Universitat Autònoma de Barcelona

# EXCEPTIONS TO THE PRINCIPLE OF INDEPENDENCE IN DOCUMENTARY LETTERS OF CREDITS

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THESIS FOR THE DEGREE OF DOCTOR OF PHILISOOHY

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June 2018

Doctoral Program in Law

Thesis for the Degree of Doctor of Philosophy:

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***TO MY FAMILY***

DECLARATION

Hereby, I declare that this thesis, submitted for assessment leading to the award of the degree of the Doctor of Philosophy in Law at faculty of Law, Autonomous University of Barcelona, is entirely prepared by myself. All care is exercised to prepare an original work. It has not been taken from work of others without following due referencing and citation rules and to my best knowledge it does not breach any copyright law.

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## List of Publications:

1. Alavi. H, (2016), “Documentary Letters of Credit, Legal Nature and Sources of Law”, *Journal of Legal Studies* 31: pp. 106-121.
2. Alavi, H. (2017), “Risk Analysis in Documentary Letter of Credit Operation”, *Financial Law Review*, 1 (4), 27-45.
3. . Alavi, H. (2016), “Comparative Study of Issuing Bank’s Obligations towards Beneficiary of the Letter of Credit under UCP and English Law”, Hasanuddin Law Review, 2(3), 289-311.
4. Alavi, H. (2015), “Autonomy Principle and Fraud Exception in Documentary Letters of Credit, a Comparative Study between United States and England”, *International and Comparative Law Review*, Vol. 15, No. 2, ,45-67.
5. Alavi. H, (2016), "Mitigating the Risk of Fraud in Documentary Letters of Credit", *Baltic Journal of European Studies* 6.1: 139-156
6. Alavi, H. (2016), “Exceptions to Principle of Autonomy in Documentary Letters of Credit; a Comparative View”, *Actual Probs. Econ. & L.* 10 (3), 123-150.
7. Alavi.H, (2016), “Illegality as an Exception to Principe of Autonomy in Documentary Letters of Credit: A Comparative Approach”, *Kor. UL Rev.*, 20, 3. 1-25.
8. Alavi, H, (2016), “Comparative study of Unconscionability exception to the principle of autonomy in law of Letter of Credits”, *Acta Universitatis Danubius*, Vol 12, No 2,94-121.
9. Alavi. H, (2017), “Contractual restrictions on right of beneficiary to draw on a Letter of Credit; possible exception to principle of autonomy”, *International and Comparative Law Review*, Vol. 16, No. 2, 67-86.
10. Alavi. H, (2017), "Limits of autonomy principle in documentary letters of credit; perspective of English law", *Journal of legal studies*, 18(33), 18-42.
11. Alavi. H, (2016), “Remedies to Fraud in Documentary Letters of Credit: A Comparative Perspective/ Opravné Opatrenia Pri Podvodoch S Dokumentárnymi Akreditívami: Komparatívna Perspektíva”, *EU agrarian Law*, 5(1), 1-13.
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**Aknowlegments**

I wish to thank my family for giving me the strength, support and motivation from start to finish of this study. My sincere gratitude to Professor Carles Gorriz Lopez, my supervisor who has always been there to make corrections and comments despite his busy schedule. Definitely, without his moral and technical support I would not be able to proceed successfully. To all the staff and faculty of faculty of Law at UAB, I say thank you.

# Contents

## Summary

International trade has been always a controversial topic. A person can approach it from any given perspective. However, almost no one can deny its impact on daily life of us. Therefore, all human capacities are employed to help development of it at global level. The regulatory question is one of the most debated issues in international trade among all others which have always been a hot topic for legal practitioners, businessmen, governments as well as academicians. The roots for such controversial issue can be sought in existence of different legal systems, different regulations, different terminology, different customs, different technologies and different methods of payment all in absence of global authority. However, while discussing regulatory issues in international trade, we should not forget about the dark side of business in which perpetrators with bad faith are ready to use the most advanced technologies in order to defraud others in the course of international transactions.

Having said that brief background on issues surrounding the international trade, the documentary letter of credit is one of the most popular methods of payment in international transactions. The key to their success is reducing risk for exporter by replacing importer's financial undertakings with a guarantee of payment from a bank. Within the framework of a complicated process, bank will guarantee to honour the seller's presentation of complying documents with terms of credit on behalf of the creditworthy buyer who will compensate the bank based on other contract. By applying two principles of autonomy and strict compliance, documentary credit mitigates the existing commercial risk of trade between buyer and seller who are in different countries and have no information about financial capacity of each other's businesses. Within the frame work of the principle of autonomy, credit is separated from underlying contract of sales and bank will pay beneficiary who presents complying documents even in case of dispute over the underlying contract. In this way seller will have the assurance for payment before departing from goods and his interests are safeguarded. On the other hand, based on the principle of strict compliance, beneficiary will be compensated only after presentation of fully complying documents and any error on the face of documents might result in rejection of payment by bank. Review of the history of payment under documentary credit operation in international trade shows that banks focus only on documents and disregard any possible disputer in underlying contract might increase the risk of fraudulent presentation by beneficiary. In many countries, increasing number of fraud cases resulted in introduction and adaptation of fraud exception to an absolute principle of autonomy of documentary credits. At

the same time, we should not forget the Unified Customs and Practices for documentary letters of credits as the most accepted set of rules for governing operation of documentary credits at global level has completely left the issue of fraud and fraudulent behaviour of beneficiary open for national laws. This will create another problem which is relevant to the standard of proof and remedies under different legal systems and conflict of laws.

Current doctoral thesis tries to find an answer to the question of fraud exception to the principle of independence of documentary credits under English law. Reason for choosing the legal system is its popularity as the governing law in many fields of international trade as well is its common law nature and the absence of statute for governing the fraud rule in documentary credits. As a matter of fact, English law has the case law approach to the problems of fraud in documentary credits which creates lots of problem on the way of judges to safeguard the justice.

As it has been mentioned already, current research paper desires to have a critical approach to practice of Common Law courts in field of fraud in documentary credits. For this purpose, it will review closely historical and modern developments of fraud rule base on the case law approach of English and American courts to the subject matter. Research will also examine approaches of other common low jurisdictions if necessary.

Research consists of two main parts. Review article and publications. The review article has six chapters. Chapter one is the introduction to the historical background of documentary letters of credit and their operation. While chapter two explores legal nature and sources of law for letters of credit chapter three will analyse the key principles of documentary letters of credits. Chapter four, will have a focus on fraud rule by analysing American and British approach to it as the first adopted exception to independent principle of documentary letters of credit. Chapter five will scrutinize other exceptions including illegality, nullity, beneficiary's bad faith and abusive demand for payment. At the end chapter six will provide a conclusion on the subject matter of study and materials covered.

The second part includes twelve published papers in international peer reviewed journals providing comprehensive and in depth legal analysis form autonomy principle and its

exceptions in law of documentary letters of credit within the framework of Common Law system.

# Resumen

El comercio internacional ha sido siempre un ámbito conflictivo. Cualquier persona puede aproximarse a él desde una perspectiva determinada. Sin embargo, es innegable que condiciona la vida diaria de todos nosotros. De ahí que se utilicen todo tipo de recursos humanos para desarrollarlo a nivel mundial. La cuestión normativa ha sido uno de los temas más debatidos en el comercio internacional, entre otros muchos, existiendo muchas discusiones entre prácticos del derecho, empresarios, gobiernos, así como académicos. Las raíces del conflicto pueden encontrarse en la existencia de sistemas jurídicos diferentes, normativas, terminología, costumbres, tecnología y métodos de pago diferentes, en ausencia de una autoridad mundial. No obstante, mientras tratamos los aspectos regulatorios del comercio internacional, no debemos olvidar el lado oscuro de los negocios, en el que los infractores dolosamente usan las tecnologías más avanzadas para defraudar a otros en el curso de transacciones globales.

El crédito documentario es uno de los métodos de pago más populares en las operaciones transfronterizas. La clave de su éxito es que reduce el riesgo de los exportadores al reemplazar los compromisos financieros con una garantía de pago de un banco. Enmarcado en un proceso complejo, el banco se obliga a honrar la presentación, por parte del vendedor, de documentos que reúnen los requisitos del crédito en nombre del comprador solvente, quien compensará al banco en base al contrato. A través de la aplicación de los dos principios de autonomía y cumplimiento estricto, el crédito documentario mitiga el riesgo comercial existente entre un comprador y un vendedor que están en Estados diferentes y carecen de información sobre la capacidad financiera de su contraparte. En virtud del principio de autonomía, el crédito es separado del contrato de venta subyacente y el banco pagará al beneficiario que presente los documentos requeridos, incluso en caso de disputa sobre la relación subyacente. De este modo, el vendedor tendrá la seguridad del pago antes de que las mercancías se transporten y su interés estará a salvo. Por otra parte, en base al principio de cumplimiento estricto, el beneficiario se verá compensado sólo cuando presente el conjunto de documentos requeridos y cualquier error respecto de los mismos podrá comportar la negativa al pago por parte del banco. La revisión de la historia de los pagos en función de operaciones de crédito documentario en el tráfico internacional evidencia que el hecho de que los bancos sólo presten atención a los documentos y hagan caso omiso de cualquier posible disputa relativa al contrato subyacente puede incrementar el riesgo de una presentación fraudulenta por parte del beneficiario. En muchos países, el incremento en el número de casos de fraude comportó la introducción y adaptación de la excepción de fraude respecto del principio absoluto de autonomía en los créditos documentarios. Al mismo tiempo, conviene no olvidar que los Usos y Prácticas Uniformes relativos a los créditos documentarios, en tanto que conjunto de reglas más aceptadas a nivel mundial, remite totalmente el tema del fraude y del comportamiento fraudulento del beneficiario a los Derechos nacionales. Esto crea otro problema que es relevante para el estándar de prueba y los remedios bajo los diferentes sistemas legales y el conflicto de leyes.

La presente tesis doctoral intenta ofrecer una respuesta al problema de la excepción de fraude al principio de independencia en los créditos documentarios conforme al Derecho inglés. Las

razones para elegir este sistema jurídico son su popularidad como norma aplicable en muchos ámbitos del comercio internacional así como su naturaleza de Derecho común en ausencia de una norma que rija la regla del fraude en el crédito documentario. Interesa añadir que el Derecho inglés tiene una aproximación casuística a los problemas del fraude en el crédito documentario que crea múltiples problemas en el trabajo de los jueces de salvaguardar la justicia.

Como ya se ha dicho, estos artículos científicos desean ofrecer una visión crítica de la práctica de los tribunales del *Common Law* en el ámbito del fraude en los créditos documentarios. A estos efectos, se revisa con detalle el desarrollo histórico y moderno de las aproximaciones judiciales inglesa y americana a la regla del fraude. También se examina el enfoque de otras jurisdicciones del *Common Law* cuando es necesario.

La tesis se compone de dos partes: un artículo de presentación y las publicaciones. El primero tiene seis capítulos. El primero es la introducción y los antecedentes históricos de los créditos documentarios y su operativa. Mientras que el capítulo segundo explora la naturaleza legal y las fuentes del Derecho, el tercero analiza los principios básicos de los créditos documentarios. El capítulo cuarto se centra en la regla del fraude y se analizan las aproximaciones estadounidense y británica al respecto, en cuanto excepción básica respecto del principio de la independencia de los créditos documentarios. En el capítulo cinco se examinan otras excepciones, como la ilegalidad, la nulidad, la mala fe del beneficiario y la exigencia abusiva de pago. Al final, el capítulo seis proporciona una conclusión sobre el tema de estudio y los materiales cubiertos.

La segunda parte contiene doce artículos publicados en revistas internacionales revisadas por expertos que brindan un análisis jurídico exhaustivo y profundo del principio de autonomía y de sus excepciones en el marco de los sistemas de *Common Law*.

# 1. Introduction

Documentary Credits, Documentary Letters of Credit or Banker's Documentary Letters of Credit are one of the old and well appreciated existing instruments for financing the international trade. Such long history of Documentary Letters of Credits has resulted in letting them to be considered as "Life Blood of Commerce"[1]. In terminology, letters of credit have roots in the French word 'Accredetif' with the meaning of power for doing something. However, Accredetif itself comes from 'Accreditiwus' in Latin which conveys the meaning of 'Trust'[2].

There is no doubt about historical use of Letters of Credit in international trade. Their usage in practice has been traced to banking systems of old Egypt and Babylon. Some excavations in Babylon provide evidences of promissory notes from 3000 B.C which show the promise for payment of exact amount and relevant interest rate in a defined date[3]. Also evidences from ancient Greece show drawing of Letter of Credits by banks to their correspondents in order to obviate the transport of spices in return to payment of accounts[4].

During middle Ages, letters of credit were used in order to solve two distinctive trade problems. (A) Lack of security in carriage of precious items and gold by merchants during their business trips and (B) Lack of common trade currency for meeting the cash need have merchant's abroad[5]. Due to security risks of carrying cash in hand, merchants of those days were preferring to exchange their cash with a 'letter of credit' at their bank with the capability of being cashed in another bank at given destination[6].

According to the De Rover, Letters of Credit were in use by Medici Bank during late 1ate 1300s in Bruges and Italy[7]. In the course of time, London gained fame as an outstanding financial centre due to growth of international trade and raise of British Banking System as

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[1] *RD Harbottle (Mercantile) Ltd v National Westminster Bank Ltd* [1978] QB 146, 155 (Kerr LJ); *Power Curber International Ltd v National Bank of Kuwait SAK* [1981] 2 Lloyd's Rep 394,400 (Griffiths LJ); *Intraco Ltd v Notis Shipping Corporation of Liberia; The Bhoja Trader* [1981] 2 Lloyd's Rep 256, 257 (Donaldson LJ); *Hong Kong and Shanghai Banking Corporation v Kloecker &Co AG* [1989] 2 Lloyd's Rep 323, 330 (Hirst J

[2] Garcia RLF '*Autonomy principle of the letter of credit'* (2009) Mexican Law Review 72

[3] Trimble RF '*The Law Merchant and the Letter of Credit'*, (1948) 61 Harvard Law Review, 982-86.

[4] Ibid. 984

[5] Toth. Z, '*Documentary Credits in the International Commercial Transaction with Special Focus on Fraud Rule'* (2006), 1, Doctoral Dissertation.

[6] Koudriachov. SA '*Application of the Letter of Credit Form of Payment in the International Business Transactions'* (2001). 10. Current International Trade Law Jurnal. 37.

[7] De Roover. R, '*Money, Banking and Credit in Medieval Bruges'*, 2 Journal of Economic History (Suppl. Issue), 1942, p.52.

monopolistic issuer of Letter of Credit which was the result of accepting Pound Sterling as currency for international trade created[8].

Letters of Credit entered United States of America after raising competition among factoring houses and acceptance of drafts against shipment[9]. In today's world, Letters of Credits are considered among the most attractive arears of research for legal, international trade and finance scholars. In this respect, Professor Roy Goode defines Documentary Letters of Credits as: "A money promise which is independent of the transaction that gives it birth and which is considered binding when received by the beneficiary without acceptance, consideration, reliance, or execution of solemn form"[10]. Latest version of Uniformed Customs and Practice for Documentary Credits (UCP 600) defines Letters of Credit as: "An arrangement however named or described, that is irrevocable and thereby constitutes and definite undertaking of the issuing bank to honour the complying presentation"[11]. Further, Article 2 of UCP 600 considers complying presentation as "a presentation that is in accordance with terms and conditions of the credit, the applicable provisions of this rule and international standard banking practice". Among other definitions, Kudriachov describes Letters of Credits as "one way abstract transaction, in which the emitting bank cannot reject the execution of its obligation by referring to non-execution of obligations by other parties to the transaction"[12].

Although Documentary Credits have very long mercantile history, their involvement in utilization of credit arrangements practically goes back to the second half of the 19th century[13]. A review on legal history of Documentary Letters of Credits shows that *Rose v Von Mierop and Hopkins* is one of the first lawsuits on letters of credits and landmark of LCs Law in English legal system.[14]

## *1.1: Functions and process of operation in Documentary Credits*

[8] Toth.Z(2006). 2

[9] Kozolchyk.B, *The Legal Nature of the Irrevocable Commercial Letter of Credit*, 14 American Journal of Comparative Law, 1965, p.395 at 398

[10] Goode.R, '*Abstract Payment Undertakings'* in Peter Cane and Jane Stapleton (eds), Essays for Patrick Atiyah (OUP 1991

[11] Article 2, UCP 600

[12] Koudriachov (2001) 41.

[13] Garcia RLF (2009). 69

[14] *Pillans and Rose Van Mierop and Hopkins* (1756) 97, English. Rep. 1035 (BURR 1666); Mc Curdy .W, '*Commercial Letters of Credit*' (1922) , Harvard Law Review, 539

Article 2 of UCP (600) defines parties to the Letter of Credit as following: "Applicant: the party to whose request the credit is issued. Beneficiary: The party in whose favour the credit is issued. Issuing Bank: Means the bank that issues a credit at the request of an applicant or on its own behalf"[15]. Basically, the process of issuing a Letter of Credit starts with request of Buyer (*rectius*, applicant or Account Party) to his bank (issuing bank) in order to issue a credit in favour of the seller (*rectius*, Beneficiary) based on the underlying contract of sales between parties. As a result, issuing bank will contact beneficiary in his country in order to inform him about opening the credit in his favour. Due to a geographical distance between issuing bank and beneficiary, advise of the credit to beneficiary will generally take place via a correspondent of issuing bank in beneficiary's country (advising bank). The responsibility of advising bank is only informing beneficiary about issuing credit in his favour while it does not have any obligation of payment to her[16]. As a result, the legal nature of relationship between issuing bank and advising bank is considered as relationship between agent and principle[17].

Beneficiary seller at this stage must compare terms and conditions of the credit with terms of underlying contract. In case of any existing discrepancy at this stage, beneficiary is entitled either to reject the credit or require amendments. After approval of the credit by beneficiary, issuing bank will enter into a contract with beneficiary to provide him with price of merchandise in return of complying documents required by the credit. As a result, any given credit will have at least three parties. Namely, Issuing bank, Beneficiary and Applicant. However, in practice number of parties might be more than three.

It might happen that issuing bank asks advising or any other bank in the country of seller to provide credit on her counter which is a very appreciated option for beneficiary who will be paid in his own country rather than the country of the buyer. In this case, the bank which provides credit on her counter is considered as Nominated Bank[18.] In some occasions, seller might ask for higher guarantee for payment which is already provided by issuing bank. In this case, a confirming bank will add her irrevocable commitment for payment of the credit to beneficiary in addition to issuing bank. As a result, any given Documentary Letter of Credit will consist of at least three independent contracts between Beneficiary and Applicant (Underlying Contract of Sales), Account Party and Issuing Bank, Issuing Bank and Beneficiary. However, in majority of cases number of contracts will increase relatively with

[15] Article 2 UCP 600
[16] Article 9.a, UCP 600
[17] *Gian Singh and Co Ltd v Banque de l'Indochine* [1974] 1 WLR 1324, 1238
[18] UCP 600 –Article 2

the increasing number of involved parties in the credit after joining confirming bank and Nominated Bank to original parties to the Documentary Credits.

Enonchong (2011) introduces four generic functions for the Letter for Credits. First, it reduces commercial risk both for importer and exporter by providing security of payment for exporter and security against the non-delivery of goods for importer[19]. The second function is providing finance for importer and helping him with cash flow while at the same time providing exporter with the chance to raise money before being paid by issuing bank. Third, Documentary Credits can be used as security for other obligations like case of Back-to-Back letter of credits. The fourth one, is the function of documentary credits as conditional payment method and providing the possibility for seller to receive payment from importer in case the credit has been dishonoured by bank[20]

Function of Documentary Letters of Credit follows different steps of the Letter of Credit's process[21]. Process starts with negotiation of the terms of contract by buyer and seller. They will enter the underlying contract of sales. According the underlying contract, exporter will undertake to provide confirmed goods which are subjected to that particular transaction and importer commits to pay the price of good via Documentary Letter of Credits.

Further, information regarding the details of the Credit will be mentioned in the underlying contract. As the second phase, buyer will require the issuing bank to open a credit in favour of exporter. In case of issuing bank's agreement to issue the credit, Importer (account party) and issuing bank enter a contract in which account party commits to reimburse the issuing bank for payment to the exporter (beneficiary) as well as paying all relevant banking fees[22]. When account party and issuing bank enters the contract for issuing the Credit, issuing bank will contact beneficiary and inform him about term of credit and enter a contract with beneficiary to pay him the price of goods sold to the importer in return for delivery of confirming stipulated documents in the credit[23]. Although, these three independent contracts are considered as basic framework for function of documentary letter of credit, but in practice, in majority of occasions, beneficiary will interact with a local bank in his own country rather than being directly involved with issuing bank. If parties decide so, then the advising bank will contact the beneficiary in

[19] Enonchong.N, *'The Independence Principle of Letters of Credits and Demand Guarantees'*. Oxford University Press, (2011). 9
[20] Ibid.
[21] Ibid,p.8,
[22] Wight R & Ward A '*The Advising Bank in Letter of Credit Transactions and the Assumption of Agency'* (1993*) Journal of International Banking Law* 432
[23] Article 7- UCP 600

order to inform him about the issuing of the credit in his favour. At the time that credit requires involvement of Nominated Bank and Confirming Bank, there will be a separate contract between Beneficiary and Nominated or Confirming Bank and Issuing Bank and Nominated and Confirming Bank. Advising Bank might or might not accept to act in the capacity of Nominated and /or Confirming Bank.

As a result, beneficiary ships goods for account party and provides confirming stipulated documents in the credit to the issuing bank, Nominated Bank or Confirming Bank. Nominated Bank will check presented documents and in case of conformity, they will pay beneficiary based on the authorisation in issuing bank[24], transfer documents to issuing bank and wait for reimbursement[25]. Issuing bank also check documents and in case of their conformity will reimburse Nominated or Confirming Bank, debit the account of applicant and inform him to come and receive his documents.

As it was mentioned earlier, most of the time credit will require the involvement of Nominated Bank and Confirming Bank as Issuing bank is not located in country of Beneficiary and it is difficult for him the confirm the authenticity of signatures by issuing bank[26].

## *1.2: Different Types of Documentary Credits*

Documentary letters of credit have been classified in different types while using different standards. In fact, as a result of the absence of harmonized standard for classification of the commercial documentary credits, there was a need to define such classification in order to facilitate the process of trade in business world[27]. Classification of documentary letters of credits is generally based on giving rise to a particular right or obligation by them[28]. However, two main categories can be mentioned: Commercial documentary letters of credit and standby letters of credit.

Commercial Letters of Credit are mostly used as a method of payment in international trade while Standby letters of credit (which most of the time used interchangeably with Demand Guarantees) function as a guarantee for performance[29]. Although, commercial and standby

[24] Längerich R 'Documentary Credits in Practice' (2000) 106
[25] Artcle 7(C), UCP 600.
[26] Längerich. R, (2000),104
[27] Richard King, "*Gutteridge and Megrah's Law of Bankers' Commercial Credits*" (8th edn, Routledge, 2001), p. 18.
[28] Enonchong. N (2011) ,17

[29] Ibid

letters of credit have different functions but, in practice they are subjected to the same rules and regulations. Since the term of guarantee has the same use as denoting the undertakings of documentary credits, therefore, such guarantees share the legal character of a commercial letter of credit[30.]

Based on the above categorization, it is possible to divide commentarial letters of credits into further subcategories including:

### 1.2.1: Revocable and Irrevocable Documentary Credits

In UCP 500, article 6 defined the difference between Revocable and Irrevocable documentary credit[31].

> "Revocable v. Irrevocable Credits A.
>
> A Credit may be either i. revocable, or ii. Irrevocable.
>
> B. The Credit, therefore, should clearly indicate whether it is revocable or irrevocable.
>
> C. In the absence of such indication the Credit shall be deemed to be irrevocable."

Revocable credit was defined as credit which could be amended or cancelled by issuing bank at any time, with or without the notice of the beneficiary[32.] Therefore, revocable credit could not provide any security for exporter as he could find out about the cancelation of the credit even after shipping the goods to the importer and presented documents to the nominated bank[33]. According to Article 6 of UCP 500, when credit fails to specify whether it is revocable or irrevocable, decision will stand for irrevocability of credit.

In a significant improvement, UCP 600 is only applied to Irrevocable Credits[34]. Article 3 of UCP 600 goes further by mentioning that: "A credit is irrevocable even if there is no indication to that effect". Therefore, the issuing bank is providing an undertaking to the beneficiary to provide him with payment after presentation of complying documents. The obligation of issuing bank according to UCP 600 will be binding upon issuing of the credit.[35]

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[30] Ibid
[31] Ibid
[32] UCP 500, Article 6
[33] *Cape Asbestus Co Ltd v. Lloyds Bank Ltd*[1921] WN274
[34] UCP600, Article 2.
[35] UCP 600, Article 7 (b).

### 1.2.2: Confirmed and Unconfirmed Credits

Although, issuing the Letter of Credit by virtue contains the obligation of issuing bank to honour the complying presentation by beneficiary, but, as issuing bank is generally located in the importer's country and there is no possibility for beneficiary to confirm the authenticity of signatures on the credit, he might require a local bank in his country to add another promise of payment to the letter of credit. As result, Credit will be confirmed after adding the commitment of confirming bank to it and Confirming Bank is bound to pay as of the time of adding confirmation to the credit[36]. When the credit is unconfirmed, the bank in the country of seller acts only as agent of issuing bank.

### 1.2.3: Sight, Deferred Payment and Acceptance Credits

Parties should make it clear that how credit will be available to the beneficiary. Article 6(b) of UCP 600 defines four methods for availability of credit. "A credit must state whether it is available by sight payment, deferred payment, acceptance or negotiation".

In sight payment, credit is due upon presentation of complying documents[37]. The deferred payment is defined by Article 2 (b) of the UCP 600 as: "to incur a deferred payment undertaking and pay at maturity if the credit is available by deferred payment". Acceptance has been also defined by Article 2 (b) of UCP 600 as honouring the complying presentation in future date: "to accept a bill of exchange ("draft") drawn by the beneficiary and pay at maturity if the credit is available by acceptance". In this case, deferred payment is similar to acceptance but there is no draft and payment might be incurred in 90 days after the date of issuing the bill of lading or for example 20 days after presentation of complying documents. The deferred payment system became popular after introducing the costly stamp duties on draft by some countries[38].

[36] UCP 600. Article 8(b).
[37] Enonchong. N (2011),18
[38] Ibid

Article 2 of UCP 600 comments on *negotiation* as: "[Negotiations] means the purchase by the nominated bank of drafts (drawn on a bank other than the nominated bank) and/or documents under a complying presentation, by advancing or agreeing to advance funds to the beneficiary on or before the banking day on which reimbursement is due to the nominated bank". Also, UCP 600 provides nominated bank with authority to negotiate the credit before maturity[39]. At the same time it differentiates between credits which are negotiable only in one bank (nominated bank) and credits which can be negotiated at any bank[40].

### 1.2.4: Revolving Credits

They are used in occasions of need for financing more than one shipment like the time of shipment by instalments. In such occasions, beneficiary will be allowed by the credit to present complying documents more than one time and receive payments of each shipment accordingly. Maximum amount of payment under each shipment will be defined in the credit while amount of credit will be replenished fully after each individual payment[41.]

### 1.2.5: Red Clause Credits

Provides payment for the seller before shipment of goods. However, complying documents should be presented to the bank after shipment. This type of the letter of credit provides finance to seller who should make advance payment to his suppliers. Under Red Clause credit, seller should provide a provisional document. Such type of credits impose a significant risk on buyer as account party is under obligation to reimburse bank even in case of sellers failure to dispatch goods[42].

[39] UCP 600.Article 7. (c) and 8 (C)
[40] UCP 600. Article 6 (a).
[41] Enonchong. N (2011),20
[42] Ibid

### 1.2.6 Transferable Credits

According to article 38 (b) of UCP 600, *Transferable Credits* should be clearly marked as Transferable Credit. Such credit provides possibility for original beneficiary to offer finance to his own suppliers via transferring a part or whole amount of credit to another beneficiary. Further, Article 38 (h), (I), and (J) provide instruction for functions of the Transferable Letter of Credit.

> "h) The first beneficiary has the right to substitute its own invoice and draft, if any, for those of a second beneficiary for an amount not in excess of that stipulated in the credit, and upon such substitution the first beneficiary can draw under the credit for the difference, if any, between its invoice and the invoice of a second beneficiary.
>
> i) If the first beneficiary is to present its own invoice and draft, if any, but fails to do so on first demand, or if the invoices presented by the first beneficiary create discrepancies that did not exist in the presentation made by the second beneficiary and the first beneficiary fails to correct them on first demand, the transferring bank has the right to present the documents as received from the second beneficiary to the issuing bank, without further responsibility to the first beneficiary.
>
> J ) The first beneficiary may, in its request for transfer, indicate that honour or negotiation is to be effected to a second beneficiary at the place to which the credit has been transferred, up to and including the expiry date of the credit. This is without prejudice to the right of the first beneficiary in accordance with sub-article 38 (h)".

Transferable Credits are used in very exceptional occasions[43]

### 1.2.7: Back to Back Credits

In practice and as result of high potential risks in their operations, transferable documentary credits might be used when a seller beneficiary uses the credit in his own favour as a guarantee to open a new credit in favour of his own suppliers[44]. Seller also can open a Counter Credit[45] by approaching his own bank and using the credit in his own favour in order to open a credit in favour of his own suppliers[46].

[43] Ibid
[44] Paul Todd, *Bills of Lading and Bankers' Documentary Credits* (2007), London, p.33
[45] Malik. A, Quest. D, Jack on Documentary Credits, Toddle Publishing, 2009. 31-2
[46] Ibid

However, back to back credits can be very risky for beneficiary and bank. Therefore, banks are not really eager to open a Back to Back credit for beneficiary unless he (beneficiary) has significant experience in this field[47].

### 1.2.8: Standby Letters of Credits

Just like commercial documentary letters of credits, standby letters of credit are obligations assumed by banks for payment upon presentation of complying documents to the beneficially[48]. Although, their form is similar to commercial documentary credits, but their function is like demand guarantees and in practice they are used to secure a performance of account party under the underlying contract[49]. Historically, formation of Standby Letter of Credit goes back to United States of America in which banks had legal restriction on issuing demand guarantee[50]. As a result, applicable rules to Demand Guarantees[51], Commercial Documentary Credits[52] and Special Rules adopted for Standby Letter of credits[53] are applicable to them as well.

## *1.3: Contractual Relations in Documentary Credits*

### 1.3.1: The Contract between account party and the issuing bank.

The underlying contract between importer and exporter can be referred to as the basis for issuing the documentary letter of credit by issuing bank. Therefore, no documentary credit will exist without presence of underlying contract which they have been issued based on[54]. As it was mentioned earlier, process of establishing the documentary credit starts with request of buyer from issuing bank to issue the credit in favour of seller[55]. Request for opening the credit by buyer should be in a timely manner[56] to provide beneficiary with enough time to fulfil his

[47] Ibid
[48] Ibid
[49] Enochong. N, (2011). 20
[50] Ibid
[51] Dolan.J, The *Law of Letters of Credits*, Boston (2002) [12.03]
[52] UN Convention on Independent Guarantees and Standby Letters of Credits
[53] UCP600, Article 1.
[54] Ibid
[55] International Standby Practices 1998 (ISP98).
[56] UCP Article 4.

obligations under the contract of sales. The court in *Garcia v. Page & Co. Ltd*[57] after considering failure of the applicant in timely opening of the letter of credit as breach of contract held for preserving the right of beneficiary to withdraw from the contract.

After accepting to issue the credit, bank will act as the agent of the applicant and provides the guarantee of payment for the price of goods to the seller on delivery of the confirming documents. Therefore, the obligations of issuing bank can be mentioned as honouring the credit and examination of the documents provided by seller[58].

As it has been mentioned by article 7 of UCP 600:

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

Issuing Bank Obligations

The first undertaking is to issue the credit based on the request of applicant[59.] Other undertakings are discussed in UCP 600 Article 7. The most important duty of the issuing bank can be mentioned as:

> *"a*) provided that the stipulated documents are presented to... the issuing bank and that they constitute a complying presentation, the issuing bank must honour...
>
> b) An issuing bank is irrevocably bound to honour as of the time it issues the credit..."[60].

The examination of documents by issuing bank will take place on their face[61].

> "*Standard for Examination of Documents:*
>
> a) ...the issuing bank must examine a presentation to determine, on the basis of the documents alone, whether or not the documents appear on their face to constitute a complying presentation.
>
> b) . . . the issuing bank shall each have a maximum of five banking days following the day of presentation to determine if a presentation is complying. This period is not

[57] *Garcia v. Page & Co. Ltd*, [1936] Vol. 55 Lloyd's Law Reports 392
[58] King. R, "*Gutteridge and Megrah's Law of Bankers'* Commercial Credits" (8th. Routledge, 2001), p. 55.
[59] UCP 600, Article 7
[60] Ibid
[61] UCP 600, Article 14

curtailed or otherwise affected by the occurrence on or after the date of presentation of any expiry date or last day for presentation"[62]

As long as bank follows the instructions of the buyer and conducts the reasonable care in examination of documents, it has fulfilled obligations towards buyer[63]. However, bank will not be entitled for reimbursement if it cannot prove that it has followed instructions and paid reasonable care while checking documents[64]. For Example, in *Equitable Trust Co of New York v. Dawson Partner Ltd*, Lord Summer held that due to accepting a non-conforming certificate, bank would not be entitled for reimbursement[65].

On return to obligations of issuing bank for reasonable care in examination of documents and payment to seller against confirming documents, the buyer undertakes to reimburse the issuing bank against performing her obligations. In case of *Gian Singh& Co Ltd V. Banque de L'Indochine*[66], despite the fact that documents where forged, Lord Diplock held that responsibility of bank for taking reasonable care against documents does not go further than examining them on their face[67].

### 1.3.2: Contract between Beneficiary and issuing bank

The relations between issuing bank and seller will start after notification of seller by issuing bank about request for a credit to be opened in his favour. According to UCP, contractual relationship between seller and issuing bank will be influenced by revocable or irrevocable Nature of the Credit[68]. Since UCP 600 only recognizes the irrevocable credits[69], in all credits which are subjected to UCP 600, bank undertakes an irrevocable obligation to pay the beneficiary against complying documents.

In return to the irrevocable undertaking of the bank, beneficiary also commits to present complying documents to the bank otherwise he will not be entitled to be paid[70].

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[62] Ibid
[63] The concept of reasonable care was used in UCP 500 but it does not exist anymore under UCP 600
[64] King. R (2001). 60
[65] *Equitable Trust Co of New York v. Dawson Partner Ltd* (1927) 27 LI.L.R. 49
[66] *Gian Singh & Co Ltd V. Banque de L'Jndoch/ne* [191 A] 2 Lloyd's Rep 1
[67] Ibid
[68] King. R. (2001). 74.
[69] UCP 600. Article 3: 'A credit is irrevocable even if there is no indication to that effect.'
[70] UCP 600. Article 16: 'Discrepant Documents, Waiver and Notice:
a. When ... the issuing bank determines that a presentation does not comply, it may refuse to honour or negotiate.
b. When an issuing bank determines that a presentation does not comply, it may in its sole judgement approach the applicant for a waiver of the discrepancies'

One reasons for operation of documentary credits in the process of international trade and necessity for seller to present complying documents is the security interest of the value of shipped good to the bank in return of her irrevocable obligation for payment. Therefore, it can be mentioned that seller will be under obligation to fulfil all his contractual undertakings with buyer because he is not only committed in the underlying contract to provide confirming goods to the buyer, but also issuing bank will dishonour the credit if seller presents documents which contain information about not confirming goods in the underlying contract.

### 1.3.3: The Relationship between Issuing Bank, Intermediary Bank and Beneficiary.

In practice of international trade, since issuing bank and beneficiary are located in two different countries, they will rarely interact together. In majority of cases, issuing bank will ask a local bank in beneficiary's country to advise the credit to him or it will authorize the intermediary bank to assume other responsibilities. Therefore, relationship and obligations of the issuing bank and intermediary bank depend on the role which intermediary bank assumes in the credit. The minimum involvement of intermediary bank in credit will be only acting as agent for issuing bank by playing the role of advising bank and informing beneficiary about opening terms of credit in his favour. The only responsibility of advising bank towards issuing bank is taking reasonable care in checking the complying of documents with terms of credit on their face. Responsibilities of the advising bank have been listed under Article 9 of UCP 600:

> "... b) by advising the credit or amendment, the advising bank signifies that it has satisfied itself as to the apparent authenticity of the credit or amendment and that the advice accurately reflects the terms and conditions of the credit or amendment received....
>
> E.) If a bank is requested to advise a credit or amendment but elects not to do so, it must so inform, without delay, the bank from which the credit, amendment or advice has been received,

> f ) If a bank is requested to advise a credit or amendment but cannot satisfy itself as to the apparent authenticity of the credit, the amendment or the advice, it must so inform, without delay, the bank from which the instructions appear to have been received...'[71].

In some occasions, Issuing Bank asks intermediary bank to take the role of nominated bank and provide the credit on her counter to the beneficiary. In such case and after accepting to pay against documents by nominated bank, the issuing bank assumes the responsibility of reimbursing the nominated bank as long as payments are against presentation of complying documents. In this regard, Article 7(c) of UCP 600 comments on issuing bank's obligation to reimburse the nominated bank that has honoured or negotiated a complying presentation and forwards documents to the issuing bank whether or not the nominated bank has prepaid or purchased before maturity. This obligation is independent from issuing bank's undertaking to the beneficiary'[72]. Reimbursement will take place after maturity. Before coming into force of UCP 600, there was a risk for nominated bank in discounting the deferred payment credits as any sort of scam could result in not being reimbursed by issuing bank. The reason behind exposure to such risk was the fact that nominated bank did not have the authority to negotiate the credit without such explicit statement in the credit[73]. A very famous authority in this regard is *Banco Santander SA v Banque Paribas* in which Waller LJ held:

> "In my view the position is that Santander (the nominated bank) had no authority from Paribas (Issuing Bank) to discount, and did not seek it. It was something they were entitled to do on their own account. If they had not chosen to discount and had waited…, they would have had a defence, and it is in those circumstances not to open to them to claim reimbursement from Paribas…"[74]

After 2007 and coming into force of UCP 600, Article 12 (b) solved this problem by providing: " By nominating a bank to accept a draft or incur deferred payment undertaking , an issuing bank authorises that nominated bank to prepay or purchase a draft accepted or a deferred payment undertaking incurred by that nominated bank"[75].

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[71] UCP600. Article9.
[72] UCP 600. Article 7 (c).
[73] Isaacs M & Barnett M 'International Trade Finance - Letters of Credit, UCP 600 and Examination of Documents' (2007*) Journal of International Banking Law* 662
[74] *Banco Santander SA v Banque Paribas* [2000] 1 All ER
[75] UCP 60 UCP 600. Article 12 (b)

Third condition is that either nominated bank or any other bank accepts to add her confirmation to the credit and play the role of confirming bank. Responsibilities of Confirming Bank are defined under article 8 of UCP 600:

> "A) Provided that the stipulated documents are presented to the confirming bank ...the confirming bank must honour...
>
> B) A confirming bank is irrevocably bound to honour or negotiate as of the time it adds its confirmation to the credit..."[76]

Upon accepting confirming documents and payment against them by confirming bank, the issuing bank will have the obligation to reimburse the confirming bank. Adding the payment undertaking of confirming bank to the credit will provide seller beneficiary with and an additional guarantee of payment which is more security for being reimbursed under the contract of sales.

## *1.4: Research Questions*

Current research follows the objective of studying the Principle of Autonomy in documentary letters of credit and different exceptions to it in common law system mainly under the

[76] UCP 600. Article 8

English law. For this purpose, research will follow up the scientific approach to the subject matter by trying to find answers to the following questions:

First: What is the documentary credit, which are different types and functions of the Letter of Credit in international trade

Second: Which are the main principles of documentary credits and how do they function in practice?

Third: With reference to UCP 600 and English Law, which are the exceptions to the principle of autonomy of documentary letters of credit?

Fourth: What is fraud under documentary credit law, what is the standard of proof for fraud and what are relevant remedies for affected party under British and American legal system?

## *1.5: Methodology*

Existing research used normative and comparative study method as the main approach to analyze existing data gathered from extensive literature review on subject matter. In this respect research will review text books, case law, legal acts, articles and other relevant publications on documentary credits with special focus on independent principle. Assessment will be done on the main sources of the documentary credit law with particular focus on latest version of International Chamber of Commerce's Uniform Customs and Practice for Documentary Credits (UCP 600). Also a comparative law approach will be taken towards the coverage of American and British law on principle of autonomy of letters of credit and relevant exceptions to it with focus on cases of fraud.

In order to conduct the research, main emphasize was given to the existing case law in England and the United States of America. However, available legal cases in other Common Law Jurisdictions have been also analyzed. The comprehensive nature of English and American case law on the subject matter and inflectional role of these two legal systems in international national trade, particularly in field of Documentary Letters of Credit can be mentioned as reason behind concentration of research on them. However, special attention has been paid to case law in Australia, Canada and Singapore particularly in areas relevant to newly established exceptions to the principle of autonomy in international LC transactions. In this way, by providing a thorough analysis from divergent legal decisions in other common law countries

to American and English case law, research endeavors to provide a comprehensive picture from existing position of different legal systems towards the subject matter.

The author took paper based approach to current doctoral dissertation due to possibility for conducting comprehensive analysis of different legal aspects of autonomy principle and relevant exceptions to it in international LC transactions. Taking paper based approach also provided the author with possibility of analyzing all possible aspects of legal issues relevant autonomy principle without concerns about volume of final work. Last but not the least, taking paper based approach to the thesis provided author with possibility to publish result of research in internationally recognized journals and to obtain agreement of informed reviewers with outcome of research.

## *1.6: Structure of the Thesis*

The research consists of scientific publications by author covering the subject matter in more detail. The articles are all published in peer reviewed legal journals with internationally recognized editorial boards. To give a clear and sufficient picture to the reader, each paper provides thorough discussion on a different legal aspect of the autonomy principle in documentary letters of credit. In fact, papers work as different chapter of the thesis. The full text of publications is provided in the last chapter of this executive summary. First three papers together play the role of introduction.

The starting point for the research is paper no 1: "Documentary Letters of Credit, Legal Nature and Sources of Law". This paper provided a comprehensive study of legal nature of the documentary credits and relevant international laws applicable to LC transactions.

Paper no2: "Risk Analysis in Documentary Letter of Credit Operation". It studies existing risks in international LC transaction from the eyes of all participants.

Paper no 3, "Comparative Study of Issuing Bank's Obligations towards Beneficiary of the Letter of Credit under UCP and English Law" provides legal analysis of issuing bank's obligation to beneficiary and increases the depth of study by taking the comparative approach.

Papers 4 and 5 act as one chapter and in a complementary manner discuss the legal nature of autonomy principle and fraud as the main international recognized exception to it in LC

transaction. Paper no 4: “Autonomy Principle and Fraud Exception in Documentary Letters of Credit, a Comparative Study between United States and England” and paper no 5 is titled: “Mitigating the Risk of Fraud in Documentary Letters of Credit."

Publications no 6,7,8 and 9 together discuss all exceptions to the principle of autonomy in international LC transaction and relevant legal issues to their recognition under different common law jurisdictions. Paper no 6 is titled: “Exceptions to Principle of Autonomy in Documentary Letters of Credit; a Comparative View”. Paper no 7 is “Illegality as an Exception to Principe of Autonomy in Documentary Letters of Credit: A Comparative Approach” and paper no 8 is “Comparative study of Unconscionability exception to the principle of autonomy in law of Letter of Credits”. The paper 9 discusses a possible exception under the title of “Contractual restrictions on right of beneficiary to draw on a Letter of Credit; possible exception to principle of autonomy”.

Finally, publications no 10, 11 and 12 conclude the discussion by providing in-depth comparative legal analysis from: “Limits of autonomy principle in documentary letters of credit”, “Remedies to Fraud in Documentary Letters of Credit” and “Arbitration and LC Fraud Disputes”. The thesis also consists of a review article at the beginning of discussion which provides an overview on legal nature of the principle of autonomy in documentary letters of credit and all exceptions relevant to it. This overview offers the informed reader about existing legal problems relevant to recognition and application of different exceptions to the principle of autonomy under the Common Law in general and the English Law in particular. The review article consists of six chapters. Chapter one is the introduction to the historical background of documentary letters of credit and their operation. While chapter two explores legal nature and sources of law for letters of credit chapter three will analyse the key principles of documentary letters of credits. Chapter four will have a focus on fraud rule by analysing American and British approach to it as the first adopted exception to independent principle of documentary letters of credit. Chapter five will scrutinize other exceptions including illegality, nullity, beneficiary’s bad faith and abusive demand for payment. At the end chapter six will provide a conclusion on the subject matter of study and materials covered.

# 2. Legal Nature and Sources of the Letter of Credit Law

## 2.1: *Introduction*

The exact time that Letters of Credits started to function as their modern form is not clear[77]. However, most researchers tend to agree that emergence of the modern letters of credits started from the middle of nineteenth century[78]. Reviewing the history of Documentary Letters of Credit explains formation of modern forms of credit as response to demands in commercial world by developing primitive forms of credit[79]. However, comparison between Modern Documentary Credits and Open Credits as one of the ancients types of credit provided by banks to merchant in international trade shows the 'resemblance is only superficial'[80]:

> "1) The object of today's letter of credit is to guarantee the payment of the purchase price in international sales of goods; the open letter of credit, on the other hand, was used to raise funds for merchants traveling overseas. A merchant who did not wish to carry cash but wished to obtain credit or cash in countries where it would have find it difficult to do so otherwise could ask its banker to issue an open letter of credit for it. On the faith of the open letter of credit, the merchant was able to obtain advances from foreign bankers against its drafts
>
> 2) While the issuer of a modem letter of credit promises to pay a seller who has already entered into a contract for the sale of the goods provided the seller submits the required documents, the issuer of an open letter of credit asked others to advance money to his customer.

[77] Xiang, GAO, and Ross P. Buckley. "*Unique Jurisprudence of Letters of Credit: Its Origin and Sources, the*." San Diego Int'l LJ 4 (2003): 104
[78] Harfield.H, & Wilbert.W. *Bank credits and acceptances*. Ronald Press Company, 1974.158-62
[79] Gao Xiang (2003). 105
[80] Kozolchyk, Boris. *Commercial Letter of Credit in the Americas: A Comparative Study of Contemporary Commercial Transactions.* Bender, (1966).4.

3) In a modern letter of credit the credit is given to some third party with whom the customer has some commercial dealings; in the open letter of credit the letter was given to the banker's customer."[81]

Reviewing the history of modern Letter of Credit also shows deference between their legal nature with other instruments used in international trade including negotiable instruments and contracts of sales.

### 2.1.1: Difference between Documentary Credits and Negotiable Instruments:

Gao Xiang defines two major differences between documentary letters of credit and negotiable instruments:

Firstly, negotiable instruments are unconditional promises for payment while documentary letters of credit are conditioned to presentation of complying documents by beneficiary. Accordingly, holder in due course of negotiable instruments does not need to meet any particular condition to receive payment; however, payment to beneficiary under documentary letters of credit is conditional to his presentation of complying documents to terms and conditions of credit to the bank.

Secondly, documentary credits do not need to have a consideration unlike negotiable instruments which need to have a consideration based on their contractual nature.[82] In fact, under English law documentary credits are considered as an exception to general principle consideration in contract law as relation between issuing bank and beneficiary is governed by mercantile usage[83]

### 2.1.2 Difference between Documentary Credits and Contracts

As it has been mentioned before, documentary credits consist of several contracts in the course of transaction in addition; it is a promise which bears some characteristics of the contract. As a result, many researches have considered letters of credit as a special form of contract named "Contract for purchase of documents"[84].

[81] Ibid
[82] GAO X & Buckley RP (2003). 105
[83] Hugo, C. (2000). Documentary Credits: The Basis of the Bank's Obligation. S. African LJ, 117, 224.
[84] *Heritage Housing Corp.v. Ferguson*, 651 S.W. 2d 272(1983)

However, some differences between Documentary Letters of Credit with similar types of contracts like CIF can be mentioned, as the theory of offer and acceptance in contract does not apply to Documentary Credits as it takes effect from the moment of issuing by the issuer in favour of beneficiary[85]. Secondly, as issuer of the Letter of Credit substitutes her gurantee of payment with the financial capability of the applicant, therefore it does not need any consideration from beneficiary in order to be binding to the issuer[86]. Thirdly, Ellinger, defines CIF as a contract for purchase of goods while documentary letters of credit are contracts for purchase of documents[87]. As a result, "most accurate to say that credits are *sui generis* and that the law of contracts supplements the law of credits only to the extent that contract principles do not interfere with the unique nature of credits"[88]. While Dolan use the term "unfortunate" for describing letters of credits as contract, we can consider legal nature of Letters of credits in the best situation a very special kind of contract[89].

## *2.2: Sources of Letter of Credit Law*

In the course of history, development of law and regulations of the documentary letters of credit was based on custom[90].However, in modern time; the International Chamber of Commerce has provided the major source of law for documentary letters of credit by assuming the responsibility for codification of relevant custom and usage under Unified Custom and Practices for Documentary Credits (UCP). Additional to UCP, International Chamber of Commerce has introduced other regulations including eUCP, Uniform Rules of Contract Guarantees, Uniform Rules for Demand Guarantees, ISP98, which is International Standby Practices for Independent Guarantees and Standby Documentary Credits. United Nations Conference for International Trade Law (UNCITRAL) also individually took the initiative to prepare universal regulations for Independent Guarantees and Standby Letters of Credits which is known as United Nations Convention on Independent Guarantees and Stand-by Letters of Credit [91]. Despite existence of many international frame works for regulation of documentary

[85] Ellinger.E.P. (1970).182
[86] U.C.C. § 5-106(a), Original U.C.C. art. 5 (1995); ("A letter of credit is issued and becomes enforceable according to its terms against the issuer when the issuer sends or otherwise transmits it to the person requested to advise or to the beneficiary."
[87] Ellinger.E.P. (1970).182
[88] DOLAN, J.F, *THE LAW OF LETTERS OF CREDIT: COMMERCIAL AND STANDBYCREDITS* (rev. ed. 1996).2-5
[89] Ibid
[90] *East Girard Sav. Ass'n v. Citizens Nat'l Bank & Trust Co*., 593 F.2d .598, 603 (1979).
[91] Hereafter: UNCITRAL Convention

credits, this issue has been addressed in few national law systems. Among Civil Law countries only Colombia, El Salvador, Greece, Guatemala, Honduras, Lebanon, Mexico, and Syria have statutory rules on the letter of credit; and, the only country in the common world is the United States. In other Common Law Countries including England, legal issues of documentary credits are subjected to case law[92].

The main focus of research in this section will be study of different International legal sources for documentary credits, and answers provided by common law system to the question of legal framework for documentary credits.

### 2.2.1: Uniform Customs and Practice for Documentary Credits (UCP)

UCP has no legislative authority, as it is neither a convention not ICC is a governmental organization[93].. UCP was introduced first time in 1933 by the Commission on Banking Technique and Practice of the International Chamber of Commerce at Vienna Conference[94]. UCP was developed due to the need for recognition of uniform procedures which could harmonize the practice of Documentary Credit at global level[95]. In order to match needs of business society at global level, UCP has gone through many revisions. The last version of UCP which is known as UCP 600 came into effect by July 2007 [96]. It has been adapted by banking system in 160 countries and known as the most important body of rules for governing Documentary Letters of Credits.

### 2.2.2- eUCP

"This is the acronym for the supplement to the uniform Customs and Practice for Documentary Credits for Electronic Presentation"[97]. Meeting the needs for electronic trade was the initiative of Banking Commotion of ICC to propose the formation of committee to work on developing

[92] Gao X & Buckley RP (2003) .108
[93] Ademola. A.O, '*Letters of Credit: Tower of Babel or Jacob's ladder? A Look at Whether Private Codifications of Commercial Usage Brings Us Any Closer to a Harmonised International Commercial Law*' (2008) (http://www.dundee.ac.uk/cepmlp/ gateway/index.php?news=29287, Accessed on 10 May 2016) 6 ; Kozolchyk, Boris. Commercial Letter of Credit in the Americas: A Comparative Study of Contemporary Commercial Transactions. Bender, (1980).10
[94] ICC Brochure No 82
[95] Chung, S. I. "*Developing a Documentary Credit Dispute Resolution System: An ICC Perspective*." *Fordham Int'l LJ* 19 (1995): 1355.
[96] UCP 600 Introduction .11
[97] UCP 600

a bridge between UCP and processing the electronic equivalent of paper based credits[98]. The working group started to work on preparation of a supplement to the UCP which "would deal with the issues of Electronic Presentation"[99]. The result of working group's efforts is known as eUCP. It came into force from 1 April 2002 and in the format of first version dealing with issues of eleteronic presrenation in order to facilitate the necessities for further revisions[100]. Current version of eUCP is the version 1.1.

Issues covered by eUCP are: "eUCP- UCP relations, format, presentation, originals and copies and examination of electronic records"[101]. Article 2 of eUCP emphasized on consistency of the all articles of eUCP with UCP while their application is only in case of electronic presentation. While using the eUCP, credit will be also subjected to UCP without any express incorporation of it[102].

### 2.2.3: Uniform Rules of Contract Guarantees (URCG)

URCG was introduced by ICC in early 1970s in order to address the need for set of rules which deal with existing inconsistencies in field of "'[g]uarantees given by banks, insurance companies and other guarantors in the form of tender bonds, performance guarantees and repayment guarantees in relation to projects in another country involving the supply of goods or services or the performance of work."[103]. Therefore, unlike UCP which was regulating the process of Letter of Credit URCG was an attempt to deal with unfair calls for demand guarantees[104].

Despite all expectations, URCG was not welcomed by the international business society for few reasons including that their applicability was only limited to independent guarantees and they had no effect on accessory guarantees[105]. The other problem was the result of URCG's attempt to prevent unfair call on demand guarantees by requiring beneficiary to produce an

[98] Gao X & Buckley RP (2003) .113.
[99] Note to National Committees and Members of the Banking Commission, ICC BANKING COMM'N Doc. 470/941rev3 (Oct. 12, 2001).
[100] Ibid
[101] Ibid
[102] Gao X & Buckley RP (2003). 114
[103] Ibid
[104] INT'L CHAMBER OF COMMERCE, ICC PUBLICATION No. 325 (1978). 7.
[105] Xiang Gao. *The fraud rule in the law of letters of credit: a comparative study*. Vol. 2. Kluwer Law International, 2002.57

evidence of failure in the format of judgement, arbitral award or the principal's written approval at the time of making the claim[106].

### 2.2.4: Uniform Rules for the Demand Guarantees (URDG)

The failure of URCG in attracting the attention of the business society at global level was the reason for ICC to introduce new set of rules and take a different approach to Demand Guarantees. URDG 458 came into force by 1992 and based on a model which was applied by British bankers[107]. Despite the fact that URDG 458 was strongly influenced by UCP, but still "[w]orldwide acceptance of the Rules ha[s] been disappointing"[108]. URDG 758 which is the revised version of URDG 458 came into force on 1 July 2010. It tries to address problems of previous version and set out functions and obligations of parties to the demand- guarantee by reflecting the best practices in business of guarantees[109].

### 2.2.5: International Standard Practice (ISP 98)

"ISP 98 is a set of rules specifically designed for standby letters of credit"[110]. It was originally introduced by American institute of International Banking Law and Practice. ISP 98 received approval by ICC in 1998[111] and came into effect by January 1999. Historically, Standby Letters of Credits have been in use for many decades without being subjected to specific regulations. They were mostly regulated by UCP; however, application of UCP to Standby Letters of Credits was source of many problems, as UCP was "originally written for use only in commercial letters of credit... many of the provisions of the U.C.P. are either inapplicable or inappropriate in a standby credit context."[112]. On the other hand, it was possible for Standby Letters of Credit to be governed by URDG due to similarity between legal character of Demand Guarantees and Standby Letters of Credits. However, URDG is becoming more popular after coming into force of its new revision URDG 758 and "[f]rom the viewpoint of the I.C.C .... Standby letters of credit continue to be covered by the U.C.P. and are not covered by the

[106] Gao X & Buckley RP (2003) .114
[107] URCG, Article 8(3) and 9
[108] INT'L CHAMBER OF COMMERCE, ICC PUBLICATION No. 458
[109] Katz.R, Report delivered at the I.C.C. Hong Kong meeting, supra note 76, reprinted in INT'L CHAMBER OF COMMERCE, ICC PUBLICATION No. 470/893, 19.
[110] Baranello J '*Understanding the URDG 758*'(2010) (http://www.fpsc.com/DB/TreasuryPulse/ Fall2010/Article4.html, Accessed on 10 May 2016)
[111] Gao X & Buckley RP (2003) .115
[112] INT'L CHAMBER OF COMMERCE, ICC PUBLICATION No. 590 (1998)

U.R.D.G."[113] Initially, similar to othe ICC rules including :UCP for regulating the function of Commercial Letters of Credits ,URDG for Independent Guarantees, the ISP 98 was drafted for purpose of regulating Standby Letters of Credits. "(l)ike the UCP and the URDG, ISP98 [applies] to any independent undertaking issued subject to it"[114] .

### 2.2.6 International Standard Banking Practice for the Examination of the Documents Under Documentary Credits Subject to UCP 600 (ISBP)

ISBP has been described by ICC as a great help to banks, corporates, logistics specialists and insurance companies[115]. The main idea behind introducing it is the explanation of how to apply UCP in practice. For example, sections 185 of ISBP comment of documents which are not covered by UCP[116], expressions which are not defined in UCP[117], management of misspelling and specific types of errors[118]; time for application of original and copies[119]; methods of signing documents[120]; and how to prepare insurance documents[121].

### 2.2.7 Uniform Rules for Bank to Bank Reimbursement under Documentary Credits

ICC introduced the URR 525 in order to standardize the bank to bank reimbursement process. Article 13(b) which is new in UCP 600 aligns it with URR 525[122]. The last renewal process of URR took place in 2008 by replacing URR 525 with URR 725. According to ICC, URR 725 should not be considered as the revision of URR 525 as it is more an update in order to be in more alignment with UCP 600[123]. Since URR 725 has not been incorporated into UCP 600, its application is only limited to bank to bank reimbursement based on explicit agreement to the

[113] Turner PS '*New Rules for Standby Letters of Credit: The International Standby Practic*es' (1999) 14. Banking & Finance Law Review 459
[114] James E. Byrne, Preface to JAMES E. BYRNE ET AL., *INTERNATIONAL STANDBYPRACTICES ISP98* 6. (ICC Publishing, Inc. 1998)
[115] Introduction of ISBP
[116] sections 19-20 ISBP
[117] section 21 of ISBP
[118] section 25 of ISBP
[119] sections 28-33 ISBP
[120] sections 37-40 ISBP
[121] sections 170-180 ISBP

[122] UCP 600, Article 13 (b): '[i]f a credit does not state that reimbursement is subject to the ICC rules for bank-to-bank reimbursements, the following apply: (…)
[123] Introduction to URR 725

reimbursement agreement.[124] Article 13(b) of UCP 600 will cover bank reimbursement obligations in absence of such provisions in reimbursement agreement.

### 2.2.8 United Nation's Convention on Independent Guarantees and Standby Letters of Credits

UNCITRAL Convention has been drafted by an intergovernmental organization which is body of United Nations General Assembly and works on preparation of instruments for harmonization of law regarding international trade[125][126]. United Nation's Convention on Independent Guarantees and Standby Letters of Credits has been adopted by UN General Assembly on 11 December of 1995[127]. Standby letters of credits and independent guarantees or any other international undertaking can be subjected to the UCITRAL Convention[128]:

> "the place of business of the guarantor/issuer at which the undertaking is issued is in a Contracting State," or "the rules of private law lead to the application of the law of a Contracting State," "unless the undertaking excludes the application of the Convention."[129]

In case of commercial letters of credit, by express address of parties in the credit, UNCITRAL Convention can be used as the governing law[130]. Although, UCP and URDG have been used as bases for drafting the UNCITRAL Convention, it is possible to distinguish some differences among them. First, UCP and URDG have been drafted by ICC which is a private institute and its approvals might only have application as voluntary rules or self-regulations while UNCITRAL Convection is a uniform law and official regulation applied to signatory countries which has been drafted by an international organization[131]. Therefore, UNCITRAL Convention can be differentiated from ICC rules due to its legal statues. In addition, UNCITRAL Convention, consist of complementary provisions

[124] URR 725, Article 1
[125] Explanatory Note: UNCITRAL Secretariat on the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit, U.N. Commission on International Trade Law, 30th Sess., note I, at 2, U.N. Doc. A/CN.9/431 (1996) (hereinafter UNCITRAL Explanatory Note).
[126] United Nation's Convention on Independent Guarantees and Standby Letters of Credits is not in force at it has been ratified only by 8 countries: Belarus , Ecuador , El Salvador, Gabon , Kuwait Liberia , Panama , Tunisia and United States of America . However, it is has not entered into force in the US. http://www.uncitral.org/uncitral/en/uncitral_texts/payments/1995Convention_guarantees_status.html (accessed ; 1, March 2018)
[127] Gao X & Buckley RP (2003) .117
[128] UNCITRAL CONVENTION art. 1(2)

[129] UNCITRAL CONVENTION art. l(1)(b).
[130] UNCITRAL CONVENTION art. 1(2)
[131] UNCITRAL Explanatory Note .5

to UCP 600, URDG and ISP 98 including abusive demand, fraud and remedies which are discussed under the section 19 of Convection.

### 2.2.9: Unified Commercial Code

Among the common law jurisdictions, United States of America is the only country with a detailed regulations on documentary letters of credit under the Article 5 of UCC[132.] "The U.C.C. is a collection of model statutes drafted and recommended by the National Conference of Commissioners of Uniform State Laws (NCCUSL) and the American Law Institute (A.L.I.) for enactment by the legislatures of the states of the United States. It consists of eleven different articles, each covering a different aspect of commercial law"[133]. Article 5 of the UCC was drafted for the first time during 1950s when it was intended to act as an "independent theoretical framework for the further development of letters of credit."[134] Article 5 of UCC was revised in 1995 almost after forty years of hard use[135] in order to overcome "weaknesses, gaps and errors in the original statute which compromise its relevance"[136]. The revised Article 5 of UCC was completed in October 1995 and was almost adopted by all states in 2002. Despite the presence of Article 5 of UCC, still UCP has great influence of American regulations of Documentary Letters of Credits[137]. According to the official commentary to article 5: "Article 5 of UCC and UCP are consistent and complementary to UCP in many occasions" However, they have substantial differences as well. Firstly, Article 5 of UCC has been drafted as a Statue while neither ICC regulation including UCP have such effect. Secondly, in accordance with UNCITRAL Convention, article 5 comments on fraud rule which has been left open by UCP[138].

[132] Grassi PS (1995) 105.
[133] Gao X & Buckley RP (2003). 117
[134] Original U.C.C. art. 5, § 5-101, Official Comment 1 (1995)
[135] Task Force on the Study of U.C.C. Article 5, Report, An Examination of U.C.C. Article 5 (Letters of Credit), 45 Bus. LAW 1521, 1532 (1990
[136] Barski. Katherine A, '*Letters of Credit: A Comparison of Article 5 of the Uniform Commercial Code and the Uniform Customs and Practice for Documentary Credits'*, 41 LOY.L. REV. 735, 739 (1996)
[137] Buckley. RP, *Documentary Compliance in Documentary Credits: Lessons from the UCC for the UCP*, 1 J. INT'L COM. L. 60, 69 (2002).
[138] Commentary on UCP 600 , ICC Publication No. 680,(2007)

# 3. Key Principles of Letter of Credit

UCP 600 explains that, for the purpose of protecting the flow of international trade and safeguarding the operation of Documentary Letters of Credits, they are subjected to two main principles: Strict Compliance and Autonomy[139]. This chapter of current research will focus on the main principles of Documentary Credits under the UCP and English Law in addition to discussing the exceptions to the principle of autonomy at the end of the chapter.

## *3.1: The Principle of Strict Compliance*

The principle of Strict Compliance expresses that issuing bank's undertaking to honour the credit is effective only upon presentation of complying documents which are stipulated in the credit by beneficiary[140]. On the other hand, in explanation of strict compliance, the general law of agency provides that an agent (issuing bank) will be entitled to for reimbursement from principle (applicant) only in case of acting in accordance with principle's instructions[141]. Therefore, banks who act as an agent for applicant in documentary credits will receive reimbursement in case of honouring the credit against presentation of complying documents. The standard for examination of documents has been set in Article 14 of UCP 600:

> "Article 14 Standard for Examination of Documents
>
> a. A nominated bank acting on its nomination, a confirming bank, if any, and the issuing bank must examine a presentation to determine, on the basis of the documents alone, whether or not the documents appear on their face to constitute a complying Presentation.
>
> d. Data in a document, when read in context with the credit, the document itself and international standard banking practice, need not be identical to, but must not conflict with, data in that document, any other stipulated document or the credit."

[139] INTER ALIA, art. 2; art .4; art. 7(a), art. 8(a), (c) and art. 15; art. 14, art. 34 (UCP 600).
[140] Interalia Article 2; Article 7(a), Article 8(a)(c) and Article 15; Article 14 and Article 34 of UCP 600
[141] King, R. (2003). *Gutteridge and Megrah's law of bankers' commercial credits*. Routledge., p. 14

The majority of discrepancies in practice of Documentary Letters of Credit include inconsistent data[142], discrepant documents of transport[143], mistakes in draft[144], drafts without signature and inconsistent invoice with credit[145], inadequate insurance[146] , and documents with wrong signature[147].

Contrary to the principle of independence, principle of Strict Compliance is protecting interests of applicant under documentary credits process which requires shipment of promised goods by beneficiary before actualization of payment. There is an ongoing scholarly debate about what constitutes the complying presentation which can be traced into legal cases[148]. The most important question can be what is the characteristic of non-complying presentation?[149]. There are two main theories regarding the determination of documentary compliance: Doctrine of Strict Compliance and Doctrine of Substantial Compliance[150].

### 3.1.1: Doctrine of Strict Compliance

According to the doctrine of Strict Compliance, presented documents should strictly comply with credit[151]. In contrary with UCP 500, the term of "Reasonable Care" has been deleted from UCP 600 which shows that only strict compliance is the criteria for reimbursement of bank by applicant[152]. However, word by word compliance is not be required by UCP 600 [153]. Simple mistakes and typographic errors might not be considered as non-conformity during the examination of documents and banks are unlikely to reject documents with minor defects. According to Woods, UCP 600 does not use the term "strict" and also provides permission for

[142] Article 14(d) UCP 600
[143] Article 19 UCP 600
[144] Article 18(c) UCP 600
[145] Article 28 UCP 600
[146] Baker B '*Exporting Against Letters of Credit'* available at http://www.qfinance.com/content Files/QF02/g1xtn5q6/12/3/exporting-against-letters-of-credit.pdf (Accessed on 1 March 2018)
[147] Article 34 UCP 600
[148] Botosh HMS '*Striking the Balance Between the Consideration of Certainty and Fairness it the Law Governing Letters of Credit*' (2000) 183-271
[149] Krazovska D '*Impact of the Doctrine of Strict Compliance on a Letter of Credit Transaction*' (2008), Master Thesis, University of Aarhus, 25-43.
[150] Ibid
[151] Ibid
[152] UCP 500, Article 13. (A): Banks must examine all documents stipulated in the Credit with reasonable care, to ascertain whether or not they appear, on their face, to be in compliance with the terms and conditions of the Credit. Compliance of the stipulated documents on their face with the terms and conditions of the Credit, shall be determined by international standard banking practice as reflected in these Articles.
[153] Wood JS (2008) 106

insignificant inconsistencies or errors[154]. However, it is difficult to distinguish the insignificant error from the significant one. For example *in Seaconsar Far East Ltd V. Bank Markazi Jomhuri Islami Iran*[155], the court defined all documents should indicate the credit number and buyer's name. However, one of the tendered documents missed the buyer's name and credit number. The Lloyd LJ held that bank was entitled to reject the presentation[156]:

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

Therefore, discrepancies can be divided into two main groups: *Irrelevant Irregularities* with no effect on principle of strict compliance and *Material* or *Genuine discrepancies* which violate the principle of strict compliance and result in rejection of documents by bank.

### 3.1.1.1.: Irrelevant Irregularities

Except in case of commercial invoice, UCP 600 does not require for strict compliance of any documents with Credit. In fact, some articles provide tolerance up to 10 percent regarding 'amount or quantity of credit while terms like 'about' or 'approximate' are used in the credit[157]. Other articles provide tolerance of 5 percent when quantity is not defined in the credit. [158]

### 3.1.1.2 Material Discrepancy

There are numerous court cases on material discrepancies. In *JH Raynor & Co. Ltd v. Hambro's Bank Ltd*[159], shipped goods were described in the bill of lading as "machine-shelled ground kernels". However, credit had the description of goods as "Coromandel groundnuts". In the judgement of court of appeal, it was held that bank was correct about rejection of tender despite

[154] Ibid
[155] *Seaconsar Far East Ltd V. Bank Markazi Jomhjouri Isami Iran* [1993] 3 W.LR. 756 (HL), [1993] 1 Lloyd's Rep. 236 (CA)
[156] Ibid
[157] UCP600, Article 30 (a)
[158] UCP 600, Article 30 (b)
[159] *JH Raynor & Co. Ltd v. Hambro's Bank Ltd* [\.9Q3] Q.B. 711

the fact that terms were proved to be the same. The reason was that banks are not required to have the knowledge of the meaning of terms in different fields[160] .

Other example is *Courtaulds North America, Inc. v. North Carolina Nat. Bank*[161] in which credit stipulated an invoice for '100% Acrylic Yarn', while the presented invoice described goods as 'Imported Acrylic Yarn' . Bank rejected the presentation[162]. The court held that bank was entitled to dishonour presentation despite the fact that description of goods on packing list were matching with credit on the basis that UCP has differentiated invoice from remaining documents[163].

> "Free of ineptness in wording the letter of credit dictated that each invoice express on its face that it covered 100% acrylic yarn. Nothing less is shown to be tolerated in the trade. No substitution and no equivalent, through interpretation or logic, will serve."[164]

*Bank Melli Iran v. Barclays Bank (Dominion, Colonial & Overseas*) is another important case on material discrepancies[165]. In above mentioned case payment was due upon presentation of commercial invoice for shipment of '100 new Chevrolet trucks' while invoice described goods as 'in new condition'. The court held that bank was entitled to reject presentation as 'in the new condition' and 'new' are not the same.[166]

### 3.1.2 Substantial Compliance

It is the test which is accepted by few courts in order to balance the interests[167]. The requirement of test is that banker should "look beyond the face of the documents, investigate the realities of the transaction, and weigh the credibility of documents, customers and beneficiaries".[168] Substantial Compliance has been considered in contradiction with Article 5 of UCP 600 which

[160] Ibid
[161] *Courtaulds North America, Inc. v. North Carolina Nat. Bank* 528 F.2d 802, C.A.N.C [1975]803
[162] Ibid, 896
[163] Article 14(e) UCP 600, which reads 'documents other than the commercial invoice'
[164] *Courtaulds North America, Inc. v North Carolina Nat. Bank* 528 F.2d 802, C.A.N.C [1975] 806
[165] *Bank Melli Iran v Barclays Bank (Dominion, Colonial & Overseas*) [1951] 2 Lloyd's Law Reports 367.
[166] Ibid
[167] Leon C (2012) 453.
[168] Hotchkiss. C, '*Strict Compliance in Letter-of-Credit Law: How Uniform is the Uniform Commercial Code*?' (1991) 23 Uniform Commercial Code Law Journal 295

emphasizes on limitation of bank's responsibility to deal with documents not goods or services[169].

## *3.2 Principle of Autonomy*

The second fundamental principle in operation of letters of credit and cornerstone of current research is the principle of autonomy. It has been appreciated in national and international legal frameworks[170]. The principle of autonomy of letters of credit has been considered as "cornerstone of the commercial validity of the letters of credit"[171], and "the engine behind the letter of credit"[172.] The autonomy principle of letter of credits has been clearly mentioned in article 4 of UCP 600:

"Article 4 Credits v. Contracts

> a. A credit by its nature is a separate transaction from the sale or other contract on which it may be based. Banks are in no way concerned with or bound by such contract, even if any reference whatsoever to it is included in the credit. Consequently, the undertaking of a bank to honour, to negotiate or to fulfil any other obligation under the credit is not subject to claims or defences by the applicant resulting from its relationships with the issuing bank or the beneficiary. A beneficiary can in no case avail itself of the contractual relationships existing between banks or between the applicant and the issuing bank.
>
> b. An issuing bank should discourage any attempt by the applicant to include, as an integral part of the credit, copies of the underlying contract, proforma invoice and the like."

Based on Autonomy Principle and the text of article 4 of UCP 600, the beneficiary exporter has assurance that his payment will be due upon presentation of complying documents to the issuing bank, while neither bank nor the account party can deny payment based on the arguments related to performance of underlying contract. Therefore, even in cases of argument

[169] UCP 600, Article 5.
[170] Article 4 UCP 600; Article 2(b) URDG; Articles 2 and 3 UNCITRAL-Convention; sections 5-10 (1)(a), 5-114 (1) and 5 5-103(d) UCC
[171] *Ward Petroleum Corp. v Federal Deposit Ins. Corp*. (1990) 903 F.2d 1299.
[172] Arkins J (2000) 31

on performance of underlying contract account party and issuing bank have no other choice rather than paying beneficiary upon presentation of complying documents and seek remedy by suing him for the breach of underlying contract. As a result, Autonomy Principle has been considered a means of promoting international trade[172] by following the logic of "pay first, argue later"[173]

The autonomy principle also has been considered as the foundation for smooth operation of letter of credits by scholars:

> "We should also remember that in many international trade transactions, there are parties involved than just the buyer or seller. The seller usually had to obtain goods or raw materials from a supplier before he is able to meet the contract made with the buyer. The seller will need to be financed in making payment to their suppliers. That financing comes from the negotiation or discounting of drafts drawn under the documentary credit system. That system of financing would break down completely if a dispute between the seller and buyer was to have the effect of "freezing" the sum in respect of which the letter of credit was opened".[174]

In order to completely address the essence of autonomy principle, article 5 of UCP 600 specifies: "banks deal with documents and not with goods, services or performance to which the documents may relate."[175]

### 3.2.1 Main functions of Autonomy Principle

The main functions of autonomy principles in operation process of Documentary Letters of Credits are payment, commercial and financing.

## 3.2.1.1: Payment Function

By separating the underlying contract from credit and substituting risks of each party, the autonomy principle reduces the commercial risk of trade[176]. As a consequence, beneficiary

[173] *Eakin v Continental Illinois National Bank & Trust Co*. (1989) 875 F.2d 114 .116.
[174] Dolan JF (2006) 480.

[175] UCP600. Article 5
[176] McCormack G '*Subrogation and Bankers` Autonomous Undertakings'* (2000) Law Quarterly Review 45

receives the payment after the tender of complying documents and bank received reimbursement from account party regardless of existence of any relevant dispute to underlying contract. [177] The account party also should pay first upon tender of complying documents and argue later about any unconformity in goods.[178]

### 3.2.1.2 Commercial Function

The commercial function of Principle of Autonomy has been discussed by Professor McCormarck[179] as an assurance for reimbursement of issuer only based on tender of complying document by beneficiary while requiring issuing bank to undertake the ministerial function of document checking[180] and fund transfer[181] in order to remove any doubts about its payment undertaking[182]. On this basis, British courts force the issuing bank to pay even on the occasion of tendering forged[183] and incorrect documents[184] and regardless of the facts represented by documents[185].

### 3.2.1.3 Financing Function

Financing function has two main characteristics. Firstly, it protects confirming and issuing bank from any interference preventing them to recieve reimbursement from the applicant after making payment to the beneficiary[186]. Secondly, it provides a support of leveraging other transactions for beneficiary by the credit which has been issued in his favour.[187]

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[177] Buckley .RP & Gao. X, The *Development of the Fraud Rule in Letter of Credit Law: The Journey So Far and the Road Ahead'* 23 (2002) University of Pennsylvania Journal of Economic Law 663
[178] Sappideen R '*International Commercial Letters of Credit: Balancing the Rights of Buyers and Sellers in Insolvency'* (2006) Journal of Business Law146
[179] McCormack G,2000
[180] Alces. P.A, *an Essay in Independence, Independence and the Surety Principle*, 3 University of Illinois Law Review, 480 (2006).
[181] Hare C '*Not so Black and White: The Limits of the Autonomy Principle'* (2004) The Cambridge Law Journal 288
[182] McCormack G, 2000
[183] *Gian Sing & Co. Ltd v. Banque de l'Indochin*e 2 All E.R. 754(1974)
[184] *Pacific Composites Ply Ltd & Anor v. Transpac Container System Ltd & Ors*
[185] *IE Contractors Limited v. Lloyds Bank Plc. 2 Lloyds Rep* 496, Staughton L.J., 499(1990).
[186] Yafrich M '*Third Party's Attachment on Letter of Credit Proceeds'* (2001) Journal of Business Law 159; Rendell RS 'Fraud and Injunctive Relief' (1990-1991) Brooklyn Law Review 113.
[187] Garcia RLF (2009) 77.

Finally, comments of Hirst J in *Tuckan Timber Ltd v. Barclays Bank Plc*[188] clearly illustrates bank's obligations under documentary credits as well as signalling the traditional hesitation of English Courts in interfering with independent principle of documentary credits.

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

### 3.2.2 Exceptions to the Autonomy Principle

The autonomy principle provides beneficiary with the shielded undertaking of the bank for payment against any interferences on issues out of the terms of documentary Credits[189]. Such undertaking intends regardless to any dispute over the underlying contract, the bank should pay to beneficiary upon tender of complying documents. As a result, the autonomy principle results in weak position of account party against abusive demands of beneficiary and his fraudulent claims. On such occasions, the only defence of applicant will be relying on strict compliance principle and rejection of non-complying documents by bank. However, this defence might not work when the beneficiary is determined to obtain payment on the basis of presenting fraudulent documents. On the other hand, the beneficiary has the upper hand against the issuing bank and account party in which regardless to any dispute on the contract of sales, he is entitled for payment upon the tender of complying documents. Such upper hand can be an incentive for abusive demand for payment or presentation of fraudulent documents by beneficiary.

For a long period of time the general belief was supportive towards the absolute nature of independent principle[190]. However, it became clear that exceptions are needed to deal with abusive and fraudulent demands. As result, the fraud exception has been established which is recognized by all common law countries. In cases of fraud, court has the obligation to decide between respecting the principle of autonomy and grating injunction to stop payment after

[188] *Tukan Timber Ltd v. Barclays Bank Pic*. [1987] 1 Lloyd's Rep 171, 174
[189] Enonchong. N (2011),93
[190] *United City Cooperation V. Allied Arab Bank* (1985) 2 Lloyds Rep.554,561

considering public policy, statutes, and public interest and third party rights.[191] Despite the fact that fraud rule is a recognized exception to principle of autonomy of documentary credits, there is no standard [192] regarding time and circumstances in which it should supersede the autonomy principle[193]. Later it became clear that exercising the public interest requires application of exceptions in case of illegal underlying contract[194]. Therefore, clear evidences show that English Legal system is ready to recognize further exceptions to the principle of autonomy.

Other Exceptions which are going to be covered in current research include: Illegality[195], nullity[196], unconscionable and reckless conduct of beneficiary[197].

[191] Garcia RLF (2009) 69
[192] Gao X '*The Fraud Rule in the Law of Letters of Credit: A Comparative Study'* (2002) is the most comprehensive study as regards the issue of the fraud rule; see also Buckley RP & Gao X '*The Development of the Fraud Rule in Letter of Credit Law: The Journey so Far and the Road Ahead'* 23 (2002) University of Pennsylvania Journal of Economic Law 663;
[193] Gao X & Buckley RP (2003) 293
[194] Enonchong N '*The Autonomy Principle of Letters of Credit: An Illegality Exception*?' (2006) Lloyd's Maritime and Commercial Law Quarterly 404; Botosh HMS (2000) 135-150; Garcia RLF (2009) 67
[195] Enonchong N (2006) 404
[196] Hooley R '*Fraud and Letters of Credit: Is there a nullity Exception*?' (2002) 61 Cambridge Law Journal 279; Garcia RLF (2009) 87
[197] Aijaz H '*Unconscionability as an Exception to the Independence Principle – A Study of Singaporean Caselaw*' (2000) available:http://papers.ssrn.com/sol3/papers.cfm? abstract_id=1689309 (Accessed on 10 May 2016).

# 4. Fraud Exception

As it was explained earlier, the principle of autonomy or independence of letter of credits law provides guarantee of payment for beneficiary upon presentationof complying documents and separates the obligation of issuing bank for making the payment to the beneficiary from obligations of beneficiary under the contract of sales with account party[198]. Such absolute guarantee might result in presentation of documents which comply with terms of credit on their face while the fraudulent beneficiary has not been performed any of his obligations in the framework of underlying contract of sales. In fact, fraud is very old and well-known phenomenon in the business world. "As long as there have been commercial systems in place there have been those who have tried to manipulate these systems."[199] Fraud has been considered as the "the most controversial and confused area"[200] as it "goes to the very heart" of the letter of credit by providing the bank to look at the facts behind complying presentation of beneficiary and stop payment in cases of fraud in transaction[201].

## *4.1 The meaning of Fraud*

According to the Article 5 of UCP 600, "bank deals with documents not goods or services"[202] which means that "banks deal in written presentations not facts"[203]. According to Dolan: "The fundamental principle governing documentary letters of credit and the characteristic which gives them their international commercial utility and efficacy is that the obligation of the issuing bank to honour the draft on a credit when it is accompanied by documents which appear on their face to be in accordance with the terms and conditions of the credit is independent of the performance of the underlying contract for which the credit was issued."[204]

[198] Garcia RLF (2009) 87
[199] *Trade Finance Fraud –Understanding the Threats and reducing the Risk,* A Special Report prepared by the ICC International Maritime Bureau (Paris) 2002, p. 9
[200] Buckley RP & Gao X (2002), p. 663 referring to Anon '"*Fraud in the Transaction*": Enjoining Letters of Credit during the Iranian Revolution' 93 (1980) Harvard Law Review. P.92
[201] Gao X & Buckley RP (2003), p. 293
[202] UCP600, Article 5
[203] Harfield.H, Bank Credits and Acceptances (5th ed., 1974) New York, p. 69
[204] Dolan. J.F, *Documentary Credit Fundamentals: Comparative Aspects*, 3 Bank. & Fin.L. R 121 (1988)

Therefore, beneficiary does not have to prove fulfilment of his obligations in underlying contract and only presentation of complying documents will entitle him for receiving payment from issuing bank. As a result, strict implementation of autonomy principle will create three distinctive scenarios regarding presentation of documents by beneficiary.

First, beneficiary presents complying documents and performs his obligations under the sales contract with account party. As a result, bank will allow payment after checking documents. Second, beneficiary presents non-complying documents while performing his obligations under the contract of sales with account party. In such situation, bank may or may not authorize payment to the beneficiary (bank may ask for waiver from account party or corrections from beneficiary).

Third scenario takes place when beneficiary presents complying documents to the terms of credit but does not perform his obligations under sales contract with account party. In such occasion, strict application of autonomy principle might lead us to fraud by beneficiary and injustice towards account party who has to bear the loss as the last person in the chain of transaction.

Therefore, in order to prevent fraud, the law of letters of credit has created fraud exception to the autonomy principle of letters of credit. However, fraud exception has been approached by different scholars and national laws in different ways. UCP 600 as the most popular set of applicable rules to documentary letters of credit take an absolute silent position towards fraud rule while leaving it open to the relevant municipal law which show a drastically non harmonious approach to the subject matter. Even the provided definitions for fraud rule are not harmonious. Gao Xiang considers fraud exception in documentary credits as "an extraordinary rule as it represents a departure from the cardinal principle of the law of letters of credits – the principle of independence. It allows the issuer or a court to view the facts behind the face of conforming documents and to disrupt the payment of a letter of credit when fraud is seen to be involved in the transaction"[205]. Schmitthoff mentions that fraud rule "permits a court to consider evidence other than the actual terms and conditions of the credit and is founded on the maxim of *ex turpi causanonoritur actio*"[206] . Conveying the message that fraudulent

[205] Xiang Gao, *The fraud rule in the law of Letters of Credit* (2002) The Hague, p. 30
[206] *Schmitthoff's Export Trade – The Law and Practice of International Trade* (12th ed., 2012) Sweet & Maxwell, p. 210

beneficiary will not be able to find an action based on his wrongdoing. Raymond Jack refers to fraud rule as "exception to the rule that the contracts made in connection with credits are autonomous"[207].

## *4.2 Rational for the Fraud Rule*

Gao has defined three rational for establishment and enforcement of fraud rule[208] :

1- **Closing the loophole in law**: Strict application of autonomy principle and providing absolute guarantee for payment to beneficiary upon presentment of complying documents might provide an opportunity for perpetrators of fraud to harm the system of international trade and operation of documentary credits by presenting forged or fraudulent documents to the bank which comply on their face with terms of credit, but do not perform their obligations under the contract of sales with account party[209]. As a result, the strict application of independent principle and complete separation of credit from underlying contract might result in false calls, abusive demands and fraud which can be considered as one of the reasons behind development of fraud rule[210]. There are doubts about capability of fraud rule to prevent any injustice resulted from fraud, but definitely it will reduce the loophole which has been created by the autonomy principle.[211].

2- **Public Policy**: The second rational for fraud exception is the result of public policy's concern over controlling and defying fraud. There should not be a possibility for fraudster beneficiary to benefit from autonomy principle while trying to obtain payment by presentation of forged documents. [212]

The interest of public policy in prevention of fraud has been reflected in many authorities. Including comments of Edenfeild J in the case of *Dynamics Corporation of America v The Citizens and Southern National Bank* who mentioned: 'there is as much public interest in discouraging fraud as in encouraging the use of letters of credit'[213]. Also in *United City*

[207] Malek. A, Quest. D,Jack. *Documentary credits: the law and practice of documentary credits including standby credits, and demand guarantees, 2009, Tottle,*
[208] Gao X (2002) 29 and 98
[209] Ibid
[210] Stewart .H, '*It is Insufficient to Rely on Documents'*, (2002), Journal *of Money Laundering Control*, p.225
[211] Gao X (2002) , p.30
[212] Kurkela MS '*Letters of Credit and Bank Guarantees under International Trade Law*' 2 ed (2008), p. 181.
[213] Gao X (2002), p. 30

*Merchants (Investment) Limited v Royal Bank of Canada*[214], Lord Diplock comments on *ex turbi causa non oritur* [215], intention of court not to allow its process to be used by dishonest person to carry out the fraud as basis for the fraud rule.

3- **To Maintain the Commercial Utility of Letters of Credit**. As discussed in previous chapters, documentary letters of credit act towards balancing the contradictory interests of beneficiary and applicant. In the operation of documentary letters of credit, issuing bank will replace her own guarantee for payment with creditworthiness of account party while beneficiary will receive money only by safeguarding interests of applicant after tendering documents which comply with terms of credit. Tendered documents including the bill of lading do not only play a significant role in operation of the letters of credit but also provide security for the bank before being reimbursed by account party. Therefore, bank's security interest will be abused in case of beneficiary's fraud. As a result the balance in the operational scheme of documentary letters of credit will be undermined while neither of users will have faith in commercial utility of documentary letters of credit anymore[216].

