

ARTICLES

THE DEVELOPMENT OF THE FRAUD RULE IN LETTER OF CREDIT LAW: THE JOURNEY SO FAR AND THE ROAD AHEAD

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The doctrine of autonomy is one of the foundation stones of the law of letters of credit. Under this doctrine, the obligation of an issuing bank of a letter of credit is independent from the underlying sale of goods contract for which the credit will provide payment. An exception to this doctrine may arise in a case of fraud.

Under the fraud rule, although the documents presented may comply strictly on their face with the terms and conditions of the letter of credit, payment under the credit may be stopped if fraud is found to have been committed before payment is made, provided the presenter or party demanding payment does not belong to a protected class.

The policy tension behind the fraud rule was well expressed by Justice Le Dain in the leading Canadian case of *Bank of Nova Scotia v. Angelica-Whitewear Ltd.*, in these terms:

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

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must not serve to encourage or facilitate fraud in such transactions.¹

The fraud rule allows an issuer or a court to view the facts behind the face of conforming documents and to halt the payment of a letter of credit when fraud is involved. The *raison d'être* of letters of credit is to provide an absolute assurance of payment to a seller, provided the seller presents the right documents. The fraud rule thus goes to the very heart of the letter of credit obligation and has been described as "the most controversial and confused area" in the law governing letters of credit.²

Why, then, is it necessary to have such a rule? There are at least three reasons: (1) to close a loophole in the law; (2) to uphold the public policy of limiting fraud; and (3) to maintain the commercial utility of letters of credit. Each will be considered.

1. CLOSING A LOOPHOLE

In accordance with the principle of autonomy, all parties under a letter of credit arrangement are dealing in documents, not the goods or services to which the documents relate. If the documents tendered appear on their face to be in strict compliance with the terms and conditions stipulated in the credit, the issuer must make the payment, irrespective of any disputes or claims with regard to other related transactions. The issuer is entitled to full recourse against the applicant, even if the documents received turn out to be forgeries or include fraudulent statements. The issuer's only duty is to exercise reasonable care to ensure that the documents tendered comply on their face with the terms and conditions of the credit. This doctrine normally serves commerce well and facilitates the commercial utility of letters of credit.

However, "[a]s is the case with any rule that paints human conduct with a broad brush, an overly rigid application" of the autonomy principle may in some cases produce harsh results, which can undermine the original purpose of the principle.³ This happens when fraud is involved in the transaction. Because of the

¹ [1987] D.L.R. 161, 168 (Can.).

² Note, "Fraud in the Transaction": Enjoining Letters of Credit During the Iranian Revolution, 93 HARV. L. REV. 992, 995 (1980).

³ Herbert A. Getz, Comment, *Enjoining the International Standby Letter of Credit: The Iranian Letter of Credit Cases*, 21 HARV. INT'L L.J. 189, 204 (1980).

document-oriented nature of the letter of credit operation, beneficiaries demanding payment do not have to show that they have properly performed their duties in the underlying transaction; they need only produce conforming documents. The separation in law of the documents from the actual performance of the underlying transaction is absolutely necessary for credits to fulfill their essential commercial function and creates a loophole for unscrupulous beneficiaries to abuse the system. Perpetrators of fraud ("Fraudsters") may thus utilize letters of credit to obtain others' money by presenting forged or fraudulent documents. The classic example is where the seller gets paid under a letter of credit by presenting forged documents that comply in form with the requirements in the credit, yet the buyer receives only a shipment of worthless rubbish instead of the expected goods. With the fraud rule in place, this loophole in the letter of credit system has shrunk: even if every injustice fraud can cause is not prevented, its effects are at least minimized.

2. PUBLIC POLICY FOR THE CONTROL OF FRAUD

The fraud rule fills a gap in the law of letters of credit and a public policy requirement. As an American judge has stated, "[T]here is as much public interest in discouraging fraud as in encouraging the use of letters of credit."⁴ Thus the fraud rule is part of a sound legal system that upholds the public policy of limiting fraud.

This policy needs more emphasis than ever in our age. In recent years, letters of credit and independent guarantees have increasingly been used by fraudsters as instruments of "a particularly vicious scam which has bilked investors out of millions of dollars not to mention uncounted hours and costs, has spurred numerous law suits, criminal investigations, and sullied the reputation of legitimate vehicles of trade and commercial finance."⁵ If

⁴ *Dynamics Corp. of Am. v. Citizens & S. Nat'l Bank*, 356 F. Supp. 991, 1000 (N.D. Ga. 1973) (Edenfield, J.).

⁵ James Byrne, *Critical Issues in the International and Domestic Harmonisation of Letter of Credit Law and Practice*, in *COMMERCIAL LAW ANNUAL* 389, 421 (1995). For a series of articles and reports on these scams, see *id.* at 421 n.47. See also ICC COMMERCIAL CRIME BUREAU, *SPECIAL REPORT: PRIME BANK INSTRUMENT FRAUDS* (1994) [hereinafter *PRIME BANK INSTRUMENT FRAUDS*]; ICC COMMERCIAL CRIME BUREAU, *SPECIAL REPORT: PRIME BANK INSTRUMENT FRAUDS II* (1996) [hereinafter *PRIME BANK INSTRUMENT FRAUDS II*].

the law takes a strong stand against fraud, prospective fraudsters may be deterred from perpetrating their dishonest deeds.

3. MAINTAINING THE UTILITY OF LETTERS OF CREDIT

Fraud in the letter of credit not only violates the public policy against fraud, but also poses "an equally serious potential threat to the commercial utility of letters of credit."⁶ The popularity of the letter of credit lies in the fact that it provides a fair balance of competing interests among the parties involved. The normal operation of the letter of credit not only provides the beneficiary with safe and rapid access to the purchase price or a sum of money when the applicant defaults, but also provides the applicant with credit and/or other commercial benefits, protects the applicant against improper calls on the credit by requiring the beneficiary to present documents indicating that it has properly performed its obligations under the underlying transaction, and most importantly, assists the applicant to realize its commercial goal. It also furnishes the issuer with a fee for its ministerial document checking service.

If one party avails itself of the loophole in the letter of credit system and defrauds other interested parties by presenting forged or fraudulent documents, their action harms the interests of the other parties and undermines the balance assumed in the letter of credit scheme. In a commercial letter of credit transaction, for example, if the seller ships nothing or only rubbish, but gets paid by tendering forged or fraudulent documents, it hurts the applicant. It might be argued that, under the law of letters of credit, the buyer may proceed against the seller for fraud under the underlying contract, but this is generally not an attractive proposition. In most of the cases, the fraudster "absconds before the fraud or forgery is discovered."⁷ Where that is so, the seller's fraudulent conduct may also impair the interests of the issuer. Often the bank agrees to issue the letter of credit on the condition that the goods will serve as security for its honor of the letter of credit. If nothing or only rub-

⁶ Guy W. Lewin Smith, *Irrevocable Letters of Credit and Third Party Fraud: The American Accord*, 24 VA. J. INT'L L. 55, 96 (1983).

⁷ Peter Ellinger, *Documentary Credits and Fraudulent Documents*, in CURRENT PROBLEMS OF INTERNATIONAL TRADE FINANCING 185, 191 (C. M. Chinkin et al. eds., 1983).

bish is shipped, the issuer's security interest over the goods fails as well.⁸

As with any commercial vehicle, the popularity of the letter of credit is based on the faith of its users. If the possibility of the abuse of the letter of credit system is not curtailed, and fraud flourishes, faith in the system of letters of credit will fade, as will the commercial utility of the letter of credit. As explained by Boris Kozolchyk:

The certainty of payment of a letter of credit is crucial for those who, as beneficiaries, supply their money, goods or services to applicants. . . . Yet what about the applicant? To leave the applicant without a remedy against fraud would equally frustrate the applicant's expectations of the letter of credit. After all, why should a good faith applicant agree to procure the issuance of a letter of credit and reimburse the issuing bank if the letter of credit becomes an automatic and unstopable vehicle for the perpetration of fraud? As is true with other commercial legal institutions, an approach that favors one party at the expense of the other undermines the viability of the institution.⁹

With the fraud rule limiting fraudsters from abusing the letter of credit system, honest letter of credit users will be more comfortable using it. Thus the fraud rule also helps to maintain the commercial utility of the letter of credit.

⁸ In practice, the issuer often takes general security over the applicant's other assets as well as particular security over the goods, so its risk is much less than the applicant's. However, if fraud is involved and the applicant cannot receive the goods, the issuer's risk clearly increases. Fraud can also damage the issuer's interests in other ways. For example, as explained by Christopher Sparks, "'Banks, and bankers, rely upon their reputation and standing—in the eyes of both the public and supervisors; a high reputation is hard won, but much more easily lost.' Fraud—internally and externally, is undoubtedly 'THE' enemy which threatens the stability of the international banking community." *PRIME BANK INSTRUMENT FRAUDS*, *supra* note 5, at 40 (emphasis in original).

⁹ Boris Kozolchyk, *The Immunization of Fraudulently Procured Letter of Credit Acceptances: All Services Exportacao, Importacao Comercio, S.A. v. Banco Bamerindus do Brazil S.A. and First Commercial v. Gotham Originals*, 58 *BROOK. L. REV.* 369, 370 (1992). For comments to similar effect, see also Byrne, *supra* note 5, at 397 ("If the credit becomes a vehicle unduly favouring one side or another, it will lose its primary attraction as a balanced safeguard for both interests of applicant and beneficiary.").

4. HISTORICAL DEVELOPMENT

To understand the fraud rule today and the development that is still needed for it to become a fully effective commercial law, one must understand where it has come from and how it has grown.

4.1. *An Early Case*

It is not easy to trace the exact time when fraud became an issue in the law governing letters of credit, but "[t]he idea that fraud upsets the usual rules of credits is an old one."¹⁰ In *Pillans v. Van Mierop*, a 1765 English case, White, a merchant in Ireland, desired to draw upon the plaintiffs, Pillans and Rose, merchants in Holland, for a sum of money.¹¹ As the condition of their accepting the bill, Pillans and Rose desired a confirmed credit upon a good house in London for their reimbursement. White named the house of the defendants, Van Mireop and Hopkins. Both White and the plaintiffs wrote to them asking whether they would agree with the arrangement, and the defendants did. However, when the plaintiffs drew on the defendants, they refused to honor the plaintiffs' bills, because White had become insolvent.

On trial, a verdict was found for the defendants. On appeal, the defendants first argued that their promise to the plaintiffs was a void undertaking as the consideration under the transaction was not appropriate. This argument was rejected by Lord Mansfield on the ground that the transaction was a commercial one. However, the respected judge at the same time observed that the defendants' refusal to honor payment could have been justified if fraud had been involved in the transaction, stating, "I was then of opinion, that Van Mierop and Hopkins were bound by their letter; unless there was some fraud upon them: for that they had engaged under their hands, in a mercantile action, 'to give credit for Pillans and Rose's reimbursement.'"¹²

Following Lord Mansfield's observation, the defendants added to their argument that "this transaction was fraudulently concealed, . . . both by White and the plaintiffs, from the defendants."¹³

¹⁰ JOHN F. DOLAN, *THE LAW OF LETTERS OF CREDIT: COMMERCIAL AND STANDBY CREDITS* ¶ 7.03[1] n.22 (rev. ed. 1996).

