Letters of Credit and

The Independence Principle

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Dedication

To my parents and family who supported me through this.
### Table of Cases

2. *Commercial Bank Co of Sidney Ltd v Jalsard Pty Ltd* (1973) AC
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10. *Hamzeh Malas & Sons v British Imex Industries Ltd* (1958) 2 QB
12. *Discount Records Ltd. V. Barclays Bank Ltd and another* (1975) 1 All ER
15. *Turkiye Is Bankasi AS v Bank of China*
16. *Deutsche Ruckversicherung AG v Wallbrook Insurance co Ltd and others* (1994) 4 ALL ER
17. *Themehelp Ltd v West and others* (1995) 3 WLR

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1. *(1973) AC p.279*
18 Loomcraft Fabrics CC v Nedbank Ltd South Africa, 1996 (1) SA 812(A)
19 Tukan Timber Ltd v Barclays Bank (1987) QB
20 UniCredito Italiano SpA v Alan Chung Wah Tang (2002)
21 Prime Deal (HK) Enterprises v HSBC and another (2002)
22 United Trading Corporation SA v Allied Arab Bank Limited (1985) 2 Lloyd’s Rep
24 Bell v. Lever Brothers Ltd (1932)
25 Smith v. Hughes (1871) LR 6 QB
Abstract

Although letters of credit are perhaps the most widely used tool in international trade, it is surprising how many people including traders get confused in some of the essentials of letters of credits.

Nearly all letters of credit are governed by the (UCP) the Uniform Customs and Practices.¹

This thesis discusses the independence principle, beginning with its history and development of the letter of credit in the first chapter. Followed by a definition and an explanation of the independence principle in the second chapter. The third chapter discusses the exceptions to the independence principle, starting with the fraud exception following its development in the United States of America and the United Kingdom with a comparison between the two. Unfortunately, there are few reported cases on letters of credit in the Sudan. For this reason, no comparison between the law in Sudan and the law in the jurisdictions referred to above as regards to letters of credit can be made. This is followed by the discussion of the illegality and the mistake exceptions. The fourth chapter (chapter 4) sets forth the conclusions to be drawn from the discussions in the previous chapters.

¹ In the United States of America letters of credit are governed by the Uniform Commercial Code (UCC)
Chapter One

The History and Development of The Letter of Credit

Merchants through history travelled to get new and better goods. For this purpose they usually carried large sums of money in order to pay for the merchandise they purchase. This made them an easy target for robbers. A solution had to be found to this increasing problem. So in the eighteenth century, banks issued a formal letter of introduction addressed to the issuing banks’ correspondents and agents abroad. This letter of introduction came to be known as the “Traveller’s Letter of Credit”.

The purpose of the “Traveller’s Letter of Credit” was to provide their clients with means for obtaining cash from banks abroad for use during their foreign travel, thereby obviating the need to carry large sums of money upon their person with the attendant risk of loss or robbery.\(^2\) By these letters of introduction the agents or correspondents were requested to provide every possible assistance. Often copies of these letters were sent ahead of the traveller to the correspondents or agents.\(^3\)

“The Traveller’s Letter of Credit” was issued in a form of a letter addressed to the correspondents/agents. It indicated that in consideration of such correspondents and agents paying cash to the named client, the issuing

\(^2\) Wickeremeratne & Rowe (Trade Finance), the complete guide p. 1/3
\(^3\) Wickeremeratne & Rowe ibid p.3 p. 1/4
bank would pay bills of exchange drawn by the correspondents/agents on the issuing bank for amounts paid plus correspondents/agents charges”.4

These letters indicated a maximum amount available under the credit and its expiry date. Each correspondent/agent was required to write down the details of each amount paid and its date, so that the next correspondent/agent to whom the letter was presented would be able to ascertain the balance available under the credit.

This continued for a number of years. But as time went by and international trade became more and more complex, and it became obvious that the “Traveller’s Letter of Credit” was no longer sufficient as a method of payment. For one thing trade is not always carried out by persons of unblemished repute. In addition the parties are located in, and governed by, different systems of law and are unaware of the financial standing, credibility, goodwill and solvency of each other. The buyer desires the contracted goods on time. He doesn’t desire to pay in advance or on shipment, but only after he has satisfactory evidence that the seller has shipped the confirming goods on time and that they are beyond the seller’s physical control. In addition to that, the buyer does not want to be deprived of the use of his capital during the time that elapses between the shipment of the goods, their receipt, and their resale.5 The seller on the other hand, does not want to lock up capital, he may use in business, until the receipt of goods.

When the goods travel across national borders, they are moved outside the jurisdiction on which the seller resides. Once outside the seller’s jurisdiction, any attempt to regain control or possession of the goods will be

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4 ibid.
5 ibid.
significantly more difficult for the seller. Similarly, if the seller does not receive payment once the goods are shipped, it will be all the more difficult to pursue the buyer for payment, because the buyer and all of his assets will probably be outside the seller’s jurisdiction. The seller will deliver goods to a foreign jurisdiction where he has little influence, and possibly very little knowledge of the applicable law. Foreign law may govern many aspects of the transaction including procedures to obtain payment, and the seller may be required to obtain any court order necessary to enforce such payment, through a foreign forum. This may prove to be inconvenient and expensive.6

Against the backdrop of the foregoing, it will be recalled that the commercial contract is the basic agreement between the seller and the buyer. It simply means that the seller undertakes to provide the goods to the buyer, and the buyer undertakes to pay the price in return.7

The agreement may prescribe for payment of the price in one of the following four methods:

1. Advanced Payment: The seller does not ship the goods before receiving payment.
2. Open Account: The seller ships the goods before receiving payment.
3. Collection: The seller sends the goods before receiving payment, and the buyer pays upon receipt of shipping documents covering the goods or on any other terms as stipulated in the collection instruction.8

In these methods a conflict arises between the interests of the contracting parties. In this sense, both the importers and exporters found it

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6 Goode “Commercial Law” p.878-879
7 Wickeremeratne & Rowe op cit p.3p. 2/3
8 ibid.
preferable to improvise a method of payment in which neither the buyer nor the seller has the upper hand. A bank as a third party and a letter of credit as a method of payment were introduced.

4 Commercial Credits: in commercial credits the bank undertakes the responsibility to the applicant on receipt of confirming documents from the beneficiary. Unless otherwise agreed the seller thus has the irrevocable undertaking of the issuing bank (or, in case the credit is confirmed) of the confirming bank, that he shall be paid if he presents the documents stipulated in the credit and, the other terms and conditions of the credit have been complied with.

Letters of credit are often preferred as the method of payment in international trade because they offer a solution to the mismatch between the seller’s desire for swift payment and the buyer’s desire of goods first. On the other hand, a letter of credit enables the seller to obtain payment from a bank within its jurisdiction. The buyer on the other hand, establishes the letter of credit in such a manner, that payment is promised on presentation of certain documents, the contents of which confirm that the goods being delivered to the buyer are goods that conform to the terms and conditions of the underlying sales agreement. The seller only needs to comply with the requirements of the credit in order to get paid. This provides comfort to both the seller and the buyer by the independent undertaking of banks. The documentary credit structure provides the seller with an independent bank undertaking of payment when he presents the stipulated documents. The buyer on the other hand, rests assured that the seller shall not be paid unless he presents documentary evidence covering the goods and their shipment.

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9 ibid 2/20.
Yet, banks are financial establishments and not traders. They cannot, therefore, be made responsible for the conformity of the goods with the terms of the underlying agreement. The underlying agreements deal with various goods. To make banks responsible for ensuring that the goods comply with the underlying agreements, they would have to be experts in all the various types of goods, learn the different laws, and study each sales contract presented to it. This is why when banks are resorted to pay the price of the goods; they were meaning to do that only on the basis of naming documents. Fortunately, each step the seller takes, whether it is manufacturing the goods, shipping or insuring them, has a document to verify it. Examples for documents relating to the goods and their shipment are bills of lading, commercial invoices, cargo insurance policies and certificates of inspection. The buyer informs the bank that he would like to open a letter of credit and instructs it to issue it to a known third party, which is known as the beneficiary, stipulating which documents shall be presented and which conditions shall be complied with. The buyer will normally request the seller to submit clean shipping documents proving that the goods have been delivered to a carrier for carriage, and the seller’s commercial invoice listing the goods, the quantities, and the price of the goods. The buyer may also request the seller to submit an insurance policy, certificates to prove quantity or quality, packing lists, and any other documentation required to show that the seller has complied with the terms of the underlying sales agreement. Accordingly, banks are instructed to pay when the seller presents documents confirming with the credit.

As mentioned earlier, banks are financial institutions, and it is not within their capacity to deal directly and inspect the goods. In addition to that banks have a time frame that they are expected to act upon, and decide
whether they will keep up the documents or refuse them and inform the beneficiary accordingly within a reasonable time, normally not exceeding seven banking days following the receipt of the documents\textsuperscript{10}, for all that banks deal in documents. This resulted in the banks dealing with the documentary credits upon two basic principles:

1. The Doctrine of Strict Compliance:

The documents tendered by the beneficiary must comply strictly on their face with the terms and conditions of the credit, in particular with the documents stipulated in the credit. This is known as the “The Doctrine of Strict Compliance”. Although this is not the subject of this dissertation, but it is a very important principle none the less. It gives rise to the independence principle and its exceptions. The doctrine of strict compliance protects the interest of the paying bank and of the buyer. It assures the buyer that the seller shall not be paid unless he presents documents that satisfy the requirements contained in the letter of credit. But most importantly, the bank is protected in that it is not required to make any judgments as to the relevance of the requirements contained in the letter of credit.

