLR

illegality<sup>282</sup> exceptions seem to be more suitable for bank guarantees and standby letters of credits, where payment is contingent on the performance and circumstances of the underlying contract, as opposed to commercial letters of credit. The latter category, as a form of guaranteed payment of the contract price, equal to “cash in hand”,<sup>283</sup> relies on its autonomy from the underlying transaction for its appeal and commercial utility. Unconscionability and illegality within the context of commercial letters of credit, as ordinary contract disputes, can be addressed through the use of alternative judicial avenues that do not undermine the credit contract. Consequently, in relation to these two concepts, commercial letters of credit are the one area where the courts should adopt a hands-off approach, if they are vigilant in safeguarding the very premise upon which the letters of credit rely; namely, the cardinal autonomy principle.

As a last comment, it is worth mentioning that, considering the UCP’s near universal acceptance and success in regulating documentary letters of credit, for any exception to reach maturity, its application should be addressed within the UCP’s provisions, lifting said exception from the national to the international level. This view is supported by the UCP’s function as regulator of the duties and obligations of banks in dealing with international letter of credit transactions. By explicitly accepting the narrow fraud and nullity exceptions, hence, implicitly rejecting the unconscionability and illegality concepts, in accordance with the position of this thesis, it shall limit the disturbances as to the autonomy principle, while upholding the viability of the documentary letter of credit by bringing the balance between the interests of the parties back near equilibrium. The ICC, as the body with the expertise to do so, may achieve the right balance between the autonomy principle and its exceptions, an exercise where the courts themselves have systematically failed. While the UCP, with regard to its form, constitutes merely a set of contractual terms, hence, is subordinate

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604; Dauphin Offshore Engineering & Trading Pte Ltd v The Private Office of HRH Sheikh Sultan bin Khalifa bin Zayed Al Nahyan [2000] 1 SLR 657; Hiap Tian Soon Construction Pte Ltd v Hola Development Pte Ltd [2003] 1 SLR 667; JBE Properties Pte Ltd v Gammon Pte Ltd [2010] SGCA 46.

<sup>282</sup> Group Josi Re v Walbrook Insurance Co Ltd [1996] 1 WLR 1152 (CA); Mahonia Ltd v JP Morgan Chase Bank (No 2) [2004] EWHC 1938 (Comm).

<sup>283</sup> Power Curber International Ltd v National Bank of Kuwait SAK [1981] 1 WLR 1233, 1241; [1981] 3 All ER 607, 612.

to national law; given its predominant influence, it is reasonable to expect the courts to give to its provisions on the fraud and nullity exceptions the same weight they have traditionally bestowed to its other provisions.<sup>284</sup> Insofar as the UCP rules stipulate the autonomy principle itself,<sup>285</sup> why should they not further define the exceptions and limits thereof?

## 5. Conclusions

The autonomy principle safeguards the interests of the seller via the provision of an irrevocable and unconditional entitlement to payment against conforming documents, irrespective of any disputes that may arise out of the underlying transaction. In the same vein, the buyer's interests are protected by requiring the tendered documents to strictly comply with the terms and conditions of the credit, thus, indicating the seller's proper performance under the underlying contract. Nevertheless, the system, insofar as it allows payment against apparently complying, yet fraudulent or worthless documents, appears to favor the seller. Any commercial device that provides preferential treatment to one party at the expense of the other is doomed to eventually disappear. Accordingly, certain exceptions to the autonomy principle; namely, fraud, nullity, unconscionability and illegality, have either found recognition or received favorable comments in various common law jurisdictions.

Notwithstanding that the fraud exception rule has been widely recognized, so as to alleviate the above-mentioned imbalance; the analysis of the U.S., English and Canadian approaches allows us to conclude that the treatise of the issue has received a varying, fragmented treatment within the common law world. The research of the fraud rule under U.K. law, in particular, reflects the near impossibility of its application in practice, primarily due to the strong position of the autonomy principle in the documentary credit system. With respect to the ambit of the fraud rule, a rather controversial issue among jurisdictions, the thesis strongly supports the narrow fraud

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<sup>284</sup> Ross P Buckley and Xiang Gao, 'The Development of the Fraud Rule in the Letter of Credit Law: The Journey So Far and the Road Ahead' (2002) 23 U Pa J Int'l Econ L 663, 712.