In response to critics of fraud rule who argue about capability of issuing bank and account party to take legal action against beneficiary based on the breach of the underlying contract, supporters of application of fraud rule consider such legal action not as a valuable alternative because, fraudulent beneficiary "absconds before the fraud or forgery is discovered"[217]. Therefore application of fraud rule will shrink the legal loophole of the autonomy principle, maintains the commercial utility of documentary letters of credits by reducing opportunities for abusive actions and maintains the balance between conflicting interests of involved parties in the credit.[218]

[214] *United City Merchants (Investment) Limited v Royal Bank of Canada* [1982] 2 All E.R. 725
[215] *Ex turpi causa non-oritur actio* can be translated as 'no action can be based on a disreputable cause', Law J & Martin EA 'A Dictionary of Law' 7 ed (2009)
[216] Buckley RP & Gao X (2002) 667
[217] Ellinger P '*Documentary Credits and Fraudulent Documents'* in Chinkin CM, Davidson RJ *et al*.eds. 'Current Problems of International Trade Financing', Lexis Law Publishing, (1983) 191
[218] Gao X (2002) 32

## *4.3 A Historical Review on Fraud Rule in Documentary Credits*

As it was mentioned earlier, despite the fact that documentary letters of credits have been in use for many centuries, their legal framework is still a developing process. As a result, exceptions to the autonomy principle like fraud and other extensions can be considered as developing legal aspects of documentary letters of credits. Since most of common law system jurisdictions are influenced by American and English legal systems, the scope of current research will be limited to development and legal aspects of exceptions to the autonomy principle of documentary credits in USA and England and Wales. In United States of America fraud exception has been codified under the Article 5 of Unified Commercial Code. Therefore, it is possible to mention that United States of America is the only country in common law system which has a statutory law on fraud in documentary credits [219]

In contrary with United States of America, fraud rule in English legal system is governed based on the case law[220]. However, English courts traditionally show a strong reluctance to interfere with the principle of autonomy and constantly have taken strict measure against the application of fraud rule. [221]

### 4.3.1: Pillans and Rose v Van Mierop and Hopkins

The historical review of relevant cases to fraud in documentary credits goes back to old case of *Pillans and Rose v Van Mierop and Hopkins*[222]. In this case, Pillans and Rose merchant bankers from Rotterdam in return of the loan request by White, the Irish merchant for a loan asked him for a letter of credit from a good house in London. White, managed to get the agreement of Van Mierop and Hopkins for issuing a confirmed letter of credit in his favour by guaranteeing White's debt to Pillans and Rose. In practice, White bankrupt before drafts were drawn on Van Mierop and Hopkins. Later, plaintiffs rejected the payment of guarantee to Pillans and Rose. In court of appeal, Lord Mansfeild after rejecting the defence of defendants on their void promise to plaintiffs due to the lack of consideration held that defendants argument could be justified if there was a fraud involved in transaction[223]. Defendants claimed

[219] Gao X & Buckley RP (2003) 294
[220] Gao X (2002) 32
[221] *Tukan Vmber Ltd v. Barclays Bank Pic*. [1987] 1 Lloyd's Rep 171, 174
[222] *Pillans and Rose v Van Mierop and Hopkins* (1756)
[223] *Pillans and Rose v Van Mierop and Hopkins* (1756) 1035

that they have been defrauded by White and plaintiffs. Lord Mansfeild, while rejecting their argument, mentioned:

"If there was any kind of fraud in this transaction, the collusion and mala fides would have vacated the [the credit]. But from these letters it seems to me clear, that there was none. [...]Both the plaintiffs and White wrote to Van Mierop and Company. They answered, 'That they would honour the plaintiffs' draughts.' So that the defendants assent to the proposal made by White, and ratify it. And it does not seem at all that the plaintiffs then doubted of White's sufficiency, or meant to conceal anything from the defendants. (Amendments made)"[224]

The decision of *Pillans and Rose v Van Mierop and Hopkins* clearly shows the fraudulent action under documentary letters of credits would not be tolerated at any cost.[225]

### 4.3.2 Higgins v. Steinharderter

In the America case of *Higgins v. Steinharderter*,[226] the plaintiff (Higgins) purchased a shipment of walnuts in which the payment was arranged by documentary letter of credit issued by Monroe &Co. Plaintiff claimed in court that, despite the fact that shipment was due on or before 7 November 1918, it did not take place until 18 December 1918, while the tendered bill of lading was predated to 30 October 1918. The court granted the injunction and Finch J held that: "It is clear that the plaintiff authorized a credit to apply only to a shipment made on or before November 7th, and hence, if shipment was made subsequent to that date, a payment made against said credit would be unauthorized. It became an unused credit, cancelled by limitation of time."[227.]

The judgment was not made on the basis of fraud, but on the ground of breaching of the underlying contract and unauthorized nature of predating the bill of lading. The decision of the *Higgins v. Steinharderter* goes back to the time that "the fraud rule in the law of letters of credit was so embryonic at least in the United States that even people in the financial centres like New York did not contemplate its relevance."[228] Although decision was not based on the fraud

[224] Ibid, 1037.
[225] Gao X (2002) 33-34
[226] *Higgins v. Steinharderter* [1919] 175 NYS 279
[227] Ibid
[228] Buckley RP & Gao X (2002) 670-671

rule, it is possible to recognize the fraudulent conduct of beneficiary by predating the bill of lading.

### 4.3.3 Societe Metallurgique D'aubrives and Villerupt v British Bank for Foreign Trade

Fraud had no rule in the case of the *Societe Metallurgique D'aubrives and Villerupt v British Bank for Foreign Trade*.[229] However, Justice Bailhache confirmed that court would intervene in the payment process in case of fraudulent transaction[230] .

> "There was a good deal of evidence given as to the actual quality of the iron, and in any action against a bank for failure to honour credit for goods which are not in order the question of quality only comes in on one or other of two ways. First of all, did the person presenting mis describe the goods in such a way as to be guilty of fraud? If that were so, then the bank in refusing to pay would be justified. But nothing of that sort is suggested in this case"[231]

### 4.3.4 Old Colony Trust Co v Lawyers' Title and Trust Co

The case of *Old Colony Trust Co v Lawyers' Title and Trust Co*[232] is very similar to the case of *Higgins v. Steinharderter*. In both cases forged documents were involved, both plaintiffs claimed the defendants have breached their undertakings in underlying contract and both courts showed intention to interfere in case on fraud's involvement.[233] However, the decision of Old *Colony Trust Co v Lawyers' Title and Trust Co* was very different from *Higgins v. Steinharderter*, as the judge held:

> "As this statement was false, there was failure of compliance with the letter of credit... Obviously, when the issuer for a letter of credit knows that a document, although correct

[229] *Societe Metallurgique v British Bank for Foreign Trade* [1922] 11 Lloyds Law Reports 168
[230] Kelly-Louw M (2008) 175
[231] *Societe Metallurgique v British Bank for Foreign Trade* [1922] 11 Lloyds Law Reports 170
[232] *Old Colony Trust Co v Lawyers' Title and Trust Co* (1924) 297 F 152
[233] Kelly-Louw M (2008) 177

> in form, is, in point of fact, false or illegal, he cannot be called up onto recognize such a document as complying with the terms of a letter of credit".[234]

Therefore, the judgment was only based on the false document which was considered by the court as non-confirming despite the fact that it was conforming on the face. As result, it is possible to conclude that Old Colony is a strong authority on application of the fraud rule. However, the exception in that case was approached from the perspective of principle of strict compliance rather than the principle of autonomy.

### 4.3.5 Maurice O'Meara Co v National Park Bank of New York

The Case of *Maurice O'Meara Co v National Park Bank of New York* was on the dispute over the quality of goods which were delivered in the framework of the contract of sales[235]. Despite the fact that complying documents were presented by beneficiary, bank withheld the payment on the basis of rising reasonable doubt about quality of delivered products (Newsprint Paper). On the basis of plaintiff's (beneficiary) legal action against the defendant bank and claim of damages suffered as the result of dishonouring the credit, court by majority held that bank should be concerned only about presented documents not the quality of delivered goods.

> "If the drafts, when presented, were accompanied by the proper documents, then it was absolutely bound to make the payment under the letter of credit, irrespective of whether it knew, or had reasons to believe, that the paper was not of the tensile strength contracted for [...]. To hold otherwise is to read into the letter of credit something, which is not there, and this the court ought not to do, since it would impose upon a bank a duty, which in many cases would defeat the primary purpose of such letter of credit. This primary purpose is an assurance to the seller of merchandise of prompt payment against documents"[236].

Despite the conformity of majority judgement with principle of autonomy, Judge Cardozo while emphasising on principle of autonomy need for bank to stick to documents descended from view of majority and mentioned that:

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[234] *Old Colony Trust Co v Lawyers' Title and Trust Co* (1924) 297 F 158
[235] *Maurice O'Meara Co v National Park Bank of New York* 146 NE 636 (1925)
[236] *Maurice O'Meara Co v National Park Bank of New York* 146 NE 636 (1925) at 639

> " [I]f it [the bank] chooses to investigate and discovers thereby that the merchandise tendered is not in truth the merchandise that the documents describe, it may be forced by the delinquent seller to make payment of the price irrespective of its knowledge. […] We are to bear in mind that this controversy [...] arises between the bank and a seller who has misrepresented the security upon which advances are demanded. Between parties so situated payment may be resisted if the documents are false. I think we lose sight of the true nature of the transaction when we view the bank as acting upon the credit of its customer to the exclusion of all else. It acts not merely upon the credit of its customer, but upon the credit also of the merchandise, which is to be tendered as security. [...] I cannot accept the statement of the majority opinion that the bank was not concerned with any question as to the character of the paper. If that is so, the bales tendered might have been rags instead of paper, and still the bank would have been helpless, though it had knowledge of the truth, if the documents tendered by the seller were sufficient on their face"[237].

The opinion in this case is different from similar cases by reflecting that false documents might result in dishonouring the credit plus considering interests of innocent third party who is the holder of the drafts without any knowledge about their value[238].

At the same time, we can trace the similar attitude with reasoning in modern cases of fraud in letters of credit by emphasize of court on the importance of the principle of independence and then considering the fraud rule elements. According to Gao, "bricks and mortar for the building of the fraud rule' were assembled by the decision of Maurice O'Meara and that Sztejn v J. Henry Schroeder Banking Corp helped to build the structure"[239]

### 4.3.6 Sztejn v Henry Schroder Banking Corporation

The American case of *Sztejn v Henry Schroder Banking Corporation*[240] had a significant effect on development of the Fraud rule in documentary letters of credits[241]. It is considered a landmark judgment as it has been used in codification of the 1962 version of UCC as well as being basis for judgment in

[237] *Maurice O'Meara Co v National Park Bank of New York 146 NE 636* (1925) 641
[238] Buckley RP & Gao X (2002) 675
[239] Ibid
[240] *Sztejn v Henry Schroder Banking Corporatio*n 31 NYS 2d 631 (1941)
[241] Buckley RP & Gao X (2002) 676

following cases of fraud in documentary credits inside and outside United States of America[242]. According to Gao, "It shaped the fraud rule in 'virtually all jurisdictions".[243]

In case of Sztejn, underlying contract of sale was between Sztejn (buyer) and Transea Traders Ltd (seller). The payment was due under the letter of credit issued by Schroder by drawing a draft on the Chartered Bank (presenting bank). Sztejn asked for injunction before presentation of documents for payment on the basis of dispatching "cow hair, other worthless material and rubbish with intent to simulate genuine merchandise and defraud the plaintiff"[244]. Sztenjn also mentioned Chartered bank as colleting bank for Transea Trades not the holder in due course for the draft. However, Chartered Bank defended that the presenting bank "is only concerned with the documents and on their face these conform to the requirements of the letter of credit"[245]. In the course of hearing, all allegations of cases were considered as true by Justice Shientag who rejected the motion to dismiss the complaint of plaintiff by Chartered Bank based on two arguments: allegation that fraud has been commented and established fact that fraud has been committed in the underlying transaction. However, he started his statement by acknowledgment of the principle of autonomy:

> "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"[246]

However, in continuation, he pointed at necessity for overruling the principle of autonomy in case of fraud:

> "Of course, the application of this doctrine [the principle of independence] presupposes that the documents accompanying the draft are genuine and conform in terms to the requirements of the letter of credit.
>
> However, I believe that a different situation is presented in the instant actions. This is not a controversy between the buyer and seller concerning a mere breach of warranty regarding the quality of the merchandise; on the present motion, it must be assumed that the seller has intentionally failed to ship any goods ordered by the buyer. In such a situation, where the seller's

[242] In 1964 version of UUC fraud rule was under Article 5 section 5-114 but after revision of 1995 it is under Article 5, section 5-109.
[243] Kelly-Louw M (2008) 179
[244] *Sztejn v Henry Schroder Banking Corporation* 31 NYS 2d 631 (1941) 633
[245] Ibid,632
[246] Ibid

> fraud had been called to the bank's attention before the drafts and documents have been presented for payment, the principle of the independence of the bank's obligation tinder the letter of credit should not be extended to protect the unscrupulous seller... Although our courts have used broad language to the effect that a letter of credit is independent of the primary contract between the buyer and seller, that language was used in cases concerning alleged breaches of warranty; no case has been brought to my attention on this point involving intentional fraud on the part of the seller which was brought to the bank's notice with the request what it withhold payment of the draft on this account"[338][247]

The Justice Sheintag held that motion of Chartered Bank for dismissing complaint of plaintiff is dismissed as well as injunction was granted to the Sztejn on the basis that:

> "Transea was engaged in a scheme to defraud the plaintiff... that the merchandise shipped by Transea is worthless rubbish and that Chartered Bank is not an innocent holder of the draft for value but is merely attempting to procure payment of the draft for Transea's account"[248].

Apart from the beneficiary's fraud, two other issues where discussed in the hearing[249]. First was bank's security interest as one of the supporting reasons behind application of fraud rule. The Justice Shientag mentioned:

> "While the primary factor in the issuance of the letter of credit is. The credit standing of the buyer, the security afforded by the merchandise is also taken into account. In fact, the letter of credit requires a bill of lading made out to the order of the bank and not the buyer. Although the bank is not interested in the exact detailed performance of the sales contract, it is vitally interested in assuring itself that there are some goods represented by the documents".[250].

Second issue was exemption of the holder in due course from being subjected to the application of fraud rule.

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

[247] Ibid 634-635
[248] Ibid .633
[249] Lu, Lu. "*The Exceptions in Documentary Credits in English Law*." (2011). 75
[250] *Sztejn v Henry Schroder Banking Corporation* 31 NYS 2d 631 (1941) ,634-635

the letter of credit would not be defeated even though the primary transaction was tainted with fraud."[251]

Therefore, decision of *Sztejn* established the basic principles of the Fraud Rule which can be listed as below:[252]

1- The payment process and autonomy principle of the letters of credit can be superseded only in case of fraud. However, the fraud should be established and only allegations of fraud will not suffice for interruption of payment.
2- The payment to the holder in due course or presenter with similar status will not be interrupted even in case of established fraud.

However, it should not be forgotten that in cases of *Sztejn* all allegations were considered as fact and as a result issue of the standard of proof for fraud was left open to be one the most controversial issues in application of fraud rule in documentary letters of credits.[253] On the basis of prevalent situation in the case, detailed issues relevant to the standard of proof for an established fraud in order to apply the fraud rule were not necessary to be discussed. Therefore, it is possible to conclude that "Shientag J was only making decision for *Sztejn* case where the fraud had been already proved from the beneficiary side and there was doubt about it"[254].

## *4.4 Application of Fraud Exception*

In this section, research will focus on application of fraud rule in documentary credits in different Common Law Jurisdictions. Namely, United States of America and England. Although many legal problems have the same symptoms wherever they occur, but their consequences and approaches to solve them can be drastically different from jurisdiction to jurisdiction.[255] In such situation, comparative study of legal problems like fraud rule in documentary letters of credit can be a good approach to find similarities and differences among common law jurisdictions and try to harmonize them. Although, English Law is strongly influenced by developments of American Law in field of documentary credit's fraud, but comparative studies which have been done in this area show the significant deviations in application of fraud rule between United States of American, England and other common law countries[256].

[251] Ibid
[252] Gao X (2002) 42
[253] Ibid
[254] Lu, Lu. "*The Exceptions in Documentary Credits in English Law*." (2011).76
[255] Gordley J (1995) '*Comparative Legal Research: Its Function in the Development of Harmonized Law*' (1995) 43 American Journal of Comparative Law 560
[256] Kelly-Louw M (2008) 135-255

In current section, research in addition to study different applications of Fraud Rule in American and England will review different standards of proof for the application of fraud rule.

### 4.4.1 Fraud Rule in American Law

Development of fraud rule in United States of American law can be categorized under three main time periods: Pre-UCC, the previous UCC Article 5 and Revised UCC Article 5[257]. The period of pre UCC was governed by the case law and it was mostly influenced by the case of *Sztejn*, as it has been discussed in previous section.

## 4.4.1.1 The Previous UCC Article 5

After introduction of Unified Commercial Code in United States of America, fraud rule in documentary credits which had been developed in the case of *Sztejn* received codification under the UCC article 5 section 5-114 (2)[258]:

> "Unless otherwise agreed when documents appear on their face to comply with the terms of a credit but a required document does not in fact conform to the warranties made on negotiation or transfer of a document of title (Section 7-507) or of a certificated security (Section 8-108) or is forged or fraudulent or there is fraud in the transaction:
>
> (a) the issuer must honour the draft or demand for payment if honour is demanded by a negotiating bank or other holder of the draft or demand which has taken the draft or demand under the credit and under circumstances which would make it a holder in due course (Section 3-302) and in an appropriate case would make it a person to whom a document of title has been duly negotiated (Section 7-502) or a bona fide purchaser of a certificated security (Section 8-302); and
>
> (b) in all other cases as against its customer, an issuer acting in good faith may honour the draft or demand for payment despite notification from the customer of fraud, forgery or other defect not apparent on the face of the documents but a court of appropriate jurisdiction may enjoin such honour"

[257] Gao X & Buckley RP (2003) 294
[258] Kelly-Louw M (2008) 211.

Some scholars[259] consider the codification of fraud rule under the UCC article 5 even more important than case of *Sztejn.* Reasons can be listed as[260]:

1- Express protection of the interests of fraud victims of letter of credit by using the fraud rule. As a result, they were not obliged to disguise their defence under other principles like principle of strict compliance in case of *Old Colony* or Contract Law in case of *Higgins*.
2- An innovative approach of article 5 -114(2) (b) was application of fraud rule in two different settings: (A) by enjoining the issuer from honouring the credit in case of presentation complying documents which are forged and occurrence of fraud in underlying contract. (B) By voluntarily invoking the draft or payment demand by issuer in case of information about the fraud.
3- Harmonization of approaches to the fraud by application of Fraud Rule
4- Strengthening the position of fraud rule by codifying it into the statute at national and international level as most of Civil Law countries show more positive attitude towards the statute that case law.

Despite all above mentioned privileges in introduction of the UCC Article 5 Section 114, Gao has raised its shortcoming as[261]:

1- Not being able to define a precise standard of proof for fraud which resulted in application of different standards in different cases.
2- Article 5 -114(2) defined three groups who might be immune from fraud rule: holder in the due course, holder of the document of title which is duly negotiated under section 7-502 of UCC and *Bona fide* purchaser of a certificated security.

However, in practice only holder in the due course was subjected to immunity under the fraud rule.

### 4.4.1.2 Revised UCC Article 5

In 1995 the UCC article 5 went through revision mostly to overcome existing weaknesses, gaps and errors of the original statute as well as challenges which were the result of constant development of letters of credits[262]. After revision, fraud rule was embodied in UCC article 5 sub- sections 109.

> "(a) If a presentation is made that appears on its face strictly to comply with the terms and conditions of the letter of credit, but a required document is forged or materially fraudulent, or

[259] Gao X (2002) 43
[260] Gao X & Buckley RP (2003) 684
[261] Ibid
[262] Gao Xiang (2002)45

honouring the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant:

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

(2) The issuer, acting in good faith, may honour or dishonour the presentation in any other case.

(b) If an applicant claims that a required document is forged or materially fraudulent or that honour of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant, a court of competent jurisdiction may temporarily or permanently enjoin the issuer from honouring a presentation or grant similar relief against the issuer or other persons only if the court finds that:

(1) The relief is not prohibited under the law applicable to an accepted draft or deferred obligation incurred by the issuer;

(2) A beneficiary, issuer, or nominated person who may be adversely affected is adequately protected against loss that it may suffer because the relief is granted;

(3) All of the conditions to entitle a person to the relief under the law of this State have been met; and

(4) On the basis of the information submitted to the court, the applicant is more likely than not to succeed under its claim of forgery or material fraud and the person demanding honour does not qualify for protection under subsection (a)(1)"

By coming into effect of revised UCC article 5 fraud rule went through a significant changes[263] and received moderation from different aspects including[264]:

[263] Gao X (2002) 45; Gao X & Buckley RP (2003) 315 ; Kelly-Louw M (2008) 222
[264] Buckley RP & Gao X (2002) 686

1- According to Article 5-109, discovery of fraud will disrupt the normal process of documentary letter of credit. Such disruption will be refusing to honour the credit at presentation by issuing bank[265], and request of account party from court to grant injunction in order to prohibit payment[266].
2- Article 5-109 provides guidance for two of the most controversial aspects in fraud rule. Firstly, it sets the standard of proof as materiality of fraud and also it provides that fraud exception covers fraud in documents as well as underlying contract.[267]
3- In section 5-109 (1) four groups of people are considered immune against application of the fraud rule. "A) Nominated person with good faith who has paid without notice of fraud. B) Confirmer who has honoured its confirmation in good faith C) The holder in due course of the draft drawn under the letter of credit which was taken after acceptance by the issuer or nominated parson D) an assignee of the issuer or nominated person's deferred obligation that was taken for value and without notice of forgery or material fraud after the obligation was incurred by the issuer or nominated person"[268] . Therefore, all four groups of protected people against fraud rule under revised article 5 -109 are relevant unlike three groups of protected people under article 5-114 in which only one group was protected.[269]
4- The article 5 -109 (b) defines four preconditions for court in order to award injunction.

"Revised UCC Article 5, Section 5-109 now stands as the most comprehensive code of the fraud rule in the law of letter of credits in the common law world"[270].

### 4.4.2 The Fraud Rule in English Law

Fraud rule is governed under the common law in England. However, it has been recognized and considered in British cases. [271] Despite such recognition, traditionally English courts show reluctance in application of fraud rule and take a strict approach against intervention with autonomy principle. In study of Fraud Rule in English Law, current research will review some of the leading cases in this area as well as analysing scope of the application fraud rule under English law.

[265] Section 5-109(a)(2)
[266] Section 5-109(b); Gao X (2002) 46
[267] Kelly-Louw M (2008) 222
[268] section 5-109(a)(1)
[269] Buckley RP & Gao X (2002) 687
[270] Kelly-Louw M (2008) 242
[271] Buckley RP & Gao X (2002) ,687

## 4.4.2.1- Hamzeh Malas and Sons v British Imex Industries Ltd

The case of *Hamzeh Malas and Sons v British Imex Industries Ltd*[272], is a good example for showing the strict historical approach of the English Courts on intervening in autonomy principle of documentary credits. The case is about buyers who signed a contract of sales for Steel Rods with the defendant seller. Payment was due by two confirmed letters of credits. After making the first payment, plaintiff buyer asked for injunction relief against the beneficiary on the basis of defectiveness of the first instalment[273].

While rejecting to award injunction in the court of appeal, Jenkins LJ commented on the autonomy principle:

> "[I]t seems to be plain enough that the opening of a confirmed letter of credit constitutes a bargain between the banker and the vendor of the goods, which 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, in my judgment, it would be wrong for this court in the present case to interfere with that established practice [...] That system [...] would break down completely if a dispute as between the vendor and the purchaser was to have the effect of "freezing," if I may use that expression, the sum in respect of which the letter of credit was opened"[274].

## 4.4.2.2 Harbottle (RD) (Mercantile) Ltd v National Westminster Bank Ltd

In the case of *Harbottle (RD) (Mercantile) Ltd v National Westminster Bank Ltd*[275], Judge Ker reemphasized in the strict approach towards autonomy principle for another time:

> "It is only in exceptional cases that the courts will interfere with the machinery of irrevocable obligations assumed by banks. They are the life-blood of international commerce. Such obligations are regarded as collateral to the underlying rights and obligations between the merchants at either end of the banking chain. Except possibly in clear cases of fraud of which the banks have notice, the courts will leave the merchants to settle their disputes under the contracts by litigation or arbitration as available to them or stipulated in the contracts [...] Otherwise, trust in international commerce could be irreparably damaged"[276].

[272] *Hamzeh Malas and Sons v British Imex Industries Ltd* [1958] 2 QB
[273] Ibid
[274] Lu, Lu. "*The Exceptions in Documentary Credits in English Law*." (2011).97
[275] *Harbottle (RD) (Mercantile) Ltd v National Westminster Bank Ltd* [1978] 1 QB 146
[276] Ibid

### 4.4.2.3 Edward Owen Engineering Ltd v Barclays Bank International Ltd

The case of *Edward Owen Engineering Ltd v Barclays Bank International Ltd* is one of the most frequently cited on principle of autonomy in English law[277]. An English supplier in 1976 contracted the sale of greenhouse and their insulations with a Libyan party, Agricultural Development Council of Libya. According to the contract of sales, payment was supposed to be made in the format of an irrevocable documentary credit in favour of the plaintiff at local Libyan bank (Umma Bank). In return, the defendant bank (Barclays) issued a demand guarantee without proof or condition upon the advice of the plaintiff which was sent to the customer. However, the letter of credit opened in favour of seller by Libyan bank was not confirmed: "Although our principals make provision for us to add our confirmation to this credit kindly note that we are unable to effect such action in view of the payment terms"[278] . As a result of failing to convince the Libyan party to confirm the letter of credit, plaintiff repudiated the contract of sales. Libyan party raised claims for demand guarantee. Strict traditional approach of English courts towards autonomy principle of letters of credits and demand guarantees can be found easily in the judgment of Lord Denning in the court of appeal:

> "The bank ought not to pay under the credit if it knows that the documents are forged or that the request for payment is made fraudulent in circumstances where there is no right to payment. … The performance guarantee stands on a similar footing to a letter of credit. A bank which gives a performance guarantee must honour that guarantee to its terms. It is not concerned in the least with the relations between the supplier and the customer; nor with the question whether the supplier has performed his contracted obligations or not; nor with the question whether the supplier is in default or not. The bank must pay according to its guarantee, on demand, if so stipulated, without proof or condition. The only exception is when there is a clear fraud of which the bank has notice."[279]

Further, Lord Geoggery mentioned:

> "The only circumstances which would justify the bank not complying with a demand

[277] *Edward Owen Engineering Ltd v Barclays Bank International Ltd*. [1978] 1 Lloyd's Rep. 166
[278] Ibid 166-167
[279] Ibid, 171-172

would be those which would exonerate them under similar circumstances if they had

entered into a letter of credit, and that is this, if it had been clear and obvious to the bank

that the buyers had been guilty of fraud."[280]

### 4.4.2.4 Discount Records Ltd. v. Barclays Bank Ltd

The case of *Discount Records Ltd. v. Barclays Bank Ltd*[281] can be considered the first English case which cited and approved Sztejn[282]. The contract of sales was signed between English buyer and French seller for the purchase of gramophone records and cassettes. According to the sales contract, buyer applied to Barclays bank for a letter of credit in favour of the seller. After shipment of goods by seller, he tendered the draft and other documents to the confirming bank in Paris and received the payment. However, in presence of the bank's representative, buyer found goods as non-complying and rubbish. As a result, he applied for injunction against honouring presentation by the issuing bank by referring to the case of *Sztejn* while claiming that seller has perpetrated fraud[283]. In the course of hearing, Judge Megarry considered the case different from *Sztejn* and rejected injunction against bank. According to the Megarry J, fraud was established in cases of *Sztejn* while in present case, there was mere allegation of fraud[284] "because it is unlikely that any action to which the seller was not a party would contain the evidence required resolving this issue"[285]

The decision of court in finding only allegation of fraud instead of established fraud despite the fact that obtained evidence by buyer was in presence of bank representative is the sign that based on the strict approach of English courts, in majority of cases it is almost impossible to obtain injunction to stop payment. However, English courts constantly claim that they "will not allow their process to be used by a dishonest person to carry out a fraud"[286].

[280] Ibid, 174
[281] *Discount Records Ltd. v Barclays Bank Ltd* [1975] 1 Llyod's Law Reports 444
[282] Zhang, Yanan. *Approaches to Resolving the International Documentary Letters of Credit Fraud Issue*. University of Eastern Finland, 2011.80
[283] *Discount Records Ltd v Barclays Bank Ltd* [1975] 1 Llyod's Law Reports 444-446
[284] Ibid 447
[285] Ibid
[286] Gao X (2002) 49-50

In the decision of *Discount Records Ltd. v. Barclays Bank Ltd* it was also held that bank's payment has no effect on the buyer's interest as buyer has possibility to claim damages from bank in case of bank's wrong payment to seller[287]. Such approach complies with common law practice that court will issue injunction only at the time that it is the final solution and applicant has no other legal resources.[288]

### 4.4.2.5 United City Merchants (Investment) Limited v Royal Bank of Canada

The case of *United City Merchants (Investment)Limited v Royal Bank of Canada*[289] is one of the most important and well-known English cases of fraud rule in documentary credits[290]. These are the facts. The contract of sales was established between Peruvian buyer Vitrorefuerzos SA (Vitro) and Glass Fibres, English seller on December 1975. According to the contract the method of payment was to be by means of irrevocable, transferable letter of credit. The credit was opened by Peruvian Bank Banco Continental SA and received confirmation by Royal Bank of Canada. The seller on 2nd December 1976 informed the freight forwarding agent about necessity to ship goods latest on 15th December. However, as the result of the cancelation of original vessel, goods were replaced in another vessel (American Accord) and shipped on 16 of December 1976. The bill of lading was made out by Mr. Backer the employee of the carrier on the date of shipment. However, the agent changed the date on the face of bill to 15 of December 1976. Bill of lading also mentioned the port of departure as London, while in fact goods were shipped from Felixstowe.[291]

Credit was dishonoured after presentation of documents by United City Merchants, assignee of the seller to the bank on the basis that commercial invoice did not comply with terms of credit and also banks information about forged nature of the bill of lading[292].

Plaintiff initiated a legal action against defendant based on wrongful dishonouring of the credit and claiming about their lack of knowledge about incorrect date of the face of bill of lading. In

[287] Zhang. Y, (2011) 81
[288] Ibid
[289] *United City Merchants (Investment) Limited v Royal Bank of Canada* [1979] 1 Lloyd's Law Reports 267
[290] Tóth, Zsuzsanna. "*DOCUMENTARY CREDITS IN INTERNATIONAL COMMERCIAL TRANSACTIONS WITH SPECIAL FOCUS ON THE FRAUD RULE*.", 2006, 102
[291] *United City Merchants (Investment) Limited v Royal Bank of Canada* [1979] 1 Lloyd's Law Reports 267
[292] Ibid

the trial court Justice Mocatta ruled for beneficiary[293]. In the court of appeal, judgement was changed in favour of the bank by taking the concept of "Half Way House" which was explained as "between fraud and accuracy namely in inaccuracy in material particular"[294].According to Stephenson LJ, despite the fact that simple inaccuracy in document might not be considered as fraud, but it can provide bank with reason to reject the Payment due to the fact that inaccuracy plays a material role in their liability to pay[295]. In the House of Lords, Lord Diplock was delivering the leading speech. He started with describing the nature of autonomous contracts in the framework of the letter of credit's operation while emphasizing the dispute in the goods are not relevant to the right of seller for payment. [296]

> "It is trite law that there are four autonomous though interconnected contractual relationships involved: (1) the underlying contract for the sale of goods … (2) the contract between the buyer and the issuing bank … (3) if payment is to be made through a confirming bank, the contract between the issuing bank and confirming bank, and … (4) the contract between the confirming bank and the seller. … Again, it is trite law that in contract (4), with which alone the instant appeal is directly concerned, the parties to it, the seller and the confirming bank, "deal in documents and not in goods….
>
> To this general statement of principle [of independence] [...] there is one established exception: that is, where the seller, for the purpose of drawing on the credit, fraudulently presents to the confirming bank documents that contain, expressly or by implication, material representations of fact that to his knowledge are untrue. Although there does not appear among the English authorities any case in which this exception has been applied, it is well established in them American cases of which the leading or "landmark" case is Sztejn v. J. Henry Schroder Banking Corporation. [...] The exception for fraud on the part of the beneficiary seeking to avail himself of the credit is a clear application of the maxim ex *turpi causa non oritur actio* or, if plain English is to be preferred, "fraud unravels all." The courts will not allow their process to be used by a dishonest person to carry out a fraud"[297]

[293] Ibid
[294] Malek A & Quest D '*Documentary Credits - The Law and Practice of Documentary* (2009) 250
[295] Lu, Lu. "*The Exceptions in Documentary Credits in English Law*." (2011).112
[296] *United City Merchants (Investment) Limited v Royal Bank of Canada* [1979] 1 Lloyd's Law Reports

[297] ibid ,301

Since seller had no information about fraudulent act of Mr. Baker in manipulating the true date of shipment on face of the bill of lading and their honest belief in "that it was true and the goods had actually been loaded on or before the 15th of December 1976, as required by the documentary credit"[298], the beneficiaries held innocent and, as the final judgment, the House of Lords ruled that: "the instant case … does not fall within the fraud exception"[299]

### 4.4.2.6 United Trading Corporation SA and Murray Clayton Ltd v allied Arab Bank Ltd

The case of *United Trading Corporation SA and Murray Clayton Ltd v Allied Arab Bank Ltd* introduced the test of "only realistic Inference" [300]. This test received acceptance by deferent judges as a standard of establishing fraud. [301] . In the *United Trading Corporation SA and Murray Clayton Ltd v Allied Arab Bank Ltd*, Justice Ackner defined the standard of evidence as:

> The evidence of fraud must be clear, both as to the fact of fraud and as to the bank's knowledge. The mere assertion or allegation of fraud would not be sufficient. [...] We would expect the Court to require strong corroborative evidence of the allegation, usually in the form of contemporary documents, particularly those emanating from the buyer. In general, for the evidence of fraud to be clear, we would also expect the buyer to have been given an opportunity to answer the allegation and to have failed to provide any, or any adequate answer in circumstances where one could properly be expected. If the Court considers that on the material before it the only realistic inference to draw is that of fraud, then the seller would have made out a sufficient case of fraud"[302].

[298] ibid, 302
[299] ibid, 303
[300] *United Trading Corporation SA and Murray Clayton Ltd v Allied Arab Bank Ltd* [1985] 2 Lloyd's Law Reports 554 (CA)
[301] Kelly-Louw M (2008) 200
[302] *United Trading Corporation SA and Murray Clayton Ltd v Allied Arab Bank Ltd* [1985] 2 Lloyd's Law Reports 554, 561

## *4.5 English position on the Fraud Rule in Documentary Letters of Credits:*

Overall observation shows the English courts have much restricted and narrower approach towards intervention in autonomy principle of letters of credit. In general scope for the fraud rule under English legal system can be summarised as[303]:

1- Material representation of the fact that is untrue.
2- Knowledge of the beneficiary
3- Documentary Fraud versus Fraud in the Underlying contract

### 4.5.1- Material Misrepresentation

In the case of *United Trading Corporation SA and Murray Clayton Ltd v Allied Arab Bank Ltd*, Lord Diplock comments on material misrepresentation when considering the third party fraud.

> "To this general statement of principle [of independence] as to the contractual obligations of the confirming bank to the seller, there is one exception: that is, where the seller, for the purpose of drawing on the credit, fraudulently presents to the confirming bank documents that contain, expressly or by implication, material representations of fact that to his knowledge are untrue"[304] .

Accordingly, material misrepresentation to Lord Diplock is a sort of fraud which can invoke the fraud rule under English Law.[305] Raymond Jack interprets material misrepresentation as: "is very close to a statement of the elements of fraudulent misrepresentation which constitute the tort of deceit."[306]. Elements of tort of deceit in under English law are: "(1) knowing the representation to be false; (2) without belief in its truth; or (3) recklessly, careless whether it be true or false."[307].

In an interpretation close to the interpretation of the material fraud in official comment on Revised UCC article 5-109, Jack states on meaning of the word Material:

[303] Ellinger P, Noe D, *The Law and Practice of Documentary Letters of Credit* (2010), 141
[304] (1983) 1 A.C. 168, 183
[305] Buckley RP & Gao X (2003) , 324
[306] Malek A & Quest D '*Documentary Credits - The Law and Practice of Documentary Credits Including Standby Credits and Demand Guarantees*' (2009) , 254
[307] Ibid

> "Material to the bank's duty to pay, so that if the document stated the truth the bank would be obliged to reject the documents,"[308]

However, interpretation of Jack does not match with the interpretation of Lord Diplock:

> "[T]he answers to the question: "to what must the misstatement in the documents be material?" should be: "material to the price which the goods to which the documents relate would fetch on sale if, failing reimbursement by the buyer, the bank should be driven to realise its security." But this would not justify the confirming bank's refusal to honour the credit in the instant case; the realisable value on arrival at Callao of a glass fibre manufacturing plant made to the specification of the buyers could not be in any way affected by having been loaded on board a ship at Flexistowe on December16, instead of December 15, 1976"[309]

It has been suggested that, Lord Diplock's interpretation on material misrepresentation goes back the value of goods. Therefore, in his view predating the bill of lading will not constitute misrepresentation as it has no effect on value of goods[310]. However, Jack's interpretation considers the effect of presentation on duty of bank to pay as material. As a result, statement of true date of shipment in case of predated bill of lading will result in rejection of document by bank[311]. It has been submitted that Jack's interpretation is much stronger argument than the construal of Lord Diplock[312].

However, Material Misrepresentation has been considered as the standard of proof for fraud in documentary credits under English Law and it has been accepted in subsequent cases like *Themehelp Ltd. v. West*[313]and *Banco Santander S.A. v. Bayfern Ltd*[314].

[308] Ibid
[309] (1983) 1 A.C , P.118
[310] Buckley RP & Gao X (2003), 324
[311] Buckley RP & Gao X (2003), 324; Malek A & Quest D 'Documentary Credits - The Law and Practice of Documentary Credits Including Standby Credits and Demand Guarantees' (2009), 254
[312] Buckley RP & Gao X (2003), 324
[313] *ThemehelpLtd. v. West*, (1995) 4 All E.R. 215
[314] *Banco Santander S.A. v. Bayfern Ltd,* 1999 WL 250019 (Q.B. June 9, 1999), aff'd, 2000 WL 191098 (C.A. Feb. 25, 2000)

### 4.5.2 Knowledge of the beneficiary

According to the *United City Merchants*, beneficiary was not held responsible for misrepresentation of documents and in fact he was not aware of them[315]. Therefore, it can be interpreted from Lord Diplock's approach that preventing beneficiary from claiming payment will not only include the situation that he was responsible for the fraud, but also at the time of presentation, the beneficiary he should be aware of misrepresentation exisating in tendered documents even if a third party is responsible for them.[316]

In this respect, the degree of beneficiary's knowledge of fraud before being infected by fraud exception can be a concerning problem[317]. "This is likely to require actual knowledge rather than constructive knowledge based on what the beneficiary as a reasonable man should have known. The question of what constitutes actual knowledge should be approached cautiously: a wilful shutting of one's eyes to the truth may in practice lead a court to make a factual finding that the beneficiary did know of the falsity."[318]

### 4.5.3 Documentary Fraud versus Fraud in the Underlying Transaction.

Despite the fact that Lord Diplock in *United City Merchants* emphasized that fraud should be relevant to documents, it is not possible to comprehend whether his lordship raised the issue of documentary fraud only due to the facts of the current case or he wanted it to the requirement for all relevant cases to fraud in documentary credits. Later English cases do notprovide further guidance.[319] For example, in *Czarnikow-Rionda Sugar Trading Inc v Standard Bank London*[320], in Court of Appeal, Rix J discharged the obtained interim injunction by buyer to prevent issuing bank from honouring the presentation based on issues other than fraud allegation not being based on documents. In *Themehelp Ltd v West and Others* as one of the very few successful cases of obtaining injunction in England, fraud was established in underlying contract rather than mere tendered documents[321]. Although, *Themehelp Ltd v West and Others* is a case on demand guarantees, it is an accepted principle in English Law that

[315] Ellinger. P, Noe. D, *The Law and Practice of Documentary Letters of Credit*, (2010), 142
[316] Ibid
[317] Ibid
[318] Ibid
[319] Ibid
[320] *Czarnikow-Rionda Sugar Trading Inc v Standard Bank Londo*n (1996) 1WRL 1152, 1161
[321] *Themehelp Ltd v West* [1996] QB 84 (CA)

demand guarantees and Commercial documentary Credits are equally subjected to principle of autonomy .[322]

The position of other common law jurisdictions shows extension of Fraud Rule to the underlying contract. In United States of America, Revised UCC Article 5-109 extends the fraud rule to documents as well and underlying contract. [323]

> "Requires that the fraudulent aspect of a document be material to a purchaser of that document or that the fraudulent act be significant to the participants in the underlying transaction."[324]

In Canada, Le Dain J from Supreme Court of Canada in case of *Bank of Nova Scotia v. Angelica–Whitewear Ltd*[325] extended the application of fraud rule to the underlying contract.

> "[T]he fraud exception to the autonomy of documentary letters of credit should not be confined to cases of fraud in the tendered documents but should include fraud in the underlying transaction of such a character as to make the demand for payment under the credit a fraudulent one.... [T]he fraud exception to the autonomy of a documentary credit should extend to any act of the beneficiary of a credit the effect of which would be to permit the beneficiary to obtain the benefit of the credit as a result of fraud. The fraud exception should be confined to fraud by the beneficiary of a credit and should not extend to fraud by a third party of which the beneficiary is innocent.... [T]he fraud exception should not be opposable to the holder in due course of a draft on a letter of credit."[326]

In contrast, Singaporean courts have taken a narrow approach to the application of fraud rule by limiting it only to fraud in documents. In the case of *White and Co Inc vs Chamet Handel Training (S) Pte Ltd*[327], the Court of Appeal of Singapore emphasized that fraud sufficient for constituting the exception to the autonomy of irrevocable documentary letters of credit was fraud in presentation of required documents to the bank while obligations of issuing or

[322] Ellinger. P, Noe. D, *The Law and Practice of Documentary Letters of* Credit, (2010), 143
[323] Buckley RP & Gao X (2003)317
[324] Official Comment to Article 5 of the Uniform Commercial Code, para. 2.
[325] *Angelica-Whitewear Ltd v Bank of Nova Scotia* 36 D.L.R. (4th) 161, EYB 1987-67726
[326] Ibid 176-177
[327] *White and Co Inc vs Chamet Handel Training* (S) Pte Ltd (1993) 1 SLR 65

confirming banks towards the beneficiary will not be affected by the fraud in underlying contract.[328].

## *4.6 Judicial Remedies of the fraud expiation Rule*

After the occurrence of the fraud, law of the documentary letters of credits provides three groups of remedies, namely: [329]

1- Bank's rejection to pay
2- Paying bank's right to reimbursement
3- Grating injunction to stop payment by court

### 4.6.1 Bank's rejection to pay

Upon presentation of confirming documents by beneficiary, issuing bank and conforming bank, if any, have the duty to honour the presentation[330]. In case of bank's decision not to effect the payment to beneficiary, it should prove the established fraud[331]. However, it is rare that the bank refuses to honour the credit on its own initiative[332]. Banks generally do not reveal fraud and the information and instructions about fraud come from the account party. After receiving allegation of fraud from account party, bank has the option to pay or not. In case it decides to effect the payment, obtaining the injection for court will be the only solution for account party to prevent payment to beneficiary.[333]. If bank decides not to pay, then either beneficiary's fraud is established or bank will be excused from payment or if otherwise happens, bank will be in breach of contract. When bank decides not to effect the payment, beneficiary might apply for summary judgement against the bank in order to get quick remedy without going to full trail[334]. Issuing the summary judgement by court in England is subjected to the English Civil Procedural Rules (CPR). Part 24.2. Accordingly:

[328] Ibid
[329] Malek A & Quest D '*Documentary Credits - The Law and Practice of Documentary Credits Including Standby Credits and Demand Guarantees'* 4ed (2009), Tottel .264
[330] Ibid
[331] Ibid
[332] Ellinger. P, Noe. D, *The Law and Practice of Documentary Letters of Credit*, (2010) ,145.
[333] Ibid
[334] Ibid

"The court may give summary judgment against a claimant or defendant on the whole of a claim or on a particular issue if –

(a) it considers that :(i) that claimant has no real prospect of succeeding on the claim or issue; or (ii) that defendant has no real prospect of successfully defending the claim or issue; and
(b) there is no other compelling reason why the case or issue should be disposed of at a trial"[335].

The decision of courts in *Solo Industries v Canara Bank*[336] , *Safa Ltd v Banque du Caire*[337] and *Banque Saudi Fransi v Lear Siegler Services Inc*[338] show that, in case of beneficiary's application for summary judgement, bank will apply a higher standard than what is required in CPR 24.2 . Therefore, for court, it is not sufficient that bank can show a real prospect of successfully establishing fraud in its defence. In addition, bank should be able to prove the real established fraud "which has the capability of being clearly established at the interlocutory stage"[339.] In occasions that bank does not resist payment on the basis of fraud rule like invalidity of letter of credit, it would be sufficient to satisfy the normal standard [340] while trying to show the real prospect of success under CPR 24.2.

### 4.6.2 Bank's Entitlement for Reimbursement

General rule is that the bank which has paid against conforming presentation is entitled for reimbursement. However, in case of fraud, the bank has no obligation against beneficiary or entitlement against the account party for effecting the payment. In case of payment in such circumstances, bank cannot have claim for reimbursement[341]. However, the bank which does not have information about the fraud of beneficiary will not be prejudiced.

[335] Part 24.2 of the Civil Procedure Rules accessed online at http: //www.hrothgar.co.uk/YAWS/rules/part24.htm#IDAZBHOB (Accessed on 10 May 2016)
[336] *Solo Industries UK Ltd v Canara Bank* [2001] 1 WLR
[337] - *Safa Ltd v Banque du Cair*e [2000] 2 Lloyd's Rep.
[338] *Banque Saudi Fransi v Lear Siegler Services Inc*. [2007] 2 Lloyd's Rep 47
[339] Ibid, 31-32
[340] Ibid, 33
[341] Ellinger. P, Noe. D, *The Law and Practice of Documentary Letters of Credit*, (2010), 147

In the case of Angelica-*Whitewear Ltd v Bank of Nova Scotia*[342] Le Dien J. from the Supreme Court of Canada argued that, in case of improperly paid draft by issuing bank, the standard of proof for fraud should be set in the question that "(w)eather fraud was so established to the knowledge of issuing bank before payment of the draft as to make the fraud clear or obvious to the bank"[343]. According to Le Dien J, standard of proof for such cases was different from standard of proof when applicant is trying to obtain interlocutory injunction against bank to restrain the payment to the beneficiary. He explained that in latter case the "strong prima facie test will apply"[344].

As it was discussed before, it can be understood that the bank which is trying to resist summary judgement against the payment to beneficiary is subjected to the higher standard of proof. However, this does not apply in the occasion that applicant, issuing bank or confirming bank try to resist the summary judgment as a result of being sued for reimbursement by the bank which has paid the fraudulent beneficiary.[345] In such occasions, defendant is expected to provide a real prospect of existing fraud and satisfy the normal test of CRP Part 24.2 at trail. In case of *Banque Saudi Fransi v Lear Siegler Inc* issuer of the performance bond was seeking for summery judgement against the instructing party provider of counter indemnity after making the payment to the beneficiary defendant raises the defence of not being bound for payment under the country indemnity due to dishonest claim of the beneficiary[346]. In trial, by showing the real prospect which was clearly established, defendant managed to successfully resist against the summary judgement[347]. In the above decision, it is implied that although, beneficiary might successfully obtain the summary judgement against bank as a result of bank's failure to establish a clear evidence of fraud, there is no guarantee that bank can in return obtain summary judgement for receiving reimbursement against the instructing party. Because the instructing party should only satisfy the low test of real prospect of fraud in the trial [348]

[342] *Angelica-Whitewear Ltd v Bank of Nova Scotia* 36 D.L.R. (4th), EYB 1987-67726
[343] Ibid 59
[344] Ibid
[345] Ellinger. P, Noe. D, *The Law and Practice of Documentary Letters of Credi*t, (2010), 147
[346] *Banque Saudi Fransi v Lear Siegler Services Inc*. [2007] 2 Lloyd's Rep 47, 18
[347] Ibid
[348] Ellinger. P, Noe. D (2010), 147

### 4.6.2.1 Fraud in deferred payment obligations

Under the deferred payment credits, the nominated bank has the obligation to pay on the maturity date in accordance with the credit. As under deferred payment system there is no immediate payment available to seller till the date of maturity of credit. Seller is responsible to ship goods and expects payment on maturity. Such process will impose financial burden on seller, therefore, market demand in similar conditions resulted in creation of forfaiting practice. In forfaiting practice, nominated bank may agree to discount the beneficiary's documents and expect reimbursement from issuing bank on maturity date. In case of beneficiary's fraud before the maturity date, applicant and issuing bank will definitely try not to reimburse the nominated bank which has paid fraudulent beneficiary. Although, this issue will depend in facts of each case separately and also UCP 600 has also provided guidance for interbank reimbursements under deferred payment regime, it is worth to study the right and obligations of nominated bank and other involved financial institutions under deferred payment before and after coming into force of the UCP 600.

*Banco Santander SA v Banque Paribas*

In *Banco Santander SA v Banque Paribas*[349], the fraud of beneficiary created serious problems for Santander which was confirming bank under the deferred payment arrangement. Napa Petroleum Trade was the applicant to the deferred payment credit at Banque Paribas in favour of Bayfern Ltd. Based on the request of Paribas, Banco Santander advised the credit as nominated bank to beneficiary plus adding its confirmation to the credit. The deferred payment was due 180 days after issuing the bill of lading. Beneficiary presented confirming documents to Santander on 15 June 1998, and according to the credit arrangements, Paribas as issuing bank and Santander as confirming bank had the duty to pay the beneficiary on 27 November 1998. However, Santander informed beneficiary about its agreement to discount the credit before maturity. Therefore, the credit was discounted by Santander and sum of payment minus discounting fee was transferred to the Bayfern's account and Bayfern irrevocably assigned Santander to its rights under the deferred payment credit. Before the date of maturity, Paribas informed Santander about presentation of forged documents by beneficiary and refused to reimburse Santander on maturity. Santander sued the Paribas and the trial judge ruled for

[349] *Banco Santander SA v. Banque Paribas*, [2000] CLC 906

Paribas as Bayfern assigned its rights to Santander. The judgment of trial court was affirmed at the court of appeal that, as assignee of Beyfern, Santander has no better position than assignor, while in case of not discounting credit, Santander would not face any risk due to refusal of Paribas to pay based on fraud exception. Alternative argument of Santander as holding the position of confirming bank was rejected by court as under UCP 500 issuing bank was only undertaking to reimburse nominated bank in case of honouring the deferred credit at maturity. Judgement of *Banco Santander v. Banque Paribas* was an unwelcome decision in the international banking society as banks were regularly discounting deferred payment credits. However, after coming into force of the UCP 600, it addressed the issue of deferred discounted payments under article 7(c ) and Article 12 (c ) .

The article 7 (c) holds that assignment of rights from the beneficiary to the discounting bank is not necessary anymore and, as a result, bank is entitled for reimbursement at the maturity date.

> "Reimbursement for the amount of a complying presentation under a credit available by acceptance or deferred payment is due at maturity, whether or not the nominated bank prepaid or purchased before maturity"[350]

The new Article 12 (c) of the UCP 600 has been the subject of many discussions among commentators. The debate is on the impact of the authorization. There is an argument among commentators who consider this new rule as legal basis for mitigating the risk of fraud between the date of payment and maturity date, while others consider it as a right given to the nominated bank and it might use such right on its own discretion and definitely on its own risk.

> 'by nominating a bank to accept a draft or incur a deferred payment undertaking, an issuing bank authorizes that nominated bank to prepay or purchase a draft accepted or a deferred payment undertaking incurred by that nominated bank'[351].

The most important objections are made by commentators who consider that UCP 600 is setting aside Banco Santander and similar cases. "Produced the undesirable result of effectively removing a useful option or risk apportionment"[352].

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[350] UCP Article 7(c)
[351] UCP Article 12 (c)
[352] K Takahashi, '*The introduction of Article 12(b) in the UCP 600: was it really a step forward?'* (2009) 24(6) JIBLR 285, 286

### 4.6.3 Injunctions

According to the independence principle, courts should not interfere in the process of documentary credit and demand guarantees operation by granting injunction, unless on the basis a recognized exception.[353]

## 4.6.3.1 Legal basis for granting injunction under English Law

Under the section 37 of the Senior Court's Act 1981, the high court may by order (whether interlocutory or final) grant an injunction in all cases in which it seems to the court to be just or convenient to do so[354]. The High Court has power to grant interim injunction in support of foreign proceedings under section 25(1) of the Civil Jurisdiction and Judgment's Act 1982[355].

Therefore, account party has the right and option for requireing the court to issue interim injections in order to restrain beneficiary from demanding money under the demand guarantee or letter of credit which is payable in England in support of foreign proceedings. However, it is not easy to obtain injunction against the beneficiary or paying bank under English law. So far three cases have managed to obtain injunction: *Themehelp Ltd. v West*[356], *Kavaerner Jhon Brown Ltd v Midland Bank Plc*,[357] *Lorne Stewart plc v Hermes Kreditversicherungs AG*[358] the general principles for granting injunction were set out in the case of *American Cyanamid Co v Ethicon*[359] based on the speech of the Lord Diplock. Applicant faces two main problems in application for interim injunction. First of all, he has to show that he has an arguable claim against the party he is trying to enjoin. For this purpose, he should establish a case of fraud to the knowledge of the party and also the fact that party owes him a duty either in contract or in tort[360]. And then it should be proved that granting the injunction by bank is correct practice and will pass the test of balance of convenience.

There have been arguments on contradictory nature of intervening in the process of bank's operation via granting of interim injunction with independent principle. As a result, it was

[353] Ehonchong 2010, 227
[354] Ibid
[355] the Civil Jurisdiction and Judgment's Act 1982 (Interim Relief) order 1997
[356] *Themehelp Ltd v West and Others* [1996] QB 84 (CA) ([1995] All ER 215 (CA)
[357] *Kavaerner Jhon Brown Ltd v Midland Bank Plc* (1998) CLC 446
[358] *Lorne Stewart plc v Hermes Kreditversicherungs AG, (1999) 2 Lloyd's Rep 187*
[359] *American Cyanamid Co v Ethicon Ltd [1975] AC396*
[360] Ibid

suggested that independent principle won't be violated in case of granting injunction against beneficiary to prevent demand on documentary credit or demand guarantee. A similar view was taken by the Court of Appeal of the *Themehelp Ltd. v West*[361]. In that case, the Court of Appeal ruled for granting injunction against the beneficiary of a demand guarantee in order to restrain him from demanding payment on the basis that the underlying contract was affected by fraudulent misrepresentation of beneficiary. However, the Themehelp Doctrine has been criticized heavily in the basis that existing the possibility to enjoin beneficiary from demanding payment violates the assurance to payment which has been provided by letter of credit. There will be no difference for beneficiary to be prevented from receiving payment by receiving injunction from court or because of an injunction preventing the bank to pay him[362]. In addition majority decision in *Themehelp* did not receive any judicial support from succeeding cases; for example it was rejected in the cases of *Group Josi Re v Walbrook Insurance Co Ltd and Others*[363], *Czarnikow-Rionda Sugar Trading Inc v Standard Bank London* [364].and *Sirius International Insurance Corp v FAI General Insurance Co. Ltd*[365]. Even May LJ in the case of *Sirius International Insurance Corp v FAI General Insurance Co. Ltd*, with whom the other members of the court of appeal agree, considered the decision of Themehelp as questionable[366].

### 4.6.3.2 The standard of proof

When account party is looking for injunction to prevent beneficiary from demanding payment or bank from enforcing payment on the basis of fraud exception, the first necessary step for him to take is meeting the standard of proof. In the case of *United City Merchants (Investment) Ltd v Royal Bank of Canada*[367], the standard of proof for fraud was considered again when Lord Diplock considered the Requirement as "(c)lear, obvious, or established fraud known to the issuer or confirmer of the letter of credit"[368]. Also Ackner LJ, in the case of *United Trading Corp. SA v Allied Arab Bank Ltd*[369] laid down the standard of "only realistic inference" in order

[361] *Themehelp Ltd v West and Others* [1996] QB 84
[362] Ellinger. P, Noe. D, *The Law and Practice of Documentary Letters of Credit*, (2010),163
[363] *Group Josi Re v Walbrook Insurance Co Ltd and Others* [1996] 1 Lloyd's Rep 345 (CA)
[364] *Czarnikow-Rionda Sugar Trading Inc v Standard Bank London* [1999] 2 Lloyd's Rep 187([1999] Lloyd's Rep Bank 197
[365] *Sirius International Insurance Corp v FAI General Insurance Co. Ltd* (2003) 1 All ER (Comm) 865
[366] Ellinger. P, Noe. D, *The Law and Practice of Documentary Letters of Credit*, (2010),163
[367] *United City merchants (Investment) Ltd v Royal Bank of Canada* [1983] 1 AC 168
[368] Ibid
[369] *United Trading Corp. SA v Allied Arab Bank Ltd*, [1985] 2 Lloyds Rep 554, 561

to provide an alternative to the "clear evidence" provided by Lord Diplock in *United City Merchants.* Ackner LJ further emphasized that:

> "The evidence of fraud must be clear, both as to the fact of the fraud and as to the [guarantor's] knowledge. The mere assertion or allegation of fraud would not be sufficient…We would expect the court to require a strong corroborative evidence of the allegation, usually in the form of contemporary documents, particularly those emanating from the buyer."[370]

Court also commented:

> "for the evidence of fraud to be clear, it would be expected that the buyer was given the necessary opportunity to answer the allegation against him and he (buyer) fails to provide any, or any adequate answer in circumstances where one could properly be expected. If the court considers that on the material before it the only realistic inference"[371].

Other similar positon was taken by Mance LJ in The Court of Appeal of *Solo Industries UK Ltd v .Canara Bank*[372]. Mance LJ while responding to the contention of bank towards standard of proof which should preclude "any possibility of innocent explanation" took as very close position to the position of *United Trading Corp. SA.*

From what has been discussed so far, it can be clearly understood that standard of proof for fraud under English law has been formulated differently. One reason can be that courts try to set a high standard from one hand to safeguard the autonomy principle and from the other hand set it too high not to be attainable in practice. As a result, there are different standards of proof including "established or obvious fraud"[373], "good arguable case which is the realistic inference on the material available for beneficiary to be fraudulent"[374] or the "real prospect"[375] of establishing fraud.

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[370] Ibid
[371] Ibid
[372] *Solo Industries v Canara Bank* [2001] 2 Lloyd's Rep 578
[373] *Edward Owen Engineering Ltd v. Barclays Bank international* [1978] QB159
[374] *United Trading Corporation SA v. Allied Arab Bank* at FN 27 per Ackner LJ at 561
[375] *Solo Industries UK Ltd v Canara Bank* [2001] 1 WLR 1800, [2001] EWCA Civ 1059

As it was mentioned earlier, the second step for obtaining the injunction is satisfying the balance of convenience. This issue, the balance of convenience, was not always considered in English court's decision while deciding to grant injunction base on fraud. One reason is that in most cases evidence was not enough to establish fraud and as a result the case did not proceed to the stage for considering the balance of convenience[376]. Therefore, when claimant manages to establish the basis for injunction, court will consider the balance of convenience in order to issue the injunction[377]. It has been mentioned that in the context of injunctions to prevent either beneficiary from claiming the payment or bank form effecting the payment in most cases balance of convenience is against granting the injunction.

The main reasons against granting injunction can be named as resistance of adequate remedies for damages, imminent expiry date of credit, availability of freezing injunction and availability of final accounting between parties[378].

[376] Enonchong (2011) 158
[377] Ibid, 236
[378] Ibid

# 5. Other Exception to the Principle of Independence

## *5.1 Nullity Exception*

The nullity would be an issue when beneficiary has no knowledge about null or void nature of the document in his hand. In contrast tofraud exception where the precondition is the [actual] knowledge of beneficiary about the material misrepresentation of tendered documents. The Nullity might happen when document is confirming to the terms of credit on its face. However, it is either a forgery or with no legal effect. Fraud rule cannot apply in the situation where beneficiary has no knowledge about forged nature of document in his hand and not played any role in production of such document. As a result, "the question will arise as to whether the nullity exception to the autonomy principle should be recognized in the meaning that bank will be entitled to reject the forged document despite its facial conformity"[379]. In this respect, current section of research will study the definition of nullity exception, continue with analysing designs of some important common law cases, and finally takes critical approach to arguments for and against recognition of nullity exception.

### 5.1.1. What is nullity?

It is not clear how to define the nullity exception. Any sort of definition for nullity will definitely result in bank's resistance to payment under the exception as the document has been considered null[380]. As a matter of fact, the nullity is an underdeveloped concept in the law of the documentary letters of credit[381]. Therefore, existing uncertainty around it is a significant reason for not recognizing the nullity exception in common law system. Examples from English case law demonstrate different understandings about the definition of nullity. The court of *Tek Chao v British Traders and Shippers* [382] held that misdated bill of lading is "valueless

[379] Ellinger. P, Noe. D, *The Law and Practice of Documentary Letters of Credit,* (2010),168
[380] Donnelly.K, '*Nothing for nothing: a nullity exception in letters of credit'* (2008) 4 JBL 316, 317
[381] Ibid
[382] [1954] 2 QB 459 (QB)

but not a complete nullity"[383]. In *Egyptian International Foreign Trade Co v Soplex Wholesale Supplies (The Raffaella)*[384] the same type of bill was considered as 'sham piece of paper"[385]. However, in *United City Merchants* a wrongly date bill of lading was considered "far from nullity". Therefore, the existing uncertainty around nullity is quite visible in English law[386]. Different suggestions have been proposed by scholars to define the nullity of one document. Including, consideration of whether or not the falsity or error in document destroys the "the whole or essence of the instrument"[387]. Other suggestion is that if the instrument can be considered as without legal effect[388]. On this basis, the Judgment of the United *City Merchants* is in consistency with definition of the nullity as a misdated bill of lading is still a valid document of title and holder can use it in order to receive goods from the ship[389].

### 5.1.2. Legal Recognition

English Law has three important cases on the nullity exception. Namely, the Court of Appeal and House of Lords decisions in *United City Merchants* and the Court of Appeal Decision of *Montrod Ltd v GuundkOtter Fleichvertriebs GmbH*[390]. In the case of *United City Merchants,* the question about effect of nullity documents was left open. However, Ackner LJ in the court of appeal commented that: "he could see no valid basis upon which the bank should be entitled to pay and debit the account party. (…) (The bank) ought not to be under on obligation to accept or pay against documents which he knows to be waste paper"[391]. In the Judgment of the House of Lords, Lord Lipclok mentioned that to him there is no reason to see the beneficiary in a worse situation than the holder in due course before leaving open the question of the rights of an innocent beneficiary.

[383] Ibid .116
[384] [1984] 1 Lloyd's Rep 102 (CA)
[385] Ibid
[386] Donnelly.K, (2008) 317.
[387] Guest.A (Gen ed), *Benjamin's Sale of Goods,* 6th edn (Sweet & Maxwell 2002) [19-034]; Malek. A, Jack *Documentary Credits* (2009) 250
[388] Neo. D, '*A Nullity Exception in Letter of Credit Transactions'* (2004) Singapore Journal of Legal Studies 46,54
[389] Enonchong.N (2011) 146
[390] [2001] EWHC 1032 (Comm), 58
[391] Donnelly.K (2008) 318

Finally, in the court of appeal of the third case, *Montrod Ltd v GuundkOtter Fleichvertriebs GmbH*, Potter LJ held that there is no nullity exception in English law[392]. According to his conclusion: "sound policy reasons for not extending the law by creation of a general nullity exception"[393]. It should be mentioned that the position of Potter LJ is limited to the documents which are null without being forged. As result, the position of documents which are forged without the notice of beneficiary are still not clear[394].

Among other Common Law jurisdictions, Singapore recognised nullity exception in the case of *Beam Technology (MFG) PTE Ltd v Standard Chartered Ban*[395]. However, the scope of the exception is very limited. "The confirming bank is not obliged to pay if it has established within the seven-day period that a material document required under the credit is forged and null and void and notice of it is given within that period"[396] The exception will apply under the following conditions:

1) When the document is forged
2) When the document is material. The court held that exception does not apply to all documents. However, no definition was provided for material document.
3) When it is null. The court provided that due to the uncertainty around definition of nullity, situation should have evaluated on the basis of facts in each case.
4) When the bank has the knowledge of nullity. According to the court, bank must come across knowledge on nullity of documents within 7 days' period which has been considered for checking documents and in addition, the due notice should be given to the beneficiary[397].

### 5.1.3. Arguments for nullity

Main arguments in favour of nullity exception can be traced in Singaporean Court of Appeal of *Beam Technology* and also The Court of Appeal of the *United City Merchants*. They include:

[392] [2003] 1 SLR 597

[393] Ibid
[394] Enonchong.N (2011) 146

[395] *Beam Technology (MFG) PTE Ltd v Standard Chartered Bank* [2003]1 SLR 597
[396] Ibid , 610
[397] Enonchong.N (2011),151

1- Non conformity of null documents: According to the principle of strict compliance, beneficiary should tender complying documents in order to be entitled to payment. Such requirement can be extended from more than facial conformity to the condition that document is really the one which is required by the credit. According to Goode, "documents which are forged, cannot conceivably treated as confirming documents"[398]. Genuine documents are required document by the credit while forged documents cannot be genuine despite of conformity on their face.
2- Bank holds bills of lading as a security of credit in addition to assurance about creditworthiness of applicant. Since bill of lading is a document of title, it is difficult to justify the rule which requires bank to pay beneficiary against the presentation of documents which are worthless to its knowledge.[399]
3- Not recognizing the nullity exception can be considered as policy of tolerance towards circulation of forged documents in international trade. Such documents are considered as "cancer in international trade"[400] and victims should bear huge losses. Since trust that forms the international trade would be undermined by free circulation of forged documents, accepting the nullity principle can prevent circulation of such documents in the process of documentary letters of credits.
4- The issuing bank has the mandate to pay against genuine documents that conform on their face with terms of credit. From this perspective, the bank that breaches its mandate in fact honours the presentation on its own risk not being reimbursed. "It is also not likely that the beneficiary who has not fulfilled his obligations to produce genuine documents would expect the bank to make payment against worthless documents or the applicant to later reimburse the bank for that"[401]

### 5.1.4 Arguments against nullity

1- The lack of Clarity in defining the nullity exception is the main argument against accepting it as another exception to the autonomy principle. The difficulty is in defining the nullity exception with precision and it would be difficult to answer the question of

[398] Goode. RM, *Commercial Law*, Second Edition, (London, Penguin 1995) 1009
[399] Ellinger. P, Noe. D, *The Law and Practice of Documentary Letters of Credit*, (2010),170
[400] *Standard Charter Bank v Pakistan National Shipping Corp* (No 2) (1998)1 Lloyd's Rep, 684, 686
[401] Hooley. R, 'Fraud *in Documentary Credits: is there a nullity exception'* (2002) *Cambridge Law Journal* 279,281

when a document is null. The main problem will arise when assessing reasonableness of something which is a common practice for courts.[402]

2- Lack of authority: The argument regarding the lack of authority was raised by Raymond Jack, the judge of the first instance court of *Montord* when the only available authority at that moment was judgement of Lord Diplock in *United City Merchants* which left the question of nullity documents open. This argument means that Nullity has not been supported either by UCP or case law. However, this is not a strong argument and lack of support under UCP should not be the reason for not recognizing the nullity exception under case law. [403] Similar to fraud exception which is not supported in UCP but, there is a well-recognized argument that UCP has left such question to answer by municipal law. [404]

3- The beneficiary should not be in worse position that the holder in due course: According to the Judgement of Lord Diplock in United City Merchants, there is no reason to see the holder in due course in better position than an innocent beneficiary when fraud has affected the documents. Goode criticised this view on the basis of the operation mechanism itself which provides more rights to the holder in the due course: "the beneficiary under the credit is not like a holder in due course of a bill of exchange; he is only entitled to be paid if the documents are in order"[405]. Goh J.C from the High Court of Singapore also criticized the argument of Lord Diplock in *Lambias*[406]: "I think the short answer to this is that as a party to the underlying contract, he (the beneficiary) has an additional recourse against the buyer which is not open to a holder in due course"[407].

4- Unfairness to beneficiary: This argument was raised by Potter L.J in the case of *Montord*. He argued that "'such an exception would be likely to act unfairly upon beneficiaries participating in a chain of contracts in cases where their good faith is not in question"[408]. In response, it is suggested that everything goes back to the balance of

[402] *Beam Technology* (2003) 1 SLR597, 36
[403] D Neo, '*A Nullity Exception in Letter of Credit Transactions'* (2004) Singapore Journal of Legal Studies 46,54
[404] Ibid
[405] Goode.R, *Commercial Law* (4th edn, Penguin 2009) 1104-1106; R Hooley, '*Fraud and letters of credit; is there a nullity exception?*' (2002) 61(2) CLJ 279
[406] Goode R, '*Abstract Payment Undertakings' in P Cane and J Stapleton, Essays for Patrick Atiyah* (Clarendon 1991) 231
[407] *Lambias (Importers & Exporters) Co Pte Ltd v Hong Kong & Shanghai Banking Corporation* [1993] 2 SLR751
[408] Ibid

interests[409]. If nullity document does not prevent bank from payment to innocent, then the buyer should be the one who bears the loss. In contrary, if the nullity exception prevents bank from payment to the beneficiary, then the seller is the one who will bear the loss. The argument is weak in principle as taking any side will have unfair outcome for the other party. Based on some other arguments, letter of credit should provide an assurance of payment to the buyer and all relevant risks should be assumed by buyer. Any different decision will undermine existing trust in financing system of the international trade.[410]The response to such argument might be statement of Stephenson L.J in the court of appeal of United City Merchants who commented on "the risk to be taken by beneficiary as banks trust the beneficiary to present honest documents". [411]

5- Creation of Further Dilemma for Banks. One of the reasons for Potter .L.J to reject the nullity exception in judgement of *Montord* was that "if a general nullity exception were to be introduced as part of English law it would place banks in a further dilemma as to the necessity to investigate facts which they are not competent to do and from which the UCP 500 is plainly to exempt them"[412]. The same will apply to UCP 600. However, banks can take the acceptance of Nullity Exception in Singapore as a guideline. In Singapore, nullity exception is limited to the situation that bank has clear knowledge of nullity before effecting the payment[413]. However, in any condition, there will be no difference between the position of bank towards facts outside documents under nullity and fraud rule.[414]

## *5.2 Recklessness Exception*

The recognition of recklessness exception can be considered as an alternative to the nullity exception in the law of the documentary letters of credits. The exception comes into force as a result of reckless or careless presentation of documents by beneficiary without considering that they are valid or void[415] or true or false nature of them[416]. Such an action will entitle bank to withhold payment to the beneficiary who is not guilty for fraudulent activity, however, his fault

[409] [2001] EWHC 1032 (Comm), [2002] 1 WLR 1975
[410] Donnelly.K (2008) 324
[411] Enonchong. N, (2011) 151
[412] *Montrod Ltd v Grundkotter Fleischvertriebs GmbH, [2001]* EWHC 1032 (Comm), [2002] 1 WLR 1975, 59
[413] [2001] EWHC 1032 (Comm), [2002] 1 WLR 1975
[414] Enonchong (n 1) 153; Donnelly (n 131) 324
[415] Enonchong. N, 2011 ,156
[416] *Derry v Peek* [1889] 14 AC 337 (HL)

is presentation of forged or nullity documents. Historically, in recklessness exception in English Law goes back to the cases of *Derry v Peek* in 1889, when reckless conduct of beneficiary has been assimilated to the knowledge of fraud[417]. Therefore, Recklessness exception can be considered as an extension to the fraud rule. In the case of *Montord*[418], Potter L.J mentioned that he "would not seek to exclude the possibility that, in an individual case, the conduct of a beneficiary in connection with the creation and/or presentation of a document forged by third part might, though itself not amounting to fraud, be of such character as not to deserve the protection available to a holder in due course"[419].

Under Singaporean Law, the high court of Singapore considered the recklessness exception in case of *Lambias*[420] The Judge stated "[Beneficiary] was nonetheless in some way clearly responsible for the turn of events that led to the perpetration of the fraud or forgery"[421] and continued that "the law cannot condone actions, which although not amounting to fraud *per se,* are of such recklessness and haste that the documents produced as a result are clearly not in conformity with the requirements of the credit"[422]. As result, the court held that according to available grounds for the bank, it is justifiable not honouring the presentation of documents by beneficiary.

A simple observation can lead us to the conclusion that Singaporean and English Legal system are ready to accept the recklessness exception despite nonexistence of leading cases[423]. As it has already mentioned, there is strong intention to consider recklessness exception as an extension to fraud. The issue of committed fraud by third party with effect of bank's payment to the beneficiary has been mentioned in *Derry v Peek, Montord and Lamibas*.

At the same time, there is tendency among some commentators to find link between nullity exception and reckless conduct[424]. As a result, recklessness of beneficiary will prevent payment only in case that he recklessly presents a nullity document. On this case, such situation is different from what has been discussed so far. In case of only covering nullity by recklessness

[417] Ibid
[418] *Montrod Ltd v Grundkotter Fleischvertriebs GmbH, [2001]* EWHC 1032 (Comm), [2002] 1 WLR 1975, 59
[419] Ibid
[420] *Lambias (Importers & Exporters) Co Pte Ltd v Hong Kong & Shanghai Banking Corporation* [1993] 2 SLR.751
[421] Ibid 764
[422] Ibid
[423] Enonchong. N, 2011 ,156
[424] Ibid

exception, documents which are forgery but not void will not be covered. However, bank is entitled to dishonour presentations based on documents which are void. Encompassing recklessness exception in both directions may result in the most optimal situation.

## *5.3 Unconscionability*

Lack of good faith and or unconsciousable demand of beneficiary for being paid are main areas covered by unconscionability exception. In such cases, there is no fraud or defective documents are involved. However, by demanding for the payment, beneficiary tries to take an unfair advantage from his position. The fraud has been formulated by absolute lack of right for payment, while abusive demand and unconscionable conduct presupposed the existence of right, i imposes an additional "inherent risk" on the exercise of such right[425]. The main area for application of exception will be Standby Letters of Credits, Performance Bond and Demand Guarantees.

### 5.3.1 Unconscionability under English Law

At the first step we should differentiate the unconscionability from recognized doctrine of unconscionable conduct in English Law. Unconscionable conduct "applies when the complainant's consent to the unfair transaction was vitiated because of a morally reprehensible act of the defendant short of fraud, duress, or undue influence"[426]. Therefore, unconscionable conduct takes place during the contract performance.

*TTI Team Telecom International Ltd v Hutchinson 3G UK Ltd* [427] is only one English authority which accepts the unconscionability as an exception to autonomy principle[428] . In this case judge held that "a lack of good faith has for a long time provided a basis to restrain a beneficiary from calling a bond or guarantee"[429]. However, the judgment of this case has received considerable amount of negative comments.[430] Flow of negatives comments towards the judgment of TTI and reluctance of case law in recognition of unconscionability as an exception

[425] Ibid
[426] Pierce.A, *Demand Guarantees in International Trade* (Sweet & Maxwell 1993) 198
[427] *TTI Team Telecom International Ltd v Hutchison 3G*, [2003] EWHC 762 (Comm), [2003] 1 All ER (Comm)
[428] Enonchong. N, Duress, undue influence and Unconscionable Dealing (Sweet &Maxwell 2006) Part II.
[429] TTI Team Telecom International Ltd v Hutchison 3G, [2003] EWHC 762
[430] Ibid

to autonomy principle of letters of credit can be positively linked to unwillingness of English legal system to recognize the doctrine of good faith in contract law[431].

### 5.3.2 Unconscionability under other Common Law Systems

In Singapore, fraud rule was the first expiation to the autonomy principle of documentary credits. However, unconscionability exception was first recognized implicitly in cases of *Royal Design Studio Pte Ltd v Chang Development Pte Ltd*[432] and *Kvaerner Singapore Ltd vUDL Shipbuilding (Singapore) Pte Ltd*[433]. Finally, Unconscionability exception was recognised explicitly by Singaporean Court in *Bocotra Constr Pte Ltd v Attorney Gen (No 2)*[434], when the judge held that "whether there is fraud or unconscionability is the sole consideration in applications for injunctions restraining payment or calls on bonds to be: granted"[435]. Four years later, the court of appeal confirmed the decision and held:

> "The concept of "unconscionability" was adopted after deliberation, and was not inadvertently inserted as a result of a slip; nor was it intended to be used synonymously or interchangeably with "fraud." There is nothing in that judgment which can be said to indicate or suggest that the court did not decide that "unconscionability" alone is not a separate ground as distinct from fraud. We accept that to that extent, *Bocotra* is a departure, and if we may respectfully say so, a conscious departure, from the English position"[436] .

The position of *Bocotra Constr Pte Ltd v Attorney Gen (No 2)* was later confirmed in *Dauphin Offshore Engineering & Trading Pte Ltd v Private Office of HRH Sheikh Sultan bin Kalifa bin Azyed al Nahyan*[437].

Unconscionability has not been codified in UCC. Therefore, it is not recognised in the United States of America as an extension to the fraud rule. Since Fraud Rule has the statuary recognition, it would be easy to understand the reluctance of judges to introduce a new

[431] Enonchong. N (2001), 164.
[432] Royal Design Studio Pte Ltd v Chang Development Pte Ltd [1990] 1 SLR 1116
[433] *Kvaerner Singapore Ltd v vUDL Shipbuilding* (Singapore) Pte Ltd
[434] *Bocotra Constr Pte Ltd v Attorney Gen* (No 2) (1995) 2 SLR 733, 744
[435] *GHL Pte Ltd v Unitrack Building Construction Pte Ltd* [1999] 4 SLR 604, 610
[436] *Dauphin Offshore Engineering & Trading Pte Ltd v Private Office of HRH Sheikh Sultan bin Kalifa bin Azyed al Nahyan* [2000] 1 SLR 657
[437] Enonchong (2011). 181

exception by using case law. However, American legal system has managed to recognize different aspects of unconscionable conducts in guarantees under the board definition of fraud[438] . For example, "fraud in transaction" includes aspects of bad faith[439]. Examples can be found in judgements of *Harris Corporation v National Iranian Radio and Television*[440] and *Rockwell International Systems v Citibank*[441].

### 5.3.3 Implications

Recognition of the unconscionability exception, regardless to its benefits to the international trade, especially in fields of guarantees[442], will impose some significant risks on the national legal systems which should not be neglected by informed Judges. Current section of research will briefly touch upon potential risks of recognizing unconscionability exception in the law of letters of credit:

1- Imprecise and unclear definition of unconscionability can be the first source of risk[443]. It is really recommended that in the area of law in which clarity and certainty have utmost value[444] it is important to confine the scope of such concepts in order not to depend on judges to access rights of each party[445].
2- It is suggested that recognition of unconscionability exception will result in more legal actions and such judicial interventions might undermine the widely recognized principle that letters of credits are equivalent to cash"[446].
3- Recognition of unconscionability exception will result in rise of courts involvement in interlocutory stage in disputes which are about breach or performance of underlying contract. However, a separate proceeding is necessary to resolve such disputes.[447]

[438] Fedotov A, '*Abuse, unconscionability and demand guarantees: new exception to independence'* (2008) 11 Int'l Trade & Bus L Rev 49, 62
[439] *Harris Corporation v National Iranian Radio and Television* (1982 11th Cir) 691 F2d 1344
[440] *Rockwell International Systems v Citibank* (1983 2nd Cir) 719 F2d 583, 588
[441] Fedotov. A, (2008).81.
[442] Loi. K, '*Two decades of restraining unconscionable calls on performance guarantee*s' (2011) 23 SAcLJ 504, 512
[443] Enonchong (2011). 170
[444] Ibid
[445] Ibid
[446] Ibid,171
[447] Ibid

## *5.4 Illegality*

Illegality is the last exception to the independent principle of documentary credits which is to be discussed in current research paper. The illegality exception has roots in possibility that the illegal nature of the underlying contract can taint the letter of credit process and, as a result, bank will be entitled to dishonour the presentation.

There are different reasons for underlying contract to be considered as illegal. Reason might be infringing lending limits on credits[448], violation of exchange control laws[449] or violating the government ban on payment to special people or countries[450]. On the same basis for application of fraud rule, the legal ground to be used in favour of illegality exception is *ex turpi causa non oritur actio*[451], in the meaning of "no court will lend its aid to man who founds his cause of action upon an immoral or an illegal act"[452]

Under English law, there are few cases which raise the issue of illegality exception. In *Group Josi Re* [453] the argument was around illegality of underlying insurance contract. Therefore, as claimants did not have the authority to work in England, the letter of credit was also affected by illegality.[454] In the Court of Appeal, Staughton L.J mentioned that letter of credit can be influenced by the illegality of the underlying contract and, as a result, court can issue injection against payment by bank or beneficiary for demanding it[455]. The idea of illegality exception as separate ground for defence was supported one year before in another judgement[456].

The case of *Mahonia Ltd v JP Morgan Chase Bank (No2)*[457] shed more light on the issue of illegality exception in English Legal System. In this case, plaintiff (Mohonia) pleaded on the basis of the illegality of the underlying contract as the contract was providing a party with a disguised loan which was used by that party for manipulation of his accounts and violation of

[448] *Id International Dairy Queen Inc v Bank of Wadley* (1976 MD Ala) 407 F Supp 1270
[449] Mugasha. A, *'Enjoining the Beneficiary's Claim on a Letter of Credit or Bank Guarantee'* (2004) 5 JBL 515
[450] *Itek Corp v First Nat Bank* (1981 D Mass) 511 F Supp 1341; *Harris Corp v National Iranian Radio & Television* (1982 11th Cir) 691 F2d 1344; *General Cable Ceat SA v Futura Trading Inc* (1983 SDNY) 1983 WL
[451] Directions 1990 (SI 1990/1591); Directions 1990 (SI 1990/1616)
[452] Enonchong. N, '*The Autonomy Principle of Letters of credit: an Illegality exception*?' (2006) LMCLQ
[453] *Group Josi Re v Walbrook Ins Co Ltd* [1996] 1 Lloyd's Rep 345 (CA)

[454] Ibid
[455] Ibid 362
[456] *Deutsche Ruckversicherung AG v Walbrook Insurance Co Ltd* [1995] 1 WLR 1017 (Com Ct) 1027
[457] *Mahonia Ltd v JP Morgan Chase Bank*(No2) [2004] EWHC 1938 (Comm)

US Law. During the action for summary judgement, Coleman J rejected the Mahonia's application while arguing that Illegality Exception should be recognised. At trial, Cook J. considered that autonomy principle has not prevented a letter of credit being tainted by the illegality of the underlying transaction[458]. Despite the fact that, decision of Cook J, Mahonia cannot be considered as a leading case in England due to its obiter nature, it serves as an indicator which shows the attitude of British courts on the subject matter[459]. Latter cases showed the same attitude. In *Oliver and Anor v Dubai Bank of Keny*[460] it was held that fraud and illegality are possible exceptions to fraud[461]. In *Lancore Services Ltd v Barclays Bank Plc*[462], Judge referred to existence of Illegality Exception as a basis for making decision.

Unified Commercial Code does not recognize the illegality exception in United States of America. The necessity for accepting illegality as an exception of autonomy principle of documentary credits has been promoted by some American scholars and even Mc Laughlin comments on providing possibility for bank under UCC to refuse presentation of documents in case illegality has affected the underlying contract[463]. Despite existence of such supports, general agreement is on not accepting the illegality exception due to its absence in revised UCC article 5. It also worth to mention that in old version of UCC article 5 the illegality issue as defence for bank to affect the payment to beneficiary was expressly rejected[464].

In this session, research will review conditions for application of the illegality exception. However, in legal systems which recognize the illegality principle, its scope of application is so narrow that it cannot be considered as a threat for autonomy principle[465].

In English law, conditions for application of illegality exception are taken from the case of *Mahonia*[466].

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[458] Ibid
[459] Enonchong (2011) .192
[460] *Oliver and Anor v Dubai Bank of Kenya* [2007] EWHC 2165 (Comm)
[461] Ibid, 12.
[462] *Lancore Services Ltd v Barclays Bank Plc*, [2008] EWHC 1264 (Ch), [2008] 1 CLC 1039
[463] Mc Laughlin '*Standby Letters of Credit and Guaranties: An Exercise in Cartog*raphy' (1993) 34 Wm & Mary L Rev 1139; G McLaughlin, '*Letters of Credit and Illegal Contracts: The Limits of the Independence Principle'* (1989) 49 OHIO ST LJ 1197
[464] Enonchong (2011) .193
[465] *St John Shipping Corporation v Joseph Rank Ltd* [1957] 1 QB 267 (QB) 288-289
[466] *Mahonia Ltd v JP Morgan Chase Ban*k(No2) [2004] EWHC 1938 (Comm)

1- There should be serious allegation of illegality[467]. However, it is not easy to define what constitutes the minor illegality and what the serious one is. The test adopted by Cook J. in the court of appeal of *Mahonia* was whether illegality has involved the deliberate wrongdoing or not.[468]

2- Bank should be aware of illegality in underlying contract and have the capability to prove it. The same standard of proof as Fraud Exception applies to the case illegality. However, in case of summary judgement, bank is required to prove its real prospect of success at the trial on the basis of illegality exception[469]. But at the time of hearing, bank should be sufficiently aware of illegality[470]. Regarding injections, account party should show a seriously arguable case on the ground of illegality for being able to obtain the injection against the bank or beneficiary[471]. At the end, the clear illegality should be proved during the judgment proceedings for claim to be successful[472].

3- Beneficiary should be either a party to the illegality in the underlying contract or possessing information about it. Since in most cases the beneficiary is not informed about the illegality involved in the underlying contract, the scope of the application of exception seems to be really limited. [473]

4- Finally, it is necessary to determine the degree of connection between the letter of credit and the illegality. In case of *Mahonia*, it was held that illegality should be closely connected to the letter of credit in order to taint it[474]. There is also a criteria to define the degree of connection between illegality and documentary letter of credit[475].

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[467] Ibid
[468] Ibid, 430.
[469] Enonchong (2011) 194
[470] Mahonia (No1) (n 460) [69]
[471] Enonchong (2011) 194
[472] *Group Josi Re v Walbrook Ins Co Ltd [1996] 1 Lloyd's Rep 345 (CA)*; *Themehelp Ltd v West [1996] QB 84 (CA).*
[473] *Mason v Clarke* [1955] AC 778 (HL)
[474] Mahonia (No1) (n 460) [428]
[475] Stowe. H, '*The "Unruly House" has* Bolted' (1994) 57 MLR 441; R Buckley, *'Law's Boundaries and the Challenge of Illegality*' in R Buckley (ed), Legal Structures (Chancery Wiley Law publications 1996) 233; N Enonchong, *Illegal Transactions* (Lloyds of London Press, 1998) 181;

# 6. Conclusion

The *reason de etre* of the documentary letters of credit can be mentioned as the need of market to an instrument of payment in international business which can mitigate the commercial risk between buyer and seller who do not have any information from financial capacity of each other. As a result, we can witness the development of documentary letters of credits in the course of history as an improvised act of market which has been regulated by customs and usages of the same market. However, during the first half of the 20$^{th}$ century International Chamber of Commerce, as the representative of merchants, tried to codify a set of rules for governing operation of documentary letters of credits which is famous as Uniformed Customs and Practices of Documentary Letters of credits (UCP). Impressive success of UCP in comparison with efforts of other organizations in codification of rules for operation of documentary credits is a sign of proper understanding of ICC from market demand.

According to UCP, operation of Documentary Letters of Credits is subjected to two main principles. autonomy and strict compliance. The first one tries to protect rights of seller by separating the underlying contract of sales from credit and, in case of any dispute on the underlying contract, it requires the buyer to pay first and argue later. By the contrast, the second protects the rights of the buyer by requiring the seller to provide genuine documents which comply with terms of credit. Interestingly, among common law countries only USA has naturally applicable statute for operation of documentary letter of credits while other countries, including England, follow the case law system. UCP is only limited to application of two main principles of letters of credit; but what if beneficiary in bad faith tries to get the payment by tendering forged documents which comply on their face with terms of credit? Due to prevalence of similar cases, fraud rule was introduced by national laws as an exception to the universal absoluteness of principle of autonomy. In the course of time, by increasing cases on different bases, other expiations also have the possibility to be either recognized or at least being considered by judges. Among other exceptions, nullity has been recognized in Singapore while being rejected in England. Illegality and unconscionability also have been demonstrated

a significant development. For example, unconscionability has a wide range of application in field of demand guarantees.

However, there is still long way to be taken by common law courts, particularity English ones, to have a harmonized approach to the problem of fraud and other exceptions to the principle of autonomy of documentary letters of credit. Current research took a critical approach to such divergent approach of English courts to the relevant issues of fraud rule as well as other exception. Therefore, in the course of study, efforts were made to analyse reasons behind historical reluctance of English courts towards intervention into the operation of autonomy principle, absence of harmonized standard of proof for fraud, difficulties in obtaining interim relief from the court and non-recognition of other exceptions. The outcome of the studies in this field are of the high importance, as existing problems of fraud and other exceptions to principle of autonomy may have negative effect on the perception of businessmen at global level on capability of Documentary Letters of Credit in mitigating the commercial risk in international trade.

In conclusion, recognition of nullity of tendered documents and also fraud of third party by English legal system are recommended. It is suggested that according to an implied term in credit, beneficiary is expected to provide genuine documents which comply of their face with terms of credit. Beneficiary will have such obligation in exchange with unconditional guarantee of issuing bank to undertake obligations of account party in the framework of underlying contact. Therefore, beneficiary should be more careful and vigilant about genuineness of documents in cases that he is not producer of them.

However, it can be also recommended to limit the application of unconscionability to the demand guarantees and not to extend it to the commercial letters of credits. Despite the fact that both instruments are subjected to same rules, the role of bank in commercial credits is different from demand guarantees. Since account party assumes the performance of the underlying contract in international trade, there is no need to protect him from the bad faith and abusive demand for payment when all documents are confirming with the terms of the credit. And in contrast with demand guarantees, in which tender is as result of failure in performance of obligation, documents are tendered in commercial credits to effect the payment base on the proper performance of the contract of the seller's part.

It is also recommended to restrict the application of exception to the autonomy principle as much as possible in order to let the parties to respect their own business merits in conditions that rules of game are mutually respected. The question of rules clearly goes to the national rules which should be more developed and harmonized specially in regard with standard of proof and judicial remedies which account party can expect in case of fraudulent tender of documents by beneficiary.