“There is no room for documents which are almost the same, or which will do just as well”.\textsuperscript{11}

Similarly, Lord Diplock states:

“the banker is not concerned whether the documents for which the buyer has stipulated serve any useful commercial purpose or as to why the customer called for the tender of a document of a particular description. Both the issuing bank and his correspondent bank has to make quick

\textsuperscript{10}Gutridge & Megrah’s Law of Bankers’ Commercial Credits p.144

\textsuperscript{11}Per Lord Sumner, in Equitable Trust Company of New York v. Dawson Partners Ltd (1927)2 Lloyds’s Rep p 49. This the leading case on strict compliance, it concerned a certificate of quality. A certificate of quality was required, signed by “experts”, but was signed by a single expert. The court held that the documents were not compliant and the bank had the right to refuse payment.
decisions as to whether a document which has been tendered by the seller complies with the requirements of a credit.”

2 The Independence Principle:

The second principle of equal importance is the independence of the documentary transaction. This means that the exchange of the documents against payment is entirely independent from the commercial transaction, i.e., the sales transaction covering the goods. “In documentary credit operations, all parties concerned deal with documents and not with goods”.

These two principles are of such great importance that the International Chamber of Commerce codified them in the UCP. “A credit by its nature is a separate transaction from the sale or other contract on which it may be based. Banks are in no way concerned with or bound by such contract, even if any reference to it is included in the credit.”

“Banks deal in documents and not with goods, services or performance to which the documents may relate”

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12 Commercial Bank Co of Sidney Ltd v Jalsard Pty Ltd (1973) AC 279
13 Jacques Saboungi, Special Documentary Credits p.8
14 UCP 600 Article 4 (a)
15 UCP 600 Article 5
Chapter Two

The Independence Principle
And
Documentary Compliance

Due to the enormous number of commercial credits around the world each day, and since the bank has to act swiftly and accurately, all this lead to the independence principle being essential in a documentary credit transaction.\textsuperscript{16} In order for the banks to deal swiftly and precisely, the banks deal solely in documents, not in goods or whatever those documents may relate to\textsuperscript{17}. It would be absurd to place upon the banks the unreasonable responsibility of examining what the documents relate to, or for example to examine the fine print in the transport documents.\textsuperscript{18}

The core of the independence principle is that banks are only concerned with documents and not with goods. Accordingly the seller will always receive payment from the bank if he submits documents that strictly comply with the credit, regardless of any development in the underlying sales agreement, or in the relationship between the buyer and the seller. By this, the interests of the seller as of the buyer, already alluded to, will be safeguarded.

\textsuperscript{16} Banks have the maximum of five banking days following the date of presentation to determine if the presentation is complying. (article 14 (b) UCP 600)
\textsuperscript{17} Article 5 of the UCP 600
\textsuperscript{18} The provisions of the UCP 600 reflect this in article 19(a) (v), article 20 (a) (v), article 21(a) (v), article 22 (b), and article 23(a) (vi)
The independence principle is so strongly recognised in international commercial trade law and banking practices that the ICC codified it in the UCP:

A credit by its nature is a separate transaction from the sale or other contract on which it may be based. Banks are in no way concerned or bound by such contract, even if any reference whatsoever to it is included in the credit.19

The bank’s duty is to examine the documents presented to it under the credit and determine, on the basis of the documents alone, whether or not the documents appear on their face to constitute a complying presentation.20 This principle is set out in the Standard Banking Practices for the Examination of Documents (SBPED)21 in the following terms:

*Independence Principle:

The examiner must determine whether or not the required documents comply with the terms and conditions of the letter of credit based solely on examination of the documents on their face. The underlying contract of goods or services should have no bearing on the examiner’s independent decision regarding the documents’ apparent compliance.

In Westpac Banking Corporation v South Carolina National Bank22, Lord Goff said:

19 Article 4 Credits v. Contracts UCP
20 Article 14 (a) of the UCP 600
21 Which is published by the International Financial Services Association
22 (1986)1 Lloyd’s Rep 311 as quoted by Richard King in Gutteridge & Megrah’s op cit p.181
“… It is well settled that a bank which issues a letter of credit is concerned with the form of the documents presented to it, and not with the underlying facts. It forms no part of the bank’s function, when considering whether to pay against the documents presented to it, to speculate about underlying facts.”

The courts have even held that the issuing bank is entitled to reimbursement or indemnity for the money paid from the buyer even if the documents that were presented to it were fraudulently prepared and presented by the seller, if on the face of the documents no fraud was apparent, and the documents on their face were compliant. In *Gian Singh & Co Ltd v Banque de L’Indochine* 23 the issuing bank debited the buyer’s account after paying under a letter of credit which called for “a certificate signed by Balwant Singh, holder of a Malaysian passport E-13276, certifying that the vessel had been built according to specifications and is in fit and proper condition to sail”. It was later discovered that the signature on the document on the certificate upon which the bank paid was a forgery. The buyer sued the bank for wrongfully debiting his account. The Privy Council held that the signature was indeed a forgery but that the certificate was in conformity with the requirements of the credit and, accordingly, the buyer was bound to reimburse the bank. Lord Diplock said:

“In business transactions financed by documentary credits banks must be able to act promptly on presentation of the documents. In the ordinary case visual inspection of the actual documents presented is all that is called for. The bank is under no duty to take any further steps to

23 (1974) 2 Lloyds Rep 1
investigate the genuineness of a signature which, on the face of it purports to be the signature of the person named or described in the letter of credit.”

The ICC has codified this in the UCP. Article 34 of the current edition of the UCP (UCP600) states that:

“A bank assumes no liability or responsibility for the form, sufficiency, accuracy, genuineness, falsification or legal effect of any document…..”\(^2^4\)

As Lord Diplock said in *Commercial Banking Co of Sydney Ltd v Jalsard Pty Ltd* \(^2^5\):

“The banker is not concerned as to whether the documents for which the buyer has stipulated serve any useful commercial purpose, or as to why the customer called for tender of a document of a particular description”

As long as the documents presented are as described, it is not the banker’s duty to exercise any sort of judgment as to the need or legal effect of those documents, not even to consider whether the bank’s customer’s wishes are being carried out. The documents simply have to comply with the terms and conditions of the credit in order for the bank to be reimbursed;\(^2^6\) there is no place for documents that are similar or “almost the same”.

The leading case of *Equitable Trust Co of New York v Dawson Partners Ltd*\(^2^7\) is a perfect example of strict compliance. A credit was opened in Batavia\(^2^8\) and it required, in addition to the usual documents, a “Dutch Government certificate of quality” relating to the goods. The

\(^{2^4}\) Article 34 of the UCP 600
\(^{2^5}\) (1973) AC p.279
\(^{2^6}\) This has developed from the general principle of the law of agency, that an agent is only entitled to reimbursement from his principal if he acts in accordance with his instructions.
\(^{2^7}\) (1927) 27 L.I.L.R.49
\(^{2^8}\) Now known as Djakarta
Government of the Dutch East Indies did not issue such certificates and the credit was, accordingly, varied so that a certificate of quality given by “experts” and signed by the Chamber of Commerce in Batavia will be acceptable. Two problems arose. First, there was no such thing as the Chamber of Commerce in Batavia, there was a body known as the Commercial Association of Batavia which discharged the functions that are normally carried out by chamber of commerce. Secondly the advice forwarded to the correspondent bank in Batavia read “expert” in the singular instead of the plural. As a result of all this the documents that were presented and taken up by the bank included a certificate signed by one expert only and countersigned by the Commercial Association of Batavia. The buyer argued that the bank did not comply with its mandate and was not entitled to indemnity in respect of the money it has paid in order to take up the drafts. The House of Lords held that on the evidence, the Commercial Association of Batavia could be regarded as equivalent to the Chamber of Commerce, but that the presentation was bad on the ground that a certificate furnished by a single expert was not enough.

Lord Summer said:

“…the accepting bank can only claim indemnity if the conditions on which it is authorised to accept are in the matter of accompanying documents strictly observed. There is no room for documents which are almost the same, or which will do just as well…The documents tendered were not exactly the documents which the defendants had promised to take up, and *prima facie* they were right in refusing them.”
It is clear from all the above, that the independence principle and the autonomous nature of letters of credit has been articulated in the current edition of the UCP, and has been repeatedly upheld in courts.

In letters of credit, banks have two duties. A duty towards the seller/beneficiary to pay him if:
   a the seller presents the documents stipulated in the credit
   b the terms and conditions of the credit have been complied with.
A a duty towards the buyer/applicant not to pay unless:
   a the seller presented the documents as stipulated in the credit
   b the seller has complied with the terms and conditions of the credit,

In fact the issuing/confirming bank is irrevocably bound to honour as of the time it issues the credit.\(^2\)

This shows that the independence principle is fundamental to the efficiency of documentary credits as a method of payment in international trade. For this reason, courts in most countries are reluctant to interfere with the mechanism of letters of credit and with the concept of autonomy.