¹¹ 97 Eng. Rep. 1035 (1765).

¹² *Id.* at 1035-36.

¹³ *Id.* at 1037.

However, Lord Mansfield repudiated the defendants' supplementary argument and said:

If there was any kind of fraud in this transaction, the collusion and mala fides would have vacated the [the letter of 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 any thing from the defendants.¹⁴

Pillans was a case decided over two hundred years ago, at a time when the letter of credit was still in the early stages of development. It was mainly litigated and adjudicated as a case of contract, and the fraud rule was not explored in any detail. However, the case sent one clear message: fraudulent conduct would not be tolerated by the law of letters of credit. *Pillans* planted the seed of the fraud rule at a time when letters of credit were barely born.

4.2. *Fraud Cases in the Early 20th Century*

The earliest case in relation to letter of credit fraud in more recent times is the oft-mentioned *Higgins v. Steinhardter*,¹⁵ a 1919 U.S. case. In *Higgins*, a letter of credit was to be used to pay for a shipment of walnuts to be shipped on or before November 7, 1918. The plaintiff purchasers, brought an action to restrain the beneficiaries, the sellers, from collection, and the issuer, Monroe & Co, from payment of the moneys called for in the letter of credit, and for the cancellation of the credit, upon the ground that the beneficiaries/sellers had defaulted on the contract in that the walnuts were not shipped until December 1918. The plaintiffs further alleged that the sellers had procured the bill of lading falsely, stating that the shipment was made on October 30, 1918, and that the issuer, although notified of the said facts, had affirmed that upon presentation of drafts accompanied by facially conforming bills of lading

¹⁴ *Id.* at 1038.

¹⁵ 175 N.Y.S. 279 (1919).

it would accept and pay the same. The court granted the injunction saying:

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, canceled by limitation of time.¹⁶

During the litigation, the issuer argued that it might have become obliged to pay drafts drawn against the said credit in any event because of the transfer of such drafts to third parties. However, the court rejected the issuer's argument and stated:

[A]s before stated, plaintiffs authorized payment only on account of a shipment made by a certain date. If defendant Monroe & Co's agent accepted in proof of such shipment a bill of lading which was in fact false as to the time of shipment, then such act of defendants' agent is proximate cause of any risk of loss by the issuance of drafts against the said credit.¹⁷

Higgins was litigated and decided shortly after World War I, a time when letters of credit were developing into their modern form. In this case, the fact that the bill of lading was found to have been fraudulently predated could have been a clear ground for the plaintiffs' pleadings, but neither the plaintiffs nor the court pursued the case in accordance with the fraud rule.

Although the plaintiffs mentioned in their complaint that the bill of lading presented contained a false statement about the date of shipment, it seems that they did so merely as a matter of fact, not as a cause of action, since their main argument was that the sellers had defaulted on the contract; they did not sue the sellers for fraud. As for the court, although the factual basis for its decision was the sellers' fraudulent predating of the bill of lading, the court did not base its decision on the fraud rule, but justified its

¹⁶ *Id.* at 280 (citations omitted).

¹⁷ *Id.* For criticism of the decision, see Note, *Commercial Letters of Credit*, 21 COLUM. L. REV. 176, 179-81 (1921).

judgment on another legal basis: payment against a bill of lading with a false statement would be "unauthorized." When the court rejected the issuer's argument that it might have to pay innocent third parties involved, it ignored one important element of today's fraud rule: the protection of innocent third parties.

Because of the pleading and the reasoning of *Higgins*, it may be safe to say that the fraud rule in the law of letters of credit was so embryonic at that time in the United States that even people in financial centers like New York did not contemplate its relevance.¹⁸ Although it was clear enough that the discovery of fraud under the letter of credit transaction was not tolerable, neither the victim nor the court used the fraud rule to fight fraud. They found another route to meet that end.

Another case related to the development of the fraud rule in the early 20th Century is *Societe Metallurgique D'Aubrives & Villerupt v. British Bank for Foreign Trade*,¹⁹ an English case of 1922. In this case, the plaintiffs sold pig iron to a Mr. Ford, and payment was to be made by way of a letter of credit. The defendant/issuer paid the price of the first consignment but later, on instructions from the buyer, refused to pay on presentation of further documents, asserting that the pig iron was not of the quality contracted for. The sellers brought an action against the issuer, claiming damages for breach of contract. In defense the issuer added to its earlier assertion that the goods were not up to contracted quality, the argument that the documents presented were not in order. But Justice Bailhache of the King's Bench Division rejected both these arguments and gave judgment for the sellers. Considering quality of goods issue, the judge in dicta mentioned the issue of fraud and observed:

But 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 misdescribe the goods in such a way as to be guilty of fraud. If that

¹⁸ This case reveals, further, that the law of letters of credit as a whole was less developed at that time, in as much as the parties treated their dispute as a default of contract.

¹⁹ 11 Lloyd's List L. Rep. 168 (K.B. 1922).

were so, then the bank in refusing to pay would be justified. But nothing of that sort is suggested in this case.²⁰

Unlike *Higgins*, *Societe Metallurgique* was a case where fraud neither existed nor was alleged. The dispute in *Societe Metallurgique* was over whether goods were of the contracted quality and whether the documents presented were in order. However, the statement of Justice Bailhache indicates that the court might have been prepared to step in and interfere with the payment of the letter of credit had fraud been found to have been committed in the transaction. This was in agreement with the English position expressed by Lord Mansfield in *Pillans*. But what remains unclear is how the court would have formulated its judgment had fraud been found in the case: would its reasoning have been like that of the U.S. court in *Higgins* or would its judgment have been based on the fraud rule as we understand it today?

The view that fraud might disturb the normal payment of a letter of credit was echoed in at least two other U.S. cases in the 1920s. One is *Old Colony Trust Co. v. Lawyers' Title & Trust Co.*, where the plaintiffs had advanced large sums to a sugar seller and received a letter of credit issued by the defendant as security.²¹ The letter of credit required that drafts should be drawn only against "net landed weights," must be made prior to November 30, 1920, and must be accompanied by negotiable delivery orders or warehouse receipts. Net landed weight could be ascertained only after the goods had been landed and weighed by customs officials to determine the duty payable on the importation, and warehouse receipts could not be issued until the goods were in the actual possession of the warehouseman. All shipments did not, in fact, clear customs until December 3, 1920 at the earliest, but drafts accompanied by facially compliant documents were presented for payment prior to the expiration date of the letter of credit. The defendant refused to honor the drafts on the basis that the documents were not in conformity with the letter of credit. The plaintiffs sued to recover damages for the defendant's breach of contract, but the trial court rejected the claim.²² On appeal, the Second Circuit Court of Appeals affirmed the original judgment and noted:

²⁰ *Id.* at 170.

²¹ 297 F. 152 (2d Cir. 1924).

²² *Id.* at 153.

The invoices in triplicate presented with the drafts each stated so many lbs. "net at 20¼c. net landed weights duty paid New York."

As this statement was false, there was failure of compliance with the letter of credit. . . .

....

Obviously, when the issuer of a letter of credit knows that a document, although correct in form, is, in point of fact, false or illegal, he cannot be called upon to recognize such a document as complying with the terms of a letter of credit.²³

The case of *Old Colony* is similar to *Higgins* in many ways. In both cases, there were fraudulent documents, the parties litigated on the basis of breach of contract, and the courts allowed interruption of payment under letters of credit because of fraud. The major distinction is that the courts based their judgments on different grounds: the court in *Higgins* reasoned that payment against a fraudulent bill of lading would be "unauthorized"; the court of *Old Colony* grounded its judgment on the basis that fraudulent documents could not be considered as complying documents. However, neither of the courts used the fraud rule as an independent weapon for fighting fraud.

Another case is *Maurice O'Meara Co. v. National Park Bank*, in which the underlying contract was for the sale of newsprint paper of a specified tensile strength.²⁴ When the plaintiff presented facially regular documents and required payment against the letter of credit, the defendant bank, the issuer, refused to pay the drafts, claiming that "[t]here has arisen a reasonable doubt regarding the quality of the newsprint paper."²⁵ The plaintiff, the beneficiary,

²³ *Id.* at 156, 158.

²⁴ 146 N.E. 636 (N.Y. 1925) (McLaughlin, J.) (Cardozo & Crane, JJ., dissenting). For special comments on the case, see Recent Decisions, *Banks and Banking – Letters of Credit – Defences Available to Bank*, 25 COLUM. L. REV. 829 (1925); Comment, *The Rights of the Seller Under a Documentary Letter of Credit*, 34 YALE L.J. 775, 777 (1925); and Note, *Banks and Banking – Letters of Credit – Issuing Bank's Liability*, 9 MINN. L. REV. 657, 659 (1925).

²⁵ *Maurice O'Meara Co.*, 146 N.E. at 639.

brought the action against the issuer for damages sustained by its assignor from the issuer's refusal to honor the letter of credit. The issuer defended against the beneficiary's action on the ground that the quality of the paper fell far short of that required. The majority judgment of the Court of Appeals of New York rejected the issuing bank's defense and said:

The bank was concerned only in the drafts and the documents accompanying them. . . . If the drafts, when presented, were accompanied by the proper documents, then it was absolutely bound to make the payment under the letter of credit, irrespective of whether it knew, or had reason to believe, that the paper was not of the tensile strength contracted for.

. . . .

To hold otherwise is to read into the letter of credit something which is not there, and this the court ought not to do, since it would impose upon a bank a duty which in many cases would defeat the primary purpose of such letters of credit.²⁶

However, Justice Cardozo disagreed with the majority judgment. After affirming the general rule that the issuing bank had no duty to investigate the performance of the underlying contract, the respected judge observed:

I dissent from the view that, if [the bank] chooses to investigate and discovers thereby that the merchandise tendered is not in truth the merchandise which the documents describe, it may be forced by the delinquent seller to make payment of the price irrespective of its knowledge. We are to bear in mind that this controversy is not one between the bank on the one side and on the other a holder of the drafts who has taken them without notice and for value. The controversy arises between the bank and a seller who has mis-

²⁶ *Id.*

represented 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.²⁷

Compared with the cases so far discussed, the reasoning of *Maurice O'Meara* is much more sophisticated, and the effect of it is more significant for the development of the fraud rule. First, in his dissenting judgment, Justice Cardozo was not only of the view that "payment may be resisted if the documents are false" under a letter of credit arrangement, but also considered the interest of innocent third parties, or "a holder of the drafts who has taken them without notice and for value," and the issuer's security interest in the goods represented by the documents.²⁸ Second, *Maurice O'Meara* was both litigated and decided on the basis of the law of letters of credit, and not, as with other cases, handled as a case of contract. Finally, looking at the majority opinion and the dissenting opinion of Justice Cardozo together, the reasoning of *Maurice O'Meara* is very similar to the reasoning of a modern letter of credit fraud case, where the court normally first emphasizes the significance of the principle of independence and then sets forth the elements of the fraud rule and applies them.