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***Publication 1***: **Alavi. H, (2016) Documentary Letters of Credit, Legal Nature and Sources of Law, *Journal of Legal Studies* 31: pp. 106-121**

DE GRUYTER OPEN

JOURNAL OF LEGAL STUDIES
"Vasile Goldiş" Western University of Arad
J. L. S.

DOI: 10.1515/jles-2016-0012

# DOCUMENTARY LETTERS OF CREDIT, LEGAL NATURE AND SOURCES OF LAW

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(Received January 2016; Accepted April 2016)

**Abstract:** There is no doubt about risky nature of international trade. Such risk can be conceptualized as country risk, transportation risk, customer risk and etc. Documentary Letters of Credit (LC) are used as a method of payment in international business for many centuries in order to reduce risk of trade specially when parties are located in different countries and do not have precise information from financial standing of each other. In such occasion LC will reduce the risk of trade by shifting payment obligation from buyer as an individual to a payment guarantee of a bank as a legal entity in return for presentation of complying documents with terms of credit by seller. Familiarity with legal nature and different legal frameworks which govern the international operation of documentary letters of credit can facilitate the process of international trade for businessmen and boost national economies. However, lack of knowledge about them can impose huge losses on international traders. Situation will be more complicated when we understand that there are many internationally recognized legal frameworks which can affect the operation of LC and they get frequently updated in order to address technological and economic developments in global market. In this paper, author tries to answer questions regarding (i) what are international legal frameworks governing operation of documentary letters of credit? (ii) which areas of LC operation has been covered by them and (iii) how do they address the legal questions regarding international operation of documentary letters of credit?

**Key Words:** Documentary Letters of Credit, Legal Framework, InternationalTrade, Payment Risk.

## 1. Introduction

Documentary Credits, Documentary Letters of Credit or Banker's Documentary Letters of Credits are one of the old and well appreciated existing instruments for financing the international trade. Such long history of Documentary Letters of Credits has resulted in letting them to be considered as "Life Blood of Commerce" [1]. In terminology, Letter of Credits has roots in the French word 'Accredetif' with the meaning of power for doing something. However, Accredetif itself comes from 'Accreditiwus' in Latin which conveys the meaning of 'Trust' [2].

There is no doubt about historical uses of Letters of Credit in International Trade. Their usage in practice of international trade has been traced to banking systems of old Egypt and Babylon. Some excavations in Babylon provide evidences of promissory notes from 3000 B.C that show the promise for payment of exact

amount and relevant interest rate in a defined date .Also evidences from ancient Greece show drawing of Letter of Credits by banks to their correspondents in order to obviate the transport of Spices in return to payment of accounts [3].

During middle Ages, Letters of Credits were used in order to solve two distinctive trade problems. (A) Lack of security in carriage of precious items and gold by merchants during their business trips and (B) Lack of common trade currency for meeting the cash need of merchant's abroad [4]. Due to security risks of carrying cash in hand, merchants of those days were preferring to exchange their cash with a 'letter of credit' at their bank with the capability of being cashed in another bank at given destination [5].

According to the De Rover, Letters of Credit were in use by Medici Bank during late 1ate 1300s in Bruges and Italy [6]. In the course of time, London gained fame as an outstanding financial centre due to growth of international trade and raise of British Banking System as monopolistic issuer of Letter of Credit which was the a result of accepting Pound Sterling as currency for international trade created.

Letter of Credits entered United States of America after raising competition among factoring houses and acceptance of drafts against shipment [7]. In today's world, Letters of Credits are considered among the most attractive arears of research for legal, international trade and finance scholars. In this respect, Professor Roy Goode defines Documentary Letters of Credits as: "A money promise which is independent of the transaction that gives it birth and which is considered binding when received by the beneficiary without acceptance, consideration, reliance, or execution of solemn form" [8]. Latest version of Uniformed Customs and Practice for Documentary Credits (UCP 600) defines Letters of Credit as: "An arrangement however named or described, that is irrevocable and thereby constitutes and definite undertaking of the issuing bank to honour the complying presentation". Further, Article 2 of UCP 600 considers complying presentation as "a presentation that is in accordance with terms and conditions of the credit, the applicable provisions of this rule and international standard banking practice" [9]. Among other definitions, Kudriachov describes Letters of Credits as "one way abstract transaction, in which the emitting bank cannot reject the execution of its obligation by referring to non-execution of obligations by other parties to the transaction" [10] Although, Documentary Credits have very long mercantile history, their involvement to utilization of credit arrangements practically goes back to the second half of the 19$^{th}$ century [11]. Therefore, current article tries to a review on general aspects of Letter of Credit operation, international legal frameworks applicable to LC transactions and main legal principles in operation of Letters of Credits. A review of legal history of Documentary Letters of Credits shows that *Rose v Von Mierop and Hopkins* [12] is one of the first lawsuits on letters of credits and landmark of LCs Law in English legal system [13].

### 1.1. Functions and process of the operation in Documentary Credits

Article 2 of UCP (600) defines parties to the Letter of Credit as following: "Applicant: the party to whose request the credit is issued. Beneficiary: The party in whose favour the credit is issued. Issuing Bank: Means the bank that issues a credit at the request of an applicant or on its own behalf" [14]. Basically, the process of issuing a Letter of Credit starts with request of Buyer (applicant or Account Party) to his bank (issuing bank) in order to issue a credit in favour of the seller (Beneficiary) based on the underlying contract of sales between parties. As a result, issuing bank will contact beneficiary in his country in order to inform him about opening the credit in his favour. Due to a geographical distance between issuing bank and beneficiary, advice of the credit to beneficiary will generally take place via a correspondent of issuing bank in beneficiaries country (advising bank). The responsibility of advising bank is only informing beneficiary about issuing credit in his favour and it does not have any obligation of payment towards beneficiary [15]. As a result, the legal nature of relationship between issuing bank and advising bank is considered as relationship between agent and principle [16].

Beneficiary seller at this stage must compare terms and conditions of the credit with terms of underlying contract. In case of any existing discrepancy at this stage, beneficiary is entitled either to reject the credit or require amendments. After approval of the credit by beneficiary, issuing bank will enter into a contract with Beneficiary to provide him with price of merchandise in return of complying documents required by the credit. As a result, any given credit will have at least three parties. Namely, Issuing bank, Beneficiary and Applicant.

However, in practice number of parties might be more than three. It might happen that issuing bank asks advising or any other bank in the country of seller to provide credit on her counter which is a very appreciated option for beneficiary who will be paid in his own country rather than the country of the buyer. In this case, the bank which provides credit on her counter is considered as Nominated Bank [17]. In some occasions, seller might ask for higher guarantee for payment which is already provided by issuing bank. In this case a confirming bank will add her irrevocable commitment for payment of the credit to beneficiary in addition to issuing bank. As a result , any given Documentary Letter of Credit will consist of at least three independent contracts between Beneficiary and Applicant (Underlying Contract of Sales), Account Party and Issuing Bank, Issuing Bank and Beneficiary. However, in majority of cases number of contracts will increase relatively with the increasing number of involved parties in the credit after joining confirming bank and Nominated Bank to original parties to the Documentary Credits.

Enonchong [18] introduces four generic functions for the Letter for Credits. First, Letter of credit reduces commercial risk both for importer and exporter by providing security of payment for exporter and security against the non-delivery of

goods for importer. Second function is providing finance for importer and helping him with cash flow while at the same time providing exporter with the chance to raise money before being paid by issuing bank. Third, Documentary Credits can be used as security for other obligations like case of Back-to-Back letter of credits. Fourth, is the function of documentary credits as conditional payment method and providing the possibility for seller to receive payment from importer in case the credit has been dishonoured by bank.

Function of Documentary Letters of Credit follows different steps of the Letter of Credit's process [19]· Process starts with negotiation of the terms of contract by buyer and seller. They will enter the underlying contract of sales. According the underlying contract, exporter will undertake to provide confirmed goods which are subjected to that particular transaction and importer commits to pay the price of good via Documentary Letter of Credits. Further, information regarding the details of the Credit will be also mentioned in the underlying contract. As the second phase, the buyer will require the issuing bank to open a credit in favour of exporter. In case of issuing bank's agreement to issue the credit, Importer (account party) to pay him the price of goods sold to the importer in return of delivering confirming stipulated documents in the credit [20].

Although, these three independent contracts are considered as basic framework for function of Documentary Letter of Credits, but in practice, in majority of occasions, beneficiary will interact with a local bank in his own country rather than being involved directly with issuing bank. If parties decide so, then the advising bank will contact the beneficiary in order to inform him about the issuing of the credit in his favour. At the time that credit requires involvement of Nominated Bank and Confirming Bank, there will be a separate contract between Beneficiary and Nominated or Confirming Bank and Issuing Bank and Nominated and Confirming Bank. Advising Bank might or might not accept to act in the capacity of Nominated and /or Confirming Bank.

As a result, beneficiary ships goods for account party and provides confirming stipulated documents in the credit to the issuing bank, Nominated Bank or Confirming Bank. Nominated Bank will check presented documents and in case of conformity, they will pay beneficiary based on the authorisation in issuing bank [21], transfer documents to issuing bank and wait for reimbursement [22]. Issuing bank also check documents and in case of their conformity will reimburse Nominated or Confirming Bank, debit the account of applicant and inform him to come and receive his documents.

As it was mentioned earlier, most of the time credit will require the involvement of Nominated Bank and Confirming Bank as Issuing bank is not located in country of Beneficiary and it is difficult for him the confirm the authenticity of signatures by issuing bank [23].

## 2. Legal Nature and Sources of the Letter of Credit Law

### 2.1. Background

The exact time that Letters of Credits started to function as their modern form is not clear [24]. However, most researchers tend to agree that emergence of the modern letters of credits started from the middle of nineteenth century [25]. Reviewing the history of Documentary Letters of Credit, explains formation of modern forms of credit as response to demands in commercial world by developing primitive forms of credit [26]. However, comparison between Modern Documentary Credits and Open Credits as one of the ancients types of credit provided by banks to merchant in international trade shows the 'resemblance is only superficial' [27]:

"1) The object of today's letter of credit is to guarantee the payment of the purchase price in international sales of goods; the open letter of credit, on the other hand, was used to raise funds for merchants traveling overseas. A merchant who did not wish to carry cash but wished to obtain credit or cash in countries where it would have find it difficult to do so otherwise could ask his banker to issue an open letter of credit for him. On the faith of the open letter of credit, the merchant was able to obtain advances from foreign bankers against its drafts.

2) While the issuer of a modem letter of credit promises to pay a seller who has already entered into a contract for the sale of the goods provided the seller submits the required documents, the issuer of an open letter of credit asked others to advance money to his customer.

3) In a modern letter of credit the credit is given to some third party with whom the customer has some commercial dealings; in the open letter of credit the letter was given to the banker's customer." [28]

Reviewing the history of modern Letter of Credit also shows deference between their legal nature with other instruments used in international trade including negotiable instruments and Contracts of Sales.

### 2.2. Sources of Letter of Credit Law

In the course of history, development of law and regulations of the Documentary Letter of Credit was based on custom. However, in modern time; International Chamber of commerce has provided the major source of law for documentary letters of by assuming the responsibility for codification of relevant customs and usage under Unified Custom and Practices for Documentary Credits (UCP). Additional to UCP, International Chamber of Commerce has introduced other regulations including eUCP, Uniform Rules of Contract Guarantees, Uniform Rules for Demand Guarantees, ISP98, which is International Standby Practices for Independent Guarantees and Standby Documentary Credits. United Nations Conference for International Trade Law also individually took the initiative to prepare universal regulations for Independent Guarantees and Standby Letters of


ISSN 2457-9017; ISSN-L 2392-7054. Web: publicatii.uvvg.ro/index.php/jls. Pages 106 - 121

Credits which is known as UNCITRAL Convention. Despite existence of many international frame works for regulation of documentary credits, this issue has been addressed in few national law systems. Among Civil Law countries only Colombia, El Salvador, Greece, Guatemala, Honduras, Lebanon, Mexico, and Syria have statutory rules on the letter of credit; and, the only country in the common law system is the United States. In other Common Law Countries including England, Legal issues of documentary credits are subjected to case law. The main focus of current paper in this section will be study of different International legal sources for documentary credits, and also the answer of common law system to the question of legal framework for documentary credits.

### 2.2.1. Uniform Customs and Practice for Documentary Credits (UCP)

UCP is the product of harmonization process for international law in order to facilitate the process of international trade and reducing conflicts among different legal systems. By escalating amount of international trade at the beginning of $20^{th}$ century as the expected aftermath of industrial revolution first national attempts towards harmonization of Letter of Credit Law stated in 1920's. The process of harmonization of LC law at national level started in the United States of America by drafting relevant banking regulations for Letter of Credit Operation by New American Commercial Credit Conference [29] which was followed by European countries [30]. At international level, Amsterdam Conference of International Chamber of Commerce in 1929 was the first step where proposed law was adopted only by France and Belgium [31]. A revised version of the text was introduced in 1933 by the Commission on Banking Technique and Practice of the International Chamber of Commerce at Vienna Conference and received acceptance from some European countries and individual American banks [32]. Further revisions on the code by ICC started after the end of World War II. During Lisbon Conference of ICC in 1951 new revision of harmonized code for international operation of LC was introduced which was adopted by several African and Asian banks but got rejection by England. New revision of UCP took place in 1962 following the objective of receiving worldwide application [33] and received adoption by banks in Britain and Commonwealth countries. In 1974 the new revision of UCP was introduced in order to meet the global needs for container shipping and multimodal transport which received breakthrough achievement of being adopted by 162 countries [34]. Next revision in UCP happened in 1983 which is known as UCP 400 [35].Innovations introduced in UCP 400 were trying to cope with challenges facing international trade due to fast developing technology and communication methods by addressing: 1) introducing negotiation of document under letter of credit 2) application of UCP to Deferred Payment LCs and Standby LCs and 3) Using SWIFT for transmission of documents and LC [36]. Further revision of UCP was adopted in ICC conference in Mexico in 1993 and came into force by first

January 1994 [37]. It is known as UCP 500 which was an improvement to UCP 400. It introduced the notion of nominated bank [38], bank duty to examine documents [39] and their rejection [40] new provisions regarding documents (articles 23-30 , on transport documents, article 34-36 on insurance documents, and article 37 on commercial invoice). Finally, the current revision of UCP known as UCP 600 came into force in 2007 and brought about further developments in international LC operation. UCP 600 can be named as the most trade friendly among all versions of Unified Customs and Practices for Documentary Letters of Credit [41]. Also by many scholars considered UCP 600 as a forward movement in harmonisation of LC regulations in international trade [42]. Main developments in UCP 600 in comparison with former versions can be categorized as: Introducing UCP articles as Rule for the first time [43], reducing number of articles from 49 in UCP 500 to 39 in UCP 600, providing more clarification by defining honour, negotiation and presentation [44], not recognition of revocable Documentary Letters of Credit [45], defining new standard of examination of documents by bank [46], clarification of the role of banks in deferred payment system [47], identification of careers and agent [48], providing clarity about documents relevant to multimodal transport [49] and finally, providing clear definition for original document [50].

UCP has no legislative authority [51], as it is neither a convention nor ICC is a governmental organization [52]. Therefore, despite the fact that its introduction in Article 1 of UCP 600 as "rules", we can consider it as globally recognized banking customs and practices which are only applicable to Documentary Letters of Credits through incorporation [53]. UCP was developed due to the need for recognition of uniform procedures which could harmonize the practice of Documentary Credit at global level [54].

**eUCP**

"This is the acronym for the supplement to the uniform Customs and Practice for Documentary Credits for Electronic Presentation" [55]. Meeting the needs for electronic trade was the initiative of Banking Commotion of ICC to propose the formation of committee to work on developing a bridge between UCP and processing the electronic equivalent of paper based credits the working group started to work on preparation of a supplement to the UCP which "would deal with the issues of Electronic Presentation" [56]. The result of working group's efforts is known as eUCP. It came into force from 1 April 2002 and in the format of version issues in order to facilitate the necessities for further revisions [57]. Current version of eUCP is the version 1.1. Issues covered by eUCP are: "eUCP- UCP relations, format, presentation, originals and copies and examination of electronic records" [58]. Article 2 of eUCP emphasized on consistency of the all articles of eUCP with UCP while their application is only in case of electronic presentation. While using

the eUCP, credit will be also subjected to UCP without any express incorporation of it [59].

### 2.2.2. Uniform Rules of Contract Guarantees (URCG)

URCG was introduced by ICC in early 1970s in order to address the need for set of rules which deal with existing inconsistencies in field of "[g]uarantees given by banks, insurance or services or the performance of work." [60]. Therefore, unlike UCP which was regulating the process of Letter of Credit URCG was an attempt to deal with unfair calls for demand guarantees. Despite all expectations, URCG was not welcomed by the international business society for few reasons including: the problem that applicability of URCG was only limited to independent guarantees and it had no effect on accessory guarantees [61].
The other problem was the result of URCG's attempt to prevent unfair call on demand guarantees by requiring beneficiary to produce an evidence of failure in the format of judgement, arbitral award or the principal's written approval at the time of making the claim [62].

### 2.2.3. Uniform Rules for the Demand Guarantees (URDG)

The failure of URCG in attracting the attention of the business society at global level was the reason for ICC to introduce new set of rules and take a different approach to Demand Guarantees. URDG 458 came into force by 1992 and based on a model which was applied by British Bankers [63]. Despite the fact that URDG 458 was strongly influenced by UCP, but still "[w]orldwide acceptance of the Rules ha[s] been disappointing" [64]. URDG 758 which is the revised version of URDG 458 came into force on 1 July 2010 .It tries to address problems of previous version and set out functions and obligations of parties to the demand-guarantee by reflecting the best practices in business of guarantees. [65]

### 2.2.4. International Standard Practice (ISP 98)

"ISP.98 is a set of rules specifically designed for standby letters of credit" [66]. It was originally introduced by American institute of International Banking Law and Practice. ISP 98 received approval by ICC in 1998 [67] and came into effect by January 1999. Historically, Standby Letters of Credits have been in use for many decades without being subjected to specific regulations. They were mostly regulated by UCP, however, application of UCP to Standby Letters of Credits was source of many problems as UCP was "originally written for use only in commercial letters of credit... many of the provisions of the U.C.P. are either inapplicable or inappropriate in a standby credit context." [68]. On the other hand, it was possible for Standby Letters of Credit to be governed by URDG due to similarity between legal character of Demand Guarantees and Standby Letters of Credits. However, URDG is becoming more popular after coming into force of its

new revision URDG 758 and "[f]rom the viewpoint of the I.C.C ... Standby letters of credit continue to be covered by the U.C.P. and are not covered by the U.R.D.G." [69] Initially, similar to UCP for regulating the function of Commercial Letters of Credits URDG for Independent Guarantees, and ISP 98 was drafted for the purpose of regulating Standby Letters of Credits. However, "Like the UCP and the URDG, ISP98 [applies] to any independent undertaking issued subject to it" [70].

### 2.2.5. International Standard Banking Practice for the Examination of the Documents under Documentary Credits Subject to UCP 600 (ISBP)

ISBP has been described by ICC as a great help to banks, corporates, logistics specialists and insurance companies [71]. The main idea behind introducing it is the explanation of how to apply UCP in practice. For example, 185 sections of ISBP comment on documents which are not covered by UCP [72], expressions which are not defined in UCP [73], management of misspelling and specific types of errors [74]; time for application of original and copies [75]; methods of signing documents [76]; and how to prepare insurance documents [77].

### 2.2.6. Uniform Rules for Bank to Bank Reimbursement under Documentary Credits

ICC introduced the URR 525 in order to standardize the bank to bank reimbursement process. Article 13(b) which is new in UCP 600 aligns it with URR 525 [78]. The last renewal process of URR took place in 2008 by replacing URR 525 with URR 725. According to ICC, URR 725 should not be considered as the revision of URR 525 as it is more an update in order to be in more alignment with UCP 600 [79]. Since URR 725 has not been incorporated into UCP 600, its application is only limited to bank to bank reimbursement based on explicit agreement to the reimbursement agreement [80].

Article 13(b) of UCP 600 will cover bank reimbursement obligations in absence of such provisions in reimbursement agreement.

### 2.2.7. United Nation's Convention on Independent Guarantees and Standby Letters of Credits

UNCITRAL Convention has been drafted by an intergovernmental organization which is body of United Nations General Assembly and works on preparation of instruments for harmonization of law regarding international trade [81]. Convention has been adopted by UN General Assembly on 11 December of 1995 [82]. Standby letters of credits and independent guarantees or any other international undertaking can be subjected to the UCITRAL Convention [83]: "the place of business of the guarantor/issuer at which the undertaking is issued is in a Contracting State," or "the rules of private law lead to the application of the law of

a Contracting State," "unless the undertaking excludes the application of the Convention."
In case of Commercial Letters of Credit, by express address of parties to the credit UNCITRAL Convention can be used as the governing law [84]. Although, UCP and URDG have been used as bases for drafting the UNCITRAL Convention, it is possible to distinguish some differences among them. First, UCP and URDG have been drafted by ICC which is a private institute and its approvals might only have application as voluntary rules or self-regulations while UNCITRAL Convection is a uniform law and official regulation applied to signatory countries which has been drafted by an international organization [85]. Therefore, UNCITRAL Convention can be differentiated from ICC rules due to its legal statues. In addition, UNCITRAL Convention, consist of complementary provisions to UCP 600, URDG and ISP 98 including abusive demand, fraud and remedies which are discussed under the section 19 of Convection.

### 2.2.8. Unified Commercial Code

Among the common law jurisdictions, United States of America is the only country which a detailed regulations on Documentary Letters of Credits under the Article 5 of UCC: "The U.C.C. is a collection of model statutes drafted and recommended by the National Conference of Commissioners of Uniform State Laws (NCCUSL) and the American Law Institute (A.L.I.) for enactment by the legislatures of the states of the United States. It consists of eleven different articles, each covering a different aspect of commercial law" [86]. Article 5 of the UCC was drafted for the first time during 1950s when it was intended to act as an "independent theoretical framework for the further development of letters of credit." [87] Article 5 of UCC was revised in 1995 almost after forty years of hard use [88] in order to overcome "weaknesses, gaps and errors in the original statute which compromise its relevance" [89]. The revised Article 5 of UUC which was completed in October 1995 and it was almost adopted by all states in 2002. Despite the presence of Article 5 of UCC, still UCP has great influence of American regulations of Documentary Letters of Credits [90]. According to the official commentary to article 5: "Article 5 of UCC and UCP are consistent and complementary to UCP in many occasions". However, they have substantial differences as well. Firstly, Article 5 of UCC has been drafted as a Statue while neither ICC regulations including UCP have such effect. Secondly, in accordance with UNCITRAL Convention, article 5 comments on fraud rule which has been left open by UCP [91].

### National Laws

There are few counties expect the United States of America which enjoy the national statuary provisions on Documentary Letters of Credit. Among them

Greece was the first country to adapt such low in 1923 [92]. Italy is the other European country which regulates LC operation under article 1530 of its Civil Code by defining rights of account party and beneficiary. It also clarifies bank's rights and obligations [93]. Some South Amirian counties including Bolivia, Colombia, Guatemala, Honduras, Mexico and El Salvador also have their own national statute for regulating LC operation [94]. In the Middle East, most of countries are influenced by Lebanese Law and Kuwaiti Law. Lebanese Law which is followed in Qatar [95] and Syria [96] regulates operation of Documentary Letters of Credit under article 313 of its Commercial Code [97]. Kuwaiti Law which is adapted in Iraq [98] and Bahrain [99] is the most comperhenveive and modern statuary law of Documentary Credits [100] which covers areas of expiry date, transfer and assignment of the credit, confirmation, fraud, duty of examination of documents by bank, definition of comprehensive presentation and autonomy principle under its articles.

## Conclusion

The development of letter of credit goes back to the demand of mercantile practice in the course of time. There is no doubt about similarities between legal characters of Letters of Credits, Negotiable Instruments and Contracts, however, unique nature of their Jurisprudence should not be confuses with the latter.

As a result, all involved practitioners in the area of international trade law and international trade finance should keep in mind similarities and differences between Letters of Credits and other financial Instruments. Legal nature of Letters of Credits are covered mostly in the framework of Unified Customs and Practices for Documentary Letters of Credits (UCP), eUCP, URCG, URDG, ISP98, UNCITRAL Convention, ISBP and Uniform Rules for Bank to Bank Reimbursement under Documentary Credits. In United States of America, Article 5 of the UCC governs legal aspects of Documentary Letters of Credit Operation. Additionally, matters related to principles of strict compliance and autonomy as well as exceptions to autonomy principle are covered mostly by domestic law of respective jurisdiction. This can be considered as the most important difference between legal nature of Documentary Letters of Credit, Negotiable Instruments and Contracts which should be kept in mind by all legal practitioners involved in Letter of Credit Operations

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[98] Article 273-284 of the commercial code, Law Number 30 of 1984.
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***Publication 2***: **Alavi. H, (2016) Documentary Letters of Credit, Legal Nature and Sources of Law, *Journal of Legal Studies* 31: pp. 106-121**

DE GRUYTER OPEN

DOI: 10.1515/flr-2016-0021

Financial Law Review

No. 1 (4)/2016

UNIVERSITY OF GDAÑSK • FACULTY OF LAW AND ADMINISTRATION

http://www.degruyter.com/view/j/flr

# RISK ANALYSIS IN DOCUMENTARY LETTER OF CREDIT OPERATION

*Hamed Alavi**

**Abstract**

Documentary Letters of Credit are among most popular methods of payment used in in- ternational trade. They function as an irrevocable promise of issuing a bank to pay instead of an applicant buyer to a beneficiary seller under the condition that the beneficiary pres- ents complying documents with terms and conditions of the credit to the bank. One of the reasons for the popularity of the LCs in international trade is shifting the payment risk from an individual buyer to a bank with a much stronger financial standing. However, LC operation in international trade is not free of risk. Despite the fact that two main princi- ples of the Documentary Letter of Credit's Operation (Principle of independence and prin- ciple of strict compliance) facilitate the process of international trade significantly, but still all parties involved in LC operation are supposed to be cautious about the existing risks relevant to their role in LC operation. Current paper tries to use legal principles of docu-

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mentary credits and risk management theory in order to define existing risks to each party (beneficiary, applicant and bank) in international LC transaction and find an answer to the question of what are exposing risks for involved parties? For this purpose, the paper starts with an explanation of the two main principles of LC operation and moves forward with using the risk management theory to explain existing risks for each party in detail.

**Keywords:**
International Trade, Documentary Letter of Credits, Risk Analysis, Applicant, Beneficiary, Bank

## 1. Introduction

Documentary Letters of Credit have long history in international trade. However, their legal nature goes back to the eighteenth century[1]. In the course of interna- tional trade, when two businessmen from different parts of the world decide to have a transaction with each other, in addition to other methods of payment, LC can help them a lot in the realization of their deal by guaranteeing the payment to the seller by a bank, whereas the buyer also receives a guarantee that according to the presented documents by the beneficiary to the bank, he will receive pur- chased goods in accordance with the conditions stipulated in the underlying con- tract of sales. Such operation is regulated in the Uniform Customs and Practices for Documentary Letters of Credits (currently UCP 600) which is a set of norms defined for regulation of international LC transaction introduced by the Interna- tional Chamber of Commerce for the purpose of protecting the flow of interna- tional trade and safeguarding the operation of Documentary Letters of Credits. It is subjected to two main principles of Strict Compliance and Autonomy. How- ever, LC transaction is not a risk free operation and the current paper will try to use risk management theory to find an answer to the question of what are the main attributed risks to each party in LC operation. Preventing associated risks to each party in LC transaction can save huge amounts of money for each party and save the reputation of Documentary Letters of Credit as an effective and safe method of payment in international trade.

[1] J. Raymond, A. Malek, D. Quest, *Documentary Credits - The Law and Practice of Documentary Letters of Credits including standby credits and demand guarantees*, Haywards Heath 2009, p. 250.

## 2. The Principle of Strict Compliance

The principle of Strict Compliance express that issuing a bank's undertaking to honour the credit is effective only upon presentation of complying documents by the beneficiary which are stipulated in the credit[2]. On the other hand, "the idea of strict compliance has developed from the general principle of the law of agency that an agent is only entitled to reimbursement from his principal if he acts in ac- cordance with his instructions"[3]. Therefore, banks who act as an agent for appli- can't in documentary credits will receive reimbursement in case of honouring the credit against complying documents. The standard for examination of documents has been set in Article 14 of UCP 600: "Article 14 Standard for Examination of Documents

a. A nominated bank acting on its nomination, a confirming bank, if any, and the is- suing bank must examine a presentation to determine, on the basis of the docu- ments alone, whether or not the documents appear on their face to constitute a complying Presentation.

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

The majority of discrepancies in practice of Documentary Letters of Credit in- clude inconsistent data[4], discrepant documents of transport[5], mistakes in draft[6], drafts without signature and inconsistent invoice with credit[7], inadequate insur- ance[8], and documents with wrong signature[9].In reality, principle of Strict Compliance is protecting interests of applicant under documentary credits process which requires shipment of promised goods by ben- eficiary before actualization of payment. There is an ongoing scholarly debate

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2 Inter alia Article 2; Article 7(a), Article 8(a)(c) and Article 15; Article 14 and Article 34 of UCP 600.

3 R. King, *Gutteridge and Megrah's law of bankers' commercial credits*, London 2001, p. 14.

4 Article 14(d) UCP 600.

5 Article 19 UCP 600.

6 Article 18(c) UCP 600.

7 Article 28 UCP 600.

8 B. Baker, *Exporting Against Letters of Credit*, http://www.financepractitioner.com/operations-ma- nagement-best-practice/exporting-against-letters-of-credit?full (last visited 08.03.2017).

9 Article 34 UCP 600.

about what constitutes the complying presentation which can be traced into legal cases[10]. However, the most important question can be what is the characteristic of non-complying presentation? [11]

There are two main theories regarding the determination of documentary compli- ance: Doctrine of Strict Compliance and Doctrine of Substantial Compliance[12].

### *2.1. Doctrine of Strict Compliance*

According to the doctrine of Strict Compliance, presented documents should strictly comply with credit[13].While former version of UCP (500) was requiring a bank to take a "Reasonable Care" in the process of examining compliance of pre- sented documents by the beneficiary, UCP 600 has deleted such term which shows that only strict compliance is the criteria for reimbursement of a bank by the applicant. However, word by word compliance is not required by UCP 600[14]. Simple mistakes and typographic errors might not be considered as non-confor- mity during the examination of documents and banks are unlikely to reject docu- ments with minor defects. According to Woods, UCP 600 does not use the term of Strict and also provides permission for insignificant inconsistencies or errors[15]. However, it is difficult to distinguish the insignificant error from the significant one. For example, *in Seaconsar Far East Ltd v. Bank Markazi Jomhuri Islami Iran*[16], the credit defining all documents should bear the credit number and buyer's name. However, one of the tendered documents missed the buyer's name and the credit number. The Lloyd LJ held that the bank was entitled to reject the presentation[17]:

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[10] H. M. S. Botosh, *Striking the Balance between the Consideration of Certainty and Fairness in the Law Gov- erning Letters of Credit*, http://etheses.whiterose.ac.uk/3063/ (last visited 09.03.2017), pp. 183-271.

[11] D. Kražovska, *Impact of the Doctrine of Strict Compliance on a Letter of Credit Transaction*, http://pure. au.dk/portal-asb-student/files/2543/Krazovska_MasterThesis.pdf (last visited 09.03.2017), pp. 25–43.

[12] Ibid.

[13] Ibid.

[14] B. Kozolchyk, *Commercial Letter of Credit in the Americas: A Comparative Study of Contemporary Com- mercial Transactions*, Albany 1980. p. 10.

[15] J. S. Wood, *Drafting letters of credit: basic issues under Article 5 of the uniform commercial code, UCP 600, and ISP98*, Banking LJ 2008, No. 125, p. 103.

[16] Seaconsar Far East Ltd V. Bank Markazi Jomhjouri Isami Iran [1993] 3 W.LR. 756 (HL), Lloyd's Rep. 1993, Vol. 1, No. 236.

[17] C. M. Schmitthoff, *Discrepancy of Documents in Letter of Credit Transactions*, Journal of Business Law 1987, No. 95.

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

Therefore, discrepancies can be further divided into two main groups: *Irrelevant Irregularities* with no effect on principle of strict compliance and *Material* or *Genuine discrepancies* which violate the principle of strict compliance and result in rejection of documents by a bank[18].

### 2.1.1. Irrelevant Irregularities

Except for the case of Commercial Invoice, UCP 600 does not require for strict compliance of any documents presented by a beneficiary with terms and condi- tions of the Credit. In fact, some articles provide tolerance up to 10 percent regard- ing the amount or quantity of credit while terms like 'about' or 'approximate' are used in the credit[19]. Other articles provide tolerance of 5 percent when quantity is not defined in the credit[20].

### 2.1.2. Material Discrepancy

There are numerous cases on material discrepancies. In *JH Raynor & Co. Ltd v. Hambro's Bank Ltd*[21], the shipped goods were described in the bill of lading as „ma- chine-shelled ground kernels", however, the credit had the description of goods as „Coromandel groundnuts". In the judgement of the court of appeal, it was held that the bank was correct about rejection of tender despite the fact that the terms were proved to be the same. As bank is not required to have the knowledge of the meaning of terms in different fields of trade[22].Other example is *Courtaulds North America, Inc. v. North Carolina Nat. Bank*[23] in which the credit stipulated an invoice for '100% Acrylic Yarn' while the presented in- voice described goods as 'Imported Acrylic Yarn'. The bank rejected the presenta-

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[18] H. Alavi, Documentary Letters of Credit, Principle of Strict Compliance and Risk of Documen- tary Discrepancy. *Kor. UL Rev.* 2016 19, 3.

[19] UCP600, Article 30 (a)

[20] UCP 600, Article 30 (b)

[21] JH Raynor & Co. Ltd v. Hambro's Bank Ltd [\.9Q3] Q.B. 711.

[22] Ibid.

[23] Courtaulds North America, Inc. v. North Carolina Nat. Bank 528 F.2d 802, C.A.N.C [1975]803.

tion[24]. The court held that the bank was entitled to dishonour the presentation de- spite the fact that the description of goods on packing list were matching with the credit on the basis that UCP has differentiated the invoice from remaining docu- ments[25].

"Free of ineptness in wording the letter of credit dictated that each invoice express on its face that it covered 100% acrylic yarn. Nothing less is shown to be tolerated in the trade. No substitution and no equivalent, through interpretation or logic, will serve"[26].

*BankMelliIranv.BarclaysBank(Dominion,Colonial&Overseas)*[27] isanotherimportant case on material discrepancies. In the above mentioned case the payment was due upon presentation of commercial invoice for shipment of '100 new Chevrolet trucks', while the invoice described goods as 'in new condition'. The court held that the bank was entitled to reject the presentation as 'in the new condition' and 'new' are not the same[28].

### *2.1.3. Substantial Compliance*

It is the test accepted by few courts in order to balance the interests[29]. The require- ment of test is that the banker should "look beyond the face of the documents, in- vestigate the realities of the transaction, and weigh the credibility of documents, customers and beneficiaries".[30] Substantial Compliance has been considered in contradiction with Article 5 of UCP 600 which emphasizes on limitation of bank's responsibility to deal with documents not goods or services[31].

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[24] Ibid. p.806.

[25] Ibid.

[26] Ibid.

[27] *Bank Melli Iran v Barclays Bank* (Dominion, Colonial & Overseas) Lloyd's Law Reports 1951, Vol. 2. No. 367.

[28] Ibid.

[29] C. Hotchkiss, *Strict Compliance in Letter-of-Credit Law: How Uniform is the Uniform Commercial Code?*, Uniform Commercial Code Law Journal 1991, No. 23, p. 295.

[30] Ibid.

[31] UCP 600, Article 5

## 3. Principle of Autonomy

The second fundamental principle in operation of letters of credit is the Principle of Autonomy. This principle has been appreciated by national and international legal frameworks[32]. The principle of autonomy of letters of credit has been consid- ered as "cornerstone of the commercial validity of the letters of credit"[33], and "the engine behind the letter of credit"[34]. The autonomy principle of letters of credit has been clearly mentioned in article 4 of UCP 600:

"Article 4 Credits v. Contracts

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

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

Based on the Autonomy Principle and the text of article 4 of UCP 600, the benefi- ciary exporter has assurance that his payment will be due upon presentation of complying documents to the issuing bank while neither bank nor the account party can deny payment based on the arguments related to the performance of the underlying contract. Therefore, even in cases of argument on the performance of the underlying contract account party and the issuing bank have no other choice rather than paying the beneficiary upon presentation of complying documents and seek remedy by suing him for the breach of underlying contract. As a result, the Autonomy Principle has been considered a means of promoting international trade by following the logic of "pay first, argue later".[35]

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[32] Article 4 UCP 600; Article 2(b) URDG; Articles 2 and 3 UNCITRAL-Convention; sections 5-10 (1)(a), 5-114 (1) and 5 5-103(d) UCC

[33] *Ward Petroleum Corp. v Federal Deposit Ins. Corp*. (1990) 903 F.2d 1299

[34] J. Dolan, *The Law of Letters of Credits*, Boston 2002 [12.03]480

[35] *Eakin v Continental Illinois National Bank & Trust Co*. (1989) 875 F.2d 114 .116.

The autonomy principle also has been considered as the foundation for smooth operation of letter of credits by many scholars:

„We should also remember that in many international trade transactions, there are more parties involved than just the buyer or seller. The seller usually had to obtain goods or raw materials from a supplier before he is able to meet the contract made with the buyer. The seller will need to be financed in making payment to their sup- pliers. That financing comes from the negotiation or discounting of drafts drawn under the documentary credit system. Such system of financing would break down completely if the dispute between the seller and the buyer was to have the effect of „freezing" the sum in respect of which the letter of credit was opened"[36].

In order to completely address the essence of the autonomy principle, article 5 of UCP 600 specifies: "banks deal with documents and not with goods, services or performance to which the documents may relate"[37].

### *3.1. Main functions of the Autonomy Principle*

The main functions of the autonomy principle in operation process of Documen- tary Letters of Credits have been defined as:

#### 3.1.1. Payment Function:

By separating the underlying contract from the credit and substituting risks of each party, the autonomy principle reduces the commercial risk of trade[38]. As a consequence, the beneficiary receives the payment after the tender of com- plying documents and the bank received reimbursement from the account party regardless of existence of any relevant dispute to underlying contract[39].

#### 3.1.2. Commercial Function

The commercial function of the Principle of Autonomy has been discussed by Professor McCormarck[40] as an assurance for reimbursement of the issuer based

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[36] J. Chuah, *Law of International Trade*, 4th ed, London 2009, p. 436.

[37] UCP 600 , Article 5.

[38] G. McCormack, *Subrogation and Bankers Autonomous Undertakings*, Law Quarterly Review 2000, No. 45.

[39] R. P. Buckley, X. Gao, *The Development of the Fraud Rule in Letter of Credit Law: The Journey so Far and the Road Ahead*, University of Pennsylvania Journal of Economic Law 2002, Vol. 23, No. 663.

[40] P. A. Alces, *An Essay on Independence, Interdependence and the Suretyship Principle*, University of Illi- nois Law Review 1993, No. 480.

only on the complying tender document by the beneficiary while requiring it to undertake the ministerial function of document checking[41] and fund transfer[42] in order to remove any doubts about its payment undertaking[43]. On this basis, the British cases bind the bank to pay even on the occasion of tendering forged[44] and incorrect documents[45] and regardless of the facts represented by the documents[46].

### 3.1.3. Financing Function:

The financing function has two main characteristics. Firstly, it protects the benefi- ciary and the applicant from any interference from being reimbursed by the issu- ing bank after paying the beneficiary[47]. Secondly, it provides a support of leverag- ing other transactions for the beneficiary by the credit which has been issued in his favour[48].

Finally, comments of Hirst J in *Tuckan Timber Ltd v. Barclays Bank Plc*[49] clearly illus- trates bank's obligations under documentary credits.

"It is of course very clearly established by the authorities that a letter of credit is autonomous. That the bank is not concerned in any way with the merits of the un- derlying transaction, and only in the most extremely exceptional circumstances should the Court interfere with the payment bank honouring a letter of credit in accordance with its terms bearing in mind the importance of the free and unre- stricted flow of normal commercial dealings"[50].

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41 C. Hare, *Not so Black and White: The Limits of the Autonomy Principle*, The Cambridge Law Journal 2008, No. 288.

42 G. McCormack, *Subrogation…*

43 C. Hare, *Not so Black and White…*

44 *Gian Sing & Co.Ltd v. Banque de l'Indochine* 2 All E.R. 754 (1974).

45 *Pacific Composites Ply Ltd & Anor v. Transpac Container System Ltd & Ors*.

46 L.J. Staughton, *IE Contractors Limited v. Lloyds Bank Plc.*, Lloyds Rep 1990, Vol. 2. No. 496, p. 499.

47 M. Yifrach, *Third Partys Attachment on Letter of Credit Proceeds*, Journal of Business Law 2001, No. 159; R. S. Rendell, *Fraud and Injunctive Relief*, Brooklyn Law Review 1990-1991, No. 113.

48 R. L. F. Garcia, *Autonomy principle of the letter of credit*, Mexican Law Review 2009, Vol. 3, No. 1, p. 77.

49 Tukan Timber Ltd v. Barclays Bank Pic. Lloyd's Rep. 1987, Vol. 1, No. 171.

50 Ibid.

## 4. Risk Analysis

In the operation of Documentary Letters of Credits at least three parties will be involved. However, in accordance with complexity of the transaction, the number of parties and contracts among them will increase in practice. Main parties to LC transaction are the applicant, the beneficiary and the issuing bank but, advising bank, confirming bank, negotiation bank and reimbursing bank can be added to this list. Similar to all methods of payment in international trade each party in LC transaction is exposed to some level of uncertainty. The rest of the current paper will be dedicated to different types of the risk which can face either party in LC transaction.

### *4.1. Risks of the Applicant*

#### 4.1.1. Fraud Risk

The principal of independence in Documentary Letter of Credit operation facili- tates the process of international trade by relying on the conformity of documents presented to the bank in order to honour the credit. However, it can also raise the risk of fraud by providing ill-fated beneficiary the opportunity to present forged documents which are confirming with the terms of credit on their face without fulfilling his obligations in the underlying contract of sales[51]. UNCITRAL report provides a list of four most common types of fraud which an applicant can face as a result of sole reliance of banks on strict compliance of docu- ments presented by the beneficiary:[52] The first one is falsification of documents by the beneficiary in order to obtain the payment from the issuing bank when no car- go exists in practice. The second is when delivered goods by the beneficiary do not comply with the contract of sales in quantity and quality. The third is selling the same cargo to more than one person and the fourth is issuing the document of title (bill of lading) twice for the same cargo. Additionally, banks have also been re- ported as frequent victims of fraud in LC transaction[53]. *SztejnvHenrySchroderBank-*

[51] H. Alavi, *Mitigating the Risk of Fraud in Documentary Letters of Credit,* Baltic Journal of European Studies 2016, Vol. 6, No. 1, pp 139-156.

[52] UNCTAD, *A Primer on New Techniques Used by the Sophisticated Financial Fraudsters with Special Reference to Commodity Market Instruments* (UNCTAD/ DITC/COM/39), 7 March 2003, available at unctad.org/en/Docs/ditccom39_ en.pdf, (visited 10 January 2017).

[53] H. Alavi, *Autonomy Principle and Fraud Exception in Documentary Letters of Credit, a Comparative Study between United States and England*, International and Comparative Law Review 2015 , Vol. 15, No. 2, p. 45.

*ing Corporation*[54] is the legal case of LC transaction in which fraud was applied for the first time as the exception to the independence principle in LC operation. Despite the fact that the fraud rule is recolonized in different jurisdictions, still many courts prefer not to interfere in the autonomy of Documentary Letters of Credit which makes the applicant vulnerable to the risk of fraud. Interestingly, UCP 600 has taken an absolute silent position regarding the risk of fraud while leaving it open to national legal systems.

#### 4.1.2. Risk of Inferior Quality and Quantity

Another risk which an applicant bears would be receiving goods with inferior quality and quantity instead of complying with the ordered quality in the interna- tional sales contract. Due to the documentary nature of LC transaction, in most cases, the applicant can have access to the document of title of ordered goods only after the negotiation of credit and receiving payment by the beneficiary. There- fore, there is a possibility for the beneficiary to ship the goods with inferior quality or quantity and negotiate the credit before the applicant has the access to the goods.[55]

#### 4.1.3. Exchange Rate Fluctuation Risk

Regardless to the type of credit used in LC transaction, it will take some time for a ship to go from the port of departure to the port of destination. Therefore, the applicant is always facing with the fluctuation risk of exchange rate in highly volatile foreign currency market. In international trade the exchange fluctuation risk has direct relations with the length of payment period. This period is equal to shipping time in sight LCs, defined number of days after issuing LC in Usance LCs and defined number of days after receiving goods in port of destination in De- ferred LCs. We should add the document examination time to the above men- tioned time period[56]. The exchange rate risk will be against the applicant when her local currency is depreciating against the currency of the credit.

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54 Sztejn v Henry Schroder Banking Corporation 31 NYS 2d 631 (1941).

55 K. Godier, *Trends Show a Declining Reliance on Letters of Credit,* Documentary Credits Insight 2001,Vol. 7, No. 3.

56 Y. Hao, L. Xiao, *Risk Analysis of Letter of Credit,* International Journal of Business and Social Sci- ences 2013,Vol. 4, No. 9, p. 207.

#### 4.1.4. Marketing Risk

There might be a substantial time lag between the effectuating payment in documentary letters of credit after negotiating complying documents and receiving the goods in the port of destination by the applicant. This can result in marketing risks in some unstable markets for the applicant.

In such occasion, the applicant faces with the risk of loss and marketing risk by decreasing the price of the imported goods in his home country during the shipping period.

#### 4.1.5. Risk of Issuing Bank's Negligence

Despite its very low probability, it is possible that the issuing bank relies on check- ing mechanisms of confirming and negotiating banks and releases problematic documents to the applicant without conducting due examination. As a result, the applicant faces with the risk of not receiving the release order from the carrier after presenting the forged or mistaken documents. On one hand, the bank has already honored or negotiated the credit and there is almost no possibility to restitute the money from the beneficiary and on the other hand, the applicant is unable to ob- tain the release order from the carrier because of non-complying documents[57].

### *4.2. Beneficiary's Risks*

#### 4.2.1. Buyer's Negligence towards Underlying Contract While Opening the LC

Despite the fact that terms and conditions of a credit should be in accordance with underlying contract, the buyer might neglect agreed terms in the contract of sales while opening the Letter of Credit or try to add new clauses in the Credit and change the deal in his own favour. Most frequent situations are witnessed in case of price fluctuation and strict foreign currency control in destination markets that lead to late opening or not opening of the credit by the applicant. The applicant might also disregard the underlying contract of sales by inserting conditions in the Credit. For Example, the applicant changes the port of delivery, terms of delivery, type of insurance or includes other restrictive terms which are known as 'Flexible Clauses'[58].

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57 R. Cranstom, *Principle of banking law*, Oxford, New York, Athens 1997, p. 15.

58 Y. Hao, L. Xiao, *Risk Analysis...*

#### 4.2.2. Imposing intentional restrictions

The intentionally imposed restrictions by the applicant in the Letter of Credit Credit are other risks which might create problems for the beneficiary in the prep- aration of complying documents. For example, the applicant can use the funda- mental principles of Documentary Credit Operation to require documents diffi- cult to receive, such as requiring the signature of a specified authority or specific type of signature on a document as well as asking the insurance policy under the delivery term of CFR and FOB.

Other types of restrictions might include asking for the certificate of quality, quan- tity and price issued by the specified government authority. While it is possible to obtain the certificate of quality and quantity from the defined state institute in any given countries, the price certificate is only applicable to goods under export con- trol regimes[59]. The applicant can also impose restrictions on typing mistakes, re- quiring conflictual documents or even providing mistaken name and address which can affect presented documents and result in their rejection by the bank.

#### 4.2.3. Risk of Conflict between LC Clauses and Applicable Law of Sales Contract

The beneficiary should consider the conflict of laws among national law of his own country, the applicant's country and the applicable law to the underlying contract of sales while reviewing LC clauses. Such negligence can cost a lot for the benefi- ciary as there might be significant differences among applicable law to the con- tract of sales, beneficiary's national law and the terms of the Credit. Hao and Xio comment of the case of a Letter of Credit issued by one British Bank requiring 'all-risks' insurance policy from a London Association Insurance Company and a 'war risk' insurance policy from a Chinese Insurance Company[60]. According to the national law of the People's Republic of China, it is impossible to have two in- surance policies from two different countries for one cargo. Therefore, an LC clause was used against the law and as a result the Letter of Credit was in need of amendment[61]. The beneficiary is recommended to learn about the national law of the country of applicant and issuing a bank in order to prevent such possible risks.

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59 Ibid.

60 Ibid.

61 Ibid.

### 4.2.4. Fraud of Applicant in Manipulating Data of another Letter of Credit

While doing business with new and unknown business partner, the beneficiary should be careful and aware of a possibility to face with different fraud schemes used by the applicant and use the services of his own bank or individual experts to prevent such risks. Such fraud schemes can be sending a bogus Letter of Credit to the beneficiary which was stolen from the issuing bank or manipulating the data of another Letter of Credit and sending it to the beneficiary.

Hao and Xio discuss the case of a Chinese Company which was advised about a credit in her name opened by a company in Hong Kong.[62] While checking LC's content and with the help of an advising bank, the beneficiary found out that in fact the LC in his favor had another beneficiary and another name of the beneficiary, the credit amount and the date of shipment were changed by the applicant.

### 4.2.5. Risk of Documentary Discrepancy

The standard for examination of documents has been set in Article 14 of UCP 600:

"Article 14 Standard for Examination of Documents

a. A nominated bank acting on its nomination, a confirming bank, if any, and the is- suing bank must examine a presentation to determine, on the basis of the docu- ments alone, whether or not the documents appear on their face to constitute a complying Presentation.

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

As a result of the complex process and interactions between the bank and the trad- ers in LC transaction, there is a high probability for occurrence of the documen- tary discrepancy. The risk of financial loss and dishonoring presentation by the bank will raise when there is no possibility to resolve discrepancies. Such discrep- ancy can be considered as a significant risk for the exporter as according to ICC[63] the global rate of documentary discrepancy in LC transaction is about 60–70%.

62 Ibid.

63 ICC Thailand 2002, *Examination of documents waiver of discrepancies and notice under UCP500*, ICC Thailand, (last visited on 10 January 2017), http://www.iccthailand.or.th/article2.asp?id=9.

Documentary discrepancy rate in the USA is considered about 73% [64] while in the UK it has been estimated to have amounted up to 50–60%[65]. Despite the fact that the costs of the documentary discrepancy have not been studied globally, but SITPRO study showed "that in 2000 the UK lost 113 million through non-com- pliant documents being presented under Letters of Credit"[66].

As it was mentioned before, the majority of discrepancies in practice of Documen- tary Letters of Credit include inconsistent data[67], discrepant documents of tran- sport[68], mistakes in drafts[69], drafts without signature and inconsistent invoice with the credit[70], inadequate insurance[71], and documents with wrong signature[72]. Therefore, the benefeciary is strongly recommended to put in place necessary check and balance systems in order not to bear the fianacial burden of the documetnary discrepancy in LC operation.

### *4.3. Risks for the Bank*

The international trade finance because of its short term, self-liquidating and se- cured nature is less risky for banks than other types of financing operations[73]. However, it does not mean that banks neglect relevant risks to international trade in general and LC operation in particular. Banking risks in international LC ope- ration can be divided into two main groups of Marco and Transactional Risks.[74]

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64 R.J. Mann, *The role of letters of credit in payment transactions*, Michigan Law Review 2000, Vol. 98, No. 8, pp. 2494-2547.

65 SITPRO Ltd. 2003, *Report on the use of export letters of credit* 2001/2002, SITPRO London, 2005, Letters of credit – an introduction, SITPRO Ltd, (last visited 10 January 2017).

66 SITPRO Ltd. 2003, *Report on the use of export letters of credit* 2001/2002, SITPRO London, p. 2.

67 Article 14(d) UCP 600.

68 Article 19 UCP 600.

69 Article 18(c) UCP 600.

70 Article 28 UCP 600.

71 Baker B. *Exporting Against Letters of Credit* available at http://www.financepractitioner.com/oper- ations-management-best-practice/exporting-against-letters-of-credit?page=1 (last visited 10 March 2017).

72 Article 34 UCP 600.

73 UNCTAD , 1999, *'Documentary Risk in Commodity Trade'*, UNCTAD/ITCD/COM/Misc. 31.

74 Ibid.

### 4.3.1. Macro Risks

The marco risks include external risks which affect the bank's role in LC operation like country risk and bank's risk. Due to many reasons such as economic and polit- ical stability, trade relations, rule of law and the existence of law enforcement in- stitutions, countries are divided into different risk categories. In dealing with high-risk countries, banks either reduce the credit limit or imposes higher charges of issuing, confirming or negotiating LCs. On the other hand, not all involving banks in LC operation have the same financial and reputation weight. Therefore, banks should consider elements of defining creditworthiness of their counter parts in other countries in order to secure receiving payment by them.

### 4.3.2. Transaction Risks

In addition to macro risks, while being involved in international LC transaction, banks are exposed to related risks of security of transaction. LC transaction risks are of three types: firstly, financial status of the customer and his credit history which is relevant to the risk of not receiving reimbursement after making payment to the beneficiary. Secondly, the nature of the traded goods: the account party might go bankrupt as a result of high level of fluctuation in price of goods and as eventually it may be possible for the issuing bank not to receive reimbursement. Therefore, banks should consider the risk of issuing LC for commodities with highly volatile market. The third and final element of transitional risk is the bank's position and her relations with other involved banks in the international LC ope- ration[75]. The issuing bank faces major risks as it is recommended to check not only the creditworthiness of her own customer but also the credibility of the benefi- ciary and her bank as well . Exporter's bank also should check the reliability of is- suing, confirming and negotiating banks overseas. There are occasions for fraud which can result in honoring LC by confirming the bank when the applicant does not accept the documents and the issuing bank does not effectuate the reimburse- ment accordingly. In such situation, the only solution for confirming the bank in- cludes recourse clauses in her contract of negotiation with the beneficiary in order to prevent the risk of fraud.

[75] Ibid p. 20.

## 5. Conclusion

The importance of Documentary Letters of Credit as a method of payment in international trade which can balance conflicting interests of exporter and importer by transferring the payment risk from the importer to the issuing bank is con- stantly growing due to constant development in trade among nations. Despite the fact that the main objective of LC operation is to reduce the level of risk in the in- ternational trade, still all involved parties to international LC transaction face nu- merous types of risk which can create problems in smooth operation of trade be- tween the importer applicant and the exporter beneficiary. Some risks even affect the banking operation involved in LC transaction. The current paper tried to shed light on different risks which either party might face in the international LC trans- action in order to warn them against the existence of such risks and prepare them to adapt proper risk management methods.

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***Publication 3***: **Alavi, H. (2016). Comparative Study of Issuing Bank's Obligations towards Beneficiary of the Letter of Credit under UCP and English Law. *Hasanuddin Law Review, 2*(3), 289-311**

# Comparative Study of Issuing Bank's obligations towards Beneficiary of the Letter of Credit Under UCP and English Law

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**Abstract**

*Process of international trade is complicated and risky. Risks will be more considerable when times come to deal with receiving/sending payments from/to unknown business partners in remote geographic areas. Employing documentary letters of credit (LC) is one of the ways to reduce payment risk in international business especially when partner's financial standing is unknown to each other. By using the LC as method of payment, parties will shift payment obligation from buyer as a natural person to the guarantee of bank as a legal person. The process of using LC is complicated and involves different players and relations between them. Amongst all relations in process of LC transaction, relation between issuing bank and beneficiary is the most complicated and least clear from legal stand point. This article tries to shed light on vague aspects of relations between issuing bank and beneficiary by studying obligations of the issuing bank towards beneficiary under the law of documentary letters of credit while comparing provisions of UCP with English Common Law on subject matter. Main objective of paper is providing answer to the question of what is the role of issuing bank in the process of LC transaction and which liabilities does it have towards beneficiary? Article consists of five main parts. Part one will provide an introduction to function and relation among different parties in process of an international LC transaction. Further, it endeavours to tap on principle of autonomy and strict compliance as governing principles of documentary letters of credit. Part two and three will take a comprehensive look at legal basis of relations between issuing bank and beneficiary, as well as bank's obligations under documentary credit law. Part four will discuss liabilities of issuing banks towards beneficiary and finally part five will touch upon situation in which bank will right to recourse against beneficiary.*

**Key Words**: Documentary Letters of Credit, Issuing bank, Beneficiary, Obligations, UCP, English Law

## 1- Introduction

While being engaged in international business, seller looks for minimizing the payment risk subsequent to delivery of goods by receiving either cash in advance or payment on delivery or where the buyer's interest is to pay only after being certain about receiving goods in accordance with contract of sales[477].

[477] Carr, I., & Stone, P. (2013). International trade law. Routledge.

Additionally, reasons including: lack of familiarity with other party's financial standing[478] possibility for either party to default in the course of business transaction, geographical distance of parties[479], difference in national currencies, need for intermediaries[480], multi-jurisdictional nature of the transaction[481] are behind decision of parties to use documentary letters of credit as a method of payment in their international transaction. LC is a written undertaking by a bank which assumes primary and absolute liabilities of buyer (applicant) and promises to pay the beneficiary (seller) to pay in accordance with terms of underlying contract of sales previously negotiated between him and the applicant.[482][483][484]

Since the buyer and seller in an international contract are generally in different countries, in the process of LC transaction, it is popular to include a fourth party from the country of beneficiary, namely a bank known as corresponding bank[485]. According to Uniform Customs and Practices for Documentary Credits (currently UCP 600), different functions for corresponding bank[486]are: acting as advising bank, nominated bank, negotiating bank and confirming bank. By confirming the credit, confirming bank assumes same liabilities as issuing bank towards beneficiary and relieves him from certain degree of risk which may result in not effectuating payment by issuing bank in accordance with terms and conditions of the credit [487][488]. Autonomy principle and strict compliance as two main governing principles of LC provide that in effectuating the payment, issuing bank does not look into the performance of beneficiary in the framework of underlying contract[489] and beneficiary is only supposed to produce complying presentation of documents stipulated in the LC to receive payment from either of issuing or confirming bank.[490] Any claim regarding performance of beneficiary under the contract of sales should be followed separately as banks deal only with documents and not goods[491].

According to Kudrianchov, the LC is a "complex of contractual obligations"[492]. Lord Diplock in *United City Merchants (Investments) Ltd. v. Royal Bank of Canada*[493]defines the relations under the letter of credit as four autonomous but interrelated contracts:

"…it is trite law that there are four autonomous though interrelated contractual relations involve:

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[478] Grassi.P,(2006) Letter of Credit Transactions: The Banks' Position in Determining Documentary Compliance. A Comparative Evaluation under U.S., Swiss and German Law, 7 (81) PACE INTERNATIONAL LAW REVIEW 122

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[481] Ibid 379

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[486] Article 2 , UCP 600

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[493] *United City Merchants (Investments) Ltd. v. Royal Bank of Canada, [*1932] 2 W.L.R. 1039, H.L.

(1) Underlying contract for the sale of goods, to which the only parties are the buyer and the seller;

(2) The contract between buyer and the issuing bank under which the latter agrees to issue the credit and either itself or through a confining bank to notify the seller and to make payments to or to the order of the seller (or to pay, accept or negotiate bills of exchange drawn by the seller) against presentation of stipulated documents; and the buyer agrees to reimburse the issuing bank for payment made under the credit. For such reimbursement, stipulated documents, if they include a document of title such as bill of lading, constitute a security available to the issuing bank;

(3) If payment is to be made through a confirming bank, bank authorizing and requiring the later to make such payments and to remit the stipulated documents to the issuing bank when they are received, the issuing bank in turn agrees to reimburse the confirming bank for payments made under the credit;

(4) The contract between the confirming bank and the seller under which the confirming bank undertakes to pay the seller (or to accept or negotiate without recourse to drawer of bills of exchange drawn to him) up to the amount of the credit against presentation of the stipulated documents"[494]

Interestingly, Lord Diplock does not give any reference to the contract between issuing bank and seller. This issue has been noticed by Raymond Jack[495]. Therefore, it is possible to mention that there are five autonomous but interconnected contracts between parties in the system of international documentary letter of credit. Among them, scholars mostly debate on legal nature of relations between issuing bank and beneficiary.

Issuing bank-beneficiary relations and its liabilities towards beneficiary as the centre of focus in current paper are important since the legal basis for their relation is not clear in different legal systems. UCP does not provide any precise definition on legal nature of relations between issuing and confirming bank with beneficiary in LC system.[496] English law has never taken a thorough approach to relations between issuing bank and the beneficiary[497]. In a way, Gutteridge and Megrah consider it as an unresolved issue[498]. Such uncertainty in legal basis of obligations of issuing bank towards beneficiary creates troubles on the way to study rights and liabilities of them against each other. Current paper tries to clarify the legal nature of relations between issuing bank and beneficiary and explain obligations of issuing bank towards beneficiary based on extensive comparative research in existing literature on subject matter as well as case law available under English law. In doing so, part one of the paper will explain the procedure of functioning of the documentary letter of credit and its main principles. Part two will focus on duty of beneficiary on presentation of documents. Part three will define obligations of the issuing bank and tap on legal basis of issuing banks obligations towards beneficiary. Finally, part four will explain conditions under which issuing bank has the right for recourse against beneficiary.

### 1-1- Functioning process of the documentary letter of credit

As it has been mentioned before, function of the documentary letters of credit involves four independent but interrelated contracts. Parties to contracts are buyer (applicant) , seller (beneficiary) , issuing /confirming

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[494] Ibid , at p.182-183

[495] Malek. A, Quest. D,(2009) Jack: Documentary Credit: the Law and Practice of Documentary Credit including Standby Credits and Demand Guarantees , 4th edn, Tottel ,p90

[496] Hugo, C. (2000). Documentary Credits: The Basis of the Bank's Obligation. S. African LJ, 117, 224.

[497] Ibid , 231

[498] Gutteridge.HC ,Megrah.M, (1984), The Law of Bankers' Commercial Credits 7 ed, 34

bank, negotiating and/or nominated bank which makes the payment. In fact, process of international LC transaction starts by agreement of buyer and seller in their underlying contract of sales to include a clause which defines documentary letter of credit as method of payment in their trade. Then the buyer approaches issuing bank in order to open LC in favour of beneficiary. In case of issuing bank's agreement, LC will be issued and advised to the beneficiary either by issuing bank or her correspondent in beneficiary's country named as "advising bank". [499] In case beneficiary seeks for further reduction of risk, he might require the guarantee of second bank on the credit which will involve "confirming bank" in the LC transaction[500]. In order to receive payment, beneficiary should present complying documents stipulated in the credit either to issuing bank or her correspondent (nominated, advising bank) or to confirming bank. Receiving bank will check documents and in case of their conformity with term of the credit, documents will be forwarded to the issuing bank for another round of checking. In case issuing bank finds presentation complying, beneficiary will be paid and applicant will be informed to take documents. Bank will be reimbursed if applicant finds documents in compliance with terms of credit. Despite the fact that UCP separates the credit from its underlying contract[501], court in *Garcia v. Page & Co. Ltd* [502]held that opening the credit mentioned in the underlying contract is condition precedent for shipping goods by seller .Also if the date for opening the credit has been defined in contract of sales, applicant should comply with it otherwise beneficiary has the right to cancel the contract based on buyer's repudiation. In case of *Pavia & Co SpA v. Thurmann-Nielsen*[503]where contract of sales had no reference to date of opening of the credit, the Court of Appeal held that buyer should provide the seller with credit before the starting of shipment period. Therefore, he will be sure that payment is secured and there will be not further financial risks involved in that particular transaction[504].

1.1.1- Autonomy Principle

First fundamental principle in operation of letters of credit is Principle of Autonomy. This principle has been appreciated in national and international legal frameworks[505]. The principle of autonomy of letters of credit has been considered as "cornerstone of the commercial validity of the letters of credit"[506], and "the engine behind the letter of credit"[507]. The autonomy principle of letter of credits has been clearly mentioned in article 4 of UCP 600:

"Article 4 Credits v. Contracts

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

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

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[499] UCP 600 , Article 2
[500] Ibid
[501] UCP 600 , Article 4
[502] (1936) 55 LI.LR 391
[503] [1952] 2 Q.B. 84.
[504] Ibid
[505] Article 4 UCP 600; Article 2(b) URDG; Articles 2 and 3 UNCITRAL-Convention; sections 5-10 (1)(a), 5-114 (1) and 5 5-103(d) UCC
[506] *Ward Petroleum Corp. v Federal Deposit Ins. Corp*. (1990) 903 F.2d 1299.
[507] Arkins J (2000) 31

Based on Autonomy Principle and the text of article 4 of UCP 600, the beneficiary exporter has assurance that his payment will be due upon presentation of complying documents to the issuing bank while neither bank nor the account party can deny payment based on the arguments related to performance of underlying contract. Therefore, even in case of argument on performance of underlying contract account party and issuing bank have no other choice rather than paying beneficiary upon presentation of complying documents and seek remedy by suing him for the breach of underlying contract. As a result, Autonomy Principle has been considered a means of promoting international trade by following the logic of "pay first, argue later"[508]

The autonomy principle also has been considered as the foundation for smooth operation of letter of credits by scholars:

"We should also remember that in many international trade transactions, there are parties involved than just the buyer or seller. The seller usually had to obtain goods or raw materials from a supplier before he is able to meet the contract made with the buyer. The seller will need to be financed in making payment to their suppliers. That financing comes from the negotiation or discounting of drafts drawn under the documentary credit system. That system of financing would break down completely if a dispute between the seller and buyer was to have the effect of "freezing" the sum in respect of which the letter of credit was opened".[509]

In order to completely address the essence of autonomy principle, article 5 of UCP 600 specifies: "banks deal with documents and not with goods, services or performance to which the documents may relate."[510]

1.1. 2- Principle of Strict Compliance

The principle of Strict Compliance express that issuing bank's undertaking to honour the credit is effective only upon presentation of complying documents which are stipulated in the credit by beneficiary[511]. On the other hand," The idea of strict compliance has developed from the general principle of the law of agency that an agent is only entitled to reimbursement from his principle if he acts in accordance with his instructions."[512] Therefore, banks who act as an agent for applicant in documentary credits will receive reimbursement in case of honouring the credit against presentation of complying documents. The standard for examination of documents has been set in Article 14 of UCP 600:

"Article 14 Standard for Examination of Documents

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

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

[508] *Eakin v Continental Illinois National Bank & Trust Co*. (1989) 875 F.2d 114 .116.
[509] Dolan JF (2006) 480.
[510] UCP600. Article 5
[511] Interalia Article 2; Article 7(a), Article 8(a)(c) and Article 15 ; Article 14 and Article 34 of UCP 600
[512] King, R. (2003). *Gutteridge and Megrah's law of bankers' commercial credits*. Routledge., p. 14

The majority of discrepancies in practice of documentary letters of credit include inconsistent data[513], discrepant documents of transport[514], mistakes in draft[515], drafts without signature and inconsistent invoice with credit[516], inadequate insurance[517] , and documents with wrong signature[518].

Contrary to the principle of independence, principle of strict compliance is protecting interests of applicant under documentary credits process which requires shipment of promised goods by beneficiary before actualization of payment. There is an ongoing scholarly debate about what constitutes the complying presentation which can be traced into legal cases[519].

1.1.3- Legal basis of Issuing bank's obligation to beneficiary

According to UCP, issuing bank is obliged irrevocably for honouring the credit from the moment of issuing it.[520]However, it is not clear in UCP that what the time for issuance of the credit is and accordingly moment from which issuing bank will be irrevocably bound to honour the credit. Two different views exist: first view which has received support in judgment of *Bunge Corp v. Vegetable Vitamin Food (Pte) Ltd*[521] emphasises that credit bounds issuing bank from the exact moment that beneficiary receives advice of it.[522]Second view is of the opinion that from moment beneficiary acts upon reliance on the credit make it will be binding to issuing bank.[523]

When the bank is required the issue a pre-advice, article 11.b of the UCP 600 provides that :

"b. A preliminary advice of the issuance of a credit or amendment ("pre-advice") shall only be sent if the issuing bank is prepared to issue the operative credit or amendment. An issuing bank that sends a pre-advice is irrevocably committed to issue the operative credit or amendment, without delay, in terms not inconsistent with the pre-advice."

Article 10 of the UCP 600 comments on binding nature of amendments on issuing bank and confirming bank from the moment of issuing the amendment for issuing bank and extending the confirmation to it by confirming bank.

Since UCP does not provide a precise explanation on legal basis of issuing bank's obligation to beneficiary, the matter is left to national laws. In English law, there is ambiguity in justification of contractual relations between beneficiary and issuing bank as unlike general principles of English contract law, in LC transaction, no consideration moves from the beneficiary to bank.[524] However, many scholars attempted to find consideration to support the bank's obligation and introduced different theories in this regard. Three of such theories are going to be discussed here:

First is theory of offer and acceptance: This is the dominant theory in English contractual law. Accordingly, issuance of the credit by bank is the offer which might be accepted by beneficiary[525]. Such contract is

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[513] Article 14(d) UCP 600
[514] Article 19 UCP 600
[515] Article 18(c) UCP 600
[516] Article 28 UCP 600
[517] Baker B '*Exporting Against Letters of Credit'* available at http://www.qfinance.com/content Files/QF02/g1xtn5q6/12/3/exporting-against-letters-of-credit.pdf (Accessed on 10 May 2016)
[518] Article 34 UCP 600
[519] Botosh HMS '*Striking the Balance Between the Consideration of Certainty and Fairness it the Law Governing Letters of Credit*' (2000) 183-271
[520] UCP 600 , Article 7.b
[521] [1985] 1Lylod's Rep. 613
[522] Malek .A , P91
[523] Ibid
[524] Beale, H. (2012). Chitty on contracts.-. Sweet & Maxwell. Chicago, Para2-019
[525] Hugo, C. (2000). Documentary Credits: The Basis of the Bank's Obligation. S. African LJ, 117, 230

known under English law as "unilateral contract"[526]. "A unilateral contract may arise when one party promises to pay the other a sum of money if the other will do ... something without making any promise to that effect: for example, when one person promises to pay another C100 if he will walk from London to York…"[527].Therefore, it is clear that in absence of beneficiary's promise, if there is a contract, it should be unilateral. Hugo explains two problems for offer and acceptance theory: "(i) the manner and time of acceptance; and (ii) whether the requirement of valuable consideration is satisfied"[528]. First problem rises in response to the question of time "at which the offer is "accepted" so as to deprive the offeror of the power of withdrawal"[529]. Alternatively, the question would be at what stage the unilateral promise of bank will become irrevocable?[530] Some scholars reply that acceptance takes place by beneficiary while presenting stipulated documents to the issuing bank. This means acceptance will be sometimes after manufacturing or shipment of the goods.[531]. In contrary, other scholars argue that beneficiary accepts the offer "sometime anterior to the tender of documents".[532] This view is based on decision of court in old case of *Urquhart Lindsay & Co Ltd v Eastern Bank Ltd*[533]where Rowlatt J held that acceptance is "acting upon the undertaking"[534]. Since Rowlatt J never defined the term "acting upon undertaking", different meanings have been suggested including: "purchasing raw materials for manufacturing" or "accepting delivery of materials necessary for production" or "taking steps to ship the goods"[535]. From the practical perspective, the theory does not show any merit as it is very vague about time for commencement of irrevocability and this is inconsistent with reality of LC process[536] .

The fact in English contract law that says consideration should "move from the promisee" will make the second problem even more serious[537]. Since bank does not bargain for delivery or manufacturing of goods, therefore, undertaking of the seller is not a valid consideration[538]. Even sellers obligation under the sales contract is cannot be considered as a valid consideration for bank's offer as it is known as past consideration[539]. Also, "the treatment of the act of presentation as consideration is inconstant with the fundamental purpose of the credit"[540]. Therefore, there is no scope left for consideration in the process of LC transaction[541].

Second theory is the agent-principle theory in which buyer is considered to be the agent of seller. However, requiring buyer to open the LC does not mean that seller intends to enter any principle-agency relations[542] with him. According to Jack: "in applying to the issuing bank for the credit to be opened, the buyer was

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[526] Penn. G, AM Shea.AM and Arora. A, (1987), The Law and Practice of International Banking: Banking Law Vol 11, 296
[527] Treitel, G. H. (2003). The law of contract. Sweet & Maxwell, p-35
[528] Hugo , C. (2000) , P 230
[529] Treitel, (2007) , The Law of Contract ,Edwin Peel ed, 12th edn, Sweet & Maxwell , p.41
[530] Todd.P,(1983), 'Sellers and Documentary Credit' , Journal of Business Law ,468
[531] Malek. A, Quest. D,(2009) Jack: Documentary Credit: the Law and Practice of Documentary Credit including Standby Credits and Demand Guarantees ( 4th edn, Tottel 2009) 94
[532] Davis. A.G, (1936), 'The Relationship between Banker and Seller under a Confirmed Credit' , 52 LQR 225
[533] [1922] 1 KB 318 (KBD)
[534] Ibid
[535] Hugo.C (2000) , 230
[536] Ellinger.E.P,(1970) Documentary Letters of Credit: A Comparative Study ,Singapore University Press, 89-90
[537] *Thomas v Thoma*s [1842] 2 QB 851 at 859; *Tweddle v Atkinson* [1861-73] All ER Rep 369 (QB); *Dunlop v Selfridge* [1914-15] All ER Rep 333 (HL) 334 (Viscount Haldane LC); *Pollway Ltd v Abdullah* [1974] 2 All ER 381 (CA).
[538] McCurdy.W, (1922),'Commercial Letter of Credit' , 35Harvard LR , 539 ; King, R (ed), (2001), Gutteridge and Megrah's Law of Banker's Commercial Credit ,8th edn, Europa Publication , 77.
[539] Dighe K.S,(1992) 'Mercantile Speciality: A Theory by which to Enforce Letters of Credit Under the Common Law' 69 University of Detroit Mercy LR 211
[540] Cane.P, Stapleton, J (eds), (1991), Essays For Patrick Atiyah , 218
[541] Ibid
[542] Malek.A (2009) , 95

acting as his (own) agent, and there is no justification for implying any such agency"[543]. Additionally, if buyer acts as agent of seller, then beneficiary is responsible for all acts of applicant towards bank. If payment to bank is affected in tort or misrepresentation of applicant, then the liability will be left for beneficiary[544]. Even in condition that buyer has fraudulently induced bank to issue the credit, beneficiary will be liable to the bank.[545] On the other hand, it can be held that since applicant acts as agent for beneficiary, there is no guarantee for applicant to prevent bank and beneficiary from changing the terms of credit[546].

Third theory is based on the Contracts (Rights of the Third Party) Act 1991.[547] Accordingly, this act will allow the third party to enforce a term of contract when it is: "(a) a contract expressly provides that he may, (b) term purports to confer a benefit to him"[548]. This theory somehow answers the question of absence of contract between beneficiary and issuing bank in English law. But, according to this theory; all beneficiary's' rights derive from the contract between applicant and bank. Actually, "the letter of credit is sent directly, or by way of a correspondent bank, to the seller and never comes into the buyer's hands at all"[549]. Third party rights theory also can be rejected based on two other additional arguments: First, the Credit involves two parties, namely issuing bank and beneficiary; applicant is not a party to the credit. [550]Second, autonomy principle rejects the explanation of issuing bank's payment undertaking to beneficiary based on the contract between the bank and applicant.

1.1. 4- Mercantile usage

In 1930's Finkelstein was the first person to raise the theory of explaining relations between parties to letters of credit based on mercantile usage.[551] He commented:

"[A] Letter of credit is a "mercantile specialty"... because it is governed, and throughout its history has always been governed, by the law merchant and has always been enforced by the common law courts in accordance with the basic principles of the law merchant. Hence, the problems of consideration and of irrevocability that still bother our text writers and some of our courts would seem to be, in reality, non-existent in the law".[552]

In support of this idea Ellinger submits that it is more reliable to refer to modern mercantile usage rather than old law merchant: "a usage which treats irrevocable credits as binding from the date at which they reach the hands of the seller"[553]. While confirming that case law in England does not provide a great support to his theory, Ellinger constructs his argument based on the counterfactual reasoning. Accordingly , the main condition for a usage to be recognized under English law is not being contradictory to Positive Law[554]. Therefore, "a usage constituting an exception to a common-law principle may be acceptable or, expressed differently, whilst a usage requiring a previous decision to be overruled is unacceptable, a usage requiring that a previous decision be distinguished should be possible". [555] Ellinger refers to the recognition of the law of negotiable instruments based on the mercantile usage and considers the same

[543] Ibid
[544] Ibid
[545] Davis.A.G,(1963), The Law Relating to Commercial Letters of Credit ,3rd edn, Isaac Pitman & Sons Ltd , 19
[546] Ellinger.E.P, 1970
[547] Chitty on Contracts, Para 18-120
[548] Malek. A, (2009) , 95
[549] Davis .A.G, (1922) 71
[550] McKendrick.E (ed) ,(2010), Goode on Commercial Law ,4th edn, Penguin , 1087
[551] Hugo.C, (2000) , 234
[552] Trimble.R.J, (1948), 'The Law Merchant and the Letter of Credit' , 61 Harvard LR 981- 1006
[553] Ellinger. E.P, (1970) , 108
[554] Ibid
[555] Hugo.C, (2000) , 235

principle applicable to documentary letters of credit.[556] Goode supports the theory of mercantile usage in explaining the obligation of issuing bank in relation with beneficiary under the letter of credit law when comments on other theories: "fall to the ground because, in an endeavour to produce an acceptable theoretical solution, they distort the character of the transaction and predicate facts and intentions at variance with what is, in practice, done and intended by the parties"[557]. With reference to Chitty, Jack comments on documentary letters of credit governed by English law being an exception to the rules applicable to consideration as undertakings of issuing and confirming bank to beneficiary are not supported by consideration. However, they are biding in law with reference to mercantile usage as reason for their binding nature.[558]

**2- <u>Issuing and Confirming banks undertakings to beneficiary</u>**

Article 7 and 8 of UCP 600 comment on obligations of the issuing bank as following:

"Issuing Bank Undertaking

a. Provided that the stipulated documents are presented to the nominated bank or to the issuing bank and that they constitute a complying presentation, the issuing bank must honour if the credit is available by:

i. sight payment, deferred payment or acceptance with the issuing bank;

ii. sight payment with a nominated bank and that nominated bank does not pay;

iii. deferred payment with a nominated bank and that nominated bank does not incur its deferred payment undertaking or, having incurred its deferred payment undertaking, does not pay at maturity;

iv. acceptance with a nominated bank and that nominated bank does not accept a draft drawn on it or, having accepted a draft drawn on it, does not pay at maturity; v. negotiation with a nominated bank and that nominated bank does not negotiate.

b. An issuing bank is irrevocably bound to honour as of the time it issues the credit.

c. An issuing bank undertakes to reimburse a nominated bank that has honoured or negotiated a complying presentation and forwarded the documents to the issuing bank. Reimbursement for the amount of a complying presentation under a credit available by acceptance or deferred payment is due at maturity, whether or not the nominated bank prepaid or purchased before maturity. An issuing bank's undertaking to reimburse a nominated bank is independent of the issuing bank's undertaking to the beneficiary"[559]

UCP 600 has introduced the notion of to "honour" the credit and provided a special technical meaning for it. Therefore, to "honour" the credit means: "(a) pay at sight if credit is available by sight payment; (b) to incur the deferred payment and pay at maturity when the credit is available by deferred payment; (c) to accept the bill of exchange drawn by the beneficiary and pay at maturity if the credit is available by acceptance"[560]. Under UCP600, obligation to honour does not have the same meaning as obligation to negotiate[561] . On the basis of article 7(a)(ii) which is the reproduction of article 9(a)(i) of UCP 500, the issuing bank has the obligation to honour the credit when it is available by sight payment, deferred payment or acceptance. Article 7(a)(ii) to (v) of UCP 600 clarify the obligation of issuing bank when the credit is available with a nominated bank, but nominated bank does not act in accordance with its nomination to pay at sight, incur deferred payment or accept or negotiate the draft. In two first situations

[556] Ellinger .E.P (1970), 120
[557] Goode.R , (1995) Commercial Law 2 ed , 987
[558] Malek. A, (2009) 93.
[559] UCP 600- Article 7
[560] UCP 600- Article 2
[561] Ellinger, E. P., & Neo, D. S. S. (2010). The Law and Practice of Documentary Letters of Credit. Hart. 114

(the credit is available by sight payment or incurring deferred payment) , when nominated bank does not act upon its nomination, issuing bank simply put itself in nominated bank's shoes and perform what it has failed to do by honouring the credit. [562] Situation is not clear under UCP 600 when the nominated bank does not act on its nomination to accept the draft and pay in its maturity.[563] Non acceptance of the draft drawn on nominated bank might make beneficiary to draw a fresh draft on issuing bank in order to be honoured under article 7 (a) . Ellinger submits that in such situation beneficiary can present the fresh draft drawn on issuing bank after the expiry date of the credit.[564]Article 9(a)(iii)(b) of the UCP 500 has a more clear position which might be applicable to UCP 600 as well: Where the credit is available on acceptance with nominated bank and nominated bank rejects to accept drafts drawn in it , the issuing bank is obliged to accept and honour drafts drawn by beneficiary on it (issuing bank) on maturity. However, where the nominated bank accepts drafts drawn on it but does not honour them on maturity, issuing bank must pay on those drafts (which are drawn on nominated bank). UCP 500 provides that in second situation, beneficiary does not need to draw fresh drafts on issuing bank.

Availability of credit with nominated bank for negotiation refers to two different situations of negotiating documents under deferred payment or negotiating documents (including bill of exchange) under acceptance credit.[565] Where nominated bank refuses to act upon its nomination and negotiate documents, issuing bank is obliged to honour the credit by incurring deferred payment or paying for drafts on maturity, but it cannot negotiate its own undertaking as provided by UCP. In such situation, issuing bank will pay in maturity and there is no possibility for beneficiary to be paid in earlier date. Issuing bank also cannot negotiate a credit with drafts drawn on applicant as it is not permitted in UCP for beneficiary to draw drafts on applicant[566]. Article 6(a) of the UCP 600 provides that credit available with nominated bank is also available with issuing bank; therefore, beneficiary can directly present documents to issuing bank rather than going to nominated bank.

"Confirming Bank Undertaking

a. Provided that the stipulated documents are presented to the confirming bank or to any other nominated bank and that they constitute a complying presentation, the confirming bank must:

i. honour, if the credit is available by:

a. sight payment, deferred payment or acceptance with the confirming bank;

b. sight payment with another nominated bank and that nominated bank does not pay;

c. deferred payment with another nominated bank and that nominated bank does not incur its deferred payment undertaking or, having incurred its deferred payment undertaking, does not pay at maturity;

d. acceptance with another nominated bank and that nominated bank does not accept a draft drawn on it or, having accepted a draft drawn on it, does not pay at maturity; e. negotiation with another nominated bank and that nominated bank does not negotiate. ii. negotiate, without recourse, if the credit is available by negotiation with the confirming bank.

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

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[562] Ibid
[563] Ibid
[564] Ibid ,115
[565] Malek . A (2009), 115
[566] UCP 600-article 6 ( c) , UCP 500-article 9(a)(iv)

c. A confirming bank undertakes to reimburse another nominated bank that has honoured or negotiated a complying presentation and forwarded the documents to the confirming bank. Reimbursement for the amount of a complying presentation under a credit available by acceptance or deferred payment is due at maturity, whether or not another nominated bank prepaid or purchased before maturity. A confirming bank's undertaking to reimburse another nominated bank is independent of the confirming bank's undertaking to the beneficiary.

d. If a bank is authorized or requested by the issuing bank to confirm a credit but is not prepared to do so, it must inform the issuing bank without delay and may advise the credit without confirmation"[567].

Reviewing article 7(a) and 8(a) of UCP 600 proves the similarity in content and structure of both articles. Obligations of confirming bank consist of honouring the credit when it is available by sight payment, incurring deferred payment or acceptance. Article 8(a)(i-b) provides that confirming bank also has the obligation of honouring the credit when it is available by sight payment, deferred payment, and acceptance with a nominated bank rejects to act upon its nomination. As it was mentioned before, general review of the obligations of confirming bank and issuing bank show strong similarity between them.

In the same vein with obligations of issuing bank under article 7 (a)(v) , article 8(a)(i-e) holds that when the credit is available with another nominated bank with negotiation and the nominated bank does not negotiate , confirming bank has obligation to honour the credit while negotiating the credit under such situation is only a discretionary act for it.[568]Article 8(a)(ii) imposes obligation on confirming bank to negotiate the credit without recourse when it is available with negotiation by confirming bank. This article has no equivalent in article 7 and imposes more onerous obligation on confirming bank than nominated bank as nominated bank is not bound to negotiate the credit without recourse.[569]

It worth to mention that obligation of the confirming bank to irrevocably honour or negotiate the credit raise as of the moment of adding confirmation to the credit.[570]

**3- Bank's duty for examination, honouring or rejection of presentation**

After presentation of documents by beneficiary to issuing, confirming or nominated, the bank has duty of examining the presentation based on documents, within specified period time mentioned in UCP[571].Examination takes place to determine whether or not the presentation is complying with terms of the credit.[572] Emphasize on necessity for bank to examine presented documents only on the basis of documents on their face has reference to principle of autonomy in order to prevent bank from considering factors like performance of beneficiary under the underlying contract .[573]

Article 15 of UCP 600 provides:

"Complying Presentation

a. When an issuing bank determines that a presentation is complying, it must honour.

b. When a confirming bank determines that a presentation is complying, it must honour or negotiate and forward the documents to the issuing bank.

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[567] UCP 600-Article 8
[568] Ellinger ,P.E (2010) 116
[569] Ibid
[570] UCP600-Article 8(b)
[571] UCP 600 –Article 14 (a) ; UCP 500-Atricle 13 (a)
[572] UCP 600 –Article 14 (b) ; UCP 500-Atricle 13 (b)
[573] UCP 500-Article 9(a) and 9(b).

c. When a nominated bank determines that a presentation is complying and honours or negotiates, it must forward the documents to the confirming bank or issuing bank."

When bank finds out that documents do not comply with terms of the credit, it has no obligation to honour or negotiate the presentation[574]. In such situation, bank may refer on its discretion to the applicant for waiver[575]. Decision of bank to reject the presentation requires it to provide beneficiary with a notice of refusal in accordance with form and within the time frame defined by UCP.[576]Article 16(f) UCP600 provides that in case of failure of issuing bank or confirming bank to act in accordance with procedure of rejection mentioned in article 16 , it will be precluded form claiming based on non-compliance of presentation[577]. Finally, as result of refusing to honour/negotiation of presentation by issuing/confirming bank, it will be entitled to reimbursement after giving the notice of refusal on the basis of article 16 of UCP 600. [578] It should be considered that examination of documents and issuing the notification of rejection are two different requirements.[579]

In UCP 500, article 13b provides that "The issuing bank, the confirming bank, if any, or a nominated bank acting on their behalf, shall each have a reasonable time, not to exceed seven banking days following the day of receipt of the documents, to examine the documents and determine whether to take up or refuse the documents and to inform the party from which it received the documents accordingly". At the same time, Article 14 (d)(i) provides that: "If the Issuing Bank and/or Confirming Bank, if any, or a Nominated Bank acting on their behalf, decides to refuse the documents, it must give notice to that effect by telecommunication or, if that is not possible, by other expeditious means, without delay but no later than the close of the seventh banking day following the day of receipt of the documents. Such notice shall be given to the bank from which it received the documents, or to the Beneficiary, if it received the documents directly from him". Therefore, there was the possibility under UCP 500 for banks which have done the examination of documents in accordance with article 13(b) to be precluded from claiming reimbursement as a result of failure in providing notice of rejection "without delay". The concept of reasonable time in examination of presentation is a vague notion and it could be flexible depending of different factors like practice in different parts of the world and also number and complexity of documents[580]. However, decisions of the Court of Appel in *Banker's Trust Co c State Bank of India*[581]and the Supreme Court of Singapore in *United Bank Ltd v Banque Nationale de Paris*[582] in addition to formulation of UCP 500 provides that seven days period for examination of documents by bank was the maximum time limit for the most complicated presentations. However, shorter time could be considered for the simpler ones.[583]

This seems to be less problematic under UCP 600 as the article 14 (b) provides: "A nominated bank acting on its nomination, a confirming bank, if any, and the issuing bank shall each have a maximum of five banking days following the day of presentation to determine if a presentation is complying. This period is not curtailed or otherwise affected by the occurrence on or after the date of presentation of any expiry date or last day for presentation". Article 14(b) clarifies that under UCP 600; bank may perform

[574] UCP 600 – Article 16(a) – UCP 500-Artcile 14 (b)
[575] UCP 600-Article 14 (b) – UCP 500-Artcile 13(c)
[576] UCP 600- Article 16( c) and (d) ; UCP 500- Article 13(b), 14(d) (i) and 14 (d)(ii)
[577] UCP 600-Article 16 (f) and UCP 500 –Article 14 (e)
[578] UCP 600- Article 16 (g) and UCP 500-Artcile 14(d)(ii)
[579] Ellinger, E. P., & Neo, D. S. S. (2010). The Law and Practice of Documentary Letters of Credit. Hart. 119
[580] Ibid
[581] [1991] 1 Lloyd's Rep 587
[582] [1992] 2 SLR 64
[583] Ellinger.P.E, (2010) 119

examination and issue the notice at any time within five banking days and notions of "reasonable time" and "without delay" are no longer relevant[584].