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\(^{29}\) Article 7(a) UCP600
\(^{30}\) Article 7(b), 8(c) of the UCP 600
Chapter Three

The Exceptions to the Independence Principle

A credit by its nature is a separate transaction from the sale or other contract on which it may be based. Banks are in no way concerned with or bound by such contract, even if any reference whatsoever to it is included in the credit.\textsuperscript{31}

The independence principle is of such importance to documentary credit transactions that it has been codified in the UCP. The wording of article 4 (a) of the current edition of the UCP (quoted above) suggests that the independence principle is absolute, but case law suggests otherwise.

The principle itself is treated with great sanctity. However, this chapter will show that there are exceptions to this principle. The following three exceptions will be discussed:

1 fraud
2 unenforceability of the obligation to make payment under the credit or illegality affecting such obligation
3 mutual mistake on the part of the seller and the bank relating to the issue of the credit.

\textsuperscript{31} UCP 600 Article 4 (a)
1 Fraud:-

A nominated bank acting on its nomination, a confirming bank, if any, and the issuing bank must examine a presentation to determine, on the basis of the documents alone, whether or not the documents appear on their face to constitute a complying presentation.\(^{32}\)

In order to understand the effect of presentation of fraudulent documents to the paying bank under an irrevocable letter of credit, the meaning of “fraud” in common law has to be explained.

In common law, a misrepresentation is (i) a statement of a fact which is (ii) untrue, and which (iii) is relied upon by the misrepresentee, especially by entering into a contract with the representor.\(^{33}\) The common law distinguishes between fraudulent and innocent misrepresentations. A misrepresentation is considered fraudulent if the maker knows that it is false, or is reckless as whether it is true or false. He is considered reckless if he does not know whether the statement he is making is true or false, and yet he makes it.\(^{34}\) In the leading case of Derry v. Peek\(^ {35}\), Lord Herschell said:”…Fraud is proved when it is shown that a false representation has been made 1) knowingly or, 2) without belief in its truth or, 3) recklessly, careless whether it be true or false.”\(^ {36}\)

There is no particular definition of fraud in documentary credits, so if we apply the definition of fraud in common law to fraud in LC it includes: supply of inferior quality of products, wrong quantity of goods, worthless

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\(^{32}\) Article 14(a) UCP600  
\(^{33}\) Misrepresentation Act 1967  
\(^{34}\) J.C. Smith, The Law of Contract p.147  
\(^{35}\) (1889)14 AC 337 p. 374  
\(^{36}\) ibid.
rubbish, presentation of false shipping documents where no goods were shipped, or forgery.

If fraud is committed, it is either:

a **Fraud in the underlying transaction:**

When a bank examines the documents presented to it under an LC and they appear, on their face, to constitute a complying presentation, the bank is under a duty to pay.\(^{37}\) In some cases the applicant may suspect fraud in the underlying contract, in which case the bank can not interfere since banks are in no way concerned with the underlying transactions.\(^{38}\) The applicant in this case may apply to the court for an injunction to restrain the bank from paying under the credit. The court will not allow the defendant to rely on the independence principle.

b **Fraud in the documents presented:**

The effect of fraudulent documents depends on the nature of the document and the state of knowledge of the paying bank. If a beneficiary presents documents which are on their face compliant with the terms and conditions of the credit, the bank has no option but to pay, unless it can establish beyond doubt that the documents were not genuine, or suffering from some defect not obvious on the face of them. Here enters the importance of the independence principle, if the documents presented comply with the credit the bank has to pay even if it has knowledge that the seller is, in fact, in breach of the contract of sale.\(^{39}\) However, if the bank suspects that the beneficiary is in breach of the contract of sale, the bank may advise the applicant to consider getting an injunction.

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\(^{37}\) Article 14(a)UCP600

\(^{38}\) Article 4(a)UCP600

\(^{39}\) Gutteridge & Megrah opcit p. 167
In general, in order for the bank to refuse payment the fraud has to be clearly established and the bank must have knowledge of this fraud before payment is made. On the other hand, since the fraud exception is dealt with through case law, international jurisdictions differ in their application of this exception. That is why a number of different jurisdictions are worth considering to show how different courts and jurisdictions approach the fraud exception.

In the English leading case of *United City Merchants (Investments) Ltd and Glass Fibres and Equipment Ltd v. Royal Bank of Canada*\(^{40}\), the English courts relied heavily in the American case *Sztejn v. Henry Schroder Banking Corporation*\(^{41}\). Overall the English case law on the fraud exception is largely based on the developments in America. In addition to that, the American system of law on Documentary Credits is codified, which serves as a good example of a legal system whose documentary credit law is contained in a statute.

\(^{40}\)(1983)AC 168  
\(^{41}\)31 NYS 2d 631 (1941)
A The American Approach:

The leading case in the American law is the *Sztejn v. Henry Schroder Banking Corporation*\(^{42}\). In this case the seller had filled 50 cases with rubbish instead of the goods purchased in terms of the underlying agreement, in order to obtain a bill of lading from the carrier, which would reflect that the purchased goods had been delivered for carriage. The seller passed his draft for collection to the Charted Bank of India, Australia & China, which in due course presented it and the documents and obtained an injunction restraining the defendants from paying. At the hearing, the beneficiary did not contest the fact that the goods delivered were not in fact the goods that were contemplated in the agreement of sale. The only issue that was in dispute was whether the buyer’s allegations could enable the court to prevent payment on the credit.

The defendant argued that since he had presented documents which on their face complied with the terms and conditions of the credit, the bank had no option, but to pay.

The court recognized the independence principle, but made a distinction between the situations where certain conditions are breached and, where the seller fraudulently presents documents in order to get paid for goods that he/she has not shipped.

“It is well established that a letter of credit is independent of the primary contract between the buyer and the seller. The issuing bank agrees to pay upon presentation of documents, not goods. This rule is

\(^{42}\) 31 NYS 2d 631 (1941) as cited by Basil Coustsoudis in the thesis “Letters of credit and the Fraud exception”
necessary to preserve the letter of credit as an instrument for the 
financing of trade.”

The court rejected the defendant’s claim that the plaintiff lacked a 
course of action, and found that the beneficiary’s fraud was ground for 
granting an injunction stopping the bank from paying the beneficiary under 
the LC.
Sheintag J said:

“… where the seller’s fraud has been called to the bank’s attention 
before the draft and documents have been presented for payment, the 
principle of independence of the bank’s obligation under the letter of credit 
should not be extended to protect the unscrupulous seller”

Sheintag J based this exception on the *ex turpi causa non oritur action* 
rule (on an illegal cause no action can be based).

The importance of the Stzejn case arises from the fact that it is the 
first reported case where the exception was applied. It simply stated that the 
independence principle shall not be extended to protect a seller who is 
seeking to receive payment through conduct which is clearly fraudulent.

The question that arises is whether the courts should look at fraud in 
the underlying transaction or on the face of the documents presented. In the 
*Stzejn* case, the fraud occurred when worthless goods were shipped instead 
of the contracted goods and the documents falsely reflected the delivery of 
confirming goods. The court looked at this as fraud relating to documents.

That is to say that the fraud is considered fundamental enough for the 
bank to refuse payment if, in accordance to the doctrine of strict compliance,

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43 Per Sheintag J in Sztejnv. Henry Schroder Banking Corporation 31 NYS 2nd 631 (1941)
the bank would be entitled to refuse payment if the true position was revealed. The distinction of some importance here is the distinction between strict compliance in LC and strict contractual principles. In the latter, a misrepresentation or fraud has to be material or fundamental in order to justify an avoidance of the innocent party’s obligations. But according to the doctrine of strict compliance, even the slightest discrepancy in the presented documents will be enough for the bank to refuse payment.

Another American case highlighting the common law fraud under the New York law and the UCC is *Hyosung America Inc. v Sumagh Textiles Co., Ltd*.44

In this case the Bank of Seoul issued an LC in favour of Sumagh for the purchase of certain fabric with a 65% rayon/35% wool content. Sumagh knowingly shipped fabric with 70% rayon and 30% wool content to Hyosung. In order to comply with the LC terms, Sumagh submitted documents which falsely indicated that the fabric had 65% rayon/35% wool content. Upon receipt of the documents, which on their face appeared to be valid, the Bank of Seoul paid Sumagh under the LC on which Hyosung was liable to reimburse the bank.45

In order for the court to decide whether Hyosung could stop the bank from making further payments on the LC and to recover the proceeds already paid, it looked at the elements of a common law fraud under the New York law, which included:

- a. a material false representation;

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44 (1998) 25 F. Supp. 2d 376 (SDNY) (USA) as quoted in King Tak Fung's Leading Court Cases on Letters of Credit

45 Note that the plaintiff is not the Bank of Seoul but Hyosung, which raised the issue whether Hyosung could successfully assert a fraud claim when Sumagh’s misrepresentation was made to the Bank of Seol.
b. intent to defraud;
c. reasonable reliance on the representation; and
d. causing damage to the plaintiff

The court applied these elements to the fact of the case and concluded that Sumagh knew that the goods shipped did not match the description of the goods stated in the documents. Sumagh also knew that the Bank of Seoul would pay if the documents on their face were compliant. The court, therefore, concluded that Sumagh had intended to defraud Hyosung. It was also clear that if Sumagh had not falsified the documents, the Bank of Seoul wouldn’t have paid on the LC. The court held that Sumagh had made a material false representation on which the Bank of Seoul relied, resulting in payment on the LC.