²⁷ *Id.* at 641. For a criticism of the dissenting view, see *Rights of the Seller*, *supra* note 24, at 781. *But cf. Banks and Banking*, *supra* note 24, at 658 (arguing that "under certain circumstances the term of the sales contract may be relied on by the bank to limit or avoid its liability").

²⁸ *Id.*

4.3. Commentary

The phenomenon of fraud is "timeless and universal."²⁹ So are efforts for the control of fraud. Therefore, the issue of the fraud rule in the law of letters of credit was raised as early as the 1760s. However, as this short survey of cases has revealed, the fraud rule was not well developed even by the 1920s, as is illustrated by the fact that none of the cases surveyed was pleaded or adjudicated according to the fraud rule. It appears that parties were not aware of the fraud rule or accustomed to using it to advance their cases at that time. This, in particular, is shown by the cases of *Higgins* and *Old Colony*.

Nonetheless, one point is clear enough in all of the cases, if only through dicta: the documents tendered by the beneficiary under a letter of credit had to be both genuine and honest, and the issuer accordingly could not be forced to take documents that it knew to be false or fraudulent. Or, in the words of Finkelstein: "At any rate, the legal principle is clear. Where the bank can show that the seller has acted fraudulently, it is under no duty to pay the seller."³⁰ Combining this basic point with the elements listed in Justice Cardozo's dissenting judgment in *Maurice O'Meara*, it might safely be submitted that almost all the bricks and mortar for the building of the fraud rule were assembled by the time of the decision of *Maurice O'Meara*: all that was needed was a case like *Sztejn v. J. Henry Schroder Banking Corp.* to help to build the structure.³¹

5. THE CATALYST — THE SZTEJN CASE

Sztejn is the landmark case in the course of the development of the fraud rule in the law of letters of credit. It has not only been codified in the Uniform Commercial Code ("U.C.C.") and followed by nearly all subsequent letter of credit fraud cases in the United States, but it has also been cited with approval or followed throughout the common law world. Because of its significance, special treatment of the case is warranted.

²⁹ L. H. LEIGH, *THE CONTROL OF COMMERCIAL FRAUD* 3 (1982).

³⁰ HERMAN N. FINKELSTEIN, *LEGAL ASPECTS OF COMMERCIAL LETTERS OF CREDIT* 248 (1930).

³¹ 31 N.Y.S.2d 631 (Special Term 1941).

5.1. *The Facts*

Sztejn contracted to buy bristles from Transea Traders Ltd., an Indian company. In order to pay for the goods, Sztejn asked Schroder to issue a letter of credit in favor of Transea. Transea placed fifty cases of material on board a steamship, procured the documents required by the letter of credit, and drew a draft to the order of Chartered Bank, which presented the draft to Schroder for payment along with the required documents. Before payment had been made, Sztejn filed a suit for a judgment declaring the letter of credit and draft thereunder void and for injunctive relief to prevent the issuer from paying the draft, alleging that the beneficiary had, in fact, "filled the fifty crates with cowhair, other worthless material and rubbish with intent to simulate genuine merchandise and defraud the plaintiff . . ."³² The plaintiff also averred that the presenting bank was merely a collecting bank for Transea, not an innocent holder of the draft for value. The presenting bank moved to dismiss the complaint on the ground that it failed to state a cause of action because "the Chartered Bank is only concerned with the documents and on their face these conform to the requirements of the letter of credit."³³

5.2. *The Judgment*

For the purpose of hearing the motion, Justice Shientag assumed that all allegations in the complaint were true, namely, that "Transea was engaged in a scheme to defraud the plaintiff . . . , that the merchandise shipped by Transea is worthless rubbish and that the 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."³⁴

Based on the "established" fact that fraud had been committed in the transaction, the Court bluntly rejected the Chartered Bank's motion to dismiss the plaintiff's complaint and ruled for the plaintiff. In reaching his decision, Justice Shientag first acknowledged the importance of the principle of independence in the law of letters of credit, stating:

³² *Id.* at 633.

³³ *Id.* at 632.

³⁴ *Id.* at 633.

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. One of the chief purposes of the letter of credit is to furnish the seller with a ready means of obtaining prompt payment for his merchandise. It would be a most unfortunate interference with business transactions if a bank before honoring drafts drawn upon it was obliged or even allowed to go behind the documents, at the request of the buyer and enter into controversies between the buyer and the seller regarding the quality of the merchandise shipped.³⁵

The judge then succinctly laid down the reasons for deciding in a way that might have seemed contrary to this principle by saying:

Of course, the application of [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 action. 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 has been called to the bank's attention before the drafts and documents have been presented for payment, *the principle of the independence of the bank's obligation under the letter of credit should not be extended to protect the unscrupulous seller. . . .*

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

³⁵ *Id.*

been brought to my attention on this point involving an intentional fraud on the part of the seller which was brought to the bank's notice with the request that it withhold payment of the draft on this account.³⁶

In what has come to be a highly regarded judgment, Justice Shientag not only established the basis upon which the payment under the letter of credit in the case should be stopped, but also weighed the interests of the other parties involved in the case: the issuing bank and the presenting bank. He recognized that the fraudulent actions of the seller might also work to the detriment of the issuing bank's security interest. To this later point, he stated:

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.³⁷

As for the position of the presenting bank, the Chartered Bank, Justice Shientag observed:

No hardship will be caused by permitting the bank to refuse payment where fraud is claimed, where the merchandise is not merely inferior in quality but consists of worthless rubbish, *where the draft and the accompanying documents are in the hands of one who stands in the same position as the fraudulent seller*, where the bank has been given notice of the fraud before being presented with the drafts and documents for payment, and where the bank itself does not wish to pay pending an adjudication of the rights and obligations of the other parties. . . .

³⁶ *Id.* at 634-35 (emphasis added) (citations omitted).

³⁷ *Id.* at 635.

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.*³⁸

5.3. Commentary

When *Sztejn* is compared with the other cases previously discussed, it is not surprising that the case is universally regarded as the seminal case in the development of the fraud rule. *Sztejn* is a case not only where the facts are typical, but also where the pleadings and the judgment provide clear guidance for future cases involving letter of credit fraud. Unlike earlier cases, *Sztejn* was both pleaded and decided on the principles of the law of letters of credit, not the law of contracts. *Sztejn* shows how a frustrated applicant who has been defrauded by a dishonest beneficiary can rely on the fraud rule to protect its interest.

More importantly, *Sztejn* was the first case to enunciate the major elements of the fraud rule. It declared three principles of paramount importance. First, payment under a letter of credit may only be interrupted in a case of fraud; mere allegation of breach of warranty cannot be an excuse for such an interruption. Second, payment under a letter of credit can only be interrupted when fraud is proven or established; mere allegation of fraud should not be an excuse for such an interruption. Third, payment should be made in accordance with the terms of the credit, notwithstanding the existence of the proven fraud, if a holder in due course or a presenter with similar status makes demand for payment.³⁹

However, it should be noted that because *Sztejn* involved a motion to dismiss the complaint and all allegations of the complaint were assumed to be true, entire issues such as the extent and onus

³⁸ *Id.* (emphasis added) (citations omitted).

³⁹ *Id.* at 634-35.

of proof and the standard or degree of fraud in the application of the fraud rule were avoided. Those untouched issues comprise the limits of the case and have reverberated throughout the subsequent development of the fraud rule both in and outside the United States.

6. THE FRAUD RULE IN THE UNITED STATES

The fraud rule laid down in *Sztejn* has been codified in Article 5 of the U.C.C., so the relevant provisions of Article 5 of the U.C.C. ought to be considered first whenever the current fraud rule in the United States is examined.

6.1. *The Previous Version of Article 5*

In the previous (initial) version of U.C.C. Article 5, the fraud rule was embodied in Section 5-114(2), which read:

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.⁴⁰

Section 5-114(2) was basically a restatement of the spirit of *Sztejn*, but, from the viewpoint of the development of the fraud rule, codifying the fraud rule in the U.C.C. was far more significant in several respects than the decision in *Sztejn* would have been by itself.

In the first place, the U.C.C. *in a statute* clearly told victims of letter of credit fraud that they could effectively protect their interest by using the weapon of the fraud rule. They no longer had to structure their cases using other principles, such as the law of contracts (as in the case of *Higgins*), or by saying that the documents were non-conforming (as in the case of *Old Colony*).

Second, Section 5-114(2)(b) indicated that the fraud rule could be applied in two settings, something not shown in early cases, including *Sztejn*: (1) a court of competent jurisdiction could enjoin an issuer from honoring a letter of credit if "documents appear on their face to comply with the terms of a credit but a required document . . . is forged . . . or there is fraud in the transaction;" and (2) the issuer could ("may") voluntarily invoke the fraud rule and refuse to honor a draft or demand for payment if fraud as above was brought to its attention.⁴¹

⁴⁰ U.C.C. § 5-114(2) (1952) (prior to 1995 revision). Prior U.C.C. Article 5, Sections 114(1) and 114(3), emphasized the principle of independence and the issuer's entitlement for reimbursement after honor, reading, respectively:

(1) An issuer must honor a draft or demand for payment which complies with the terms of the relevant credit regardless of whether the goods or documents conform to the underlying contract for sale or other contract between the customer and the beneficiary. The issuer is not excused from honor of such a draft or demand by reason of an additional general term that all documents must be satisfactory to the issuer, but an issuer may require that specified documents must be satisfactory to it.

(3) Unless otherwise agreed an issuer which has duly honored a draft or demand for payment is entitled to immediate reimbursement of any payment made under the credit and to be put in effectively available funds not later than the day before maturity of any acceptance made under the credit.

⁴¹ *Id.* sec. (2)(a), cmt. 2. But the issuer is not obliged to do so. For a succinct summary of the reasons, see Wolfgang Freiherr von Marschall, *Recent Developments in the Fields of Standby Letters of Credit, Bank Guarantees and Performance Bonds*, in CURRENT PROBLEMS OF INTERNATIONAL TRADE FINANCING 260, 275-82 (C. M. Chinkin ed., 1983). In practice, banks are more likely to pay than to refuse to

Third, this codification, notwithstanding its modest form, played a very important role in the harmonization and unification of the fraud rule in the law of letters of credit. After promulgation, Section 5-114(2) was cited and utilized by courts and letter of credit users in the United States on a regular basis, served as a good uniform guideline to parties dealing with letter of credit fraud disputes, and in many areas unified earlier divergent practices.