Application of the article 16(f) of the UCP 600 can impose severe consequences on bank examining presented documents by beneficiary as it provides that issuing or confirming bank which fail to comply with due procedure of rejection stipulated in article 16 will be precluded from claiming non-compliance of presentation with terms of credit. Such situation will result in obligation of bank to accept documents and pay for presentation while it will not be eligible for reimbursement by instructing party.[585] UCP 600 confines preclusion to issuing and confirming bank while not mentioning a word about nominated bank in the same situation. Such position is understandable since nominated bank acts as agent of issuing bank and does not have any obligation to beneficiary regarding honour or negotiation of the credit.[586]However, according to the agency law, failure of nominated bank in acting upon UCP instructions will affect position of issuing bank to be precluded from reimbursement by applicant.[587]In return, issuing bank may raise a claim for losses against nominated bank due to breach of mandate and failure to comply with UCP instructions.[588]

In regard with extent of the application of Article 16(f), different court decisions confine it clearly to the documentary discrepancy in the framework of article 16. Therefore, failure of beneficiary to comply with provisions of article 16 due to reasons including improper time or place of presentation will not preclude bank from claiming reimbursement from instructing party. [589]

The court of *Bayerische Vereins Bank Aktiengesellschaft v. NationalBank of Pakistan*,[590] held that article 13 and 14 of UCP (then UCP 500) only refer to discrepancies on the face of documents. Therefore, as time of presentation cannot be considered as discrepancy on the face of documents, article 13 and 14 do not apply in case of presentation had been made out of time.[591] However, issuing or confirming bank which intend to reject the presentation is recommended to mention all discrepancies (documentary and non-documentary) within the notice of rejection in order to be safe from possible consequences of preclusion by article 16 (f). [592] Such recommendation will not apply in cases that bank decides to reject presentation due to committing fraud by beneficiary. Since in case of beneficiary's fraud, there is no discrepancy in documents, bank has no obligation to follow instructions of article 16.[593] This is argued that in case of nullity, presentation can be considered as discrepant as beneficiary has the implied duty to present genuine document under the credit and bank will be precluded from reimbursement according to article 16(f) if it does not provide the proper notice of rejection[594] .

According to common law principles, when the preclusion under UCP is no the matter of concern , it might be held that apart from failing to state discrepancies in notice of rejection , bank has waived or estopped from relying on them.[595] Also, failure of bank to reject documents within reasonable time can stand for acceptance of presentation[596].

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[584] Malek. A (2009) 110.
[585] Ellinger. P.E (2010) 120.
[586] Ibid
[587] Ibid
[588] Ibid
[589] Malik. A (2009) 110.
[590] *Bayerische Vereins Bank Aktiengesellschaft v. NationalBank of Pakistan*, [1997] 1 Lloyd'sRep. 59,
[591] Ibid, 67
[592] Ellinger. P.E (2010) 121.
[593] Alavi, H. (2016). Documentary Letters of Credit, Principle of Strict Compliance and Risk of Documentary Discrepancy. Kor. UL Rev., 19, 3.
[594] Ellinger. P.E (2010) 121.
[595] Malek, A (2009) , 120.
[596] Ellinger. P.E (2010) 121.

## 4- Liability of issuing bank to beneficiary

4.1 - Payment to incorrect party

The bank should effectuate payment under the credit to party who is entitled for receiving it.[597]In case bank pays to the party who is not entitled for receiving the money, the obligation to pay to the entitled party will remain with bank and it should pay once again.[598] The decision of *Cleveland Manufacturing Co Ltd v Muslim Commercial Bank*[599]is a good example. In the case of *Cleveland*, plaintiffs instructed shipping agents to prepare and present documents to defendant bank. The bank effectuated payment to shipping agents but they did not pay beneficiary as a result of getting liquidated. Since shipping agents were not agents of beneficiary, plaintiff succeeded in court against the bank.

4.2- Late Payment

In English law, when there is a delay in making payment by bank, beneficiary should prove his loss is recoverable under ordinary rules of causation plus remoteness of damages to get favourable ruling from the hearing.[600] In the case of *Ozalid Group (Export) Ltd v African Continental Bank Ltd*[601]bank made the payment of US$ 125,939 to beneficiary English Company) with two months of delay. As during above mentioned period USD depreciated against Pound and due to existing exchange rate controls on that time, company had to convert its dollars to sterling. The court ordered in favour of beneficiary and they recovered sterling value of dollars between the time that they were supposed to be received and time that they actually received, plus interest of total sum during two months of delay and reasonable costs incurred by sellers in attempt to collect payment. In *International Minerals and Chemical Corpn v Karl O Helm AG*[602] in absence of exchange regulations, plaintiff (an English company) should prove that they have converted UDSs to Sterling at the same time or after their receipt due to company financial policy in order to justify their loss. Therefore it was sufficient to satisfy the test of the likelihood (remoteness) of damage which was also recited in the House of Lord decision of *Koufus v C Carnikow Ltd* [603]. At present time, claims for interest where banks pays with delay (but before beginning of court proceeding) is governed by the decision of the House of Lard in *Sempra Metals Ltd v IRS*[604]. Accordingly, court would have jurisdiction under common law "to award compound and simple interest on claims for breach of a contract to pay a debt"[605]. Recovery of actual interest lossed due to breach of contract by bank will be conditional to beneficiary's capability to provide proof of loss , satisfy tests of the remoteness of damages, oblations for mitigating damages and other relevant rules .[606]

4.3- Non-payment

Bank has the obligation to honour the conforming presentation. In case of dishonouring the conforming presentation and rejection of bank to pay against complying documents , beneficiary has the right to sue it provided that seller beneficiary remains capable of tendering documents to bank against payment[607]. Even in case of non-compliance of documents if issuing or confirming bank does not follow the guidelines

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[597] Malek, A (2009) , 129
[598] Ibid
[599] [1981] 2 Lloyd's Rep 646
[600] Malek.A (2009), 128
[601] [1979] 2 Lloyd's Rep 239
[602] [1986] 1 Lloyd's Rep 81 , P105
[603] [1969] 1 AC 350
[604] [2007] 3 WLR 754.
[605] Malek.A (2009) , 129
[606] Ibid
[607] Malek . A (2009) , 125

for examination and rejection of documents provided in articles 7 and 8 of UCP 600 will be precluded from rejection of presentation.[608] In effect, wrongful dishonour of the presentation by bank means non-payment of amount due on beneficiary under the credit. In such situation, beneficiary has two different bases for his claim against bank: first one is to bring action against bank and aim for damages resulting from breach of bank's obligation. Second, is bringing an action in debt of the sum due under the credit.[609] Although, beneficiary might take either of actions, courts seem to treat both actions as the same manner. Greer J in *Dexters Ltd v Shenker & Co* [610] mentioned:

"...the date of the payment has passed and the payment has not been made, the way to read the claim of this sort is that it is the claim for damages for non-payment of money, and in ninety-nine out of hundred cases the amount of damages will be the sum which there has been the undertaking to pay."[611]

In practice , beneficiary will incur loss equal to the price mentioned in the credit[612] and interest due to delay in payment .This amount will be similar to what can be required under the claim in debt. However, it is submitted that claim in damages might have more effect and result higher awards[613]. General principles of English contract law provides that "injured party will be awarded damages which put him in a position that he would have been in has the contract been performed"[614]. Where there is claim for consequential losses incurred due to the breach of contract, such losses will be recovered if claimant manages to satisfy rules of the remoteness of damage.[615] In *Prehn v. Royal Bank of Liverpool*[616], defendant bank rejected the draft drawn on it despite its acceptance at beginning. The court considered case as breach of contract of honouring drafts which became due and ordered in favour of claimants the amount of draft in addition to cost of purchasing fresh drafts from other bank, cost of cable and expenses in protesting the drafts. In *Urquhart Industry and Co. Ltd. v. Eastern Bank Ltd*[617], the case was about sale of machinery which was manufactured and shipped by beneficiary seller in different instalments. Defendant bank opened the credit in favour of beneficiary but, rejected honouring a bill despite being presented together with complying documents. The court held that due to bank's refusal beneficiary does not need to continue shipment of future instalments. Therefore, beneficiary should consider the contract terminated and sue in accordance with loss in the whole contract[618]. From this case it is possible to comprehend that issuing bank's breach of obligations to pay under the credit would be considered equal to repudiation of applicant under the contract of sales with beneficiary.[619]

It has been submitted that claim for damages resulting from breach of contract has a disadvantage of existence of expectations from claimant to mitigate his losses[620]. This means that beneficiary facing with wrongful dishonour of credit by issuing bank will try to sell goods to other buyer and cover his losses partially. However, such argument does not comply with fundamental principles of LC as beneficiary is guaranteed to receive payment from issuing bank after presentation of complying documents with terms of the credit and as a result, mitigation principle has not received any support in court's decisions.[621] In *Belgian Grain*

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[608] Ellinger.P.E, (2010) 122
[609] Ibid
[610] (1923) 14 Lloyd's Rep
[611] Ibid 586
[612] *English Imex Industries Ltd v Mainland Bank Ltd* [1958] 1 QB 542
[613] Ellinger.P.E, (2010) 123
[614] Ibid
[615] *Prehn v. Royal Bank of Liverpool* (1870) LR 5 Ex 92.
[616] Ibid
[617] *Urquhart Industry and Co. Ltd. v. Eastern Bank Ltd* [1922] 1 KB 318
[618] Ibid 324
[619] Ellinger .P.E (2010) 124
[620] Malik. A (2009) , 120
[621] *Belgian Grain and Produce Ltd v. Cox & CO*. (France) Ltd., (1919) 1 Lloyd's Rep 256;
*Stein v. Hambros Bank of Nothern Commerce,* (1921) 9 Lloyd's Rep 433.

*and Produce Ltd v. Cox & CO. (France) Ltd.*[622], Banks LJ held that "requirement for mitigation would defeat the object of the letter of credits which is to avoid controversies as to damages. It would also be contradictory to the fundamental understanding between the bank and the beneficiary that the letter is entitled to be paid as long as he makes a confirming presentation under the credit"[623].

For beneficiary to win the claim against wrongful dishonour of issuing bank it is necessary to prove that presentation was complying with terms of the credit. However, there is always some inherent uncertainty that court to rule in his favour[624]. Also in case of dealing with perishable goods or high storage costs, the time lag between dispute and rendering the judgment by court will be against interests of beneficiary. Therefore, one solution can be selling his goods and then suing the issuing bank for difference between the price of resale and amount of credit.[625]An alternative solution would be applying for expedited hearing from the court[626]. In *British Imex Industries Ltd v Midland Bank Ltd*[627], presentation of documents for the sale of steel bars rejected by bank on 10 of December , hearing started on 11 of December and decision was rendered if favour of beneficiary on 20 December[628]. Third solution can be opening a joint account for beneficiary and issuing bank in order to deposit the money from reselling goods if it is easy to sell them.[629] However, this will be difficult option when goods are custom made or not ready for market. Finally, if no action is taken, loser will take all the loss and this is really rare for beneficiary to be so sure about his claim not to act upon reselling the products.[630]

Under English law, payment of the credit by acceptance which means conjunction of drafts to the credit will subject it to the rules of the bills of exchange. Section 57 (1) of Chapter 61 of the Bills of Exchange Act 1882 holds that bank which dishonours an already accepted draft is liable for damages that will be calculated based on the amount of the bill , plus interest and cost of protest and noting.

Where draft is discounted by beneficiary and accepted by the drawee bank, the holder of draft will be eligible to sue for wrongful dishonour of it by bank[631]

**5- Issuing banks right to recourse against beneficiary**

In certain situations, issuing or confirming bank might seek recovery from beneficiary after paying to him. According to Jack most probable of such situations can be[632]:

- First and foremost possibility is when the bank examines presentation, finds documents compliant to terms of the credit and effectuates the payment to beneficiary. However, it will be found subsequently that documents are discrepant and bank is not entitled for reimbursement.
- Second is when applicant files for bankruptcy and will not be able to reimburse the issuing bank after honouring the credit.
- Third situation might be the occasion that bank has negotiated the credit and draft drawn on the applicant and draft will be dishonoured later.

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[622] (1919) 1 Lloyd's Rep 256
[623] Ellinger .P.E (2010) 124
[624] Ibid
[625] Malik. A (2009) , 120
[626] Ibid
[627] *British Imex Industires Ltd v Midland Bank Ltd* [1958] 1 QB 542
[628] Malik. A (2009) , 120
[629] Ellinger .P.E (2010) 124
[630] Ibid
[631] Ibid , 128
[632] Malek. A (2009) , 129

The general view is that bank (issuing/confirming) will not have any right for receiving reimbursement from beneficiary as it is against the principle of documentary letters of credit to provide a secure means of payment for beneficiary. Therefore, recourse rights against beneficiary may not exist.

5.1- Complying presentation

Where bank has paid beneficiary against complying documents to terms and conditions of the credit, and then applicant refuses to reimburse the bank for any given reason, bank will not have any cause of action against beneficiary under UCP or common law.[633] Bank is supposed to check the credit worthiness of applicant before issuing the credit and beneficiary is not by any means concerned regarding applicant's impecuniousness. Issuing bank should take an action against applicant instead of trying to take the money back from beneficiary. However, it is submitted that since bank is generally in possession of documents of title under the letter of credit, it can compensate part of loss by reselling goods[634]

5.2- Non-Complying presentation

When the UCP applies, the position is that bank does not have any obligation to pay beneficiary against presentation of non-complying documents. The issuing bank which fails to examine and reject non complying presentation in accordance with procedure explained in articles 7 and 8 of UCP 600 will be precluded from raising any claim about discrepancy of documents.[635] This is clear position of UCP to prevent bank from raising any claim on non-compliance of documents to terms of credit after certain number of days passing from presentation[636]. Therefore, issuing bank is bound[637]by provisions of UCP to pay the beneficiary in case of failure to reject presentation due to discrepancy of documents.

Where UCP is not corporated or relevant provisions of it are excluded then situation will be governed by general principles of common law[638]. On the basis of contractual obligations, beneficiary will be entitled to payment after presentation of complying documents. Therefore, bank can avoid payment when the presentation is non-complying. Therefore, if beneficiary is paid under such circumstances, under common law principles, bank is entitled to claim for "restitution of money paid under mistake"[639]. Alternatively, issuing bank can raise a claim for restitution of money paid to beneficiary based on mistake when the beneficiary is paid but was not entitled for payment or because of committing fraud.[640]

5.3- Bills of Exchange

Where bills of exchange are included in the credit, law of negotiable instruments will be relevant under English law. In such situation, issuing bank is the drawee of the draft and undertakes to honour the credit upon presentation of complying documents by beneficiary. Therefore, issuing bank will not have any right of recourse against beneficiary as drawer of the draft.[641] Alternative possibility is when issuing bank undertakes to negotiate drafts drawn on the applicant by beneficiary after presentation of complying documents despite the fact that drafts are not allowed to be drawn on applicant under UCP.[642] In such a situation (which is possible if parties decide to exclude relevant provisions of UCP ),section 43 (2) or 47

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633 Ellinger .P.E (2010) 133
634 Ibid
635 UCP 600-Artilcle 16(f)
636 Ellinger .P.E (2010) , 133
637 Ibid
638 Ibid
639 ibid
640 *Niru Battery Manufacturing Co and Another v Milestone Trading Ltd and Others [2004] QB 985*.
641 Ellinger .P.E (2010) , 135
642 UCP600 , Article 6 (c) ; UCP 500-Article 11 (b) (iv)

(2) of the Bill of Exchange Act (1882) possibly will give the issuing bank (as the holder or endorsee of the draft ) right to recourse against beneficiary (drawer) when applicants (drawee) rejects to pay it.[643]

5.4- Fraud and misrepresentation

Since UCP takes a silent approach to fraud, fraud and other expectations to principle of independence in documentary letters of credit are governed by national law.[644] In English law, there will be no legal problem on the way of issuing bank to claim for restitution against beneficiary in the case of fraud. In case of committing fraud by beneficiary, issuing and confirming bank will have right to claim for restitution against beneficiary on the basis of the tort of deceit.[645] The difference under American law is that while getting paid, beneficiary provides bank with warranty that no fraud or forgery is involved and if contrary is proved, and then bank will have the right for restitution as a result of the breach of warranty.[646] However, where the fraud is not involved, it would be difficult for issuing/confirming bank to get restitution based on negligent misrepresentation of the beneficiary[647]. It was held in *DBS Bank Ltd v Carrier Singapore*[648]*:*

*"*if were to accept … that the bank may rely on negligent misrepresentation by beneficiary to recover any money it had paid out to the beneficiary, the law would also have to accept that banks are also entitled to invoke negligent misrepresentation by the beneficiary as a ground for not paying the beneficiary at first place. The practical effect of this would be to unravel the narrow fraud exception the House of Lords [in United City Merchants] took pains to limit; banks could refuse to pay the beneficiary once there was any inaccurate statement of material fact by simply alleging that the beneficiary had been negligent. One has to bear in mind that the underlying foundation of the system of documentary credits is to give sellers as far as possible , an "assured right" to payment notwithstanding disputes in the underlying sale contract … in my view developing the law to allow for the negligent misrepresentation exception would be an unjustified erosion of this very promise. Documentary credits must be allowed to be honoured as far as possible, free from interference form the courts. Otherwise trust in international commerce could be irreparably damaged"[649]

The decision in *DBS Bank Ltd v Carrier Singapore* proposed that bank or applicant can raise an action against beneficiary for negligent misrepresentation when the issuer of document provides warranty for documents as accurate to either issuing or confirming bank or applicant.[650] However, agreement of beneficiary to terms of LC in normal situation "is an insufficient material from which to imply any such assumption of responsibility"[651].

## 6- Conclusion

In practice of international trade, documentary letters of credit are in circulation for many centuries. Their existence, popularity and unique model of functioning are proving for their effectiveness in addressing relevant problems to payment risk in international trade finance. Despite numerous efforts of legal experts and academic scholars in defining unclear aspects in complicated process of LC operation, there are yet

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643 Ellinger. P.E (2010) , 135

644 Alavi , H. "Autonomy Principle and Fraud Exception in Documentary Letters of Credit, a Comparative Study between United States and England" . International and Comparative Law Review, Vol. 15, No. 2 ,(2015) ,45-67

645 *Derry v Peek* (1889) 14 App Cas 337

646 Ellinger. P.E (2010) , 136

647 *DBS Bank Ltd v Carrier Singapur* (Pte) [2008] 3 SLR 261

648 Ibid 99-100

649 Ibid

650 Ibid 104

651 Ibid

uncertainties in areas including issuing bank relations with beneficiary. As an interesting and controversial problem, issuing bank's obligations towards beneficiary were scrutinized as the subject matter of current paper. Starting with legal nature of issuing bank's obligation to pay beneficiary, author got to the result that payment obligation of bank to beneficiary is regulated by mercantile usage as UCP does not touch upon the problem and none of contract law theories in common law system are not capable of addressing absence of movement of consideration from beneficiary to issuing bank properly. Further, examination, honour and rejection process of beneficiary's presentation by (issuing/confirming) bank as main obligations towards beneficiary were discussed and relevant case law was considered. In continuation, principle liabilities of issuing bank towards beneficiary were defined under three headings of wrongful dishonour of personation, late payment and payment to wrong party. Last but not the least, discussion of conditions under which bank has right to recourse for restitution of money paid to beneficiary under common law provisions and UCP showed that unlike common law , UCP does not provide issuing bank with right to recourse based on payment under mistake when presentation is complying . Finally, in case of fraud bank has right for recourse against beneficiary under common law provisions where UCP is taking an absolute silent stance.

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***Publication 4*** : **Alavi, H. (2015), "Autonomy Principle and Fraud Exception in Documentary Letters of Credit, a Comparative Study between United States and England". *International and Comparative Law Review*, Vol. 15, No. 2, ,45-67.**

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*ICLR, 2015, Vol. 15, No. 2.*

# Autonomy Principle and Fraud Exception in Documentary Letters of Credit, a Comparative Study between United States and England

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ALAVI, Hamed. Autonomy Principle and Fraud Exception in Documentary Let- ters of Credit, a Comparative Study between United States and England. *Interna- tional and Comparative Law Review*, 2015, vol. 15, no. 2, pp. 47–68.
DOI: 10.1515/iclr-2016-0035.

**Abstract:** Despite the fact that Documentary Letters of Credit are involved in process of International Trade for many centuries, but their legal personality is very new and their life span is much shorter than their existence. In the middle of Eightieth Century, Lord Mansfield introduced legal aspects of LC operation for the first time to the Common Law System. Later, International Chamber of Commerce started to codified regulations regarding international operation of Documentary Letters of Credit in 1933 under the title of Uniform Customs and Practices for Documentary Letters of Credit and updated them constantly up to current date. However, many aspects of LC operation including fraud are not codified under the UCP which subjects them to national laws. Diversified nature of National Laws in different countries can be source of confusion and prob- lem for many businessmen active in international operation of Documentary Letters of Credit. Such differences are more problematic in Common Law countries as a result of following precedent. For Example, legal aspects of International LC transactions under British Law are only based on case law, however, American Law addresses Letter of Credit Operation under Article 5 of Unified Commercial Code. Due to important role of English and American law in practice of international trade, current paper will try to compare their approach to autonomy principle of in LC operation, fraud rule as a recognized exception to it and search for answer to following questions what is defini- tion of fraud, and what are standards of proof for fraud in LC operation, under English and American law?

**Keywords:** Documentary Letters of Credit, Autonomy Principle, Fraud Rule, English Law, American Law, UCC.

# 1 Introduction

Involvement in international trade has been always a temptation for businessmen. Although, doing business overseas has relatively high risks also providing higher level of profit in comparison with local market. Financial risks are well-known among other kinds of risk in international trade. Unlike doing trade in national markets, most of overseas traders have no information about the financial standing of other party and as result, it will be risky for exporter to part from goods before receiving payment and also importer will assume the risk of receiving non-conforming goods in case of making the payment before delivery of goods and checking . In the course of mercantile history, different methods of payment have been developed on the basis of market demand and goal of reducing financial risk for either party involved in international sales of goods. Among different existing methods of payment , Documentary Letters of Credit have a significant role in conduct of trade internationally by removing the out- standing risk of payment from a natural person (importer) and shifting it to the guarantee of legal person( a bank) for payment of purchased goods by importer against tender of complying documents by exporter. For many centuries Docu- mentary Letters of Credit are in usage for the purpose of facilitating payments in international trade. However, their legal character has relatively short life span. Raymond Jack believes that entrance of Documentary Letters of Credit into the English legal system goes back to desire of Lord Mansfield in the middle of eight- eenth century to include them in the Common Law practice[2]. Currently, relevant legal aspects of Documentary Letters of Credit are regulated via internationaly accepted Unified Customs and Practices for Documentary Letters of Credit which is prepared by International Chamber of Commerce. According to UCP, operation of documentary credits is subjected to two well recognized principles of independence which separates credit from its underlying contract and strict compliance which limits the responsibility of bank to honor the credit after ten- der of complying documents by beneficiary rather than being concerned about actual fulfilment of underlying contract. Despite warm welcome of trade society to UCP, still many legal aspects of Letter of Credit operation are regulated by national laws, including fraud and other exceptions to independence principle which are regulated by common law principles in England and Unified Com- mercial Code in United States of America. Current research will try to review the legal aspects of Principle of Autonomy in Documentary Letters of Credit while taking a comparative approach to fraud as the main exception to principle of autonomy in England and United States of America. Therefore, paper will try to find answers to questions regarding definitions, standards of proof, and legal remedies under English and American law.

2 Malek. A, Quest .D, Jack. *Documentary credits: the law and practice of documentary credits including standby credits, and demand guarantees, Tottle*, 2009


ISSN 1213-8770 (print), ISSN: 2464-6601 (online)

## 2 Principle of Autonomy

Alongside with principle of strict compliance in operation of letters of credit and cornerstone of current article is Principle of Autonomy. Independence prin- ciple has been recognized and appreciated in national and international law[3]. The principle of autonomy of letters of credit has been considered as "the engine behind the letter of credit"[4], and "cornerstone of the commercial validity of the letters of credit"[5]. Principle of Independence has been clearly mentioned in article 4 of UCP 600:

> "Article 4 Credits v. Contracts
> a. A credit by its nature is a separate transaction from the sale or other contract on which it may be based. Banks are in no way concerned with or bound by such contract, even if any reference whatsoever to it is included in the credit. Consequently, the undertaking of a bank to honour, to negotiate or to fulfil any other obligation under the credit is not subject to claims or defenses by the applicant resulting from its relationships with the issuing bank or the beneficiary."

According to Article 4 of the UCP 600 and by referring to principle of independence, the beneficiary exporter receives the guarantee that he will be paid after tender the complying presentation of documents to the issuing bank. Nei- ther bank nor the account party will be able to withhold payment with relevant arguments to the quality of delivered goods or other issues related to performance of underlying contract. Therefore, even in case of conflict on performance of underlying contract account party and issuing bank have no other choice rather than paying beneficiary upon presentation of complying documents and seek remedy by suing him for the breach of underlying contract. As a result, Autonomy Principle has been considered a means of promoting international trade by following the logic of "pay first, argue later"[6]

The autonomy principle also has been considered as the foundation for smooth operation of letter of credits by many scholars.[7]

In order to completely address the essence of autonomy principle, article 5 of UCP 600 specifies: "banks deal with documents and not with goods, services or performance to which the documents may relate."[8]

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**3** Article 4 UCP 600; Article 2(b) URDG; Articles 2 and 3 UNCITRAL-Convention; sections 5-10 (1)(a), 5-114 (1) and 5 5-103(d) UCC

**4** Arkins.J.R.C. (2000) "*SNOW WHITE V. FROST WHITE: THE NEW COLD WAR IN BANKING LAW*" Journal of International Banking Law, J.I.B.L. 2000, 15(2), 30–41

**5** *Ward Petroleum Corp. v Federal Deposit Ins. Corp.* (1990) 903 F.2d 1299.

**6** Dolan. J .F, (1996). *The Law of Letters of Credit: Commercial and Standby Credits*, Fourth Edition, Warren, Gorham & Lamont, Incorporated, USA

**7** *Eakin v Continental Illinois National Bank & Trust Co.* (1989) 875 F.2d 114 .116.

**8** UCP600. Article 5


ISSN 1213-8770 (print), ISSN: 2464-6601 (online)

## 2.1 Principle of Autonomy and Common Law Position

The principle of autonomy has been recognized in many common law cases[9]. Particularly, the importance of autonomy principle has been recognized by Lord Diplock in *United City merchants (Investment) Ltd v Royal Bank of Canada*[10].

'The whole commercial purpose for which the system of confirmed irrevocable documentary credits has been developed in international trade is to give to the seller an assured right to be paid before he parts with control of the goods that does not permit of any dispute with the buyer as to the performance of the contract of sale being used as a ground for non-payment or reduction or deferment of payment'

*Trans Trust SPRL v Danubian Co Ltd* [11] is other English case which raise the importance of autonomy principle when Denning LJ refers to necessity for seller to finaince his own suppliers and as a result relies on provided LC by buyer for honouring his own account payables to the third party.

American Case law also illustrates the importance of autonomy principle . For Example in *Semetex Corporation v UBAF Arab American Bank*[12],US District court granted Semtex a summary Judgement against the UBAF on the basis of autonomy principle of Irrevocable Letters of Credit depsite the fact that under- lying contract was not performed due to the Executive Order which blocked all Iraqi assets in USA after Iraqi invation to Kuwait on August 2 , 1990. *Power Curber International Ltd v. National Bank of Kuwait SAK*[13]is another case which prohibits applicatant and issuing bank from dishonoring the credit based on non performance of the underlying countract .

### *2.1.1 Uniform Commercial Code of USA*

In United States of America , Documentary Letters of Credit are governed by Article 5 of Uniform Commercial Code . Unlike earlier version of Article 5 of UCC did not point at the autonomy principle[14] revised version of UCC Article 5 clearly separates the undertaking of issuer in documentary letter of credit from existence, non-existence, performance or non-perforance of underlying contract.

> 'the rights and obligations of an issuer to a beneficiary or a nominated person under a letter of credit are independent of the existence, performance, or non-performance of the contract or arrangement out of

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9 *Hamzeh Malas & Sons v. British Imex Industries Ltd* [1958] 2 QB 127; [1958] 2 WLR 100; [1958] 1 All ER 262,C.A.

10 *United City Merchants (Investments) Ltd v Royal Bank Of Canada* [1983] 1AC 168,183

11 *Trans Trust SPRL v Danubian Co Ltd* [1952] 2QB 297 at 304 12 [1995] 2Bank LR73

13 [1981]2 Lloyd's Rep 394.

14 Enonchong, N. (2011). *The independence principle of letters of credit and demand guaran- tees*. Oxford University Press.

which the letter of credit arises or which underlie it, including contracts or arrangements between the issuer and the applicant and between the applicant and the beneficiary'[15].'an issuer is not responsible for the performance ,non-performance of the underlying contract, arrangement, or transaction'[16]

### 2.2 Exceptions to the Autonomy Principle

The autonomy principle provides beneficiary with the guarantee of the bank for payment against any issue within of the terms of documentary Credits[17]. Such guarantee desires payment to the beneficiary regardless to any dispute on the underlying contract, upon tender of complying documents. Therefore, the autonomy principle creates a weaker position for account party against abusive demands of beneficiary and his fraudulent claims. On such occasions, relying on strict compliance principle and rejection of non-complying documents by bank will be the only defense of applicant. However, this defense might not work when the beneficiary is determined to obtain payment on the basis of presenting fraudulent Documents. On the other hand, the beneficiary has the upper hand against the issuing bank and account party in which regardless to any dispute on the contract of sales, he is entitled for payment upon tender of complying documents. Such upper hand can be an incentive for abusive demand for payment or presentation of fraudulent documents by beneficiary. For a long period of time the general belief was supportive towards the absolute nature of independent principle[18]. However, it became clear that exceptions are needed to deal with abusive and fraudulent demands. As result, the fraud exception has been established which is recognized by all common law and many civil law countries. In cases of fraud, court has the obligation to decide between respecting the principle of autonomy and grating injunction to stop payment after considering pub- lic policy, statutes, public interest and third party rights[19]. Despite the fact that Fraud rule is a recognized expectation to principle of autonomy of documentary credits, but there is no standard[20] regarding time and circumstances in which it should supersede the autonomy principle[21]. Later it become clear that exercising the public interest requires application of exceptions in case of illegal underlying

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15 UCC. Article 5-103(d)

16 UCC. Article 5-108(f)(1)

17 Enonchong, N. (2011). *The independence principle of letters of credit and demand guaran*- tees. Oxford University Press93

18 *United City Cooperation v. Allied Arab Bank* (1985) 2 Lloyds Rep .554,561

19 Garcia RLF '*Autonomy principle of the letter of credit'* (2009) Mexican Law Review .69

20 Gao X '*The Fraud Rule in the Law of Letters of Credit: A Comparative Study'* (2002) is the most comprehensive study as regards the issue of the fraud rule;

21 Gao X., & Buckley, R. P. (2003). *Comparative Analysis of the Standard of Fraud Required under the Fraud Rule in Letter of Credit Law*, A. *Duke J. Comp. & Int'l L., 13*, 293.


ISSN 1213-8770 (print), ISSN: 2464-6601 (online).

contract[22]. Therefore, clear evidences show that English Legal system is ready to recognize other exceptions to the principle of autonomy.

## 3 Fraud Exception

In fact, Fraud is very old and well-known phenomenon in the business world. "As long as there have been commercial systems in place there have been those who have tried to manipulate these systems."[23] Fraud has been considered as the "the most controversial and confused area"[24] as it "goes to the very heart" of the letter of credit by providing the bank to look at the facts behind complying presentation of beneficiary and stop payment in cases of fraud in transaction.[25].

### 3.1 The meaning of Fraud

According to the Article 5 of UCP 600, "bank deals with documents not goods or services"[26] which means that "banks deal in written presentations not facts"[27].

Therefore, beneficiary does not have to prove fulfilment of his obligations in underlying contract and only presentation of complying documents will entitle him to receive payment from issuing bank. As a result, strict implementation of autonomy principle will create three distinctive scenarios regarding presentation of documents by beneficiary.

First, beneficiary presents complying documents and performs his obligations under the sales contract with account party. As a result, bank will allow payment after checking documents.

Second, beneficiary presents non-complying documents while performing his obligations under the contract of sales with account party. In such situation, bank may or may not authorize payment to the beneficiary (bank may ask for waiver from account party or corrections from beneficiary).

Third scenario takes place when beneficiary presents complying documents to the terms of credit but does not perform his obligations under sales contract with account party. In such occasion, strict application of autonomy principle might lead us to fraud by beneficiary and injustice towards account party who has to bear the loss as the last person in the chain of transaction.

22 Enonchong N '*The Autonomy Principle of Letters of Credit: An Illegality Exception*?' (2006) Lloyd's Maritime and Commercial Law Quarterly 404

23 *Trade Finance Fraud –Understanding the Threats and reducing the Risk,* A Special Report prepared by the ICC International Maritime Bureau (Paris) 2002, p. 9

24 Buckley RP & Gao X (2002),p. 663 referring to Anon '"Fraud in the Transaction*": Enjoining Letters of Credit during the Iranian Revolution*' 93 (1980) Harvard Law Review. P.92

25 Gao X & Buckley RP (2003), p. 293

26 UCP600, Article 5

27 Harfield.H, *Bank Credits and Acceptances* (5th ed., 1974) New York, p. 69


ISSN 1213-8770 (print), ISSN: 2464-6601 (online).

In such occasions and in order to prevent fraud, the law of letters of credit has created fraud exception to the autonomy principle of letters of credit. However, fraud expiations has been approached by different scholars and national laws in different ways .UCP 600 as the most popular set of applicable rules to documentary letters of credit take an absolute silent position towards fraud rule while leaving it open to the relevant municipal law which show a drastically non harmonious approach to the subject matter . Even the provided definitions for fraud rule are not harmonious. Gao Xiang considers fraud exception in documentary credits as "an extraordinary rule as it represents a departure from the cardinal principle of the law of letters of credits – the principle of independence. It allows the issuer or a court to view the facts behind the face of conforming documents and to disrupt the payment of a letter of credit when fraud is seen to be involved in the transaction"[28]. Schmitthoff mentions that fraud rule "permits a court to consider evidence other than the actual terms and conditions of the credit and is founded on the maxim *ex turpi causanonoritur actio*"[29]. Conveying the mes- sage that fraudulent beneficiary will not be able to find an action based on his wrongdoing. Raymond Jack refers to fraud rule as "exception to the rule that the contracts made in connection with credits are autonomous"[30]

### 3.1 Rational for the Fraud Rule

Gao has defined three rational for establishment and enforcement of fraud rule[31]:

1. **Closing the loophole in law**: Strict application of autonomy principle and providing absolute guarantee for payment to beneficiary upon presentment of complying documents might provide an opportunity for perpetrators of fraud to harm the system of international trade and operation of documentary credits by presenting forged or fraudulent documents to the bank which comply on their face with terms of credit, but do not perform their obligations under the contract of sales with account party[32]. There are doubts about capability of fraud rule to prevent any injustice resulted from fraud, but definitely it will reduce the loophole which has been created by the autonomy principle.[33]
2. **Public Policy**: The second rational for fraud exception is the result of public policy's concern over controlling and defying fraud. There should not be a possibility for fraudster beneficiary to benefit from autonomy

28 Gao X, *The fraud rule in the law of Letters of Credit* (2002) The Hague, p. 30

29 *Schmitthoff's Export Trade – The Law and Practice of International Trade (*12th ed., 2012) Sweet & Maxwell , p.210

30 Malek. A, Quest .D, Jack. *Documentary credits: the law and practice of documentary credits including standby credits, and demand guarantees, Tottle*, 2009

31 Gao X (2002) 29 and 98

32 Ibid 30

33 Ibid


ISSN 1213-8770 (print), ISSN: 2464-6601 (online).

principle while trying to obtain payment by presentation of forged documents.[34] The interest of public policy in prevention of fraud has been reflected in many authorities. Also in *United City Merchants (Investment) Limited v Royal Bank of Canada*[35], Lord Diplock comments on *ex turbi causa non oritur* [36], intention of court not to allow its process to be used by dishonest person to carry out the fraud as basis for the fraud rule.

3. **To Maintain the Commercial Utility of Letters of Credit**. Documentary letters of credit act towards balancing the contradictory interests of beneficiary and applicant. Tendered documents including the bill of lading not only play a significant role in operation of the Letters of Credits but also provide security for the bank before being reimbursed by account party. Therefore, bank's security interest will be abused in case of beneficiary's fraud. As a result, the balance in the operational scheme of documentary letters of credit will be undermined while neither of users will have faith in commercial utility of documentary letters of credit anymore[37].

In response to critics of Fraud Rule who argue about capability of issuing bank and account party to take legal action against beneficiary based on the breach of the underlying contract, supporters of application of fraud rule con- sider such legal action as a valuable alternative because, fraudulent beneficiary "absconds before the fraud or forgery is discovered"[38].

*3.2.1 Sztejn v Henry Schroder Banking Corporation*

The American case of *Sztejn v Henry Schroder Banking Corporation* [39]had a significant role in development of the Fraud rule in documentary letters of credits[40]. Sztejn is considered landmark cases as it has been used in codification of the 1962 version of UCC as well as being basis for judgment in following cases of fraud in documentary credits inside and outside United States of America[41]. According to Gao, "It shaped the fraud rule in 'virtually all jurisdictions".[42]

34 Ibid

35 *United City Merchants (Investment) Limited v Royal Bank of Canada* [1982] 2 All E.R. 725

36 Ex turpi causa non-oritur actio can be translated as 'no action can be based on a disrepu- table cause', Law J & Martin EA 'A Dictionary of Law' 7 ed (2009)

37 Buckley RP & Gao X (2003) Buckley .RP & GAO. X, '*The Development of the Fraud Rule in Letter of Credit Law: The Journey so Far and the Road Ahead*' (2003) 23 U Pa J of Int'l L ,667

38 Ellinger P *'Documentary Credits and Fraudulent Documents'* in Chinkin CM, Davidson RJ et al.eds. 'Current Problems of International Trade Financing' (1983) 191

39 *Sztejn v Henry Schroder Banking Corporation* 31 NYS 2d 631 (1941)

40 Buckley RP & Gao X (2003)676

41 In 1964 version of UUC fraud rule was under Article 5 section 5-114 but after revision of 1995 it is under Article 5, section 5-109.

42 Kelly-Louw, M. (2009). *The documentary nature of demand guarantees and the doctrine of strict compliance* (part 1). *SA Mercantile Law Journal= SA Tydskrif vir Handelsreg, 21*(3), 306–321


ISSN 1213-8770 (print), ISSN: 2464-6601 (online).

In case of Sztejn, underlying contract of sale was between Sztejn (buyer) and Transea Traders Ltd (seller). The payment was due under the letter of credit issued by Schroder by drawing a draft to the Chartered Bank (presenting bank). Sztejn asked for injunction before presentation of documents for payment on the basis of dispatching "cow hair, other worthless material and rubbish with intent to simulate genuine merchandise and defraud the plaintiff "[43]. Sztenjn also men- tioned Chartered bank as colleting bank for Transea Trades not the holder in due course for the draft. However, Chartered Bank defended that the presenting banks "is only concerned with the documents and on their face these conform to the requirements of the letter of credit"[44]. In the course of hearing, all allegations of cases were considered as true by Justice Shientag who rejected the motion to dismiss the complaint of plaintiff by Chartered Bank based on two arguments: allegation that fraud has been commented and established fact that fraud has been committed in the underlying transaction. However, in continuation, he pointed at necessity for overruling the principle of autonomy in case of fraud:

> „Of course, the application of this doctrine [the principle of independence] presupposes that the documents accompanying the draft are genuine and conform in terms to the requirements of the letter of credit."[45]

The Justice Sheintag held that motion of Chartered Bank for dismissing complaint of plaintiff is dismissed as well as injunction was granted to the Sztejn on the basis that :

> „Transea was engaged in a scheme to defraud the plaintiff... that the merchandise shipped by Transea is worthless rubbish and that Char- tered Bank is not an innocent holder of the draft for value but is merely attempting to procure payment of the draft for Transea's account"[46].

Apart from the beneficiary's fraud, two other issues where discussed in the hearing[47]:

First was bank's security interest as one of the supporting reasons behind application of fraud rule. The Justice Shientag mentioned:

> „While the primary factor in the issuance of the letter of credit is. The credit standing of the buyer, the security afforded by the merchandise is also taken into account".[48]

Second issue was exemption of the holder in due course from being subjected to the application of fraud rule.

43 *Sztejn v Henry Schroder Banking Corporation* 31 NYS 2d 631 (1941) 633 44
ibid, 632.
45 Ibid 633
46 Ibid
47 Lu, Lu. "*The Exceptions in Documentary Credits in English Law*." (2011). 75
48 *Sztejn v Henry Schroder Banking Corporation* 31 NYS 2d 631 (1941), 634–635


ISSN 1213-8770 (print), ISSN: 2464-6601 (online).

„On this motion only the complaint is before me and I am bound by its allegation that the Chartered Bank is not a holder in due course but is a mere agent for collection for the account of the seller charged with fraud. Therefore, the Chartered Bank‘s motion to dismiss the complaint must be denied, if it had appeared from the face of the complaint that the bank presenting the draft for payment was a holder in due course, its claim against the bank issuing the letter of credit would not be defeated even though the primary transaction was tainted with fraud.“[49]

Therefore, decision of *Sztejn* established the basic principles of the Fraud Rule which can be listed as below: [50]

1. The payment process and autonomy principle of the letters of credit can be superseded only in case of fraud. However, the fraud should be established and only allegations of fraud will not suffice for interruption of payment.
2. The payment to the holder of due course or presenter with similar status will not be interrupted even in case of established fraud.

However, it should not be forgotten that in cases of *Sztejn* all allegations were considered as fact and as a result issue of the standard of proof for fraud was left open to be one the most controversial issues in application of fraud rule in documentary letters of credits.[51] Therefore, it is possible to conclude that “Shientag J was only making decision for *Sztejn* case where the fraud had been already proved from the beneficiary side and there was doubt about it”[52].

### 3.3 Application of Fraud Exception

In this section, focus will be on application of fraud rule in documentary credits in different Common Law Jurisdictions. Namely, United States of America and England. Although many legal problems have the same symptoms wherever they occur, but their consequences and approaches to solve them can be drastically different from jurisdiction to jurisdiction. [53]. In such situation, comparative study of legal problems like fraud rule in documentary letters of credit can be a good approach to find similarities and differences among common law jurisdictions and try to harmonize them. Although, English Law is strongly influenced by developments of American Law in field of documentary credit’s fraud, but comparative studies which have been done in this area show the significant devi-

49 Ibid

50 Gao X (2002) 42

51 Ibid

52 Lu, Lu. “*The Exceptions in Documentary Credits in English Law.*” (2011).76

*53* Gordley J (1995) ‘*Comparative Legal Research: Its Function in the Development of Harmonized Law’* (1995) 43 American Journal of Comparative Law 560


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ations in application of fraud rule between United States of American, England and other common law countries[54].

*3.3.1 Fraud Rule in American Law*

Development of fraud rule in United States of American law can be categorized under three main time periods: Pre-UCC, The previous UCC Article 5 and Revised UCC Article 5[55].

The period of pre UCC was governed by the case law and it was mostly influenced by the case of *Sztejn* as it has been discussed in previous section.

*Revised UCC Article 5*

In 1995 the UCC article 5 went through revision mostly to overcome existing weaknesses, gaps and errors of the original statute as well as challenges which were the result of constant development of letters of credits[56]. After revision, fraud rule was embodied in UCC article 5 sub – sections 109[57].

By coming into effect of revised UCC article 5 fraud rule went through a significant changes and received moderation from different aspects including[58]:

1. According to Article 5-109, discovery of fraud will disrupt the normal process of documentary letter of credit. Refusing to honour the credit at presentation by issuing bank[59], and request of account party from court to grant injunction in order to prohibit payment.[60]
2. Article 5-109 provides guidance for two of the most controversial aspects in fraud rule. Firstly, it sets the standard of proof as materiality of fraud and also it provides that fraud exception covers fraud in documents as well as underlying contract.[61]
3. In section 5-109 (1) four groups of people are considered immune against application of the fraud rule. "A) Nominated person with good faith who has paid without notice of fraud. B) Confirmer who has honoured its confirmation in good faith C) The holder in due course of the

54 Kelly-Louw, M. (2009). *The documentary nature of demand guarantees and the doctrine of strict compliance* (part 1). *SA Mercantile Law Journal= SA Tydskrif vir Handelsreg, 21*(3), 306–321

55 Gao X & Buckley RP (2003)294

56 Gao Xiang (2002)45

57 UCC article 5 sub – sections 109

58 Buckley RP & Gao X (2002) 686

59 UCC .Section 5-109(a)(2)

60 Section 5-109(b); Gao X (2002) 46

61 Kelly-Louw, M. (2009). *The documentary nature of demand guarantees and the doctrine of strict compliance* (part 1). *SA Mercantile Law Journal= SA Tydskrif vir Handelsreg, 21*(3), 306–321


ISSN 1213-8770 (print), ISSN: 2464-6601 (online).

draft drawn under the letter of credit which was taken after acceptance by the issuer or nominated parson D) an assignee of the issuer or nominated person's deferred obligation that was taken for value and without notice of forgery or material fraud after the obligation was incurred by the issuer or nominated person"[62] . Therefore, all four groups of protected people against fraud rule under revised article 5-109 are relevant unlike three groups of protected people under article 5-114 in which only one group was protected. [63]

4. The article 5-109 (b) defines four preconditions for court in order to award injunction. "Revised UCC Article 5, Section 5-109 now stands as the most comprehensive code of the fraud rule in the law of letter of credits in the common law world"[64].

*3.3.2 The Fraud Rule in English Law*

Fraud rule is governed under the common law in England. Therefore, it has been recognized and considered in British cases.[65] Despite such recognition, traditionally English courts show reluctance in application of fraud rule and take a strict approach towards intervention with autonomy principle. In study of Fraud Rule in English Law, we will review some of the leading cases in this area as well as analysing scope of the application fraud rule under English law.

*Hamzeh Malas and Sons v British Imex Industries Ltd*

The case of *Hamzeh Malas and Sons v British Imex Industries Ltd*[66], is a good example for showing the strict historical approach of the English Courts on intervening in autonomy principle of documentary credits. The case is about buyers who signed a contract of sales for Steel Rods with the defendant seller. Payment was due by two confirmed letters of credits. After making the first payment, plaintiff buyer asked for injunction relief against the beneficiary on the basis of defectives of the first instalment

While rejecting to award injunction in the court of appeal, Jenkins LJ commented on the autonomy principle:

> "An elaborate commercial system has been built up on the footing that bankers'confirmed credits are of that character, and, in my judgment, it would be wrong for this court in the present case to interfere with that established practice [...] That system [...] would break down completely if

62 section 5-109(a)(1)

63 Buckley RP & Gao X (2002)687

64 Kelly-Louw, M. (2009). *The documentary nature of demand guarantees and the doctrine of strict compliance* (part 1). *SA Mercantile Law Journal= SA Tydskrif vir Handelsreg, 21*(3), 306–321

65 Buckley RP & Gao X (2002),687

66 *Hamzeh Malas and Sons v British Imex Industries Ltd* [1958] 2 QB


ISSN 1213-8770 (print), ISSN: 2464-6601 (online).

a dispute as between the vendor and the purchaser was to have the effect of "freezing," if I may use that expression, the sum in respect of which the letter of credit was opened"[68]

*Harbottle (RD) (Mercantile) Ltd v National Westminster Bank Ltd*

In the case of *Harbottle (RD) (Mercantile) Ltd v National Westminster Bank Ltd*[69], Judge Ker reemphasized in the strict approach towards autonomy principle for another time:

"It is only in exceptional cases that the courts will interfere with the machinery of irrevocable obligations assumed by banks. They are the life-blood of international commerce. Such obligations are regarded as collateral to the underlying rights and obligations between the merchants at either end of the banking chain. Except possibly in clear cases of fraud of which the banks have notice, the courts will leave the merchants to settle their disputes under the contracts by litigation or arbitration as available to them or stipulated in the contracts [...] Otherwise, trust in international commerce could be irreparably damaged".[70]

*Edward Owen Engineering Ltd v Barclays Bank International Ltd*

The case of *Edward Owen Engineering Ltd v Barclays Bank International Ltd*[71] is one of the most frequently cited on principle of autonomy in English law. An English supplier in 1976 contracted the sale of greenhouse and their insulations with a Libyan party, Agricultural Development Council of Libya. According to the contract of sales, payment was supposed to be made in the format of an irrevocable documentary credit in favour of the plaintiff at local Libyan bank (Umma Bank). In return, the defendant bank (Barclays) issued a demand guarantee without proof or condition upon the advice of the plaintiff which was sent to the customer. However, the letter of credit opened in favour of seller by Libyan bank was not confirmed. As a result of failing to convince the Libyan party to confirm the letter of credit, plaintiff repudiated the contract of sales. Libyan par- ty raised claims for demand guarantee.

"… The performance guarantee stands on a similar footing to a letter of credit. A bank which gives a performance guarantee must honour that guarantee to its terms. It is not concerned in the least with the relations between the supplier and the customer; nor with the question whether the supplier has performed his contracted obligations or not; nor with the question whether the supplier is in default or not. The bank must pay according to its guarantee, on demand, if so stipulated, without proof or

67 Ibid

68 *Harbottle (RD) (Mercantile) Ltd v National Westminster Bank Ltd* [1978] 1 QB 146.

69 Ibid

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


ISSN 1213-8770 (print), ISSN: 2464-6601 (online).

condition. The only exception is when there is a clear fraud of which the bank has notice."[72]

*Discount Records Ltd. v. Barclays Bank Ltd*

The case of *Discount Records Ltd. v. Barclays Bank Ltd*[73] can be considered the first English case which cited and approved Sztejn[74]. The contract of sales was signed between English buyer and French seller for the purchase of gramo- phone records and cassettes. According to the sales contract, buyer applied to Barclays bank for a letter of credit in favour of the seller. After shipment of goods by seller, he tendered the draft and other documents to the confirming bank in Paris and received the payment. However, in presence of the bank's representa- tive, buyer found goods as non-complying and rubbish. As a result, he applied for injunction against honouring presentation by the issuing bank by referring to the case of *Sztejn* while claiming that seller has perpetrated fraud[75]. In the course of hearing, Judge Megarry considered the case different from *Sztejn* and rejected injunction against bank. According to the Megarry J, fraud was estab- lished in cases of *Sztejn* while in present case, there was mere allegation of fraud[76] "because it is unlikely that any action to which the seller was not a party would contain the evidence reuired resolving this issue"[77]

In the decision of *Discount Records Ltd. v. Barclays Bank Ltd* it was also held that bank's payment has no effect on the buyer's interest as buyer has possibil- ity to claim damages from bank in case of bank's wrong payment to seller[78] Such approach complies with common law practice that court will only issue injunction at the time that it is the final solution and applicant has no other legal resources.[79]

*United City Merchants (Investmen t) Limited v Royal Bank of Canada*

The case of *United City Merchants (Investment)Limited v Royal Bank of Can- ada*[80] is one of the most important and well-known English cases of fraud rule in documentary credits.[81]

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72 Ibid, 171–172

73 *Discount Records Ltd. v Barclays Bank Ltd* [1975] 1 Llyod's Law Reports 444

74 Zhang, Y. *Approaches to Resolving the International Documentary Letters of Credit Fraud Issue.* University of Eastern Finland, 2011.80

75 *Discount Records Ltd v Barclays Bank Ltd* [1975] 1 Llyod's Law Reports 444–446

76 Ibid 447

77 ibid

78 Zhang. Y,( 2011) 81

79 Tóth, Z. "*DOCUMENTARY CREDITS IN INTERNATIONAL COMMERCIAL TRANSAC- TIONS WITH SPECIAL FOCUS ON THE FRAUD RULE*.", 2006, 102

80 *United City Merchants (Investment) Limited v Royal Bank of Canada* [1979] 1 Lloyd's Law Reports 267

81 Ibid


ISSN 1213-8770 (print), ISSN: 2464-6601 (online).

The Facts:

The contract of sales was established between Peruvian buyer Vitrorefuer- zos SA (Vitro) and Glass Fibres, English seller on December 1975. According to the contract the method of Payment was to be irrevocable, transferable letter of credit. The credit was opened by Peruvian bank Banco Continental SA and received confirmation by Royal Bank of Canada. The seller on 2nd December 1976 informed the freight forwarding agent about necessity to ship goods latest on 15th December. However, as the result of the cancelation of original vessel, goods were replaced in another vessel (American Accord) and shipped on 16 of December 1976. The bill of lading was made out by Mr. Backer the employee of the carrier on the date of shipment. The agent changed the date on the face of bill to 15 of December 1976. Bill of lading also mentioned the port of departure as London while in fact goods were shipped from Felixstowe.[82]Credit was dis- honoured after presentation of documents by United City Merchants , assignee of the seller to the bank on the basis that commercial invoice did not comply with terms of credit and also banks information about forged nature of the bill of lading[83]. Plaintiff initiated a legal action against defendant based on wrong- ful dishonouring of the credit and claiming about their lack of knowledge about incorrect date of the face of bill of lading. In the trial court Justice Mocatta ruled for beneficiary[84]. In the court of appeal, judgement was changed in favour of the bank by taking the concept of "Half Way House" which was explained as "between fraud and accuracy namely in inaccuracy in material particular" [85] In the House of Lords, Lord Diplock was delivering the leading speech . He started with describing the nature of autonomous contracts in the framework of the letter of credit's operation while emphasizing the dispute in the goods are not relevant to the right of seller for payment. [86]

> "To this general statement of principle [of independence] [...] there is one established exception: that is, where the seller, for the purpose of drawing on the credit, fraudulently presents to the confirming bank documents that contain, expressly or by implication, material representations of fact that to his knowledge are untrue. Although there does not appear among the English authorities any case in which this exception has been applied, it is well established in them American cases of which the leading or "landmark" case is Sztejn v. J. Henry Schroder Banking Corporation. [...] The exception for fraud on the part of the beneficiary seeking to avail himself of the credit is a clear application of the maxim ex turpi causa

82 Ibid

83 Ibid

84 Ibid

85 Malek A & Quest D '*Documentary Credits – The Law and Practice of Documentary Credits Including Standby Credits and Demand Guarantees*' (2009) ,264

86 *United City Merchants (Investment) Limited v Royal Bank of Canada* [1979] 1 Lloyd's Law Reports

> non oritur actio or, if plain English is to be preferred, "fraud unravels all." The courts will not allow their process to be used by a dishonest person to carry out a fraud"[87]

Since seller had no information about fraudulent act of Mr. Baker in manipulating the true date of shipment on face of the bill of lading and their honest belief in "that it was true and the goods had actually been loaded on or before the 15th of December 1976, as required by the documentary credit"[88] the beneficiaries held innocent and as the final judgment, the House of Lords ruled that: "the instant case … does not fall within the fraud exception" [89]

*United Trading Corporation SA and Murray Clayton Ltd v allied Arab Bank Ltd*

The case of *United Trading Corporation SA and Murray Clayton Ltd v Allied Arab Bank Ltd*[90] introduced the test of "only realistic Inference". The test of only realistic inference received acceptance by deferent judges as a standard of establishing fraud·[91] In the *United Trading Corporation SA and Murray Clayton Ltd v allied Arab Bank Ltd*, Justice Ackner defined the standard of evidence as:

> The evidence of fraud must be clear, both as to the fact of fraud and as to the bank's knowledge. The mere assertion or allegation of fraud would not be sufficient. [...] We would expect the Court to require strong corroborative evidence of the allegation, usually in the form of contemporary documents, particularly those emanating from the buyer."[92]

**3.4 English position on the Fraud Rule in Documentary Letters of Credits:**

Overall observation shows the English courts have restrict and narrow approach towards intervention in autonomy principle of letters of credit. In general scope for the fraud rule under English legal system can be summarised as: [93]

Material representation of the fact that is untrue, Knowledge of the beneficiary, Documentary Fraud versus Fraud in the Underlying contract

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87 Ibid, 301
88 Ibid, 302
89 Ibid, 303
90 *United Trading Corporation SA and Murray Clayton Ltd v Allied Arab Bank Ltd* [1985] 2 Lloyd's Law Reports 554 (CA)
91 Kelly-Louw, M. (2009). *The documentary nature of demand guarantees and the doctrine of strict compliance* (part 1). *SA Mercantile Law Journal= SA Tydskrif vir Handelsreg, 21*(3), 306–321
92 *United Trading Corporation SA and Murray Clayton Ltd v Allied Arab Bank Ltd* [1985] 2 Lloyd's Law Reports 554 , 561
93 Ellinger .P, Noe. D , *The Law and Practice of Documentary Letters of Credit* , (2010) , 141

*3.4.1 Material representation of the fact that is untrue*

In the case of *United Trading Corporation SA and Murray Clayton Ltd v Allied Arab Bank Ltd*, Lord Diplock comments on material misrepresentation when considering the third party fraud.

> "To this general statement of principle [of independence] as to the contractual obligations of the confirming bank to the seller, there is one exception: that is, where the seller, for the purpose of drawing on the credit, fraudulently presents to the confirming bank documents that contain, expressly or by implication, material representations of fact that to his knowledge are untrue"[94].

Accordingly, material misrepresentation to Lord Diplock is a sort of fraud which can invoke the fraud rule under English Law. [95] In an interpretation close to interpretation of the material fraud in official comment on Revised UCC article 5-109, Jack states on meaning of the word Material:

> "Material to the bank's duty to pay, so that if the document stated the truth the bank would be obliged to reject the documents,"[96]

However, interpretation of Jack does not match with the interpretation of Lord Diplock:

> "[T]he answers to the question: "to what must the misstatement in the documents be material?" should be: "material to the price which the goods to which the documents relate would fetch on sale if, failing reimbursement by the buyer, the bank should be driven to realise its security."[97]

It has been suggested that, Lord Diplock's interpretation on material misrepresentation goes back the value of goods. Therefore, in his view predating the bill of lading will not constitute misrepresentation as it has no effect on value of goods[98]. However, Jack's interpretation considers the effect of presentation on duty of bank to pay as material. As a result, statement of true date of shipment in case of predated bill of lading will result in rejection of document by bank[99]. It has been submitted that Jack's interpretation is much stronger argument than interpretation of Lord Diplock.

Material Misrepresentation has been considered as the standard of proof for fraud in documentary credits under English Law and it has been accepted in

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94 (1983) 1 A.C. 168, 183

95 Buckley RP & Gao X (2003) , 324

96 Malek A & Quest D '*Documentary Credits – The Law and Practice of Documentary Credits Including Standby Credits and Demand Guarantees*' (2009) ,254

97 (1983) 1 A.C , P.118

98 Buckley RP & Gao X (2003) , 324

99 Ibid

subsequent cases like *Themehelp Ltd. v. West*[100] and *Banco Santander S.A. v. Bayfern Ltd*[101].

*3.4.2 Knowledge of the beneficiary*

According to the *United City Merchants*, beneficiary was not held responsi- ble formisrepresentation of documents and in fact he was not aware of them[102]. Therefore, it can be interpreted from Lord Diplock's approach that preventing beneficiary from claiming payment will not only include the situation that he was responsible for the fraud , but also at the time of presentation , he should be aware of misrepresentation in tendered documents even if he is not responsible for them.[103]In this respect, degree of beneficiary's knowledge of fraud before being infected by fraud exception can be a concerning problem[104]. "This is likely to require actual knowledge rather than constructive knowledge based on what the beneficiary as a reasonable man should have known. The question of what constitutes actual knowledge should be approached cautiously: a wilful shutting of one's eyes to the truth may in practice lead a court to make a factual finding that the beneficiary did know of the falsity."[105]

*3.4.3 Documentary Fraud versus Fraud in the Underlying Transaction.*

Despite the fact that Lord Diplock in *United City Merchants* emphasized that fraud should be relevant to documents, it is not possible to comprehend whether his lordship raised the issue of documentary fraud only due to the facts of the current case or he wanted it to the requirement for all relevant cases to fraud in documentary credits. Later English cases do not show strong adherence to this issue.[106] For example, in *Czarnikow-Rionda Sugar Trading Inc v Standard Bank London*[107], in Court of Appeal, Rix J discharged the obtained interim injunction by buyer to prevent issuing bank from honoring the presentation based on issues other than fraud allegation not being based on documents.

Scholars argue that as fraud Rule follows the rational of preventing fraudulent beneficiary from benefiting from his own wrong, there is a merit of extending the exception to underlying transaction. However, it must be clearly established that fraud is in connection with credit transaction like fraudulent demand of beneficiary under the credit.[108] The position of other Common law Jurisdic-

100 *ThemehelpLtd. v. West,* (1995) 4 All E.R. 215

101 *Banco Santander S.A. v. Bayfern Ltd,* 1999 WL 250019 (Q.B. June 9, 1999), aff 'd, 2000 WL 191098 (C.A. Feb. 25, 2000)

102 Ellinger .P, Noe. D , The Law and Practice of Documentary Letters of Credit , (2010) , 142 103 Ibid

104 Ibid

105 Ibid

106 Ibid

107 *Czarnikow-Rionda Sugar Trading Inc v Standard Bank London* (1996) 1WRL 1152, 1161 108 Ellinger .P, Noe. D , *The Law and Practice of Documentary Letters of Credit* , (2010) , 143

tions show extension of Fraud Rule to the underlying contract. In United States of America, Revised UCC Article 5-109 extends the fraud rule to documents as well and underlying contract.[109]

> "Requires that the fraudulent aspect of a document be material to a purchaser of that document or that the fraudulent act be significant to the participants in the underlying transaction."[110]

In Canada, Le Dain J from Supreme Court of Canada in case of *Bank of Nova Scotia v. Angelica–Whitewear Ltd*[111] extended the application of fraud rule to the underlying contract.

In contrast, Singaporean courts have taken a narrow approach to the application of fraud rule by limiting it only to fraud in documents. The court of Appeal of Signature In the case of *White and Co Inc vs Chamet Handel Training (S) Pte Ltd*[112] emphasized that fraud sufficient for constituting the exception to the autonomy of irrevocable documentary letters of credit was fraud in presentation of required documents to the bank while obligations of issuing or confirming banks towards the beneficiary will not be affected by the fraud in underlying contract.[113]

## 4 Conclusion

Reason de Etre of the documentary letters of credit can be mentioned as the need of market to an instrument of payment in international business which can mitigate the commercial risk between buyer and seller who do not have any information from financial capacity of each other. As a result, we can witness the development of documentary letters of credits in the course of history as an improvised act of market which has been regulated by customs and usages of the same market. According to UCP, operation of Documentary Letters of Credits is subjected to two main principles of autonomy and strict compliance. While principle of Autonomy tries to protect rights of seller by separating the underlying contract of sales from credit and by requiring buyer to pay first and argue later in case of any problems in fulfilment of underlying contract, the principle of strict compliance protects rights of buyer by requiring seller to provide genuine documents which comply with terms of credit. Interestingly, among common law countries only USA has naturally applicable statute for operation of documentary letter of credits while other countries including England follow the case law system.

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109 Buckley RP & Gao X (2003)317

110 Official Comment to Article 5 of the Uniform Commercial Code, para. 2.

111 *Angelica-Whitewear Ltd v Bank of Nova Scotia 36 D.L.R.* (4th) 161, EYB 1987-67726 112 *White and Co Inc vs Chamet Handel Training* (S) Pte Ltd(1993) 1 SLR 65

113 Ibid

There is still long way to be taken by common law courts ,particularity English Judges should show a harmonized approach to problem of fraud and other exceptions to the principle of autonomy of documentary letters of credit. Cur- rent research took a critical view to such divergent approach of English courts to the relevant issues to fraud rule and compared it with American approach to the same problem based on Article 5 of the Unified Commercial Code. In the course of study, efforts were made to analyse reasons behind historical reluctance of English courts towards intervention into the operation of autonomy princi- ple, absence of harmonized standard of proof for fraud, difficulties in obtaining interim relief from the court and non-recognition of other exceptions. The out- comes of study in this field are of the high importance as existing problems of fraud as the main exception to principle of autonomy may have negative effect on the perception of businessmen at global level on capability of Documentary Letters of Credit in mitigating the commercial risk of international trade.

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*Publication 5* : **Alavi. H, (2016), "Mitigating the Risk of Fraud in Documentary Letters of Credit." Baltic Journal of European Studies 6.1: 139-156.**

# Mitigating the risk of fraud in documentary letters of credit

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**abstract:** *Despite the fact that documentary letters of credit (LC) are meant to facilitate the process of international trade, their specific characteristics may increase the risk of fraud while being used as the method of payment in the process of international transaction. Many factors like exclusive use of documents, geographical distance, absence of efficient prosecution, the diversity of legal system at the global level and restricted application of fraud rule can be considered as reasons for LC fraud. While billions of dollars are lost annually due to fraud in the course of LC operations, such vulnerability can result in reducing the global popularity of documentary letters of credit as the main method of payment used in international trade. Meanwhile, it is worth mentioning that fraud risk management is an unexplored territory in the practice of documentary letters of credit operation. Existing research tries to fill the gap in the study on comprehensive methods for mitigating fraud risk in operations with documentary letters of credit by using risk management theory in order to answer the question of how to manage fraud risk in LC transactions? In a quest to answer the research question, the paper is divided into two parts: the first part is dedicated to preventive measures while the latter explores responsive measures of an enterprise to manage fraud risk in LC transactions.*

**Keywords:** *documentary letters of credit, fraud, international trade, risk management*

 

# 1. introduction

Risk has been attributed to uncertainty (Crockford, 1980) and risk management in the business world is defined as managing the risks of an enterprise on the way to achieve its objectives (Monahan, 2008). In order to manage risk, it is necessary to have a proper understanding of factors contributing to risk, such as risk-driving controls, probable events which take place in the presence of risk and, finally, possible outcomes. The logical steps to manage an existing risk are: risk identification, risk measurement, risk evaluation and its re-evaluation (Hertz & Howard, 1983, pp. 11–17). In addition, it is recommended to reduce the probability of the occurring risk via putting a ban on risky activities, reducing any activity which might result in a risk occurrence, and conducting a thorough analysis of all factors which contribute to the risky nature of the company's activities (Crouch & Wison, 1982, pp. 195–201). As a result, researchers recommend applying risk management techniques as an integral part of business activities (Carey & Turnbull, 2001).

In fact, fraud is one of the oldest and best-known phenomena in the business world. "As long as there have been commercial systems in place, there have been those who have tried to manipulate these systems" (ICC International Maritime Bureau, 2002). Due to the huge costs that fraud might impose on small and large enterprises, it has been argued by Spencer Pickett (2006) that it should be put at the center stage. However, evidence shows that many companies involved in international trade have failed to elaborate the risk of fraud in the framework of their enterprise risk management (ERM). Controversially, the risk of fraud and its potential cost for an enterprise will increase if a less serious attitude is taken towards it. The essential elements in a company which result in vulnerability to fraud risk are: weak controls, dishonest employees, lack of clarity regarding company resources and negligent managers. Fraudsters victimize companies which do not employ proper control measures and protect themselves from law enforcement bodies by finding legal loopholes in particular jurisdictions (ICC Commercial Crime Services, 2002). Especially companies active in international trade are advised to consider risk of fraud seriously and implement sound anti-fraud measures in order to reduce the possibility of being a fraud victim. In comparison to domestic trade, risk of fraud in international trade is much higher due to factors like the geographical distance between parties, the use of other methods of payment based on documents rather than cash or payment in advance, and the lack of efficient prosecution and diversity of legal systems

According to the American Institute of Certified Public Accountants (AICPA, 2009), a sound anti-fraud policy should adopt four main measures, including prevention, detection, deterrence and response. However, effective fraud risk management policy will be considered to be the one which can prevent the fraud and its costly consequences before its actualization. Since none of fraud preventive measures are fully accountable, it is necessary to include a response plan in the policy of fraud risk management by providing the employees proper instruction and information.

## 2. fraud in documentary letters of credit

Documentary letters of credit, or LCs, are widely used in international trade as a means of financing and payment. Although they are supposed to facilitate the process of international trade by shifting the payment risk from the applicant buyer to the payment guarantee offered by the bank, the sole reliance of the bank on the presentation of complying documents with LC requirement and the absolute application of the principle of independence will make them vulnerable to the risk of fraud. The principle of independence of documentary credits separates the obligation of the issuing bank in making payment to the beneficiary from obligations of the beneficiary to the account party under the contract of sales. According to Article 5 of the Uniform Customs and Practice for Documentary Credits, UCP 600, "banks deal with documents not goods or services", which means that banks "deal with written presentation not fact" (Harfield, 1974, p. 69). Therefore, a beneficiary does not need to prove fulfilment of his obligation in an underlying contract and only presenting the complying documents will entitle him to receive a payment from the issuing bank. Fraud has been considered as the "most controversial and confused area" (*Harvard Law Review*, 1980) as it goes to the very heart of documentary credit by obliging the bank to look at the facts behind complying presentation and stop payment in cases of fraud in transaction" (Buckley & Gao, 2002, p. 66). A report of the United Nations' Conference on Trade and Development (UNCTAD, 2009) considers buyers as victims of fraud in LC transactions, while defining four types of LC frauds as the most popular methods of defrauding account parties in international trade: the first is a falsification of documents by the beneficiary in order to obtain the payment from the issuing bank when no cargo exists in practice. The second is when the goods delivered by the beneficiary do not comply with the contract of sales in quantity and quality. The third is selling the same cargo to more than one person, and the fourth is issuing a document

of title (bill of lading) twice for the same cargo. Additionally, banks have also been reported as frequent victims of fraud in LC transactions (Ellen, 1998, p. 1). According to an UNCTAD report, fraudsters fabricate patterns of international trade by heavy investments during a few years and then defraud bankers who are only focused on documents (UNCTAD, 2003).

Fraud in LC transactions is becoming more and more sophisticated and new fraud schemes are developed constantly (Mukundan, 2009). In this respect, there are two main problems which should be addressed. First, there is no internationally accepted legal regime for combating fraud risk in LC transactions and it is covered under national rules.[1] Second, prevention of fraud in LC transactions has not been explored thoroughly by researchers. The increasing number of cases of fraud in international LC transactions has resulted in recognition of fraud rule as the first and foremost exception to the principle of independence of LCs. While on the one hand, there is no harmonious attitude towards fraud rule in different jurisdictions, on the other hand, the high number of legal cases will undermine the popularity of documentary letters of credit as a major tool in trade finance. Therefore, current research will try to use risk management theory for the purpose of reducing fraud risk in international LC transactions and seek answer to the question of which are best practices in mitigating the risk of fraud in international LC transaction.

## 3. Grounds for fraud in international lc transaction

Fraudsters might affect any of parties involved in international LC transactions. Despite the fact that in the majority of cases the applicant is considered a victim of fraudulent activities, development of new fraud schemes has resulted in an increasing number of legal cases with beneficiary and banks as fraud victims. Different discovered grounds for fraud in international LC transaction will be discussed as follows.

[1] Unified Customs and Practices in Practice of Documentary Letters of Credit (currently, UCP 600) as the most internationally popular set of rules in LC operation takes an absolute silent position regarding fraud and the UNCITRAL Convention on Bank Gaurantees and Standby Credits does not cover commercial documentary letters of credit.

### 3.1 defrauding applicant

On the basis of an underlying international sales contract, the buyer applies for opening the credit in favor of the seller. The documentary nature of LC can be a good motivation to an ill-fated beneficiary to defraud the applicant by submission of conforming documents to the bank without fulfilling his commitments in the underlying sales contract and shipping goods to the buyer. Since it will take time for the ship to cover the distance between the port of departure and the port of destination, the applicant buyer will be informed about the forged nature of the documents tendered by the beneficiary to the bank long after credit negotiation (Godier, 2001). Other techniques for defrauding the applicant buyer have been explained in the UNCTAD 2003 Report (UNCTAD, 2003).

### 3.2 defrauding the issuing bank

In the process of the documentary letter of credit's operation, the beneficiary seller should submit original negotiation documents of title either to the issuing bank in the applicant's country or to the confirming, negotiating, or advising bank in his own country. Meanwhile, the beneficiary will dispatch a non-negotiable set of documents of title to the applicant in order to advise him regarding name of ship and approximate date of its arrival at the port of destination. An ill-fated applicant can forge original documents of title on the basis of non-negotiable ones which has been received from the seller, present them to the carrier upon the arrival of the ship at the port of destination and receive a delivery order of releasing the goods while leaving the bank with a liability to make the payment to the beneficiary (Demir-Araz, 2002).

### 3.3 Defrauding the confirming bank

In the famous cases of *Banco Santander S.A. v Bayfern Ltd* [1999], the beneficiary negotiated complying documents of a deferred payment letter of credit to Banco Santander, which was the confirming bank in the abovementioned credit. Upon maturity of the credit, Banco Santander required a payment from the issuing bank, which was denied due to the submission of fraudulent documents. Decision of the court in the case of *Banco Santander SA v Banque Paribas* was in favor of the issuing bank and ruled that the issuing bank was right in withholding payment to the confirming bank. However, in the recent revision of UCP (UCP 600, Art. 7C), the issuing bank is mandated to reimburse the confirming bank in case of honoring deferred credits before maturity.

### 3.4 defrauding the insurance company

Fraudulent parties can enter into contract of sales, ship no goods, scuttle the vessel on the way to the port of destination and claim damages from an insurance company. It is also possible to sell shipped goods to a third party and then scuttle the ship after redirecting it and claim damages from the insurance company (Demir-Araz, 2002).

## 4. fraud risk management in documentary letters of credit

As it has already been discussed, effective fraud risk management strategy includes four main elements of prevention, detection, deterrence and response (AICPA, 2009). In the framework of documentary letters of credit, such effective anti-fraud strategy will be more relevant to prevention and response. The next segment of current research will focus on preventive anti-fraud strategies for different parties involved in operation of documentary letters of credit.

### 4.1 preventive measures for banks

As it has been mentioned already, Article 5 of UCP 600 stipulates that in order to honor a credit, banks deal only with documents, not goods or services. In accordance with Article 5, Article 14(a) of UCP 600 on standards for examination of documents mentions that: "A nominated bank acting on its nomination, a confirming bank if any and the issuing bank must examine the presentation to determine, on the basis of documents alone, whether or not the documents appear to constitute a complying presentation". The emphasis of UCP 600 on separating credit from its underlying contact and limiting duty of bank to check the presentation of complying documents on their face follows the goal of facilitating the process of international trade and increasing the speed of cross-border transactions. On the other hand, it will result in the vulnerability of documentary letter of credit to fraudulent conduct of ill-fated beneficiaries. Altogether, limiting the duty of banks only to examine the presented documents on their face and taking an absolute silent position towards the risk of fraud in LC transactions has resulted in criticism of UCP 600 by many scholars. Shoia Lin Kuo comments on the necessity to extend the banks duty to check performance of beneficiary in fulfilling his promises in underlying contract rather than just dealing with documents in order to prevent fraud risk in international trade and operation of documentary letter of credits (Demir-Araz, 2002). Gao and

Buckley (2002, p. 66) also raise the issue of a need to include the fraud rule in the next versions of UCP.

### 4.1.1 offer of "super service"

Yanan Zhang (2012) recommends banks to offer a "super service" in order prevent the risk of fraud. Offering a bank "super service" to mitigate the risk of fraud in LC transactions was first proposed by UNCTAD in the 1980s (UNCTAD, 1983). Such a service entailed assuming responsibility of investigating the authenticity, accuracy and validity of presented documents by the beneficiary before undertaking payment. Offering a bank "super service" has received many criticisms, including the lack of capability for the bank to look behind documents and check their authenticity, existence of doubt about the effectiveness of "super service" to prevent fraud, high costs of providing such service, access of bank to sufficient communication networks in order to collect sufficient information about the authenticity of documents and signatures from agents, shippers, freight forwarders, buyers and sellers globally, and the existence of demand for such service.

As a result, offering such banking "super service" will have direct relations with customer demand and available resources for banks. Currently, some banks offer "super service" on optional basis.

### 4.1.2 further investigations

Banks are generally affected by LC fraud in two ways. Either the bank's interests are threatened by a loss of defrauded applicant who will go bankrupt while not being able to reimburse the bank, or the applicant and the beneficiary collude together in order to defraud the bank (Todd, 1996). In both situations, the bank's interest is towards further investigation of the financial standing of the parties of the documentary LC as well as conducting individual investigations in nature transactions by their customers which might result in finding clues towards fraud or discovering discrepancies in documents presented by the beneficiary. However, such further investigations need time and sufficient qualified personnel, which, in practice, interprets as additional costs and less profit for the bank processing the LC transaction.

### 4.1.3 More awareness in conducting daily business

Banks are recommended to be prudent and aware in the course of conducting their daily business. The first step in increasing awareness among bank employees is offering fraud detective educational program (Liu, 2006, p. 21). Conducting proper check on the credibility of LC applicants is another measure which will

increase the bank's awareness against fraudsters. Additionally, occasional check on documents presented by new clients, such as a random check of bill of lading presented by a less-known beneficiary, is recommended (Mukundan, 2008). Banks are also recommended to apply the fraud exception rule in the condition of receiving precise information about intention to conduct fraudulent claim before making payment to the beneficiary.

### 4.1.4 commercial crime service of the icc

The commercial crime division (CCS) of the International Chamber of Commerce (ICC) provides free service to its bank members (Islam & Ahamed, 2008, p. 7). The issuing and confirming banks can always send complying documents presented by the beneficiary for authenticity check to the CCS. Since the CCS has access to databases of information from different parts of the world, asking it to perform an authenticity check on confirming documents presented to the bank will reduce the risk of fraud.

## *4.2 preventive measures for the applicant*

It has been constantly argued that the majority of LC fraud cases in the current status of international trade are targeted to the importer, buyer or applicant of documentary letter of credit. Therefore, it is worth studying fraud preventive measures which can be taken by the applicant in a comprehensive manner. As an accepted rule of thumb, preventive measures can be justified only in the case that their application will prevent higher expenses than their own costs. Therefore, the applicant is strongly advised to apply a thorough and comparative cost-benefit analysis before choosing any preventive measure to use. Having a complete picture about the expected costs of preventive measures can help an applicant makes a rational decision as to which measure of combination of measures to choose. The most important preventive measures which can help an applicant to mitigate the risk of fraud in LC transaction are the following: studying the financial standing of the beneficiary, checking the location and condition of the contractual vehicle, employing independent inspectors, accepting time drafts instead of sight drafts, imposing the condition of "sales on approval" in the contract of sales, checking the authenticity of bill of lading, demanding carrier to dispatch the bill of lading to the bank, require performance guarantee, and use export credit insurance.

### 4.2.1 Checking the financial standing of the beneficiary

The buyer is strongly recommended to conduct an extensive investigation on the financial standing of their business partner before entering into any contract with them (Xinqing, 2007). Applicants must consider that the existing cost of gathering information on credit-worthiness of their trade partner is much lower than a future loss as a result of being defrauded by an ill-fated beneficiary. Therefore, it will be beneficial for the applicant to bear costs of preliminary investigations in order to choose a trustworthy partner in international business transactions.

### 4.2.2 Employing independent inspectors

In the operation of documentary letters of credit, the bank will honor complying presentation only based on documents which are handed over by the beneficiary. This mode of operation might result in presenting complying documents by the seller without fully performing his obligations based on the underlying contract. In order to reduce the risk of payment based on forged documents or documents which incorrectly prove the fulfilment of the seller's obligation based on the underlying contract, applicants are advised to employ an independent inspector and insert in the contract the condition of presenting third-party independent inspection certificate to honor the credit by the issuing bank (Nelson, 2000, p. 48).

Independent inspectors can provide a different range of services and certificates including the determination of the quality and quantity of goods, proof of loading the goods, the determination of components and packaging of goods, etc. Employing independent inspectors is costly based on the bargaining power of parties; however, it would be possible to share costs of inspection on the basis of negotiations.

### 4.2.3 acceptance of time drafts instead of sight drafts

While in presenting sight drafts, the beneficiary will be paid immediately, in the operation of time drafts there a gap between presentations of draft by the beneficiary and honoring the credit by the issuing or the confirming bank. Application of a sight draft will make the inspection of goods by the buyer impossible and creates a chance of fraudulent conduct by the beneficiary. Therefore, in the operation of documentary letters of credit, applicants are advised to accept time drafts instead of sight drafts and, in this way, stop payment after discovering any possible fraud between the date of arrival of goods and the date of payment (Murray, 1993, p. 509). Another option is to include a provision

in LC that permits honoring or complying the presentation to the beneficiary in a certain number of days after the presentation in order to provide necessary time for the applicant to verify the intended facts (Ying, 2003, pp. 46, 48). This way, the applicant will have a possibility to check the quality and quantity of delivered goods and apply for injunction in case of any unconformity with the underlying contract.

### 4.2.4 checking the position and capacity of the contractual vehicle

The buyer is advised to insert provisions regarding the name of the contracted vehicle and date of shipment in the underlying contract (Xiaorong & Ruiping, 2005). By agreeing to insert such clauses in the underlying contract, the applicant will have the chance to use databases such as the Lloyd's List Intelligence in order to confirm the location of the ship, its availability, its capacity and the possible date of arrival to the port of destination.

Additionally, the buyer should be aware of different terms of shipment and allocation of risks and liabilities to each partner accordingly. Extensive knowledge of trade and shipping terms can be a huge advantage for the buyer. For example, while preparing the contract of sales, buyers are recommended to use FOB terms instead of CIF terms in order to have maximum control over the shipped consignment (Ruiting & Yunqing, 2005, p. 218).

### 4.2.5 Confirming the authenticity of a bill of lading

It is customary for buyers to ask a copy of the bill of lading and other documents of title to be emailed by the beneficiary before their presentation to the bank (Mukundan, 2008). Access to such documents will allow the buyer to determine the authenticity of them as well as their issuing body (Murray, 1993, p. 509).

The buyer is recommended to conduct a search on authenticity of the carrier's address and phone numbers besides legally recording the conversation with the issuer while confirming the authenticity of the bill of lading.

### 4.2.6 obliging the carrier to dispatch the bill of lading to the bank

In some cases, the carrier provides the shipper (beneficiary of his agent) with a blank copy of the bill of lading long before the shipment is to take place. In such a condition, the risk of fraud will be very high as the beneficiary has access to a blank document of title and without any problem can fill it up and sign in the name of the carrier's agent (Murray, 1993, p. 509). As a result, in order to reduce the risk of fraud, the buyer is recommended to insert a provision in the contract of sales which conditions honoring the credit to the delivery of the bill

of lading to the bank by the carrier. However, like all other preventive measures, delivery of a bill of lading to the bank by the carrier is not an absolute measure to prevent fraud, since no one has control over a situation in which the carrier and the beneficiary are both involved in a conspiracy of delivering a false bill of lading to the bank.

### 4.2.7 application of the 'sales on approval' clause

Originally, the sales on approval clause has been included in international sales contracts for the purpose of examining the quality of delivered goods to the buyer in return to the payment to the seller. In such a condition, the seller will receive the payment after the buyer has approved the conformity of the delivered goods with the terms of the underlying contract. However, such a clause can also be used in order to prevent payment against nonexisting goods to fraudulent seller (Murray, 1993, p. 509). Therefore, the applicant buyers are recommended to insert a provision of sales on approval in their underlying contract of sales.

Despite all criticisms related to the inclusion of sales on approval clause in LC and the underlying contract against the autonomy principle of documentary letters of credit, the existence of such a provision (as an effective strategy) will provide the buyer with a legal basis to prevent honoring the presentation of fraudulent beneficiary by the bank and prohibit the bank from effectuating the payment.

The decision of the UK court in the case of *Sirius International Insurance Corp v FAI General Insurance Co Ltd.* [2003] was in favor of inserting the sales on approval clause into the underlying sales contract. Jacob J of the court of first instance decided that the principle of autonomy will not cover the condition in which the beneficiary has expressly agreed in the underlying contract that he cannot draw down the amount of LC without agreement of applicant. The decision was confirmed by the Court of Appeal.

### 4.2.8 obtaining export credit insurance

Buyers may apply for export credit insurance which is provided by the government and private institutions as well as obtain an insurance policy from insurance companies in order to mitigate the risk of fraud by beneficiary in an LC transaction. Insurance is considered as one of the most significant tools used in practice of risk management by shifting risks from the buyer to the insurance company (Young & Tippins, 2001). Unfortunately, many insurance companies do not offer suitable insurance policies against fraud risk in LC transaction. Insurance companies either do not insure the LC fraud or insure it with very

high premiums. Some insurance companies require a chain of transactions to be insured instead of one single transaction that will impose significant costs on the LC applicant.

By supporting importer and exporter at the same time, expert credit insurance plays an important role in facilitation of international trade. Export credit insurance services are provided by different institutions in different countries while they generally cover import, export and foreign investment risks. According to Van Houtte (2002), the main areas of risk coverage by export credit insurance include three categories: (1) Commercial and business risk: insolvency of the buyer, unwillingness of the buyer to pay and failure to perform the contract adequately; (2) political and country risk; and (3) financial and currency risks.

Fraud risk in a LC transaction can be categorized under a failure to perform the contract if the payment for nonexistent goods is the seller's failure to fulfill the contract of sales. Therefore, depending on the terms and conditions of export credit insurance, coverage will be provided for such failure.

### 4.2.9 requiring the electronic submission of conforming documents

The process of documentary letter of credit transaction is overwhelmed with extreme amount of paperwork which is not only time-consuming but also inefficient and vulnerable to fraud (Christensen, 2003, p. 3). In order to solve this problem, the BOLERO project was introduced in 1999 (Islam & Ahamed, 2008). BOLERO is a secure cross-industry platform for transfer of information which is owned by the SWIFT and TT Club (Insurer of ship-owners, terminal operators, freight forwarders and port authorities)(Godier, 2000, p. 1). The main idea behind the introduction of the BOLERO is reducing paperwork, vulnerability to fraud and secure delivery of documents of trade in electronic format. Legal framework of electronic presentation of documents in LC operation has been introduced by the ICC as eUCP. BOLERO can be an efficient and effective solution to manage the risk of fraud for all parties of international LC transaction (bank, buyer and seller) despite insignificant cost of using it. Buyers can require electronic presentation of documents which will reduce the risk of fraud due to higher security of digital signatures and use of other cryptographic techniques (Collyer, 2003, p. 1).

## *4.3 Preventive measures for the beneficiary*

### 4.3.1 doing business with reliable buyers

Trading with a reliable business partner is considered the most useful fraud prevention measure for either party in international transaction of documentary letters of credit. A beneficiary may access information about the financial standing and business history of new buyers from local banks and professional institutions which provide information on business credibility (Cheng & Xiao, 2008). Such information will be of utmost importance when the buying business partner is an intermediary. Therefore, doing research on its financial standing and business history becomes vital in fraud risk management.

### 4.3.2 conducting a thorough check on details of lc before accepting its terms

After receiving the letter of credit, a beneficiary should check all the details of LC clauses with due care. Also, the beneficiary needs to allocate enough time to apply for necessary amendments which prevent difficulties in preparation of confirming documents. In checking the LC clauses, two main issues should be considered by the beneficiary. First of all, the validity of the letter of credit should be approved. Validity check of an LC includes terms for effectuating payment, credibility of the issuing bank and proper period of validity. Later on, the beneficiary or his employees should conduct due checks on conformity of LC clauses with underlying international sales contract (Hu, 2007).

In case of defining any discrepancy or soft clauses in LC, the beneficiary should inform the applicant immediately and require amendments. Consecutively, the deadline for amendments should be clarified by the seller as well as any new required guarantee and extension of LCs expiry date due to delays caused as a result of required amendment (Cheng, 2007). The beneficiary has the right to claim for damages for breach of underlying contract in case of the applicant's inability to obtain LC with inclusion of required amendments or time or refusal to implement amendments and extend the expiry date.

### 4.3.3 prudence in drafting sales contracts

Underlying international sales contract serves as a foundation of operation of the letter of credit. Therefore, it is recommended that the beneficiary pay enough attention in drafting international sales contract with a particular emphasis on the clarity of required document (Tao, 2009). Such required documents can be bill of lading, commercial invoice, insurance policy, certificate of origin, inspection certificate and any other required document. Additionally, scenario planning and

defining contingency plans in case of raising problems in underlying contract is recommended as a technique used by the beneficiary in order to reduce the risk of fraud.

### 4.3.4 promoting inter-organizational communication and cooperation with banks

LC operation is risky and the beneficiary should be confident that all internal units are aware of existing risks. Such confidence will be achieved only by establishing effective internal communication among different units. It is also advised to the beneficiary to establish cooperative relations with the advising bank. The beneficiary can find out about the "credibility of issuing bank, avoid soft clauses in LC and transfer the risk of fraud in documentary letters of credit" (Ying & Zhiyong, 2003, pp. 44) through cooperation with the advising bank.