The court held:

“…The harm to Hyosung was immediate and definite: by drawing on the letters of credit, Sumagh imposed on Hyosung a new obligation to the Bank.”46

“The doctrine of independent contracts seeks to ensure that the issuing bank will promptly pay on letters of credit. However, once the issuer has paid on the letter of credit, the independent contract doctrine’s purpose is satisfied; it cannot be invoked as a bar to recovery against a beneficiary who submitted false documents to draw down on the letter of credit…”47

This case shows the common law fraud elements under the New York law and the key criteria a court may consider in granting an injunction stopping a bank from paying under an LC, and that the applicant may rely on

46 ibid
47 ibid
misrepresentations which were presented to the bank and not to the applicant personally.

*The American Uniform Commercial Code (UCC)*

The UCC provided one of the few examples of a codified system of law relating to documentary transactions. In most jurisdictions, the law relating to documentary credits arises through case law. The *Sztejn v. Henry Schroder Banking Corporation* 48 was a very important turning point in the American law and it is thought that the American law on documentary credit fraud being codified in the UCC was a direct result of that case.

The UCP is generally applied by the courts because most international banks adopt these rules when dealing with documentary transactions. Unlike the UCP, the UCC has specific provisions concerning the exceptions to the independence principle, with particular reference to the fraud exception.

The UCC is an Act that harmonizes the laws of sale and other commercial transactions in 50 states within the United States of America. This is important because of the nature of commercial transactions that extend beyond one state. For example where goods are manufactured in state A, warehoused in state B, sold in state C, and delivered in state D.

The UCC allows a bank to avoid payment on a letter of credit, if the documents presented are fraudulent, or if there is fraud in the transaction 49. It limits the doctrine of strict compliance, and gives the bank the opportunity to refuse payment under a letter of credit. It also answers the question of whether the fraud that gives rise to refusal of payment should be fraud in the

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48 31 NYS 2d 631 (1941)
49 Article 5-109 specifically provides that a bank can dishonor a letter of credit if payment would facilitate a material fraud by the beneficiary on the issuer or applicant. In other words, the fraud need not be contained in the presented documentation. This means that even fraud in the underlying transaction could give the bank grounds for not paying.
underlying transaction or in the documents presented. It states that if the documents presented appear on their face to comply with the terms and conditions of the credit, but a certain document is forged, or if honouring the credit would facilitate fraud on the applicant or issuer by the beneficiary the bank may refuse to pay.

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

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

(2) the issuer, acting in good faith, may honour or dishonour the presentation in any other case.\(^{50}\)

This answers the question of whether the fraud committed should be in the underlying contract or in the documents presented. The wording of the

\(^{50}\) Article 5-109
UCC clearly states that if the fraud is in the documents, then it is ground for the bank to refuse payment. In addition to that, it states that if the honouring of the credit would help commit a fraudulent act or assist in inflicting damage then the bank may also refuse to pay. This means that even if the documents are in order but there is fraud in the underlying contract then this still gives rise to the fraud exception.
The UCC and the UCP:

If a conflict arises between the UCC and the UCP, especially when a letter of credit has been issued under the terms of the UCP, certain states legislatures have provided that article 5 of the UCC will be inapplicable. However, since the UCP does not deal with the Fraud exception, all issues relating to fraud in such states will still be dealt under the terms of the UCC.\textsuperscript{51}

In conclusion, the approach in American Law has been a broad and more diverse one than in other jurisdictions. Although the UCC has limited the exceptions to the independence principle to fraud, it made it clear that the fraud exception extends to fraud in the underlying contract and not merely to fraud in the presented documents.

\textsuperscript{51} Basil Coutsoudis Op cit p. 21
Unlike the English courts, the American courts were more willing to recognize and apply the fraud exception. The development in the English courts was much slower but more stable. In the matters of *Hamzeh Malas & Sons v British Imex Industries Ltd* and *Edward Owen Engineering Ltd v Barclays Bank International Ltd* the court expressed the evidence needed for the establishment of fraud.

In *Hamzeh Malas & Sons v British Imex Industries Ltd* the plaintiffs, a Jordanian firm, contracted to purchase from the defendants, a British firm, a large quantity of reinforced steel rods, to be delivered in two instalments. Payment was to be effected by the opening in favour of the defendants of two confirmed letters of credit with the Midland Bank Ltd in London, one in respect of each instalment. The letters of credit were duly opened and the first was realized by the defendants on the delivery of the first instalment. The plaintiffs complained that that instalment was defective and sought an injunction to bar the defendants from realizing the second letter of credit. Donovan J. refused the application. The plaintiffs appealed and it was held that although the court had a wide jurisdiction to grant injunctions, this was not a case in which, in exercise of its discretion, it ought to do so. An elaborate commercial system had been built upon the footing that a confirmed letter of credit constituted a bargain between the banker and the

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52 (1958)2 QB 127
53 (1978) All ER 976
54 (1958)2 QB 127
vendor of the goods, which imposed upon the banker an absolute obligation
to pay, irrespective of any dispute there might be between the parties as to
whether or not, the goods were up to contract. In the words of Jenkins L.J.
“The court’s jurisdiction to grant injunctions is wide, but in my judgment,
this is not a case in which the court ought to grant one”. In an obiter
statement, Sellers LJ, suggested that the court may under certain
circumstances grant the injunction sought, such as in the case of a fraudulent
transaction.

In Edward Owen Engineering Ltd v Barclays Bank International
Ltd55, the court cited the Sztejn56 case and held that the only case where it
could interfere with the bank’s obligation to pay would be in the case of
obvious fraud, to the knowledge of the bank. Both of these case fell short of
establishing fraud according to the bank’s requirements, clear evidence of
fraud and the knowledge of the paying bank.

Both of the above cases are related to performance guarantees and not
letters of credit. The difference between the two is that performance
guarantees secure compensation for non performance while letters of credit
secure payment for performance. Since the principles relating to letters of
credit apply to performance guarantees, the principles of these cases apply
equally to the letters of credit.

Thirty Five Years after the fraud exception had been applied in the
American courts, the English courts in the late 1970’s bended the
independence principle by applying the fraud exception and establishing
clear principle relating to it.

55 (1978)All ER 976
56 ibid p.21
The first reported case where the scope and nature of the fraud exception was examined in detail is the case of *Discount Records Ltd. V. Barclays Bank Ltd and another*\(^\text{57}\). The facts of this case are similar to the facts of the American Sztejn case\(^\text{58}\). In this case the plaintiff applied for an injunction against the bank, on the basis that the seller had acted fraudulently, in knowingly shipping worthless goods to the buyer, in order to obtain shipping documents, to obtain payment on the letter of credit. The court was reluctant to issue an injunction against the bank, in the basis that the plaintiff was not affected by such a payment since it was made with the bank’s funds. The plaintiff could later simply refuse to reimburse the bank, if the bank had indeed acted wrongly in making payment to the seller.\(^\text{59}\)

This puts the bank in a difficult position, as it runs the risk of not being reimbursed by the buyer if it made payment notwithstanding the existence of adequate justification not to pay on the basis of the fraud exception. On the other hand, the bank may risk being sued if it refuses to pay the beneficiary without adequate justification.

Due to the similarities between this case and the *Sztejn v Henry Schrouder Banking Corporation*\(^\text{60}\) it should be noted here the difference between the approach of the American courts and the English courts. In the Sztejn case the court held that shipping of worthless goods was ground for granting an injunction. On the other hand, the English courts recognized the existence of an exception based on fraud, but it limited its application to a defence that is available only to the party that is defending a claim to make payment under a letter of credit. The issue of the applicant obtaining an

\(^{57}\) (1975)1 All ER 1071

\(^{58}\) Sztejn v. J Henry Shrouder Banking Corporation  op cit p.21

\(^{59}\) It is said that a court should not grant an injunction, unless it is an absolute final remedy, and unless the applicant has absolutely no other recourse in law.

\(^{60}\) ibid 21
injunction to prevent the bank from paying has never been questioned subsequent to the Discount Records matter. It is said that if this case was presented to the court several years later, the court would have applied the fraud exception on the facts of the matter, and would most probably have granted the injunction.\(^{61}\)

\*\textit{United City Merchants (Investment) Ltd and Glass Fibres and Equipment Ltd v. Royal Bank of Canada}\(^{62}\)

This is perhaps the most referred to case in the English law as regards letters of credit. It is a landmark case concerning two of the most important exceptions to the principle of autonomy, the fraud exception and the illegality exception. The illegality shall be discussed later in this thesis. Prior to this case all of the cases involving the fraud exception, the beneficiary was a party to the fraud.