Finally, as a result of codifying the case law into a statute, the position of the fraud rule was strengthened in the law of letters of credit. The promulgation of Section 5-114(2) has greatly fostered study of the fraud rule, a fact illustrated by a greatly increased volume of case law on letter of credit fraud⁴² and by much more commentary on the fraud rule worldwide.⁴³ In fact, it may be that its influence has been even greater in civil law countries than in common law countries, as civil law countries normally look to statutes rather than cases in seeking sources of law.⁴⁴

pay because doing the latter may damage their biggest asset—reputation. In many cases they even oppose applicants' applications for injunction, because "by obtaining an injunction restraining the bank from honouring that undertaking, he [the applicant] will undermine what is the bank's greatest asset, however large and rich it may be, namely its reputation for financial and contractual probity." *Bolivinter Oil S.A. v. Chase Manhattan Bank*, 1 Lloyd's Rep. 251, 257 (C.A. 1984) (Sir John Donaldson, M.R.).

⁴² A good source for case law with respect to the development of the fraud rule is the annual survey for letter of credit cases published by the Institute of International Banking Law and Practice. See, e.g., INSTITUTE OF INTERNATIONAL BANKING LAW & PRACTICE, INC., ANNUAL SURVEY OF LETTER OF CREDIT LAW AND PRACTICE (James E. Byrne ed., 1996). These surveys, compiled by U.S. letters of credit experts, are about letters of credit cases handed down in the previous year by U.S. courts. They include not only the number of cases decided, but also discuss different types of cases and provide brief comments on the cases.

⁴³ A great deal has been written about the fraud rule since the promulgation of Article 5 of the U.C.C. There is too much written work to be listed here. According to Professor Byrne, the treatment of fraud in Article 5 of the U.C.C. interested the letter of credit community worldwide although the Article itself as a whole failed to do so. James E. Byrne, *The Revision of U.C.C. Article 5: A Strategy for Success*, 56 BROOK. L. REV. 13, 16 (1990). As noted in Robert S. Rendell, *Fraud and Injunctive Relief*, 56 BROOK. L. REV. 111, 117 (1990), "The fraud doctrine as embodied in U.C.C. Section 5-114(2) is one of the most important provisions in article 5."

⁴⁴ For example, in China, the whole U.C.C. has been translated into Chinese, and many people in the legal profession regard it as a good reference for modern commercial law. But relatively few foreign cases have been translated into Chinese. There are at least three reasons for this: (1) China is a civil law country, where cases are not regarded as law, so people in China naturally think much less of cases than of statutes; (2) the sheer volume of case law mitigates against transla-

Nonetheless, the previous version of Article 5 was drafted more than forty years ago, and as a basis for future development.⁴⁵ The provisions of Section 5-114(2) were not entirely faultless, and in some cases even led to confusion among courts and letter of credit users. For example, Section 5-114(2) failed to mention what constituted fraud under the fraud rule, so different standards of fraud were subsequently applied in different cases. Further, Section 5-114(2) provided that the fraud rule should be applied "when . . . a required document . . . is forged or fraudulent" or when "there is fraud in the transaction. . . ." Separating these two issues led to unnecessary confusion about where fraud needed to be located. In addition, Section 5-114(2) named three types of parties that might be immune from the fraud rule: (a) a "holder in due course" stipulated in Section 3-302 of the U.C.C.; (b) a holder of a document of title duly negotiated according to Section 7-502 of the U.C.C.; and (c) a "bona fide purchaser of a certificated security" under Section 8-302 of the U.C.C. In fact, only the type of parties named in (a), a "holder in due course," has proven to be relevant to the application of the fraud rule.⁴⁶

6.2. Revised U.C.C. Article 5

Along with the whole of Article 5, Section 5-114(2) was thoroughly revised in 1995 to cure the "weaknesses, gaps, and errors in the original statute which compromise its relevance"⁴⁷ and to meet

tion; and (3) learning an area of foreign law from scattered cases is technically much more difficult than studying a statute.

⁴⁵ See U.C.C. § 5-101 cmt. (1952) (prior to 1995 revision) (stating that the article is intended "to set an independent theoretical frame for the further development of letters of credit"); Note, *Letters of Credit: Injunction as a Remedy for Fraud in U.C.C. Section 5-114*, 63 MINN. L. REV. 487, 493 n.27 (1979) (noting the drafters of the article "felt that no statute could effectively or wisely codify the law of letters of credit without hampering development of the device").

⁴⁶ According to the investigation of the Task Force formed for the revision of Article 5: "There are no cases applying U.C.C. Articles 7 or 8 in the context of Section 5-114." Task Force on the Study of U.C.C. Article 5, *An Examination of U.C.C. Article 5 (Letters of Credit)*, 45 BUS. LAW 1521, 1621 (1990) [hereinafter Task Force Report]. For a discussion about Section 7-507 of the U.C.C. under the context of Section 5-114(2), see Kerry L. Macintosh, *Letters of Credit: Dishonor When a Required Document Fails to Conform to the Section 7-507(b) Warranty*, 6 J.L. & COM. 1, 1-2 (1986) (arguing that a required document's "failure . . . to conform to any one of the three transfer warranties . . . justifies dishonor").

⁴⁷ Task Force Report, *supra* note 46, at 1532.

the challenges of the constant development of letters of credit.⁴⁸ The fraud rule is now embodied in Article 5, Section 5-109, which reads:

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

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

(2) the issuer, acting in good faith, may honor or dishonor the presentation in any other case.

(b) If an applicant claims that a required document is forged or materially fraudulent or that honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant, a court of competent jurisdiction may temporarily or permanently enjoin the issuer from

⁴⁸ Articles of the U.C.C. are revised by a drafting committee specifically appointed for the task by the two sponsoring organizations of the U.C.C.: the National Conference of Commissioners of Uniform State Laws and the American Law Institute. For a list of the jurisdictions that have adopted Revised Article 5, see National Conference of Commissioners on Uniform State Laws, *A Few Facts about the UCC Article 5—Letters of Credit*, at http://www.nccusl.org/nccusl/uniformact_factsheets/uniformacts-fs-ucca5.asp (last visited Oct. 30, 2002); and Legal Information Institute, *Uniform Commercial Code Locator, Article 5: Letters of Credit*, at <http://www.law.cornell.edu/uniform/ucc.html#a5> (last visited Oct. 30, 2002).

honoring a presentation or grant similar relief against the issuer or other persons only if the court finds that:

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

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

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

(4) on the basis of the information submitted to the court, the applicant is more likely than not to succeed under its claim of forgery or material fraud and the person demanding honor does not qualify for protection under subsection (a)(1).⁴⁹

Compared with the previous version of Article 5, Section 5-114(2), Revised U.C.C. Article 5, Section 5-109, has fine-tuned the fraud rule in a number of areas.⁵⁰ First, Section 5-109 has expressly declared that, when fraud is found, the normal operation of a letter of credit may be disrupted in two different ways: by the issuer's refusing to honor a presentation,⁵¹ or by the applicant's asking a court to enjoin the payment or presentation.⁵² Second, Section 5-109 has tackled one of the most controversial issues raised in the application the fraud rule since the promulgation of the previous,

⁴⁹ U.C.C. § 5-109 (1952) (revised 1995).

⁵⁰ The text of Section 5-109 also demonstrates how succinctly most of the common law restrictions on the issuance of injunctions can be expressed in codified form. *Id.*

⁵¹ *Id.* § 5-109(a)(2) (1952) (revised 1995); U.C.C. § 5-109 cmt. 2 (1952) (revised 1995).

⁵² U.C.C. § 5-109(b) (1952) (revised 1995). There is no obligation upon the issuer to refuse to honor a letter of credit simply at the request of the applicant. The applicant's primary remedy is to seek an injunction restraining honors by the issuer, as their potential liability for wrongful dishonor will presumably make most issuers rather keen to honor a letter of credit unless restrained by a court.

initial version of U.C.C. Article 5: the standard of fraud. Section 5-109 provides that, to invoke the fraud rule, the fraud involved has to be "material." Third, Section 5-109(a)(1) lists four types of parties who may be immune from the fraud rule:

(i) a nominated person who has given value in good faith and without notice of the fraud;⁵³

(ii) a confirmer who has honoured its confirmation in good faith;⁵⁴

(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;⁵⁵ 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.⁵⁶

Unlike the previous version of Section 5-114(2), which named three groups of parties who should be protected under the fraud rule, only one of which proved to be relevant, all four groups named under Revised U.C.C. Article 5, Section 5-109 are relevant to the fraud rule, a great improvement.

⁵³ *Id.* § 5-109(a)(1)(i).

⁵⁴ *Id.* § 5-109(a)(1)(ii).

⁵⁵ *Id.* § 5-109(a)(1)(iii). It should be noted that the requirements specified in Revised U.C.C. Article 5 to render a holder in due course immune from the fraud rule are different from those mentioned in Prior U.C.C. Article 5. While a holder in due course under Prior U.C.C. Article 5 might be a negotiating bank or any other holder of a draft or demand who could meet the requirements for a holder in due course stipulated in Section 3-302 of the U.C.C., a holder in due course under Revised U.C.C. Article 5 should be a holder of a draft taken after acceptance by the issuer or nominated person. Compared with Prior U.C.C. Article 5, Revised U.C.C. Article 5 has narrowed the scope of immunity for parties who are holders in due course. In other words, to be entitled to the immunity two conditions have to be met: (1) the party must qualify as a holder in due course under the terms set forth in Article 3 of the U.C.C.; and (2) the draft must have been accepted by the issuer or nominated person.

⁵⁶ *Id.* § 5-109(a)(1)(iv).

Finally, Section 5-109(b) has specified four conditions that must be met when a court considers an injunction. They are intended to reduce the frequency with which the fraud rule has been used since the late 1970s and signal that the "standard for injunctive relief is high" under Revised U.C.C. Article 5.⁵⁷ Revised U.C.C. Article 5, Section 5-109 now stands as the most comprehensive code of the fraud rule in the law of letters of credit in the common law world.

7. THE FRAUD RULE IN OTHER JURISDICTIONS

The fraud rule has been recognized and upheld in most jurisdictions, generally with explicit reference to, and adoption of, the U.S. decision in *Sztejn*. The approach of the courts of the United Kingdom, Canada, and Australia towards the fraud rule will be considered.

7.1. United Kingdom

The most well-known English case on the fraud rule is *United City Merchants (Investments) Ltd. v. Royal Bank of Canada*, where payment of a letter of credit was refused when the bill of lading presented had been fraudulently pre-dated by a third party.⁵⁸ The beneficiary sued for wrongful refusal to honor the letter of credit. Before considering the issue of third-party fraud, Lord Diplock stated:

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 the

⁵⁷ U.C.C. § 5-109 cmt. 4 (1952) (revised 1995).

⁵⁸ 1 Lloyd's Rep. 267 (Q.B. 1979) (Mocatta, J.) (holding there was not sufficient evidence of fraud); *aff'd* 1 Lloyd's Rep. 604 (Eng. C.A. 1981) (holding that beneficiaries were innocent of a third party's fraud); *aff'd* 1983 A.C. 168 (H.L. 1982) (Lord Diplock) (emphasizing that a beneficiary is not liable for fraud perpetrated by third parties).