### 4.3.5 Defining a criteria to deal with soft clauses

Since there is no global criteria for the classification of LC soft clauses and such clauses are numerous in different stages of LC operation, the beneficiary should manage the risk of soft clauses by defining effective criteria for identification of them in international LC transaction. Availability of such criteria will help the beneficiary to recognize the existence of soft clause in documentary letter of credit, defining its type and recognizing the way to mitigate its risk (Zhang, 2011). Beneficiary sellers are strongly recommended to solve the problem of LC soft clauses before dispatching goods to applicants.

# 5. responding to lc fraud

Even the most advanced preventive measures might fail. Therefore, any party involved in an international LC transaction should have a proper and systematic response system in place to react promptly in case of facing documentary letter of credit fraud (Zhang, 2012). Such systematic response should include different steps including: identification and search for suspected signals, and determining the reality of the situation via approach to foreign banks, shipping and cargo agents, brokers, maritime organizations such as the Lloyd's List, etc. The next step can be investigating facts in the country of the fraudster, taking legal action against the fraudster, applying for interim injunction in order to freeze the fraudster's financial assets (Yuqun & Zhenying, 1999, p. 312).

## 6. conclusion

Fraud can impose significant costs on the enterprise. Therefore it is recommended to include fraud risk in the core of the enterprise risk management (ERM) program. Proper fraud risk management contains effective preventive and responsive measures which also apply to fraud risk management programs applied to documentary letters of credit. There are many reasons for the vulnerability of international LC transactions to fraud risk, including the banks' sole reliance on documents, the geographical distance between the applicant and the beneficiary, lack of globally accepted legal framework to prevent and respond to risk of fraud in LC transaction. Therefore, all parties involved in operation of documentary letters of credit are required to implement necessary preventive and responsive measures in order to mitigate the risk of LC fraud. In addition to analyzing theoretical aspects of fraud in documentary letters of credit, this paper tried to explore different methods for mitigating fraud risk by taking a look at various preventive methods which can be applied by applicants, beneficiaries and banks to minimize the occurrence of fraud as well as the different steps that an enterprise should take while being defrauded.

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***Publication 6*** : **Alavi, H. (2016). Exceptions to Principle of Autonomy in Documentary Letters of Credit; a Comparative View.** ***Actual Probs. Econ. & L. 10 (3),*** **123-150**

# ГРАЖДАНСКОЕ ПРАВО / CIVIL LAW

**УДК 339.7:347.73./76** **DOI: http://dx.doi.org/10.21202/1993-047X.10.2016.3.123-150**

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## EXCEPTIONS TO PRINCIPLE OF AUTONOMY IN DOCUMENTARY LETTERS OF CREDIT; A COMPARATIVE VIEW

**Objective:** comparative analysis of exceptions to the principle of autonomy of documentary letters of credit.

**Methods:** dialectical method, systemic method, analysis, synthesis, comparison.

**Results:** it is proved that documentary letters of credit are among the most popular methods of payment in international trade which facilitate the process of transaction by replacing risk of payment by applicant buyer with the guarantee of bank. It is proved that operation of documentary letters of credit (LC) is subjected to two globally recognized principles of autonomy (independence) and strict compliance. A rule is identified, according to which courts in different countries started to recognize exceptions to the principle of autonomy in international LC transaction despite their reluctance in interfering in function of autonomy principle. **Scientific novelty:** the article views the principle of autonomy and recognized exceptions to it in comparative aspect, proves the to recognize exceptions to the principle of autonomy in international LC transaction among common law jurisdictions, lists the exceptions recognized by courts and analyzes the attitude of the courts in other common law jurisdictions.

**Practical significance:** the paper is addressed to researchers and educators, practicing lawyers, graduate and post-graduate students, and everyone interested in the principle of autonomy of documentary letters of credit.

**Keywords:** Civil law; Documentary letter of credit; Principle of autonomy; Principle of strict compliance; International

trade; Methods of payment; International transactions.

## *Introduction*

According to Uniform Customs and Practices for Documentary Letters of Credit (current version UCP 600) LC operation as a method of payment in international trade is subjected to two main principles of autonomy and strict compliance. Different articles of UCP 600 refer to principle of strict compliance by emphasizing the obligation of the issuning bank to honour the presentation of stipulated documents in the credit by benefeciary only under the condition that all presented documents are compleltly conform with the stipulated condition in the credit itself[1]. As a result, the bank that pays against presentation of documents under LC operation will be eligible for reimbursement by applicant only when the examination of documents prove their strict compliance with credit requirements. Article 14 of UCP 600 defines the standard for examination and clarification of their compliance with credit requirements:

"Standard for Examination of Documents:

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

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

[1] Interalia Article 2; Article 7(a), Article 8(a)(c) and Article 15; Article 14 and Article 34 of UCP 600.

In fact, principle of strict compliance protects applicant's interest where it is necessary to be sure that shipped goods by beneficiary seller are fulfilling requirements of order by applicant buyer in the underlying contract. However, Principle of Autonomy as the main focus of this paper will take the position in which banks only rely on presented documents by beneficiary in order to authorize the payment rather than being concerned with fulfilment of underlying contract. Scholars consider the Principle of Autonomy in international LC transaction as "corner stone in commercial validity of the letters of credit"[2]as well as the "engine behind the letter of credit"[1]. Article 4 of UCP 600 clearly defines Principle of Autonomy as:

"Credits vs. Contracts

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

According to the Principle of Autonomy, and explicit text of Article 4 of UCP 600, beneficiary receives the guarantee to be paid after presentation of complying documents stipulated in the credit to the bank when neither applicant nor issuing bank can deny payment to him with reference to his failure in fulfilling his obligations in underlying contract. Therefore, it is possible to conclude that Principle of Autonomy is a mean of promoting international trade on the basis of "pay first, argue later" [2]. Autonomy principle is recognized in different jurisdictions. For example, it has been established in many English cases including *Hamzeh Malas & Sons vs. British Imex Industries Ltd*[3], *United City merchants (Investment) Ltd vs. Royal Bank of Canada*[4], *Trans Trust SPRL vs. Danubian Co Ltd*[5]. While recognizinng importance of the Autonomy principle in *United City merchants (Investment) Ltd vs. Royal Bank of Canada*[6], Lord Diplock mentioned : 'The whole commercial purpose for which the system of confirmed irrevocable documentary credits have been developed in international trade is to give to the seller an assured right to be paid before he parts with control of the goods that does not permit of any dispute with the buyer as to the performance of the contract of sale being used as a ground for non-payment or reduction or deferment of payment'[7].

In American Law, Operation of Documentary Letters of Credit is governed under Article 5 of revised version of Unified Commercial Code. Despite the fact that former version of UCC did not recognize the Autonomy Principle [3], current version clearly differentiates undertaking of issuing bank from existance, performance or non- performance of underlying contract.

'The rights and obligations of an issuer to a beneficiary or a nominated person under a letter of credit are independent of the existence, performance, or non- performance of the contract or arrangement out of which the letter of credit arises or which underlie it, including contracts or arrangements between the issuer and the applicant and between the applicant and the beneficiary'[8]. 'An issuer is not responsible for the performance ,non- performance of the underlying contract, arrangement, or transaction'[9].

The unconditional and irrevocable guarentee[10] which autonomy principle provides for beneficiary to be paid even before parting from goods subjected to the sales contract (in case of negotiating the credit with negotiation or confirming bank[11]) may result in three different possible conditions: First, beneficiary performs his obligations in the framework of underlying contract and presents complying documents to bank. Outcome will be honouring the credit after due examination of documents by bank. Second, benefeciary performs his obligations in the framework of sales contract but, dose not present complying

[2] *Ward Petroleum Corp. vs. Federal Deposit Inc. Corp* (1990) 903 F. 2d 1299.

[3] *Hamzeh Malas & Sons vs. British Imex Industries Ltd* [1958] 2 QB 127; [1958] 2 WLR 100; [1958] 1 All ER 262, C.A.

[4] *United City Merchants (Investments) Ltd vs. Royal Bank of Canada* [1983] 1AC 168.

[5] *Trans Trust SPRL vs. Danubian Co Ltd* [1952] 2QB 297 at 304

[6] *United City Merchants (Investments) Ltd vs. Royal Bank of Canada* [1983] 1AC 168.

[7] Ibid, p. 183.

[8] UCC. Article 5-103(d).

[9] UCC. Article 5-108(f)(1).

[10] UCP 600. Article 3.

[11] UCP 600/ Article 8.

documents to bank. In this case, presentation may or may not be honoured by bank as the issuing bank has authority to seek for waiver from applicant or ask benefeciary for correction of documents[12]. Thirdpossibility will happen when benefeciary presents complying documents to the bank but does not perform his obligations in the framework of underlying contract.Application of the Principle of Autonomy in such situation will create weaker position for applicant against abusive demands of benefeciary and presentation of forged but complying documents by him. For long period of time, legal scholars supported the a absolute application of the principle of autonomy in operation of Documentary Letters of Credit [13]. However, repetitive legal cases relevant to fraud in international LC transaction resulted in need for recognition of exceptions to the Autonomy Priniciple in order to deal with abusive and fraudulant demands of benefeciary. Fruad rule was the first execption recognized against absolute application of the Autonomy Principle . Despite general recogniation of fraud rule in different jourisdictions, there is no common standard of proof regarding situation under which its application will supersede the autonomy principle [4]. Other exceptions to the principle of autonomy were inroduced later and as result of considering public interest and public policy in international trade operation [5]. Other exceptions to the principle of autonomy in international LC operation include illigality, nulity, uncunciotalble conduct and reclessness of benefeciary. Current article provides a comprehensive and analytical view to different execptinos to the autonomy principle of Documentary Letters of Credit and arguments fore and agaisnt recognizing them in different jourisdictions.

### *Fraud Expection*

Fraud is one of oldest and most well-known phenomenon's in business environment. "As long as there have been commercial systems in place there have been those who have tried to manipulate these systems" [6]. Since fraud goes beyond bank's duty to check presentation of complying documents by beneficiary and investigate in fact regarding performance of his obligation in underlying contract , it was been considered as "the most controversial and confused area" [7] which "goes to the very heart of the Documentary Letters of Credit" [4, p. 293].

Legal scholars and different jurisdictions have approached Fraud Exception to the Autonomy Principle of Documentary Letters of Credit differently. Absolute silence of UCP (current version is UCP 600) as the most popular set of rules applicable to LC transaction towards fraud and leaving the subject matter open to national laws shows the lack of harmoniums approach to the subject matter in international trade society. Such diversity can be seen even in numerous definitions provided for fraud exception: Schmithoff considers fraud rule as an act which"…permits a court to consider evidence other than the actual terms and conditions of the credit and is founded on the maxim *ex turpi causano no ritur actio*"[14]. Meanwhile according to Gao Xinag Fraud Exception is "an extraordinary rule as it represents a departure from the cardinal principle of the law of letters of credits – the principle of independence. It allows the issuer or a court to view the facts behind the face of conforming documents and to disrupt the payment of a letter of credit when fraud is seen to be involved in the transaction" [9, p. 30].

Gao Xiang comments on three different rationales for recognition and enforcement of fraud rule [9, p. 29]: First, closing the legal loophole as result of absolute application of autonomy principle in international operation of LC and providing beneficiary with opportunity to present forged but complying documents to bank in order to receive payment without fulfilling his obligations in underlying contract. Despite existence of strong doubts in capability of fraud rule to prevent fraud and abusive demands of beneficiary, it has the potential for closing the legal loophole created by the autonomy principle. Second rational is concern of Public Policy on controlling fraudulent actions in the society. Beneficiary should not have possibility to get benefit from autonomy principle by presenting forged document [9, p. 29]. In English Case of *United City Merchants (Investment) Limited vs. Royal Bank of Canada*[15] Lord Diplock raised the issues of *ex turbi causa non oritur* which refers to intention of court in not allowing dishonest person to commit fraud

[12] UCP 600, Article 16.

[13] *United City Cooperation vs. Allied Arab Bank* (1985) 2 Lloyds Rep. 554, 561.

[14] *Schmitthoff 's Export Trade – The Law and Practice of International Trade (*12th ed., 2012) Sweet & Maxwell, p. 210.

[15] *United City Merchants (Investment) Limited vs. Royal Bank of Canada* [1982] 2 All E.R. 725.

by benefiting from court procedure[16]. Thirdrational, is maintaining the commercial utility of Letters of Credit. Since presented documents are providing security for bank as guarantor of payment before actual delivery of goods to the port of discharge, committing fraud by beneficiary will abuse the security interest of bank. Therefore, providing beneficiary with chance to defraud bank via presentation of forged documents, will result in losing faith of all parties in operation of Documentary Letters of Credit as a safe method of payment in international trade [7].

### *1. Application of Fraud Rule*

This section takes a comparative approach to application of fraud rule in different jurisdictions, namely, United States of America and England. Despite the fact that English law is under the influence of developments in American law in field of Documentary Letters of Credit, studies show significant differences in application and consequences of application of fraud rule under American and English law. Despite the fact that research on application Fraud Exception in LC operation under Civil Law and comparative study of it with Common law system can add a substantial value to subject matter, it is not in the scope current research. Therefore, our study will be limited to application of fraud expectation to autonomy principle in international LC transactions under Common Law Jurisdictions.

#### *1.1. Fraud Rule in the United States of America*

Development of Fraud rule under American law can be tracked in three main periods: Pre-UCC,The Previous UCC Article 5 and Revised UCC Article 5 [7, p. 294].

During the period of Pre-UCC, Fraud Rule was governed by case law in the United States. The leading case in this aspect was *Sztejn vs. Henry Schroder Banking Corporation*[17]. Gao refers to it as: "It has shaped the fraud rule in virtually all jurisdictions" [9, p. 32].

In this case, sales contract was signed between Sztejn (applicant) and Transea Traders Ltd (beneficiary) where the Schroder as issuing bank of credit required its honour by drawing draft on Chartered Bank(presenting bank). Before presentation of documents by beneficiary, Sztejn required court to grant injunction for stopping payment based on dispatch of "cow hair, other worthless material and rubbish with intent to simulate genuine merchandise and defraud the plaintiff"[18]. It was also mentioned that Chartered Bank cannot be recognised as holder in due course because it is only collecting bank for beneficiary (Transea). Justice Shinetag considered all allegations in the course of hearing as true and commented: "Of course, the application of this doctrine [the principle of independence] presupposes that the documents accompanying the draft are genuine and conform in terms to the requirements of the letter of credit"[19].

Later, in the course of hearing, Justice Sheintag granted injunction in favour of Sztejn on the basis of : "Transea was engaged in a scheme to defraud the plaintiff... that the merchandise shipped by Transea is worthless rubbish and that Chartered Bank is not an innocent holder of the draft for value but is merely attempting to procure payment of the draft for Transea's account"[20].

In the case of Sztejn two other issues in addition to beneficiary's fraud were discussed [10]: First was security interest of bank which was raised as a supporting reason for application of fraud rule. According to Justice Sheintag: "While the primary factor in the issuance of the letter of credit is the credit standing of the buyer, the security afforded by the merchandise is also taken into account"[21]. Second issue was exception of holder in due course from being affected in application of fraud rule: "On this motion only the complaint is before me and I am bound by its allegation that the Chartered Bank is not a holder in due course but is a mere agent for collection for the account of the seller charged with fraud. Therefore, the Chartered Bank's motion to dismiss the complaint must be denied, if it had appeared from the face of the complaint that the bank presenting the draft for payment was a holder in due course, its claim against the bank issuing the letter of credit would not be defeated even though the primary transaction was tainted with fraud"[22].

Therefore, it is possible to conclude that in American Law decision of court in Sztejn laid foundation for fraud rule as following:

[16] Ex turpi causa non-orituractio can be translated as 'no action can be based on a disreputable cause', Law J & Martin EA 'A Dictionary of Law' 7 ed (2009).

[17] *Sztejn vs. Henry Schroder Banking Corporation* 31 NYS 2d 631 (1941).

[18] *Sztejn vs. Henry Schroder Banking Corporation* 31 NYS 2d 631 (1941) 633.

[19] Ibid.

[20] Ibid.

[21] *Sztejn vs. Henry Schroder Banking Corporation* 31 NYS 2d 631 (1941), 634–635.

A) Only condition which supersedes the absolute application of autonomy principle is commitment of fraud by beneficiary and in order to apply the exception, fraud should be established whereas only allegations of fraud will not be sufficient for interrupting payment process by bank.

B) Court will not stop payment process to the holder in due course even in case of established fraud by beneficiary.

By introduction of Unified Commercial Code in the United States of America in 1950s, fraud exception in the documentary letters of credit entered the statute under section of 114(2) of Article 5 [11]:

"Unless otherwise agreed when documents appear on their face to comply with the terms of a credit but a required document does not in fact conform to the warranties made on negotiation or transfer of a document of title (Section 7-507) or of a certificated security (Section 8-108) or is forged or fraudulent or there is fraud in the transaction:

(a) the issuer must honor the draft or demand for payment if honor is demanded by a negotiating bank or other holder of the draft or demand which has taken the draft or demand under the credit and under circumstances which would make it a holder in due course (Section 3-302) and in an appropriate case would make it a person to whom a document of title has been duly negotiated (Section 7-502) or a bona fide purchaser of a certificated security (Section 8-302); and

(b) in all other cases as against its customer, an issuer acting in good faith may honor the draft or demand for payment despite notification from the customer of fraud, forgery or other defect not apparent on the face of the documents but a court of appropriate jurisdiction may enjoin such honor".

After revision of Article 5 of UCC in 1995, fraud rule was embodied under section 109 of Article 5. By revision of UCC, fraud rule changed substantially [9, p. 45; 4, p. 315; 11, p. 222]. Currently, principles of fraud exception under the American Law can be listed as below:

First, on the basis of Article 5-109 of the UCC, commitment of fraud will affect the regular process in the operation of documentary letters of credit. The effect include: the refusal of bank to honour the credit after presentation of document by beneficiary[23] and granting injunction to account party in order to interrupt payment by bank [9, p. 46].

[23] UCC. Section 5-109(a)(2).

Second, besides setting standard of proof for fraud, article 5-109 confirms that under American law fraud exception includes fraud in documents as well as in the underlying contract [11, p. 222].

Third, article 5-109(1) defines four groups of immune people to application of fraud exception. "A) Nominated person with good faith who has paid without notice of fraud. B) Confirmer who has honoured its confirmation in good faith C) The holder in due course of the draft drawn under the letter of credit which was taken after acceptance by the issuer or nominated parson D) an assignee of the issuer or nominated person's deferred obligation that was taken for value and without notice of forgery or material fraud after the obligation was incurred by the issuer or nominated person"[24].

Fourth, article 5-109 (b) defines preconditions for granting injunction by court and application of found expectation[25].

Currently, revised article 5-109 of UCC is the most comprehensive code applicable to fraud rule in the Common Law World" [11, p. 242].

*1.2. The Fraud Exception under English Law*

In English law, fraud exception is recognized and considered under common law [7, p. 687]. Despite its recognition, English courts have a tradition of showing reluctance to intervene in autonomy principle and apply fraud exception. This is clearly visible in the study of most well-known legal cases relevant to fraud rule under English law[26].

[24] UCC Article5-109(a)(1).

[25] UCC Article 5-109 (b).

[26] Most famous legal cases relevant to fraud exception under English law can be mention as: *Hamzeh Malas and Sons vs. British Imex Industries Ltd* [1958] 2 QB; *Harbottle (RD) (Mercantile) Ltd vs. National Westminster Bank Ltd* [1978] 1 QB; *Edward Owen Engineering Ltd vs. Barclays Bank International Ltd*. [1978] 1 Lloyd's Rep; *Discount Records Ltd. vs. Barclays Bank Ltd* [1975] 1 Llyod's Law Reports; *Discount Records Ltd vs. Barclays Bank Ltd* [1975] 1 Llyod's Law Reports; *United City Merchants (Investment) Limited vs. Royal Bank of Canada* [1979] 1 Lloyd's Law Reports; *United Trading Corporation SA and Murray Clayton Ltd vs. Allied Arab Bank Ltd* [1985] 2 Lloyd's Law Reports 554 (CA); *Themehelp Ltd. vs. West*, (1995) 4 All E.R. 215;*Banco Santander S.A. vs. Bayfern Ltd,*1999 WL 250019 (Q.B. June 9, 1999), *Czarnikow-Rionda Sugar Trading Inc vs. Standard Bank London* (1996) 1WRL 1152;*Angelica-Whitewear Ltd vs. Bank of Nova Scotia 36 D.L.R*. (4th) 161, EYB 1987;*White and Co Inc vs Chamet Handel Training* (S) Pte Ltd(1993) 1 SLR 65.

As it has been mentioned, English courts have a narrow and restrictive approach to application of fraud exception in operation of documentary letters of credit despite recognizing it. Generally, the scope for application of fraud exception under English Law can be defined in three notes: Material misrepresentation of facts, knowledge of beneficiary, fraud in underlying sales contract vs. documentary fraud [12, p. 141].

*1.2. A) Material Misrepresentation of Facts*

Material Misrepresentation of facts was explained by Lord Diplock in the case of *United Trading Corporation SA and Murray Clayton Ltd vs. Allied Arab Bank Ltd*[27] *as:* "To this general statement of principle [of independence] as to the contractual obligations of the confirming bank to the seller, there is one exception: that is, where the seller, for the purpose of drawing on the credit, fraudulently presents to the confirming bank documents that contain, expressly or by implication, material representations of fact that to his knowledge are untrue"[28].

Despite the fact that there is no agreement on definition of material misrepresentation among scholars in field of English law, it has been recognized as standard of proof for fraud in documentary letters of credit and applied in subsequent cases including: *Themehelp Ltd. vs. West*[29] *and Banco Santander S.A. vs. Bayfern Ltd*[30].

*1.2. B) Knowledge of Beneficiary*

According to the judgment of court in case of *United City Merchants* it is impossible to hold beneficiary responsible for misrepresentation of fact when he does not have any knowledge about such an act [12, p. 142]. Therefore, comments of Lord Diplock can be interpreted as: in order to stop payment to beneficiary , not only he should be responsible for material misrepresentation, but also, he should be knowledgeable about misrepresentation of documents at the time of presentation . Knowledge of beneficiary about existence of material misrepresentation even in circumstances when he is not responsible in producing such documents is sufficient for invoking fraud exception [12, p. 142].

Therefore, it is necessary to define the degree of beneficiary's knowledge prior to apply fraud rule. For this purpose will use the test of reasonable man's decision to clarify the actual knowledge of beneficiary and his approach to misrepresentation of facts. Therefore, a consciously ignoring truth by beneficiary might result in court's decision that he had actual knowledge of falsity [12, p. 142].

*1.2. C) Fraud in Documents versus Fraud in Underlying Contract*

It is not clear from statements of Lord Diplock in *United City Merchants* referring to fraud in documents that his lordship was emphasizing on the facts of that particular case or he was generalizing such condition to all cases of fraud in documentary letters of credit. Latter English cases like *Czarnikow-Rionda Sugar Trading Inc vs. Standard Bank London*[31]*, do not apply this principle strictly as Rix J in the court of Appeal discharged injunction in favour of applicant on the basis of evidences other than non-documentary claim for application of fraud rule*[32]*. It has been argued that due to following the principle of Ex turpi causa non-oritur action*as rational for prohibiting beneficiary from his own action by fraud rule, there is merit in application of extension to underlying contract when it is clearly established that beneficiary's demand under the credit is on the basis of fraud [12, p. 143]. Study of the position of other common law jurisdictions confirms the application of fraud exception to the underlying contract. For example, Revised UCC article 5-109 in the United States of America, confirms application of fraud rule to underlying contract [7, p. 317].

"Requires that the fraudulent aspect of a document be material to a purchaser of that document or that the fraudulent act be significant to the participants in the underlying transaction"[33].

In Canadian case of *Bank of Nova Scotia vs. Angelica-Whitewear Ltd*[34], Le Dain J of the Supreme Court of Canada

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[27] *United Trading Corporation SA and Murray Clayton Ltd vs. Allied Arab Bank Ltd* (1983) 1 A.C. 168.

[28] Ibid, p. 183.

[29] *Themehelp Ltd. vs. West*, (1995) 4 All E.R. 215.

[30] *Banco Santander S.A. vs. Bayfern Ltd,*1999 WL 250019 (Q.B. June 9, 1999), aff'd, 2000 WL 191098 (C.A. Feb. 25,2000).

[31] *Czarnikow-Rionda Sugar Trading Inc vs. Standard Bank London* (1996) 1WRL 1152, 1161.

[32] Ibid.

[33] Official Comment to Article 5 of the Uniform Commercial Code, para. 2.

[34] *Angelica-Whitewear Ltd vs. Bank of Nova Scotia 36 D.L.R.* (4th) 161, EYB 1987.

confirmed application of fraud rule to the underlying contract.

In Singapore, application of fraud rule is limited to fraud in documents. According to the judgement of court of Appeal in *White and Co Inc vs Chamet Handel Training*

*(S) Pte Ltd*[35] in order to constitute the fraud exception to the autonomy principle evidence is limited to documents presented by beneficiary and fraud in underlying contract will not affect responsibilities of bank against him[36].

***2. Nullity Exception***

The nullity comes into effect when beneficiary has no knowledge about null or void nature of document in his hand. In contrast, fraud exception has the precondition of [actual] knowledge of beneficiary about the material misrepresentation in tendered documents. The nullity might happen when document is conforming to the terms of the credit on its face; however, it is either a forgery or with no legal effect. Fraud rule cannot apply in the condition that beneficiary has no idea about forged nature of document in his hand and has not played any role in production of such document. As a result, "the question will arise as to whether the nullity exception to the autonomy principle should be recognized in the meaning that bank will be entitled to reject the forged document despite its facial conformity" [12, p. 168].

In this respect, current section of research will study the definition of nullity exception, continue with analysing of some important common law cases, and finally takes critical approach to arguments for and against recognition of nullity Exception.

*2.1. What is Nullity?*

It is not clear how to define the nullity exception. Any sort of definition for nullity will definitely result in bank's resistance to payment under the exception as the document has been considered null and without any effect [13, pp. 316, 317]. As a matter of fact, the nullity is an underdeveloped concept in the law of the documentary letters of credit [13, pp. 316, 317]. Therefore, existing uncertainty around it is a significant reason for difficulties in recognizing the nullity exception in common law system. Examples from English case law demonstrate different understandings about the definition of nullity. The court of *Tek Chao vs. British Traders and Shippers*[37] held that misdated bill of lading is 'valueless but not a complete nullity"[38]. When in *Egyptian International Foreign Trade Co vs. Soplex Wholesale Supplies* (The Raffaella)[39] same type of bill was considered as 'sham piece of paper"[40]. However, in *United City Merchants* a wrongly dated bill of lading was considered as "far from nullity" [3, p. 146]. Therefore, the uncertainty around nullity is quite visible in English law [13, p. 317]. Different suggestions have been proposed by scholars to define the nullity of one document. Including, consideration of whether falsity or error in document destroys the "the whole or essence of the instrument" [14, 15]. Other suggestion is that if the instrument can be considered as without legal effect [16]. On this basis, the Judgment of the *United City Merchants* is in consistency with definition of the nullity as a misdated bill of lading is still a valid document of title and holder can use it in order to receive goods from the ship[41].

*2.2. Legal Recognition*

English Law has three important cases on the nullity exception. Namely, the Court of Appeal and House of Lords decision in *United City Merchants* and the Court of Appeal Decision of *Montrod Ltd vs. Guundk Otter Fleichvertriebs GmbH*[42]. In the case of *United City Merchants* the question about effect of nullitydocuments was left open. However, Ackner LJ in the Court of Appeal commented that: "he could see no valid basis upon which the bank should be entitled to pay and debit the account party (…) (The bank) ought not to be under no obligation to accept or pay against documents which he knows to be waste paper"[43]. In the Judgment of the House of Lords, Lord Diplock mentioned that to him there is no reason to see the beneficiary in a worse situation than the holder in due course before leaving open the question of the rights of an innocent beneficiary [3, p. 146].

35 *White and Co Inc vs Chamet Handel Training* (S) Pte Ltd(1993) 1 SLR.

36 Ibid, p. 65.

37 [1954] 2 QB 459 (QB).

38 Ibid, p. 476.

39 [1984] 1 Lloyd's Rep 102 (CA).

40 Ibid, p. 116.

41 *United City Merchants (Investment) Limited vs. Royal Bank of Canada* [1979] 1 Lloyd's Law Reports.

42 [2001] EWHC 1032 (Comm).

43 *United City Merchants (Investment) Limited vs. Royal Bank of Canada* [1979] 1 Lloyd's Law Reports.

Finally, in the court of appeal of the third case, *Montrod Ltd vs. Guundk Otter Fleichvertriebs GmbH*, Potter LJ held that, there is no nullity exception in English law[44]. According to his conclusion: "sound policy reasons for not extending the law by creation of a general nullity exception"[45]. It should be mentioned that the position of Potter LJ is limited to the documents which are null without being forged. As result, the positions of documents which are forged without the notice of beneficiary are still not clear [3, p. 146].

Among other Common Law jurisdictions, Singapore recognised nullity exception in the case of *Beam Technology (MFG) PTE Ltd vs. Standard Chartered Bank*[46]. However, the scope of the exception is very limited. "The confirming bank is not obliged to pay if it has established within the seven-day period that a material document required under the credit is forged and null and void and notice of it is given within that period"[47]. The exception will apply under following conditions:

First, when the document is forged. Second, when the document is material. The court held that exception does not apply to all documents. However, no definition was provided for material document. Third, when document is null. The court provided that due to the uncertainty around definition of nullity, situation should evaluated on the basis of facts in each case. Fourth, when the bank has the knowledge of nullity. According to the court, bank must come across knowledge on nullity of documents within 7 days period which has been considered for checking documents and in addition, the due notice should be given to the beneficiary [3, p. 151].

*2.3. Arguments in favour of Nullity*

Main arguments in favour of nullity exception can be traced in Singaporean court of appeal of *Beam Technology* and also the Court of Appeal in the *United City Merchants.* They include:

Firstly, non-conformity of null documents: According to the principle of strict compliance, beneficiary should tender complying documents in order to be entitled to payment. Such requirement can be extended from more than facial conformity to the condition that document is really the one which is required by the credit. According to Goode "documents which are forged, cannot conceivably treated as confirming documents" [17]. Genuine Documents are required by the credit while a forged document cannot be genuine despite of conformity on its face.

Secondly, bank holds bills of lading as a security of credit in addition to assurance about creditworthiness of applicant. Since bill of lading is recognized as the document of title, it is difficult to justify the rule that requires bank to pay beneficiary against the presentation of documents which are worthless to its knowledge [12].

Thirdly, not recognizing the nullity exception can be considered as policy of tolerance against circulation of forged documents in international trade. Such documents are considered as "cancer in international trade"[48] and victims should bear huge losses. Since trust that forms the international trade would be undermined by free circulation of forged documents, accepting the nullity principle can prevent circulation of such documents in the process of documentary letters of credits.

Fourthly, the issuing bank has the mandate to pay against genuine documents that conform on their face with terms of credit. From this perspective, the bank that breaches its mandate in fact honours the presentation on its own risk for not being reimbursed. "It is also not likely that the beneficiary who has not fulfilled his obligations to produce genuine documents would expect the bank to make payment against worthless documents or the applicant to later reimburse the bank for that" [18].

*2.4. Arguments against nullity*

Lack of Clarity in defining the nullity is the main argument against accepting it as another exception to the autonomy principle. The difficulty is in defining the nullity exception with precision and it would be difficult to answer the question that when a document is nullity. The main problem will arise when assessing a reasonableness of something which is a common practice for courts[49].

Second, lack of authority: The argument regarding the lack of authority was raised by Raymond Jack, the judge of the first instance court of *Montord* when the only available authority at that moment was judgement of Lord Diplock in *United City Merchants* which left the

[44] [2001] EWHC 1032 (Comm), 58.

[45] Ibid.

[46] [2003] 1 SLR 597.

[47] Ibid, p. 160.

[48] *Standard Charter Bank vs. Pakistan National Shipping Corp* (No 2) (1998)1 Lloyd's Rep, 684, 686.

[49] *Beam Technology* (2003) 1 SLR597, 36.

question of nullity documents open. This argument means that nullity has not been supported either by UCP or case law. However, this is not a strong argument since UCP does not have statutory effect; lack of support under UCP is not the reason for not recognizing the nullity exception under case law [16, p. 46, 54].

Third, the beneficiary should not be in worse position that holder in due course: According to the Judgement of Lord Diplock in *United City Merchants*, there is no reason to see the holder in due course in better position than innocent beneficiary while fraud has affected the documents. Goode criticised this view on the basis of the operation mechanism itself that provides more rights to the holder in the due course: "The beneficiary under the credit is not like a holder in due course of a bill of exchange; he is only entitled to be paid if the documents are in order" [19]. Goh J.C from the High Court of Singapore also criticized the argument of Lord Diplock in *Lambias*[50]*: "I think the short answer to this is that as a party to the underlying contract, he (the beneficiary) has an additional recourse against the buyer which is not open to a holder in due course".*

*Forth, unfairness to beneficiary. This argument was raised by Potter L.J in the case of Montord*. He argued that "such an exception would be likely to act unfairly upon beneficiaries participating in a chain of contracts in cases where their good faith is not in question"[51]. In response, it is suggested that everything goes back to the balance of interests[52]. If nullity document does not prevent bank from payment to innocent, then the buyer should be the one who bears the loss. In contrary, if the nullity exception prevents bank from payment to the beneficiary, then the seller is the one who will bear the loss. The argument is weak in principle as taking any side will have unfair outcome for the other party. Based on some other arguments, letter of credit should provide an assurance of payment to the seller and all relevant risks should be assumed by buyer. Any different decision will undermine existing trust in financing system of the international trade [13]. The response to such argument might be statement of Stephenson L.J in the court of appeal of *United City Merchants* who commented on "the risk to be taken by beneficiary as banks trust the beneficiary to present honest documents"[53].

Last, creation of Further Dilemma for Banks. One of the reasons for Potter L.J to reject the nullity exception in judgement of *Montord* was that "if a general nullity exception were to be introduced as part of English law it would place banks in a further dilemma as to the necessity to investigate facts which they are not competent to do and from which the UCP 500 is plainly to exempt them"[54]. The same will apply to UCP 600. However, banks can take the acceptance of the nullity exception in Singapore as a guideline. In Singapore, Nullity Exception is limited to the situation that bank has clear knowledge of nullity before effecting the payment [3, p. 153]. However, in any condition, there will be no difference between the position of bank towards facts outside documents under nullity and fraud rule [3, p. 153].

### *3. Recklessness exception*

The recognition of recklessness exception can be considered as an alternative to the nullity exception in the law of the documentary letters of credits. It comes into force as a result of reckless or careless presentation of documents by beneficiary without considering that they are valid or void, or their true or false nature [3, c. 156]. Such an action will entitle bank to withhold payment to the beneficiary who is not guilty for fraudulent activity. Historically, in Recklessness Exception in English Law goes back to the cases of *Derry vs. Peek*[55] in 1889 when reckless conduct of beneficiary has been assimilated to knowledge of fraud. Therefore, Recklessness exception can be considered as an extension to the fraud rule. Recently, in the case of *Montord*[56], Potter L.J mentioned that he "would not seek to exclude the possibility that, in an individual case, the conduct of a beneficiary in connection with the creation and/or presentation of a document forged by third part might, though itself not amounting to fraud, be of such character as not to deserve the protection available to a holder in due course"[57].

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50 Lambias (Importers & Exporters) Co Pte Ltd vs. Hong Kong & Shanghai Banking Corporation [1993] 2 SLR751.

51 *Montrod Ltd vs. GrundkotterFleischvertriebs GmbH*, [2001] EWHC 1032 (Comm), [2002] 1 WLR 1975, 59.

52 Ibid, p. 69.

53 UnitedCityMerchants(Investments)LtdandOthersvs.Royal Bank of Canada and Others [1982] QB 208 (CA) 246.

54 [2001] EWHC 1032 (Comm), [2002] 1 WLR 1975, 59.

55 *Derry vs. Peek* [1889] 14 AC 337 (HL).

56 *Montrod Ltd vs. GrundkotterFleischvertriebs GmbH, [2001]* EWHC 1032 (Comm), [2002] 1 WLR 1975, 59.

57 Ibid.

Under Singaporean Law, The high court of Singapore considered the recklessness exception in case of *Lambias*[58]. The Judge stated "[Beneficiary] was nonetheless in some way clearly responsible for the turn of events that led to the perpetration of the fraud or forgery"[59] and continued that "the law cannot condone actions, which although not amounting to fraud per se, are of such recklessness and haste that the documents produced as a result are clearly not in conformity with the requirements of the credit"[60]. As result, the court held that according on further grounds available for the bank to justify not honouring the presentation of documents by beneficiary.

A simple observation can lead us to the conclusion that Singaporean and English Legal system are ready to accept the recklessness exception despite nonexistence of leading casessince the issue of committed fraud by third party with effect of bank's payment to the beneficiary has been mentioned in *Derry vs. Peek*, *Montord* and*Lamibas* [3, c. 156]. Legal basis of above mentioned decisionshas been explained in previous paragraphs.

At the same time, there is tendency among some commentators to finda link between the nullity exception and reckless the conduct [3, c. 156]. As a result, recklessness of beneficiary will prevent payment only in case that he recklessly presents a nullity document. In this case, such situation is different from what has been discussed so far. In case of only covering nullity by recklessness exception, documents which are forgery but not void will not be covered. However, bank is entitled to dishonour presentations based on documents that are void. Encompassing recklessness exception in both directions may result in the most optimal situation.

### *4. Unconscionability*

Lack of good faith and or unconscionable demand of beneficiary for being paid are the main areas covered by unconscionability exception [20]. In such cases, no fraud or defective documents are involved. However, based on the principle of unjust enrichment, demanding for the payment will provide beneficiary with chance to take an unfair advantage from his position. The fraud has been formulated by absolute lack of right for payment, while abusive demand and unconscionable conduct presupposed the existence of right, it imposes an additional "inherent risk" on the exercise of such right [3, c. 160]. The main area for application of exception will be Standby Letters of Credits, Performance Bond and Demand Guarantees.

#### *4.1. Unconscionability under English Law*

At the first step we should differentiate the unconscionability from recognized doctrine of unconscionable conduct in English Law. Unconscionable conduct "applies when the complainant's consent to the unfair transaction was vitiated because of a morally reprehensible act of the defendant short of fraud, duress, or undue influence" [21, p. 198]. Therefore, unconscionable conduct takes place during the contract performance.

*TTI Team Telecom International Ltd vs. Hutchinson 3G UK Ltd*[61]is the only one English authority which accepts the unconscionability as an exception to autonomy principle

. In this case judge held that "a lack of good faith has for a long time provided a basis to restrain a beneficiary from calling a bond or guarantee"[62]. However, the judgment of this case has been received considerable amount of negative comments [3, p. 164]. Flow of negatives comments towards the judgment of TTI and reluctance of case law in recognition of unconscionability as an exception to autonomy principle of letters of credit can be positively linked to unwillingness of English legal system to recognize the doctrine of good faith in contract law [3, p. 164].

#### *4.2. Unconscionability under other Common Law Systems*

In Singapore, unconscionability exception was first recognized implicitly in the cases *Royal Design Studio Pte Ltd vs. Chang Development Pte Ltd*[63] and *Kvaerner Singapore Ltd vUDL Shipbuilding (Singapore) Pte Ltd*[64] Finally, unconscionability exception was recognised explicitly by Singaporean Court in *Bocotra ConstrPte Ltd vs. Attorney Gen (No 2)*[65]when the judge held that

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[58] *Lambias (Importers & Exporters) Co Pte Ltd vs. Hong Kong & Shanghai Banking Corporation* [1993] 2 SLR.751.

[59] Ibid, p. 764.

[60] Ibid.

[61] *TTI Team Telecom International Ltd vs. Hutchison 3G,* [2003] EWHC 762 (Comm), [2003] 1 All ER (Comm),762.

[62] Ibid.

[63] *Royal Design Studio Pte Ltd vs. Chang Development Pte Ltd* [1990] 1 SLR 1116.

[64] *Kvaerner Singapore Ltd vs. UDL Shipbuilding (Singapore) Pte Ltd* [1993] 3 SLR 350.

[65] *Bocotra Constr Pte Ltd vs. Attorney Gen (No 2)* (1995) 2 SLR.

"whether there is fraud or unconscionability is the sole consideration in applications for injunctions restraining payment or calls on bonds to be: granted"[66].

The position of *Bocotra Constr Pte Ltd vs. Attorney Gen* (No 2) was later confirmed in *Dauphin Offshore Engineering & Trading Pte Ltd vs. Private Office of HRH Sheikh Sultan bin Kalifa bin Azyed al Nahyan*[67].

In United States of America, unconscionability has not been codified in UCC. Therefore, it is not recognised in USA as an extension to the fraud rule. Since fraud rule has the statuary recognition, it would be easy to understand the reluctance of judges to introduce a new exception by using case law. However, American legal system has managed to recognize different aspects of unconscious conducts in guarantees under the board definition of fraud [22]. For example "fraud in transaction" includes aspects of bad faith [22]. Examples can be found in judgements of *Harris Corporation vs. National Iranian Radio and Television*[68], *Rockwell International Systems vs. Citibank*[69].

*4.3. Implications*

Recognition of the unconscionability exception, it has the potential to create some risks at national law level which should be considered by informed judges [23]. Current section of research will briefly touch upon potential risks of recognizing unconscionability exception in the law of letters of credit:

1. Imprecise and unclear definition of unconscionability can be the first source of risk [3, p. 170]. It is really recommended that in the area of law in which clarity and certainty have utmost value it is important to confine the scope of such concepts in order not to depend on judges to access rights of each party [3, p. 170].

2. It is suggested that recognition of unconscionability exception will result in more legal actions and such judicial interventions might undermine the widely recognized principle that "letters of credits are equivalent to cash" [3, p. 171].

3. Recognition of unconscionability exception will result in rise of courts involvement in interlocutory stage in disputes which are about breach or performance of underlying contract. However, a separate proceeding is necessary to resolve such disputes [3, p. 170].

***5. Illegality***

Illegality is the last exception to the independent principle of documentary credits which is to be discussed in current paper. The illegality exception has roots in the possibility that the illegal nature of the underlying contract can taint the letter of credit process and as a result, bank will be entitled to dishonour the presentation.

There are different reasons for underlying contract to be considered as illegal, it might be infringing lending limits on credits[70], violation of exchange control laws [24], or violating the government ban on payment to special people or countries[71]. On the same basis for application of fraud rule, the legal basis to be used in favour of illegality exception is *exturpi causa non orituractio*in the meaning of "no court will lend its aid to man who founds his cause of action upon an immoral or an illegal act" [25].

Under English law, there are few cases which raise the issue of illegality exception. In *Group Josi Re*[72] *the argument was around illegality of underlying insurance contract. Therefore, as claimants did not have the au- thority to work in England, the letter of credit was also affected by illegality*[73]. *In the Court of Appeal, Staughton L.J mentioned that letter of credit can be influenced by the illegality of the underlying contract and as a result, court can issue injection against payment by bank or benefi- ciary for demanding it*[74]. *The idea of illegality exception as separate ground for defence was supported one year before in another judgement*[75].

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[66] Ibid, p. 744.

[67] *Dauphin Offshore Engineering & Trading Pte Ltd vs. Private Office of HRH Sheikh Sultan bin Kalifa bin Azyed al Nahyan* [2000] 1 SLR 657.

[68] *Harris Corporation vs. National Iranian Radio and Television* (1982 11th Cir) 691 F2d 1344.

[69] *Rockwell International Systems vs. Citibank* (1983 2nd Cir) 719 F2d 583, 588.

[70] Id International Dairy Queen Inc vs. Bank of Wadley (1976 MD Ala) 407 F Supp 1270.

[71] *Itek Corp vs. First Nat Bank* (1981 D Mass) 511 F Supp 1341; *Harris Corp vs. National Iranian Radio & Television (*1982 11th Cir) 691 F2d 1344; *General Cable Ceat SA vs. Futura Trading Inc* (1983 SDNY) 1983 WL.

[72] *Group Josi Re vs. Walbrook Ins Co Ltd* [1996] 1 Lloyd's Rep 345 (CA).

[73] Ibid, p. 360.

[74] Ibid, p. 362.

[75] *Deutsche Ruckversicherung AG vs. Walbrook Insurance Co Ltd* [1995] 1 WLR 1017 (Com Ct) 1027.

*Mahonia Ltd vs. JP Morgan Chase Bank (No2)*[76] *shed more light on the issue of illegality exception in English Legal System. In this case, plaintiff (Mohonia) pleaded on the basis of the illegality of the underlying contract as the contract was providing a party with a disguised loan which was used by that party for manipulation of his accounts and violation of US Law. During the action for summary judgement, Coleman J rejected the Maho- nia*'s application while arguing that Illegality Exception should be recognised. At trial, Cook J. considered that autonomy principle has not prevented a letter of credit being tainted by the illegality of the underlying transac- tion. Despite the fact that due to obiter decision of Cook J, Mahonia cannot be considered as a leading case in England ,it serves as an indicator for showing the attitude of British courts on the subject matter [3, p. 192]. Later cases showed the same attitude. In *Oliver and Anor vs. Dubai Bank of Kenya*[77] it was held that fraud and ille- gality are possible exceptions to autonomy principle[78]. In *Lancore Services Ltd vs. Barclays Bank Plc*[79]*, Judge referred to existence of illegality exception as a basis for making decision.*

*Unified Commercial Code does not recognize the il- legality exception in the United States of America. The necessity for accepting illegality as an exception of au- tonomy principal documentary credits has been promoted by some American scholars including Mc Laughlin com- ments on providing possibility for bank under UCC to refuse presentation of documents in case illegality in the underlying contract [26, 27]. Despite existence of such supports, general agreement is on not accepting the illegality exception due to its absence in revised UCC article 5. It also worth to mention that in old version of UCC article 5 the illegality issue as defence for bank to affect the payment to beneficiary was expressly rejected [3, p. 193].*

*In this section, conditions for application of the il- legality exception will be reviewed. However, in legal systems which recognize the illegality principle, its scope of application is so narrow that it cannot be considered as a threat for absolute application of autonomy principle*[80]*. In English law, conditions for application of illegality exception are taken from the case of Mahonia*[81]:

1. There should be serious allegation of illegality. However, it is not easy to define which constitutes the minor illegality and what is the material one. The test adopted by Cook J. in the court of appeal of *Mahonia* was whether illegality involved the deliberate wrongdoing or not[82].

2. Bank should be aware of illegality in underlying contract and have the capability to prove it. The same standard of proof as fraud exception applies to the case of illegality. However, while applying for summary judgement, bank is required to prove its real prospect of success at the trial on the basis of illegality exception [3, p. 194]. But at the time of hearing, bank should be sufficiently aware of illegality[83]. Regarding injunctions, account party should show a seriously arguable case on the ground of illegality for being able to obtain the injunction against the bank or beneficiary [3, p. 194]. At the end, the clear illegality should be proved during the judgment proceedings for claim to be successful[84].

3. Beneficiary should be either a party to the illegality in the underlying contract or possessing information about it. Since in most cases the beneficiary is not informed about the illegality involved in the underlying contract, the scope of the application of exception seems to be really limited[85].

4. Finally, it is necessary to determine the degree of connection between the letter of credit and the illegality. In case of *Mahonia*, it was held that illegality should be closely connected to the letter of credit in order to taint it[86]. There is also a criteria to define the degree of connection between illegality and documentary letter of credit [28].

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76 *Mahonia Ltd vs. JP Morgan Chase Bank*(No2) [2004] EWHC 1938 (Comm).

77 *Oliver and Anor vs. Dubai Bank of Kenya* [2007] EWHC 2165 (Comm).

78 Ibid, p. 12.

79 *Lancore Services Ltd vs. Barclays Bank Plc, [*2008] EWHC 1264 (Ch), [2008] 1 CLC 1039.

80 *St John Shipping Corporation vs. Joseph Rank Ltd* [1957] 1 QB 267 (QB) 288–289.

81 *Mahonia Ltd vs. JP Morgan Chase Bank(*No2) [2004] EWHC 1938 (Comm).

82 Ibid, p. 340.

83 *Mohonia* (No1) (n460) 69.

84 *Group Josi Re vs. Walbrook Ins Co Ltd* [1996] 1 Lloyd's Rep 345 (CA); *Themehelp Ltd vs. West* [1996] QB 84 (CA).

85 *Mason vs. Clarke [*1955] AC 778 (HL)..

### *Conclusion*

While principle of Autonomy in international LC transaction tries to protect rights of seller by separating the underlying contract of sales from credit, the principle of strict compliance protects rights of buyer by requiring seller to provide genuine documents which comply with terms of credit. In this way application two main pivotal principles of LC transaction creates balance between contradicting interests of exporter and importer and facilitates the process of international trade. However, absolute application of autonomy principle might lead to abusive demands and fraudulent conduct of beneficiary who presents complying documents to the bank without fulfilling his obligations in underlying contract of sales. Fraud rule as the first exception to the absolute application of autonomy principle in LC operation has been recognized for the first time in American case of *Sztejn* and later got recognition in all common law jurisdictions. Increasing number of legal cases on different issues resulted in recognition of further exceptions to autonomy principle of LC operation in common law countries. Namely, nullity has been recognized in Singapore while being rejected in England, illegality and unconscionability also have been demonstrated a significant potential to be recognized as other exceptions to principle of Autonomy in Documentary Letters of Credit.

Despite main similarity among all exceptions to the principle of autonomy in documentary letters of credit which is presentation of complying but unreal documents by beneficiary to the bank, each exception has a particular characteristic which helps court to distinguish it from others. Nullity would be result of defect which makes a document void ab initio. Such defect might be outcome of forgery or an innocent mistake. Recklessness expectation is mostly applied under the condition which nullity is not recognized and it provides bank not to pay against presentation of void by complying documents by beneficiary. Unlike nullity exception which is more relevant beneficiary's lack of knowledge about void nature of presented documents, recklessness will be applied to blameworthy conduct of beneficiary when he presents documents to bank despite his knowledge from their null nature. Under unconscionability exception, which applies mostly to demand guarantees, there is no fraud or other type of forgery in presented documents. However, law provides protection for account party against abusive demand of beneficiary against his conduct to make the demand for payment based on bad faith. Such exception is applicable when making the demand will be an abuse of beneficiary's right under demand guarantee. Unlike other exceptions to the principle of autonomy, illegality deals with extent to which illegality of underlying contract affects right and obligations of parties to LC.

There is still long way to be taken by common law courts (particularity English ones) to achieve a harmonized approach to problem of fraud and other exceptions to the principle of autonomy of documentary letters of credit. Current paper took a critical approach to such divergent view of courtsto the fraud rule and other exception to the principle of autonomy in common law jurisdictions by analysing historical and current situation of different expectations to autonomy principle in LC transaction among different Common Law Jurisdictions. In conclusion, recognition of nullity of tendered documents and also fraud of third party by English legal system are recommended. It is suggested that according to an implied term in credit, beneficiary is expected to provide genuine documents which comply of their face with terms of credit. Therefore, beneficiary should be more careful and vigilant about genuineness of documents in cases that he is not producer of them. It is also recommended to limit the application of unconscionability to the demand guarantees and not to extend it to the commercial letters of credits.

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*Received 01.07.2016*

*Accepted 31.08.2016*

*Available online 20.09.2016*



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***Publication 7*: Alavi.H, (2016). "Illegality as an Exception to Principe of Autonomy in Documentary Letters of Credit: A Comparative Approach". *Kor. UL Rev., 20,* 3. 1-25**

# Illegality as an exception to principle of autonomy in Documentary Letters of Credit; A comparative approach

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**Abstract**

*The case of Sztejn V. J. Henry Schroder banking Corporation and recognition of fraud exception was starting point to erode the absolute application of autonomy principle in documentary letters of credit at global level. More than seventy years after recognition of fraud exception, complicated process of international trade gave rise to other possible exceptions to autonomy principle including illegality, unconscionability, nullity and recklessness of beneficiary. Despite the fact that principle of illegality has age old application in different legal systems to make contracts against statue, good faith and public policy as unenforceable, its application to documentary letters of credit is not completely clear. Clearly, the LC or bank guarantee which has been issued on an illegal basis will be considered unenforceable even without involving the autonomy principle. However, problem will occur where underlying contract is illegal as autonomy principle separates the credit from the underlying contract. In current paper, author tries to tap on problem of illegality in underlying contract and its effect on enforceability of the credit in different jurisdictions. In doing so, this paper*

*endeavours to provide answers to following questions: what is the legal nature of illegality and what are preconditions for its application in the framework of documentary letters of credit? How do different national laws regard illegality as a possible exception process of LC transaction? And what are existing criticisms against recognition of illegality defence as an exception to autonomy principle in documentary letters of credit system?*

**Key words**: International Trade, Documentary Letter of Credit, Bank Guarantee, Exceptions to the Principle of Autonomy, Illegality

## 1- Introduction

Two principles of autonomy and strict compliance play significant role in smooth operation of international documentary letters of credit. Principle of autonomy as the main corner stone of existing research separates the underlying contract between applicant and beneficiary from the credit[652]. Autonomy principle is considered as "the engine behind the letter of credit"[653]and for a long time its absolute application could not be contested by courts. However, the case of *Sztejn V. J. Henry Schroder banking Corporation* [654], introduced fraud as first exception to universal and absolute

[652] UCP 600 –Article 4
[653] Alavi, H. (2016). Documentary Letters of Credit, Principle of Strict Compliance and Risk of Documentary Discrepancy. Kor. UL Rev., 19, 3.
[654] *Sztejn V. J. Henry Schroder banking Corporation* (1941) N.Y.S. 2

application of the autonomy principle in international LC transactions.[655] After 70 years from introduction of the fraud exception, it seems that complication of international trade makes courts of different countries ready to accept other exceptions to the principle of autonomy including unconscionability[656], nullity, illegality and recklessness[657] of beneficiary. Among such possible exceptions, current paper would focus on illegality which can overweigh the application of autonomy principle in LC transaction while referencing to public policy concerns. Accordingly, paper would follow the objective of studying: different types, legal nature, policy grounds for application, and finally criticisms against recognition of illegality as a defence for payment under letter of credit law. For this purpose, author tries to answer following questions: What is the legal nature of illegality and what are preconditions for its application in the framework of documentary letters of credit? How do different national laws address illegality as

[655] Alavi, H. (2016). Mitigating the Risk of Fraud in Documentary Letters of Credit. *Baltic Journal of European Studies*, *6*(1), 139-156.
[656] Alavi, H. (2016). Comparative study of Unconscionability exception to the principle of autonomy in law of Letter of Credits. *Acta Universitatis Danubius. Juridica*, *12*(2), 94
[657] Alavi . H, (2016) , EXCEPTIONS TO PRINCIPLE OF AUTONOMY IN DOCUMENTARY LETTERS OF CREDIT; A COMPARATIVE VIEW, *Actual Problems of Economics and Law*, 2016, vol. 10, No. 3, 123-150

possible exception to autonomy principle in process of LC transaction? And what are existing criticisms against recognition of illegality defence as a defence for payment in documentary letters of credit system?

This paper is organized in the following order: after an introductory segment, discussion will continue with explanation of the process of LC transaction and application of autonomy principle. Third part will explore the nature of illegality while fourth part analyses different preconditions for application of exception. Fifth part reviews approach of different legal systems to illegality as an exception to autonomy principle. Finally, sixth part explores its current state and criticisms on recognition of illegality as another exception to principle of autonomy (in addition to fraud).

## 2- Letter of credits and autonomy principle

Principle of autonomy is fundamental in operation of letter of credit[658]. By separating the obligations of bank to pay under the credit from disputes in underlying contract, it creates an abstract payment

[658] Alavi , H. (2015)"Autonomy Principle and Fraud Exception in Documentary Letters of Credit, a Comparative Study between United States and England" . International and Comparative Law Review, Vol. 15, No. 2 ,45

undertaking for issuing bank to pay the beneficiary independently from performance of contracts between applicant and issuing bank and contract between applicant and beneficiary. The main implication of autonomy principle would be failure of beneficiary to provide applicant goods with quality and quantity agreed in the underlying contract will not affect payment obligation of issuing bank as long as he provides issuing bank with complying presentation of document stipulated in the credit[659]. In English law, providing an assurance to beneficiary to be paid before dispatching goods in favour of applicant is considered as basis for strict application of autonomy principle[660].Therefore, in case of raising any argument on quality or quantity of goods provided by beneficiary, issuing bank and applicant have no other choice rather than paying him upon personation of complying presentation and look for remedies later under a claim for breach of warranty.[661] In practice of English law, autonomy principle protects the flow of international trade by means

[659] Alavi, H. (2016). Documentary Letters of Credit, Legal Nature and Sources of Law. *Journal of Legal Studies*, *17*(31), 106-121.
[660] *United City Merchants (Investments) Ltd. v. Royal Bank of Canada*, [1983] 1 AC 168, 183.
[661] Alavi, H., 2016. Mitigating the Risk of Fraud in Documentary Letters of Credit. *Baltic Journal of European Studies*, *6*(1), pp.139-156

of the logic of: "pay first, argue later"[662]. However, some scholars are of the opinion that autonomy principle does not exclude assurance of buyer's (applicant) interests to be fulfilled.[663]

At global scale, documentary letters of credit are operating under well recognized set of rules established by the International Chamber of Commerce[664]. Uniform Customs and Practices for Documentary Credits (UCP) published for the first time in 1933 and passed many revisions in order to meet requirements of technology development relevant to international trade. Article 4 and 5 of UCP 600 (current version) refer to principle of autonomy as following:

> "A credit by its nature is a separate transaction from the sale or other contract on which it may be based. Banks are in no way concerned with or bound by such contract, even if any reference whatsoever to it is included in the credit. Consequently, the undertaking of a bank to honour, to negotiate or fulfil any other obligation under the credit is not

[662] *Eakin v Continental Illinois National Bank & Trust Co*. (1989) 875 F.2d 114 .116
[663] Horowitz. D, (2010), Letters of Credits and Demand Guarantees Defences to Payment , Oxford University Press , 20
[664] Alavi .H , (2016), Arbitration and LC Fraud Disputes: a Comparative Approach, Russian Journal of Comparative Law, Vol. (8), 2, 70

subject to claims or defences by the applicant resulting from its relationships with the issuing bank or the beneficiary."[665]

"A beneficiary can in no case avail itself of the contractual relationships existing between the banks or between the applicant and the issuing bank. An issuing bank should discourage any attempt by the applicant to include, as an integral part of the credit, copies of the underlying contract, pro forma invoice and the like. Finally, banks deals with documents and not with the goods, services or performance to which the document relate."[666]

In the United States of America, operation of documentary letters of credit is regulated under article 5 of Unified Commercial Code. In fact, the USA is only country which has statutory regulation for LC operation. Autonomy principle is recognized under Article 5- 103(d) of UCC:

"the rights and obligations of an issuer to a beneficiary or a nominated person under a letter of credit are independent of the existence, performance, or non-performance of the

[665] UCP600-Article 4
[666] UCP 600- Article 5

> contract or arrangement out of which the letter of credit arises or which underlies it, including contracts or arrangements between the issuer and the applicant and between the applicant and the beneficiary"

Further, article 5-108(f)(1) confirms :

> "[a]n issuer is not responsible for the performance or non-performance of the underlying contract, arrangement or transaction"

From the above discussion, it might seem that autonomy principle is applied within the process of international operation in an absolute fashion. In practice, courts in different countries show traditional hesitation with interfering in process of LC transaction and enjoining bank from making payment under the credit. This position is confirmed in the court of *Hamza Malas* [667] : "[the autonomy principle] imposed upon the banker an absolute obligation to pay, irrespective of any dispute here maybe between the parties as to whether the goods are up to the contract or not".[668] Such strict approach is popular among English courts and resulted criticism

[667] *Hamza Malas &Sons v. British Imex Industries LtD* (1958) 2 QB 127
[668] Ibid

among scholars: “English courts have become beguiled by the autonomy doctrine that they decline to allow refusal of payment in favour of a beneficiary acting in good faith even where the documents are forged or otherwise fraudulent, on the supposed principle that the beneficiary’s duty is to tender documents which appear to conform to the credit even if they are in fact fraudulent and worthless”[669].

However, in contrary with existing authority of autonomy principle, its application in LC transaction is not absolute and courts have recognized different exceptions to it. Fraud is known as the first recognized exception to principle of autonomy in documentary letters of credit.[670] It is also submitted that illegal nature of underlying contract would be another exception to principle of authority together with nullity of documents presented by beneficiary and unconscionable conduct of beneficiary in drawing under the credit where he is not entitled to do so. Following chapters will analyse illegality of the underlying contract and its effect on LC transaction in different jurisdictions in comparative manners.

### 3- Nature of Illegality

[669] Goode. R , (2004)Commercial Law ,Penguin, 972
[670] Alavi . H , (2015) , 45

3.1- Defining illegality

The first step in clarifying nature of illegality would be providing a clear definition for it. Enonchong is of the opinion that: "A transaction is illegal or at least affected by illegality If the transaction or some aspect of it is prohibited by law"[671].Accordingly, illegal transaction follows an intention to commit an act which is wrong under law or public policy. As a result, illegality which is outcome of illegal transaction would fall under two categories: First is illegality as a result of transactions prohibited by law. Second is illegality as a result of transaction which is against the public policy.[672]While considering transaction as illegality against statute, intention of the actor plays a significant role in decision of court.

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

[671] Enonchong.N ,(1998), "Illegality Transactions",Lloyd's of London Press, p. 2.
[672] Amaefule, C. (2012). *The exceptions to the principle of autonomy of documentary credits* (Doctoral dissertation, University of Birmingham).P, 183

itself, is intended to be performed in a manner which the statute prohibits."[673]

Accordingly, illegality on the basis of statute will be further divided into two subgroups: Transactions prohibited by law and transactions that their purpose is prohibited by law. Attention should be given to point that in addition to transactions prohibited expressly by the statute of law, a transaction will also be considered as an illegality which is prohibited by statute impliedly[674] . In the court of *Johnson v. Moreton*[675] , Lord Simon of Glaisdale held that an impliedly prohibited transaction by statute is the same illegal as the once which is expressly prohibited[676].

Second category of illegal transactions is about ones considered against public policy. While discussing public policy illegality, as the first step, it is necessary to define the public policy. The court of *Gray v Barr* [677]commented on public policy as: " [public policy] is a method which the courts use where there is conduct which the public

[673] *Yango Pastoral Co. Pty. Ltd v. First Chicago Australia Ltd Ltd {1978) 139 C.LR. 410, 413, per Gibbs A.C.J.*
[674] *Cf. Johnson v. Moreton [1980] A.C. 36*
[675] Ibid
[676] Ibid
[677] Gray v. Barr [1971] 2 Q.B. 554

disavow"[678]. It is difficult to clarify public policy in terms of definition due to its different characteristics like flexibility and rationality. Therefore, judges face with potential difficulty to decide on illegality of a transaction based on public policy concerns. In order to prevent subjective judgments English legal system has adopted a difficult test for recognizing a transaction against public policy. Accordingly, a transaction would be illegality against public policy only under condition that "the harm to the public is substantially incontestable"[679] and "the contract is incontestable and on any view inimical to the public interest"[680]. As a result, it is clear that substantial harm should rise from a transaction in order to overcome public interest in a law which otherwise will take care of the matter.

3-2- Effects of illegality in English law

It is of necessity to find out effect of illegality on a contract. In English law, there is "some inconsistency in determining whether [illegal contracts] are void, voidable or unenforceable"[681]. It worth to remind that void and unenforceable contracts are totally

[678] Ibid 561
[679] *Fender v. St. John Midmay* [1938] A.C. 1, 12
[680] *Monkland v. Jack Barclay* [1951] 2 K.B. 252, 26
[681] *Aratra Potato Co. v. Taylor Johnson Garretti* [1995] 4 All E.R. 695, 708 ; N Enonchong, (1995) "Effects of Illegality: A Comparative Study in French and. English Law" 44ICLQ 196, 198-199.

distinguishable from each other as void contract is null and no right of parties can be exercised in it. However, in unenforceable contract, agreement comes into existence but, it will not receive any legal support to be enforced.[682] Meanwhile, some rights might be exercisable under an unenforceable contract (including property rights). Since in English law majority of cases which proceed under illegality of transaction are considered as unenforceable[683] it might be reasonable to say that illegal contracts under English law are merely unenforceable.

3-3 Illegality exception to autonomy principle in documentary letters of credit

On the basis of recognition of the fraud exception to autonomy principle in documentary letters of credit, and unenforceability of contract due to illegality, it would be a valid question if we ask what is the effect of illegality on letter of credit transaction? To answer this question, it is submitted that differentiation should be made

[682] *re Mahmoud and Ispahani* [1921] 2 K.B. 716; *Maries v. Philip Trant & Sons* [1954] 1 Q.B. 29, 38.
[683] *Cleaver V. Mutual Reserve Fund Life Association* [1892] 1 Q.B. 147,152; *Bennett v. Bennett*[1952] 1 K.B. 260; *Aratra Potato v. Taylor J. Garrett* [1995] 4 All E.R. 695

between circumstances in which the illegality affects letter of credit and/or it affects the underlying contract[684].

### 3.3.1- Illegality in the letter of credit

In circumstances where letter of credit has been issued illegally, conclusion would be that credit itself is illegal. The LC can be illegal as either it was issued on an illegal basis or law has prohibited the enforcement of the letter of credit[685] . However, in both conditions, English law would possibility render the credit unenforceable on basis of authorities and discussions made by the Law Commission[686].

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[684]Enonchong N, (2006), 'The Autonomy Principle of Letters of Credit: an Illegality Exception?'LMCLQ 404

[685] Ibid

[686] LC 320 Is the final report published by the Law Commission to conclude a long-running review of the illegality defence, which has considered how the defence applies to the law of contract, unjust enrichment, tort and trusts. The final report followed most of the recommendations in the 2009 consultative report CP 189. CP 189 is the most recent consultation paper published by the Law Commission to discuss "the illegality defence". The effect of Illegality was discussed as one of the main issues in illegality in CP 189. However, the analysis of this issue in CP 189 was highly depending on the old paper of CP 154, which was published In 1999 and entitled "Illegal transactions: the effect of Illegality on contracts and trusts". The central proposal put forward in CP 154 was that, in general, a court dealing with a transaction tainted by illegality should have discretion whether to enforce it. The discretion would be "structured" by setting out the factors that the court should take into account (such as the seriousness of the illegal purpose, whether refusing to enforce the transaction would tend to deter illegality of that kind, and so on). This thesis organized the research of the effect of illegality on the basis of CP 154 ,2.3 to 2.31 http://www.lawcom.gov.uk/docs/cpl54.pdf; the relevant sections in CP 189 are 3.3 to 3.49 http://www.lawcom.aov.uk/docs/cp189.pdf; the relevant sections in LC320 are 3.1 to 3.47 http://www.lawcom.gov.uk/docs/lc320.pdf.[ accessed 2 July 2016]

As a result, LC should be considered unenforceable if performance or issuance of it was banned by law.

3.3.2- Underlying contract is illegal

Controversial issue in application of illegality to documentary letters of credit is whether or not LC is considered unenforceable because of illegality in the underlying contract. Approach of English courts to illegality in underlying contract shows their readiness to accept it as an exception to autonomy principle[687]. Main arguments against inclusion of illegality exception in LC transaction and scholarly response can be mentioned as following:

First, recognition of illegality exception is against the very nature of the principle of autonomy in LC transaction .Affecting process of the credit with illegality in underlying contract would erode autonomy principle. Where same argument rose against recognition of fraud exception, it was responded by principle of "ex turpi causa non oritur actio"[688]. The translation of maxim into English can be "no action can

[687] Johns, R. J., & Blodgett, M. S. (2010). Fairness at the Expense of Commercial Certainty: The International Emergence of Unconscionability and Illegality as Exceptions to the Independence Principle of Letters of Credit and Bank Guarantees. N. Ill. UL Rev., 31, 297

[688] "ex turpi causa non oritur action" first time explained by Lord Mansfield in 1775 in *Holman v. Jolins (1775) 1 Cowp 341*

arise from a base cause" or "no action arises from an unworthy cause". In the same vein as fraud, “ex turpi causa non oritur actio” may be applied to illegality since both fraud and illegality are considered in English Law as an “unworthy cause”.[689] Enonchong submits that unlike fraud which is only against private interest, illegality affects public interests. Therefore, "If fraud against the private interest of a bank is weighty enough to displace the principle of autonomy, then illegality against the wider public interest should have the same potent effect”[690].

Second, with reference to the Law Commission CP 189, it will not be possible for party to a contract to enforce it if his entrance into contract follows the goal of conducting a legal wrong or carrying out an action contrary to the common law principles.[691] As a result, like any other contract, in process of LC transaction, there will be no reason to enforce a letter of credit if it was issued based on an illegal purpose. Additionally, court will be in breach of public policy by

[689] Enonchong . N (2006) , 404
[690] Ibid 412
[691] The Law Commission CP 189 , P27

providing assistance for enforcement to a party to LC where the credit has been issued based on an illegal underlying contract.[692]

Third, opponents of recognition of illegality exception to autonomy principle comment on it as hurdle to smooth operation of LC process.[693] Since method for application of illegality exception in LC transaction is a matter of technicality, any uncertainty regarding its effect on process of LC transaction can be referred to application of fraud rule.

### 4- Application of Exception

4-1- Current state of authorities

Currently, there is no and case of application and recognition of illegality exception in international LC transactions under English law. However, existing *obiter dictum* from English cases show readiness of courts to accept the illegality exception.[694] This section of research will analyse existing court decisions relevant to effect of illegal underlying contract on LC transaction under English law and discusses requirements to apply the exception. *Group Josi Re v.*

[692] Enonchong, N (2006) , 404
[693] Lu, L. (2011). The Exceptions in Documentary Credits in English Law.
[694] Enonchong, N (2006) , 404

*Walbrook Insurance Co. Ltd*[695]is the first English case directly raising the issue of the effect of illegality in underlying contract of LC as an exception to principle of autonomy. The case was between reinsurer claimants under different reinsurance contracts and their defendant reinsured companies. Letters of credits were issued for defendants on request of claimants in return of paying a sum by defendants for the purpose of loss reserve. Later claimants required injunction to prevent insured companies from demanding payment under the letter of credit. Among others, a ground for requesting injunction by claimants was illegality of reinsurance contracts based on section 2 of English insurance Companies Act 1982 which banned claimants from performing insurance business in England in absence of an official authority. Claimants argued, since illegality in underlying reinsurance contracts will affect the letters of credit, they are unenforceable and court should enjoin bank from honouring them.

In the hearing, Clarke J held that letters of credit are valid and enforceable as principle of autonomy separates them from illegal underlying contract of reinsurance.[696] Claimants appealed and the

[695] [1996] 1 W.L.R. 1152, 1162
[696] Ibid

Court of Appeal ruled that in accordance with section 132(6) of the Financial Services Act 1986 , prohibition effect of 1982 act will only make reinsurance contracts unenforceable by reinsurers while it will not affect their enforceability by reinsured. Therefore, as defendants could enforce the underlying contract, they were entitled to payment.[697]However, court did not decide whether or not illegality of underlying contract will lead to unenforceability and illegality of letter of credit.

While Rose L.J did not comment on the subject matter, Saville L.J was of the opinion that illegality in underlying reinsurance contract does not affect enforceability of the letters of credit[698]. In an opposite position, Staughton L.J. mentioned that illegality in underlying contract can affect enforceability of letters of credit if they are used for payment due under such contracts. He believed that, in addition to fraud, illegality is "a separate ground of defence under the letter of credit"[699].

[697] Ibid
[698] Ibid,368
[699] Ibid ,362

*Mahonia Ltd v. JP Morgan Chase Bank* [700] was the case raised in aftermath of the collapse of energy giant Enron and helped to reduce uncertainties of English law around effect of illegal underlying contracts on LC process .[701] In *Mahonia* a letter of credit was issued by West LB AG a German bank in favour of *Mahonia* based on the request of Enron[702]. The credit was supporting a swap transaction between *Mahonia* and Enron North American Corporation (ENAC) as one of Enron's subsidiaries. West LB AG issued the credit on 5 October 2001 shortly before starting of Enron's financial problems. Enron filed under chapter 11 of the bankruptcy law on 2 December 2001 which provided event for default under the credit . As a result, *Mohania* was entitled to demand for sum due under the credit and presented complying documents to bank to demand 165 million USD on 5 December 2001. Despite conformity of presentation bank denied payment and argued for unenforceability of the credit based on illegality of underling contract. Bank's claim on illegality referred to a disguised loan which swap transaction provided for Enron and enabled it to manipulate its accounts and breach US Generally

[700] [2003] EWHC1927 (Comm); [2003] 2 Lloyd's Rep 911 and (No. 2) [2004] EWHC 1938 (Comm)
[701] Enonchong, N (2006) , 406
[702] Ibid , 405

Accepted Accounting Principles (GAAP) and Security Exchange Act 1934.

During the summary judgement, Colman .J rejected *Mahonia's* application and held that under certain circumstances, illegality in underlying transaction can affect the LC and make it unenforceable[703].Further, he held that: "there is at least a strongly arguable case that the letter of credit cannot be permitted to be enforced against the defendant bank"[704]. He continued: "the uncertainty of this area of law is such that this is an issue which out to be determined by reference to the evidence before the court at trial"[705]

At the end of trial, Cooke .J held that underlying transaction was not illegal as Enron did not violate US Securities law and *Mahonia* was not a privy to illegal transaction[706]. Therefore, in the same vein as *Group Jose Re*, court did not decide on the effect of illegality in underlying contract (swap transaction)on LC's enforceability. However, Cooke .J commented on the issue and like Colman, J

[703] [2003] 2 Lloyd's Rep .911
[704] Ibid , 69
[705] Ibid
[706] [2004] EWHC 1938 (Comm)

concluded that illegality can be an exception to autonomy principle of documentary letters of credit and form a defence to the enforcement of LC. [707]

In conclusion, there is no English authority on refusal of payment under the letter of credit where underlying contract is illegal and all available decisions are *Obiter.*[708]However, from conformity of Cook.J's opinion in the full trial with Coleman.J in summary judgment of same case and Staughton.L.J in the *Group Jose Re*, it is clearly possible to envisage readiness of courts are English courts for accepting illegality as a defence of payment under letter of credit law[709]. Such readiness is clearly visible in subsequent cases including *Oliver v Dubai Bank of Kenia*[710]where Andrew Smith J was of the opinion that exceptions to the principle of autonomy in LC transaction include fraud committed by beneficiary and "possibly illegality"[711] .Also in *Lancore Services Ltd v. Barclays Bank Plc* [712], court was of the opinion that as long as illegality of underlying

[707] Ibid
[708] Eonchong . N, (2006) , 410
[709] Ibid
[710] *Oliver v Dubai Bank of Kenia [2007] EWHC 2165(Comm) ,*
[711] Ibid , 12
[712] *Lancore Services Ltd v. Barclays Bank Plc[2008] EWHC 1264, aff'd [2009]EWCA ,Civ 725;[2009] 2 CLC ,306*

contract is a defence for payment in letter of credit " illegality in underlying transaction must also found a defence to the claim in respect to card payments"[713] .

4.2- Scope of Illegality Exception

It is not possible to define a wide scope for illegality exception. Such wide scope will definitely erode the independence principle of the letter of credits and reduce their usage by international traders. It is submitted that scope of illegality exception will be the same as fraud[714]. In fact, scope of illegality defence proposed in the case of *Mahonia* is really narrow and even if it was recognized, letters of credit would be enforceable in most of circumstances in presence of illegal underlying contract. In the same vein with fraud exception, it is argued that party applying for enforcement of the illegality exception must overcome serious difficulties including: first, high standard of proof for illegality. Second, established illegality should be serious enough in order to trigger the exception .Third; exception will be applied only when beneficiary is involved in the scheme of established serious illegality. And finally, even if all above conditions

[713] Ibid 115
[714] Eonchong . N, (2006) , 414

are met, exception will be applied only where the illegality has sufficient connection with the credit.[715]

4-2.1- Evidence

4.2.1.1- Standard of Proof

As per opinion of Staughton L.J in *Group Josi* , standard of proof at trial stage will be "clearly established" illegality[716]. In the same vein with fraud, it would not be sufficient to have only suspicion of illegality. "[if] the illegality for the payment is merely doubtful, it maybe that the bank would not be restrained (by court)"[717]. Without any doubt, a clearly established illegality is very high standard and it seems that like fraud, only few cases will manage to establish such a standard successfully.

However, considering standard of proof leads us to two different circumstances:

First is where beneficiary applies for summary judgment against bank under CRP Pt 24 and bank would like to refuse honouring the credit on the basis of illegality defence .In such situation and similar to

[715] Ibid
[716] *Group Josi Re v. Walbrook Insurance Co. Ltd*. [1996] 1 Lloyds .Rep ,345, 362
[717] Ibid 357

fraud exception, required standard of proof will be " a real prospect of success". This means that, bank should show a real prospect of success based on illegality defence at trial level.[718]

Second situation happens when an applicant tries to enjoin beneficiary from drawing under the credit. Here, it is submitted that similar standard of proof for fraud exception in the case of *United Trading Corporation SA v. Allied Arab Bank Ltd*[719]would apply. This means applicant should prove existence of a seriously arguable case that based on available evidences, underlying contract is tainted with illegality and therefore, the credit is unenforceable [720] .

4.2.1.2- Time for evidence

Time for bank to provide clear evidence of illegality has been considered as the time of hearing[721].Similar to application of fraud exception, bank can refuse payment based on illegality without access to clear evidence relevant to illegality of underlying contract at the time of presentation. However, it is necessary for bank to

[718] Enonchong.N, (2011), 'The Independence Principle of Letters of Credits and Demand Guarantees'. Oxford University Press, 194
[719] *United Trading Corporation SA v. Allied Arab Bank Ltd* [1985]2 Lloyd's Rep .554
[720] Enonchong .N (2011) , 194
[721] Ibid

provide the court with such evidence at the time of hearing. This approach is supported in the case law. In *Mahonia* , bank provided evidence of established illegality at trial date and it did not have access to such evidence at the time in which payment was due.[722] Accordingly, Colman J in *Mahonia* referenced to Mance LJ in *Balfore Beatty* [723]case who held: "Another way of reaching the same conclusion… maybe by applying Lord Diplock's underlying principle that the court should not lend its process to assist fraud and that fraud "unravels all". Now, question arises in this context of the granting injunctive relief or any requirement for that purpose to have a course of action. It would affront good sense … if courts were obliged to give judgement in favour of beneficiary now shown to be acting fraudulently"[724]. Mance LJ's position is supported by other legal scholars.[725]

At trial stage of *Mahonia* , Cooke J was of the opinion that bank should be entitled to refuse payment to beneficiary on the basis of illegality even in absence of clear evidence of illegality at the time of

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[722] *Mahonia Ltd v. JP Morgan Chase Bank* (No. 1) [2003] EWHC1927 (Comm);
[723] *Balfour Beatty Civil Engineering Ltd. v. Technical & General Guarantee*[2000] C.L.C. 252.
[724] *Ibid*. P- 148
[725] Enonchong . N , (2006) , 415

refusal.[726]Further, he referred to fraud rule and mentioned: "the position is stronger in relations to arguments on unlawfulness because of the public policy consideration which came into play"[727]. This approach is both legally persuasive and sensible as it refers to public policy concerns in recognition of fraud exception.

4.2.2- Seriousness of illegality

In *Standard Chartered Bank v Pakistan National Shipping Corporation and others* (No 2)[728], Croswell J commented on seriousness of illegality as an essential factor for winning a case under illegality defence : "whatever theory founds a defence of *ex turpi*, the defendant must establish (a) that the plaintiff's conduct is so clearly reprehensible so as to justify its condemnation by the Court and (b) that the conduct is so much part of the claim against the defendant...as to justify refusing any remedy to the plaintiff"[729]. Therefore, seriousness of illegality is a good indicator for limiting the exception and also a proof for illegality resulted from underlying contract.

[726] *Mahonia Ltd v. JP Morgan Chase Bank(No. 2)* [2004] EWHC 1938 (Comm).
[727] Ibid ,433
[728] *Standard Chartered Bank v Pakistan National Shipping Corporation and others* (No 2) [1998] 1 Lloyd's Rep 684
[729] Ibid 705-706

A valid question regarding seriousness of illegality is how a serious illegality should be differentiated from the not serious one?[730] Staughton LJ in *Group Jose* case gives example of underlying contract of sales of arms to Iraq when such transaction is announced as illegal.[731]In *Mohania* case also Colman J used the example of underlying contract of sales for narcotics namely heroin[732]. However, in their approach, neither of judges used clear criteria to distinguish serious illegality. Additionally, none of extreme examples used by them would (frequently) happen in normal course of international trade.

In *Mahonia*(No 2) , Cooke LJ explained the criteria for defining serious illegality by dividing it into two main groups : illegality based on intentional commission of wrong act (capable of establishing illegality defence ) and illegality as a result of sheer inadvertence (incapable of establishing illegality defence)[733]. Despite the fact that above mentioned criterion does not provide a clear answer to

[730] Enonchong . N(2006) , 416
[731] *Group Josi Re v Walbrook Insurance Co. Ltd[*1996] 1 Lloyd's Rep 345.
[732] *Mahonia Ltd v JP Morgan Chase Bank and West LB (*No. 1) [2003] EWHC 1927 (Comm) [2003] 2 Lloyd's Rep 911
[733] [2004] EWHC 1938 (Comm) [2004] WL 1, 808-816

question of when illegality should be considered serious, it can be used as a mechanism for defining illegality in underlying contract.

4.2.3- Beneficiary's knowledge

Illegality exception will apply only where beneficiary has knowledge of it in the context of underlying contract and in fact, he (or she) is a party to it[734]. Based on general principles of English law, a claimant with no knowledge of illegality in contract with an illegal purpose is not prohibited from exercising his rights[735]. With reference to above mentioned general principles the conclusion would be that in operation of documentary letters of credit, claim of beneficiary who has no knowledge about illegality in underlying contract would not be affected. As a result, in the case of *Mahonia*, even if the underlying contract would be established as illegal, it was impossible to bar beneficiary from his claim unless in presence of evidence proving his knowledge of such illegality.

Requirement of beneficiary's knowledge about illegality of underlying contract is a limiting factor for application of the exception. The same type of limitation is evidenced in scope of fraud

[734] Enonchung .N (2006), 416
[735] Enonchung . N (1998) Illigal Transactions , Lloyds of London press , London , Ch -15

rule where knowledge of beneficiary about fraud is essential for application of exception[736]

4.2.4- Degree of connection

Close connection between letter of credit and illegality in underlying contract is another factor to determine and limit the scope of illegality exception.[737] The problem rising from concept of the degree of connection was first noticed in *Fidelity & Deposit Co of Maryland v Grand Nat. Bank* [738] by addressing the question of which criteria to use in determining connection between letter of credit and illegal underlying contract? Main tests used by court for determining such connection are "reliance test" and "*Mahonia* test" .

4.2.4.1- Reliance test

Developed in the Court of Appeal of *Bowmakers Ltd v Barnet Instruments Ltd*[739], reliance test was confirmed in the House of Lords decision of *Tinsley v Millingan*[740]. According to this test: "a party is not to rely on his own fraud or illegality in order to assist his

[736] *MontrodLtd V. GrundkotterFleischvertriebs GmbH*[2001]EWCA Civ 1954, [2002] 1 W.L.R 1975
[737] [2004] EWHC 1938 (Comm) [2004] WL 1 , 428
[738] *Fidelity & Deposit Co of Maryland v Grand Nat.Bank,* 2 F Supp 666,668 (E D Mo 1933).
[739] *Bowmakers Ltd v Barnet Instruments Ltd [1945] KB 65.*
[740] *Tinsley v Millingan [1994] 1 AC 340*

claim"[741]. Case of *Tinsley*, was about a right of property ownership .The test gets further elaboration as :

> "In my judgment the time has come to decide clearly that the rule is the same whether a plaintiff founds himself on a legal or equitable title: he is entitled to recover if he is not forced to plead or rely on the illegality, even if it emerges that the title on which he relied was acquired in the course of carrying through an illegal transaction."[742]

Despite the fact that the Law Commission holds that "outside the context of proprietary claims, the reliance principle is by no means the universal rule that is used to determine whether illegality should have any effect on the civil claim"[743]case law evidences broadening of the scope of application of reliance principle overtime[744].

However, for the sake of following reasons, it is submitted that reliance principle is not satisfactory tool for defining close relations between LC and illegal underlying contract in the framework of

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[741] Ibid 366
[742] Ibid 376
[743] LC 320, section 3.2
[744] *Cross v. kirkby* [2000] All ER (D) 212, *Hewison v. Meridian Shipping Services PTELtd* [2003] ICR 766.

documentary letters of credit:[745]First, as the test is not based on any policy grounds, its general application is considered as unsatisfactory[746]. Second, there is uncertainty in scope of the application of test. It is not clear whether claimant is prevented from his own illegal act or illegal underlying contract.[747]In the case of *Group Josi* , at one point , Staughton L.J comments on prohibiting party to rely on his own "illegality"[748] and later shifts to prohibiting party from relying on the "illegal contract"[749]. These two scopes are different from each other and as first one is much narrower, it will provide more possibility for claimant to enforce his claim where underlying contract is tainted with illegality[750].Third, since the scope of test is really narrow, its application to illegality exception in the framework of documentary letters of credit will make prospect of success illusionary even where the underlying contract has been really tainted with illegality[751]. This means as beneficiary does not

[745] Enonchong .N,(2011) , 197
[746] Enonchong. N , (1994) , "Illegality, the fading flame of Public Policy" 14 OJLS 295-299
[747] Enonchong . N, (2011) , 197
[748] *Group Josi Re v. Walbrook Insurance Co. Ltd*. [1996] 1 W.L.R. 1152, 1162. P360
[749] Ibid 360
[750] Enonchong .N (2010) , 198
[751] Ibid

need to rely on his own illegality; he is able to enforce the credit even in presence of illegality in the underlying contract.

4.2.4.2- *Mahonia* Test

In the case of *Mahonia Limited v JP Morgan Chase Bank, West LB AG (No 2)*[752] Cooke J did not introduce any convincing test to ascertain connection between illegality in underlying contract and documentary letter of credit issued on that basis. Cook J held , if the illegality of underlying contract was established ,he immediately accepts that : " [LC was] was directly tied to the illegal purpose since it was an important part of the scheme which was to give rise to the unlawful accounting albeit that it was not directly connected to the accounting itself, in the manner of the Three Swaps"[753]. There is a strong doubt about capability of criteria to conclude an established connection between illegality in underlying contract and the credit.[754] Judgement of Cooke J , could only be justified with judgement of Kerr and Bingham LJJ in the case of *Saunders v Edwards*[755] where both Lord Justices held that :

[752] *Mahonia Limited v JP Morgan Chase Bank, West LB AG* (No 2) [2004] EWHC 1938 (Comm), 2004 WL 1 808-816.
[753] Ibid 427
[754] Enonching . N (2006) , 404
[755] *Saunders v Edwards* [1987] 1 WLR 1116.

"Where issues of illegality are raised, the courts have...to steer a middle course between two unacceptable positions. On the one hand it is unacceptable that any court of law should aid or lend its authority to a party seeking to pursue or enforce an object or agreement which the law prohibits. On the other hand, it is unacceptable that the court should, on the first indication of unlawfulness affecting any aspect of a transaction, draw up its skirts and refuse all assistance to the plaintiff, no matter how serious his loss nor how disproportionate his loss to the unlawfulness of his conduct... . [O]n the whole the courts have tended to adopt a pragmatic approach to these problems, seeking where possible to see that genuine wrongs are righted so long as the court does not thereby promote or countenance a nefarious object or bargain which it is bound to condemn. Where the plaintiff's action in truth arises *directly ex turpi causa*, he is likely to fail... [w]here the plaintiff has suffered a genuine wrong, to which the allegedly unlawful conduct is incidental, he is likely to succeed...."[756]

[756] Ibid 1143

Enonchog suggests that "sole criteria that should be used to determine whether the letter of credit is sufficiently connected to the illegality in the underlying transaction should be the beneficiary's complicity in it"[757]. According to him, close connection between illegal underlying contract and the credit is established where beneficiary has knowledge of illegality in underlying contract[758]. This approach is regarded as persuasive and commended.[759]

### 5- Illegality in different jurisdictions

Review of the position of other jurisdictions to illegality as an exception to autonomy principle in documentary letters of credit provides different approaches and attitudes. Exception seems to be completely rejected under American law while Australian law shows positive attitude towards accepting it. Where UCP takes an absolute silent position towards all exceptions to the principle of autonomy, signatory countries of the UN Convention on Independence Guarantees and Standby Letters of Credit recognize illegality as an exception to autonomy principle within scope of the convention.

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[757] Enonchong (2006) , 421
[758] Ibid 421
[759] Amaefule, C. (2012). The exceptions to the principle of autonomy of documentary credits (Doctoral dissertation, University of Birmingham). 245

## 5.1- Uniform Customs and Practices for Documentary Letters of Credit

The UCP is set of rules prepared by International Chamber of Commerce for regulating application , issuance , advise , confirming, negotiation , reimbursement and requirements for documentary compliance under the LC operation in addition to rules relevant to fundamental principles of documentary letters of credit.

Current version of UCP (600) together with its predecessors take an absolute silent position towards exceptions to principle of autonomy in documentary letters of credit and leave it open for national laws.