The summary of the facts concerning fraud is that Glass Fibres entered into contractual relations with a Vitrorefuerzos to manufacture equipment necessary for Vitrorefuerzos to be able to make fibreglass in Peru. Vitro instructed its bank to open a letter of credit in favour of Glass Fibres, and this was done through the defendants, the Royal Bank of Canada. On 30 of March 1976, Royal Bank of Canada notified Glass Fibres that it had confirmed an irrevocable L/C issued in its favour by Banco Continental SA. Payment was to be made on the f.o.b value of the equipment plus 100%, against a full set of clean on board ocean bills of lading drawn to the order of Banco. Glass Fibres thereafter assigned to the first plaintiffs (United City Merchants) their rights, entitlements and benefits due under the letter of

\(^{61}\) Basil Coutsoudis op cit p.21

\(^{62}\) (1983) AC 168
credit, and notice of the assignment was given to the defendants. Some time later, the defendants wrote to Glass Fibres, stating that in accordance with instructions received the credit was thereby amended. Neither of the plaintiffs confirmed their agreement to the amendment.

The terms of the L/C required “on board” bills of lading evidencing shipment of goods from London on or before 15 December 1976. Glass Fibres forwarded the various pieces of equipment to M.C.K. Freight Ltd, with explicit instructions confirming the terms of the letters of credit, and in particular pointing out that shipment was to take place on or before the 15th of October 1976. The containers arrived in Felixstowe on the 9th of December, and were loaded on the American Accord on the 16th of December. This was obviously contrary to the provisions of the letters of credit, and would thus have allowed the defendant bank under normal circumstances to refuse to make payment under the letters of credit63.

Upon presentation the defendants refused the documents because they had information in their possession suggesting that the goods were shipped from Felixstowe on the 16th, not on the 15th from London as it appeared on the bills of lading. They also said that the plaintiffs knew of the discrepancies before presenting the documents. It was also alleged that Mr. Baker, an official of the freight agents, acted as an agent on the plaintiff’s behalf in making out the bills of lading as he did, with full knowledge that the statement was incorrect and that if the correct statement was reflected on the bills, that the bank would have refused payment. The counsel acting for the bank also argued that, alternatively, the bank was still entitled to refuse payment as the beneficiary’s knowledge was immaterial to the fraud exception.

63 Such refusal would be in accordance with the principle of strict compliance.
Counsel for the seller tried to reply to each argument. Thus, while accepting the existence of the fraud exception, they argued that the bank was not entitled to use it, due to the fact that the exception requires fraud which occurred with the knowledge of the beneficiary, or the person who presented the documents to the paying bank.

Before discussing the House of Lords judgment, the decisions of the High Court and the Court of Appeal will first be discussed.

**Queen’s Bench Decision:-**

The court held that Mr Baker knew that he was making a false presentation on the bills of lading, upon which the bank was going to pay. The plaintiffs were not aware of his fraudulent behaviour.

Mocatta J. rejected the defendant’s claim that the plaintiff had failed to abide by the terms of the amendments, on the basis that the UCP specifically requires the beneficiary’s consent prior to an amendment of the terms of letter of credit. The fact that the plaintiffs had been notified of the proposed amendment and the fact that they failed to respond could not be construed as an acceptance of the amendment.

Mocatta J found that Mr. Baker was indeed guilty of committing fraud by presenting documents that falsely presented the date of shipment. However Mocatta J could not find that the freight agents were working as agents for the plaintiff, they were in fact acting as loading brokers for Prudential Lines. By proving this, there was no evidence whatsoever to establish fraud on the part of the plaintiffs.

Having dealt with those issues, it was time to deal with the most important one, the issue of strict compliance. In his opinion, the second set of bills of lading which were produced appeared to be in compliance with
the terms of the credit. Thus the bank was compelled to make payment on
the documents. He referred to previous cases including *Hamzeh Malass v
British Imex*[^64] and *Edward Owen Engineering Ltd. V Barclay’s Bank
International*[^65]. He quoted Jenkins LJ in the former case, who stated “It
seems to be plain enough that the opening of the confirmed letter of credit
constitutes a bargain between the banker and the vendor of the goods, which
imposes on the banker an absolute obligation to pay, irrespective of any
dispute 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 a
bankers’ confirmed credit is of that character, and, in my judgment, it would
be wrong for the Court *in the present case*[^66] to interfere with that established
practice.”

In addition to those cases, he also referred to the American *Sztejn
case*[^67] where it was held that “It must be assumed that the seller has
intentionally failed to ship the goods ordered by the buyer. In such a
situation, where the bank got to know of the seller’s fraud 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.”

Mocatta J appeared as if he established the fraud exception as a
defence by stating that “…seems to be nothing in the authorities to prevent a
confirming bank from raising the issue of fraud as a defence after having
refused to pay on the presentation of the documents…”. It should be noted

[^64]: (1958)2 QB 127
[^65]: (1978)All ER 976
[^66]: United City Merchants (Investment )Ltd and Glass Fibres and Equipment Ltd  v. Royal Bank of Canada
[^67]: supra p.21
that the traditional application of fraud was focused on obtaining injunctions preventing the bank from paying under a letter of credit.

According to all of the above, Mocatta J held that, in spite of the fact that, fraud was sufficiently established on its face, it was not within the knowledge of the beneficiary, and for this reason, allowed the plaintiff’s claim against the defendant bank, as far as it related to the fraud exception.

The importance of Mocatta J view of inaccuracy arises from the fact that all the previous cases dealt with fraud on part of the beneficiary, but the vital aspect of this decision is not so much whether the fraud exception can be extended to incorporate material inaccuracy, but rather, whether it was limited to instances where the beneficiary had knowledge of the fraud on presentation of the documents.

*Court of Appeal Decision:-*

The judgment was given by Stephenson L.J., who initially went through the same set of facts relating to the matter. Stephenson L.J. like Mocatta J, dealt with the illegality and with the fraud exception separately. As mentioned earlier the illegality shall be discussed later.

When dealing with the issue of fraud, he specifically dealt with the question of whether the fraud exception could be applied in cases where the beneficiary was unaware of such fraud. Stephenson L.J. made a distinction between an inaccurate document and a false one. A document that tells a lie about the maker or about the time or place of making is a forged document. On the other hand, a document which lies about its contents would be considered as a fraudulent document. The court recognized the distinction, but it held that it need not take it further.
Stephenson L.J. addressed these issues by saying, “the exception of fraud does not apply when the fraud is not the fraud of the seller or beneficiary who tenders the documents. In my judgment it does, and I therefore express no opinion on the effect of material inaccuracy honestly included in the document presented to the bank…” Accordingly, Stephenson reversed Mocatta’s decision, and ruled that it is immaterial to the exception whether the fraud is that of the beneficiary, or of a third party. It is also immaterial as to whether the beneficiary knew of the fraud committed by such third party.

In his decision Stephenson L.J. also referred to the Sztejn\textsuperscript{68} case where it was stated that, “The bank ought not to pay under the credit if it knows that the documents are forged or that the request for payment is made fraudulently in circumstances where there is no right to payment”. In Bank Russo-Iran v Gordon Woodroffe & Co Ltd\textsuperscript{69}, it was stated that, “The exception is that where the documents under the credit are presented by the beneficiary himself, and the bank knows when the documents presented that they are forged or fraudulent, the bank is entitled to refuse payment.”

Stephenson L.J. points out that these cases dealt with fraud on the part of the beneficiary, but in his opinion this does not support the plaintiff’s assertion that the fraud exception is not applicable where the fraud was committed by a third party and the beneficiary was unaware of it. His point of view is quite practical, he thought of who should bear the loss. In his opinion, the bank and applicant are both innocent parties. On the other hand, even if the beneficiary is innocent and did not commit the fraud, he is under the duty to present conforming documents, and if by choosing a third party

\textsuperscript{68}Op cit p.21
\textsuperscript{69}Unreported (1972)
who did not fulfil his obligations under the credit, then he should be deemed responsible and face the risk of loss.\textsuperscript{70}

The requirements of fraud in Stephenson L.J. judgement are:
(a) a fraudulent misrepresentation must be contained in the document
(b) the fraud must be clearly established
(c) the bank must have knowledge of the fraud

By this, Mocatta’s decision was overruled, and the Court ruled in favour of the bank.

The matter was then referred to the House of Lords.

\textit{House of Lords Decision:-}

The House of Lords confirmed the findings of the previous courts, in particular those relating to Mr Baker’s fraud. The House of Lords was required to determine if the previous courts applied the law correctly to the facts, and in particular whether the fraud exception could be enforced if the beneficiary presenting the documents was unaware of the fraud. The court confirmed the independence principle by stating that it was given that the contract between the beneficiary and the paying bank is based on the conformity of the documents and not goods.