American cases of which the leading or "landmark" case is *Sztejn v. J. Henry Schroder Banking Corporation*.⁵⁹

As this quotation shows,⁶⁰ *Sztejn* is the "foundation stone of English law in this area . . ." ⁶¹ However, although the fraud rule is recognized in the United Kingdom, it has not often been applied. The English courts have traditionally been very reluctant to interfere with the operation of a letter of credit and have adopted a relatively inflexible and narrow approach towards the application of the fraud rule. The well-known statement of Lord Justice Jenkins in *Hamzeh Malas & Sons v. British Imex Industries Ltd.* explains the reason:

[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.⁶²

Sticking to the general non-interference approach, English courts have saddled plaintiffs with a great burden of proof, requir-

⁵⁹ 1983 A.C. 168, 183 (H.L. 1982) (Lord Diplock).

⁶⁰ The other oft-cited passage in this regard is from Lord Justice Denning in *Edward Owen Engineering Ltd. v. Barclays Bank International Ltd.*, 1 All E.R. 976, 981 (C.A. 1977), where he said: "To this general principle [of independence] there is an exception in the case of what is called established or obvious fraud to the knowledge of the bank. The most illuminating case is of *Sztejn v. J Henry Schroder Banking Corp.* . . ."

⁶¹ RAYMOND JACK ET AL., *DOCUMENTARY CREDITS* 260 (3d ed. 2001).

⁶² 2 Q.B. 127, 129 (1958).

ing them to establish the existence of "clear" or "obvious" fraud known to the issuer in order to invoke the fraud rule.⁶³

The difficulty of meeting this high standard of proof in the English courts is well demonstrated by the first English case to cite *Sztejn* with approval: *Discount Records Ltd. v. Barclays Bank Ltd.*⁶⁴ In that case, the plaintiff, an English buyer, contracted with a French company, Promodisc, to buy 8625 discs and 825 cassettes. The buyer instructed the defendant to issue a documentary credit in favor of the seller. The seller shipped goods purporting to be those ordered, and presented the draft with documents regular on their face to the confirming bank in Paris, which the bank accepted.⁶⁵

When the goods arrived, the buyer inspected the goods *in the presence of a representative* of the issuer. The inspection revealed that:

[T]here were 94 cartons, but of these two were empty, five were filled with rubbish or packing, twenty-five of the records boxes and three of the cassette boxes were only partly filled, and two boxes labelled as cassettes were filled with records; instead of 825 cassettes, as ordered, there were only 518 cassettes and 25 cartridges. Out of the 518 cassettes delivered, 75 percent were not as ordered . . . out of the 8,625 records ordered, only 275 were delivered as per order. The rest were not as ordered and were either rejects or unsaleable.⁶⁶

⁶³ In *R D Harbottle (Mercantile) Ltd. v. National Westminster Bank Ltd.*, 2 All E.R. 862, 870 (Q.B. 1977), Judge Kerr states:

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. (emphasis added).

⁶⁴ 1 All E.R. 1071 (Ch. 1974).

⁶⁵ *Id.* at 1072-73.

⁶⁶ *Id.* at 1073.

Relying upon *Sztejn*, the buyer attempted to enjoin the issuer from honoring the seller's drafts drawn upon the letter of credit, alleging that the seller was guilty of fraud. Judge Megarry of the Chancery Division rejected the buyer's claim, distinguished the case from *Sztejn*, and said:

[I]t is important to notice that in the *Sztejn* case the proceedings consisted of a motion to dismiss the formal complaint on the ground that it disclosed no cause of action. That being so, the court had to assume that the facts stated in the complaint were true. The complaint alleged fraud, and so the court was dealing with a case of established fraud. In the present case *there is, of course, no established fraud, but merely an allegation of fraud.* The defendants, who were not concerned with that matter, have understandably adduced no evidence on the issue of fraud. Indeed, it seems unlikely that any action to which Promodisc was not a party would contain the evidence required to resolve this issue. Accordingly, the matter has to be dealt with on the footing that this is a case in which fraud is alleged but has not been established.⁶⁷

In this case, the buyer obtained its evidence in the presence of a third party, the issuer, showing that a great proportion of the shipment was either rubbish or empty cartons. It was striking to hear that the court found there was "no established fraud, but merely an allegation of fraud."⁶⁸ With this approach, obtaining an injunction to prevent the payment of a letter of credit is practically impossible in most cases in England, despite English courts' claims that they "will not allow their process to be used by a dishonest person to carry out a fraud."⁶⁹

However, some of the more recent decisions have indicated that the English courts might have started to move away from this rigid non-interference approach. In *Themehelp Ltd. v. West*,⁷⁰ the plaintiffs agreed to purchase the defendants' share capital in a

⁶⁷ *Id.* at 1074 (citations omitted) (emphasis added).

⁶⁸ *Id.*

⁶⁹ *United City Merchs. (Invs.), Ltd. v. Royal Bank of Can.*, 1983 A.C. 168, 184 (1982).

⁷⁰ 4 All E.R. 215 (C.A. 1995).

company which owned the trading assets of Shinecrest, whose main business activity was the manufacture of stands for television sets. The purchase price was negotiated on the basis of profit projections prepared on an assumption that demand from a major customer of the business, Sony, would continue. Part of the purchase price was payable upon completion of the contract, and the balance by subsequent installments at stipulated dates. The third (and the largest) installment was secured by a performance guarantee (which, for these purposes, is the legal equivalent of a letter of credit).

After the first two installments had been paid, the plaintiffs "started proceedings for rescission of the contract and damages on the ground of alleged fraudulent misrepresentation by" the defendants.⁷¹ The buyers claimed that the sellers had concealed important information about the business, having "become aware by the date of execution of the agreement that there was no longer any basis" for the assumption used for calculating the purchase price, because Sony "had decided to order all future supplies . . . from a competitor of the sellers."⁷² In the proceedings, the buyers applied for an injunction "to restrain the sellers from giving notice to the guarantors [to enforce the guarantee] until the trial . . ."⁷³ The injunction was granted on the ground that "the evidence was sufficient to raise a seriously arguable case at trial that the *only reasonable inference* which could be drawn from the circumstances was that the sellers were fraudulent."⁷⁴ The Court of Appeals affirmed the sellers' appeal.⁷⁵

⁷¹ *Id.* at 218.

⁷² *Id.*

⁷³ *Id.*

⁷⁴ *Id.* (emphasis added). It should be noted that it was also stated that this "case was exceptional, in that here the relief was sought at an earlier stage—that is to say a restraint against the beneficiary alone in proceedings to which the guarantor is not a party, to prevent the exercise by the beneficiary of his power to enforce the guarantee . . ." *Id.* at 225. A similar approach was once also suggested in an earlier case, *United Trading Corp. v. Allied Arab Bank Ltd.*, 2 Lloyd's Rep. 554, 561 (C.A. 1984), where Lord Justice Ackner of the Court of Appeal stated:

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. . . . 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.

⁷⁵ The affirmation was given by two to one: Lord Justice Waite delivered the judgment, Lord Justice Balcombe agreed, and Lord Justice Evans dissented. For a

None of the limited number of English cases where the fraud rule has been applied involved actions brought by the applicant against the bank. They are cases involving either actions against the bank's refusal to honor a letter of credit, such as *Banco Santander SA v. Bayfern Ltd.*,⁷⁶ or actions against the beneficiary's demand for payment, such as *Themehelp*.⁷⁷ Hence it appears that English courts have taken a different approach in cases where the applicant takes an action against the issuer for an injunction preventing it from honoring a letter of credit from cases where the beneficiary takes an action against the issuer for wrongful refusal to honor a letter of credit, or cases where the applicant takes an action against the beneficiary to prevent it from demanding payment. This seems to have been implied by Judge Megarry in *Discount Records* when he said, "The defendants [the issuers], who were not concerned with that matter, have understandably adduced no evidence on the issue of fraud. Indeed, it seems unlikely that any action to which Promodisc [the beneficiary] was not a party would contain the evidence required to resolve this issue,"⁷⁸ and also to have been supported by some commentators. For example, Professor Goode has commented:

A distinction must be drawn between the evidence required to obtain an interlocutory injunction and the evidence necessary to entitle a bank that has refused to pay to justify its refusal in proceedings against it. In the latter case . . . all that the bank has to show at the trial is that on a balance of probabilities the beneficiary was guilty of fraud. In proceedings against the bank for an injunction, either the fraud must be established or the evidence of it must be compelling.⁷⁹

special comment on the case, see Anthony Pugh-Thomas, *Letters of Credit – Injunctions – The Purist and the Pragmatist: Can a Buyer Bypass the Guarantor and Stop the Seller from Demanding Payment from the Guarantor?*, 11 J. INT'L BANKING L. 210 (1996).

⁷⁶ 2 All E.R. 18 (1999 Q.B.), *aff'd*, 1 All E.R. 776 (C.A. 2000).

⁷⁷ *Themehelp Ltd. v. West*, 4 All E.R. 215 (C.A. 1995).

⁷⁸ *Discount Records Ltd. v. Barclays Bank Ltd.*, 1 All E.R. 1071, 1074 (Ch. 1974).

⁷⁹ Roy M. Goode, *Reflections on Letters of Credit – I*, 1980 J. BUS. L. 291, 294.

However, since the number of cases in which the fraud rule has been applied is very small, it is too early to make such a conclusion definitively.

It seems that no such distinction has been made in the United States. This can be inferred from Official Comment 5 on Revised U.C.C. Article 5, Section 5-109:

Although the statute deals principally with injunctions against honor, it also cautions against granting "similar relief" and the same principles apply when the applicant or issuer attempts to achieve the same legal outcome by injunction against presentation . . . interpleader, declaratory judgment, or attachment.⁸⁰

7.2. Canada

In Canada, as in the U.K., *Sztejn*⁸¹ is regarded as the foundational case in this area.⁸² In applying the fraud rule, the earlier cases also followed the English line set out in *Edward Owen*⁸³ in requiring a clear and obvious fraud to invoke the fraud rule. In *Aspen Planners Ltd. v. Commerce Masonry & Forming Ltd.*,⁸⁴ the plaintiff and the defendant entered into a contract to erect a building for the plaintiff. Payment was to be made by installments through a standby letter of credit on the account of the plaintiff against certificates of entitlement presented by the defendant. When partially completed, the building collapsed. The plaintiff claimed damages for breach of the building contract by the defendant, and sought a declaration that the defendant was "not entitled to deliver further certificates to obtain payment . . . under the letters of credit and

⁸⁰ U.C.C., § 5-109, official cmt. 5 (1952) (revised 1995).

⁸¹ *Sztejn v. J. Henry Schroder Banking Corp.*, 31 N.Y.S.2d 631 (Special Term 1941).

⁸² In the leading Canadian case on the fraud rule, *Bank of Nova Scotia v. Angelica-Whitewear Ltd.*, [1987] D.L.R.4th 161, 177, Justice Le Dain of the Supreme Court of Canada stated: "I think it is preferable, in the interests of the uniformity that is so important in this area of the law, that we should follow the rule that was affirmed in *Sztejn* . . ." *Id.* at 177.

⁸³ *Edward Owen Eng'g Ltd. v. Barclays Bank Int'l Ltd.*, 1 All E.R. 976, 981 (C.A. 1977).