## 5-2 Common Law Jurisdictions

Article 5 of the Uniform Commercial Code in the United Sates of America in does not recognize illegality exception to autonomy principle of documentary letters of credit. Article 5-109 defines fraud and forgery as sole recognized exceptions. The majority opinion in the US is in favour of not recognizing it as illegality is not explicitly addressed in the code, and bank is mandated to pay against presentation of conforming documents even where that underlying

contract is tainted with illegality.[760] This view has received some support from authorities'[761].Mc Laughlin argues that in absence of statuary provision, the UCC has not expelled illegality defence and where illegality exception is applicable; bank is entitled to refuse payment due under the credit.[762] However, old UCC Article 5 was also of the opinion that "there is nothing in the UCC … which excuses an issuing bank from paying a letter of credit because of supervening illegality"[763]

In contrary, Australian courts not yet faced with the case of illegality exception in documentary letters of credit, seem to be ready to recognize the exception. The *Obiter dicta* of *Fletcher Coustrauction Australia Ltd v Vransdorf Pty Ltd* [764] says: "in the absence of fraud or illegality, [the beneficiary] cannot be restrained from acting in conformity with the contract".

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[760] *J Zeevi & Sons Ltd v Grindlays Bank (Uganda) Ltd (NY Ct of App 1975) 333 NE2d 168.*
[761] Ibid
[762] McLaughlin. G (2002) , Exploring boundaries : A legal and Structural Analysis of the Independence Principle of Letter of Credit Law",119 Banking LJ 501,527-8.
[763] KMW International v Chase Manhattan Bank NA 606 F 2d 10 (1979).
[764] *Fletcher Coustrauction Australia Ltd v Vransforf Pty Ltd [1997]*

In Canada, exception seems to be rejected by courts .As in *Morguard Bank of Canada v Reigate Resources Canada Ltd* [765] , Power J held that due to separation of the letter of credit form underlying contract it is not affected by illegality of the underlying contract . [766] It has been argued that opinion of Power J's was *obiter* despite of receiving approval in subsequent cases[767]. In *Cineplex Oden Corp v 100 Bloor Street West General Partnership Inc*[768]Blair J . Commented on fundamental nature of autonomy principle of LC referred to fraud as only admitted exception to it. Later, he referred to Riddle LJ in *Washburn v Wright* [769] who held "fraud is not mistake, error in interpreting a contract; fraud is something dishonest and morally wrong , and much mischief is … done as much as much unnecessary pain inflicted by its use where " illegality" and "illegal" are the real appropriate expressions"[770]. Balir J was cited and confirmed in other Canadian cases including: *Standard Trust Co (Liq) v Bank of Nova*

[765] Morguard Bank of Canada v Reigate Resources Canada Ltd (1985) 40 Alta Lr (2d) 77.
[766] Ibid ,81
[767] *Morguard Trust Co v. Royal Bank of Canada* (1988) ACWS(3th) 416 54
[768] *Cineplex Oden Corp v 100 Bloor Street West General Partnership Inc [1993]OJ No 112 , 9*
[769] *Washburn v Wright* (1913)( App. Div) .
[770] Ibid 147

*Scotia* and *Royal Bank of Canada v Gentra Canada Investments Inc* [771].

Despite the fact that Singaporean courts have recognized unconscionability[772]and nullity[773] as exceptions to the principle of autotomy in documentary letters of credit in addition to fraud, they have no reported decision on illegality exception[774].However; there are judicial opinions against the recognition of illegality exception. In the case of *American Assurance Co v Hong Lam Marine Pte Ltd* [775], performance bonds were refused to be honoured by issuing bank as a result of illegality in underlying contract . The Singapore Court of Appeal rejected the claim and held that underlying contract for building a ship is enforceable. Further , court stated that even in case of illegality in underlying contract ,such illegality would not affect beneficiary's claim on performance bonds as " [performance bonds ] are independent of the underlying contract , there was no reason why

[771] *Standard Trust Co (Liq) v Bank of Nova Scotia* [2001] NFCA 27 ; *Royal Bank of Canada v Gentra Canada Investments Inc* [2000] OTC 86 , 56
[772] *GHL Pte V Unitrack Construction Ltd* [1999]4 SLR 604.
[773] *Beam Technology (Mfg) Pte Ltd v Standard Chartered* [2003] 1 SLR 597.
[774] Enonchong (2011) , 205
[775] *American Assurance Co v Hong Lam Marine Pte Ltd [1999] 3 SLR 862*

the illegality in the form of the backdating had to have any effect on the respondent's claim" [776]

5-3 UN Convention on Independent Guarantees and Standby Letters of Credit

In the framework of the UN Convention on Independent Guarantees and Standby Letters of Credit, invalidity exceptions are among considered provisions including invalidity as a result of illegality. According to article 19(1), "[if it is clear that demand] has no conceivable basis, the guarantor/ issuer, acting in good faith, has a right as against the beneficiary to withhold payment". Further, paragraph 2 of article 19 defines conditions under which demand cannot be considered as conceivable: "the underlying obligation of the principle/ applicant has been declared invalid by the court or arbitral tribunal; unless the undertaken indicates that such contingency falls within the risk to be covered by the undertaking". It means that, in case of recognition of illegality in underlying contract, demand for payment of guarantee issued on the basis of such contract would be unconceivable and bank has discretion to refuse its effectuation. The precondition for such refusal of payment is

[776] *Ibid 68*

recognizing the underlying contract as illegal by court or arbitration tribunal. Therefore, bank cannot refuse payment before recognizing the contract by court as illegal and should pay for claim before the hearing even it has clear evidence on contract being tainted by illegality.[777] The Convention does not provide answer to the question that in such circumstances, whether applicant can ask for interim injunction to prevent bank from making payment or beneficiary from claiming payment under the guarantee or not?

### 6- Criticisms to Illegality as a defence for payment

As it has been discussed in previous sections, illegality defence to payment under letter of credit law is either accepted or ready for being accepted in many jurisdictions. However, there are also several arguments against application of illegality in underlying contract as an exception to autonomy principle in international LC transaction.

First argument points at the fact that almost all available opinions in favour of recognition of illegality in underlying contract as defence for payment in letter of credits transaction are based on two English cases. In addition, there are some other issues with provide necessity

[777] Enonchong . N (2011) , 206

for more cautious approach: In the cases of *Group Josi*[778] and *Mahonia* [779]all statements of learned judges in favour of illegality were *Obiter* and not *ratio decidendi*. Plus, it worth to mention that none of those letters of credits were commercial LCs used the process of international trade (they were both claims on bank guarantees). In none of those cases, court concluded that underlying contract was tainted with illegality, and *Obiter dicta* of judges in above mentioned courts not been cited or referred to by the Court of Appeal of House of Lords in England. Last but not the least, (as emphasized earlier) examples given in those cases for the purpose supporting recognition of illegality exception including contract for selling weapons to Iraq during war time[780] and contract of sales for trading narcotics are extreme and rare.[781]

Second, it seems in the same vein with statement of Lord Denning, in *Edward Owen v Barclays Bank International*[782]: "[a]ll this leads to

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[778] *Group Josi Re v Walbrook Insurance Co. Ltd[*1996] 1 Lloyd's Rep 345.
[779] *Mahonia Ltd v JP Morgan Chase Bank and West LB (*No. 1) [2003] EWHC 1927 (Comm) [2003] 2Lloyd's Rep 911

[780] *[*1996] 1 Lloyd's Rep 345
[781] [2003] EWHC 1927 (Comm) [2003] 2Lloyd's Rep 911

[782] *Edward Owen v Barclays Bank International* [1978] 1 Lloyd's Rep 166 per Lord Denning at 171-172

the conclusion that the performance guarantee stands on a similar footing to a letter of credit"[783], bank guarantees and commercial letters of credits are taken as similar financing tools by pro illegality exception arguments. Pro illegality arguments in *Group Josi* and *Mahonia* fail to mention that tools used for financing the underlying contract in both cases where not commercial documentary letters of credit . They aslo fail to answer to the question why both standby letters of credit and commercial LC should follow same rule regarding application of the illegality exception? Standby letters of Credit and bank guarantees are used as: "not to act as a conduit for the payment of the price [which is the purpose of commercial letters of credit]…but to cajole the seller into performance, particularly performance of his physical obligations under the contract of sale, and the bond is consequently closely linked to that contract".[784] Despite the fact that both instruments are subjected to independence principle , but above mentioned argument makes standby letters of credits and bank guarantees to be "less independent" [785]than commercial LCs to underlying contract. In approval of above

[783] Ibid
[784] Debattista. C (1997), "Performance bonds and letters of credit: a cracked mirror image" JBL 289 at 303.
[785] Ibid 301

discussion, Eveleign LJ in the case of *Potton Homes Ltd v Coleman Contractors Ltd*[786], submitted that : "In attributing to the bond may 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."[787]

As a result, it would not be admissible to say illegality exception should apply to commercial letters of credit similar to its application to bank guarantees and without justification of existing fundamental differences[788].

Third, pro illegality argument do not make any distinction between illegality in underlying contract and fraud exception. All proponents of recognition of illegality exception comment on principle of *ex turpi causa* to justify their arguments. Similarly, *ex turpi causa* is the justifying principle of fraud exception; but no argument in favour of illegality explains why same principle must apply equally to two different legal conditions. [789] It is submitted that the principle might

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[786] *Potton Homes Ltd v Coleman Contractors Ltd*[1984] 28 Build L R 19
[787] Ibid , 27
[788] Liao, Z. (2015, August). The" illegality exception" reconsidered. In Conference on International Trade and Business Law (INTRABIL 2015).
[789] [2003] EWHC 1927 (Comm) per Colman J at [68].

not apply equality to fraud and illegality in underlying contract[790]. As in case of fraud in international sales contract, dishonesty or knowledge of party should be established. However, there is possibility that neither party to the underlying contract would be aware of its illegal nature.

It also worth to mention that interests affected by fraud are mostly private while illegality affects public interests via obtaining benefit by imposition of cost at society. As a result, it will serve more efficiently to prevent illegality by statute. This will let the court to grant injunction based on request of public or private entities while relying on a particular statute of law not on the basis of vague exception in underlying contract.[791]

## 7- Conclusion

In paper paper, author studied illegality as a defence against impregnability of principle of autonomy in documentary letters of credit. As a result, two conditions were defined: First is a circumstance in which the letter of credit is illegal that does not involve principle of autonomy .In this case, LC would be

[790] Liao, Z. (2015, August). 24
[791] Ibid

unenforceable with reference to age long principle of illegality of contracts. Second is where underlying contract is illegal and this makes court to involve autonomy principle in case of deciding to announce the LC as unenforceable. A comparative study of illegality defence in common law countries show that except the United States of America other jurisdictions have either accepted or getting ready to recognize it as another (independent of fraud) exception to principal of autonomy in documentary letters of credit and demand guarantees.

However, in-depth analysis of legal nature, scope, rationales and case law relevant to illegality exception in different jurisdictions prove that it is still at very early stage of life and there is need for further clarification in all above mentioned areas.

It also worth to mention that illegality exception has been criticised seriously by some commentators in terms of available case law, its applicability to demand guarantees and commercial letters of credit , its effect on popularity of LC as trade finance tool among international trades and also its distinction from fraud . Therefore, further research is inevitably necessary to answer existing criticism and clarifying ambiguous aspects of its legal nature.

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- *Sztejn V. J. Henry Schroder banking Corporation* [1941] N.Y.S. 2
- The Law Commission CP 189 , P27
- *Tinsley v Millingan [1994] 1 AC 340*
- *United City Merchants (Investments) Ltd. v. Royal Bank of Canada*, [1983] 1 AC 168, 183
- *United Trading Corporation SA v. Allied Arab Bank Ltd* [1985]2 Lloyd's Rep .554
- *Washburn v Wright* [1913]( App. Div) .
- *Yango Pastoral Co. Pty. Ltd v. First Chicago Australia Ltd Ltd [1978] 139 C.LR. 410, 413, per Gibbs A.C.J.*

**Publication 8: Alavi, H, (2016), "Comparative study of Unconscionability exception to the principle of autonomy in law of Letter of Credits", *Acta Universitatis Danubius*, Vol 12, No 2,94-121**

# Comparative study of Unconscionability exception to the principle of autonomy in law of Letter of Credits

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**Abstract**

*This paper touches upon legal nature and scope of unconscionability as an exception to autonomy principle of documentary letters of credit (LC) and bank guarantees. Complicated process of international trade is known as the main reason behind development of new exceptions to globally appreciated principle of autonomy in process of LC transaction. Apart from fraud which has been recognized in international business society and various jurisdictions, other exceptions including unconscionability, nullity, illegality and recklessness have received different treatments in different national laws. Unconscionability is applied to situations where beneficiary's demand to draw under the LC is not fraudulent but affected with bad faith in a way that court prevents bank from honouring the credit. While UCP leaves the problem of fraud and other exceptions to autonomy principle to be solved by national laws, , among common law countries , unconscionability defence has been recognized in Australia and Singapore but others do not show welcoming attitude towards it. Current paper tries to find reasons behind different attitudes of common law jurisdictions to*

*unconscionability defence in letter of credit process by answering following questions: What is the nature of unconscionability? How different common law jurisdictions have received it as an exception to principle of autonomy in documentary letters of credit and bank guarantees? And last but not the least, what are arguments in favour and against its universal recognition as a defence for payment under letter of credit and bank guarantee system?*

**Key Words**: Documentary Letters of Credit, International Trade, Exceptions to Principle of Autonomy, Unconscionability, Common Law System

## 1- Introduction

In the process of international business, documentary letters of credit are used historically for the purpose of shifting risk of payment from applicant as a natural person to the bank as a more reputable entity with legal personality. By using documentary credits, seller would be sure that his payment is ready upon presentation of complying documents to bank and regardless to any dispute on the underlying contract .On the other hand, buyer is sure that in case of noncompliance of documents with terms and conditions of credit or committing fraud and forgery by seller bank would not make payment and his interests are protected.[792] Mechanism of international LC transaction just like bank guarantee is subjected to two main principles of autonomy and strict compliance[793]. Accordingly, principle of autonomy separates the credit from its underlying contract while principle of strict compliance imposes

[792] Alavi, H. (2016). Documentary Letters of Credit, Legal Nature and Sources of Law. *Journal of Legal Studies*, *17*(31), 106-121.
[793] UCP 600 , Article 4 ,5 and 6

condition of strict compliance of presentation with terms and conditions of credit for letting bank to effectuate the payment. Before case of *Sztejn v Henry Schroder banking Corporation*[794]absolute application of the principle of autonomy deemed uncontested. However, recognition of fraud as the first exception to the principle of autonomy in documentary letters of credit raised fear of moving "down the slippery slope toward a more pervasive impairment of the utility of letters of credit"[795] among commentators. Such concerns seem to be true as trade practices started to develop further disruptions including unconscionability, illegality, recklessness and nullity as new exceptions to the principle of autonomy in international LC transaction[796].

Unconscionability, as the focus point of current research, refers to condition in which claim of beneficiary to draw under the credit or bank guarantee is so affected with bad faith that court decides to prevent bank from payment in absence of fraud or forgery.[797] The unclear nature of unconscionability has resulted in divergent approaches to above mentioned circumstances in different jurisdictions. Many legal practitioners and academicians endeavoured to articulate it and occasions under which

[794] *Sztejn v Henry Schroder banking Corporation* 31 NYS 2d 631 (1941)
[795] Johns, R. J., & Blodgett, M. S. (2010). Fairness at the Expense of Commercial Certainty: The International Emergence of Unconscionability and Illegality as Exceptions to the Independence Principle of Letters of Credit and Bank Guarantees. *N. Ill. UL Rev.*, *31*, 297.
[796] Alavi .H , (2016), Arbitration and LC Fraud Disputes: a Comparative Approach, Russian Journal of Comparative Law, Vol. (8), 2, 70
[797] Ellinger. E.P,Neo.D.S.S (2010), The Law and Practice of Documentary Credit , Hart Publishing, Portland 169

unconscionability can be used as a defence.[798] However, majority of efforts have been failed due to difficulties in providing a precise definition and circumstances for application of unconscionability as an exception to autonomy principle of documentary letters of credit[799]. At the same time, its supporters claim that unconscionability will provide court with more flexibility[800] and possibility to "police agreement directly"[801] and reject contractual rights in absence of the free choice.[802] In contract, its ardent critics argue that unconscionability is "an emotionally satisfying incantation acting as a refuge for the desperate and analytically lazy"[803] which means "nothing" in practice.

With reference to documentary letters of credit, unconscionability has received different treatment in different common law jurisdictions. While it is recognized under Singaporean and Australian Law, it has not experienced such welcoming approach towards in English and American law. Therefore, it is possible to conclude (due to its recognition in two common law countries) that unconscionably represents a sort of merit as an exception to the principle of autonomy[804].

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[798] Rickett. C, (2006), 'Unconscionability and Commercial Law' in John Lowry Commercial Law : Perspective and Practice ,Lexis Nexis , 175

[799] Amaefule, C. (2012). The exceptions to the principle of autonomy of documentary credits (Doctoral dissertation, University of Birmingham)

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[801] Hilman. R, (1981) 'Debunking some Myth About Unconscionability: A New Framework for UCC Section 2-302' 67 Cornell L Rev 1, 15 .

[802] Hawkland UCC SERIES, S.2-302 (Art. 2) (1997-1999) 1.

[803] Rickett. C, (2006), 179

[804] Amaefule, C. (2012).165

While discussing such contradictory opinions on developing concept like unconscionably, it worth to keep in mind that exceptions to the autonomy principle in documentary letters of credit and bank guarantees is a changing area of law and it gradually develops towards further wisdom[805] .

Therefore, current paper endeavours providing an answer to questions of what is the nature of unconscionability. How different jurisdictions have received it as an exception to principle of autonomy in documentary letters of credit and bank guarantees? And last but not the least, what are arguments in favour and against its universal recognition as a defence for payment under letter of credit and bank guarantee system? Following the objective of answering above mentioned research questions, paper is divided into seven parts. After an introduction, second part will tap on the autonomy principle in LC law. Third part will discuss the nature of unconscionably, and fourth will review approaches of different common law jurisdictions to it as an exception to principle of autonomy. While part five and six discuss the standard of proof and arguments for and against recognition of unconscionability in documentary letters of credit under English law, final part will make overall conclusion on discussion over the subject matter.

## 2- Autonomy as a fundamental principle in Letter of Credit's law

[805] Mugasha, A (2004)'Enjoining the Beneficiary's Claim on a Letter of Credit or Bank Guarantee' , JBL 515 at 538

The process of documentary letters of credit is subjected to two main principles of autonomy and strict compliance[806]. Simultaneous application of both principles facilities the smoothness of international trade, autonomy principle prevents effects of dispute on underlying contract to affect payment under abstract obligation of issuer and assures beneficiary about receiving payment upon presentation of complying documents with terms and conditions of the credit. In the same vein, principle of strict compliance safeguards interests of applicant by providing the beneficiary would not be paid before presenting documents which prove compliance of shipped goods with terms of the credit.[807] According to article 4 of the UCP 600:

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

[806] Alavi, H. (2016). Documentary Letters of Credit, Principle of Strict Compliance and Risk of Documentary Discrepancy. *Kor. UL Rev.*, *19*, 3.
[807] Alavi , H. "Autonomy Principle and Fraud Exception in Documentary Letters of Credit, a Comparative Study between United States and England" . *International and Comparative Law Review,* Vol. 15, No. 2 ,(2015) ,45-67

A beneficiary can in no case avail itself of the contractual relationships existing between banks or between the applicant and the issuing bank. b. An issuing bank should discourage any attempt by the applicant to include, as an integral part of the credit, copies of the underlying contract, proforma invoice and the like."

Although, geographical distance of parties in regular practice of international trade provides beneficiary with asymmetrical access to information which provides him with possibility to commit fraud, but application of autonomy principle would reduce risk of trade down to acceptable point for both parties[808]. However, it is more than seventy years that absolute application of independence principle has been eroded by global recognition of fraud rule as a basis for interference of courts in regular process of LC operation. [809] Despite age long recognition of fraud rule in in international LC operation on the basis of mercantile usage[810], it was first time applied to the case of in 1941.[811] Since the application of fraud rule in international LC operation, there were always concerns among legal scholars that availability of injection relief in the framework of disputes in underlying contract would affect the utility of documentary letters of credit as a popular means of finance among international trades[812] .

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[808] Wiener Katz.A, (1999), An Economic Analysis of the Guaranty Contract, 66 U. CHI. L. REv. 47, 105

[809] Symons, Jr., (1980)Letters of Credit: Fraud, Good Faith and the Basis for Injunctive Relief 54 TUL. L. REv. 338, 341-42

[810] Blodgett .M, Mayer. D,(1998), International Letters of Credit: Arbitral Alternatives to Litigating Fraud, 35 AM. Bus. L.J. 443, 12

[811] Sztejn v. J. Henry Schroder Banking Corp 31 N.Y.S.2d 631 (1941).

[812] Johns, R. J., & Blodgett, M. S. (2010). Fairness at the Expense of Commercial Certainty: The International Emergence of Unconscionability and Illegality as

> "It is axiomatic that courts and legislatures must tether the fraud inquiry in independent obligations law, for untethered, the inquiry destroys these independent commercial devices, which are crucial to international trade and domestic commerce."[813]

As a result, most of courts in different jurisdictions show hesitance in issuing injections on the basis of fraud in documentary letters of credit and demand guarantees.

It has been argued *Sztejn* case had a significant effect on introduction of more erosions in universal application of independence principle as it took the first step down the slop towards introduction of further expectations[814]. Such concerns seems to be valid as at the same time that policy exigencies try to keep the predictability of law of the letter of credits viable, new exceptions like unconscionability , nullity and illegality started to raise on the basis of commercial practices.[815]

It seems necessary that before going more in-depth into the legal issues relevant to unconscionability exception to principle of autonomy in documentary letters of credit to pay attention to different nature of primary and secondary payment obligations in banking industry. It is common for courts to use interchangeably the law of

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Exceptions to the Independence Principle of Letters of Credit and Bank Guarantees. *N. Ill. UL Rev.*, *31*, 297.

[813] Dolan.J.F (2006), Tethering the Fraud Inquiry in Letter of Credit Law, 21 BANKING & FIN. L. REv. 480

[814] Kalson .D.J (1983), Note, The International Monetary Fund Agreement and Letters of Credit: A Balancing of Purposes, 44 U. PIrr. L. REV. 1061, 1065

[815] Leigh. M (1984), Decision: Iranian Assets Control RegulationsStandby Letters of Credit-Blocking of Foreign Assets, 78 AM. J. INT'L L. 224

injunction for primary obligation bank guarantees and commercial letters of credit as they have been developed alongside each other.[816] However, bank guarantees (standby letters of credit) are primary obligations where performance bonds are secondary obligations[817] . While primary obligations are completely independent from underlying contract, secondary obligations do not show such independent nature.

### 3- Nature of Unconscionability

Efforts for defining the unconscionability would result in further ambiguity due to amorphousness of its nature[818]. However, there are several available definitions of unconscionability including: Unified Commercial Code in the United States which comments on unconscionability as a principle following the goal of "prevention of oppression and unfair surprise and not of disturbance for the allocation of risks because of superior bargaining power"[819]. In the same vein, in Australia ,during the hearing of *Optus Networks Pty Limited v Telstra Corporation Limited*[820] , Edmond's J with reference to Australian Trade Practices Act of 1974 [821]mentioned that

[816] Group Josi Re v. Walbrook Ins. Co., [1996] 1 W.L.R. 1152
[817] Leigh. M (1984) 226
[818] Editors Note on 'Unconscionability: an attempt at definition' (1969-1970) 31 U Pitt L Rev 333.
[819] UCC Article 2-302
[820] *Optus Networks Pty Limited v Telstra Corporation Limited* [2009] WL 1998981 (FCA), [2009] FCA 728.
[821] Australian Trade Practices Act 1974 Section 51 AA

unconscionability : "includes conduct in respect of which a judge in equity would have been prepared to grant relief"

Therefore, it is necessary to review unconscionability from two different perspectives of procedure and substance. This can be considered the main difference between illegality, fraud, duress, mistake and impossibility with unconscionability.[822] According to Leff, while all above mentioned defences can be viewed either from the perspective of the process of contracting or outcome of the contract, unconscionability can exist both in process and outcome.[823]According to him, procedural unconscionability is in fact "bargaining naughtiness"[824]which displays elements of defect in negotiation process by one party with result in oppression of the other party[825]. On the other hand, substantive unconscionability refers to the ill faith resulted from contact[826].

Many jurisdictions have pointed at unconscionability as a legal tool. For example, section 36 of the Nordic Contracts Act mentions: "If a contract or a term thereof is unfair, or its application would be unfair, it may be adjusted or left unapplied. When considering the unfairness the whole content of the contract, the position of the parties, the circumstances when the contract was made and thereafter and other

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[822] Leff. A.A, (1967) 'Unconscionability and the Code-The Emperors New Clause' , 115 U
PA L Rev 485
[823] Ibid
[824] Ibid
[825] Horowitz. C (1986), Comment 'Reviving the Law of Substantive Unconscionability: Applying the implied Covenant of Good Faith and Fair Dealing to Excessively Priced Consumer Credit Contracts', 33 UNCLA L Rev 940.
[826] Leff. A.A, (1967), 492

circumstances shall be taken into account". Article 2-302 of the UCC in the United States of America clearly established that: "'If the court as a matter of law finds the contract or any clause of the contract to have been unconscionable at the time it was made, the court may refuse to enforce the contract, or it may enforce the remainder of the contract without the unconscionable clause, or it may so limit the application of any unconscionable clause as to avoid any unconscionable result". At the same time , Section 51. AA of Australian Trade Practices 1974 provides that : "A corporation must not, in trade or commerce, engage in conduct that is unconscionable within the meaning of the unwritten law, from time to time, of the States and Territories". As a result , it is possible to conclude that using unconscionability as a legal tool follows the goal of overcoming the problem in common law to set aside contracts which are "clearly oppressive and unfair"[827] but "at the same time not fraudulent"[828].

In the context of documentary letters of credit, judgements of learned judges show that unconscionability is only possible to be defined in a broad sense under terms like absence of good faith. [829]. In other case , it was defined as : "Unconscionability to me involves unfairness, as distinct from dishonesty or fraud, or conduct of a kind so reprehensible or lacking in good faith that a court of conscience would either restrain the party or refuse to assist the party. Mere

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[827] Price. D, (1981), 'The conscience of Judge and Jury: Statutory Unconscionability as a Mixed Question of Fact and Law' 54 Temp L Q 743,746.
[828] Ibid
[829] *Dauphin Offshore Engineering & Trading Pte Ltd v The Private Office of HRH Sheikh Sultan bin Khalifa bin Zayed Al Nahyan* [2000] 1 SLR 657

breaches of contract by the party in question ... would not by themselves be unconscionable"[830]. Although, experience shows that efforts in clarifying legal position of unconscionability will lead to further ambiguity , but such problems should be expected due to the nature of the term . "The point needs to be made that unconscionability is an equitable creation and some of the primary considerations in its determination is what is commercially reasonable, devoid of mala fides and meets the commercial and contractual expectation of the parties."[831]

## 4- Unconscionability in different jurisdictions

4-1 Status of Unconscionability under English Law

The English law has history of dealing with unconscionable contracts since 1697. [832]In the case of *Earl of Chesterfield v Janssen*[833], Lord Hardwicke pronounced the term "unconscientious" while ruling on unenforceability of a contract based on presumptive fraud

> "It may be apparent from the intrinsic nature and subject of the bargain itself; such as no man in his senses and not under a delusion would make on the one hand, and as no honest man and fair man would accept on the other; which are unequitable and

[830] *GHL Pte Ltd v Unitrack Building Construction Pte Ltd* [1999] 4 SLR 604.
[831] Amaefule, C. (2012). *The exceptions to the principle of autonomy of documentary credits* (Doctoral dissertation, University of Birmingham). 169-170
[832] Vener. L.J (1984), 'Unconscionable Terms and Penalty Clauses: A Review of Cases Under Article 2 of the Uniform Commercial Code' , 89 Com. LJ 403,404
[833] *Earl of Chesterfield v Janssen* 2 Ves Sr 125 at 128 Eng. Reprint 821 Atk 30126 Eng Rep 191

unconscientious bargains; and of such even the common law has taken notice"[834]

According to early English cases on the subject matter of unconscionability, it appears that unconscionability were applied to circumstances where fraud, duress, or illegality could not be established[835].

In the framework of documentary letters of credit and bank guarantees, first indication of unconscionability in English law goes back to 1966 in the case of *Elian and Rabbath v Matsas and Matsas*[836], The Court of Appeal held that in system of performance guarantees, there might be circumstances where the bad faith of a party entitles court to erode principle of independence by granting injunction in order to prevent an "irrevocable injustice"[837]However, Lord Denning tried to elaborate the difference between commercial letters of credit and performance bonds but it was not precise and issue was left unclear:

"Now I quite agree that a bank guarantee is very much like a letter of credit. The Courts will do their utmost to enforce it according to its terms. They will not, in the ordinary course of things, interfere by way of injunction to prevent its due implementation. But that is not an absolute rule. Circumstances may arise such as to warrant interference by injunction…. Although the shippers

[834] Ibid 155
[835] Enonchong, N. (2006). *Duress, undue influence and unconscionable dealing*. Sweet & Maxwell.Part III.
[836] *Elian and Rabbath v Matsas and Matsas* [1966] 2 Lloyds Rep 495
[837] Ibid 172

were not parties to the bank guarantee, nevertheless they have a most important interest in it. If the bank pays under this guarantee, they will claim against the Lebanese bank who in turn will claim against the shippers. The shippers will certainly be debited with the account. On being so debited, they will have to sue the ship-owners for breach of their promise, express or implied, to release the goods. Are the shippers to be forced to take that course? Or can they short-circuit the dispute by suing the ship-owners at once for an injunction?"[838]

In the Court of Appeal of *Potton Homes Ltd v Coleman Contractors (Oversea) Ltd*[839], Eveleigh LJ in an *obiter dictum* mentioned:

"In principle I do not think it possible to say that in no circumstances whatsoever, apart from fraud will the court restrain the buyer. The facts of each case must be considered. If the contract is avoided or if there is a failure of consideration between the buyer and the seller for which the seller undertook to procure the issue of a performance bond, I do not see why, as between seller and buyer, the seller should not be unable to prevent a call on the bond by the mere assertion that the bond is to be treated as cash in hand."[840]

In support of the opinion that principle of autonomy can be displaced on the basis of other reasons rather than fraud exception , he continued: " [the seller lawfully] avoided the contract prima facie it

[838] Ibid
[839] *Potton Homes Ltd v Coleman Contractors (Oversea) Ltd* (1984) 28 Build LR 19.

[840] Ibid 20-21

seems …[the seller] should be entitled to restrain the buyer from making use of the performance bond"[841]. In *TTI Telecom International Ltd v Hutchison 3G UK limited* [842]by referring to recognition of unconscionability as a defence for payment in Singapore , the court held that it can be a reason for displacing the principle of autonomy in performance bonds under English law[843].

However, despite existence of above mentioned *obiter dicta*, unconscionability has no equal position of fraud as recognized exception to the principle of autonomy in documentary letters of credit and it seems that English courts have taken a silent position in terms of its recognition as a defence for payment in international LC transactions as well as bank guarantees and performance bonds.

4.2- Singapore Law

Due to its colonial ties with England, common law system of England has been adopted in Singapore. Accordingly, for a long time, fraud was the only recognized exception to autonomy principle on documentary credits and bank guarantees under Singaporean law. [844] However, later court is Singapore got separated from the English law and developed its own unique approach to the subject matter. Following the case of *Patton Homes*[845], two judgements in Singapore found its *dictum* favourable. In *Royal Design Studio Pte Ltd v Chang*

[841] Ibid
[842] *TTI Telecom International Ltd v Hutchison 3G UK limited* [2003] 1 All ER 914.
[843] Ibid
[844] Johns, R. J., & Blodgett, M. S. (2010) , 297
[845] Potton Homes Ltd v Coleman Contractors (Oversea) Ltd (1984) 28 Build LR 19.

*Development Pte Ltd* [846], court granted an injunction to prevent beneficiary of a performance bond form benefiting from his own wrong[847]. The court's decision was followed rational of granting injunction on the basis of performance in underlying contract and it did not interfere with system of performance bond at all. [848]However, in the case *Kvaerner Singapore Ltd v UDL Shipbuilding (Singapore) Pte Ltd*[849]court took a different approach and granted injunction against issuer of the performance bond[850]. Above mentioned decisions of Singaporean courts clearly show intention of legal system in this country towards development of new exception to autonomy principle in documentary letters of credit and performance bonds based on unconscionability and bad faith of beneficiary. Those decisions are famous as "implicit unconscionability"[851]. Taking the direction of moving towards "explicit unconscionability"[852] , the court of *Bocotra Construction Pte Ltd. v. Attorney General (No. 2)*[853]held that sole considerations which amount for granting interlocutory injunction are either fraud or unconscionability[854]. Although, decision of *Bocotra* was contested with later decision of *Civilbuild Pte Ltd. v. Guobena Sdn Bhd*[855] on the basis that unconscionability might affect the moral rights but it does not affect

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[846] *Royal Design Studio Pte Ltd v Chang Development Pte Ltd [1990] 1 SLR 1116*
[847] Ibid 314
[848] Ibid
[849] *Kvaerner Singapore Ltd v UDL Shipbuilding (Singapore) Pte Ltd [1993], 3 SLR 350*
[850] Ibid
[851] [1990] 1 SLR 1116 , 314
[852] Johns, R. J., & Blodgett, M. S. (2010) , 297
[853] *Bocotra Construction Pte Ltd. v. Attorney General (No. 2) [1995) 2 S.L.R. 733*
[854] Ibid 747
[855] *Civilbuild Pte Ltd. v. Guobena Sdn Bhd [1999]1 SLR 374*

the legal right of beneficiary for receiving payment under LC or performance bond[856], subsequent cases established it as an exception to autonomy principle in documentary letters of credit under Singaporean law.

In *Dauphin Offshore Engineering & Trading Pte Ltd. v. Private Office of HRH Sheikh Sultan bin Kalifa bin Azyed al Nahyan*[857], the court ruled that unconscionable conduct of party in the framework of underlying contract would be enough reason for granting interlocutory relief on the basis of *providing prima* facie evidence of unconscionability. [858] In an endeavour to clarify the notion of unconscionability, court of *McConnell Dowell Constructors (Aust) Pty Ltd v Sembcorp Engineers and Constructors Pte Ltd*[859]held that case of unconscionability should deal with an element of unfairness. [860] Also, confirming the decision of *Dauphine*,in terms need to approach the unconscionability on the case by case basis rather than providing an overall definition for it, the court of *Hiap Tian Soon Construction Pte Ltd v Hola Development Pte Ltd* [861]held : "…what kind of situation would constitute unconscionability would have to depend on the facts of each case…There is no pre-determined categorization"[862].

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[856] Ibid 375
[857] *Dauphin Offshore Engineering & Trading Pte Ltd. v. Private Office of HRH Sheikh Sultan bin Kalifa bin Azyed al Nahyan* [2000] 1 S.L.R. 657.
[858] Ibid 672
[859] *McConnell Dowell Constructors (Aust) Pty Ltd v Sembcorp Engineers and ConstructorsPte Ltd* [2002] 1 SLR 199

[860] Ibid
[861] *Hiap Tian Soon Construction Pte Ltd v Hola Development Pte Ltd* [2003] 1 SLR 667.
[862] Ibid 63

It is possible to conclude that following points apply to position of Singapore towards unconscionability defence: in Singapore, unconscionability is recognized as an independent defence to autonomy principle in addition to fraud. Despite existence of problems in clarifying the notion of unconscionability, it is fully recognized. Due to application of exception to performance bonds , it is possible to mention that it is also recognized under LC law of Singapore. Last but not the least, recognition of unconscionability defence in Singapore has not provoked any criticism about negative effect of its subjective nature on process of international trade. Finally, the Singapore Court of Appeal confirmed in the recent case of *JBE Properties Pte Ltd v Gammon Pte Ltd* [863] "juridical basis for adopting unconscionability as a relevant ground (separate from and independent of fraud) lies in the equitable nature of the injunction. Considerations of unconscionability are applicable in relation to the use of the injunction in other areas of the law, and there is no reason why these considerations should not be applied for the purposes of determining whether a call on the performance bond should be restrained so as to achieve a fair balance between the interests of the beneficiary and those of obligor"[864].

4-3 Australian law

In Australian law, unconscionability has different position as it is subjected to legislative effect of Australian Customer Law Act. Currently, it is governed by Section 20 (1) of the Australian Consumer Law Act of 2010 as the reproduction of Section 51 AA of

[863] *JBE Properties Pte Ltd v Gammon Pte Ltd [2010] SGCA 46* .
[864] Ibid

Trade Practices Act 1974. Interestingly, the Section 51 AA did not provide any definition for unconscionability, mandated the court to use the "unwritten law, from time to time, of the States and Territories"[865]which is equal to the common law of the Australia[866]. The first record of dealing with unconscionability under letter of credit and performance guarantee law in Australia goes back to 1985 and case of *Hortico (Australia) Pty. Ltd. v. Energy Equipment Co. (Australia) Pty. Ltd*[867]. Where in an *obiter dicta* , State Court of New South Wales stated that: "it does not seem to me that anything short of actual fraud would warrant this Court in intervening, though it may be that in some cases (not this one), the unconscionable conduct may be so gross as to lead to [the] exercise of the discretionary power."[868] And, recognized the possibility for unconscionability as a ground for granting injunctions under common law of Australia. Eleven years later, Victoria State Supreme Court accepted the unconscionability as a defence for payment in *Olex Focas Pty. Ltd. v. Skodaexport Co. Ltd* [869]under letter of credit and performance bonds but, on the basis of different reasoning than *Hortico*. In this case, plaintiff Olex Focas the provider of communication, power cables and telecommunication equipment, entered a contract with defendant Skodaexport , the contractor for construction of oil pipeline in India.[870] In order to start

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[865] Trade Practices Act 1974, Section 51 AA(1), available at, http://www.chartermerc.com.au/pdfTradePractices%20act/201974.pdf. [Accessed 10 July 2016]

[866] Lange v Australisan Competition and Consumer Commission v Samton Holdings Pty Ltd & Ors [2002], 117 (FCR) 301

[867] *Hortico (Australia) Pty. Ltd. v. Energy Equipment Co. (Australia) Pty. Ltd* [1985] 1 NSWLR 545.

[868] Ibid 554

[869] *Olex Focas Pty. Ltd. v. Skodaexport Co. Ltd No. 6282, 1996 VIC LEXIS 1245*

[870] Ibid 5-6

the work, Olex Focas received two payments from defendant in return for two bank guarantees protecting it from loss of advanced payments . Upon delay of Olex Focas in starting the work, dispute started between parties and defendant made request for payment under bank guarantees. Olex Focas sought injunction against bank from paying under guarantees and Skodaexport from receiving payment. In the process of hearing , court rejected granting injunction based on common law despite existence of *Hortico* dictum and held : "[if unconscionability] were a ground, even allowing for the considerable growth in importance of unconscionability as a sword and a shield in Australian jurisprudence of late one would expect it to have been mentioned in the cases much earlier."[871] However, final judgement of the court of Olex Focas was in favour of issuing injunction based on the statutory law of Australia[872] . Later, the court of *Boral Formwork v Action Makers*[873]difficulties with clarification of definition for unconscionability under the law of documentary letters of credit became more evident where the court decided to grant a temporary injunction on the basis of Section 51 AA and in accordance with the decision of Olex Focas. The decision of Barol shifted the inquiry on position of unconscionability in Australian law from rule-based criteria which aimed at protecting the application of the principle of autonomy to the fact based criteria

[871] Ibid 60-61
[872] Section 51 AA of Australia Trade Practices Act 1974
[873] *Boral Formwork v Action Makers* [2003] ATPR 41-953[14].

which determines level of judge's tolerance towards degree of unconscionability in beneficiary's conduct.[874]

In the case of *Clough Engineering Ltd v Oil and Natural Gas Corporation Limited (No 2)*[875], it was held that injunction under Section 51 AA is available for unconscionability in addition to common law defence for fraud. [876] In case of *Clough Engineering Ltd* , action was taken by plaintiff to prevent a customer from drawing bank guarantees provide by plaintiff against risk of his failure under a construction contract between parities. [877] *Oil and Natural Gas Corporation Limited (*customer) applied for drawing under guarantees based on claim that *Clough Engineering Ltd* breached the underlying contract. [878] Plaintiff in return claimed that drawing under guarantees is unconscionable as breach of contract was the result of earlier breaches by the customer. [879] Further, court provided following definition unconscionability:

"under the unwritten law, which is the common law of Australia, unconscionable conduct will be such conduct as would support the grant of relief on principles set out in specific equitable doctrines.

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[874] Johns, R. J., & Blodgett, M. S. (2010). Fairness at the Expense of Commercial Certainty: The International Emergence of Unconscionability and Illegality as Exceptions to the Independence Principle of Letters of Credit and Bank Guarantees. *N. Ill. UL Rev.*, *31*, 324

[875] *Clough Engineering Ltd v Oil and Natural Gas Corporation Limited (No 2)[2008] FCAFC 136*

[876] Ibid 77

[877] Ibid 1

[878] Ibid 12

[879] Ibid 3

Equity does not provide a remedy in respect of conduct in trade or commerce which is, in the opinion of a judge, unfair".[880]

Following the line of the development of unconscionability exception in Australian law, it is possible to conclude that it has been recognized as a defence for payment against autonomy principle of documentary letters of credit despite existing confusions around it statutory development parallel to common law.

4-4 American Law

Uniform Commercial Code of the United States of America does not recognize unconscionability or bad faith in addition to fraud and forgery as provide by article 5-109. Therefore, it would not be possible for claimant in the United States to seek for interlocutory relief when the conduct of beneficiary is tainted with bad faith but does not amount for fraud or forgery[881]. In American case of *Mid-America Tire v PTZ Trading Ltd Import and Export Agents*[882]Valen J. In a dissenting view with other judges mentioned that beneficiary is guilty of fraud as a result of violating his obligations of good faith, diligence, reasonableness and care. However, it is submitted that violation of the none of above mentioned obligations would not amount for fraud[883]

4-5 – Malaysia Law

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[880] Ibid 131
[881] Enonchong . N(2011) , 181
[882] *Mid-America Tire v PTZ Trading Ltd Import and Export Agents 2000 Ohio App , LEXIS 5402 , 43 UCC Rep . Serv 2ed 964 (2000)*
[883] Enonchong . N(2011) , 181

In Malaysia, like England, fraud is the only recognized exception to the principle of autonomy in documentary letters of credit. In the case of LEC *Contractors Sdn Bhd v. Castle Inn Sdn Bhd*[884], with reference to English courts, the Court of Appeal of Malaysia held : "… authorities we have referred to clearly indicate that in order to justify any injunction to stop payment there must be clear evidence of fraud on the part of the first defendant which comes to the knowledge of the second defendant. Bad faith or unconscionable conduct by itself is not fraud" [885]. This position was reflected in the High Court case of *Mitsubishi Corp & Ors v Sepangar Bay Power Corp Sdn Bhd*[886]where claimant was asking to restrain beneficiary from drawing under the performance bond based on unconscionability. Kang Gee J with reliance on decision of LEC *Contractors* rejected the argument that unconscionability could be an exception to autonomy principle of documentary letters of credit and performance bonds. [887]

However, Hishamodin J in the case of *Pasukhas Construction Sdn Bhd v MTM Millennium Holdings Sdn Bhd*[888]despite being bond with principle of *LEC Contractors* which recognized fraud as the only exception to autonomy principle, showed his regret for being bound to follow such decision under the principle of binding precedent.

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[884] *LEC Contractors Sdn Bhd v. Castle Inn Sdn Bhd* [2000] 3 MLJ 339.
[885] Ibid 361
[886] *Mitsubishi Corp & Ors v Sepangar Bay Power Corp Sdn Bhd* [2009] 9 MLJ 121.
[887] Ibid
[888] *Pasukhas Construction Sdn Bhd v MTM Millennium Holdings Sdn Bhd, [2009] 8 MLJU 0025.*

Further, he commented on unconscionability recognized as defence for payment in the Court of Appeal decision of *Bocotra Construction*[889] as a sound principle.[890]

Further, in two Malaysian cases, *Nafas Abadi Holdings Sdn Bhd v Putrajaya Holdings Sdn Bhd & Anor* [891]and *Perkasa Duta Sdn. Bhd. v Perbadanan Kemajuan Negeri Selangor* [892]unconscionability conduct considered to be a ground for restraining payment to beneficiary. In *Nafas Abadi* , Suriyadi J was of the opinion that commercial documentary letters of credit and performance bonds are at the same legal ground and fraud is a recognized exception to principle of autonomy in both instruments . He held that : "I do not think it is possible to say that in no circumstances whatsoever, apart from fraud, will the court restrain the buyer. The facts of each case must be considered. In our opinion,… fraud and unconscionability are considerations in application for injunction restraining payment or calls on bonds"[893]. Similar decision was taken in latter case that the court has authority to interfere in process of documentary letters of credit ad enjoin beneficiary on the basis of unconscionably.

It is possible to conclude that under Malaysian law, position of the Court of Appeal is in favour of fraud as the only exception to the principle of autonomy in documentary letters of credit. However, sympathy of lower courts towards unconscionability as separate

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[889] [1995] 2 SLR 733
[890] [2009] 8 MLJU 0025.21
[891] *Nafas Abadi Holdings Sdn Bhd v Putrajaya Holdings Sdn Bhd & Anor* [2004] MLJU 148
[892] *Perkasa Duta Sdn. Bhd. v Perbadanan Kemajuan Negeri Selangor* [2002] 2 CLJ 307,
[893] [2004] MLJU 148 , 3-6

defence to payment which was even resulted in its adoption in some cases creates doubt about rational of higher court.[894] On the other hand, despite existence of support in Malaysian courts towards recognition of unconscionability, it would not be recognized as a separate exception to autonomy principle in documentary letters of credit and performance bonds unless appellate court decides otherwise. [895]

4-6- UN Convention

The United Nations Convention on Independence Guarantees and Standby Letters of Credit recognizes bad faith as reason for issuer to spot payment. According to article 15 (3) of the Convention , in occasion of demanding the payment , beneficiary " is deemed to certify that the demand is not in bad faith and that none of the elements referred to in sub paragraph (a) , (b) and (c ) of paragraph 1 of the article 19 are present"[896]. Accordingly, article 19-1 (a) is concerned with falsified and non-genuine documents. Subparagraph (b) is concerned with points " where no payment is due on the basis asserted in the demand and the supporting documents" which seems more relevant to fraud exception . Subparagraph (c ) is about circumstances where " judging by the type and purpose of the

[894] Bains Harding (Malaysia) Sdn Bhd v Arab-Malaysian Merchant Bank Bhd [1996] 1 MLJ 425;
[895] Amaefule, C. (2012). *The exceptions to the principle of autonomy of documentary credits* (Doctoral dissertation, University of Birmingham). 182
[896] The UN Convenion article 15-1Radio & General Trading Co Sdn v Wayss & Freytag (Malaysia) Sdn Bhd [1997] MLJU 462; Pasukhas Construction Sdn Bhd & Anor v MTM Millennium Holdings Sdn Bhd & Anor [2009] 8 MLJ [21]

undertaking , the demand has no conceivable basis" . Further, article 19- 2 provides :

"(2) For the purposes of subparagraph (c) of paragraph (1) of this article, the following are types of situations in which a demand has no conceivable basis:

(a) The contingency or risk against which the undertaking was designed to secure the beneficiary has undoubtedly not materialized;

(b) The underlying obligation of the principal/applicant has been declared invalid by a court or arbitral tribunal, unless the undertaking indicates that such contingency falls within the risk to be covered by the undertaking;

(c) The underlying obligation has undoubtedly been fulfilled to the satisfaction of the beneficiary;

(d) Fulfilment of the underlying obligation has clearly been prevented by wilful misconduct of the beneficiary;

(e) In the case of a demand under a counter-guarantee, the beneficiary of the counter-guarantee has made payment in bad faith as guarantor/ issuer of the undertaking to which the counter-guarantee relates"[897]

It is submitted that situation in which demand does not have a conceivable basis are similar to the effect of unconscionability under jurisdictions which recognize it. [898]However, application of the UN convention would provide less flexibility in application of the exception as number of circumstances which amount for

[897] Ibid –Article 19-2
[898] Enonchong (2011) , 183

unconscionability under article 19-1 (c ) and 19-2 are limited . For example, in application of above mentioned articles, court might not be able to grant injunction when bad faith demand is for excessive demand. Since excessive demand is not recognised by the convention among demands with no conceivable basis.

4-7 Uniform Customs and Practices for Documentary Letters of Credit

The UCP is set of rules prepared by International Chamber of Commerce regulating the application , issuance , advise , confirming, negotiation , reimbursement and requirements for documentary compliance under the LC operation in addition to rules relevant to fundamental principles of documentary letters of credit.

Current version of UCP (600) takes an absolute silent position towards exceptions to principle of autonomy in documentary letters of credit and leaves it open for national laws.

## 5- Standard of Proof

The standard of proof for claim on the basis of unconscionable conduct of beneficiary against autonomy principle of documentary letters of credit has two different aspects. First is the claim of applicant to enjoin beneficiary from drawing under the credit on the basis of unconscionability. Second is the claim of applicant to enjoin bank from payment against unconscionable demand of beneficiary to

draw under the credit. Therefore, dealing with standard of proof , two main questions should seek for answer : what is the standard of proof at pre trail stage for applicant to prevent beneficiary from claiming unconscionable demand under the credit and second question is what is the standard of proof at full trail ?

5-1- Singapore

In Singapore, case law is not very clear on answering the question of what is the standard of proof to issue interlocutory injunction at pre trail stage. Some authorities held that depending on the circumstances of each case, the court has discretion to grant interlocutory injunction when applicant establishes the case of unconscionability.[899] Since there is no clarity in above mentioned decision whether to apply a high or law standard, it is submitted that it does not help in defining the required standard of proof. However, two major trends can be followed in Singaporean authorities regarding the standard of proof for unconscionability. Namely high standard in early cases and more flexible standard in recent cases. The High Court in *Raymond Construction Pte Ltd v Low Yang Tong* [900]held if a contractor is applying to enjoin employer from drawing under performance bonds ,it is not sufficient to bring allegations of unconscionability. In order to grant an interlocutory injunction, court requires strong prima facie evidence of established unconscionability[901]. In the case of *Bocotra*[902], the court was of the opinion that "a higher degree of

[899] *Samwoh Asphalt Premix v Sum Cheong Piling Pte Ltd* [2002] SLR 459 (CA)
[900] [1993] 3 SLR 350.
[901] Ibid
[902] 565 [1995] 2 SLR 733, 744.

strictness applies'. It was his contention that to establish unconscionability, the principal must 'establish a clear case in interlocutory proceedings. It is clear that mere allegation is not enough"[903]. However, since end 1990s, it seems that Singapore courts have adopted a lower standard of proof . In *GHL v Unitrack*[904], the court held that: "where there is a prima facie evidence of fraud or unconscionability, the court should step in to intervene at the interlocutory stage until the whole of the circumstances of the case has been investigated"[905].

5-2- Australia

In Australia, due to statutory recognition of unconscionability a different standard of proof is required than the one asked by Singaporean courts. In the case of *Western Australia v Vetter Trittler*[906], court was of the opinion that: "that a prima facie case is made out, if, on the material before the Court, inferences are open which if translated into findings of fact would support the relief claimed"[907]. This is the sign of traditional approach of Australian courts to requirement for claimant to establish the existence of prima facie cases as standard of proof for grating interlocutory injunction. In the case of *Australian Broadcasting Corporation Ltd v O'Neil*[908], by reliance on decision of *Beecham Group Ltd v Bristol Laboratories*

[903] Ibid
[904] *GHL v Unitrack* 568 [1999] 4 SLR 604.
[905] Ibid 614-16
[906] Western Australia v Vetter Trittler (1991) 30 FCR 102, 110.
[907] Ibid
[908] *Australian Broadcasting Corporation Ltd v O'Neil* [2006] 80 ALJR 1672 .

*Pty Ltd*[909] ,definition of prima facie was provided as : "By using the phrase 'prima facie case', their Honours did not mean that the plaintiff must show that it is more probable than not that at trial the plaintiff will succeed; it is sufficient that the plaintiff show a sufficient likelihood of success to justify in the circumstances the preservation of the status quo pending the trial. This was the sense in which the Court was referring to the notion of a prima facie case"[910]

Within the context of documentary letters of credit, in the case of *Clough Engineering Ltd v Oil and Natural Gas Corporation Limited*[911]with reliance on the same approach, it was held that in order to grant an interlocutory injunction in favour of plaintiff (Clough) in order to prevent defendant from drawing under performance bonds a prima facie case of unconscionably under the terms of Trade Practices Act (1974) should be established.

Also it is necessary to point at approach of Australian courts to the standard of proof at full trail. It is submitted that standard of proof for unconscionability at full trail is the same as standard of proof for establishing fraud in civil proceedings. Being a civil law notion (in opposite to criminal law), the standard of proof for unconscionability is the same at full trial in all civil proceedings. As a result, case law in common law jurisdictions point at balance of probabilities as requirement for establishing unconscionability at full trail[912]. In

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[909] *Beecham Group Ltd v Bristol Laboratories Pty Ltd [1968] 118 CLR 618.*
[910] [2006] 80 ALJR 1672 [65].
[911] *Clough Engineering Ltd v Oil and Natural Gas Corporation Limited* [2007] FCA 927.
[912] The same standard of proof is required in England, Australia , Malesia and Singapore .

contract with Singapore and Malesia which do not consider the necessity to exercise the balance of convenience, another enquiry in Australian law in addition to the standard of proof is where the balance of convenience lies. After the providing prima facie evidence of unconscionability, claimant should stratify where the balance of convenience lies in order to get interlocutory injunction granted in his favour. [913]

### 6- Recognition of Unconscionability in English law

There are reasons in public policy for advocating recognition of the unconscionability exception to the autonomy principle in LC transaction under English law. However, there are strong reasons against its recognition as well. As to settling the controversy between recognition or rejection of the exception in respect to policy ,some scholars are of the opinion that rationales against recognition of the exception in English law outweigh the supportive ones.[914]Current section of will tap the issue of policy reasons for and against recognition of unconscionability exception to autonomy principle of documentary letters of credit in English law.

6-1- Rationales for recognition of unconscionability exception.

[913] Johns, R. J., & Blodgett, M. S. (2010). Fairness at the Expense of Commercial Certainty: The International Emergence of Unconscionability and Illegality as Exceptions to the Independence Principle of Letters of Credit and Bank Guarantees. *N. Ill. UL Rev.*, *31*, 326

[914] Enonchong.N, (2011)'The Independence Principle of Letters of Credits and Demand Guarantees'. Oxford University Press, 169 .

6.1.1- Long history for recognition of unconscionability in English law

The history for application of unconscionability as a vitiating factor of contact in English common law goes back to 1697 and the case of *Earl of Chesterfield v Janssen*[915]where Lord Hardwicke held : "where no man in his right senses and not under a delusion nor an honest and fair man would accept on the other hand that which is inequitable and unconscientious…"[916]. Unlike the *Earl of Chesterfield v Janssen*, which was only limited to application of unconscionability in case of vulnerable group, decisions of *Multiservice Bookbinding v Marden*[917] , *Alec Lobb v Total Oil*[918]*and Ruddick v Ormston*[919]provided a wider application of unconscionability defence in English law almost applicable to any type of contract . It is submitted that above mentioned cases suggest "a general principle entitling a court to intervene on the grounds of unconscionability"[920].As a result, historical recognition of the exception in English common law is a strong reason for its application in the framework of documentary letters of credit in order to displace autonomy principle. In fact, there are Obiter Dicta's in case law which support the idea of application of unconscionability exception in documentary letters of credit .[921]

[915] 28 Eng. Rep. 82 (Ch. 1751)
[916] Ibid
[917] *Bookbinding v Marden* [1979] Ch 84
[918]*Alec Lobb v Total Oil* [1983] 1WLR 87
[919] Ruddick v Ormston [2005] EWHC 2547
[920] Siopis.A, (1984)'Unconscionable Bargains and General Principle' 100 LQR 523, 525
[921] Elian and Rabbath v Matsas [1966] 2 Lloyds Rep 495; TTI Team Telecom International v Hutchinson 3G UK Ltd [2003] 1 All ER 914 ; Samwoh Asphalt Premix v Sum Cheong Pilling Pte Ltd. [2002] BLR 450; Mc Connell Dowell

Despite the fact that some of them are on performance bonds , it was held in *TTI Team Telecom International v Hutchinson 3G UK Ltd* that "Although this case is concerned with a contract describing itself as a performance bond, the principles governing the court's supervisory jurisdiction in relation to a beneficiary's threatened call are not limited to bonds... These credits are used to finance, secure or assist an underlying commercial transaction whether of sale, services or the provision of work and materials and to give comfort to one party to that transaction that the other party will honour or discharge a payment obligation to which that underlying transaction subjects it to"[922].

6-1-2- Complementary to fraud exception

The principle rational in supporting the recognition of unconscionability exception is complementary role which it plays to cover existing gap from non-effective application of fraud rule.[923] In fact, unconscionability defence can be an effective way to prevent abusive call when fraud rule and even breach of underlying contract are not available[924]It worth to mention that apart from recognition of only fraud exception to autonomy principle of letters of credits in England, application of fraud rule is extremely difficult due to problems in proving elements of common law fraud like knowledge, intention, and dishonesty. For example in the case of *Discount*

Constructors (Aus) Pty Ltd v Sembcorp Engineering and Constructors Pte. Ltd. [2002] BLR 450.

[922] [2003] 1 All ER 914

[923] Enonchong . N(2011) , 169

[924] Ibid

*Records Ltd v Barclays Bank Ltd*[925]the court ordered for fraud not to be established despite existence of substantial evidence on inferiority of number and quality of goods delivered in comparison with what was promised in underlying contract. Therefore, in circumstances where reliance on fraud rule is not rendered in abusive and *mala fide* calls under primary payment obligations, unconscionability exception can provide court with a complementary mechanism to prevent beneficiary in benefiting from his wrong. According to Enonchong , courts may try to extend boundaries of fraud while protecting good faith claimant and granting injunction against abusive demand of *mala fide* defendant [926]. However, such extensions might create criticisms as of not being justifiable under fraud rule.[927]Recognition of unconscionability exception provides possibility to displace autonomy principle in circumstances where request for drawing under credit is missing the proof of fraud but it is at the same time abusive and unconscionable.

### 6-1-3 Flexibility

Flexible nature of unconscionability exception refers to possibility to make it suitable for different facts and circumstances in absence of strict preconditions for its application. Experience of courts in Singapore, to use flexible nature of unconscionability in preventing abusive calls under demand guarantees which fall short of being actual fraud is a very good explanation for this rational.

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[925] *Discount Records Ltd v Barclays Bank Ltd* [1975] 1 WLR 315
[926] Enonchong .N. (2007)'The Problem of Abusive Calls on Demand Guarantees'LMCLQ 97,104.
[927] Bolivinter Oil SA v Chase Manhattan Bank NA [1984] 1Lloyd's Rep. 251

### 6-1-4 Recognition of unconscionability in other jurisdictions

Some other common law jurisdictions have already recognized unconscionability in addition to fraud as a defence to autonomy principle of documentary letters of credit and performance bonds. In Singapore, (at least in term of performance bonds) unconscionability is an established exception to principle of autonomy. In Australia, it has statutory nature under Australian Consumer Law Act with application to common law of Australia including international sales of goods which clearly prevents payment under unconscionable demands.

## 6-2- Rationales against recognition of unconscionability exception

### 6-2-1- Vague nature of unconscionability

The very first rational against recognition of unconscionability in English law is going back to its uncertain nature.[928] There is no doubt that its recognition as a defence against autonomy principle in letter of credit process will create lots of impression in the area of law which requires utmost level of clarity. As experienced in Singapore, recognition of unconscionability may lead to high number of legal cases and increase number of claims against beneficiary's right to draw under the performance bond or commercial letter of credit[929].

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[928] Enonchong . N (2011) , 170

[929] Anvar v Teo Hee Lai Building Constructing Pte Ltd [2003] 1 SLR 394 ; Samwuth Asphalt Premix Pte Ltd v Sum Cheong Piling Pte Ltd [2002] 1 SLR ; Mc Conell Dowell Constructors (Aust) Pty Ltd v Sembcorp Engeneers and Constructors Pte Ltd [2002] 1SLR 199 ; *Dauphin Offshore Engineering & Trading Pte Ltd. v. Private Office of HRH Sheikh Sultan bin Kalifa bin Azyed al*

Such increase in number of litigations will definitely reduce the attractiveness of documentary letters of credit and performance bonds as a financial tool in business society.

However, it should be noted that uncertainty (particularly in international trade) is an inherent part of the business life which also applicable to the operation of documentary letters of credit and performance bonds.[930]The argument of uncertainty also can be refuted with reference to argument of Toohey J on conscionability in *Louth v Diporose* [931] : "although the concept of unconscionability has been expressed in fairly wide terms, the courts are exercising an equitable jurisdiction according to recognized principles. They are not armed with a general power to set aside contractual bargains simply because in the eyes of the judges, they appear to be unfair, harsh or unconscionable"[932] . Application of Toohey J's opinion on LC operation leads us to the point that courts do not decide with full discretion while invoking the unconscionability but acting on the

*Nahyan [2000] 1 SLR 627; Electro International Pte Ltd v CGH Development Pte Ltd [2000] 4 SLR 290*

[930] Cardozo. B (1921) , The Nature of Judicial Process , Yale University Press, 166; Klau .D, (1990) ,'What Price Certainty, Corbin, Williston, and Restatement of Contract' 70 BUL Rev 511, 1: " I sought for certainty. I was oppressed and disheartened when I found that the quest for it was futile.... As the years have gone by, and as I have reflected more and more on the nature of judicial process, I have become reconciled to uncertainty, because I have grown to see it as inevitable. I have grown to see the process in its highest reaches, is not discovery but creation: and that the doubts and misgiving, the hopes and fears, are part of the mind, the pangs of death and the pangs of birth, in which principle that have served their day expire, and new principles are born."

[931] *Louth v Diporose* [1992] 175 CLR 621

[932] Ibid

basis of recognized principle, they exercise an equitable jurisdiction[933]

6-2-2- Eroding the effectiveness of autonomy principle by granting higher number of injunctions

It is submitted since it is easier to establish unconscionably than fraud, recognition of unconscionability as an exception to autonomy principle will increase the number of injunctions against beneficiary which will consecutively reduce reliance of businessmen on documentary letters of credit[934]. However, point should not be missed that standard of proof required for claimant is to provide evidences which show unconscionability is "significant and clearly established" [935]. Also, in the case of *Czarnikow-Rionda Sugar Trading Inc v Standard Bank London Ltd* [936]it was held that for injunction to be granted in favour of claimant in the process of LC transaction, he should establish that in addition to cause of action against defendant, balance of convenience also lies in his favour. Such prerequisite for granting injunction is a matter of great difficulty for claimant and can be used as a complementary argument to refute doubts about increasing number of pre-trial relief issue by court after recognition of unconscionability exception.

6-2-3 Involving banks in disputes over the underlying contract

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[933] Ibid 654
[934] Enonchong . N(2007) 'The Problem of Abusive Calls on Demand Guarantees' , LMCLQ 97, 104.
[935] *TTI Team Telecom International V Hutchinson 3G* [2003] 1 All ER 914 [37]
[936] *Czarnikow-Rionda Sugar Trading Inc v Standard Bank London Ltd* [1999] 2 Lloyd's Rep 187

There is likelihood that recognition of unconscionability exception would lead banks to get involved in disputes related to underlying contract, whereas such disputes should be resolved under different claims. This will lead to court's involvement in determining what are losses incurred by beneficiary and in cases the beneficiary in holding some security whether or not the remedies for breach would be more than securities held by beneficiary [937]. However, the main objective of letter of credit system is to provide beneficiary with guarantee of bank that he would be paid before raising any disputes in underlying contract rather than pending his payment up to resolution of such disputes. As a result, recognition of unconscionability exception would be against the purpose of the letter of credit system up to the extent which it depends the payment to beneficiary on resolution of disputes relevant to underlying contract .

However, it has been argued that the same point applies to fraud exception as it also will let court to prevent payment to beneficiary until disputes on performance in underlying contract is settled .

## 7- Conclusion

Current paper tried to review nature and legal arguments relevant to unconscionability as an exception to principle of autonomy in documentary letters of credit. For this purpose, approach of different jurisdictions to unconscionability was examined, standard of proof and case law in countries which accepted the exception was analysed and reason for and against adoption of exception in English law were

[937] *Anvar v Teo Hee Lai Building Constructing Pte Ltd* [2003] 1 SLR 394

scrutinized. While application of unconscionability would amount for injunction against beneficiary or bank in the same manner as fraud and other exceptions to the principle of autonomy , the difference lays in the fact that injunction would be granted to stop unconscionable (or extra ) demand . Beneficiary is however, entitled to receive in the balance.

While principle of autonomy has created stability and certainty to the system of documentary letters of credit, there are lots of arguments that recognition of an additional exception to fraud against the principle of autonomy will affect the certainty in process LC transaction negatively. Therefore, it would not be easy to say whether or not English law will recognize it. However, despite need for acknowledgement of all criticisms against unconscionability, there are sufficient arguments like historical recognition of unconscionable conduct in English law, filling the gap resulted in application of fraud rule, flexibility provided by it to the court to define the degree of unconscionability of beneficiary based on the facts in each case as well as its recognition in other common law jurisdictions which support its recognition.

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***Publication 9*** : **Alavi. H, (2017), "Contractual restrictions on right of beneficiary to draw on a Letter of Credit; possible exception to principle of autonomy",** ***International and Comparative Law Review,*** **Vol. 16, No. 2, 67-86**

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# Contractual restrictions on right of beneficiary to draw on a Letter of Credit; possible exception to principle of autonomy

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ALAVI, Hamed. Contractual restrictions on right of beneficiary to draw on a Letter of Credit; possible exception to principle of autonomy. *International and Comparative Law Review*, 2016, vol. 16, no. 2, pp. 67–86. DOI: 10.1515/iclr-2016-0015.

**Summary**: In some circumstances and despite having right to draw under the Letter of Credit, beneficiary agrees in underlying contract that he would not exercise his right before realization of certain conditions stipulated in the contract or any other agreement with applicant. Despite the fact that the instrument itself (documentary letters of credit and bank guarantees) entitles beneficiary for being paid upon presentation of complying documents, making such commitment will impose restrictions on beneficiary within the framework of underlying contract and creates different scenarios that raises respec- tive questions. First scenario would be that beneficiary fulfills his commitments in underlying contract and receives payment under the credit and there will be no dispute between parties. Second scenario is where beneficiary presents complying documents to bank and demands for being paid the amount stipulated in the credit despite existence of an ongoing dispute with applicant regarding his performance in underling contract. Here, it will be a valid question if we ask whether or not breach of such restrictions by beneficiary will influence principle of autonomy? Consecutive question would be, shall the court consider beneficiary's violation of his restrictive commitment in under- lying contract as a new exception to principle of autonomy? To put it in different way, where beneficiary of documentary letters of credit or demand guarantee regardless of his awareness from independence of underlying contract from the credit commits in underlying contract to condition which restricts his right to draw on the credit; will he be allowed by court to rely on the principle of autonomy to neglect his commitment in underling contract? In short, should law recognize other exception in addition to fraud which is in accordance with limits imposed by underlying contract on beneficiary's right to draw on the credit? In quest of answering above mentioned questions, this paper will be divided into six main parts. After the introduction, second part will describe nature of documentary leers of credit and principle of autonomy. Third part will analyse the nature of exception while fourth one will look at approach of different jurisdictions to this issue. Fifth part will provide different arguments in favour and against recognition of "underlying contract exception"[1] and finally last part provides concluding remarks on the subject matter.

1 ENONCHONG, Nelson.. The Problem of Abusive Drawing on Demand Guarantees.

**Keywords**: Documentary Letters of Credit, Autonomy Principle, Contractual Restrictions on Beneficiary, Exception, Comparative Study.

## 1 Introduction

In the law of letters of credit, fraud is the only exception to the principle of autonomy which has received global recognition. Other exceptions including illegality, nullity, unconscionability and recklessness of beneficiary are all accepted or rejected in different jurisdictions and there is no uniform global position towards their recognition.[2]

In some circumstances and despite having right to draw under the credit, beneficiary agrees in underlying contract that he would not exercise his right before realization of certain conditions stipulated in the contract or any other agreement with applicant. Despite the fact that the instrument itself (documentary letters of credit and bank guarantees) entitles beneficiary for being paid upon presentation of complying documents, making such commitment will impose restrictions on beneficiary within the framework of underlying contract.

Based on the general principles of law, where beneficiary presents complying documents with terms and conditions of the credit, bank is bound to make payment regardless to beneficiary's breach of his commitments within underlying contract. Where there is a dispute between parties to the underlying contract, applicant can claim for damages against beneficiary after reimbursing the bank which has already honoured a complying presentation made by beneficiary. Where applicant considers that collectable damages from beneficiary in a separate action to be insufficient, he might require intervention of court and seek for injunctive relief against beneficiary or bank. Therefore, inclusion of restrictive clauses to beneficiary's right to draw on the credit in underlying contract creates different scenarios and raises respective questions. First scenario would be that beneficiary fulfilled his commitments in underlying contracts, receives payment under the credit and there will be no dispute between parties. Second scenario is where beneficiary presents complying documents to bank and demands for being paid the amount stipulated in the credit despite existence of an ongoing dispute with applicant regarding his performance in underling contract. In sec- ond scenario, it will be valid question if we ask whether or not breach of such restrictions by beneficiary will influence principle of autonomy? Consecutive question would be, shall the court consider beneficiary's violation of his restrictive commitment in underlying contract as a new exception to principle of autonomy? To put it in different way, where beneficiary of documentary letters of credit or demand guarantee regardless of his awareness about independence

*Lloyd's Maritime and Commercial Law Quarterly*, 2007, pp. 83–106.

2 ALAVI . Hamed. Illegality as an exception to principle of autonomy in Documentary Letters of Credit; A comparative approach, *Korea University Law Review*, 2016, vol. *20*, pp. 3–23.

of underlying contract from the credit commits in underlying contract to conisations which restrict his right to draw on the credit; will he be allowed by court to rely on principle of autonomy to neglect his commitment in underling contract? In short, should law recognize other exception in addition to fraud which is in accordance with limits imposed by underlying contract on beneficiary's right to draw on the credit?

In practice, problem will arise as courts in different jurisdictions have taken different approaches towards granting injunction against beneficiary and preventing him from drawing on the credit.[3] Some consider granting injunctive relief against beneficiary and preventing him to claim payment does not affect the independence principle while others are of the contradictory opinion and consider granting any injunction against right of beneficiary to draw on the credit as violating application of independence principle.[4] The same argument exist among legal scholars where some are of the opinion that granting injunc- tion to prevent beneficiary's demand under the credit dose not affects princi- ple of autonomy while others take the opposite position.[5] However, everyone agrees that granting injunction against bank's right to pay as a result beneficiary' s complying presentation affects autonomy principle on the basis of public policy concerns.[6]

In quest of answering above mentioned questions, this paper will be divided into six main parts. After the introduction, second part will describe nature of documentary leers of credit and principle of autonomy. Third part will analyse the nature of exception while fourth will look at approach of different jurisdic- tions to this issue. Fifth part will provide different arguments in favour and against recognition of "underlying contract exception"[7] and finally last part pro- vides concluding remarks on the subject matter.

## 2 Documentary Letter of Credit and Principle of Autonomy

At global scale, documentary letters of credit are operating under well recog- nized set of rules established by International Chamber of Commerce. Uniform Customs and Practices for Documentary Credits (UCP) published in 1933 for the first time and endured many revisions in order to meet requirements of ever evolving nature of international trade . Article 4 and 5 of UCP 600 (current version) define the principle of autonomy as following:

3 ENONCHONG, Nelson. *The Independence Principle of Letters of Credits and Demand Guarantees*. Oxford: Oxford University Press, 2011, p. 212.

4 MUGASHA, Agasha, Enjoining the beneficiary's claim on a letter of credit or bank guarantee. *Journal of business law*, 2004, vol. 5, pp. 515–538.

5 Ibid

6 O'DONOVAN James and PHILLIPS, John. *The Modern Contract of Guarantee*. London: Sweet and Maxwell, 2013, para 13–27.

7 ENONCHONG, Nelson.. The Problem of Abusive Drawing on Demand Guarantees. *Lloyd's Maritime and Commercial Law Quarterly*, 2007, p. 83.

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

"A beneficiary can in no case avail itself of the contractual relationships exist- ing between the banks or between the applicant and the issuing bank. An issuing bank should discourage any attempt by the applicant to include, as an integral part of the credit, copies of the underlying contract, proforma invoice and the like. Finally, banks deals with documents and not with the goods, services or performance to which the document relate."

In the United States of America, applicable rules for governing the operation of letters of credit are defined in article 5 of Unified Commercial Code. In fact, the USA is only country which enjoys statutory law in place for LC operation. Under Article 5-103(d) of UCC the autonomy principle is recognised as follow- ing :

"the rights and obligations of an issuer to a beneficiary or a nominated person under a letter of credit are independent of the existence, performance, or non-performance of the contract or arrangement out of which the letter of credit aris- es or which underlie it, including contracts or arrangements between the issuer and the applicant and between the applicant and the beneficiary"

Further, article 5-108(f)(1) confirms :

"[a]n issuer is not responsible for the performance or non-performance of the underlying contract, arrangement or transaction"

In practice, courts in different countries show traditional hesitation with interfering in process of LC transaction and enjoining bank or beneficiary to prevent payment under the credit due to existence of the general understanding in favour of absolute application of principle of autonomy. The decision of court in *Hamzeh Malas and Sons v British Imex Industries Ltd* confirms this position[8]: "[the autonomy principle] imposed upon the banker an absolute obligation to pay, irrespective of any dispute here maybe between the parties as to whether the goods are up to the contract or not".[9] Together with principle of Strict Compli- ance, Principle of autonomy (also known as principle of independence) is laying down the foundation for successful operation of documentary letters of credit in international trade.[10] Principle of independence separates obligations of bank to

8 *Hamzeh Malas and Sons v British Imex Industries Ltd* [1958] 2 QB

9 Ibid, 703

10 ALAVI, Hamed. Mitigating the Risk of Fraud in Documentary Letters of Credit. *Baltic Journal of European Studies*, 2016, vol. 6, no. 1, pp.139–156.

pay under the credit from commitments of parties in underlying contract[11]. As a result, it forms an abstract payment undertaking for issuing bank to pay (upon receiving complying presentation from the beneficiary) which is independent from performance of underlying contracts between parties to it[12]. The main implication of autonomy principle would be as long as beneficiary provides the bank with complying presentation of document stipulated in the credit , his entitlement for being paid by bank will not be affected by failure in fulfilling his obligations within the framework of underlying contract[13].Therefore, in case of rising any dispute on quality or quantity of goods provided by beneficiary, issuing bank has no other choice rather than honouring complying presenta- tion and leave applicant with sole possibility of looking for remedies in claim for beneficiary's breach of warranty at later stage. However, some scholars are of the opinion that autonomy principle does not exclude buyer's (applicant) interests from being fulfilled.[14]

In contrary with existing image on absolute authority of autonomy principle, courts in different jurisdictions have recognized few conditions which revoke the unconditional payment obligation of bank[15]. Fraud is known as the first recognized exception to principle of autonomy in documentary letters of credit.[16] It is also submitted that illegal nature of underlying contract would be another exception to principle of authority together with nullity of documents presented by beneficiary[17]. Unconscionable conduct of beneficiary in drawing under the

11 HOROWITZ, Deborah,. *Letters of credit and demand guarantees: defences to payment*. Oxford: Oxford University Press, 2010.

12 ALAVI, Hamed. Autonomy Principle and Fraud Exception in Documentary Letters of Credit, a Comparative Study between United States and England. International and Comparative Law Review, 2015, vol. 15, no. 2, p. 45; ALAVI, Hamed. Exceptions to Principle of Autonomy in Documentary Letters of Credit; A Comparative View. *Actual Problems of Economics and Law*, 2016, vol. 10, no. 3, pp. 123–150.

13 FRÍAS GARCÍA, Roberto Luis. The Autonomy Principle of Letters of Credit. *Mexican Law Review*, 2010, vol. 3, no. 1, p. 4.

14 ELLINGER. Peter; NEO. Dora. *The Law and Practice of Documentary Letters of Credit.* Oxford: Hart Publishing, 2010, p. 84; BUCKLEY Ross P.; GAO, Xiang. Development of the Fraud Rule in Letter of Credit Law: The Journey So Far and the Road Ahead. *University of Pennsylvania Journal of International Law*, 2002, vol. 23, no. 4, p. 663.

15 JOHNS, R. J., & BLODGETT, M. S. . Fairness at the Expense of Commercial Certainty: The International Emergence of Unconscionability and Illegality as Exceptions to the Independence Principle of Letters of Creditand Bank Guarantees. *Northern Illinois University Law Review*, 2010, vol. 31, no. 2, p. 297.

16 LIPTON, Jacqueline. D. Documentary Credit Law and Practice in the Global Information Age. *Fordham International Law Journal*, 1998, vol. 22, no. 5, p. 1972.

*17* ENONCHONG, Nelson. Effects of Illegality: A Comparative Study in French and. English Law. *International & Comparative Law Quarterly*, 1995 vol. 44, no. 1, p. 196, 198–199; REN, John . A nullity exception in letter of credit law? *Journal of business law*, 2015, no. 1, pp. 1–19; ANTONIOU, Anna Mari. Nullities in Letters of Credit: Extending the Fraud Exception. *Journal of International Banking Law and Regulation*, 2014, vol. 29, no. 4, pp. 229–238; HOOLEY, Richard. Fraud and Letters of Credit: Is there a Nullity Exception? *The*

credit where he is not entitled to do so is also recognized as an exception to the principle of autonomy in some jurisdictions[18]. Following chapters will analyse legal potentials imposed by express restrictions on beneficiary to draw on the credit in the framework of underlying contact as a potential exception to principle of autonomy and its effect on LC transaction in different jurisdictions.

## 3 Nature of exception

As it is already discussed, operation of the letter of credit is based on two fundamental principles of autonomy and strict compliance. Principle of autonomy separates the credit (or bank guarantee) from underlying contract.[19] At the same time principle of strict compliance provides beneficiary with right to draw on the credit (or bank guarantee) by presenting complying documents to bank[20]. In such situation, applicant would be rightly concerned about possibility to face with beneficiary's fraud or unconscionable conduct while it is almost impos- sible to stop bank from payment against complying presentation. Therefore, he might look for further alternatives to safeguard his economic interests. A practi- cal solution can be including restrictive clause against drawing right of benefi- ciary in underlying contract. Different reasons might stand behind agreement of beneficiary with such restrictive clauses including: higher bargaining power of buyer, need for building trust with buyer and also applying such negative covenants instead of assuming costs of counter guarantee.

## 4 Approach of different Jurisdictions

### *4.1 England*

Review of relevant authorities reviles the fact that English law does not have any clear stance regarding the exception[21]. The fact is that no English case has rejected possibility to grant injunctive relief against beneficiary who has called for drawing on the credit in contrary to his commitment under the contract for not doing so. At the same time, there is no authority which agrees with granting injunction to restrain beneficiary to an instrument (the commercial documen- tary letter of credit or demand guarantee) on the basis of violation beneficiary's obligations in underlying contract. However, approach of English courts in recent cases show positive tendency towards recognition of the exception.

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*Cambridge Law Journal*, 2002, vol. 61, no. 2, pp. 239–294.

18 ALAVI, Hamed . Comparative study of Unconscionability exception to the principle of autonomy in law of Letter of Credits. *Acta Universitatis Danubius. Juridica*, 2016, vol. 12, no. 2, pp. 94–121.

19 Article 4 &5 UCP 600

20 ALAVI . Hamed. Illegality as an exception to principle of autonomy in Documentary Letters of Credit; A comparative approach, *Korea University Law Review*, 2016, vol. *20*, p. 3.

21 ENONCHONG, Nelson. *The Independence Principle of Letters of Credits and Demand Guarantees*. Oxford: Oxford University Press, 2011, p. 100.

### *4.1.1 Early Cases*

The case of *RD Harbottle (Mercantile) v National Westminster Bank*[22]touched upon possibility of granting injunction against beneficiary who demands pay- ment under the demand guarantee by violating provisions regulating such demand in underlying contract. In that case, dispute arose among parties regarding the quality of goods supplied and buyer (Beneficiary to the guarantee) requested payment under the demand guarantee provided by seller in support of his commitments within the framework of underlying contract. Buyer made the demand by neglecting respective procedural provisions for demand in the underling contract. Account party to the guarantee applied for an injunction on the ground that demand of beneficiary is qualified to meeting provisions of underlying contract[23]. In the hearing, Kerr J. observed: "the plaintiffs may well be right in contending that the buyers have no contractual right to payment of any part, let alone the whole, of the guarantee… But all these issues turn on con- tractual disputes"[24]. While rejecting to grant injunction, he argued: in absence of fraud, court will not interfere and let parties to settle relevant dispute either by litigation of arbitration as available to them.[25]

In *Themehelp Ltd v West and Others*[26], at trial court, injunction was granted against beneficiary on the basis of fraud. However, in The Court of Appeal, Waite J , changed the position as it was claimed that beneficiary's call to draw on the credit was violating underlying contract . He held: "I do not find it necessary to consider whether the principle extends beyond instances of fraud to cases where the beneficiary under the guarantee is alleged to be in non-fraudulent breach of the main contract"[27].

### *4.1.2 Recent approach*

In more recent case of *Sirius Insurance International Ltd v FAI General Insur- ance* [28] issue was discussed again. In this case where a Lloyd's syndicate (Agnew) intended to reinsure her liabilities, FAI General Insurance was proposed for this purpose. Not being happy with solvency issues of FAI, Agnew searched for more solid reinsurance company. As a result, Sirius International was chosen where it agreed to make payments to Agnew upon requests and then receive the reim- bursement from FAI. In fronting FAI's agreement with Agnew, Sirius asked for a letter of credit to support its payment obligations in underlying contract with FAI and agreed not to draw on the credit until certain conditions are met. Where the problems arose, the Court of Appeal unanimously rejected Sirius's conten-

22 *RD Harbottle (Mercantile) v National Westminster* Bank [1978] QB 146.
23 Ibid
24 Ibid 155
25 Ibid 156
26 *Themehelp Ltd v West and Others* [1996] QB 84
27 Ibid 99
28 *Sirius Insurance International Ltd v FAI General Insurance* [2003] 1 WLR 87.

tion that with reference to autonomy principle he is entitled to draw on the credit upon presentation of confirming documents. The court held that on the facts of the case, it would grant injunction and restrain Sirius from demanding payment under the LC due to its breach of underling contract with FAI.[29]

However, the House of Lords reversed the judgement by holding Sirius eli- gible to demand under the LC as conditions in underlying contract were met.[30] Therefore, they did not reach the point whether or not demand of beneficiary under the letter of credit or bank guarantee in breach of his commitment in underlying contract will qualify for granting injunction against him.[31]

In conclusion, English law does not have a clear approach to this problem. However, analysing relevant authorities show development of trend towards rec- ognition of such exception where court will grant injunction against beneficiary whose demand is in breach of contract with third party.

*4.1.3 Scope of the Exception.*

According to existing authorities in English Law, underlying contract excep- tion might find application in limited number of occasions: Firstly, exception can apply only in case of existence of a negative covenant made by beneficiary in underlying contract. Secondly, it applies only where negative covenant is given in express terms. In contrary with Australian courts which grant injunction in presence of both implied and express negative covenant, English law does not consider implied terms as a ground for granting injunction.[32] Thirdly, exception only applies in cases of granting injunction against beneficiary's demand to draw on letter of credit. It does not prevent bank from effecting payment after receiv- ing complying presentation. Finally, bank cannot use existing negative covenant of beneficiary in underlying contract as a ground to stop payment after receiving the complying presentation.

*4.1.3.1 Negative Covenant.*

Legal basis for granting injunction in presence of negative covenant under English law is decision of court in *Lumley v Wagner*[33] and *Doherty v Allman*[34] where the court considered existence of negative covenant of beneficiary in con- tract as a ground for enjoining him. The Court of Appeal in *Sirius Insurance International Ltd v FAI General Insurance* with reference to decision of the House of Lords in *Doherty v Allman* and its well-respected implication in English Law

29 Ibid 29

30 [2004] UKHL 54

31 ENONCHONG, Nelson. *The Independence Principle of Letters of Credits and Demand Guarantees*. Oxford: Oxford University Press, 2011, p. 213.

32 Ibid 214

33 *Lumley v Wagner* (1852) 1 De , GM & G 604

34 *Doherty v Allman (*1877–78) LR 3 App Case 709


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considered restriction on beneficiary's right to draw on the credit to be grated due to his negative covenant in underling contract.[35] Therefore, May LJ held: "There is no authority extending this autonomy of documentary credit for the benefit of the beneficiary of letter of credit so as to entitle him as against the applicant to draw the letter of credit when he is expressly not entitled to do so"[36].

*4.1.3.2 Presence of express term.*

Under English law, where there is no express term in underlying contract which limits entitlement of beneficiary to draw on letter of credit or demand guarantee , it will be fairly impossible for court to issue injunction and uphold the exception to prevent beneficiary from receiving payment.[37] In case of *Deutsche Ruckversicherung Aktiengeslleschaft v Walbrook Insurance Co ltd*,[38] , Phillips J considered it wrong to "imply a term into the underlying contract that the beneficiary will not draw on the letter of credit unless payment under the underlying contract is due"[39]. In the case of *Sirius*, existence of the express term which was restriction of beneficiaries right to be paid upon realization of particular situation, made the Court of Appeal to consider the contract as "unusual"[40] or "variant of more typical case"[41]. With reference to restriction expressly mentioned in underlying contract, court considered the letter of credit in that case as "less than equivalent of cash" and eligible for granting an injunction to restrain beneficiary.[42] However, as it will be discussed later, Australian courts fully recognize the exception. However, they consider implied restrictions imposed on beneficiary within the framework of underlying contract in addition to express ones as a ground for granting injunction against him.

35 in *Doherty v Allman* Lord Cairns, with respect to a negative covenant and the basis of which it could be used to grant an injunction, justified its rationale by stating thus: "if there had been a negative covenant, I apprehend, according to well-settled practice, a Court would have had no discretion to exercise. If parties, for valuable consideration, with their eyes open, contract that a particular thing shall not be done, all that a Court has to do is to say, by way of injunction, that which the parties have already said by way of covenant, that the thing shall not be done; and in such case the injunction does nothing more than give the sanction of the process of the Court to that which already is the contract between the parties. It is not then a question of the balance of convenience or inconvenience, or of the amount of damage or of injury— it is the specific performance, by the Court, of that negative bargain which the parties have made, with their eyes open, between themselves".

36 *Sirius International Insurance Corp v FAI General Insurance Co Ltd* [2003] EWCA Civ 470 [2003], 1 WLR 2214, 2224–25.

37 ENONCHONG, Nelson. *The Independence Principle of Letters of Credits and Demand Guarantees*. Oxford: Oxford University Press, 2011, p. 214.

38 *Deutsche Ruckversicherung Aktiengeslleschaft v Walbrook Insurance Co ltd* [1995] IWLR 1017, [1995] 1 Lloyd's Rep 153.

39 Ibid at 1030

40 [2003] 1 WLR 87,91. At 30

41 Ibid at 27

42 Ibid


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*4.1.3.3 Non availability of exception against the bank.*

The pool of authorities shows that underlying contract exception would be only applicable to beneficiary who is party to underlying contract and no one else. Therefore, it is impossible to rely on beneficiary's breach of the underlying contract to grant injunction against bank and restrain it from payment under the credit if it wishes to do so. This would be a serious limitation on applicability of the exception as even obtaining injunction against beneficiary might not prevent him from being paid by bank. In *Bolivinter Oil SA v Chase Manhattan Bank*,[43] within the framework of underlying contract of affreighement, Boliventer agreed to take a certain cargo of oil from Iran to Syria and deliver it to the General Company Homs Refinery. According to the terms of contract, Boliventer opened a demand guarantee in favour of Homes which issued by Commercial Bank of Syria (CBS) after receiving instructions form Chase Manhattan Bank. In return CBS issues an irrevocable documentary letter of credit in favour of Chase Man- hattan. Despite arising disputes between parties to the contract of affreightment, they entered into a second contract based on similar terms but different amount of cargo to be delivered. According to Boliventer, parties agreed to release the guarantee after reaching the final shipment of cargo from second contract to Syria. Homes claimed such agreement was under duress and claimed for pay- ment of guarantee after receiving final shipment. In an *ex parte* action, Boliven- ter managed to get injunction for restraining CBS to pay beneficiary, Chase bank to paym CBS, and beneficiary from receiving payment under the guarantee.[44] During the hearing, Staughton J. lifted injunction against banks but emphasized on continuation of injunction against Homes (the beneficiary). While ruling in favour of plaintiffs, judge concluded that existence of agreement to release the guarantee at the end of second contract is sufficient to prove fraudulent action by Homes. Ruling was upheld by The Court of Appeal.[45]

*4.1.3.4 Bank cannot rely of exception as a defence for payment.*

The exception is only available for parties to the contract under which beneficiary has been restrained from drawing on the instrument. As a result, bank cannot rely on the exception as it is not originally a party to the underlying contract which is reason for issuing the letter of credit. In English law, legal basis to preclude issuing bank from using exception as defence for payment against beneficiary lies in Doctrine of the Privity of Contract[46].