Lord Diplock stated:

“If, on their face, the documents presented to the confirming bank by the seller conform with the requirements of the credit as notified to him by the confirming bank, the bank is under a contractual obligation to the seller

\textsuperscript{70} It should be noted here that shipping the goods one day late would not have been material in a normal sale of goods contract and the buyer would not have been legally entitled to avoid his obligations, but since this case was concerned with payment under a letter of credit then the doctrine of strict compliance governed the matter.
to honour the credit, notwithstanding, the fact that the bank has knowledge
that the seller at the time of presentation of the conforming documents is
alleged by the buyer to have, and in fact has already, committed a breach of
his contract with the buyer for the sale of the goods to which the documents
appear on their face to relate, that would have entitled the buyer to treat the
contract of sale as rescinded, reject the goods and refuse to pay the seller the
purchase price."

Lord Diplock clearly supports the application of the independence
principle in English Law, and that there is only one exception to it, fraud.

Lord Diplock referred to the fraud exception as one that has as yet not
been applied in any English case law. He considered that the fraud exception
was well established in American law, and confirmed that it was based on
the ex turpi causa rule. In Sztejn v J. Schroder Banking Corporation, the
nature of the exception required that the beneficiary must have acted
fraudulently. That meant that the beneficiary should not benefit from his
own fraud.

It was held that the case at hand did not fall under the fraud exception
because the sellers were not aware of Mr. Baker’s fraud. The court also
rejected the defendants argument that the confirming bank is under no
obligation to make payment under the documentary credit if the documents
presented contained an inaccurate material fact, even if the documents on
their face were conforming on their face to the terms of the credit. The court

71 Lord Diplock referred to Sztejn v J. Schroder Banking Corporation (1941) 31 N.Y.S. 2d 631. He also
referred to Edward Owen Engineering Ltd. v Barclays Bank International Ltd. (1987) Q.B. 159
72 (1941) 31 N.Y.S 2D. 631
rejected this argument on the basis that it would undermine the whole system of financial international trade by means of documentary credits.

The court did not go into the fraud exception beyond the *ex turpi causa* rule, and decided that the fraud exception was limited to the cases where the beneficiary had knowledge, and that a third-party fraud, of which the beneficiary was not aware of when presenting the documents, *is not sufficient*.

Lord Diplock also referred to Article 9 of the UCP, where it stated that issuing or confirming banks assume no liability to the buyer, for the form, sufficiency, accuracy, genuineness, falsification, or legal effect of any documents. He stated that this duty of the bank towards the applicant must correspond with its duty towards the beneficiary. On this basis, he rejected the defendants’ claim that the bank need not pay if the documents contained any material statement that was inaccurate.

Lord Goode pointed out that Article 9 of the UCP does not create a duty to the bank, but rather creates an entitlement in favour of the bank enabling it to make payment to the beneficiary on documents, which on their face appear to conform to the requirements of the credit, without fear of recourse from the applicant in the event of the documents later being false.\(^\text{73}\)

The House of Lords placed a lot of emphasis on the fact that when Baker committed the fraud, the documents were so designed as to deceive the plaintiff just as much as it was designed to deceive the other party. One might agree with the decision of the Court of Appeal on the basis that the buyer is an innocent party and should be protected from such fraud. In addition to that, it may be argued that it is the seller’s duty to present

\(^\text{73}\) On the other hand this gives the bank the choice not to pay.
conforming documents to the paying bank, and it is his duty to make sure that all the documents are compliant.

It is apparent that American courts are much more willing and open minded when it comes to the application of the fraud exception. The English courts should look beyond the *ex turpi causa rule* and apply the exception even in cases where the beneficiary was unaware of the fraudulent statement.

In the above case, let us assume that the goods in question were some type of medicine and the delay in shipping affected them. Would the bank still be obliged to pay, even if it had information that the goods were in fact defective, merely on the fact that the beneficiary was not aware of the inaccuracy? The decision of the House of Lords states that it should pay.

*The Narrow and The Wide Approach to the Fraud Exception:*

From all that has been discussed, it seems that there are two approaches to the application of the fraud exception. The first is the *narrow approach* which narrows the application of the fraud exception to fraud that relates to documents. On the other hand, the *wider approach* applies the exception even if the fraud exists in the underlying transaction.74

*The Position after United City Merchants:*

Subsequent case law helped to develop some aspects of the law that were not dealt with in *United City Merchants.*

74 In the *Edward Owen* case it is apparent that Lord Denning leaned towards the wider approach
Clear requirements as to the onus of proof required from the party who seeks to avoid payment under the letter of credit were established. If a plaintiff applied for an injunction to stop the bank from paying under the credit, then he must show that the payment is likely to permit the beneficiary to profit from his own fraud at the expense of the plaintiff.75 In order for an injunction to be granted then the plaintiff has to convince the court by presenting a clear and sufficient case of fraud. The mere allegation of fraud is not sufficient.76 Clear strong evidence is required, normally in the form of documentation, is required by the court. The court must decide, solely on the documents in front of it, whether the only realistic conclusion to draw is that fraud has been committed.

When viewing the standard of proof as stated in United Trading Corporation, Waller J in the case of Turkiye Is Bankasi AS v Bank of China77 stated:

“it is not for the bank to make enquiries about the allegations that are being made by one side against the other… (the applicant) must put the irrefutable evidence in front of the bank.”

He stressed that the bank should not be expected to investigate whether the allegations of fraud are true or not. The evidence placed in front of it should clearly make it apparent that fraud has been committed.

In the case of Deutsche Ruckversichering AG v Wallbrook Insurance co Ltd and others78 the plaintiffs tried to convince the court that the onus of proof differed, whether that plaintiff was applying for an injunction against

75 Bolivinter Oil SA v Chase Manhattan Bank, Commercial Bank of Syria and General Company of Homs Refinery (1984) 1 Lloyd’s Rep 251 as quoted by Basil Coutsoudis op cit 31
76 United Trading Corporation SA and Murray Clayton Ltd v Allied Arab Bank Ltd and others (1985) 2 Lloyd’s’s Rep 554 as quoted by Basil Coutsoudis op cit 30
77 (1996) 2 Lloyd’s Rep 611
78 (1994) 4 ALL ER 181
the beneficiary directly, or against the bank preventing it from making payment to the beneficiary under the letter of credit. The court rejected this argument on the basis that it would interfere with the independence principle and the beneficiary’s rights.

In *United City Merchants* the fraud dealt with was present in documents; the court did not deal with fraud in the underlying transaction, since it was not relevant. In *Themehelp Ltd v West and others* the arguments discuss whether the fraud must be present in the documentary credit transaction or whether it is sufficient that fraud is present in the underlying transaction. In this case the plaintiff alleged that the beneficiary had fraudulently misrepresented facts during the negotiation of the contract of sale, in averring to have the support of a client that had in fact transferred its business to a competitor. The contract was to the knowledge of both parties concluded on the basis of this representation. This misrepresentation was not a condition on the bank guarantee, and thus the fraud committed was not present in the documents, but merely in the underlying transaction.

Waite L.J. upheld the fraud exception as stated in *United City Merchants*, and the onus of proof as stated in *Bolivinter Oil SA*, and *United Trading Corporation SA*. He was of the opinion that the plaintiff satisfied the onus of proof, and was thus entitled for an injunction.

The court decided that the fraud exception did in fact apply. It is suggested that was not merely an oversight on the part of the court, because Evans LJ, in his dissenting judgment, specifically took this distinction into

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79 Op cit p. 31  
80 (1995) 3 WLR 751  
81 As quoted by Basil Coutsoudis op cit p 54  
82 Op cit p. 31  
83 Op cit p. 39
account and stated his opinion that the intended drawing on the letter of credit or guarantee itself must be fraudulent.

This judgment doesn’t mean that the decision of the House of Lords in *United City Merchants* and other cases applies to cases where fraud is only apparent in the underlying transaction. It does, however, suggest that when such a case of fraud appears it is in the hands of the court to determine whether the fraud exception applies or not, and to interpret the decision of the House of Lords.
Comparison between the American and the English Approach to the Fraud Exception:

The three fundamental elements concerning fraud are:
1. the fraud should be clear,
2. the bank should have knowledge of the fraud,
3. the beneficiary’s knowledge of the fraud committed.

The approach of either the American or English courts differs towards these elements and their importance.

In the American case of *Sztejn v. Henry Schroder Banking Corporation*\(^{84}\), which is considered the most important case concerning the American courts’ approach to the fraud exception, the court decided that fraud is considered fundamental enough for the bank to refuse payment if in accordance to the doctrine of strict compliance the bank would have been entitled to refuse payment if the true position was revealed. This clearly covers the first two elements mentioned earlier. That is to say that if the fraud was clearly established and the bank had clear knowledge of it the bank would be entitled to refuse payment. In addition to that, the UCC allows the bank to refuse payment even if the fraud is in the underlying contract\(^{85}\), which means that the fraud need not necessarily be established in the document presented.

The American courts’ approach to fraud simply means that if fraud is committed, either in the documents presented or in the underlying contract, and the bank has clear knowledge of that fraud, which entitles the bank to refuse payment. This is quite a wide approach of the fraud exception.