⁸⁴ [1979] D.L.R.3d 546 (1979).

should be enjoined from doing so, and that the bank should be enjoined from making further payments to the" defendant.⁸⁵

No fraud was alleged in the case. But in dismissing the plaintiff's request for injunction, Judge Henry of the Ontario High Court of Justice started his judgment by saying that "[t]he law respecting . . . letters of credit has been developed principally in the United Kingdom and is well settled."⁸⁶ He then quoted heavily from the English case of *Edward Owen* and decided that only "what is called established or obvious fraud to the knowledge of the bank"⁸⁷ in the transaction could justify an injunction for the payment of a letter of credit.

However, many of the Canadian courts have been less hesitant to apply the fraud rule. They "have on the whole adopted the test of a strong prima facie case of fraud"⁸⁸ as applied by Judge Galligan in *C.D.N. Research & Developments Ltd. v. Bank of Nova Scotia*.⁸⁹ In *C.D.N. Research & Development*, the plaintiff contracted to sell to the Ministry of War of Iran five fire-fighting vehicles. Two letters of credit were issued by the defendant in favor of the Ministry. One of them was issued as a delivery guarantee. Long after the delivery was effected, a demand for payment under the letter of credit was made. The plaintiff moved to enjoin the issuer/defendant from making payment of the letter of credit on the basis that a call on the letter of credit would be fraudulent. Although Judge Galligan of the Ontario High Court also quoted Lord Denning's remark in *Edward Owen* as it appeared in *Aspen Planners*, he granted the injunction by saying:

A good deal of argument was addressed to the issue of whether or not fraud has been established by the plaintiff in this case. . . . It seems, on the material before me, that there can be no doubt that the five firefighting vehicles were delivered It is my opinion, in this case, an injunction ought to be granted. In my view . . . the plaintiff has made out a *strong prima facie case* that the demand made by the

⁸⁵ *Id.* at 546-47.

⁸⁶ *Id.* at 549.

⁸⁷ *Id.* (quoting *Edward Owen Eng'g Ltd.*, 1 All E.R. at 981).

⁸⁸ *Bank of Nova Scotia v. Angelica Whitewear Ltd.*, [1987] D.L.R.4th 161, 174 (emphasis omitted).

⁸⁹ 18 C.P.C. 62 (1980).

agent of the Ministry of War is fraudulent. Delivery has clearly been made and claim for a payment of a delivery guarantee necessarily implying that delivery was not made is clearly untrue and false.⁹⁰

In *Bank of Nova Scotia v. Angelica-Whitewear Ltd.*,⁹¹ at the request of Whitewear Manufacturing Co. Ltd. ("Whitewear"), Bank of Nova Scotia ("the Bank") opened an irrevocable negotiation letter of credit in favor of Protective Clothing Company ("Protective") to cover the purchase price of contracted garments. Before the payment of one of the invoices, Whitewear, the applicant, informed the Bank, among others, that the signature on the inspection certificate was forged and payment under the letter of credit should be withheld. However, payment under the letter of credit was finally made upon repeated demands by the negotiation bank, and the applicant's account was debited. The issuer instituted an action against the applicant for the balance owed. The applicant claimed that the issuer was not entitled to debit its account, as it was not obliged to pay because of prior knowledge of fraud by the beneficiary. The applicant also alleged that the Bank was informed before payment was made that the prices in the invoice were fraudulently inflated. The trial court found for the Bank. An appeal was allowed and the court upheld the contention for fraud. The Bank then appealed to the Canadian Supreme Court.⁹² Justice Le Dain distinguished actions for interlocutory injunction before the issuer pays the beneficiary from disputes between the issuer and the applicant after the issuer pays the beneficiary and stated:

I would draw a distinction between what must be shown on an application for an interlocutory injunction to restrain payment under a letter of credit on the ground of fraud by the beneficiary of the credit and what must be shown, in a case such as this one, to establish that a draft was improperly paid by the issuing bank after notice of alleged fraud by the beneficiary. A *strong prima facie case of fraud* would

⁹⁰ *Id.* at 65 (emphasis added).

⁹¹ [1987] D.L.R.4th 161.

⁹² The appeal was dismissed, but on the basis of the application of the strict compliance rule, which is outside the scope of this work, and will not be discussed further.

appear to be a sufficient test on an application for an interlocutory injunction. Where, however, no such application was made and the issuing bank has had to exercise its own judgment as to whether or not to honour a draft, the test in my opinion should be the one laid down in *Edward Owen Engineering*—whether fraud was so established to the knowledge of the issuing bank before payment of the draft as to make *the fraud clear or obvious to the bank*.⁹³

In conclusion, “[t]he judgment of the Court of Appeal allowing Whitewear’s appeal [could not], therefore, be supported on the ground of fraud.”⁹⁴

This approach is similar to the approach taken by English courts in the sense, as mentioned, that English courts take different approaches to actions against different parties. Whereas, “American courts have generally not observed the distinction between cases involving interlocutory injunctions and those arising after the fact of payment.”⁹⁵

Before reaching that conclusion, the Court also considered the following issues with respect to the application of the fraud rule: whether the application of the fraud exception “should be confined to cases of forged or false documents or whether it should extend to fraud in the underlying [sale of goods] transaction;” whether the application of the fraud exception “should be confined to fraud by the beneficiary . . . , or whether it should include fraud by a third party which affects the letter of credit transaction but of which the beneficiary of the credit is innocent;” and whether “a holder in due course of a draft” should be immune from the application of the fraud rule.⁹⁶

After referring to *Sztejn*, relevant provisions of the previous version of U.C.C. Article 5, Section 5-114(2), the French position towards the fraud rule, and many cases decided in the United States, the United Kingdom, and Canada, the Court observed:

⁹³ Bank of Nova Scotia, [1987] D.L.R.4th at 177 (first and third emphases added).

⁹⁴ *Id.* at 184.

⁹⁵ John F. Dolan, *Documentary Credit Fundamentals: Comparative Aspects*, 3 BANKING & FIN. L. REV. 121, 130 (1989).

⁹⁶ Bank of Nova Scotia, [1987] D.L.R.4th at 168.

[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.⁹⁷

Many aspects of the fraud rule were thoroughly considered in this case, which has been appraised as “a scholarly decision,”⁹⁸ and “a lucid and comprehensive judgment setting out the Canadian position to the exception.”⁹⁹ However, it is a pity that one of the most important issues with regard to the application of the fraud rule—the kind of fraud that can invoke the fraud rule—was barely mentioned in the case.

7.3. Australia

Sztejn and the fraud rule have also been recognized in Australia. The first Australian case to apply the fraud rule and cite *Sztejn* with approval was *Contronic Distributors Party Ltd. v. Bank of New South Wales*.¹⁰⁰ In that case, Contronic wished to purchase semi-conductors from GEC, to whom it was already indebted for earlier dealings. It suggested the use of a letter of credit, which would cover both the existing indebtedness and the purchase price of the goods that it wished to purchase. Contronic's business had been financed from time to time by Balfour, which granted credit facilities to Contronic by way of applying for letters of credit from the Bank of New South Wales in favor of the suppliers. Balfour also

⁹⁷ *Id.* at 176-77.

⁹⁸ Dolan, *supra* note 95, at 122.

⁹⁹ Greg Fellingner, *Letters of Credit: The Autonomy Principle and the Fraud Exception*, 1 J. BANKING FIN. L. & PRAC. 4, 21 (1990).

¹⁰⁰ (1984) 3 N.S.W.L.R. 110.

financed this transaction in the same way, but the financier did not know that the letter of credit would also cover the earlier debt. When the financier discovered the true state of affairs, it brought proceedings to restrain the bank from paying against the letter of credit, and to prevent GEC from presenting the documents. The Supreme Court of New South Wales granted the injunction. Justice Helsham of the Court started his judgment by saying: "It is said that the English law in relation to this topic is not settled, but it seems to me to be sufficiently settled to indicate that this Court can and should make an order restraining the presentation of the payment against this letter of credit."¹⁰¹ He then quoted from English textbooks on the topic, and relied on the English case of *Discount Records Ltd. v. Barclays Bank Ltd.*,¹⁰² all of which cited *Sztejn* as the authority of law in the area, and concluded:

[I]t seems to me that the law stated in the American decisions reflects the law of England by reason of the decision. . . . In my view the law is perhaps now settled, and in any event would establish that a seller can be restrained from presenting a letter of credit for payment or having payment made against it in the event that the documents which are needed to require payment to be made are false to the knowledge of the seller.¹⁰³

So far, Australian cases on the fraud rule are limited. And there has been no case such as *Angelica-Whitewear* that comprehensively sets out the Australian position. Although Australian courts have claimed, in cases such as *Contronic*, that they are following the English position, they have required neither "clear" nor "obvious" fraud to invoke the fraud rule, nor taken different approaches towards actions against different parties.

¹⁰¹ *Id.* at 114.

¹⁰² 1 All E.R. 1071 (Ch. 1974).

¹⁰³ *Contronic Distributors Pty. Ltd.* (1984) 3 N.S.W.L.R. 110, 116.

8. THE FRAUD RULE IN INTERNATIONAL CHAMBER OF COMMERCE ("ICC") RULES

8.1. *Uniform Customs and Practice for Documentary Credits*

The Uniform Customs and Practice for Documentary Credits ("UCP")¹⁰⁴ is silent with respect to the issue of fraud and the fraud rule. The reason usually given for this lacuna is that it is not the function of the UCP to regulate issues that are the proper province of national law and national courts. "Both the content and the interpretation of ICC uniform rules are influenced by the fact that their function is to serve as rules of best banking practice, not rules of law,"¹⁰⁵ and the fraud issue is traditionally considered as "the province of the applicable law and of the courts of the forum . . ."¹⁰⁶ National laws should therefore deal with any injunctive relief on the ground of fraud by the beneficiary. In other words, although "[t]he ICC drafters are clearly aware of the fraud issue,"¹⁰⁷ they have deliberately left it out.¹⁰⁸

The inactive approach of the UCP has been applauded by some commentators as a striking success. In their view, any effort to formulate a uniform fraud rule by the ICC is unnecessary and bound to fail, as the fraud rule is quite sensitive to local rules and these rules vary among jurisdictions. They argue that the current

¹⁰⁴ INTERNATIONAL CHAMBER OF COMMERCE, ICC UNIFORM CUSTOMS AND PRACTICE FOR DOCUMENTARY CREDITS (1951) (revised 1993) (I.C.C. Publication No. 500) [hereinafter UCP]. The UCP was initially published in 1933 and revised versions were issued in 1951, 1962, 1974, 1983, and 1993. The pattern of a revision every decade, apparent in the above series of revisions, reflected the needs of those times rather than a conscious policy, so there may well not be a new revision in 2004 or 2005. A Supplement to the UCP for electronic presentation (the "eUCP") came into force as of April 1, 2002. The eUCP is not a revision to the UCP and does not affect any of the matters addressed in this article. It simply facilitates the application of the UCP to electronic documents and other documents presented electronically.