43 *Bolivinter Oil SA v Chase Manhattan Bank* [1984] 1 Lloyd's Rep 251.

44 Ibid

45 Ibid 257

46 "The doctrine of privity means that a contract cannot, as a general rule, confer rights or impose obligations arising under it on any person except the parties to it." In TREITEL, G. H.. *The law of contract*. London: Sweet & Maxwell, 2003.


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*4.1.4 Standard of Proof*

In accordance with fraud exception, it seems that standard of proof at trial stage should be establishing the fact that beneficiary's demand is in breach of an express term in underlying contract between parties.[47] With the same analogy, at the interlocutory stage in might be presumed that standard of proof for grant- ing injunction should be in favour of existence of a seriously arguable case.[48] However, The Court of Appeal in Sirius granted injection because in addition to existence of seriously arguable case, applicants established that beneficiary is trying to draw payment on the credit in breach of underlying contract. [49] Later, in case of *Permasteelisa Japan KK v. Bouyguesstroi* [50]which was concerned with a performance bond, decision of *Sirius* was interpreted as requirement for higher standard of "positively established" case.

However, according to Enonchong, there is no possibility to conclude that required standard of "positively established case" was introduced by The Court of Appel of *Serious*.[51] He further argues that The Court of Appeal in that par- ticular case mentioned applicant has not only met the standard of "seriously arguable" case but also provided evidence which "positively established" non- entitlement of beneficiary to draw under the credit.[52]Therefore, by referencing to standard of "positively established" case, The Court of Appel was merely making decision about the fact of case in hand rather than laying down a general stand- ard of proof.

Enonchong also introduces two main advantages of his interpretation from statement of The Court of Appeal: first is that in accordance with required standard of proof in fraud, "underlying contact exception" keeps the same low- er standard of "seriously arguable case" for interlocutory stage and standard of "positively established" case for trial. Second, such approach will keep the stand- ard of proof in English law synchronized with other jurisdictions (as it will be discussed in next part, Australia has also accepted the "seriously arguable case" as standard of proof for interlocutory stage).[53]

*4.2 Australia*

Australian cases show positive approach to establish contractual restrictions on beneficiary for drawing down on credit as an exception to the principle of

47 ENONCHONG, Nelson. *The Independence Principle of Letters of Credits and Demand Guarantees*. Oxford: Oxford University Press, 2011, p. 217.

48 Ibid

49 [2003] 1 WLR 87,91. At30

50 *Permasteelisa Japan KK v. Bouyguesstroi* [2007] EWHC 3508

51 ENONCHONG, Nelson. *The Independence Principle of Letters of Credits and Demand Guarantees*. Oxford: Oxford University Press, 2011, p. 217.

52 Ibid

53 Ibid


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autonomy. Although most cases are relevant to bank guarantees, but it is possible to say that except High Court of Australia, other courts are of the position that: "there is an exception to the principle of autonomy where there is an underly- ing contract between the applicant for the guarantee and the beneficiary which restricts the beneficiary's power to demand payment under the guarantee"[54].

*Pearson Bridge Pty Ltd v State Rail Authority of New South Wales* [55]is among earliest and most prominent cases in this regard. In *Pearson* case, article 15.5 of underlying contract of construction between parties provided necessary security for performance of contract.[56] Yeldham J, considered the clause as negative covenant which provides definition of circumstances under which beneficiary can demand payment under the guarantee and issued injunction against beneficiary on the ground that demand of beneficiary in presence of negative stipulation in the underlying contract was a serious issue to be tried[57]. While making decision, court refed to other Australian cases in supporting its conclusion[58].

*Wood Hall Ltd v Pipeline Authority*[59]is often cited Australian case in regard with underlying contract exception. In this case, an unqualified guarantee was issued in favour of beneficiary for the purpose of constructing a pipeline. Upon demand of beneficiary to draw on the guarantee, applicant claimed that benefi- ciary cannot demand payment under guarantee as they (applicants) were not in breach of underlying contract. The High Court of Australia while ruling in favour of beneficiary held that it was not possible to stop payment claimed under the guarantee in presence of unqualified conditions obliging bank to pay unconditionally against such claim. [60]

There are considerable similarities between ways in which exception is recognized and applied under English and Australian law. First, exception in both jurisdictions will be applicable only in presence of express term in underlying contract to restrict beneficiary from claiming payment under the LC or bank guarantee before realization of certain circumstances.

54 *Clough Engineering limited v Oil and Gas Corporation Limited* [2008] FCAFC 136.

55 *Pearson Bridge Pty Ltd v State Rail Authority of New South Wales* (1982) 1 Aust. Construction LR 81.

56 " if the principles becomes entitled to exercise all or ant of his rights under the contract in respect of the security , the principle may convert into money the security that does not consist of money. The principle shall not be liable for any loss occasioned by such conversions."

57 ENONCHONG, Nelson. *The Independence Principle of Letters of Credits and Demand Guarantees*. Oxford: Oxford University Press, 2011, p. 219.

58 *Williamson Limited v Lukey and Mulholland* (1931) 45 CLR 282, 299; *Ampol Petroleum Limited v Mutton* (1952) 53 SR1

59 *Wood Hall Ltd v Pipeline Authority* (1979) 141 CLR 443

60 ENONCHONG, Nelson. *The Independence Principle of Letters of Credits and Demand Guarantees*. Oxford: Oxford University Press, 2011, p. 219.


ISSN (print): 1213-8770; ISSN (online): 2464-6601

Second, such express term in both jurisdictions is recognized only if it shows the format of negative covenant. Third, exception is only applicable against beneficiary's demand and it cannot be used for stopping bank from payment. In both jurisdictions, restriction cannot be used as a defence by bank to refrain payment under documentary letter of credit or bank guarantee.

Despite similarities between the way in which Australian and English courts apply the exception, there are certain differences between their approaches which are worth of attention: Firstly, in contrary with English practice, many Australian cases consider the scope of exception extended to implied terms in addition to express negative covenants in the underlying contract[61]. Secondly, early cases in Australia adopted the low standard of proof of "a serious issue to be tried" for granting interim injunction against beneficiary whose claim was not in accordance with negative covenant in underlying contract.[62]Recent cases show the trend of among courts for adopting higher standard of "seriously arguable" case under which applicant should be able to show at trial that demand was in breach of conditions stipulated in underlying contract[63]. English courts apply a much higher standard of "positively established case" which creates difficulties for applicant to attain injunction against beneficiary on the basis of underlying contract exception.

Thirdly, in Australia applicant should provide court with evidence of facing loss as a result of beneficiary's demand in contrary to his commitments in under- ling contract to be able to obtain interim injunction. Such evidence is provided through application of the balance of convenience mechanism[64]. However, bal- ance of convenience has very limited application under English Law. Therefore, in England applicant may obtain injunction against beneficiary by satisfying the standard of proof and without showing any loss which is in contrary with Australian position in which obtaining injunction after satisfying the standard of proof would be possible only by showing damages endured as result of benefi- ciary's demand . [65]

61 *Australian Winch and Haulage Co Pty Ltd v .Walter Construction Group Ltd* [2002] FCA 1181 ; *Reed Construction Services Pty Ltd v. Kheng Seng (Australia) Pty Ltd* (1999) 15 BCL 158 ; *Fletcher Construction Australia Ltd v. Varnsdorf Pty Ltd* [1998] 3 VR 812

62 *Pearson Bridge Pty Ltd v State Rail Authority of New South Wales* (1982) 1 Aust. Construction LR 81; *Selvas Pty Ltd v Hansen & Yuncken (S.A.) Pty Ltd* (1987) 6 ACLR 36.; *J H Evans Industries (NT) Pty Ltd v Diano Nominees Pty Ltd* (unreported NT Supreme Court, 30 January 1989) ; *Barclay Mowlem Construction Ltd v Simon Engineering (Australia) Pty Ltd* (1991) 23 NSWLR 451.

63 *Rejan Constructions Pty Ltd v. Manningham Medical Center Pty Lt*d ( Supreme Court of Victoria , 20 December 2002 , Byrne J) .

64 ENONCHONG, Nelson. *The Independence Principle of Letters of Credits and Demand Guarantees*. Oxford: Oxford University Press, 2011, p. 221.

65 Ibid


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In conclusion , more extended scope of exception in Australia which includes implied terms in the contract between applicant and beneficiary and lower standard of proof are adjusted by application of balance of convenience test and requiring applicant to show damages which he will bear in absence of injection. The same adjustment has been achieved by English courts via counterbalancing a higher standard of proof and more limited scope of exception with no applica- tion of the balance of convenience test.

### *4.3 Scotland*

In the case of *Peak Well Management Ltd v. Globalsaltafe Drilling UK Ltd* [66]under a contract between parties, beneficiary (Globalsaltafe) agreed to supply a mobile drilling rig to applicant (Peak Well Management) and applicant provided beneficiary with a standby letter of credit. After arising problems between parties, applicant required court to issue an interdict and prevent beneficiary from demanding under the credit based on rational that in the underlying contract parties agreed that demand to draw on the credit will be fulfilled only in respect of unpaid invoices that did not receive notice of payment by account party. In hearing, beneficiary argued that in absence of fraud, account party has no right to interfere with autonomy principle of documentary letters of credit[67]. While rejecting the contention of beneficiary , court held that entitlement of benefi- ciary to draw on the credit depends on terms of underlying contract. Therefore, the court held that demand is in breach of underlying contract and issued the interdict against beneficiary.[68]

### *4.4 Malaysia*

In similar vein with Australian courts, Malaysia courts to have a settled approach towards contractual restrictions imposed on beneficiary to draw on the credit. In *Daewoo Engineering & Construction Co Ltd v The Titular Roman Catholic Archbishop of Kuala Lumpur* [69] claimant opened a guarantee in favour of defendant for the purpose of getting his consent in order to install ground anchors in his land. Within the underlying contract for opening the guaran- tee, it was clearly mentioned that defendant's right to draw on the guarantee, among other things , will be subjected to : "must inform Daewoo Corporation by written notice of your intention to claim against the guarantee not later than 14 (fourteen) days before the date of the aforesaid demand"[70]. After expiration of agreement, parties agreed to renew it . However, defendant insisted on remov- al of the express term in underlying contract which was rejected by plaintiffs.

66 *Peak Well Management Ltd v. Globalsaltafe Drilling UK Ltd*[2006] Scot SC3
67 Ibid 24
68 Ibid
69 *Daewoo Engineering & Construction Co Ltd v The Titular Roman Catholic Archbishop of Kuala Lumpur* [2004] 7 MLJ 136.
70 Ibid 18


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Finally, plaintiff failed to renew the agreement due to insisting of the defend- ant to remove the express restrictions relevant to call on guarantee, defendants made the call for it and argued that bank guarantee is separated from underlying contract and not subjected to any restriction imposed by it. During the hearing, injunction was granted in favour of the plaintiff on the ground of existence of serious issues to be tried.[71]

According to the case of *Daewoo Engineering & Construction Co Ltd v The Titular Roman Catholic Archbishop of Kuala Lumpur* it is possible to conclude that existence of express contractual agreement between beneficiary and account party of letters of credit and independent guarantees which imposes restriction on beneficiary's right of unconditional drawing on the instrument is recognized as an exception to principle of autonomy by Malaysian courts.

### *4.5 Singapore*

Singaporean courts have not touched upon this problem directly. However, in respective cases of fraud and unconscionable conduct where injunction has been granted against the beneficiary, main claim raised by account party attributed to beneficiary's non-entitlement to draw on the credit as condition precedent for payment mentioned in underlying contract was not fulfilled. In *Kvaerner Singapore Plc Ltd v UDL Shipbuilding (Singapore) Ltd* [72]contract of sales covered sales of equipment and supported by performance bond of beneficiary under the condition in which buyer provides sales price via opening a documentary letter of credit. After failure of buyer in opening the credit, court granted inunction restraining buyer from drawing under performance bond as he could not fulfil the condition precedent stipulated in the underlying contract[73]. Further, court mentioned that buyer's conduct was considered as unconscionable conduct due to lacking good faith.[74]

In conclusion, the underlying contract exception has been touched upon by Singaporean courts. However, it is not clear from the details of the case law whether or not court will grant restraining order against beneficiary in absence of fraud and unconscionable conduct only on the basis of beneficiary's breach of his commitment in underlying contract.

### *4.6 United States of America*

Under Uniform Commercial Code, there is no injunction available against beneficiary's demand to draw on the credit in breach of his commitments within underlying contract with applicant. According to Article 5-110 (2) of UCC : " if it presentation is honoured , the beneficiary warrants … to the [account party]

71 Ibid 25

72 *Kvaerner Singapore Plc Ltd v UDL Shipbuilding (Singapore) Ltd* [1993] 3 SLR 350

73 Ibid

74 Ibid


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that the drawing does not violate any agreement between the [account party] and the beneficiary or any other agreement intended by them to be augmented by the letter of credit" . The only caveat to above mentioned passages is that it only works where presentation made by beneficiary is honoured. Paragraph 1 of the official commentary on UCC clarifies that bank cannot rely on beneficiary's breach of warranty with applicant to refuse payment. In the same way, applicant cannot rely on beneficiary's breach of his commitments in underlying contract to refuse reimbursement of bank. Since warranty can be obtained only after honouring the credit or guarantee, such breach can occur only after effectuating the payment. Therefore, under the UCC, instead of grating injunction , remedy for breach of warrantee is in the format of damages.

## 5 Arguments for and against recognition of exception

Reviewing the exception in different jurisdictions shows diversified approach of courts in different countries to the problem of "underlying contract exception" to principle of autonomy in letter of credit law. While some countries like Aus- tralia, Malesia and Singapore have recognized the exception, English courts are taking unsettled position and UCC in the United States of America rejects recog- nition of any exception to the principle of autonomy other than Fraud. However, in terms of legal policy, there are some arguments in favour of the recognition of exception which balance the contradicting arguments against recognition of it. In this section arguments in favour and against recognition of the exception will are going to be reviewed.

### *5.1 Arguments in favour of the recognition of exception*

#### *5.1.1 Novelty of exception*

The novelty brought about by exception has been discussed by Australian courts like in case of *Bachmann Pty Ltd v B.H.P Power New Zealand Ltd*[75]. The issue of novelty was restated by Rolf .J in *Barclay Mowlem Construction Ltd v Simon Engineering (Australia) Pty* Ltd[76] when he submitted that :

75 (1999) 1 VR 420. In this case the judge observed :
"...so far as I am aware, of the cases which have come before the courts in this country the present may be said to be novel in one respect and unusual in another. It is novel in the sense that the present case raises for the first time the effect of an express, albeit qualified, contractual prohibition (in the underlying contract) on the conversion of a security into cash. The novelty resides in the circumstance that the present contract contains an express, but qualified, prohibition on conversion of a security into cash – express in the sense that it is in form a negative stipulation ('a party shall not convert . . . until the party becomes entitled').

76 *Barclay Mowlem Construction Ltd v Simon Engineering (Australia) Pty Ltd* (1991) 23 NSWLR 451,457


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"In my opinion neither *Wood Hall* nor *Hortico*, nor the various cases to which I was referred stating that there was an obligation on the party giving an unconditional performance bond to pay that bond on demand are determinative of the present case. Indeed in Wood Hall, Stephen J expressly leaves open, so it seems to me, this question for determination"[77]

To clarify his comments, Rolf J. referenced statement of Stephen J , in *Wood Hall :* "... Had the construction contract itself contained some qualification upon the Authority's power to make a demand under a performance guarantee, the position might well have been different."[78]

In English case of *Sirius Insurance International v FAI General Insurance*[79]al- so pointed at novelty of cases under which beneficiary is facing retractions by underlying contract for purpose of drawing on the credit[80].

It is possible to conclude that irreversible and express consent of beneficiary in underlying contract for not drawing on credit before meeting some conditions will create a novel condition which turns the cash principle of documentary let- ters of credit conditional to fulfilment of stipulated conditions.

### *5.1.1 Parties expectations from underlying contract*

It can be mentioned with confidence that according to general principles of contract law, enforcement of legitimate expectations of parties in the framework of underling contract is the main concern of contract. In substantial number of cases, under English law and other jurisdictions court has referred to method agreed by parties in underlying contract and surrounding circumstances of the case as the main factor for determining how to resolve their dispute. Therefore, on the occasion where underlying contract gives right to draw on credit to ben- eficiary after meeting special conditions , the court will look upon the contract and circumstances of the case to define whether or not bank is entitled to effectu- ate the payment. In the leading English case of *Sirius* May LJ implied the legiti-

77 Ibid 457

78 *Wood Hall Ltd v Pipeline Authority* (1979) 141 CLR 443,459 restated in *Barclay Mowlem Construction Ltd v Simon Engineering (Australia) Pty Ltd (1991)* 23 NSWLR 451,457.

79 *Sirius International Insurance Co v FAI General Insurance Ltd and others* [2002] EWHC 1611 (Ch) [2003] 1 WLR 87,.

80 Ibid 92-93, Jacob J.:

"...whilst I accept the submission that the principle of autonomy is of vital importance, I cannot see that it is undermined in the very special case where a party expressly agrees not to draw down unless certain conditions are met. Suppose instead of a letter of credit an account had been opened in the name of *Sirius* with *Westpac* and credited with the US$5m. Suppose *Sirius* had agreed with FAI not to touch the account unless the conditions were satisfied. I can see no reason why a contract to that effect should not be enforced. Cash, like a letter of credit, is autonomous, perhaps even more so, but people can agree not to touch identified pots of it, if that is what they want to do. If such an agreement is made, there is no reason why the law should not enforce it'.


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mate expectations of parties from the underlying contract when he refused the augment of the council of defendants. In *Sirius International Insurance Co v FAI General Insurance Ltd and others*, the council of *Sirius* was of the opinion that with reference to autonomy principle, he is entitled to draw on the credit even in presence of negative covenant in underlying contract which clearly defines situation to draw dawn on the credit.

*5.1.1 Existence of the negative covenant and its restrictive nature*

According to the Court of First Instance and the Court of Appeal of *Sirius*, negative covenant by beneficiary in underling contract is the main reason to restrain his right to draw down on the credit. As it was discussed before, the court of *Doherty v Allman*[81],as a leading authority in negative covenant explains that court has almost no discretion over the negative covenant which expressly restricts rights of the party under the contract.

*5.1.2 Lack of authority against the recognition of exception*

In the case of the *Sirius*, The Court of Appeal as well as the Supreme Court admitted that there is no authority against accepting the "underlying contract exception". The court admitted that none of the cases referred to are against accepting the exception. Further the court observed: "express provision in the underlying contract saying that the beneficiary will not draw down unless conditions have been fulfilled. In those circumstances, you do not have the normal case of 'pay first, argues later', which is the main point of providing letters of credit in normal circumstances"[82]. To state it differently, with reference to absence of authority against recognition of underling contract exception, the court did not observe any problem in recognizing capability of express contractual restriction in the underlying contract to be a defence against principle of autonomy.

*5.2 Arguments against recognition of the exception*

*5.2.1 Acting against the age long principle of autonomy*

The often cited argument against recognition of "underlying contract excep- tion" is alleged contradiction of the exception with principle of autonomy in documentary letters of credit. As it was argued in the Court of First Instance in case of *Sirius*, letters of credit are independent undertakings of bank not affected by the conditions stipulated in the underlying contract. Since the remedy for breach of underling contract is determined in terms of damages, therefore, beneficiary cannot be prevented from drawing dawn on credit on credit based on terms of underlying contract. While responding to appellant's contention, Jacob J, started his argument with reference to importance of the autonomy principle. However,

81 (1877–78) LR 3 App Cas 709.
82 [2002] EWHC 1611 (Ch) [2003] 1 WLR 87,92 [18]


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he continued, it is not clear to him that principle of autonomy would be undermined where beneficiary expressly agrees that before realization of certain circumstances; he would not draw on the credit.[83]

*5.2.2 Creation of uncertainty*

The argument of promoting uncertainty by recognition of exception has been favoured in Australian cases. [84] Argument raises the question that meaning to expressed terms in the underlying contract might be construed in different ways resulting in different outcomes and creating uncertainty over situation under which injunction should be granted or not.[85] Such uncertainty might result in reducing the popularity of documentary letters of credits in international trade and create policy concerns.[86]However, according to Enonchong , problem of uncertainty shall overcome by applying the exception only in presence of express contractual terms which agreed upon openly by consent of both parties. Under such express term, parties agree that beneficiary's right to draw on the credit is qualified to meeting condition of restrictive conditions mentions in the contract. [87]

## 6 Conclusion

This paper tried to study of legal issues surrounding effects of including a restrictive clause on beneficiary's right to draw down on the documentary let- ter of credit in the underlying contract between buyer and seller in the course of international trade. Despite the fact that it might seem against application of autonomy principle, recognition "underlying contract exception" in Australasia, Scotland and Malaysia plus positive approach of English courts towards it seems to be a signal for readiness of global society to set aside traditional restrictive approach to principle of autonomy in documentary letters of credit. However, regarding the underlying contract exception, there are significant issues which should be resolved, namely, lack of certainty which exist in diversified approach of different jurisdictions to standard of proof. Particularly, acceptance of implied consent of beneficiary as a negative covenant in Australia might result is subjective approach of the court and promotion of uncertainty which in turn can reduce turnout of international trade society to documentary letters of credit at global stage.

However, courage of courts to consider restrictive conditions on beneficiary within the framework of under lying contract to be paid under the credit a signif-

83 Ibid , 19

84 *Bachmann Pty Ltd v BHP Power New Zealand Ltd* [1999] 1 V R 420, *Fletcher Construction Australia Ltd v Varnsdorf Pty Ltd* [1998] 3 VR 812.

85 [1999] 1 V R 420

86 ENONCHONG, Nelson. *The Independence Principle of Letters of Credits and Demand Guarantees*. Oxford: Oxford University Press, 2011, p. 266.

87 ENONCHONG, Nelson.. The Problem of Abusive Drawing on Demand Guarantees. *Lloyd's Maritime and Commercial Law Quarterly*, 2007, p. 96.


ISSN (print): 1213-8770; ISSN (online): 2464-6601

icant issue to be tried is an important development in international commercial law. Such development will be more considerable as recognition of such excep- tion will turn cash nature of documentary letters of credit and bank guarantees in to a conditional instrument under which receiving the payment by beneficiary will depend on fulfilment of his obligations in the underling contract. There- fore, it is not clearly possible for a beneficiary to a documentary letter of credit or bank guarantee to rely on freedom of contract to commit whatever possible obligation in the contract with applicant and then neglect fulfilment of those obligations with reference to autonomy principle and separation of the credit form underlying contract.

***Publication 10*: Alavi. H, (2017), "Limits** of **autonomy principle in documentary letters** of **credit; perspective** of **English law", *Journal of legal studies, 18*(33), 18-42**

# Limits of Autonomy principle in documentary letters of credit; Perspective of English Law

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## Abstract

*In this article, author reviews the approach of English courts to limits of autonomy principle and tries to answer following research questions: What obligations the applicant should fulfil while opening a credit in accordance with underlying contract? What are seller's remedies when buyer fails to perform his duties regarding opining and performance of the credit? On the other hand, what are seller's duties in the process of opening the credit and what will be buyer's remedy in case of his failure? What is the legal position regarding variation of the credit? What is the position of court regarding absolute or conditional nature of the credit? In order to answer the above research questions, paper is divided seven parts: after the introductory comments, second part will review the nature of the buyer's obligation in opening the credit. Third part is focused on effect of non-compliance by the buyer and fourth part studies variation of the credit and its effect on party's rights within underlying contract. part five deals with buyer's rights after opening credit while part six will discuss absolute or conditional nature of the payment obligation to pay under the LC. Last but not the least, final part will provide concluding remarks.*

**Key Words : Documentary Letters of Credit , Autonomy Principle, Limits , English Law**

## 1- Introduction

Letters of credit used in international trade finance are governed by two fundamental principles of autonomy and strict compliance[938]. While principle of strict compliance provides guarantee for the beneficiary to be paid after presenting bank with compliant documents to the trams and conditions of the credit, principle of autonomy separates undertaking of bank to honour the beneficiary's presentation from performance of underlying contract. As a result, any disputes in the framework

[938] Alavi , H. (2015)"Autonomy Principle and Fraud Exception in Documentary Letters of Credit, a Comparative Study between United States and England" . International and Comparative Law Review, Vol. 15, No. 2 ,45

of contract between buyer and seller or between issuing bank and applicant should be reviewed separately from issues relevant to performance of the credit *per se* [939]. In practice, principle of autonomy implies that any failure of beneficiary to comply with his obligations in underlying contract and delivery of goods with promised quantities or quality will neither affect bank's obligation to pay him after receiving complying presentation nor applicants obligation to reimburse the issuing bank which has honoured a complying presentation[940].Therefore, "pay first and argue later" is an accepted outcome of autonomy principal's application in international LC operation.[941]It is possible to conclude that autonomy principle promotes the international trade by safeguarding the smooth operation of documentary letters of credit.[942] As a result, autonomy principle is the "cornerstone of the validity of the letter of credit"[943] and "the engine behind the letter of credit"[944].

The operation of the letters of credit is governed by globally recognized set of rules introduced by International Chamber of Commerce[945]. Published for the first time in 1933, Uniform Customs and Practices for Documentary Credits (UCP) have been revised constantly in order to comply with evolving trade requirements and technology developments in the field of international trade. Principle of autonomy is shrined in Article 4 and 5 of UCP 600 (current version) as following:

> "A credit by its nature is a separate transaction from the sale or other contract on which it may be based. Banks are in no way concerned with or bound by such contract, even if any reference whatsoever to it is included in the credit. Consequently, the undertaking of a bank to honour, to negotiate or fulfil any other obligation under the credit is not subject to claims or defences by the applicant resulting from its relationships with the issuing bank or the beneficiary."[946]

> "A beneficiary can in no case avail itself of the contractual relationships existing between the banks or between the applicant and the issuing bank. An issuing bank should discourage any attempt by the applicant to include, as an integral part of the credit, copies of the underlying

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[939] Alavi, Hamed. (2016) "DOCUMENTARY LETTERS OF CREDIT, PRINCIPLE OF STRICT COMPLIANCE AND RISK OF DOCUMENTARY DISCREPANCY."Korea University Law Review 19.단일호 : 3-21

[940] Alavi, H. (2016). Documentary Letters of Credit, Legal Nature and Sources of Law. *Journal of Legal Studies*, *17*(31), 106-121.

[941] *Eakinv. Continental Illinois National Bank & Trust Co*. 875 F.2d 114.116. (1989).

[942] Alavi, H., 2016. Mitigating the Risk of Fraud in Documentary Letters of Credit. *Baltic Journal of European Studies*, *6*(1), pp.139-156; Alavi . H (2016) , Illegality as an exception to principle of autonomy in Documentary Letters of Credit; A comparative approach, *Kor. UL Rev*., 20, 3

[943] *Ward Petroleum Corp. v. Federal Deposit Ins. Corp.*, 903 F.2d 1299 (1990).

[944] ARKINS, J. (2000). Snow White v. Frost White: The New Cold War in Banking Law?, *JOURNAL OF INTERNATIONAL BANKING LAW*, 15(2), 30-41.

[945] Alavi .H , (2016), Arbitration and LC Fraud Disputes: a Comparative Approach, Russian Journal of Comparative Law, Vol. (8), 2, 70

[946] UCP600-Article 4

contract, proforma invoice and the like. Finally, banks deals with documents and not with the goods, services or performance to which the document relate."[947]

The United States of America is the only country which has regulated operation of documentary letters of credit in national statutory format .Article 5 of Unified Commercial Code. Article 5- 103(d) of UCC formulates the autonomy principle as following :

> "the rights and obligations of an issuer to a beneficiary or a nominated person under a letter of credit are independent of the existence, performance, or non-performance of the contract or arrangement out of which the letter of credit arises or which underlie it, including contracts or arrangements between the issuer and the applicant and between the applicant and the beneficiary"

Also, article 5-108(f)(1) confirms :

> "[a]n issuer is not responsible for the performance or non-performance of the underlying contract, arrangement or transaction"

From the above discussion, it might seem that autonomy principle applied in the process of financing international operation has an absolute fashion and the credit is completely separated from the underlying contract which gives reason to its existence. In fact, existing body of English authorities indicate a completely contradictory reality. Unlike customary belief that performance under the credit has nothing to do with performance in underlying contract, there are many conditions under which these two separate contracts show substantial overlap. Such overlaps show borders and limits of the principle of autonomy which are not reflected in UCP. Therefore, national laws are supposed to resolve disputes of this kind but, diversified nature of national laws create difficulty for learned observers to reach legally sound conclusion about situations under which performance of the credit depends on performance of underlying contract. For the purpose of reducing confusion, in this article, author reviews the approach of English courts to limits of autonomy principle and tries to answer following research questions: What obligations the applicant should fulfil while opening a credit in the framework of underlying contract? What are seller's remedies when buyer fails to perform his duties regarding opining and performance of the credit? On the other hand, what are seller's duties in the process of opening the credit and what will be buyer's remedy in case of his

[947] UCP 600- Article 5

failure? What is the legal position regarding variation of the credit? What is the position of court regarding absolute or conditional nature of the credit? In order to answer the above research questions, paper is divided seven parts: after the introductory comments, second part will review the nature of the buyer's obligation in opening the credit. Third part is focused on effect of non-compliance by the buyer and fourth part studies variation of the credit and its effect on party's rights within underlying contract. part five deals with buyer's rights after opening credit while part six will discuss absolute or conditional nature of the payment obligation to pay under the LC. Last but not the least, final part will provide concluding remarks.

## 2- The nature of the buyer's obligation to open the credit

In the framework of international trade, as a general rule, letters of credit come to existence when a buyer (applicant) and sellers (Beneficiary) agree in their underlying contract for the payment to be arranged by opening of the credit. Incorporation of letter of credit clause in the contract of sales (or any other agreement between parties) will impose a duty on applicant to procure the credit in favour of the beneficiary. Under English law, depending on stipulations in underlying contract, existence of the applicant's duty to open a credit can bring about different legal consequences which are covered in relevant authorities. In Trans *Trust S. P. R. L. v. Danubian Trading Co. Ltd*[948],where buyer failed to open a credit as stipulated in the underlying contract of sales , Denning L.J observed :

> "What is the legal position of such a stipulation [that a credit should be provided]? Sometimes it is a condition precedent to the formation of a contract, that is, it is a condition which must be fulfilled before any contract is concluded at all. In those cases the stipulation `subject to the opening of a credit' is rather like a stipulation `subject to contract'. If no credit is provided, there is no contract between the parties. In other cases a contract is concluded and the stipulation for a credit is a condition which is an essential term of the contract. In these cases the provision of the credit is a condition precedent, not to the formation of the contract, but to the obligation of the seller to deliver the goods. If the buyer fails to provide the credit, the seller can treat himself as discharged from any further performance of the contract and can sue the buyer for damages for not providing the credit".[949]

Todd differentiates consequences of conditions explained by Denning L.J in two different situations: in former, seller and buyer are both exempted from obligation under the contract where no letter of

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[948] *Trans Trust S. P. R. L. v. Danubian Trading Co. Ltd [1952] 2 Q. B. 297*
[949] Ibid ,304.

credit has been procured. However, in the latter situation, buyer will be liable for damages where the seller is relieved from his obligations in the underlying contract[950].

There are line of authorities and academic opinions in favour of above mentioned observation. Benjamin explains that buyer's obligation to open a credit in favour of the seller may not be condition precedent for all responsibilities of the seller; however, it is condition precedent for delivery of goods[951]. There are certain conditions considered as condition precedent for buyer's obligation to open the LC in favour of the Seller. In *Knotz v. Fairclough, Dodds and Jones Ltd*[952], which was relevant to sales of copra, issuing a proforma invoice by seller was a condition precedent for buyer to open the credit in his favour. As a result of sellers failure to issue proforma invoice, court ruled in favour of buyer by holding that:

> "The buyers' obligation to provide a letter of credit did not arise until a provisional invoice was tendered by sellers and proper notice given by him as to the form of credit he required"[953].

Ventris differentiates legal consequences of situation where buyer agrees to pay the price of underlying contract directly to seller from situation under which he agrees to procure a credit in favour of the seller.[954] AS a result, in latter condition obligations of the buyer in contract with seller will be fulfilled where he opens a credit in favour of seller which conforms to requirements stipulated in underlying contract.

**1-2 : Cooperation of Buyer in process of operation of the LC :**

With respect to the terms of underlying contract, credit might require buyer's cooperation in operation of credit's.[955]This can be situation under which buyer is supposed to nominate the vessel (e.g . in case of classic FOB contracts) . Without cooperation of buyer, in nominating the vessel, seller will not be able to perform his duty in the contract of sales and in case no nomination of vessels takes place, buyer is the one to be liable for breach of contractual obligations[956]. Such collaboration might be in two forms: first, buyer informs the bank about nomination of vessel. Therefore, bank will effectuate payment where shipping documents show the shipment on the nominated vessel. Second

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950 Todd, P. (2013). *Bills of lading and bankers' documentary credits*. Taylor & Francis.p. 61

951 A. G. Guest , *(1997),Benjamin's Sale of Goods*, Fifth edition. Sweet & Maxwell, London, n15 at § 23-064 p. 1684. ; Tiplady, D. (1989) , *Introduction to the Law of International Trade* ,London,p. 176.

952 *Knotz v. Fairclough, Dodds and Jones Ltd.* [1952] 1 Lloyd's Rep 226

953 Ibid

954 Ventris, F. M., (1975), 'New Problems of Financing Oil Shipments' LMCLQ, p. 38 at 42

955 Ellinger .P and Neo.N , (2010) ,The Law and Practice of Documentary Letters of Credit , 84

956 Malek. A, Quest .D, (2009) , Jack. Documentary credits: the law and practice of documentary credits including standby credits, and demand guarantees, Tottle,

situation is where seller provides bank with documents stipulating that vessel is nominated by buyer.[957]

Other circumstance which requires buyer's cooperation is where he agrees in underlying contract to participate in completion of tender of documents under the credit. This might happen by signing the certificate of inspection by him or his representative .Buyer's failure to cooperate in fulfilment of his obligation under the credit will result in breach of his contract with seller.[958] The buyer might be obliged by court to cooperate and in case of his inability to cooperate a third party (a court official) will receive authority to take his place.[959]

**1.3- Type of the Credit to be Opened**

The type of documentary letter of credit which buyer procures in favour of seller should be in compliance (in form and substance) with requirements in underlying contract.[960] In *Wahbe Taman & Sons Ltd. v. Colprogeca Sociedade Geral de Fibras. Cafes e Produtos Coloniais Lda*[961], the contract of sales asked for opening of the confirmed credit. However, the correspondent bank reserved right of recourse against beneficiary. As a result, court held applicant liable for failure in providing type of credit stipulated in underlying credit.[962]It might occur that parties do not specify the type of credit in underlying contract. In such situation, English courts incline towards presuming agreement of parties towards irrevocable credit to be provided.[963] In *Giddens v. Anglo African Produce Ltd* [964] contract of sales required for "establishment" of credit with a defined bank. Issuing bank opened a revocable credit which resulted in refrainment of beneficiary to deliver goods. In the hearing, Balihach, J. ruled in favour of the seller.[965] Benjamin confirms the ruling of Bailhach J as judge "read the word `established' as describing the word `credit' and explained that the revocable credit furnished by the buyers could not be considered an `established credit"[966].

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[957] This was the requirement of credit in *Banque de l 'Indochine et de Suez SA v JH Rayner* (Mincing Lan) Ltd. [1983] Q. B. 711

[958] Malek. A, Quest (2009) .D, Jack. *Documentary credits: the law and practice of documentary credits including standby credits, and demand guarantees, Tottle*,

[959] *Astro Exito Navegacion SA v Chase Manhattan Bank NA* [1983] 2 AC 787

[960] *Panoutsos v. Raymond Hadley Corporation* [1917] 2 KB 473) ;*Soproma S. p. A v. Marine and Animal By-Products Corporation* [1966] 1 Lloyd's Rep. 367,386. );*Enrico Furst & Co. v. WE Fischer Ltd*.
[1960] 2 Lloyd's Rep 340.

[961] *Wahbe Tamari & Sons Ltd. v Colprogeca Sociedade Geral de Fibras, Cafes e Produtos Coloniais Ld*a[1969] 2 Lloyd's Rep. 18.

[962] Ibid 19

[963] Benjamin's Sale of Goods, at § 23-066 p. 1685

[964] *Giddens v. Anglo African Produce Ltd* (1923) 14 LI. L. Rep. 230

[965] Bailhache J., in delivering judgment for the sellers said:

> "Here is a contract which calls for an established credit and in purported satisfaction of what this contract calls for what they get is this: `Negotiations of drafts under these credits are subject to the bank's convenience. All drafts hereunder are negotiated with recourse against yourselves.' How that can be called an established credit in any sense of the word absolutely passes my comprehension".

[966] Benjamin's Sale of Goods, at § 23-066 p. 1685

It should be kept in mind that contract is not considered as concluded where nature of credit is not defined or tendering documents against payment are not determined[967]. Thefore, no party will be liable as no *consensus ad idiem* has been taken place.

**1-4 Time for availability of the credit**

Where underlying contract provides payment to be done by documentary letters of credit, buyer is obliged to provide the credit in time and he is liable even for delays resulted by factors out of his control. [968] Underlying contract should contain information regarding time for availability of the credit. In absence of such information courts will intervene in order to determine the reliance of seller on contract of sales and determine reasonable time for buyer in opening the credit[969] . In following lines we examine different scenarios which might occur in absence of defined time to open the credit in underlying contract. If the contract calls for credit to be opened immediately, applicant should be given a reasonable time sufficient for a diligent person to establish the credit.[970] If contract requires for credit to be opened in within few weeks, then reasonable time would be defined based on the nature of contracted goods which are subject to trade.[971]If opening of credit is conditioned upon seller to provide information about readiness of goods for shipment, it will be compulsory for buyer to open the credit immediately after receiving such information from seller[972]. Under the situation where shipment is supposed to take place over a period of time, the credit should be opened within the whole period of time mentioned in the contract[973].

Ambiguous clauses regarding the time for opening of the credit in underlying contract can create problems. In American case of *Sohio Supply Co. v Gatoil (USA) Inc*[974]contract of sales required buyer to provide the credit 10 days before the time of loading. However, problem occurred when parties expressed different interpretations from the clause. Seller considered time for opening of the credit

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[967] Malek. A, Quest .D, (2009),Jack. Documentary credits: the law and practice of documentary credits including standby credits, and demand guarantees, Tottle,

[968] In *Lindsay (AE) & Co Ltd v Cook [1953*] 1 Lloyd's Rep 328, where a delay was caused by the inter-bank communication, the seller was held entitled to repudiate the contract of sale.

[969] Todd, P. (2013). *Bills of lading and bankers' documentary credits*. Taylor & Francis. p. 61.

[970] Hedley, W. (1997), Bills of Exchanges and Bankers' Documentary Credits pp. 286-7. Also regarding the determination of reasonable time , Porter J . in in the hearing of *Garcia v . Page & Co Ltd (*1936) [55 LI Rep 391]refers to test which was established by Lord Watson in the Judgment of *Hick v. Raymond & Reid* [1893] A.C. 22 :

> "When the language of a contract does not expressly, or by implication, fix any time for the performance of a contractual obligation, the law implies that it shall be performed within a reasonable time. The rule is of general application, and is not confined to contracts for the carriage of goods by sea. In the case of other contracts the condition of reasonable time has been frequently interpreted; and has invariably been held to mean that the party upon whom it is incumbent duly fulfils his obligations, so long as such delay is attributable to causes beyond his control, and he has neither acted negligently nor unreasonably"

[971] Benjamin's Sale of Goods, at § 23-068 p. 1685

[972] Ellinger .P, Noe. D, (2010), *the Law and Practice of Documentary Letters of Credit*, 141

[973] Hedley, W. (1997). *Bills of exchange and bankers' documentary credits*. LLP. p. 287

[974] *Sohio Supply Co. v Gatoil* (USA) Inc. [1989] 1 Lloyd's Rep 588.

10 days from starting the voyage while buyer based his calculations on the arrival day of the ship. In Staughton L.J supported the sellers position by observing :

> "I have no doubt that the sellers show a good arguable case on that point; I do not think it would be right for me to say more than that. That makes it unnecessary to consider whether the affidavit which they produced sufficiently displays a good arguable case on the point of custom"[975].

Other interesting case is *Transpetrol Ltd. v. Transöl Olieprodukten Nederland BV*[976]in which buyer committed to open the credit one day after receiving notice of appointment of the ship. However, problem arose where in underlying contract, seller agreed to give additional three days to buyer in the format of intention to nominate the vessel. In the hearing Philips J. observed: "It seems to me that the concept of being required to give a minimum of three days' notice of intention to nominate is nonsensical. Prima facie such a notice is of no value to the buyer for it is implicit that there is the intention to nominate in any event"[977]. The court ruled in favour of seller and held that seller had the right to repudiate contract of sales as a result of delay in opening the credit. [978]

**1-4-1- Time for opening of credit under CIF contracts**

In the practice of international trade, most of the time CIF contracts specify the date or period of shipment without referring to time for opening the credit.[979] Since English law follows rational of entitling seller to have access to credit before shipment of goods, in CIF contracts of sale which specify date of shipment, buyer should open the credit at reasonable time before that date[980]. However, parties may include different provisions in the contract which affects such obligation. For example, when parties agree that opening of credit will be subjected to receive particular instructions from seller, opening of the credit will depend on time of receiving such instructions from seller and buyer's obligation will start immediately from the moment of receiving them.[981]

When underlying contract provides period of shipment , then ambiguity rise regarding time for buyer's obligation to furnish the credit. In such cases , English law does not have a clear position

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[975] Ibid 591
[976] *Transpetrol Ltd. v TransölO lieproduktenN ederlandB V* [1989] 1 Lloyd's Rep 309.
[977] Ibid , at 310-311
[978] Ibid at 309
[979] Malek. A, Quest .D, (2009),Jack. *Documentary credits: the law and practice of documentary credits including standby credits, and demand guarantees*, *Tottle*, § 3-16 p. 42; Benjamin's Sale of Goods, at § 23-069 pp. 1686-7.
[980] *Plasticmoda Societa perAzioni v Davidsons (Manchester) Ltd*. [1952] 1 Lloyd's Rep 537,538
[981] Nicolene Ltd v Simmonds [1952] 2 Lloyd's Rep 419, affd. [1953] 2 Q. B. 543

whether credit should be furnished at reasonable time before shipment of goods or at first day of shipment[982].

In *Pavia & Co. S. p. A. v. Thurmann-Nielsen*[983]contract of sales defined the period of shipment between Februarys to April 1949, but the credit was opened on April 22. Denning L.J observed that: in absence of express stipulation, beginning of shipment period is time for opening the credit "because the seller is entitled, before he ships the goods, to be assured that, on shipment, he will be paid. The seller is not bound to tell the buyer the precise date when he is going to ship; and whenever he does ship the goods, he must be able to draw on the credit. He may ship on the very first day of the shipment period"[984]. There is possibility to consider two conditions from Denning L.J's observation: One is, the first day of shipment is latest time for furnishing the credit. Second, since seller is entitled to have assurance about payment before dispatch of goods, the latest date for furnishing the credit is reasonable time before commencement of shipment[985]. In *Sinason-Teicher Inter-American Grain Corporation v. Oilcakes and Oilseeds Trading Co. Ltd*[986] contract of sales considered shipments of barely between Octobers to November 1952, seller cancelled the contract on 10 of September due to failure of buyer in providing the bank guarantee. Supporting the second view, Lord Denning said: "The correct view is that, if nothing is said about time in the contract, the buyer must provide the letter of credit within a reasonable time before the first date for shipment. The same applies to a bank guarantee".[987]

**1-4-2- Time for opening of credit under FOB contracts**

Although in some variations of the FOB contract seller will make the shipping arrangements, in general, such type of contracts provide buyer with possibility to define the date of shipment[988]. In the case of *Ian Stach Ltd. v, Baker Bosley Ltd*[989] where the terms of sales were set as FOB contract, Lord Diplock rejected the view that letter of credit should be opened at reasonable time before nominating

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[982] Malek. A, Quest .D, (2009),
[983] Pavia & Co. S. p. A. v. Thurmann-Nielsen [1952] 2 Q. B. 84
[984] Ibid at pp. 88-89.
[985] Benjamin's Sale of Goods, at § 23-069 p. 1686 ; Chorley & Smart, (1990),*Leading Cases in the Law of Banking*, 6s' ed., (Sweet & Maxwell, London,) pp. 265-268
[986] *Sinason-Teicher Inter-American Grain Corporation v Oilcakes and Oilseeds Trading Co. Ltd*. [1954] 1 WLR 1394.
[987] Ibid at 1400
[988]Malek. A, Quest .D,(2009)
[989] *Ian Stach Ltd. v Baker Bosley Ltd* [1958] 2 Q. B. 130

vessel by buyer and set the first day of shipment period as the last date for furnishing the credit by buyer.[990]

### 3- Effect of non-compliance by the buyer

#### 3-1 Seller's right to terminate the underlying contract

In the practice of international trade, seller is entitled to for withholding goods until the complying credit with terms of underlying contract has been furnished by buyer. In case of buyer's failure to open the credit (upon specified date or within the framework of reasonable time), seller has the right to terminate the contract[991]. However, it should be kept in mind that English law only entitles seller to terminate the contract after serving buyer with a due notice of intention to terminate[992]. In the notice, seller should notify the buyer with precise deadline for opening the complying credit. As a result of buyer's failure to open the credit on time, seller will be fully entitled to repudiate the contract and claim for damages from buyer.[993] In *British and Commonwealth Holdings plc v. Quadrex Holdings Inc*[994],Sir Nickolas Browne-Wilkinson observed that : "where, if a time for completion had been specified in the contract, time would have been of the essence, the innocent party can make time of the essence by serving a reasonable notice to complete even though the guilty party has not been guilty of improper or undue delay".[995] Jack justifies the seller's right for repudiation under English law by pointing at buyer's privilege to open a credit within a specified period of time. Therefore, seller should hold the right to end the contract if buyer's behaviour at the end of that period is a sign of his repudiation[996].

#### 3-2 The seller's remedies against the buyer's failure

Seller is fully entitled for damages against the buyer under the circumstances in which failure of buyer to open a complying letter of credit is reason for non-performance of the contract.[997]Legal basis

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[990] He Commented : "the buyer would not know how long it would take to bring the goods from the place where they were and transport them to the port: he would not know in a case of this kind, and did not know, whether or not the goods had to be rolled to order or whether they were in stock or whether they were partly rolled. It seems to me that in a case of this kind, and in the case of an ordinary f. o. b. contract financed by a confirmed banker's credit, the prima facie rule is that the credit must be opened at latest... by the earliest shipping date"

[991] Malek. A, Quest .D,(2009); Ellinger. P, Dora , N (2010)

[992] Ibid

[993] Ibid

[994] *British and Commonwealth Holdings plc v. Quadrex Holdings Inc*[1989] Q. B. 842

[995] Ibid 857

[996] Malek. A, Quest .D,(2009), at § 3-25 p. 46

[997] *Heisler v Anglo-dal Ltd.* [1954] 2 All ER 770.; Schmitthoff, C. M., Schmitthof"s Export Trade: The Law & Practice of International Trade 9th ed (London, Stevens & Sons, 1990) p. 421

for assessment of damages will be the same as situation in which buyer is found liable for rejecting the contract. [998] Damages will be assessed via reduction of contract price of goods from their market price[999].In *Ian Stach Ltd. v Baker Bosley Ltd*; sellers were rewarded with difference of the contract price and the market price of goods, which they have received by re-selling them.[1000] It is also held that if buyers become aware of some particular information during the conclusion of the contract of sales , measures for estimation of their liability for damages while failing to open the credit on time will be different. [1001]In *Trans Trust SPRL v Danubian Trading Co Ltd* buyers already knew that failure to open the credit on time will prevent sellers to procure essential materials required under the contract of sales.[1002] Therefore, plaintiff sellers were awarded with "a sum equal to the profit which they would have made if the credit had been opened and the successive sales had gone through"[1003].

**3-3- Buyer's failure to open the credit on time or provide solvent paymaster**

Since sellers use the credit as a mean of collecting finance, documentary letters of credit involved in the practice of international trade are considered more than just a method of payment for the price stipulated in the underlying contract. Therefore, buyer's failure to open the credit will make him liable to breach of contract and make sellers entitled to damages under principles of contract law. In the case of *Trans Trust S. P. R. L. v. Danubian Trading Co. Ltd*[1004] where underlying contract covered sales of steel , buyers failed to open complying credit with terms and conditions of the contract. Subsequently, sellers claimed for loss of profit which they could gain from sales process. In response, buyers argued that sellers could re-sale goods as market was rising[1005]. Sellers replied that they were relying on credit to finance their transaction and in fact, due to buyer's failure to open the credit it was not possible for them to sell the steel which they did not buy from manufacturer[1006] . Same

[998]Malek. A, Quest .D,(2009), a t § 3-28p p. 47-48.
[999] Sale of Goods Act 1979, s. 50
[1000] *Ian Stach Ltd. v Baker Bosley Ltd*_ [1958] 2 Q. B. 130,
[1001] *Trans Trust SPRL v Danubian Trading Co Ltd* [1952] 2 Q. B. 297.
[1002] Ibid
[1003] Ibid at 300
[1004] *Trans Trust SPRL v Danubian Trading Co Ltd* [1952] 2 Q. B. 297;
[1005] Ibid 305
[1006] Denning L. J. in *Trans Trust SPRL v Danubian Trading Co Ltd* about treating the provision of the credit as simply an alternative way of paying the price, said:

> "This argument reminds me of the argument we heard in *Pavia & Co. v. Thurmann- Nielsen* It treats the obligation to provide a credit as the same thing as the obligation to pay the price. That is, I think, a mistake. A banker's confirmed credit is a different thing from payment. It is an assurance in advance that the seller will be paid. It is even more than that. It is a chose in action which is of immediate benefit to the seller. It is irrevocable by the banker, and it is often expressly made transferable by the seller. The seller may be relying on it to obtain the goods himself. If it is not provided, the seller may be prevented from obtaining the goods at all. The damages he will then suffer will not in fact be nominal. Even if the market price of the goods has risen, he will not be able to take advantage of the rise because he will not have any goods to resell. His loss will be the profit which he would have made if the credit had been provided. Is he entitled to recover that loss? I think he is [subject to the normal rules of remoteness of damage in contract]... "

principles will be in place while calculating damages in falling market. In *Ian Stach Ltd. v. Baker Bosley Lts*[1007], after considering sellers right in repudiation of contract due to failure of buyers in furnishing the credit on time, Lord Diplock J, explained that sellers are entitled to damages which are measured based on difference between contract price and price of goods at the time of repudiation (which he considered as loss of profit for sellers due to falling market). [1008]

In *Urquhart Lindsay & Co. v. Eastern Bank Ltd.,*[1009]underlying contract covered sales of machinery by instalment in accordance with number of shipments which were supposed to deliver the goods. Buyer paid two instalments after recovering respective shipments. However, they ordered bank not to pay the instalment relevant to the third shipment. Sellers sued for damages and question arose about amount of damages. Rowlatt J concluded that trading by instalment entitles sellers to cancel the entire contract. Therefore, sellers were able to repudiate the entire contract on the basis of failure of buyer in payment of one instalment and their claim on damages would be calculated on the basis of damages in entire transaction.[1010]

In summary, buyer would be in breach of underlying contract while failing to open complying credit or when the credit fails to operate properly. It also worth to mention that failure in opening or operation of credit is not simple shortcoming in payment for price of goods. As credit is used by seller in financing his activities, therefore, it means much more than simple method of payment. According to Todd: "the damages are not limited to the payment of the price, but will be anything that is recoverable under ordinary principles applicable to contractual damages"[1011].

## 4- Variation of the credit and its effect on party's rights within underlying contract

### 4-1- Amendment of the credit

Amendment is an agreed variation of credit which takes place with consent of all parties involved in the credit. Generally, amendment is initiated by applicant's request either with consent or upon

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[1007] *Ian Stach Ltd. v Baker Bosley Ltd [1958] 2 Q.B . 130.*

[1008] Ibid at 145 : Lord Diplock observed :

> "The measure of damagesi s the loss of profit on the transaction, since the defendants must have known that their failure to provide the letter of credit would make it impossible for the plaintiffs to carry out the transaction. I think, therefore, that probably the right basis is loss of profit".

[1009] *Urquhart Lindsay & Co. v. Eastern Bank Ltd* [1922] 1 K. B. 318.

[1010] Ibid 323-324. Rowlatt J, held :

> "Now if a buyer under a contract of this sort declines to pay for an instalment of the goods, the seller can cancel and claim damages upon the footing of an anticipatory breach of the contract of sale as a whole. These damages are not for non-payment of money. It is true that non-payment of money was what the buyer was guilty of; but such non-payment is evidence of a repudiation of the contract to accept and pay for the remainder of the goods; and the damages are in respect of such repudiation."

[1011] Todd, P.,*(2013), Bills of Lading & Bankers'Documentary* Credits p. 72.

request of the beneficiary[1012].In practice, amendment will be effected in between beneficiary and issuing bank and most probably it will involve advising bank which will be discussed in following.

4-1-1- Legal position

The documentary letter of credit is a binding guarantee undertaken by issuing bank in favour of beneficiary. Similar to the contract which can be changed only after consent of all parties, the credit can be amended only with agreement of issuing bank and beneficiary seller. Consent of advising bank would be required where it is supposed to confirm the credit. Agreement of the buyer is impliedly necessary (though applicant is not a party to the credit) as both credit and amendment are issued based on his initiative. [1013] There are many reasons for initiating an amendment to a credit including: unhappiness of beneficiary with terms and conditions of the credit, seller's need for extension of shipping time or changing the type of credit.

Article 7 and 8 of the UCP 600 define responsibilities of the issuing and confirming bank, and article 10 covers relevant legal aspects of issuing as well as amending the credit.[1014]

Text of article 10 clearly defines parties to the credit as beneficiary, issuing and confirming bank without reference to applicant. In respect with advise of an amendment, article9.d of the UCP 600 provides :

> "d. A bank utilizing the services of an advising bank or second advising bank to advise a credit must use the same bank to advise any amendment thereto".

4-2- Practical problems

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[1012] Jack 56

[1013] Rosenblith, R. M., `*Modifying Letters of Credit: The Rules and the Reality*' ,19 Uniform Commercial Code Law Journal (1987) 245, at 246, n. 3

[1014] UCP 600 , Article 10 : Amendments :

> "a. Except as otherwise provided by article 38, a credit can neither be amended nor cancelled without the agreement of the issuing bank, the confirming bank, if any, and the beneficiary.
> b. An issuing bank is irrevocably bound by an amendment as of the time it issues the amendment. A confirming bank may extend its confirmation to an amendment and will be irrevocably bound as of the time it advises the amendment. A confirming bank may, however, choose to advise an amendment without extending its confirmation and, if so, it must inform the issuing bank without delay and inform the beneficiary in its advice.
> c. The terms and conditions of the original credit (or a credit incorporating previously accepted amendments) will remain in force for the beneficiary until the beneficiary communicates its acceptance of the amendment to the bank that advised such amendment. The beneficiary should give notification of acceptance or rejection of an amendment. If the beneficiary fails to give such notification, a presentation that complies with the credit and to any not yet accepted amendment will be deemed to be notification of acceptance by the beneficiary of such amendment. As of that moment the credit will be amended.
> d. A bank that advises an amendment should inform the bank from which it received the amendment of any notification of acceptance or rejection.
> e. Partial acceptance of an amendment is not allowed and will be deemed to be notification of rejection of the amendment. f. A provision in an amendment to the effect that the amendment shall enter into force unless rejected by the beneficiary within a certain time shall be disregarded"

In majority of cases, after receiving beneficiary's request for amending the credit, applicant will discuss the matter with issuing bank. Upon agreement of issuing bank to issue required amendment, it will inform advising bank and finally beneficiary will be informed about issuance of the amendment via advising bank. Notice of amendment might or might not include a request for beneficiary to inform the bank about his acceptance or rejection of amendment.[1015] Beneficiary is entitled to inform bank about his dissatisfaction with an amendment or reflect his intention to be bound with original terms of the credit[1016]. There is possibility that beneficiary does not appreciate his right to objet against amendment or he is not aware about existence of such rights. Beneficiary might even assume that presentation of complying documents with original terms of the credit might result in dishonouring presentation by bank.[1017] In case of bank's rejection to comply with request of beneficiary to modify the amendment or stick to terms of original contract, he has access to different remedies:

Beneficiary may consider insistence of bank on enforcement of amendment as repudiation of the credit and claim for damages from bank. Other option would be, returning to applicant and asking for withdrawal of amendment. Where withdrawal of amendment is rejected by applicant, then beneficiary has clear cause of action against bank and applicant together under the sales contract and the credit.[1018]Final option available to beneficiary is presenting documents in accordance with non-amended credit.[1019]

According to article 10 (c ) of UCP 600 , advising an amendment to beneficiary is equal to an offer provided by bank to him and without express acceptance of beneficiary or his action upon amendment, it will not have any legal obligation for him. Article 10 (f) even prohibits parties to include condition like amendment should come into force after certain time if it's not rejected expressly by beneficiary.

4-3- Confirming bank and Amendment

UCP provides that issuing bank is legally bound to an amendment upon issuing it. Even silence of beneficiary will not relieve issuing bank from its liability in terms of issued amendment[1020]. However, situation is not the same for confirming bank as it can simply advise the amendment without adding

[1015] Malek. A, Quest .D,(2009) , 58
[1016] UCP 600 , Article 10 (a) and 10 (c)
[1017] *Ficom SA v Sociedad Cadex Ltda* [1980] 2 Lloyd's Rep 118 at 127; *United City Merchants v Royal Bank of Canada* [1979] 1 Lloyd's Rep 267 at 275
[1018] Ellinger. P, Noe , D, (2010) , 72
[1019] UCP 600 , Article 10 (c )
[1020] UCP 600 , Article 10 (b)

confirmation to it. Before accepting amendment by beneficiary, credit remains non-amended and bank continue its obligation as confirming bank to it. New circumstances will come into existence where amendment is accepted by beneficiary. By then, credit is amended and confirming bank will be only an advising bank to it without any extra liability.[1021]

**4-2- Non-conformation of the credit with underlying contract**

Where credit conforms to terms and conditions of the underlying contract, seller cannot object upon it. [1022]Where the credit is not conforming to terms and conditions of underlying contract, beneficiary must inform the applicant about irregularities. In such circumstances, mostly beneficiary either rejects the credit or asks for amendments. However, there might be situation in which seller performs under contract of sales despite disconformity of the credit. In English legal system, three different possibilities are considered for such situation: first, seller might have waived the non-conformity. Second, he might be estopped from relying of irregularities. Third, it might be held that underlying contract has been varied in conformity with credit which is opened for the purpose of financing it[1023] . In case of waiver or estoppel seller can issue a notice to buyer and require fixing of irregularities within a reasonable time. Therefore, first two situations have only "suspensory effect" on the rights of seller.[1024]However, variation of underlying contract particularly ,being supported by consideration has much border effect.[1025]

Under English Law, *Panoutsos v. Raymond Hadley Corporation* is leading case on waiver.[1026]According to the contract of sales, buyer was supposed to provide payment in format of the confirmed documentary letter of credit in instalments. However, the credit was furnished but without confirmation. Sellers did not react and made shipments as already agreed and collected payments. Later, they cancelled the contract without giving any notice to buyers stating that the credit was not in compliant with terms and conditions in underlying contract. The Court of Apple held that despite the fact that seller was entitled for cancelation of the contract due to non-conformance of the credit; they could do so, either before making shipments and receiving part of payment or after sending a proper notice of intention to buyers and giving them reasonable time to obtain confirmation for the

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[1021] Ibid
[1022] Malek. A, Quest .D,(2009), 54
[1023] Ibid
[1024] Ibid
[1025] Ellinger ,P. Noe.D, (2010)
[1026] *Panoutsos v. Raymond Hadley Corporation* [1917] 2 K. B. 473.

credit.[1027]Therefore, sellers were held not to be in position for repudiating the contract as they have already waived buyer's failure to furnish a confirmed credit.[1028]

In the framework of English law, doctrine of estoppel refers to condition under which a party to a contract is estopped from claiming a right due to representation which he has made and resulted in other's parties' reliance. [1029] In the case of *Glencore Grain Rotterdom BV v Lebanese Organization for International Commerce* [1030]underlying contract covered sale of 25,000 tons of wheat at US$ 135/ton. Additionally, buyers agreed to pay extra US$ 7/ ton in case of their failure to accept goods according to contract. Terms of shipment in the contract was set as FOB on a chartered vessel by buyers and payment was supposed to be made via confirmed irrevocable letter of credit. Additionally, buyers mentioned that bill of lading should mention "freight prepaid" which got rejected by sellers. However, buyers kept their position firm and sellers did not raise any further objection. The chartered vessel had one day delay while arriving in the port of loading which resulted in refrainment of sellers to load the cargo and ask extra payment for pre-payment of freight and additional US$7 per ton. The buyers sued sellers and claimed for damages. However, The Court of Appeal ruling in favour of beneficiary sellers held[1031]: "sellers conduct was not inconsistent with their previous objection and that there had been no unequivocal representation that the sellers had relinquished or would relinquish their rights arising out of buyer's failure to open a conforming letter of credit"[1032].

*W. J Alan & Co. Ltd. v. El Nasr Export and Import Co*[1033]is the leading case on variation of contract resulted from conduct of beneficiary sellers. In contract of sales for two consignment of Kenyan coffee to Egypt, price was quoted in Kenyan Shilling; however, letter of credit for financing the

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[1027] Ibid

[1028] Ibid , 478 . In this regard, Viscount Reading CJ. observed:

> "In *Bentsen v. Taylor. Sons & Co.* Bowen L. J. stated the law as to waiver thus: `Did the defendants by their acts or conduct lead the plaintiff reasonably to suppose that they did not intend to treat the contract for the future as at an end, on account of the failure to perform the condition precedent?' Reading sellers for defendants and buyer for plaintiff in that passage, it applies exactly to the present case. The sellers did lead the buyer to think so, and when they intended to change that position it was incumbent on them to give reasonable notice of that intention to the buyer so as to enable him to comply with the condition which up to that time had been waived."

[1029] Todd, P,(2013), Bills of Lading & Bankers' Documentary Credits p. 67.

[1030] *Glencore Grain Rotherdom BV v Lebanese Organization for International Commerce* [*1 997]4 All ER 514.*

[1031] Ibid at 527 : Evans L. J. commented *obiter* that:

> "What may be called the classic rules of estoppel and waiver can apply in circumstances such as these, so as to prevent a party who fails or refuses to perform the contract from relying upon conduct by the other party which would otherwise justify his doing so. The occasions when these rules may be involved in these circumstances are limited, for example, by the fact that it is rarely if ever possible to imply an unequivocal representation of fact from a party's silence on the relevant issue."

[1032] Malek. A, Quest .D,(2009) at P, 56;

[1033] *WJAIan & Co. Ltd. v El Nasr Export and Import Co* [1972] 2 Q. B. 189.

contract was opened in Sterling.[1034]Beneficiaries did not complain on non-conformity of the credit upon its opening , but difficulties appeared when after making shipments and before presenting documents to the bank , Sterling depreciated and sellers tried to receive different in exchange rate by claim against buyers. In the Court of Appeal, Lord Denning MR, considered the case as a waiver. Megaw LJ held that the case is a variation of underlying contract as sellers have accepted offer of bank based on instructions of applicant buyer. As a result, bank is bound to a non-alterable credit which cannot be changed without consent of all parties involved. Therefore, currency of contract has been varied to the one in the credit. [1035] Stephenson LJ held: "they (sellers) were attempting to assert a liability which , by variation or waiver , they had allowed buyers to alter"[1036].

In conclusion, doctrine of waiver and estoppel will be effective only where stipulation of waiver or being estopped to rely on his respective rights is added to the contract by party directly benefiting from it[1037]. To differentiate waiver form variation, court will decide on facts of each case separately[1038]. However, variation will be effective only in presence of consideration[1039].

## 5- The buyer's rights after opening credit

### 5-1- buyer's remedies due to presentation of forged documents by sellers

Despite the fact that independent principle of documentary letters of credit emphasizes on separation of the credit from underlying contract, honouring of the credit in majority of cases does not discharge all rights of parties in underlying contract.[1040] As a result, buyer has right to bring an action in deceit against seller who is presenting forged documents[1041]. In such cases, buyer will be entitled to damages where presented documents by seller are nothing but "waste paper".[1042]

### 5-2- Buyer's entitlement to repudiate the contract of sales due to inability of seller to tender complying presentation.

*Shamsher Jute Mills v. Sehtia*[1043]is the authority which provides buyer with right to repudiate underlying contract of sales in the occasion of sellers failure to present required documents

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[1034] Ibid
[1035] Ibid 218
[1036] Ibid at 221
[1037] Todd, P.(2013), *Bills of Lading & Bankers'Documentary Credits* p. 69.
[1038] *Benjamin's Sale of Goods*, at § 23-076 pp. 1688-89
[1039] Chitty, J. (2012). *Chitty on contracts: General principles* (Vol. 1). Sweet & Maxwell. at § 23-034 p 1156
[1040] Bridge, M. G. (2012). *Benjamin's sale of goods* (Vol. 11). Sweet & Maxwell. § 23-120 p. 1712.
[1041] *Famouri v Dialcord Ltd* (1983) 133 NLJ 153.
[1042] *Benjamin's Sale of Goods*, at § 23-090 p. 1696
[1043] *ShamsherJute Mills v. Sehtia* (London[1987] 1 Lloyd's Rep 388

stipulated in the credit to bank. In this case, seller was obliged under the irrevocable credit to tender set of stipulated documents to bank. Upon failure of seller to present of required documents and despite conformity of goods with terms of contract , court held that such failure of seller not only prevents him from obtaining payment under the credit, but also entitles buyer to refrain from contract of sales and consider it repudiated.

### 6- Absolute or conditional nature of the payment obligation to pay under the LC

Since the credit is in fact a guarantee provided to seller beneficiary by issuing bank, it is not possible for direct tender of documents by seller to buyer applicant and request of payment to be made by him. The contract of sales in *Soproma S. P. A. v. Marine & Animal By-Products Corporation*[1044]required payment to be effectuated via irrevocable letter of credit. After rejection of first presentation by bank, seller made the second presentation directly to the buyers though outside the time limit for presentation stipulated in the credit. . Documents were rejected by buyers and in the hearing; McNair J. ruled in favour of buyers due to late presentation and invalidity of direct presentation of documents to applicant under documentary credit system[1045] . McNair J observed :

> "It seems to me to be quite inconsistent with the express terms of a contract such as this to hold that the sellers have an alternative right to obtain payment from the buyers by presenting the documents direct to the buyers. Assuming that a letter of credit has been opened by the buyer for the opening of which the buyer would normally be required to provide the bank both with cash or some form of authority; could the seller at his option disregard the contractual letter of credit and present the documents direct to the buyer? As it seems to me, the answer must plainly be in the negative"[1046]

In confirmation of above judgement, it is submitted that in the course of international transaction, privilege of effectuating payment by documentary letters of credit is an equal right shared by applicant and beneficiary. This is not a right solely available to seller which he can unilaterally waive[1047]. Providing possibility for seller to have direct approach to buyer in request for payment instead of making presentation to the bank violates applicant's rights.

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[1044] *Soproma S. P. A. v. Marine & Animal By-Products Corporation*[1966] 1 Lloyd's Rep. 367
[1045] Ibid
[1046] Ibid at 386
[1047] T odd, P.(2013), Bills of Lading & Bankers' Documentary Credits p. 73.

"Under this form of contract, as it seems to me, the buyer performs his obligation as to payment if he provides for the sellers a reliable and solvent paymaster from whom he can obtain payment-if necessary by suit- although it may well be that if the banker fails to pay by reason of his insolvency the buyer would be liable; but in such a case, as at present advised, I think that the basis of the liability must in principle be his failure to provide a proper letter of credit which involves (inter alia) that the obligee under the letter of credit is financially solvent. (This point as to the buyer's liability for the insolvency of the bank was not fully argued before me and I prefer to express no concluded opinion upon it as I understand that it may arise for decision in other cases pending in this Court. )"[1048].

The position is confirmed in UCP 600 by preventing beneficiary from drawing draft on applicant.[1049]

**6-1 General provisions on Absolute or conditional nature of the credit**

It might happen in practice that despite presentation of complying documents , beneficiary seller will not be paid by issuing bank in case of non-confirmed credit or either confirming/issuing bank in case of confirmed credit. In such situation, seller should be able to answer the question of whether or not he has right for recourse against applicant. In order to answer above question properly, it is necessary to consider two other questions: first is what can be the main reason behind inability of seller to get payment from bank? And second is how this issue has been addressed in the underlying contract of sales? [1050]

6-1-1 Reason for inability of seller to get payment

Where seller is unable to receive payment from the bank, there are two possible reasons: first is that seller himself is either late in making the presentation or , presentation in non-compliant with terms and conditions of the credit. In such condition, seller is himself in breach of contract with issuing bank under which he has to present compliant documents to the bank[1051]. However, if seller provides evidences that his complying presentation has been rejected unreasonably, then the bank will be in breach of contract. Such situation will provide sellers with different options. On one hand he can dispose goods for sale in order to mitigate his loss and then bring an action against the bank to court. On the other hand, it is possible to appeal to the applicant buyer in claim for price of goods under the contract of sales.[1052] General practice of international trade indicates that in majority of occasions,

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[1048] *Soproma S. P. A. v. Marine & Animal By-Products Corporation*[1966] 1 Lloyd's Rep. 367 , at 385
[1049] UCP 600 , Article 6 (c ) : "A credit must not be issued available by a draft drawn on the applicant"
[1050] Ventris,F .M .(1990) , Bankers' Documentary Credits,3 rd ,Lloyd's of LondonPress Ltd, p p. 85-86.
[1051] Ibid 86
[1052] Ibid 87

buyer will waive discrepancy of documents and let bank to effectuate payment to beneficiary. Such practice is supported by UCP. [1053]

6-1-2 Drafting payment clause in the underlying contract of sales

Where bank refrain from effectuating payment despite presentation of complying documents by beneficiary, it will be possible for him to refer to the underlying contract with applicant in order to find a relief.[1054] Such relief depends on interpretation of the payment clause in underlying contract which determines opening of the credit by applicant was either absolute or conditional means of payment.[1055] In the first glance and with reference to autonomy principle of documentary letters of credit, it seems that payment by the means of using LC is an absolute undertaking of bank which is accepted by seller. Therefore, seller will have no remedies in case of being left unpaid by bank despite presentation of complying document. The above presumption is correct when seller expressly admits the absolute nature of payment by the credit which can happen for example through his requirement to open LC with a particular bank rather than bank suggested by applicant[1056]. Even where the court considers nature of payment by LC as absolute, there might be some possibilities for seller to refer for payment of goods to the buyer. Namely, when buyer askes the bank not to pay he will be in breach of contract with seller. Other occasion would be the time that buyer takes the possession of goods.

In *Newman Industries Ltd v. Indo-British Industries*[1057], plaintiffs sent a generator to their buyers Govindram Brothers Ltd in India through intermediaries Indo-British Industries. Defendants required bank (after opening the credit) not to effectuate payment before presentation of a guarantee document by plaintiffs. However, such document was not required neither in underlying sales contract not in the credit.[1058] In the course hearing Sellers J, mentioned: "I do not think there is any evidence to establish, or any inferences to be drawn, that the draft under the letter of credit to be taken as absolute payment. I see no reason why the plaintiffs, in the circumstances which have so unfortunately and unnecessarily arisen look to the defendants, as buyers for payment"[1059]. The take away point from the judgment is that court considered the possibility for entitlement of sellers to be

[1053] UCP 600 , Article 16 (C ,iii ,b ) : that the issuing bank is holding the documents until it receives a waiver from the applicant and agrees to accept it, or receives further instructions from the presenter prior to agreeing to accept a waiver;
[1054] Ellinger ,P. Noe .R (2010)
[1055] *W J Alan & Co v El Nasr Export and Import Co* [1972]2 Q.B . 189
[1056] Malek. A, Quest .D, (2009) 62
[1057] *Newman Industries Ltd v Indo-British Industries* [1956] 2 Lloyd's Rep 219
[1058] Ibid
[1059] Ibid , at 236

recovered by buyers under given circumstances. [1060] However, The Court of Appeal reversed the decision on the basis of non-conclusion of sales agreement[1061].

In Australian case of *Saffron v Societete Miniere Cafrika* [1062], presentation was lawfully rejected by bank as Chromium shipped was below the minimum required tonnage under the contract and also bill of lading was not endorsed in bank's order as pre requirement. Sub-buyer took the possession of goods where buyer was not paid the price. With reference to rules of negotiable instruments, the trial judge concluded that under given circumstances, LC was not supposed to be the only method of payment.[1063] The decision was upheld by The High Court of Australia.

In regard with absolute or conditional nature of the credit, decision of *WJ AIan & Co v EI Nasr Export and Import Co*[1064]is a key authority despite the fact that observation of court regarding conditional nature of the credit is not relevant to decision and stays strictly *obiter*[1065].In the course of hearing, counsel of defendants raised the issue that after opening, the credit has absolute nature and seller cannot refer to buyer in case of rejection of presentation by bank. Lord Denning MR made general comments on the issue:

> "When the contract of sale stipulates for payment to be made by confirmed irrevocable letter of credit, then when the letter of credit is issued and accepted by the seller, it operates as a conditional payment of the price. It does not operate as absolute payment… if the letter of credit is honoured by the bank when documents are presented to it, the debtor is discharged. If it is not honoured the debt is not discharged "[1066].

In *Maran Road Saw Mill v .Austin Taylor Ltd*[1067], where an agent was taking the role of buyer, bank failed in effectuating payment under the credit. Anker J. of the Queen's Bank ruling in favour of seller said:

> "Can it then be said that [the defendants] have discharged their contractual obligation, when, although they have established a letter of credit, payment has not been made under it? To my mind, the answer is a simple one and is in the negative. I respectfully adopt and slightly adapt the language used by Stephenson L. J. in *W. J. Alan & Co. Ltd. v. El Nasr Exhort and Import CO*. The

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[1060] Malek. A, Quest .D,(2009) 62
[1061] [1957] 1 Lloyd's Rep 211
[1062] *Saffron v Societete Miniere Cafrika* (1958)100 CLR 231.
[1063] Ibid at 244.
[1064] *W JAIan & Co v EI Nasr Export and Import Co* [ 1972] 2 Q.B . 189.
[1065] Malek. A, Quest .D,(2009) ,64
[1066] Ibid , at 212
[1067] *Maran RoadS awMill v. Austin Taylor Ltd* [1975] 1 Lloyd's Rep. 156

agents promised to pay by letter of credit not to provide by a letter of credit a source of payment which did not pay."[1068]

With reference to decisions of *W. J. Alan & Co. Ltd. v. El Nasr Exhort and Import CO* and *Maran Road Saw Mill v .Austin Taylor Ltd* it is submitted that principles set in these cases are nothing but "rebuttable presumptions" as based on unique situation in each case court is making final decision whether the credit has absolute or conditional nature.[1069]

Some authorities consider implied or express stipulation of seller in underlying contract as a sign for absolute nature of the credit. Such satiation will arise where: seller ""stipulates for the credit to be issued by a particular bank, in such circumstances that it is to be inferred that the seller looks to that particular banker to the exclusion of the buyer"[1070].In *Soproma S. p. A v. Marine and Animal By-Products Corporation*[1071], the judge held view that only bankruptcy of the bank will make seller to reach buyer for payment directly[1072]. With respect, it is submitted that applicant buyer is normally in charge of nomination of issuing bank; therefore, seller who has not participated in such process should not take consequences of bank's failure in honouring the credit.

In *E. D. & F. Man Ltd. v. Nigerian Sweets & Confectionery Co.Ltd*[1073]where Nigerian buyers opened an irrevocable credit with a bank in London. Buyers received the goods and paid the bank against a 90 days draft. However, bank went insolvent and sellers claimed against buyers for payment. In hearing and in response to buyers argument on absolute nature of the credit, Anker .J held sellers entitled to ask for buyer for price. [1074]

Finally, in *Shamsher Jute Milles Ltd v Sethia (London) Ltd*[1075] , Sellers of FOB contract presented documents to bank after shipping goods to buyers. After rejection of presentation by bank due to discrepancy, sellers directly claimed against buyers for contract price plus damages. Goods were

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[1068] Ibid at 159

[1069] Todd, P.,(2013) Bills of Lading & Bankers'Documentary Credits p. 75.

[1070] *WJAIan & Co v EI Nasr Export and Import Co* [ 1972] 2 Q.B . 189 at 220

[1071] [1966] 1 Lloyd's Rep 367

[1072] Ibid , at 386

[1073] *E .D . &F. Man Ltd v. Nigerian Sweets& Confectionery Co. Ltd* [1977] 2 Lloyd's Rep. 50.

[1074] Ibid , at 56 . Anker .J: "Mr Evans [for the buyers] sought to submit as a proposition of law, that where the identity of the bank is agreed between the parties, and not left to the choice of the buyers, it must follow that the sellers impliedly agree that the liability of the issuing bank has been accepted by them in place of that of the buyers. I do not think that this is correct. The fact that the sellers have agreed on the identity of the issuing bank is but one of the factors to be taken into account when considering whether there are circumstances from which it can be properly inferred that the sellers look to that particular bank to the exclusion of the buyer. It is in no way conclusive. In this case..., there were other circumstances which clearly supported the presumption that the letters of credit were not given as absolute payment but as conditional payment... The sellers remedy in such circumstances is to claim from the buyers either the price agreed in the contract of sale or damages for breach of their contractual promise to pay by letter of credit. "

[1075] *Shamsher Jute Milles Ltd v Sethia* (London) Ltd [1987] 1 Lloyd's Rep 388.

sold in Antwerp to cover costs and neither seller not buyer benefited from the contract. In hearing, Bingham J answered questions regarding conditional nature of credit and entitlement of sellers to claim price from buyer as a result of the conformity of goods. He held that accepting the credit means sellers either waived their right in underlying contract to claim payment directly from buyer or varied the contract. Therefore, they are in breach of contract with buyers due to making non-compliant presentation and as a result they cannot entitle to recover the contract price from buyers.

**6-2- The Bank's bankruptcy**

Problems will come where the issuing bank files for bankruptcy after making the presentation by seller beneficiary and before payment of draft to him. In such situation two possibilities exist : first, buyer has already paid the LC amount to bank , and second , buyer has not paid the LC price to bank. In the first situation and where buyer has already paid the amount due under LC to the bank and bank goes into bankruptcy, under absolute payment term, seller will only receive *pro rate* liquidation dividends which is obviously less than contract price [1076].However, where the payment under the credit is conditional, seller will receive the liquidation dividends from the bank and he can appeal for rest of purchase price to buyer applicant.[1077]In such situation, buyer has already paid the amount due under the LC to bank and he should also cover the difference between sales price and liquidation dividends for seller.[1078]Where the buyer has not paid the LC price and bank declares bankruptcy, under absolute credit, English law will hold: "a loss to the seller equal to the difference between the sales price and the liquidating dividend. The general creditors of the bank would reap a benefit to the extent that the buyer's payment of funds to the bank prior to the bank's insolvency exceeds the pro rata liquidating dividend received by the seller as one general creditor"[1079].However, under conditional letter of credit, seller will have right to appeal for LC price to the buyer applicant and as a result, not of them will face substantial loss.[1080]

## 7- Conclusions

[1076] *ED& F Man Ltd. v Nigerian Sweets and Confectionery Co. Ltd*. [1977] 2 Lloyd's Rep 50.
[1077] Ibid
[1078] Ibid
[1079] Berger, S. R., `The Effects of Issuing Bank Insolvency on Letters of Credit' 21 Harvard International Law Journal (1980)161, at. 175
[1080] *ED& F Man Ltd. v Nigerian Sweets and Confectionery Co. Ltd*. [1977] 2 Lloyd's Rep 50.

This paper studied limits of autonomy principle in documentary letters of credit under English Law. Despite the fact that according to principle of autonomy it is globally accepted that letter of credit is independent from underlying contract which gives reason to its existence, paper touched upon different areas which can question unlimited application of autonomy principle in practice of international trade. Existence of such limits can be advantageous for savvy businessmen in protecting their own economic interests. Interestingly, the fact that underling contract can affect operation of LC in numerous aspects provides guidelines for courts and arbitrators on how to solve possible disputes between parties. Such interplay between contract of sales and the credit can be found in different areas from nature of parties obligations under the credit, to effects of non-compliance of parties to terms of the credit, variations in the LC and absolute of conditional nature of the credit are all items which can be defined in the framework of underlying contract based on agreement of parties and play significant role in resolution of even complicated disputes in the course of their transaction. As a result, paper concludes the discussion with providing parties to international trade who intend to use letters of credit as method of payment with some recommendations in better safe guarding their own interests.

Parties are recommended to include checklist of conditions which other side should perform under the credit and include it in their underlying contract. It is also recommended to provide flexible term of shipment like 45-60 days from conclusion of the sales contract rather than designating a fixed date. Such provision will help both parties to have more room for performing their responsibilities. Terms of shipment and all relevant charges including insurance costs should be clarified and party in charge of each cost should be defined. It is recommended to seller not to impose the credit to be opened by any specific bank and to require it to be advised by his own bank. Sellers are also recommended to require a confirmed letter of credit from buyers. In return, buyers are advised to require a certificate of inspection for goods provided by an independent inspector in underling contract. Buyers can further require procurement of bank guarantee from seller in regard with capability to perform their commitments in the underlying contract. Buyers are recommended to impose complex documentary requirements from seller in the framework of underlying contract in order to minimise the risk of seller's fraud. Finally, buyers are advised to include the clause of sales on approval in the contract of sales in order to prevent possibility for breach of warrantee by seller.

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***Publication 11*** **: Alavi.H, (2016). "Remedies to Fraud in Documentary Letters of Credit: A Comparative Perspective/ Opravné Opatrenia Pri Podvodoch S Dokumentárnymi Akreditívami: Komparatívna Perspektíva" In *EU agrarian Law*, 5(1), 1-13.**

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vydanie 1/2016

# REMEDIES TO FRAUD IN DOCUMENTARY LETTERS OF CREDIT: A COMPARATIVE PERSPECTIVE

# OPRAVNÉ OPATRENIA PRI PODVODOCH S DOKUMENTÁRNYMI AKREDITÍVAMI: KOMPARATÍVNA PERSPEKTÍVA

Hamed ALAVI*

## I. Introduction

It is customary to face with disputes while practicing international trade. Diversified nature of such disputes range from arguments over on performance of parties in the sales contract to delays in delivery, quality of goods sold and etc. Among others, payment problems consist a major area of disagreements in international business disputes. Fraud is a common justification for importer (buyer) to refuse pay- ment when documentary letter of credit is method of pay- ment in international sales contract and courts of different jurisdictions have extensive experience in facing with LC fraud disputes[1]. In principle to apply fraud exception to in-

[1] Alavi, H .(2016). "Mitigating the Risk of Fraud in Documentary Letters of Credit." Baltic Journal of European Studies 6.1: 139– 156

**(EN)**

Article 4 of the Unified Customs and Practices of Documentary Letters of Credit establishes the notion of autonomy principle by separating cre- dit from underlying contract between account party and beneficiary. Article 5 by recognizing the autonomy principle confirms that effectuate the payment under credit, banks only deal with documents and not with goods. As a result, while documentary letters of credit are meant to facilitate the process of international trade, their sole dependency on compliance of presented documents to bank by beneficiary to actualize the payment will increase the risk of fraud and forgery in the course of their operation. Interestingly, UCP (currently UCP600) takes a silent status regarding the problem of fraud in international LC operation and leaves the ground open for national laws to provide remedies to affected parties by fraudulent beneficiary. National Laws have different approaches to the problem of fraud in general and fraud in international LC operation in particular which makes the access of affected parties to possible remedies complicated and difficult. Current paper tries to find answer to the questions of (i) what available remedies are provided to affected parties in international LC fraud by different legal systems?

(ii) And what are conditions for benefiting from such remedies under different legal systems? In achieving its objective, paper will be divid- ed in two main parts to study remedies provided by intentional legal frameworks as well as the ones offered by national laws. Part one will study the position of UCP and UNCITRAL Convention on Independent Guarantees and Standby Letters of Credit (UNCITRAL Convention) and remedies, which they provide to LC fraud in international trade. Part two in contrary will study available remedies to LC fraud and condition for success them under English and American legal system.

**(EN)**

documentary letters of credit, fraud, remedies, English Law, American Law, UNCITRAL Convention, UCP

**(SK)**

Článok 4 Jednotných pravidiel používania obchodných dokumentárnych akreditívov zavádza princíp autonómie. Článok 5 uznaním princípu autonómie potvrdzuje, že pri vykonaní platby za úver sa banky zaoberajú iba dokumentom a nie tovarom. Výsledkom je, že zatiaľ čo dokumentárne akreditívy sú určené na uľahčenie procesu medzinárodného obchodu, ich výhradná závislosť na predložení dokumentu banke príjemcom zvyšuje riziko podvodu a falšovania v procese ich používania. Je zaujímavé, že UCP (v súčasnej dobe UCP600) zaujíma pasívnu pozíciu vo vzťahu k problému podvodov v oblasti medzinárodných akreditívov a necháva priestor pre národné zákony, ktoré zavádza- jú opravné opatrenia pre dotknuté strany. Vnútroštátne legislatívy uplatňujú rôzne prístupy k problematike podvodov všeobecne, a tiež k problematike podvodov v prípade dokumentárnych akreditív, čo značne komplikuje postup, najmä pri dostupnosti opravných prostriedkov dotknutými stranami. Predkladaný príspevok sa snaží zodpovedať otázky

(i) aké opravné prostriedky sú dostupné pre dotknuté strany pri podvodoch s dokumentárnymi akreditívmi v rôznych právnych systémoch?
(ii) aké sú podmienky pre prístup k takýmto opravným prostriedkom?
Za účelom dosiahnutia stanoveného cieľa je príspevok rozdelený na dve hlavné časti, ktoré sa zameriavajú jednak na analýzu opravných prostriedkov poskytovaných medzinárodným právnym rámcom a jednak na tie, ktoré sú poskytované národnou legislatívou. Prvá časť sa zameriava na štúdium pozície UCP a UNCITRAL Konvencie a štúdium opravných prostriedkov, ktoré používajú v prípade akreditívou v medzinárodnom obchode. Druhá časť sa zameriava na štúdium dostupných opravných prostriedkov v podmienkach anglického a amerického

**slová (SK)**

dokumentárne akreditíva, podvod, opravné prostriedky, anglický právny systém, americký právny systém, UNCITRAL Konvencia, UCP

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dependence principle under LC transaction, national courts should establish the commitment of fraud by beneficiary.

Despite the fact that many legal problems seem similar any- where they occur; their implication in different jurisdictions are different and different solutions should be applied by na- tional courts in resolving them[2]. Logically, it is inevitable to consider different approaches of national legal systems while dealing with an international legal problem. In the same vein, current paper intends to study different approaches of in- ternational and national legal systems to LC Fraud Disputes to define what type of remedies exist for affected party in LC fraud dispute? And under which circumstances, affected party can benefit from such remedies?

In order to fulfil its objective, paper will study both inter- national and national legal frameworks relevant to LC trans- action. American and English Law are national laws to be studies for the purpose of answering our research questions where Uniform Customs and Practices in Documentary Let- ters of Credit, and Convention on Independent Guarantees and Standby Letters of Credit[3] (UNCITRAL Convention) are international legal frameworks chosen for this purpose.

There are two reasons for choice of studying American law. First, LC fraud exception was recognized for the first time in American legal System and extended to other jurisdictions later[4]. Second, LC fraud rule is currently codified under Ar- ticle 5 of American Unified Commercial Code. Article 5 of the UCC is important for being the only statute covering LC fraud in Common Law System as well as being a strong and reliable reference for other national legal systems that intend to tackle similar problem. On the other hand, English law has an extremely rich history of resolving maritime disputes. Although, English case law shows an inflexible approach to- wards intervening in fundamental principles of Documen- tary Letters of Credit, study of the LC fraud exception rules in England will be significant help in finding answers to our research questions.

Paper has been divided into two main parts: first part cov- ers approach of international legal frameworks to LC fraud, starting with the study of UCP view and continuing with approach of UNCITRAL Convention to this problem. Sec- ond part, with focus on national laws, will study the view of American and English Law to LC fraud, existing remedies and circumstances under which affected party can benefit from such remedies.

[2] Gordley, James (1995), 'Comparative Legal Research: Its Func- tion in the Development of Harmonized Law', 43 Am. J. Comp. L. 555, Autumn.), p. 560.

[3] United Nations Convention on Independent Guarantees and Standby Letters of Credit, adopted on December 1995 and came into force from beginning of 2000.

[4] Principle case of *Szetjn vs Henry Schroder Banking Corporation* was the first authority, which applied the fraud exception to in- dependence principle of documentary letters of credit.