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\(^{84}\) supra p.21
\(^{85}\) Article 5-109
On the other hand, the English courts were very cautious when applying the fraud exception and specially when issuing injunctions. The English courts in the majority of the cases held that the bank’s can be ordered to stop payment in cases of obvious fraud, to the knowledge of the bank.\(^{86}\)

These two points are just the same as in the American approach. But perhaps the most fundamental difference is the one of the beneficiary’s knowledge or involvement in the fraudulent act itself. It has been held in *United City Merchants (Investment) Ltd and Glass Fibres and Equipment Ltd v. Royal Bank of Canada* that if the documents presented by the seller conform with the requirement of the credit then the bank is under a contractual obligation to the seller to honour the credit notwithstanding the fact that the bank at the time of presentation has knowledge that the seller has allegedly committed a breach of his contract with the buyer.\(^{87}\) That means that if the fraud is committed in the underlying contract and the presented documents are conforming then the independence principle applies and the bank is under a duty to pay.

Perhaps the most fundamental difference between the American and English approach in addition to the one concerning the fraud contained in the underlying contract, is the one concerning the beneficiary’s knowledge. The court held in the *United City Merchants* case that if the beneficiary did not commit the fraud himself or even if he was not aware of the fraud committed by a third party then this does not give rise to the fraud exception.

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\(^{86}\) Hamzeh Malas & Sons v. British Inex Industries Ltd., and Edwrd Owen Engineering Ltd V. Barclay’s Bank International Ltd.

\(^{87}\) The courts stand by the independence principle
*In English courts, fraud affects payment when:

1. the beneficiary himself has committed the fraud
2. the beneficiary is aware of the fact that the documents presented, although seem genuine, contain some facts which are untrue.
*The Fraud Exception in Other Jurisdictions*

**South Africa:**

* Loomcraft Fabrics CC v Nedbank Ltd**88**

In this case, the applicant sought to restrain Nedbank from making payment on the letter of credit, based on the allegation that the beneficiary had fraudulently misrepresented the date of shipment on the shipping documents.

This case was the first time where the Appellate Division of the South African High Court dealt with the fraud exception. The court referred to all the classic English cases relating to the principle of independence, including *Edward Owen Engineering*, *Bolivinter Oil*, and others. By doing this the court showed its intention of using the English case law as a guide to the development of the law in South Africa.**89**

Scott AJA lowered the standard regarding the onus of proof by stating that the onus is discharged on the ordinary civil onus, that is, on a balance of probabilities. This is clearly lower than the one required in English law, as stated in *Tukan Timber Ltd v Barclays Bank***90**, where the fraud must be clearly established. Scott AJA stated “fraud will not lightly be inferred particularly when, I should add, it is brought in motion proceeding”.**91**

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**88** South Africa, 1996 (1) SA 812(A)

**89** The facts of this case are very similar to those of the *United City Merchants* since both deal with fraudulent shipping dates. It is likely that the court was guided by the fraud exception as stated by Lord Diplock.

**90** (1987) QB 175

**91** However, in the case of *ZZ Enterprises* (1995) CLD 769 (W) the onus of proof was formulated according to the English case law, and the court held that the fraud must be clearly established before the fraud exception can be invoked.
In addition to that, Scott AJA limited the fraud exception to cases where the appellant had to prove that the beneficiary presented to the bank documents that contained material misrepresentation that, to his knowledge, was untrue, and he knew that the bank would rely on those documents when paying him on the letter of credit. This shows that the South African courts adopted the narrow approach to the fraud exception rather than the wider one, which means that in South Africa the exception exists only with fraud in the documents and not when the fraud exists in the underlying transaction.

While ruling on this case Scott AJA was unclear as to the use of the term material representation, he either referred to the standard required in terms of the law of contract, or as it was adopted in the decision of the House of Lord in *United City Merchants*, were if the bank was aware of the true position would be justified for non-payment.

In the South African law, a party may not as a general rule apply for an injunction if there is an alternative option. In the case at hand the buyer would have had the option to refuse to reimburse the bank and to defend any claims for payment made by the bank, if the bank had indeed wrongly paid under the credit.

In his judgment Scott AJA stated that when conforming documents are presented to the bank, “the bank will escape liability only on proof of fraud on the part of the beneficiary.” From his statement, it seems that according to him, the only possible exception is that of fraud by the beneficiary, where he knowingly presents documents that contain a material misrepresentation.

In his judgment, Scott AJA also recognized the national view that an injunction is possible but only under the most extreme and exceptional circumstances. It is limited to cases of clear and established fraud. The
requirements of clear and established fraud did not exist and mostly for that reason the application for an injunction failed.

It is clear that even though the courts have very wide and large powers for giving an injunction, they are reluctant to do so, whether it is the English courts or the South African ones. I am not aware of a case where an application by the buyer for an injunction has actually been approved by the court. The buyer has the option not to reimburse the bank if it wrongly paid under the letter of credit, or he can sue the seller under the contract of sale.

According to Scott AJA statement “the bank will escape liability only on proof of fraud on the part of the beneficiary” it seems that the only exception in the South African law is of fraud; when the beneficiary knowingly presents documents that contain a fraudulent misrepresentation.92

**Hong Kong:-**

A recent case in Hong Kong provides an excellent illustration of the application of fraud. The court stated that the fraud must be clear and obvious.

*UniCredito Italiano SpA v Alan Chung Wah Tang (2002)*93

The facts of the case are that Guang Xin applied to UniCredito for two local L/Cs of US $2.78 million and US$ 1.09 million, respectively. UniCredito issued the two L/Cs in accordance with the application, except that the beneficiary’s drafts were not included on the list of required

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92 As it is going to be discussed later the House of Lords in England recognized another exception, that of illegality.
93 King Tak Fung's Leading Court Cases on Letters of Credit
documents. On the same day that each of the L/Cs was issued, Guang Xin signed a trust receipt in favour of the bank. Upon the receipt of compliant documents, UniCredito effected payment under the L/Cs and booked two trust receipt loans due on 19 November and 2 December 1998, respectively. On 12 October 1998, Guang Xin went into liquidation. No actual goods pertaining to the L/Cs were found. The bank’s submission of proof of debt for the sums due under the L/C were rejected by the liquidators of Guang Xin on the grounds that UniCredito has been “reckless” and “turned a blind eye” in issuing the L/Cs and in making payments under the L/Cs. UniCredito sought a court order to overturn the liquidator’s rejection of UniCredito’s claims under the L/Cs.

The counsel for the liquidator said that in the absence of “positive knowledge” of fraud by the bank, a lesser standard of “recklessness” against the bank should be tested. The judge held that:

“it is well-established law that the test is whether, standing in the shoes of the paying bank at the time of payment, the fraud was clear and obvious to it…If fraud was clear and obvious, then the bank pays the beneficiary at its own peril and it is not entitled to reimbursement. But if fraud is not clear and obvious, then it is not for a banker to question why the businessmen involved in the underlying transaction had chosen to conduct their business in any particular way.”

The judge further stated:

“It is clear that fraud must only be alleged when there is sufficient evidence and then it must be alleged specifically with full particulars. It is established principle that it is not fair and just to permit a party to raise a vague unparticularised case in the hope of making it good after discovery…Although one understands the constraints placed upon
liquidators and their duty to examine all claims with care, that principle nevertheless applies to them. They cannot put forward an amorphous case of fraud unsupported by proper particulars, prompting a denial by the other party and then assert that a proper issue of fraud has been joined between the parties.”

It was then held that no issue of fraud has been properly and validly raised by the liquidators in the present case. In one of the liquidators arguments, it was argued that the bank’s “recklessness” was shown by it having “turned a blind eye to the [following] points of suspicion”.

“[I]n relation to the applications for the letters of credit, that the letters of credit applied for were for a substantial sum, that the beneficiaries’ offices were located near the Company, that no Advising Bank was involved, and that the documents required were few and simple…”

The judge said:

“in relation to the points made on the applications for the letters of credit, none of the matters referred to, whether singly or jointly, could give clear and obvious notice of fraud. The company was a subsidiary of GITIC, a financial institution wholly owned by the Guangdong Provincial Government that engaged in a wide variety of business activities. The letters of credit in question were for amounts which were within approved or authorized limits for the Company. Since these were purportedly for goods sold and delivered locally, the absence of requirements for shipping documents, air way bills, insurance documents and other paraphernalia of international trade would not have been surprising. Similarly, the absence of an advising bank would not have been surprising. As for the fact that the offices of the beneficiaries were within a few hundred meters (in case of one) and a few kilometres (in case of the other) of the Company, I fail to see
how that could have caused a banker to have notice that fraud was clear and obvious.”

This case clearly shows the elements needed in order for fraud to be applied as an exception. In addition to that, the case shows how the courts are protective of the letters of credit as an international mechanism and will not accept weak allegations of fraud in L/Cs.

This other case in Hong Kong concerns the standard of proof needed for a court in order to restrain a bank from making payment and the beneficiary from dealing with the L/C:

**Prime Deal (HK) Enterprises v HSBC and another (2002)**

In this case, at the request of Prime Deal, on 24 May 2001 and 4 April 2002, HSBC issued two standby L/Cs for 250,000 pounds and 100,000 pounds respectively in favour of Teddy SpA. On 28 May 2002, Teddy SpA drew both standby L/Cs for a total of 350,000 pounds. Prime Deal attempted to contact Teddy SpA by both telephone and e-mail but received no response. Prime Deal contended that Teddy had been perpetrating a fraud. On an ex parte application of Prime Deal, it obtained an interlocutory injunction restraining HSBC from paying out under the L/C; and restraining Teddy from obtaining payment under the two standby L/Cs. Teddy then applied to discharge the injunctions and the Hong Kong court had to decide whether to extend or discharge such injunctions.