¹⁰⁵ Roy Goode, *Abstract Payment Undertakings and the Rules of the International Chamber of Commerce*, 39 ST. LOUIS U. L.J. 725, 727 (1995).

¹⁰⁶ *Id.*

¹⁰⁷ John F. Dolan, *Commentary on Legislative Developments in Letter of Credit Law: An Interim Report*, 8 BANKING & FIN. L. REV. 53, 63 (1993).

¹⁰⁸ Katherine A. Barski, *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, 751 (1996) ("[T]he lack of a fraud provision in the U.C.P. indicates that the intent of the drafters was to defer to local law on the fraud issue.").

position of the UCP may "create[] an incentive for the various jurisdictions to fashion fraud rules that do not interfere with the marketability of credits issued by the jurisdiction's banks."¹⁰⁹

However, there are difficulties with this view. While it is correct that the UCP is technically not law, but rather a compilation of accepted commercial practices, the reality is that the UCP is currently "incorporated into substantially all cross-border commercial letters of credit, studied and observed by letter of credit bankers and users worldwide, and treated as quasi-law in the many countries that have little or no statutory law governing letters of credit."¹¹⁰ Indeed, an applicant seeking a letter of credit not subject to the UCP anywhere in the world except in the United States (where Article 5 of the U.C.C. provides the law) is likely to have a fruitless search. The very success of the UCP in gaining worldwide acceptance casts upon it the burdens that any law bears: to be fair and equitable to all parties.¹¹¹ In short, its success means the UCP has become the de facto law.¹¹²

A good commercial law is one that promotes commerce because it maximizes certainty and predictability for the commercial community. To achieve this end, a law should give the best answers it can give to problems that can be predicted. The UCP cannot meet this standard without dealing with the fraud issue. The drafters of the UCP know of the problem of fraud; nevertheless they chose not to address it, leaving users of letters of credit without any guidance in dealing with the fraud problems they might encounter. This generates an unacceptable—because unnecessary—degree of uncertainty and unpredictability.

To make matters worse, local fraud rules are diverse and unclear. In such an environment, when a fraud case goes to court and a decision is made, that decision is likely to be criticized by letter of

¹⁰⁹ *Id.* See also Dolan, *supra* note 107, at 63 (noting the difficulty of codifying the fraud issue and discussing why the ICC policy is successful).

¹¹⁰ James G. Barnes, *Internationalization of Revised UCC Article 5 (Letters of Credit)*, 16 *NW. J. INT'L L. & BUS.* 215, 216 (1995).

¹¹¹ Ross P. Buckley, *The 1993 Revision of the Uniform Customs and Practice for Documentary Credits*, 28 *GEO. WASH. J. INT'L L. & ECON.* 265, 267-68 (1995) ("[T]he UCP will be best served in the future by a broader representation of interested parties in its revision process.").

¹¹² *Id.* See also JOHN F. DOLAN, *THE LAW OF LETTERS OF CREDIT: COMMERCIAL AND STANDBY CREDITS* ¶ 4.04 n.76 (2d ed. 1991 & cumulative supp. 1995) ("The drafters of the Uniform Customs consistently have protested that the Uniform Customs are not law, but they cannot deny that the Customs have the force of law.").

credit experts for not complying with the practices of the letter of credit community and for being detrimental to the commercial utility of letters of credit. It is therefore ironic that when drafting the UCP, some of those same letter of credit specialists said it is for the courts to make the relevant rules.¹¹³ This is neither logical nor fair to the courts.

Judges should be legal experts, but it is not practical to expect every judge to be an expert in the law of the letter of credit or to make good law within the short framework of time that a case is before a court. The reality is that "[m]ost trial judges have had little experience with letter of credit matters . . ." ¹¹⁴ Therefore, it is desirable for the drafters of the UCP, who are all well-known letter of credit experts, to provide guidance on these issues.

As pointed out by the learned and notable expert, Professor Clive Schmitthoff, some twenty years ago now: "It would be desirable that the next revision of the Uniform Customs and Practice . . . should deal with this problem."¹¹⁵ It did not. Neither did the following revision in 1993. But the incidence of fraudulent practice that prompted Clive Schmitthoff's call, has, if anything, increased in the past twenty years.

8.2. *Uniform Rules for Contract Guarantees*

Unlike the UCP, the Uniform Rules for Contract Guarantees ("URCG") have attempted to tackle the issue of fraud, or in this context the "unfair calling" of independent guarantees. Article 9 of the URCG provides:

If a guarantee does not specify the documentation to be produced in support of a claim or merely specifies only a statement of claim by the beneficiary, the beneficiary must submit:

¹¹³ The Working Group that prepared the latest revision of the UCP was the first to include members other than bankers, in this case some bank lawyers and two law professors. The parties served by documentary credits—exporters and importers—are not directly represented in the drafting process. See John A. Spanogle, Jr., *The Arrival of International Private Law*, 25 GEO. WASH. J. INT'L L. & ECON. 477, 492 (1992) (discussing the use of a committee to resolve issues).

¹¹⁴ Task Force Report, *supra* note 46, at 1611.

¹¹⁵ Clive M. Schmitthoff, *Export Trade*, J. BUS. L. 319, 321 (1983).

a) in the case of a tender guarantee, his declaration that the principal's tender has been accepted and that the principal has then either failed to sign the contract or has failed to submit a performance guarantee as provided for in the tender, and his declaration of agreement, addressed to the principal, to have any dispute on any claim by the principal for payment to him by the beneficiary of all or part of the amount paid under the guarantee settled by a judicial or arbitral tribunal as specified in the tender documents or, if not so specified or otherwise agreed upon, by arbitration in accordance with the Rules of the ICC Court of Arbitration or with the UNCITRAL Arbitration Rules, at the option of the principal;

b) in the case of a performance guarantee or of a repayment guarantee, either a court decision or an arbitral award justifying the claim, or approval of the principal in writing to the claim and the amount to be paid.¹¹⁶

Strictly speaking, these provisions are not the same as the fraud rule under discussion. The fraud rule is concerned with the circumstances under which payment under a letter of credit may be disrupted. Article 9 of the URCG provides the conditions that trigger the payment of independent guarantees.

Nonetheless, the purpose of the fraud rule and this article of the URCG is the same: the prevention of fraud. Unfortunately, the URCG has been accepted by few users of independent guarantees.¹¹⁷

¹¹⁶ INTERNATIONAL CHAMBER OF COMMERCE, ICC UNIFORM RULES FOR CONTRACT GUARANTEES art. 9 (1978) [hereinafter URCG].

¹¹⁷ The URCG has rarely been accepted or used since its publication. One reason is a conceptual problem in that the URCG has not made clear that it is confined to independent guarantees and does not apply to accessory guarantees (the more usual secondary guarantee of a liability). But the major hurdle to the general acceptance of the URCG is because of the provision in Article 9, as it requires the beneficiary to produce a judgment or arbitral award or the principal's written approval when making a claim. The condition is designed to deal with the problem of unfair calling, but, in the words of Roy Goode, the URCG "proved too far removed from the market practice," as it virtually turns independent guarantees into accessory ones. Roy Goode, *The New I.C.C. Uniform Rules for Demand Guarantees*, 1992 LLOYD'S MAR. & COM. L. Q. 190, 190 (1992).

8.3. *Uniform Rules for Demand Guarantees*

Having learned from the experience of the URCCG, the drafters of the Uniform Rules for Demand Guarantees (URDG) chose to take a similar position to the UCP on the issue of fraud, i.e., be silent and leave it to the courts of the various jurisdictions.

Divergent views, however, were expressed during the formulation of the rules, reflecting the competing interests of the parties concerned. Banks sought a simple mechanism whereby the issuer would have to pay without having to make difficult investigations or take hard decisions based on unclear evidence. Beneficiaries at large claimed that they needed a mechanism whereby they would get paid against a simple demand or document without risking obscure objections. Applicants were interested in having some kind of safety device in the system so as to prevent unjustified callings.¹¹⁸ Out of all this, in order to prevent the beneficiary's outright unjustified calling, Article 20 of the URDG implicitly goes some small way towards putting restrictions on the beneficiary's right of payment, saying:

Any demand for payment under the Guarantee shall be in writing and shall (in addition to such other documents as may be specified in the Guarantee) be supported by a written statement (whether in the demand itself or in a separate document or documents accompanying the demand and referred to in it) stating:

that the Principal is in breach of his obligation(s) under the underlying contract(s) or, in the case of tender guarantee, the tender conditions; and

the respect in which the Principal is in breach.

Any demand under the Counter-Guarantee shall be supported by a written statement that the Guarantor has received a demand for payment under the Guarantee in accordance with its terms and with this Article.

¹¹⁸ Lars Gorton, *Draft UNCITRAL Convention on Independent Guarantees*, J. BUS. L., 240, 244 (1997).

Paragraph (a) of this Article applies except to the extent that it is expressly excluded by the terms of the Guarantee. Paragraph (b) of this Article applies except to the extent that it is expressly excluded by the terms of the Counter-Guarantee.¹¹⁹

As can be seen, Article 20 of the URDG requires the beneficiary when demanding payment to state in writing both that there is some kind of breach of the underlying transaction and what type of breach is involved, thus giving the other parties some kind of protection by providing a ground for a claim of fraud. This puts on the beneficiary a certain obligation to show its hand.¹²⁰ However, this provision is similar to that of Article 9 of the URDG in nature, in providing a kind of safety device for the trigger of the payment of the independent guarantee to prevent fraud, but it differs from the fraud rule under discussion, which addresses what to do when fraud is found to have been committed. As the URDG is not yet well accepted by users of independent guarantees, the effectiveness of this approach remains to be seen.

8.4. *International Standby Practices*

The International Standby Practices ("ISP98") takes a similar approach to the UCP and expressly leaves "defences to honour based on fraud, abuse, or similar matters . . . to applicable law."¹²¹

¹¹⁹ URDG *supra* note 116, art. 20.

¹²⁰ Gorton, *supra* note 118, at 249.

¹²¹ INTERNATIONAL STANDBY PRACTICES, R. 1.05(c) (1998).

Under Rules 4.16¹²² and 4.17¹²³ of ISP98, a demand for payment under a standby letter of credit is not required to indicate a default or other event in the underlying transaction if that is not required under the terms and conditions of the standby letter of credit. This is a step back from the position of the URDG, in which the beneficiary is required to state that there is a breach of the underlying transaction and what type of breach is involved.

The omission of the fraud rule from ISP98 has nevertheless been applauded by some commentators as "especially welcome," because fraud has been "addressed in different ways in different countries. To have included provisions on fraud in the ISP would probably have created needless complications in countries such as the United States . . ." ¹²⁴ However, as stated above, avoiding problems may not be the best way to resolve them.

¹²² International Standby Practices Rule 4.16, entitled "Demand for Payment," provides:

A demand for payment need not be separate from the beneficiary's statement or other required document.

If a separate demand is required, it must contain:

- a demand for payment from the beneficiary directed to the issuer or nominated person;
- a date indicating when the demand was issued;
- the amount demanded; and
- the beneficiary's signature.