# II. International Legal Frameworks on LC Fraud Exception

## II.1 UCP's view

The Unified Customs and Practices for Documentary Let- ters of Credit (currently UCP600) were published by ICC for the first time in 1933. UCP is considered as one the most successful private initiatives in regulating international trade practice. Article 5 of the UCP has recognized the principle of autonomy in LC transaction by emphasizing that bank deals with documents not goods and liability of bank is limited to pay to beneficiary against presentation of complying docu- ments[5]. However, it takes an absolute silent position to- wards fraud and leaves it open for national laws[6]. To justify their approach, ICC authorities point at different ways to ad- dress the problem of abusive demand and fraud in different jurisdictions and consider protection of parties in good faith as responsibility of national courts[7]. Many scholars confirm the sensitivity of fraud and different approaches of national jurisdictions to it by considering the silent approach of UCP to fraud exception as a ground–breaking success[8]. They ar- gue that current approach of UCP to fraud encourages na- tional courts to deal with this problem with no negative ef- fect on the market position of Documentary Letters of Credit as popular trade finance tool in international trade[9]. In the same vein, Goode comments: "the content and explanation of ICC Uniform Rules are influenced by the fact that these uniform rules are rules of best banking practice, not the rules of law…"while fraud is "the province of the applicable law of the courts of the forum"[10]. This would convey the meaning that despite recognition of the problem of fraud by drafters of UCP[11], they have intentionally set it aside[12].

[5] UCP 600, Article 5.

[6] ICC, edited by Bernard Wheble (1987), Opinions of the ICC Banking Commission – On Queries relating to Uniform Cus- toms and Practice for Documentary Credits 1984–1986, ICC Publishing S.A., ICC Publication No. 434, p. 23; Kurkela, Matti (1985), Letters of Credit Under International Trade Law: UCC, UCP and Law Merchant, New York, London & Rome: Oceana Publications. Inc., pp. 31–32; Collyer, Gary, Presentation in Sem- inar 'UCP 600: Understanding the New Documentary Credits Rules', organized by ICC Finland, Helsinki, 21 March, 2007.

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

[8] Dolan, John F. (2002), 'Commentary on Legislative Develop- ments in Letter of Credit Law: An Interim Report', 8 Banking & Fin. L. Rev. 53p. 63.

[9] Ibid.

[10] Goode, R, (1995), 'Abstract Payment Undertakings and the Rules of the International Chamber of Commerce', 39 Saint Lou- is University Law Journal 725, p. 727.

[11] Dolan, John F. (1993), p. 63.

[12] Barski, Katherine A. (1996), 'Letters of Credit: A Comparison of

Leacock considers UCP approach to LC fraud as "unquali- fied liability"[13]. He further explains that with reference to independent principle, paying bank does not have any liabil- ity to beneficiary's fraud in case of paying against confirming documents even after receiving notice from applicant[14].

However, UCP's silent approach to fraud has been criti- cized by other scholars on the basis that regulations should provide secure and predictable environment for trading part- ners, where different approaches of national laws to fraud is unsatisfactory as there is not provide certainty for business- men who intend to enter international trade[15]. Inclusion of fraud rule in UCP is one of the recommend solutions for non–harmonized approaches of national laws to this prob- lem[16]. Drafting a set of transnational trade law with spe- cial focus on non–harmonized aspects of international LC operation including fraud is another scholarly proposal[17] which does not seem realistic due to time consuming pro- cess of ratification of such draft by different nations[18]. In brief, fraud exception is excluded from UCP and left under the discretion of national law. This approach of ICC has been denounced by some scholars who consider it as a reason for uncertainty in international trade while others call it as suc- cessful step towards increasing international marketability of Documentary Letters of Credit[19].

## II.2 UNCITRAL Convention's View

In late 1995 the United Nations Convention on Independ- ent Guarantees and Standby Letters of Credit came into force with the goal of facilitating the function of Independ- ent Guarantees and Standby Letters of Credit in interna- tional trade[20]. The Convention is effective in contracting States[21] and despite the fact that its scope is limited to demand guarantees and standby letters of credit; it has ap- plication to Commercial Documentary Letters of Credit as well[22]. This convention is the first international effort to ad- dress the problem of fraud in international LC transaction and three of its articles (article 15, 19 and 20) directly deal with abusive and fraudulent demand for payment under standby letters of credit and independent guarantees plus ways to prevent them. Therefore, Convention is considered a supportive regulatory framework to UCP[23]. However; the word fraud has not been mentioned throughout the conven- tion following the logic of preventing confusions, which may result from different interpretations of the term in different jurisdictions[24].

Article 15 is the guideline for beneficiary in making the de- mand under standby letters of credit and independent guar- antees. It refers to condition under which beneficiary's de- mand can be prevented: "[t]he beneficiary, when demanding payment, is deemed to certify that the demand is not in bad faith (for example by providing confirmation letters from an authorized inspection firm regarding compliance of shipped consignment with terms of LC)and that none of the elements referred to in subparagraphs (a), (b) and (c) of paragraph 1 of article 19 are present."[25]

Article 19 titled: "Exceptions to payment obligation" pro- vides list of situations, which provides issues with choice of refusing, demanded payment by beneficiary. Paragraph (1) provides that: "Any document is not genuine or has been falsified; no payment is due on the basis asserted in the de- mand and the supporting documents; or Judging by the type and purpose of the undertaking, the demand has no con- ceivable basis…"[26]. Paragraph 2 explains the meaning of "no conceivable basis" (a)The contingency or risk against which the undertaking was designed to secure the beneficiary has undoubtedly not materialised; (b)The underlying obliga- tion of the principal/applicant has been declared invalid by a court or arbitral tribunal, unless the undertaking indicates that such contingency falls within the risk to be covered by the undertaking; (c) The underlying obligation has undoubt- edly been fulfilled to the satisfaction of the beneficiary; (d) Fulfilment of the underlying obligation has clearly been pre- vented by wilful misconduct of the beneficiary; (e) or In the case of a demand under a counter–guarantee, the beneficiary of the counter–guarantee has made payment in bad faith as guarantor/issuer of the undertaking to which the counter– guarantee relates".[27]

Further , paragraph (3) of the same article provides that: "in the circumstances set out in subparagraphs (a), (b) and (c) of paragraph 1 of this article, the principal/applicant is entitled to provisional court measures in accordance with article 20"[28]. Scholars consider article 19 of convention suc- cessful in achieving it political and technical objectives[29].

Article 5 of the Uniform Commercial Code and the Uniform Customs and Practice for Documentary Credits', 41 Loy. L. Rev. 735, p. 751.

[13] Leacock, Stephen J. (1984), 'Fraud in International Transaction: Enjoining Payment of Letters of credit in International Transac- tions', 17 Vand. J. Transnat'l L. 885 (Fall), p. 912

[14] Ibid. 913

[15] Buckley, Ross P. & Gao, Xiang (2002), 'The Development of the Fraud Rule Letter of Credit Law: The Journey So Far and the Road Ahead', 23 University of Pennsylvania Journal of Interna- tional Economic Law 663 (Winter), p. 701.

[16] Kuo–Ellen, Lin S. (2002), 'UCP Needs to Change', Journal of Money Laundering Control, Vol. 5, No. 3, p. 231.

[17] Rowe, M, (1998), 'Do We Need a Transnational Law on Documentary Credits? Michael Rowe & Bernard Wheble Debate', DCI (ICC), Spring, Vol. 4, No. 2, pp. 16–17.

[18] Ibid.

[19] Buckley, Ross P. & Gao, Xiang (2002), 'The Development of the Fraud Rule Letter of Credit Law: the Journey So Far and the Road Ahead', University of Pennsylvania Journal of International Economic Law 663, (Winter) 676.

[20] Xiang , Gao, (2002), The Fraud Rule in Law of the Letters of Credit" ,The Hague, 125.

[21] UNCITRAL Convention, article 26.

[22] UNCITRAL Convention , articles 19 and 20.

[23] Goode, Roy (2004), Transnational Commercial Law - Interna- tional Instruments and Commentary, Oxford: Oxford University Press, 1st ed., p. 341.

[24] Xiang , Gao (2002), 126.

[25] UNCITRAL Convention, article 15, para. 3.

[26] UNCITRAL CONVENTION, article 19(1).

[27] Ibid , article 19(2)

[28] Ibid , article 19(3)

[29] De Ly, Filip (1999), 'The UN Convention on Independent Guar-

Article 20 continues with providing possibilities for court action under the title of "Provisional court measures":

"**1.** Where, on an application by the principal/applicant or the instructing party, it is shown that there is a high prob- ability that, with regard to a demand made, or expected to be made, by the beneficiary, one of the circumstances referred to in subparagraphs (a), (b) and (c) of paragraph I of article 19 is present, the court, on the basis of immediately available strong evidence, may: a. Issue a provisional order to the effect that the beneficiary does not receive payment, including an order that the guarantor/issuer hold the amount of the un- dertaking, or b. Issue a provisional court order to the effect that the proceeds of the undertaking paid to the beneficiary are blocked, taking into account whether in the absence of such an order the principal/applicant would be likely to suf- fer serious harm.

**2.** The court, when issuing a provisional order referred to in paragraph 1 of this article, may require the person applying therefor to furnish such form of security as the court deems appropriate.

**3.** The court may not issue a provisional order of the kind referred to in paragraph 1 of this article based on any objection to payment other than those referred to in subparagraphs (a), (b) and (c) of paragraph 1 of article 19, or use of the undertaking for a criminal purpose".[30]

From technical point of view, the Convention is success- ful in addressing major apects of fraud rule developed by national courts in addition to offering a precise and useful guidelines. Article 19 (1) lists types of misconduct by ben- eficiary, which result in application of fraud rule both under LC contract and underlying sales contract. Also Convention provides guidance for actions which victim of fraud can take by either withholding payment or refusing to honour pres- entation (bank) and applying for injunction remedy at court (applicant) in order to prevent issuing bank from honour- ing fraudulent presentation[31]. Gao and Buckley consider fraud related provisions in UNCITRAL Convention as vital and positive development, which can be used as a guide for national courts while applying the fraud rule[32].

There are two main criticisms to UNCITRAL Convention articles on fraud. On one hand, scholars criticise vagueness of provisions, which might create problem in practice of inde- pendent undertakings[33]. On the other hand, other scholars express concern on possibility for different court interpre- tations as result of applying Convention's provisions which might increase the risk of international trade[34]. In conclusion, UNCITRAL Convention has provided a constructive development in international application of LC fraud rule despite existence of different interpretations among national courts, which will be discussed in later chapters of this paper.

# III. National Laws Approach to LC Fraud Exception

## III. 1 The American View

In this section, American approach to LC fraud will be reviewed. In doing so, principle case of Sztejn v. J.Henry Schroder will be studied. Sztejn case is known for laying the foundation of LC fraud exception in the United States of American and also in England. Further, Article 5–109 of Unified Commercial Code as statuary body of law, which regulates Fraud in LC operation in the United States and grant of injunction as a judiciary remedy to fraud will be analysed.

*Sztejn v. J. Henry Schroder banking Corporation*[35]

This is the leading case on fraud rule in the United States of America that seriously affected the development of fraud exception in documentary letters of credit.[36] Another importance of Sztejn case is being a reference in the process of codification of 1962 version of UCC as well as being the principle authority for latter cases on fraud in LC operation[37]. Gao refers to Sztejn case as "it shaped the fraud rule in virtually all jurisdictions"[38].

In this case, based on the international contract of sale between Sztejn (the buyer) and Transea Traders Ltd (the Seller), documentary letter of credit issued by Schroder ( the issuing bank) as the method of payment with the draft drawn by issuing bank on the Chartered bank (presenting bank). Before presentation of documents to the bank, applicant (Sztejn) demanded court for granting injunction against beneficiary based on receiving "cow hair, other worthless material and rubbish with intent to simulate genuine merchandise and defraud the plaintiff"[39]. Szetjn also named Chartered bank as collecting bank not the holder in due course of the draft is- sued by issuing bank. Justice Sheintag of the New York Court of Appeal considered all allegations in case as truth and rejected to motion of Chartered Bank to dismiss the compliant of Szetjn on the basis of two arguments: allegation and established fact of fraud being committed within the framework of underlying contract. His statement started as following:

*"It is well established that a letter of credit is independent of*

antees and Standby Letters of Credit', 33 Int'l Law 831 (Fall), p. 843

[30] UCITRAL CONVENTINON, Article 20.

[31] UNCITRAL CONVENTION article 19 (3) and 20.

[32] Gao, Xiang & Buckley, Ross P. (2003a), 'A Comparative Analysis of the Standard of Fraud Required under the Fraud rule in Letter of Credit Law', 13 Duke Journal of Comparative and Interna- tional law p. 333.

[33] Dolan, John F. (1997), 'The UN Convention on International Independent Undertakings: Do States with Mature Letter-of-Credit Regimes Need It?', 13 B.F.L.R.1, p. 23.

[34] Gorton, Lars (1996), 'Draft UNCITRAL Convention on Inde- pendent Guarantees', LMCLQ, Part 2, May, 42, p. 49.

[35] (1941) 31 N.Y. S.2d 631.

[36] Buckley, Ross P. & Gao, Xiang (2002), 'The Development of the Fraud Rule Letter of Credit Law: the Journey So Far and the Road Ahead', 23 University of Pennsylvania Journal of Interna- tional Economic Law 663, (Winter)676.

[37] In 1964 version of UUC fraud rule was under Article 5 section 5–114 but after revision of 1995 it is under Article 5, section 5–109.

[38] Kelly–Louw, M. (2009). Selective legal aspects of bank demand guarantees(Doctoral dissertation). 179.

[39] 31 NYS 2d 631 (1941) 633.

*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"*[40].

And continued on necessity to overrule the principle of independence in case of committing fraud by beneficiary:

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

*However, I believe that a different situation is presented in the instant actions. This is not a controversy between the buyer and seller concerning a mere breach of warranty regarding the quality of the merchandise; on the present motion, it must be assumed that the seller has intentionally failed to ship any goods ordered by the buyer. In such a situation, where the seller's fraud had been called to the bank's attention before the drafts and docu- ments have been presented for payment, the principle of the inde- pendence of the bank's obligation tinder the letter of credit should not be extended to protect the unscrupulous seller... Although our courts have used broad language to the effect that a letter of credit is independent of the primary contract between the buyer and seller, that language was used in cases concerning alleged breach- es of warranty; no case has been brought to my attention on this point involving intentional fraud on the part of the seller which was brought to the bank's notice with the request what it withhold payment of the draft on this account".*[41]

Court dismissed the motion of Chartered Bank against complaint of plaintiff and granted injunction to Szetjn :

*"Transea was engaged in a scheme to defraud the plaintiff..., that the merchandise shipped by Transea is worthless rubbish and that Chartered Bank is not an innocent holder of the draft for value but is merely attempting to procure payment of the draft for Transea's account".*[42]

The case of Sztejn is also important for recognizing the im- munity of the holder in due course as well as bank security as a supporting reason in application of fraud exception:

*"While the primary factor in the issuance of the letter of credit is the credit standing of the buyer, the security afforded by the merchandise is also taken into account. In fact, the letter of credit requires a bill of lading made out to the order of the bank and not the buyer. Although the bank is not interested in the exact detailed performance of the sales contract, it is vitally interested in assuring itself that there are some goods represented by the documents".*[43] *"On this motion only the complaint is before me and I am bound by its allegation that the Chartered Bank is not a holder in due course but is a mere agent for collection for the account of the seller charged with fraud. Therefore, the Chartered Bank's motion to dismiss the complaint must be denied, if it had appeared from the face of the complaint that the bank presenting the draft for payment was a holder in due course, its claim against the bank issuing the letter of credit would not be defeated even though the primary transaction was tainted with fraud."*[44]

[40] Ibid 632.
[41] Ibid 633.
[42] Ibid.
[43] Ibid, 634–635.
[44] Ibid

*Injunction*

Injunction in the United States of America is court order which obliges enjoined party refrain or perform an action[45]. Federal Rules of Civil Procedure 65 (FRCP) define two types of temporary injunctive relief as preliminary injunction and temporary restraining order. Preliminary injunction is granted in a hearing and after notice to enjoined party where applicant has sufficient proof for preserving status quo till final hearing. Temporary Restraining Order preserve the sta- tus quo for defined number of days and it might be granted without notice of enjoined party. Both type of injunction can be named interlocutory injunction[46]. Permanent injunction is another judicial remedy to be granted on the basis of merit after trail[47].

*Article 5 of the Unified Commercial Code*

Article 5 of the Unified Commercial Code is governing the operation of Documentary Letters of Credits besides Case Law in the United States of America. The UCC had a perma- nent editorial board which published commentaries which are often cited by judges as an authority for explanation of different provisions[48]. Article 5 of the current version of UCC is fully allocated to Documentary Letters of Credit . Drafting committee was following the goal of finding a way for further harmonization of US law with international regu- lations besides flexibility in practice to meet technological changes and keep the competitive position of LC in inter- national trade. Article 5 of the UCC also contains relevant provisions in LC fraud exception[49].

Current Article 5–109 is titled "Fraud and Forgery" covers circumstances necessary for granting interlocutory injunc- tion the text of article such circumstances as following:

*"(a) If a presentation is made that appears on its face strictly to comply with the terms and conditions of the letter of credit, but a required document is forged or materially fraudulent, or honour of the presentation would facilitate a material fraud by the ben- eficiary on the issuer or applicant: (1) the issuer shall honour the presentation, if honour is demanded by (i) a nominated person who has given value in good faith and without notice of forgery or material fraud, (ii) a confirmer who has honoured its confirma- tion in good faith, (iii) a holder in due course of a draft drawn under the letter of credit which was taken after acceptance by the issuer or nominated person, or (iv) an assignee of the issuer's or nominated person's deferred obligation that was taken for value and without notice of forgery or material fraud after the obliga-*

[45] Wunnicke, Brooke & Wunnicke, Diane B. (1996), Standby and Commercial Letters of Credit, New York: Wiley Law Publica- tions, 2nd ed., p. 174.
[46] Ziegel, Jacob S. (1979) (Chief Ed.), International Encyclopedia of Comparative Law Volume IX Commerical Transactions and In- stitutions, under the auspices of the Internatioonal Association of Legal Science, Martinus Nijhoff Publishers', pp. 123–124.
[47] Liu, Yuxia (2007), 'Study of Legislation on Court Injunction in L/C Fraud', Economic and Social Development, Vol. 5, No. 7, Jul., 117.
[48] Zhang, Y. (2011). Approaches to Resolving the International Documentary Letters of Credit Fraud Issue. University of East- ern Finland. p 74.
[49] UCC , Article 5 –109.

*tion was incurred by the issuer or nominated person; and (2) the issuer, acting in good faith, may honour or dishonour the presen- tation in any other case.*

*(b) If an applicant claims that a required document is forged or materially fraudulent or that honour of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant, a court of competent jurisdiction may temporarily or permanently enjoin the issuer from honouring a presentation or grant similar relief against the issuer or other persons only if the court finds that: (1) the relief is not prohibited under the law applicable to an accepted draft or deferred obligation incurred by the issuer; (2) a beneficiary, issuer, or nominated person who may be adversely affected is adequately protected against loss that it may suffer because the relief is granted; (3) all of the conditions to entitle a person to the relief under the law of this State have been met; and (4) on the basis of the information submitted to the court, the applicant is more likely than not to succeed under its claim of forgery or material fraud and the person demanding honour does not qualify for protection under subsection (a) (1)."* Text of UCC article 5–109 follows two main directions of "fraud immunisation" and "fraud exception"[50]. An impor- tant aspect of Article 5–109 (a) is clarification of the fact that fraud is applicable both to forgery in documents stipulated in the Credit and in underlying sales contract. Article also comments on necessity of fraud to be material in order to issue injunctive relief. However, it does not define what does it mean for fraud to be material? Whereby, official comment on the Article provides: "the beneficiary has no colourable (meaningful) right to expect honour and where there is no basis in fact to support such a right to honour"[51].

Neither text of article 5–109 nor its official commentary refers to intention of beneficiary to defraud. As a result, it has been argued that UCC article 5–109 has focus on serious- ness of fraud in the course of transaction not beneficiary's in- tention and state of mind[52]. It is clear from the official com- mentary that standard of proof for fraud is set high and mere allegation of fraud is not sufficient for granting injunction to applicant[53]. Injunction will be granted only after meeting high standard of proof for the purpose of preventing threats to independence principle in LC operation. Commentary also stipulates that granting similar reliefs like attachment and declaratory judgement by court should follow similar high standards[54]. Attachment is a sort of preliminary relief to secure or seize the disputed property following the ob- jective to force compliance with court decision on pending case[55]. Declaratory Judgement refers to court judgement in determining the rights of parties under, a statute, a contract or a will, on the basis of any fact or law.

Scholars consider the US approach[56] to fraud in docu- mentary letters of credit as "unduly narrow approach" which limits the application of LC fraud exception[57]. Different in- terpretations of judges from standard of proof are also a dis- couraging factor[58]. This can be a disadvantage for American law to show different interpretations of judges from a sin- gle problem in presence of uniform standard of "material fraud"[59].

## III.2 English Law

Under English Law, Documentary Letters of Credit are con- sidered as the life blood of the commerce[60] while fraud is considered as "the most controversial and confused area"[61] as it affects the independence principle in international op- eration of LC. Historically, English courts take a restrictive approach in interfering in obligation of bank to pay unless there is a corroborate evidence of committing fraud by ben- eficiary. Even nullity and illegality of underlying sales con- tract does not affect the court decision to interrupt the regu- lar operation of LC by issuing stop order payment to bank[62]. Unlike American law, there is no statute regulating LC fraud rules in England and this area of law has been consistently governed by case law from late 1970s till today[63].

English law does not have any definition for fraud and court should conclude its establishment on the case to case basis. However, according to existing authorities, there are four main types of LC fraud disputes distinguished in Eng- lish Law. First, beneficiary sues the bank on the basis of bank's rejection to pay despite receiving compliant presen- tation. Second, Bank has payed beneficiary, however, sues beneficiary due to presentation of fraudulent documents and request for restitution of the payment. Third, paying bank sues the issuing bank in request for reimbursement after ef- fectuating the payment, and refusal of issuing bank to reim- burse on the basis of fraud. Finally, before effectuating the

[50] Wunnicke, B & Wunnicke, Diane B. (1996), Standby and Com- mercial Letters of Credit, New York: Wiley Law Publications, 2nd ed, pp. 165–179.

[51] UCC Article 5 Letters of Credit, UCC§5-109 Forgery and Fraud, Official Comment 1.

[52] Buckley, Ross P. (1995), 'The 1993 Revision of the Uniform Cus- toms and Practice for Documentary Credits', 6 Journal of Bank- ing & Finance Law & Practice 77, p. 97.

[53] UCC Article 5 Letters of Credit, UCC§5-109 Forgery and Fraud, Official Comment 4.

[54] Ibid.

[55] Fletcher, George P. & Sheppard, Steve (2005), American Law in a Global Context: The Basics, Oxford; New York: Oxford Univer- sity Press, p. 511.

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

[57] Barnes, James G. & Byrne, James E., 'Letters of Credit', in Byrnes, James E. & Byrnes, Christopher S. (Eds.) (2007), 2007 Annual Survey of Letter of Credit Law and Practice, MD: The Institute of International Banking Law & Practice, Inc., pp. 39–42.

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

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

[60] *Horbottel v. National Westminster Bank* [1978] QB 146;100.

[61] Buckley RP & Gao X (2002), p. 663.

[62] D'Arcy, Leo (2000), Schmitthoff's Export Trade – The law and Practice of International Trade, London: Sweet & Maxwell, 10th ed, p. 166.

[63] Alavi , H. "Autonomy Principle and Fraud Exception in Documentary Letters of Credit, a Comparative Study between United States and England". *International and Comparative Law Review*, Vol. 15, No. 2 ,(2015) ,45–67.

payment by bank, applicant request interlocutory injunction from court to stop bank from payment on the basis of ben- eficiary's fraud[64].

In similar way to American Law, it seems that under Eng- lish law injunction is the most popular legal relief sought by applicant against either bank or beneficiary in cases of LC fraud. However, restrictive approach of English courts to in- terfere in independence principle of Documentary Letters of Credit creates doubt in usefulness of such remedy. This sec- tion explores non–harmonious approach of English courts to different types of LC fraud disputes with special focus on procedural aspects of interlocutory injunction in England.

*Bank's rejection to pay*

Upon presentation of confirming documents by beneficiary, issuing bank and conforming bank if any has the duty to honour the presentation.[65] In case of bank's decision not to effect the payment to beneficiary, it should prove the estab- lishment of fraud based on existing standard of proof intro- duced by English Courts[66] (discussed in injunction chapter of current paper). However, it is rare that the bank refuses to honour the credit on its own initiative[67]. Banks generally do not reveal fraud and the information and instructions about fraud come from account party. After receiving allegation of fraud from account party, bank has the option to pay or not. In case it decides to effect the payment, obtaining the injec- tion from court will be the only solution for account party to prevent payment to beneficiary[68]. If bank decides not to pay, then either beneficiary's fraud is established and bank will be excused from payment or if otherwise happened, bank will be in breach of contract. When bank decides not to effect the payment, beneficiary might apply for summary judgement against the bank in order to get quick remedy without going to full trail[69]. Issuing the summary judgement by court in England is subjected to the English Civil Procedural Rules (CPR). Part 24.2. Accordingly:

*"The court may give summary judgment against a claimant or defendant on the whole of a claim or on a particular issue if–*

*(a) it considers that: (i) that claimant has no real prospect of succeeding on the claim or issue; or (ii) that defendant has no real prospect of successfully defending the claim or issue; and*

*(b) There is no other compelling reason why the case or issue should be disposed of at a trial"*[70].

The decision of courts in Solo Industries v Canara Bank[71], Safa Ltd v Banque du Caire[72] and Banque Saudi Fransi v Lear Siegler Services Inc[73] show that in case of beneficiary's application for summary judgement, bank is subjected to a higher standard than what is required in CPR 24.2. There- fore, for court, it is not sufficient that bank can show a real prospect of successfully establishing fraud in its defence. In addition, bank is required to prove the real established fraud "which has the capability of being clearly established at the interlocutory stage"[74]. In occasions that bank does not re- sist payment on the basis of fraud rule like refraining to pay based on invalidity of letter of credit, it would be sufficient to satisfy the normal standard[75] while trying to show the real prospect of success under CPR 24.2.

*Bank's Entitlement for Reimbursement*

General rule is that the bank, which has paid against con- forming presentation, is entitled for reimbursement. How- ever, in case of fraud, bank has no obligation against benefi- ciary or entitlement against the account party to effect the payment. In case of payment in such circumstances, bank cannot claim for reimbursement[76]. However, the bank, which does not have information about the fraud of benefi- ciary, will not be prejudiced.

In the case of Angelica–Whitewear Ltd v Bank of Nova Scotia[77] which was referenced by English courts, Le Dien J. from the Supreme court of Canada argued that it case of im- properly paid draft by issuing bank the standard of proof for fraud should be set in the question that "Whether fraud was so established to the knowledge of issuing bank before pay- ment of the draft as to make the fraud clear or obvious to the bank"[78]. According to Le Dien J, standard of proof for such cases was different from standard of proof when applicant is trying to obtain interlocutory injunction against bank to restrain the payment to the beneficiary. He explained that in latter case the "strong prima facie test will apply"[79].

As it was discussed before, it can be understood that the bank which is trying to resist summary judgement against the payment to beneficiary is subjected to the higher stand- ard of proof. However, this does not apply in the occasion that applicant, issuing bank or confirming bank try to resist the summary judgment as a result of being sued for reim- bursement by the bank which has paid the fraudulent benefi- ciary.[80] In such occasions, defendant is expected to provide a real prospect of existing fraud and satisfy the normal test of CRP Part 24.2 at trail[81].

[64] Malek A & Quest D (2009), 'Documentary Credits - The Law and Practice of Documentary Credits Including Standby Credits and Demand Guarantees' 4ed , Tottel ., para 9.2, pp. 207–208.

[65] Malek A & Quest D (2009), 'Documentary Credits – The Law and Practice of Documentary Credits Including Standby Credits and Demand Guarantees' 4ed , Tottel 264.

[66] Ibid.

[67] Ellinger. P – Noe D. (2010) , The Law and Practice of Documen- tary Letters of Credit , 145.

[68] Ibid.

[69] Ibid.

[70] Part 24.2 of the Civil Procedure Rules accessed online: at http://www.hrothgar.co.uk/YAWS/rules/part24.htm#IDAZBHOB (Accessed 1 Feb 2016).

[71] Solo Industries UK Ltd v Canara Bank [2001] 1 WLR 1800.

[72] Safa Ltd v Banque du Caire [2000] 2 Lloyd's Rep. 600.

[73] Banque Saudi Fransi v Lear Siegler Services Inc. [2007] 2 Lloyd's Rep 47.

[74] Ibid, 31–32.

[75] Ibid 33.

[76] Ellinger .P, Noe. D , (2010 ), 147

[77] Angelica-Whitewear Ltd v Bank of Nova Scotia 36 D.L.R. (4th) , EYB 1987-67726.

[78] Ibid, 59, 84.

[79] Ibid.

[80] Ellinger .P, Noe. D , (2010 ), 147.

[81] Ibid.

In case of Banque Saudi Fransi v Lear Siegler Inc[82], the is- suer of a performance bond was seeking for summary judge- ment against the instructing party who provided a counter indemnity. After making the payment to the beneficiary de- fendant, issuing bank raised the defence of not being bound for payment under the country indemnity due to dishonest claim of the beneficiary. In trial, defendant managed to suc- cessfully resist against the summary judgement by showing the real prospect, which was clearly established[83]. In the above decision, it is implied that although, beneficiary might successfully obtain the summary judgement against bank as a result of bank's failure to establish a clear evidence of fraud

, there is no guarantee that bank can in return obtain sum- mary judgement for receiving reimbursement against the instructing party. Because the instructing party should only meet requirements of the low test of real prospect of fraud in the trial.[84]

*Fraud in deferred payment obligations*

Under the deferred payment credits, the nominated bank has the obligation to pay on the maturity date in accordance with the credit terms. As under deferred payment system there is no immediate payment available to seller till the date of maturity of credit, the seller is responsible to ship goods and expects payment on maturity. Such process will impose financial burden on seller. Therefore, market demand in simi- lar conditions resulted in creation of forfaiting practice. In forfaiting practice, nominated bank may agree to discount the beneficiary's documents and expect reimbursement from issuing bank on maturity date. In case of beneficiary's fraud before the maturity date, applicant and issuing bank will definitely try not to reimburse the nominated bank, which has paid to fraudulent beneficiary. Despite the fact that establishment of beneficiary's fraud will depend in facts of each individual case and in addition guideline for inter- bank reimbursements under differed payment is provided by UCP 600, it worth to review the right and obligations of in- volved financial institutions under deferred payment before and after coming into force of the UCP 600.

*Banco Santander SA v Banque Paribas*

In Banco Santander SA v Banque Paribas, the fraud of ben- eficiary created serious problems for Santander, which was the confirming bank under the deferred payment arrange- ment[85].

In 1980 Napa Petroleum Trade applied to open a deferred payment credit at Banque Paribas in favour of Bayfern Ltd. Based on the request of Paribas, Banco Santander advised the credit as nominated bank to beneficiary. Later, Banco Santander decided to add its confirmation to the credit. The deferred payment was due 180 days after issuing the bill of lading. Beneficiary presented confirming documents to Santander on 15 June 1998. According to the credit arrange- ments, Paribas as issuing bank and Santander as confirming bank had the duty to pay the beneficiary on 27 November 1998. However, Santander agreed to discount the credit be- fore maturity. Therefore, Santander discounted the credit and sum of payment minus discounting fee was transferred to the Bayfern's account. Bayfern irrevocably assigned San- tander to its rights under the credit. However, before the date of maturity, Paribas informed Santander about presentation of forged documents by beneficiary and refused to reimburse Santander on maturity. Santander sued the Paribas and the trial judge ruled in favour of Paribas as Bayfern assigned its rights under the credit to Santander. The Court of Appeal confirm the judgment of trial court as an assignee of Bey- fern , Santander has no better position than assignor given that in case of non–discounting credit , Santander would not face any risk due to refusal of Paribas based on beneficiary's fraud . Alternative argument of Santander as holder the posi- tion of confirming bank was rejected by court because under UCP500 issuing bank was only undertaking to reimburse nominated bank in case of honouring the deferred credit at maturity. Judgement of Banco Santander v. Banque Paribas was an unwelcomed decision in the international banking society as banks were regularly discounting deferred pay- ment credits. However, after coming into force of the UCP 600, it addressed the issue of deferred discounted payments under article 7(c) and Article 12 (c).

The article 7 (c) holds that assignment of rights from the beneficiary to the discounting bank is not necessary any- more and as a result ,bank is entitled for reimbursement at the maturity date.

*"Reimbursement for the amount of a complying presentation under a credit available by acceptance or deferred payment is due at maturity, whether or not the nominated bank prepaid or purchased before maturity"*[86]

The new Article 12 (c) of the UCP 600 has been the subject of many discussions among commentators. The debate is on the impact of the authorization. There is an argument among commentators who consider this new rule as legal basis for mitigating the risk of fraud between the date of payment and maturity date while others consider it as a right given to the nominated bank, which might be used under its own discre- tion and definitely on its own risk[87].

*'by nominating a bank to accept a draft or incur a deferred pay- ment undertaking, an issuing bank authorizes that nominated bank to prepay or purchase a draft accepted or a deferred pay- ment undertaking incurred by that nominated bank'*[88]

The most important objections are made by commentators who consider that UCP 600 is setting aside Banco Santander and similar cases. "Produced the undesirable result of effec- tively removing a useful option or risk apportionment".[89]

*Injunction*

According to the independence principle, courts should not

[82] Banque Saudi Fransi v Lear Siegler Services Inc. [2007] 2 Lloyd's Rep 47 , 18.
[83] Ibid.
[84] Ibid.
[85] Banco Santander SA v. Banque Paribas, [2000] CLC 906.
[86] UCP Article 7(c).
[87] Takahashi. K , (2009) , "The introduction of article 12(b) in the UCP 600: Was it a really step forward?", JIBLR 24 (6) , 285–286.
[88] UCP Article 12 (C).
[89] Takahashi. K , (2009), 285–286.

interfere in the process of documentary credit and demand guarantees operation and grant injunction unless a recog- nized exception is established[90]. Under English legal sys- tem, injunction is recognized as an equitable remedy in pri- vate law; therefore, court has discretion whether or not to grant it[91]. Injunction has a prohibiting nature, which means to stop doing, repeating or continuing, an act or to undo an act with wrongful nature[92]. There are two main types: interlocutory and perpetual injunctions in English law. The interlocutory ones also known as pre–trial or interim intend to preserve the status quo before going to trial. However, perpetual injunction will be granted after approval of the ap- plicant's case in trail[93]. As it will be explained later, a Freez- ing order or Mareva Injunction is "an order of the court re- straining a party to proceedings from removing assets from the jurisdiction of the court or otherwise dealing with assets located within the jurisdiction and, in more limited circum- stances, from dealing with assets outside the jurisdiction"[94]. From the explanation, it is clear that Mareva Injunction is also a type of interlocutory injunction. It follows the objec- tive of preventing actions against judgment by transferring assets out of jurisdiction or disappearing them within ju- risdiction[95]. Freezing order can be granted as ex parte and without notice of beneficiary[96].

Since it will be really difficult for account party to recover payment in cases of real LC fraud, interlocutory injunctions provide some remedy for affected party by prohibiting pay- ment to beneficiary. When there is doubt about fraudulent conduct of beneficiary, applicant may apply to court for inter- locutory injunction against beneficiary, paying bank or both of them. However, application for injunction against benefi- ciary should be done before presentation of stipulated docu- ments in the credit to the bank. After presentation of docu- ments by beneficiary, it is only possible to require granting injunction against bank. This section will review approach of English legal system to interlocutory injunction when there is allegation of fraud in international operation of Documen- tary Letters of Credit.

*Legal basis for granting injunction under English Law*

Under the section 37 of the Senior Court's Act 1981, The High Court may order (whether interlocutory or final) to grant injunction in all cases in which it seems to the court to be just or convenient to do so[97]. Power of the High Court to grant interim injunction in support of foreign proceed- ings under section 25(1) of the Civil Jurisdiction and Judg- ment's Act 1982[98]. Therefore, account party has the right and option to require court for issuing interim injections in order to restrain beneficiary from demanding money under the demand guarantee or letter of credit which is payable in England in support of foreign proceedings. However, it is not easy to obtain injunction against the beneficiary or paying bank under English law. So far only three cases have managed to obtain injunction: Themehelp Ltd. v West[99], Kavaerner Jhon Brown Ltd v Midland Bank Plc[100], Lorne Stewart Plc v Hermes Kreditversicherungs AG[101] The gen- eral principles for granting injunction were set out in the case of American Cyanamid Co v Ethicon[102] based on the speech of the Lord Diplock . Applicant faces two main problems in application for interim injunction. First of all, he has to show an arguable claim against the party he is trying to enjoin. For this purpose, applicant should establish the fact that party owes him a duty either in contract or in tort which against that duty fraud is taking place and being enough evidences that beneficiary is knowledge about taking place of fraud[103]. Besides it should be proved that granting the injunction by bank is correct practice and will pass the test of balance of convenience.

There have been arguments on contradictory nature of in- tervening in the process of bank's operation via granting of interim injunction with independent principle. As a result, it was suggested that independent principle will not be vio- lated in case of granting injunction against beneficiary to pre- vent demand on documentary credit or demand guarantee. A similar view was taken by court in the court of appeal of the Themehelp Ltd. v West[104]. In that case, the Court of Ap- peal ruled for granting injunction against the beneficiary of a demand guarantee in order to restrain him from demand- ing payment on the basis that the underlying contract was af- fected by fraudulent misrepresentation of him. However, the Themehelp Doctrine has been criticized heavily on the basis that enjoining beneficiary for demanding payment violates the assurance of payment provided by letter of credit. There will be no difference for beneficiary to be prevented from re- ceiving payment by being enjoined from court or because of an injunction preventing the bank to pay him[105]. In addition majority decision in Themehelp did not receive any judicial support from succeeding cases for example it was rejected in the cases of Group Josi Re v Walbrook Insurance Co Ltd and Others[106], Czarnikow–Rionda Sugar Trading Inc v Standard Bank London[107] and Sirius International Insurance Corp

[98] The Civil Jurisdiction and Judgement's Act, 1982 (Interim Re- lief) Order 1997.

[90] Enonchung (2010) , 227.

[91] Ingman, Terence (1994), The English Legal Process, London: Blackstone Press Limited, 5th ed., p. 313; Treitel, Guenter (2003), The Law of Contract, London: Thomson Sweet & Max- well, 11th ed., pp. 1040-1048; Atiyah, P. S. & Smith, Stephen A. (2005), pp. 377–388.

[92] Ingman, Terence (1994), pp. 314–315.

[93] Ibid, 315.

[94] Hapgood, Mark (1989), Paget's Law of Banking, London & Ed- inburth: Butterworths, 10th ed., p. 332.

[95] Ibid, p. 333.

[96] Sealy, L.S. & Hooley, R J A (2005), p. 852.

[97] Enonchung (2010), 227.

[99] Themehelp Ltd v West and Others [1996] QB 84.

[100] Kavaerner Jhon Brown Ltd v Midland Bank Plc (1998) CLC 446.

[101] *Lorne Stewart plc v Hermes Kreditversicherungs AG*, (1999) 2 Lloyd's Rep 187.

[102] American Cyanamid Co v Ethicon Ltd [1975] AC396.

[103] Ibid.

[104] Themehelp Ltd v West and Others [1996] QB 84.

[105] Ellinger .P, Noe. D , (2010),163.

[106] *Group Josi Re v Walbrook Insurance Co Ltd and Others* [1996] 1 Lloyd's Rep 345 (CA).

[107] Czarnikow-Rionda Sugar Trading Inc v Standard Bank London

v FAI General Insurance Co. Ltd [108]. Even May LJ in the case of Sirius International Insurance Corp v FAI General Insur- ance Co. Ltd, with whom the other members of the court of appeal agree, considered the decision of Themehelp as ques- tionable[109].

*The standard of proof*

When account party is looking for injunction to prevent beneficiary from demanding payment or bank from enforcing payment on the basis of fraud exception, the first necessary step to take is meeting the standard of proof[110]. In the case of United City Merchants (Investment) Ltd v Royal Bank of Canada[111], the standard of proof for fraud was considered when Lord Diplock held the requirement as "Clear, obvious, or established fraud known to the issuer or confirmer of the letter of credit."[112]. Also Ackner LJ, in the case of United Trading Corp. SA v Allied Arab Bank Ltd[113] laid down the standard of "only realistic inference" in order to provide an alternative to the "clear evidence" provided by Lord Diplock in United City Merchants. Ackner LJ further emphasized that:

*"The evidence of fraud must be clear, both as to the fact of the fraud and as to the [guarantor's] knowledge. The mere assertion or allegation of fraud would not be sufficient…We would expect the court to require a strong corroborative evidence of the allega- tion, usually in the form of contemporary documents, particu- larly those emanating from the buyer."* [114]

Court also commented:

*"for the evidence of fraud to be clear, it would be expected that the buyer was given the necessary opportunity to answer the al- legation against him and he (buyer) fails to provide any, or any adequate answer in circumstances where one could properly be expected. If the court considers that on the material before it the only realistic inference"[115]*

Other similar positon was taken by Mance LJ in The Court of Appeal of Solo Industries UK Ltd v. Canara Bank[116]. Mance LJ while responding to the contention of bank to- wards standard of proof which should preclude "any pos- sibility of innocent explanation" took as very close position to the position of United Trading Corp. SA . From what has been discussed so far, it can be clearly understood that stand- ard of proof for fraud under English law has been formulated differently. One reason can be that courts try to set not too high standard from one hand to safeguard the autonomy principle and on the other hand set it too high not to be at- tainable in practice. As a result, there are different standards of proof including "established or obvious fraud"[117],"good arguable case which is the realistic inference on the mate- rial available for beneficiary to be fraudulent"[118] or the "real prospect"[119] of establishing fraud.

As it was mentioned earlier, the second step for obtaining the injunction is satisfying the balance of convenience.

The issue was not always considered in English court's decision while deciding to grant injunction base on fraud. One reason is that in most cases evidence was not enough to establish fraud and as a result the case did not proceed to the stage for considering the balance of convenience.[120] Therefore, when claimant manages to establish the basis for injunction, court will consider the balance of convenience in order to issue the injunction. it has been mentioned that in the context of injunctions to prevent either beneficiary from claiming the payment or bank form effecting the payment in most cases balance of convenience is against granting the injunction.[121] The main reasons against granting injunction can be named as resistance of adequate remedies for damages, im- minent expiry date of credit, availability of freezing injunc- tion and availability of final accounting between parties[122].

*Mareva Injunction or Freezing Orders*

It can be concluded from the discussion above that English courts are not willing to interfere in operation of Documenta- ry Letters of Credit by issuing Interlocutory Injunction. How- ever, there is possibility for plaintiff to apply for Freezing Or- der against belongings of the beneficiary[123]. Since freezing orders are also of the interlocutory nature, English courts are prudent in granting them and numerous conditions should be satisfied by applicant for obtaining it:

The first is that the plaintiff should show a substantive cause of action against the defendant[124]. Judgement of Fou- rie v. Le Roux[125] has approved this requirement, which was

[1999] 2 Lloyd's Rep 187([1999] Lloyd's Rep Bank 197.

[108] Sirius International Insurance Corp v FAI General Insurance Co.Ltd (2003) 1 All ER (Comm ) 865.

[109] Ellinger .P, Noe. D , The Law and Practice of Documentary Letters of Credit , (2010), 163.

[110] Discount Record Ltd v Barclays Bank Ltd [1975] 1WLR 315; RD Harbottle (Mercantile)
National Westminster Bank [1978] QB 146; Edward Owen Engineering Ltd v Barclays Bank
International Ltd [1978] QB 159; Bolivinter Oil SA v Chase Manhattan Bank [1984] Lloyd's Rep 251;
Group Josi Re v Walbrook Insurance Co Ltd [1996] 1 WLR 1152.

[111] United Trading Corp. SA v Allied Arab Bank Ltd, [1985] 2 Lloyds Rep 554, 561.

[112] Ibid.

[113] United Trading Corp. SA v Allied Arab Bank Ltd, [1985] 2 Lloyds Rep 554, 561.

[114] Ibid.

[115] Ibid

[116] Solo Industries v Canara Bank [2001] 2 Lloyd's Rep 578.

[117] Edward Owen Engineering Ltd v. Barclays Bank International [1978] QB 159, per Lord Denning.

[118] United Trading Corporation SA v. Allied Arab Bank at FN 27 per Ackner LJ at 561.

[119] Solo Industries UK Ltd v Canara Bank [2001] 1 WLR 1800, [2001] EWCA Civ 1059.

[120] Enonchong (2011) 158.

[121] Enonchong (2011) 236.

[122] Ibid.

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

[124] Capper, David (2007), 'Case Comment: Asset Freezing Orders – Failure to State the Cause of Action', C.J.Q. 26 (APR), 181-184, p. 181.

[125] [2007] UKHL 1.

raised for the first time in the case of Siskina[126]. Second, a good arguable case must be established in order to grant Freezing Order. This requirement was established in case of Ninemia Maritime Corp v. Trave Schiffahrtsgesellschaft & Co[127]. Third, plaintiff should provide court with evidence that in cases of not restraining defendant's assets, there is a real risk for removing them out of jurisdiction before en- forcement of judgement[128]. Since assets should be located in England [129], plaintiff should prove that defendant's as- sets are present within the jurisdiction[130]. Fourth, in case of considering freezing order as unjustified, plaintiff must have access to sufficient financial resources to cover dam- ages[131]. Exceptionally, it is possible to obtain freezing order despite access to limited financial resources[132]. Fifth, all rel- evant information, which can affect the process of granting ex part injunction, should be disclosed by plaintiff[133]. This precondition is of extreme importance in granting freezing order due to possibility for creation of prejudice for defend- ant[134]. Finally, plaintiff should satisfy the court that granting freezing order is "just and convenient" otherwise court might reject issuing such another despite existence of other requirements[135].

Granting freezing orders will become crucial when defend- ant is located in the foreign jurisdiction or his assets in do- mestic jurisdiction are not sufficient [136]. Since 1988, issuing the globally effective freezing orders by English courts gain more importance[137]. There are three elements involved in international freezing orders: a defendant subjected to do- mestic jurisdiction, assets located abroad, third party with control over assets who is located either within the jurisdic- tion or abroad[138]. One of the main problems on the way of obtaining international freezing order is convincing the court on "just and convenient nature" of the plaintiff's claim due to oppressive effect of internationally enforcing court order on defendant who is located in a different jurisdic- tion[139]. Second issue is relevant to the third parties affected by global freezing orders. Generally, international banks are affected with such orders[140] and when such third parties are involved, enforceability of freezing order issued by English court in another jurisdiction is a valid question[141]. In gen- eral manner, banks are not subjected to freezing orders[142] as such orders will create inconvenience for their normal busi- ness process and place the customer's confidence to bank in danger[143]. Other problem is enforcing third party in a other jurisdiction to obey a court order issued by a foreign court. It has been argued that inserting a term in the court order, which binds parties who can obey, and excuse orders can be a solution to this problem[144].

In conclusion, English courts have a restricted approach in interfering with autonomy principle of Documentary Let- ters of Credit. Despite existence of remedies like interlocu- tory injunction and freezing order, difficulties on the way of obtaining them in LC fraud cases create doubts about their effectiveness. Possibility to obtain global freezing order can be a relief in LC fraud cases for trades involved in interna- tional business. However, grating them is under the discre- tion of court and subjected to precondition of being "just and convenient".

# IV. Conclusion

Current paper discussed the possible access to remedies for affected party in case of fraud in Documentary Letters of Credit from a comparative perspective. For this purpose, paper has been divided into two main parts: part one studied problem of LC fraud from the lens of international regula- tions by scrutinizing approaches of Uniform Customs and Practices of Documentary Letters of Credit and UNCITRAL Convention on Standby Letters of Credit and Demand Guar- antees. Part two reviewed English and American law perspec- tives on the subject matter. UCP is silent regarding fraud and leaves the ground open for national laws. UNCITRAL Con- vention does not use the term fraud. However, within the framework of article 15,19 and 20 defines condition under which payment can be prevented and provisional measures which can be taken by court .

Under American Law, LC fraud is regulated in Article 5–109 of the Unified Commercial Code which defines standard of proof for court and remedies for affected party. According to article 5–109 of UCC, injunction is the main remedy for LC fraud in the United States of America while scope of benefi- ciary's fraud include forgery in presented documents as well as fraud in underlying sales contract. Injunction has been considered a remedy because in case of effectuating payment

[126] Siskina (Cargo Owners) v. Distos Compania Naviera SA [1979] AC 210, HL.

[127] The Niedersachsen [1984] 1 All ER 398 pp. 414-415, [1983] 1 WLR 1412, p. 1417, CA

[128] Aiglon Ltd v. Gau Shan Co Ltd, [1993] 1 Lloyd's Rep. 164; The Niedersachsen [1983]; Great Future International Ltd v. Sea- land Housing Corp, [2003] EWCA Civ682.

[129] Derby & Co. Ltd v. Weldon (No. 3 and 4) [1990] Ch. 65.

[130] Suen, Henry & Cheung, Sai On (2007), 'Mareva Injunctions: Evolving Principles and Practices Revisited', Const.L.J. 23 (2), 117–136, pp. 120–121.

[131] *The Niedersachsen* [1984], p. 416.

[132] *Allen v. Jambo Holdings Ltd* [1980] 2 All E.R. 502, CA.

[133] *Third Chandris Shipping Corpn v. Unimarine SA* [1979] QB 645, pp. 668–669.

[134] *Bank Mellat v. Nikpour* [1985] F.S.R. 87, p. 92.

[135] *The Niedersachsen* [1984], p. 1426.

[136] *Derby & Co Ltd v. Weldon* (No. 3 and 4) [1989] 1 All ER 1002, p. 1007, [1989] 2 WLR 412, p. 419.

[137] Aslett, Pepin (2003), 'Cross-border Asset Protection: An Off- shore Perspective', Journal of Financial Crime, 10(3), 229–245.

[138] Devonshire. P. (1996), 'The Implications of Third Parties Hold- ing Assets Subject to a Mareva Injunction', LMCLQ, (May), Part 2, p. 269.

[139] Meisel, Frank (2007), 'Case Comment: Worldwide Freezing Or- ders – the Dadourian Guidelines', C.J.Q., 26 (APR), 176–180, p. 176.

[140] Ibid.

[141] Ibid, 177.

[142] 'Case Comment – Mareva Injunction on Bank's Assets in the Context of Tracing Action', J.B.L.1992, Jul, 416-419.

[143] *Bankers Trust Co. v. Shapira* [1980] 1 W.L.R. 1274.

[144] Capper D, (1996), 'The Trans–Jurisdictional Effects of Mareva Injunctions', C.J.Q. 15 (JUL), 211–233, p. 219.

by bank, account party will have very limited chance for returning the money from fraudulent beneficiary. Although, granting injunction is not easy in the United States, but its seems to be more difficult to obtain such remedy under Eng- lish Law. LC fraud is regulated under case law in England. Despite the fact that English law also considers injunction as the main remedy for affected party before granting the final court order, scope of fraud in England is limited to forgery in presented documents by beneficiary to bank. Such limited scope of fraud rule has roots in historical tendency of English courts neither to interfere in smooth operation of interna- tional trade nor undermine the absolute application of in- dependence principle in LC operation. Also high standards of proof for establishing fraud in court and limited access of applicant to interlocutory injunction in English legal system create doubts about usefulness of such remedies. Freezing orders (domestic and international) are alternative remedies for LC fraud in England, which affected parties, hence their advocates should keep that in mind. However, they should remember that English courts demand specific requirements for granting such remedies which are principally different from requirements for granting injunction. Therefore, it is recommended to plaintiff to define his defence strategy on the basis of either remedy from the beginning. Therefore, it is recommended to parties in international trade to be aware of availability of remedies for fraud in ap- plicable law to their contract and requirements for grating them, which are not the same in different jurisdictions.

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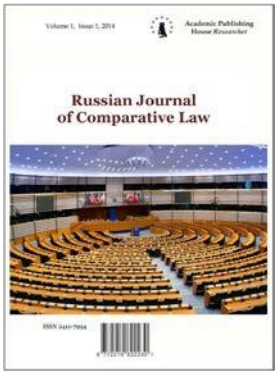
***Publication 12*: Alavi, H, (2016), "Arbitration and LC Fraud Disputes: A Comparative Approach", *Russian Journal of Comparative Law,* Vol 8, 2, pp. 59-72.**

Published in the Russian Federation
Russian Journal of Comparative Law
Has been issued since 2014.
ISSN 2411-7994
E-ISSN 2413-7618
Vol. 8, Is. 2, pp. 59-72, 2016

DOI: 10.13187/rjcl.2016.8.59
http://ejournal41.com




Articles and Statements

UDC 347.469.1

# Arbitration and LC Fraud Disputes: a Comparative Approach

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**Abstract**

Historically, litigation is the method of choice for resolving fraud related disputes in Documentary Letters of Credit (hereinafter - LC). However, it is difficult to meet the standard of proof and obtain injunction and stop bank from paying to fraudulent beneficiary. In late 1990's Blodgett and Meyers proposed for the first time the possibility of referring LC fraud cases to arbitration for the purpose of resolving them by industry experts in shorter period and lower costs in comparison with litigation. Despite the fact that after almost twenty years from Blodgett and Meyer's proposal, arbitration is not a popular method for resolving LC fraud disputes, it can be considered as an open option for resolving fraud disputes by parties to the letter of credit. Current paper, tries to find an answer to the question of why arbitration is not a popular method in resolving LC fraud cases by exploring existence of possibility to handle LC fraud disputes via arbitration and study legal concerns on the way of arbitrating such cases. On this basis, main research questions will be:

(i) whether or not LC fraud cases can be referred to arbitration;

(ii) What can be important aspects of arbitration agreement between parties in LC fraud disputes;

(iii) What types of remedies are available in case of referring cases of LC Fraud to arbitration tribunal;

(iv) Finally, paper will discuss the possibility to resolve LC fraud cases with reference to DOCDEX Rules.

**Keywords**: International Trade, Arbitration, Documentary Letters of Credit, Fraud, Litigation.

## Introduction

Despite the fact that fraud is first recognized exception to the autonomy principle of Documentary Letters of Credit, and fraud rule is recognized in many jurisdictions, still dealing with LC fraud in court has many disadvantages [1; 2]. Among others, defrauded party is dealing with

problems like: different standards of proof and difficulty to obtain injunction, long period and high cost of litigation process [3], challenges for enforcement of interlocutory injunction if account party succeeds in obtaining it from the court and finally, overcoming the court's opinion in undermining the authority of independent principle in smooth operation of documentary letters of credit. In case of LC fraud, difficulty is existence of different contracts. Namely, underlying sales contract between applicant and beneficiary and contract of the Credit from one hand between bank and applicant and from other hand between bank and beneficiary. Although, it is a common practice for parties to sales contract to refer their disputes to ADR (particularly Arbitration), as an intermediary to finance the international transaction, bank has no interest in being involved in arbitration process when disputes arise in the framework of underlying sales contract. Mistrust of banks in resolving disputes via arbitration is attributed by some scholars to their criticism on lack of sufficient knowledge of international national banking practice among arbitrators [4]. Non-involvement of bank in contract of sales between parties has been emphasized in Article 4 of UCP 600:

"Credits v. Contracts

A credit by its nature is a separate transaction from the sale or other contract on which it may be based. Banks are in no way concerned with or bound by such contract, even if any reference whatsoever to it is included in the credit. Consequently, the undertaking of a bank to honour, to negotiate or to fulfill any other obligation under the credit is not subject to claims or defenses by the applicant resulting from its relationships with the issuing bank or the beneficiary." [5]

Therefore, it is not unexpected that banks take distance from any disputes in underlying contract between applicant and beneficiary by providing standard LC application form with emphasize on jurisdiction of particular court in dispute resolution clause. The same applies to the LC contract between issuing bank and beneficiary where litigation is the only form of dispute resolution proposed in standard contract form between parties [6].

**Materials and methods**

In this paper author presents study on possibility to use arbitration as a method for dispute resolution in LC fraud disputes. On the basis of electronic research in academic legal databases, an extensive comparative study has taken place among existing literature and case law on using arbitration as method for resolving LC fraud disputes in legal practice and possible remedies for affected party by fraud. In the study the author has applied the method of descriptive and comparative analysis and the method of synthesis.

**Discussion**

Application of above mentioned condition in contract between bank and parties to the Credit makes it difficult for applicant to seek justice via ADR methods instead of dealing with difficulties of litigation when facing with any potential fraudulent conduct of beneficiary. However, in late 1990s, Blodgett and Mayer proposed the arbitration as alternative to litigation in legal cases relevant to LC fraud in international trade [7]. Their proposal in practice consists of two main parts: Firstly, buyer and seller in the underlying sales contract between agree that, method of payment in their transaction will be Documentary Letters of Credit, applicable law to it will be UCP and all relevant disputes will be referred to arbitration [7, P. 462] . The power of arbitrator further would be defined as issuing award, determination of fees for attorneys and relevant damages (consequential and compensatory) in case of beneficiary's approach with a fraudulent and abusive claim for payment [7]. Parties might even agree on inclusion of punitive damages in arbitral award where evidences establish the outrageous conduct of either party under contract of sales [7].

Secondly, as existence of arbitration agreement between the buyer and seller would not prohibit buyer to seek injunction from court in order to stop bank from payment to seller while facing with his abusive and fraudulent demand for payment, an arbitration clause is proposed for being included in LC contract between bank and applicant [7, P. 462-463]. Blodgett and Mayer formulated an arbitration clause in their proposal as following: "account party agrees that it will not seek to prohibit payment under the LC in any event where the bank receives documents conforming to the credit's requirements; account party agrees that any legal claims or equitable actions arising from the seller/beneficiary's fraud ,the problem of quality, lack of quantity, or non- existence of goods will be pursued directly against the seller whether by arbitration and not litigation" [7]. On the basis of above mentioned arbitration clause in the LC contract between bank

and applicant, the right to seek injunction in court against fraud of beneficiary will be self-denied by applicant and instead the matter should be referred to arbitration tribunal. With reference to above mentioned arbitration clauses in underlying contract of sales and LC contract, court will dismiss any application of for granting interlocutory injunction and case will be automatically referred to arbitration tribunal.

In justification in their proposal, Blodgett and Mayer argue that replacement of litigation with arbitration will reduce the cost of LC operation , correct the fallacy of the belief that litigation is the only way to provide remedy for beneficiary's fraud [7], and it does neither need forum establishment nor problems are too specific that arbitrators would not be able to deal with them [7, P. 464].

According to Blodgett and Mayer, while seller enjoys the benefit of being paid under LC after presentation of complying documents, buyer has the advantage of access to arbitration award including consequential and compensatory damages in case of fraudulent demand for payment by beneficiary. Recognition of the New York Convention on Enforcement of Foreign Arbitration Awards in many jurisdictions guarantee the enforcement of award issued by arbitration tribunal.

After almost 20 years from proposing to use arbitration instead of litigation in cases of LC fraud by Blodgett and Mayer, there is no significant turnout towards using arbitration in banking practice in general and in international LC operation in particular let alone its application to cases of LC fraud disputes. As a result, current paper tries to find an answer to the question of why arbitration is not a popular method in resolving LC fraud cases by exploring existence of possibility to handle LC fraud disputes via arbitration and study legal concerns on the way of arbitrating such cases. On this basis, main research questions will be whether or not LC fraud cases can be referred to arbitration? What can be important aspects of arbitration agreement between parties in LC disputes? What types of remedies are available in case of referring cases of LC fraud to arbitration tribunal? Finally, paper will discuss the possibility to resolve LC fraud cases with reference to DOCDEX Rules.

In order to answer above mentioned questions, paper will take a comparative approach and study the subject matter in different jurisdictions.

*Current situation of Arbitration as an alternative to litigation in international LC disputes*

As it has been mentioned earlier, almost after 20 years from the proposal of Blodgett and Mayer arbitration could not establish itself as an alternative for litigation in LC fraud disputes. Some of the reasons behind such failure can be traced in limits of proposal. First of all, Blodgett and Mayer completely remove the possibility to use litigation from their proposal. As a result, even in case of committing material fraud by beneficiary, it is impossible to seek for injunction order as the fastest available remedy to stop payment process. Second, proposal only takes into account the fraud committed by beneficiary and totally neglects other possible forms of fraud in LC operation. Finally, there is not clarification in scope of fraud in Blodgett and Mayer's proposal as it does not differentiate the fraud in underlying contract from fraud in LC operation which is totally different issues from technical perspective [8].

While discussing the fraud in LC operation, important role of bank as a party to the LC contract should not be neglected and despite the fact that many scholars confirm positive turnout of banks to arbitration within recent years [9] , still it is not possible to consider arbitration as a popular method for solving financial disputes in banking community [10]. Generally, bankers consider arbitrators as not being aware of principles of their business while arbitrators criticise lack of sufficient appreciation towards their practice among bankers [10].

Connerty [11], comments on different reasons for bank's reluctance to use of arbitration in solving LC fraud disputes. Experience of commercial courts in financial centres seems sufficient for resolving fraud related disputes under the Credit contract, therefore, there is no need for application of arbitration in above mentioned cases. Also, by using arbitration for solving the LC fraud disputes, banks will be deprived from access to summary judgement issued by national courts. Other reasons for lack of bank's interest in using arbitration as dispute resolution method in LC fraud cases can be summarized as: Difficulties of enforcing international arbitral award in comparison with enforcement of national court order and possibility to delay the arbitration process by applying to court for determining jurisdiction of arbitrational tribunal and validity of arbitration agreement.

In practice review of statistics from ICC Court of Arbitration Secretariat in 2003 shows that only in 9 cases banks were involved as parties while at the same time no banker was arbitrator in 1135 pending cases before the same court at that moment.[10]

According to James Byrne, arbitration has not been a successful alternative for litigation in LC disputes as it is easier and less time consuming to get the result in court rather than educating arbitrators about principles of international LC operation [12]. Statistical reports of ICC Arbitration Court confirm Byrne opinion by showing that in 1994 only 11.7% of submitted disputes where relevant to banks [13]. Even Blodgett and Mayer admit that arbitration cannot be the best way for resolving all types of LC disputes, but they confirm that it can be used successfully in cases of fraud and nonexistence of goods [7, P. 464].The unsuccessful experience of International Centre for Letter of Credit Arbitration(ICLOCA) in the USA which was established by International Institute of Banking Law and Practice (IIBLP) can be considered as another evidence for failure of arbitration in replacing litigation to resolve relevant disputes to LC transactions. It has been argued that in the Europe most of LC disputes are resolved through litigation and by agreement between parties rather than using arbitration [14].

In contrast many scholars believe that arbitration as a faster and more cost effective dispute resolution method is becoming more and more popular in banking society [15]. With reference to ICC statistics, Henefeld comments on raise of arbitration cases in banking and finance between 2008 to 2010 from 7.2% to 15%. [16]. Some scholars consider use of experienced arbitrators who are familiar with banking world as a reason behind increasing popularity of arbitration in banking and finance sector in recent years [15, P. 266].

*Possibility to resolve fraud disputes by arbitration*

Arbitrability is the notion which defines possibility to deal with dispute through arbitration[17]. It can be defined as legal restriction on jurisdiction of arbitral tribunal and validity of arbitration agreement [17].

American law has recognized the jurisdiction of arbitral tribunals which handle fraud cases [18].

In English Law, “matters which are (not) capable of settlement by arbitrators” is the term used in practice more than arbitrabiltiy [17, P. 282]. Arbitrabliity is determined by common law in England as Arbitration Act of 1996 in England and Wales has not determined arbitrability clearly [8, P. 176]. Section 81 (1) of the arbitration act refers determination of arbitrability to “any rule of law” where law is common law. According to Rutherfeld and Sims, arbitrability is defined in a very broad term under English law and it is difficult to find a dispute which does not qualify for settlement by arbitration [19] .However, English Law does not recognize the jurisdiction of arbitral tribunal in case of disputes that “affect public at large” (possible negative effect on public policy) and particular types of illegal contracts [20]. In case of *Lornrho* where the claim was made on the basis of breaching the contract and also on tort (negligence and conspiracy) the court decided that tortuous claim should be referred to arbitration due to connection with contractual claim and existence of arbitration agreement [21; 22]. Some scholars also comment on possibility in English Law to refer fraud cases in LC operation to arbitration tribunal in the same vein as litigations in national courts [8].

So far, ICC Court of International Arbitration has dealt only with one LC fraud case [23]. In *Bank (Thailand) v. Bank (Spain)*, defendant bank ( Spanish bank) issued a letter of credit upon request of a Spanish importer in favour of Thai Exporter . The credit was confirmed by a Thai bank and first payment was executed by issuing bank. However, second payment was rejected as result of beneficiary’s fraud and presentation of forged document. On the basis of UCP (1974 version) the award established that defendant bank was not obliged to honour the fraudulent presentation by beneficiary [23].

The concept of arbitrability of LC fraud has been supported by different arbitration scholars including Georges Affiki [8, P. 177] . He argues that arbitration can offer advantage of expertise and rapidity more than adjudication; however, suitable mechanism for dispute resolution should be defined on the case to case basis. Therefore, it is possible to conclude that despite the fact that arbitrability is not a clearly defined notion, there is an agreement on possibility to refer LC fraud disputes to arbitral tribunal.

*Arbitration Agreement in LC Fraud Disputes*

Agreement of parties to solve their disputes in arbitration will result in their rejection of chance to solve same disputes by litigation. Therefore, the main outcome of including arbitration agreement in the contract is withdrawal from the right to decide about disputes in court while having the right to solve existing disputes in a private process [24]. Within the arbitration agreement, parties consent on procedural rules, language, location, governing law and arbitrators in the format of a clause included in the contract of sales.

Many legal systems recognize the principle of Separability of arbitration clause. As a result, arbitration clause might stay valid even when main contract is recognized as void or null [25]. According to the principle of Separability, allegations regarding termination of contract of sales based on its nullity will not remove jurisdiction from arbitrators as validity of arbitration clause solely depends on relevant factors to itself , including genuine submission of arbitration request, capability of parties to agreement as well as formality and content of agreement. Since fraud can affect the validity of the contract, it is necessary to distinguish between situations in which whole contract is affected by fraud and when arbitration agreement is not affected [22]. It has been argued that main incentive of fraudulent party is to benefit from conducting fraud in the underlying contract and as result, in case of implementing the separability principle and taking the matter to arbitration even after nullification of main contract; it will be possible that award to be against fraudster and in favour of affected party. The Separability principle has been recognized globally and by most arbitration laws [26].

For example, under English Arbitration Act 1996, section 7 confirms that invalidity of another agreement will not result in non-existence, invalidity, or ineffectiveness of arbitration agreement since it should be considered as a different agreement. The English court in *Harbor Assurance (UK) Ltd v. Kansa General International Insurance* [27] ordered on separation of arbitration agreement included in the contract from the contract itself. Also the decision of the Court of Appeal and House of Lords in case of *Premium Nafta Products Limited & Others v. Fili Shipping Co & Others* [28] which confirmed separabiltiy of arbitration clause from validity of main contract has received a warm welcome in business society. In this regard, it has been argued that the decision of House of Lords in *Premium Nafta Products Limited & Others v. Fili Shipping Co & Others* limits access of parties to court when they have already agreed to proceed their dispute resolution via arbitration [8].

There is an argument among scholars regarding application of arbitration agreement in underlying sales contract to the cases of fraud in Documentary Letters of Credit [29]. According to the principle of autonomy of Documentary Letters of Credit emphasized in article 4 of UCP 600, banks deal with documents not goods and performance of parties in underlying sales contract will not affect their guarantee of payment under LC [30]. Therefore it is possible to conclude that including arbitration clause in underlying sales contract may not affect the fraud disputes in Documentary Letters of Credit as first of all, the international contract of sales has been signed between importer(buyer) and exporter (seller). But, parties to LC contract are not the same. In Documentary Letters of Credit different contracts exist and parties to them are not the same. For example, contracts in LC operation include: contract between applicant and issuing bank, contract between issuing bank and beneficiary, contract between beneficiary and nominated or confirming bank and finally, contract between nominated or confirming bank and issuing bank where each contract is only binding to its parties. Therefore, banks which are not party to underlying sales contract cannot be affected by its contents.

Secondly, as a sign of mutual assent, agreement on resolving disputes via arbitration should be mentioned freely by involved parties in the contract [24]. As a result, in many national and international laws including section 5 of English Arbitration Act 1996 and article II of New York Convention, it is mandatory for arbitration agreement to be in written format in order to prove agreement of parities [31]. For signatory countries of New Convention, in case of conflict between national law and its content of convention, it has been argued that New York Convention is prevailed over national law [29].

It is possible to conclude that possibility to settle fraud disputes in Documentary Letters of Credit by arbitration depends on involved parties to the dispute , existence of arbitration agreement among those parties and nature of claim (whether it is against parties in underlying contract or parties in LC contract).

*Applicable Law and Fraud Disputes in Documentary Letters of Credit*

There is no doubt about importance of applicable law in the contracts of sales under which parties agree to refer their disputes to arbitration [32]. While dealing with contractual problems and disputes, contract law is the most important reference. However, fraud is not a fully discovered area either under national contract laws or international frameworks for regulation of international sales contracts. With reference to English Law, fraud is covered under contract law as misrepresentation where misrepresentation of one party will entitle the other one to step out of her liabilities under the contract [33].In addition to the right to claim for damages. Relevant regulations of damages are mostly tort law; however, in English law it is possible to face with liability under tort law and contract law at the same time. English law does not provide clear view on liabilities and rights of affected party when other party commits fraud in the framework of contract.

The United Nations Convention on Contracts for The International Sales of Goods (CISG) is frequently chosen as the applicable law where the arbitration is the preferred method of dispute settlement by parties [29]. Despite the fact that CISG does not provide any direct reference to fraud in international sales contracts, it neither imposes any restrictions on rights and liabilities defined by national law to contract parties affected by fraud. Article 4 of CISG provides excluded issues from the scope of convention. Therefore, by regulating issues resulting from contract, article 4 of CISG in fact safeguards protection of national law for affected party of fraud in an international sales contract [34].

As it was mentioned earlier, CISG does not provide any direct guidance for cases involving fraud, however, problem of fraud has not been totally excluded from the Convention. According to article 74 of the CISG, it is possible to consider the fraudulent conduct as breach of contract and conducting fraudulent conduct by one party provides other party with eligibility to benefit from damages for breach of contract [35].

*Remedies for fraud in arbitration proceeding*

In the arbitration process, interim measures are those remedies which are granted before announcement of final award [24]. Power of arbitration tribunals to award interim measure was limited for many years, or not recognized in many jurisdictions as it was considered to be granted only under court's discretion [36].After coming into force of the UNCITRAL Model Law on International Commercial Arbitration, granting interim measures are included among powers which signatory countries provided for arbitral tribunals [37]. It also worth of discussion that the term "interim measure" has not been reached a harmonized interpretation and still different jurisdictions provide different guidelines about how, where and when to use them [38]. Despite the fact that jurisdiction of arbitration tribunals to grant interim measures has received global consent, there is no global agreement on whether or not to include interlocutory injunction or freezing order among such measures [17]. Granting *ex parte* order without notice of beneficiary in case of emergency is another necessary issue which is facing with silence of different national and international arbitration regulations [26]. Another important issue in this regard is the difference between granting interim measures against parties to the arbitration agreement or against third parties as arbitration agreement can limit the power of arbitrator to issue awards only against parties to the agreement [22].

In this section, paper studies English, American and German approaches to interim measures in arbitration in general and in case of fraud.

*England*

In England, Arbitration is regulated under Arbitration Act 1996, the New York Convention, the Geneva Convention 1927, the Administration and Justice Act 1920, the Foreign Judgement Acts 1933 and Common Law [39]. On the basis of Arbitration Act 1996 , according to agreement between parties, the arbitrators are entitled to power of ordering security for costs, inspect property, preserve property and preserve all evidences [40]. Therefore, Arbitration Act 1996 entitles the arbitrators to use freezing orders and interlocutory injunctions as interim measure upon express agreement of parties.

In the case of *Mobil Cerro Negro Ltd v. Petroleos de Venezuela SA* [41] with reference to section 44 in the Arbitration Act 1996, English court supported the New York ICC Arbitration award between Petroleos de Venezuela SA and Mobil Cerro Negro Ltd by granting a freezing order which clearly shows the power of English Courts to support foreign arbitration awards. However,

supportive attitude of English courts towards enforcement of foreign arbitration awards does not mean that they will use their power in awarding interim measures as they preferably refer the case to arbitration tribunal when parities have inserted an arbitration agreement in their contract and included such measures into the arbitration agreement [18]. For Example in *Channel Tunnel Group Ltd v. Balfour Beatty Construction Ltd* [42]"the HL decided that it had jurisdiction, but refused to issue the injunction order because of the potential conflict between the court's tentative assessment of the merits of a case and respect for the choice of arbitral tribunal by the parties" [8].

*The United States of America*

Federal Arbitration Act of 1925 and Uniform Arbitration Act of 1955 are two federal statues for regulating arbitration [43]. According to Huela, in ratification FAA and UAA at federal level, Congress was following goals of overcoming traditional hesitance of U.S. Courts in accepting arbitration as recognized form of dispute resolution and making sure that U.S. States will enact mandating statues relevant to arbitration agreement's enforcement [44]. The USA is member of New York Convention on Recognition and Enforcement of Foreign Arbitral Awards, European Convention on International Commercial Arbitration of 1961 and Inter American Convention on International Commercial Arbitration (Panama Convention of 1975) are other international treaties on arbitration applicable in the United States of America. Despite the fact that membership in Panama Convention seems a logical act due to high level of trade between the USA and other counties in American Continent, the United States joined the European Convention on International Commercial Arbitration (1961) due to its supplementary role to the New York Convention (1958) and convention's provision which was providing State to be a party to arbitration agreement [45; 46]. At the Federal level, it has been argued that American Congress enacted the FAA in order to convince American courts about legitimacy of arbitration as an alternative method for dispute resolution and overcome reluctance of US in enacting statues on enforcement of arbitration agreements [43].

Although, the FAA and UAA are both silent regarding capability of arbitration tribunal to award interim measures; it has been held by US Courts that arbitrators have power to grant such measures as long as it is not contradictory with content of arbitration agreement between parties [47].

In case of *Pacific Reins. Mgmt Corp vs Ohio Reins Corp* [48], the Ninth Circuited argued: "temporary equitable relief in arbitral proceedings can be indispensable to preserve assets or enforce performance which if not preserved or enforced may render the final award meaningless" [48]. In accordance with pivotal rule of FAA on enforceability of arbitration agreements .there is no American authority which shows that according to FAA, arbitration tribunal cannot grant interim measures despite express agreement of parties [47]. However, only few courts referred to FAA on lack of arbitration tribunal's authority to award interim measures where parties have not clearly such capability to it by parties to arbitration agreement [47]. For example, low court of *Swift Indus.Inc. v. Botany Indus,Inc* [49] held that : "having reviewed the agreement in the light of its language, its context and the parties' apparent intent , and in terms of the question of the arbitrator's authority to fashion relief we conclude that the arbitrator's award of a six million USD cash surety bond does not draw its essence therefrom and that it is in manifest disregard thereof and must be set aside" [49]. As a source of arbitration tribunal's power to grant interim measures, arbitration agreement in the contract complies with applicable rules chosen for arbitration agreement like, *lex loci arbiri*, rules of international institutions for arbitration and law of the seat of arbitration [50].

In the United States, FAA, State Law and the New York Convection govern the enforcement of interim measures granted by arbitrators [51]. According to FAA and the New York Convention interim measures only have an interim function and as a result of tendency to exclude them from final awards [52], it is impossible to enforce them by court. However, with reference to section 9 [53] and 10 of FAA, US case law confirms the view that interim measures are final awards and enforceable in majority of claims [52; 53; 54; 55]. In the case *of Yasuda Fire & Marine Insurance v. Continental Casualty,* an interim measure granted by arbitration tribunal in order to oblige defendant to open an interim letter of credit in response to release request by the plaintiff, court had to decide on the basis of sections 9 and 10 of the FAA whether the granted relief was an award or not. With reference to decision of Pacific *Reinsurance v. Ohio Reinsurance* where interim arbitral order to deposit money under dispute in an escrow account as final, the court held [56;57]:

*"The arbitration panel in this case ordered Yasuda to post an interim letter of credit to protect a possible final award in favour of CAN. [ ... ] Because this relief protects CAN's interests, CAN has the right to confirm the order in the district court, which it has done. Analogously, Yasuda should have the right to attack this relief. The interim relief represents a temporary equitable order [ ... ] calculated to preserve assets [ ... ] needed to make a potential final award more meaningful. [ ... ] We find that an interim letter of credit constitutes an 'award' under section 10 and that the district court had jurisdiction to consider Yasuda's Petition to Vacate".[56]*

*Germany*

The Tenth Book of Code of the Civil Procedure also known as ZPO (*Zivilprozessordnung)* contains the German Arbitration Law. The new German Arbitration Law which is based on 1985 UNCITRAL Model Law in International Arbitration came into force on 1 January 1998 [44]. Also in 1992 Germany recognized institutional framework for national and international arbitration by gathering all existing arbitration institutions under the umbrella of German Institute of Arbitration (*Deutsche Institution für Schiedsgerichtsbarkeit*) [58].

Enacting the new law of Arbitration in Germany was an end to the dispute regarding power of arbitration tribunal in granting interim measures [59]. On the basis of the article 17 of UNCITRAL Model Law, Section 1041 (1) of ZPO provides arbitrational tribunal with power to grant interim measure [18]. Arbitration tribunal has the power to evaluate which measure is suitable and necessary for each particular case and there is no limit on its power to grant different types of interim measure [60]. In contrary, court can grant interim measures which meet the prerequisites defined in law [61].

Article 1041 (2) provides power for arbitration tribunal to grant interim measures that do not fit the enforcement system in Germany, as according to the provision, court might redesign the measure granted by arbitrators in order to meet necessities for enforcement [61]. This will gain importance where arbitration tribunal grants interim measures that are not ordered in Germany like granting worldwide freezing order similar to English law [61].

Under ZPO, s.1042(2) provides that court has the power to enforce the interim measure granted by arbitrators except for cases that application for similar interim measures has been already done to the court on the basis of s.1033 of same law [62]. It should be notices that German courts only order protection of interim measures which are provided under German law [63]. Section 1062(1) comments on the Court of Appeal to be the competent court for enforcement of measures granted by arbitrational tribunal. However, where party fails to refer the matter to specific court, the District Court of the seat of arbitration has power to enforce interim measures granted by tribunal.

In conclusion, it is possible for arbitrational tribunals in different countries to grant interim measures against cases of fraud. However, having such power depends on inclusion of granting it to the tribunal in arbitration agreement by parties and also providing such possibility to arbitrators by national law of the country in which the arbitration is taking place as well as the country in which interim measure is going to be enforced.

*Arbitration Tribunals and Punitive Damages*

It has been globally accepted that powers of arbitrational tribunals are not similar to powers of the court as for example arbitrators cannot convict someone to prison or impose fine. Such penalties are generally governed under national law and executed by judges.

In practice, principle of equivalence is governing damages and compensations in the field of civil law and full compensation in tort and contract law establishes that victim must receive such compensation as if harm has never been done. Complementary to this idea is notion of liquidated damages and contractual penalties in cases of anticipatory breach of contract recognized by CISG [64]. However, their enforceability depends on national law [65]. Full or fair compensatory damages seem to be insufficient in international trade and more damages might be required by victim for example in cases of fraud, violence, malice and oppression [66; 67]. Such punitive damages do not follow the goal of compensating victims, but to punish the wrongdoer and prevent such faulty actions in future [68].

According to the proposal of Blodgett and Mayer it is possible to provide arbitrational tribunal (in the frame work of arbitration agreement) with the power to award punitive damages in particular situations. However, area of punitive damages is a debated train as national laws show diversified attitudes towards it.

Since fight against corruption and fraud has become a global phenomenon [69], it is possible that arbitrators respond to such behaviours with awarding punitive damages. On one hand, it is argued that awarding punitive damages by arbitrators will be against the principle of fairness as a result of limited review on arbitral procedure and awards [67]. On the other hand, it is not possible to neglect challenges imposed by applicable law of the seat of arbitration on the awards. Under the English law, authorities are against enforcement of punitive damages and generally, English courts do not enforce the penal law [70; 71]. Although, English law does not consider the enforcement of punitive damages in contradiction with public policy, case law has strong influence on enforcement process [72].

Historically, in the United States of America existence of punitive damages goes back to the case law in England. However, they have more recognition than English law particularly in cases of fraud and extreme civil offences and, it is still valid argument whether or not arbitration tribunal has power to award punitive damages [66; 73]. However, on the basis of Supreme Court's ruling, under the regulation of state law, parties may agree to grant arbitrators with power to award punitive damages [74].

In Civil Law Countries like Germany, punitive damages as legal concept are not popular. German legal system does not recognize punitive damages since they are understood as undue enrichment in favour of victim. Therefore, do not conform to doctrine of proportionality between damage and compensation [66]. German Courts reject enforcement of punitive damages as being against the public policy [66].

As a result, it is possible to conclude that arbitrators should consider different issues while making decision on awarding punitive damages, First of all , such power should be attributed to the arbitrator by parties to the arbitration agreement. Secondly, arbitrators should act upon authority available by applicable law of the dispute. Thirdly, law of the country in which arbitration is taking place should be considered as award is granted in accordance with national law and public policy of the country of the seat of arbitration [67]. Finally, arbitrators should consider the enforceability of the award [73]. Therefore, only having the power to grant punitive damages in not sufficient for awarding them. Arbitrators should carefully observe all relevant aspects of the award before granting it.

*DOCDEX Rules and LC Fraud Disputes*

In 1997, International Chamber of Commerce introduced Documentary Instruments Dispute Resolution Expertise (DOCDEX) in order to resolve LC disputes with the help of an expert based panel [74]. DOCDEX was revised in 2002 in order to include disputes over demand guarantees and documentary collection in addition to LCs. The main idea behind introduction of DOCDEX was using an independent, prompt expert decision panel to resolve disputes based on content of ICC Rules and financial instrument's contract [75]. DOCDEX process can start by request of one party to the dispute or all involved parties. On the basis of documents submitted by parties, panel of three experts will make decision which should be reviewed by the Technical Advisor of the ICC Banking Commission. DOCDEX decision is non-binding in principle, and unlike arbitration awards, it will not receive any legal follow up regarding enforcement. It is also argued that DOCDEX rules are meant more for resolving disputes on documentary discrepancies in international operation of LCs [11]. Additionally, according to Article 1.1 of DOCDEX, relevant disputes to these rules are connected to ICC regulations. As result, it is questionable whether or not DOCDEX process may resolve LC fraud disputes where UCP 600 takes the silent potion regarding LC fraud and leaves them to be governed by national laws. Other issue which raises doubts about applicability of DOCDEX rules in fraud related disputes of LCs is their procedure and decision making process. It is possible to initiate DOCDEX procedure even by one party in the dispute and without participation of the other party proceedings might continue. Therefore, it is not necessary for parties to agree upon insertion of DOCDEX rules in their contract. Another concerning issue is non-binding nature of DOCDEX decisions where a binding award is necessary in LC fraud disputes as it is unlikely to solve them on the basis of voluntary decisions.

Therefore, it is possible to conclude that DOCDEX rules are more suitable for discrepancy problems and other technical issues in international LC operation and do not provide strong basis for resolving LC fraud disputes.

**Results**

From technical perspective it is possible and desirable to reduce time and cost of dispute resolution process in LC fraud cases by referring them to arbitration rather than traditional litigation. The trend of considering arbitration for resolving LC fraud disputes started in late 1990s with works of Blodgett and Meyers and received support by that time from different legal scholars and institutions. Despite the fact that parties to LC fraud dispute can benefit from numerus benefits of arbitration, its use in such cases is limited and rare. There are severe problems on the way of replacing traditional approach of resolving such cases via litigation with more flexible dispute resolution methods like arbitration. As a result of conducting research in available legal literature, current paper considers reasons behind unpopularity of using arbitration as a dispute resolution method in LC fraud cases as following: Establishing the jurisdiction of arbitration tribunal for to issue an award in LC fraud disputes, hesitation of banks lack of interest among them in using arbitration as a dispute resolution method, lack of harmonized regulation regarding LC fraud disputes at international level, difficulties on the way to enforcement of international arbitration award and problems to issue punitive damages in arbitration process of LC fraud disputes . Therefore, with emphasize on complicated process of International LC transaction and existing complexities in LC fraud disputes, further research is recommended in order to clarify unclear and vague areas of using arbitration in LC fraud disputes and prepare the ground for more harmonized legal approach to the subject matter at international level.

**Conclusion**

Current paper tried to review possibility for using arbitration as an alternative method rather than litigation in resolving LC fraud disputes in the field of comparative law. From theoretical perspective and with reference to Blodgett and Mayer, in LC fraud disputes, arbitration can be a faster and more cost effective method than going to court. However, due to complex nature of fraud in operation of documentary letters of credit, referring to arbitration in order to resolve such problems is not easy in practice. By taking a comparative approach among different national laws, it became clear that first challenge for using arbitration in LC fraud disputes is jurisdiction of arbitral tribunal to grant an award in such cases.

Other important challenge is existence of arbitration agreement between parties. Problem will rise when bank is party to LC fraud dispute and since there is no place for arbitration in standard LC contract between banks, beneficiary applicant; banks prefer litigation process rather than arbitration and arbitration agreement does not have any place in standard LC contracts between bank with either applicant or beneficiary.

Other existing challenges for resolving LC fraud disputes by arbitration can be listed as: silence of UCP regarding fraud problem in LC operation, different approaches of national legal systems available remedies for victim which was explored from the perspective of interim measures and punitive damages as well as enforcement problem of arbitral awards in international arena. Therefore, scholars cannot agree on possibility for resolving LC fraud disputes by arbitration better than litigation. However, further research on using other alternative dispute resolution mechanisms instead of litigation in LC fraud cases is highly recommended.

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53. U.S.C § 9: If the parties in their agreement have agreed that a judgment of the court shall be entered upon the award made pursuant to the arbitration, and shall specify the court, then at any time within one year after the award is made any party to the arbitration may apply to the court so specified for an order confirming the award, and thereupon the court must grant such order unless the award is vacated, modified, or corrected as prescribed in sections 10 and 11 of this title. If no court is specified in the agreement of the parties, then such application may be made to the United States court in and for the district within which such award was made. Notice of the application shall be served upon the adverse party, and thereupon the court shall have jurisdiction of such party as though he had appeared generally in the proceeding. If the adverse party is a resident of the district within which the award was made, such service shall be made upon the adverse party or his attorney as prescribed by law for service of notice of motion in an action in the same court. If the adverse party shall be a non-resident, then the notice of application shall be served by the marshal of any district within which the adverse party may be found in like manner as other process of the court

54. U.S.C § 10: (a) In any of the following cases the United States court in and for the district wherein the award was made may make an order vacating the award upon the application of any party to the arbitration-- 1. Where the award was procured by corruption, fraud, or undue means. 2. Where there was evident partiality or corruption in the arbitrators, or either of them. 3. Where the arbitrators were guilty of misconduct in refusing to postpone a hearing, upon sufficient cause shown, or in refusing to hear evidence pertinent and material to the controversy; or of any other

misbehaviour by which the rights of any party have been prejudiced. 4. Where the arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final, and definite award upon the subject matter submitted was not made. 5. Where an award is vacated and the time within which the agreement required the award to be made has nit expired the court may, in its discretion, direct a rehearing by the arbitrators. (b) The United States district court for the district wherein an award was made that was issued pursuant to section 580 of title 5 may make an order vacating the award upon the application of a person, other than a party to the arbitration, who's adversely affected or aggrieved by the award, if the use of arbitration or the award is clearly inconsistent with the factors set forth in section 572 of title 5.

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УДК 347.469.1

# Арбитраж и споры по делам о мошенничестве с документарными аккредитивами: сравнительный подход

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**Аннотация.** Исторически сложилось, что судебный процесс является одним из способов решения споров по мошенничествам в отношении документарных аккредитивов. Тем не менее, трудно встретить стандарт доказывания и получить судебный запрет и остановить банк от уплаты получателю-мошеннику. В конце 1990-х годов Blodgett и Мейерс впервые предложили обращаться по "аккредитиыным" мошенничествам в арбитраж. Цель – решение спора экспертами в более короткие сроки и снижение затрат по сравнению ссудебным разбирательством. Несмотря на это, арбитраж пока не является популярным методом для разрешения споров по случаям мошенничества с аккредитивами. Автор пытается ответить на вопрос "почему"? Основные проблемы, освещаемые в статье:
1) можно ли и когда передавать в арбитраж мошенничества в отношении аккредитивов;
2) каковы существенные условия арбитражного соглашения по такого рода спорам;
3) какие типы средств доступны в случае рассмотрения таких споров в арбитраже; 4) может ли арбитраж применять Правила DOCDEX?

**Ключевые слова:** международная торговля, арбитраж, документарные аккредитивы, мошенничество.