<sup>285</sup> International Chamber of Commerce, 'Uniform Customs and Practice for Documentary Credits (UCP) 600' (2006) art 4 & 5.

rule, strictly referring to documentary fraud, as opposed to further extending the rule to fraud manifested in the underlying transaction. Insofar as the latter ultimately takes the form of the former to induce payment, the narrow formulation alone protects against the majority of the fraudulent cases encountered in the documentary credit system, while concurrently adhering to the contractual allocation of risk as between the parties and best serving the rationale behind the fraud rule; namely the abuse of the letter of credit system by the fraudulent beneficiary, not the absolute condemnation of fraud.

Additionally, to the extent that the fraud exception rule is generally restricted to fraud committed or known to the beneficiary, on the basis of the *ex turpi causa non oritur action maxim*, the prospective universal acceptance of the nullity exception appears to complement the fraud rule, filling the gap created by the restricted application of the latter. In that regard, the Singaporean *Beam Technologies* case<sup>286</sup> departed from the English position, expressed in *Montrod*,<sup>287</sup> by recognizing a separate nullity exception. The formulation found in *Beam Technologies* may serve as the basis for the further development of the rule. After analysing the arguments in support and against the nullity exception, the thesis argued that a limited nullity exception, referring solely to void *ab initio* documents, appears to be an appropriate development on the basis of the prevention of the circulation of commercially worthless documents within the documentary credit mechanism, as well as the beneficiary's duty to be diligent in providing conforming documents for payment, especially when produced by third parties.

It is evident that the ideology of complete separation between the letter of credit transaction and the underlying contract may only be envisaged when the tendered documents are safely presumed true and genuine. A document, either fraudulent or merely null and void, known to the bank as such prior to payment, under no reasonable definition may be regarded as a complying documentary tender. Moreover, both the narrow fraud and nullity exceptions, insofar as they retain a degree of connection to the documents themselves, cause the least interference to the

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<sup>286</sup> *Beam Technologies v Standard Chartered Bank* [2003] 1 SLR 597.

<sup>287</sup> *Montrod Ltd v Grundkotter Fleischvertriebs GmbH* [2002] 1 WLR 1975.

autonomy principle, while upholding the integrity of, and hence, trust in, the banking and documentary credit systems.

Conversely, under the unconscionability and illegality concepts, the tendered documents are in no way affected by the unconscionable conduct under, or illegal nature of, the underlying transaction; hence, constituting a truly conforming documentary presentation. Said concepts, to the extent that they allow purely contractual issues to defeat the letter of credit, obliterate the autonomy of the credit, hindering altogether the efficacy and commercial utility of the letter of credit as an independent, autonomous guarantee of payment. Additionally, it is recommended, on the basis of the pertinent case law, to restrict the possible application of these two exceptions to standby letters of credit and demand guarantees, as opposed to extending them to further encompass commercial letters of credit. The former, to the extent that payment is contingent on the principal's default under the underlying contract, maintain a closer link as to the conduct and circumstances relating to said underlying contract. By contrast, the autonomy principle is fundamental as to commercial letters of credit, whose function is not that of a security but of an independent payment method of the contract price.

The UCP, having become the predominant influence in the area of documentary letters of credit, constitutes the appropriate instrument to incorporate any recognized exception to the autonomy principle, elevating it from the national to the international level. By recognizing the narrow fraud and nullity exceptions, thus, tethering the exceptions to the documents themselves, under explicit harmonized, uniform conditions, it shall provide a secure and predictable environment for international trading partners. The ICC, by utilizing its expertise in regulating international letter of credit transactions, may balance the autonomy principle and its exceptions in a way that best serves both the interests of the importer-buyer and the exporter-seller, hence, upholding the utility and subsequent viability of the documentary credit system. In any case, to the extent that the UCP stipulates the autonomy principle itself, it seems appropriate to further define the exceptions and limits thereof.



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