A demand may be in the form of a draft or other instruction, order, or request for pay. If a standby requires presentation of a "draft" or "bill of exchange," that draft or bill of exchange need not be in negotiable form unless the standby so states.

Id. at R. 4.16.

¹²³ International Standby Practices Rule 4.17, entitled "Statement of Default or Other Drawing Event," provides:

If a standby requires a statement, certificate, or other recital of a default or other drawing event and does not specify content, the document complies if it contains:

- a representation to the effect that payment is due because a drawing event described in the standby has occurred;
- a date indicating when it was issued; and
- the beneficiary's signature.

Id. at R. 4.17

¹²⁴ Paul S. Turner, *New Rules for Standby Letters of Credit: The International Standby Practices*, 14 BANKING & FIN. L. REV. 457, 463 (1999). Issues of fraud and the fraud rule were considered when ISP98 was drafted: "A rule that would have made the provisions of the United Nations Convention on Independent Guarantees and Standby Letters of Credit applicable when the standby credit failed to

9. THE FRAUD RULE UNDER THE UNCITRAL CONVENTION

Unlike the ICC rules, the Convention on Independent Guarantees and Standby Letters of Credit ("Convention" or "UNCITRAL Convention")¹²⁵ made an effort to address the issue of fraud and to prevent fraudulent or unjustified calling of standby letters of credit or independent guarantees.¹²⁶ There are three articles in relation to the fraud rule under the Convention.

In Article 15, the Convention puts up a general requirement for a beneficiary demanding payment under a letter of credit or independent guarantee. Article 15(3) of the Convention provides that "[t]he beneficiary, when demanding payment, is deemed to certify that the demand is not in bad faith and that none of the elements referred to in subparagraphs (a), (b) and (c) of paragraph 1 of article 19 are present."¹²⁷ Put another way, payment under a letter of credit or independent guarantee has the potential to be disrupted if the elements listed in Article 19 exist in the demand.

Article 19, entitled, "Exception to Payment Obligation," then enumerates the circumstances under which the issuer may refuse to honor the beneficiary's demand for payment. Paragraph (1) of Article 19 provides that the guarantor/issuer has a right, as against the beneficiary, to withhold payment if one of the following is "manifest and clear": "Any document is not genuine or has been falsified; no payment is due on the basis asserted in the demand and the supporting documents; or Judging by the type and purpose of the undertaking, the demand has no conceivable ba-

choose a jurisdictional law was wisely omitted at the very end of the drafting process." *Id.* at 463 n.16.

¹²⁵ United Nations Convention on Independent Guarantees and Standby Letters of Credit, Dec. 11, 1995, 35 I.L.M. 735 (1996) [hereinafter UNCITRAL Convention].

¹²⁶ However, this position has been criticized by some legal writers. See, e.g., Dolan, *supra* note 107, at 63 (arguing that UNCITRAL is "floundering" in its attempt to confront the issue of fraud). The word "fraud" has not been used in the Convention in order to avoid possible confusion resulting from different interpretations developed in different jurisdictions about the meaning of the term. See Eric E. Bergsten, *A New Regime for International Independent Guarantees and Standby Letters of Credit: The UNCITRAL Draft Convention on Guaranty Letters*, 27 INT'L L. 859, 872 (1993) (contending that UNCITRAL have avoided the terms "fraud" and "abuse of right").

¹²⁷ UNCITRAL Convention, *supra* note 125, art. 15, para. 3.

sis. . . .¹²⁸ Paragraph (2) of Article 19 explains what the phrase “no conceivable basis” means, stating:

The contingency or risk against which the undertaking was designed to secure the beneficiary has undoubtedly not materialised;

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;

The underlying obligation has undoubtedly been fulfilled to the satisfaction of the beneficiary;

Fulfilment (sic) of the underlying obligation has clearly been prevented by willful (sic) misconduct of the beneficiary; 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.¹²⁹

Article 19 not only provides the issuer with some basis for refusing payment, but also enables the applicant to take court measures against a fraudulent beneficiary. Paragraph (3) of the Article provides that “[i]n 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

¹²⁸ *Id.* art. 19, para. 1. Because the Article does not use the word “may” as does Article 5 of the U.C.C., some commentators have suggested that it implies certain duties on the guarantor to make a judgment whether the demand for payment is warranted. See Gorton, *supra* note 118, at 249 (arguing that the language of Article 19, paragraph 2 “implies a certain duty on the issuer to make a judgment whether the requirements are met or not”). However, due to the nature of letters of credit, the issuer should not be obliged to consider whether the demand is justified or not, but should have the discretion to either honor a payment when demanded or not.

¹²⁹ UNCITRAL Convention, *supra* note 125, art. 19, para. 2.

20.”¹³⁰ Article 20 of the Convention, with the heading of “Provisional court measures,” then lists the measures a court can take by providing:

1. Where, on an application by the principal/applicant or the instructing party, it is shown that there is a high probability 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 1 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 undertaking, 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 suffer 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.¹³¹

These provisions of the Convention are by and large in accordance with current practice. They include most of the elements of

¹³⁰ *Id.* art. 19, para. 3.

¹³¹ *Id.* art. 20.

the fraud rule that have been developed over the years by national courts and/or legislators and provide a detailed and helpful guide to users of letters of credit and the courts. Like Revised U.C.C. Article 5, Section 5-109(b), the Convention has clearly spelled out what kind of actions victims of fraud may take when fraud is "manifest and clear" in a transaction of standby letters of credit or independent guarantees, namely the issuer's refusal to honor a presentation or withholding payment,¹³² and the applicant's entitlement to a court injunction preventing the honoring of a presentation by the issuer;¹³³ has listed what kind of misconduct may invoke the fraud rule;¹³⁴ has indicated that either fraud in the documents or fraud in the underlying transaction may invoke the fraud rule;¹³⁵ and has provided necessary guidelines for courts considering the application of the fraud rule.¹³⁶

From a critical point of view, however, there are a few areas that may need further improvement. First, one broad element of the fraud rule is missing from the Convention: it fails to mention who should be immune from the fraud rule, an important element that should be considered whenever the fraud rule is applied so that innocent third parties can be protected. Second, the influence on the letter of credit world of the fraud rule as articulated in the Convention may be affected by the fact that the Convention itself is specifically designed to regulate standby letters of credit and independent guarantees although commercial letter of credit users may choose to use it if they so wish.¹³⁷ If the Convention were drafted to cover all letters of credit, its influence might be much stronger.

However, the provisions regarding the fraud rule embodied in the Convention signal a significant and encouraging development in the area. First, the Convention is the initial document to provide details of the fraud rule at an international level. Second, unlike the ICC rules, which have to be incorporated into the letter of credit as contractual terms to be effective, the Convention becomes law in a country that signs and/or ratifies it. Finally, based on the early signs, the influence of the Convention in the letter of credit community ought not to be underestimated, because (1) it became

¹³² *Id.* art. 19, para. 1.

¹³³ *Id.* art. 19, para. 3.

¹³⁴ *Id.* art. 19, para. 1(a)-(c).

¹³⁵ *Id.* art. 19 para. 1(a), (c).

¹³⁶ *Id.* art. 20.

¹³⁷ *Id.* art. 1, para. 2.

effective less than five years after its promulgation; and (2) in the list of signatory countries there are such important letter of credit users as the United States.

10. CONCLUSION

The fraud rule is an integral part of the law governing letters of credit and was developed to fill a gap in that law—to prevent unscrupulous beneficiaries from abusing the letter of credit system and defrauding the applicant and the issuer.

The fraud rule is an extraordinary rule in the law of letters of credit because it is in direct conflict with the fundamental principle of the law of letters of credit—the principle of autonomy. Accordingly, the fraud rule should be applied cautiously and confined strictly to its purpose. Any broadening of the rule may destroy the independence, and undermine the commercial utility, of the letter of credit.

From the early cases considered to Revised U.C.C. Article 5 and the UNCITRAL Convention, the development of the fraud rule has come a long way. Now it has not only been recognized by virtually all jurisdictions but also has been codified in the UNCITRAL Convention at the international level. Today *Sztejn* and its codification in the U.C.C. are regarded as two milestones in the history of the development of the fraud rule. One day the promulgation of the fraud rule in the UNCITRAL Convention may well be considered as another leap forward along that path, formally lifting the fraud rule from the national to the international level.

At present, however, the fraud rule is still a developing area and the most important source of jurisprudence with respect to the rule is to be found in Article 5 of the U.C.C. and the cases decided thereunder.

The most regrettable fact in the course of development of the fraud rule is that the rule is not included in the Uniform Customs and Practice for Documentary Credits—the influential rules for letters of credit that are incorporated by reference into virtually all credits issued worldwide.¹³⁸

Courts in most jurisdictions outside the United States are inexperienced with letters of credit, and the litigation of fraud under letters of credit is rare outside the United States. Accordingly, there has been no opportunity elsewhere to develop a sophisti-

¹³⁸ UCP, *supra* note 104.

cated and coherent body of case law on the issue.¹³⁹ The proper body to determine the extent of the fraud exception to the doctrine of autonomy is the body with the expertise to do so, the publisher of the UCP, the International Chamber of Commerce.

As the UCP is, in form, merely a set of contractual terms, whatever provisions it might include regarding fraud would be subordinate to local law on the issue.¹⁴⁰ However, there is no reason to expect that courts would not give to UCP provisions on fraud the same weight they have given to its other provisions. After all the UCP prescribes the doctrine of autonomy,¹⁴¹ so why should it not also prescribe the exception and limits to the doctrine?

To build the best legal system in a complex area like letters of credit, experts need to exercise their expertise, make the hard decisions, and draw up detailed rules to help ensure the smooth operation of the system.

It is hoped that in the next revision of the UCP, the revision committee chooses to deal with the issue of fraud, and in doing so takes its lead from the U.C.C. and the UNCITRAL Convention. If the UCP embraces the law on fraud as set forth in Section 5-109 of the U.C.C., as amplified by the definition of fraud from Article 19 of the UNCITRAL Convention, the result will be a highly workable jurisprudence that will serve to enhance the commercial utility of letters of credit and limit their use to perpetrate fraud. Given the near universal acceptance and use of the UCP, for the fraud rule to reach maturity the UCP needs to address the issue of fraud. Only when the UCP deals with this issue will the international commercial community enjoy a letter of credit system that appropriately protects it against fraudsters; and only when the UCP proscribes fraud will the journey that commenced with Lord Mansfield's judgment in *Pillans v. Van Mierop*¹⁴² reach its end.

¹³⁹ England has a sophisticated and well-developed jurisprudence on letter of credit law in general, but not on the fraud issue in particular.

¹⁴⁰ Robert Wight & Alan Ward, *The Liability of Banks in Documentary Credit Transactions Under English Law*, 13 J. INT'L BANKING L. 387, 390 (1998).

¹⁴¹ See UCP, *supra* note 104, arts. 3 & 4 (defining the distinction between credits and contracts and between documents and goods/services/performances).

¹⁴² 97 Eng. Rep. 1035 (1765).