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94 ibid
A beneficiary can apply to the court for one of two injunctions, either and injunction to restrain the bank from paying under an L/C, or an injunction to restrain the beneficiary from dealing with the L/C.

_injunctions to restrain payment under an L/C:_

As stated earlier, courts are very protective about L/Cs, they try to preserve the characteristics of L/Cs in their independence from the underlying contract. The judge in the present case quoted Lord Donaldson’s words in the *Bolivinter Oil* case:

“…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. Furthermore, if this happens at all frequently, the value of all irrevocable letters of credit and performance bonds and guarantees will be undermined.”

The judge summarized the key principles that a court looks at when granting an injunction:

“…in order to satisfy the court that an interlocutory injunction should be granted to restrain payment, the applicant must show by clear and cogent evidence both the fact of the fraud and the banks’ knowledge of it. Clear and cogent evidence means that a mere assertion will certainly not be enough: there must be strong or compelling corroborative evidence and the usual form of this would be contemporaneous documents. Where feasible, the court will expect alleged fraudulent party (the beneficiary under the letter of credit in

95 *Bolivinter Oil SA v Chase Manhattan Bank (CA) (1984) 1 WLR*
the question) to have been given an opportunity to answer allegations relating to the fraud before an application for an interlocutory injunction is made. Sometimes this is not feasible, but often it will be. The failure to give any or any proper explanation in answer to the queries raised when an answer can be expected will support the applicant’s case.”

The judge also quoted the following principle from the United Trading Corporation96 case:

“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.”

The judge then explained what was needed in order for an “only realistic inference” to be drawn. He stated that compelling and clear evidence is required. This involves both the serious question to be tried and the balance of convenience requirements.

The serious question to be tried is a result of the principle that states that the more serious the allegation, the more compelling the evidence must be.

As to the balance of convenience, in addition to the proof of fraud, the court will have to examine other factors to see whether the balance of convenience is or is not in favour of stopping payment. In the United Trading Corporation case stated above the court not only looked at the position of the applicant or beneficiary, but also to the position of the bank.

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It did so because if it were to issue an injunction it would seriously affect the reputation and integrity of the bank, which is vital in its business.

In addition to that, even if the applicant could in fact prove fraud, and damages were an available remedy for him, then the courts will refuse to issue an injunction.97

In this case, the court discharged the injunction on the basis that the injunction applications revealed some disputes between the parties, so the judge decided that based on the evidence before him, the only realistic inference to draw was that fraud had not been involved.

The judge then noted that even if fraud has been established then he would not have granted the injunction, based on the fact that the plaintiff did not show that damages would not be available as a remedy. Both HSBC a well known bank and Teddy, a substantial Italian company, if at some later point were in fact held liable; then Prime Deal could recover its damage from the responsible party or parties.

B Injunctions restraining the beneficiary from dealing with the L/C proceeds:

This option is considered when courts do not grant an interlocutory injunction for whatever reason. Such an injunction will only be granted if there is a risk that the beneficiary will dissipate the proceeds and thereby thwart any judgment that the plaintiff may obtain against him. The issues to consider when issuing such an injunction are similar to those of a Mareva injunction98, in which case fraud does not have to be shown or proven, all that is required is a good arguable case, usually a breach of contract (or any cause of action for that matter, a risk of dissipation and the balance of

97 This is quite similar to the position in the South African law supra p.20
98 Where the person will not be allowed to deal in the proceeds before the judgment.
convenience. If these requirements are applied to the case at hand then we find that both HSBC and Teddy are well-known companies and thus the risk of dissipation of assets was minimal. Accordingly, the court did not grant the injunction to restrain the beneficiary from dealing with the L/C proceeds.

**France:**

*Credit Lyonnais v. Canara Bank International Division*\(^\text{99}\)

In this case, the Court of Cassation (the Supreme Court of France) was faced with the question: if a bank has confirmed a documentary credit available by acceptance, and accepted and discounted the draft drawn on it, is it entitled to reimbursement if fraud is established before maturity?

The facts of the case are as follows, upon the request of Hamco, an aluminium importer based in India, Canara Bank, on 18 of March 1998, issued a documentary credit available by acceptance and stated to be payable 180 days after the bill of lading date. Credit Lyonnais confirmed the credit. On 30 of March 1998, the French beneficiary, Soficom, presented the required documents. On 1 April 1998, the beneficiary discounted the yet to be accepted drafts with BDEI, a subsidiary of Credit Lyonnais. On 9 of April 1998, Credit Lyonnais acknowledged the conformity of the documents, accepted the drafts drawn on it, undertook to pay them at maturity (15 September 1998) and transmitted the documents to the issuing bank.

At maturity, BDEI presented the accepted drafts to Credit Lyonnais for payment, but Credit Lyonnais refused to pay. It first contended that it had not yet received payment from the issuing bank, then indicated that it had

\(^\text{99}\) From the ICC Newsletter *Documentary Credits Insight* by Georges Affaki
earlier agreed to an extension of the due date to 15 March 1999. Finally, on 24 of September 1998, it rejected payment outright on account of fraud.

Later, Credit Lyonnais went through a number of corporate reorganization changes, the result of which was that BDEI transferred its receivables portfolio, including its payment claim under the documentary credit in hand to Credit Lyonnais Forfaiting, another subsidiary of Credit Lyonnais. In turn, Credit Lyonnais absorbed Credit Lyonnais Forfaiting, thereby merging two different titles: creditor and debtor under the documentary credit.

Fraud consisting of forgery of the shipping documents was discovered. It should be noted that on the date when fraud was established, Credit Lyonnais had not yet made payment under the documentary credit.

Credit Lyonnais claimed reimbursement from the issuing bank since it had already accepted the drafts drawn on it under the credit when fraud was established. It claimed that it should, therefore, be considered as having performed its undertaking under the credit and should be entitled to reimbursement notwithstanding the fraud. The Commercial Court, the Court of Appeal and the Court of Cassation rejected Credit Lyonnais’ claim. It held that

Whereas a documentary credit available by acceptance can only be considered as executed upon payment of the accepted drafts, a fraud established before such payment invalidated the payment obligation of the accepting bank under the documentary credit, unless the draft is presented by a third party holder in good faith that is not a party to the credit.100

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100 Free translation in the article by Georges Affaki for the ICC Newsletter Documentary Credits Insight
This shows that the French court enforced the internationally upheld rule that no payment is due by a confirming bank under a documentary credit when fraud is established before that bank performs its undertaking under that credit.101

**Ways of Preventing and Minimizing Fraud:-**

As mentioned earlier, letters of credit are normally carried out between parties that have never even met. Since the fundamental principle of LC is that banks pay against documents and are not concerned with the underlying transaction, this gives rise to a problem since not all buyers and sellers are not always honest, banks may find themselves in a position where fraud has been committed and they are forced to pay against presented documents.

It is said that the most important things to do in order to prevent fraud are to know who you are dealing with and to know the business in which you are operating.102 The buyer may help himself by simply checking the *bona fides* of the seller before entering into a contract.

Normally in fraud cases the victim is the buyer where the goods are non-existent and the documents presented were forged and the bank had to pay, and the buyer had to reimburse the bank since it paid against documents which on their face seemed authentic.

101 The other question that the court was faced with was: what moment in time is the confirming bank considered to have performed its undertaking under a credit available by acceptance? This is of importance because when that point is determined the occurrence of fraud before or after that moment would stop or oblige the bank to pay. In the case at hand the court decided that a confirming bank has performed its undertaking under a documentary credit available by acceptance when the bank *actually pays* the draft it has previously accepted. Thus the court denied Credit Lyonnais’s entitlement to reimbursement.

102 Captain P. Mukundan at the International Maritime Bureau as Quoted by Micheal Rowe in “Letters of Credit” 2nd edition p.241
A lot of cases go unreported since the buyer would rather face the loss than to face public embarrassment.

In some cases the buyer, wanting to be on a safe side, stipulates in the credit for presentation of a document to the bank issued or countersigned by him.\textsuperscript{103} In that case, when the buyer is convinced that the seller has shipped the contracted goods he may then issue or countersign the required document so that the seller may present the full set of documents to the bank and receive his payment. The question that arises here is what happens if the buyer refuses to issue such a document and the seller has no way of presenting the full set of documents required under the credit?

In that case if the seller has already shipped the goods and the buyer has obtained property of them then the buyer will be liable to the seller for the price. In addition, the court may be prepared to imply into the contract a term that states that the parties will co-operate to ensure the performance of their bargain. Failure of the buyer to issue or countersign such a document will be treated as a breach of such a term and he will be liable to the seller in damages.\textsuperscript{104}

Another method is the \textit{certificate of inspection}. Where the buyer and the seller agree on a third party to inspect the goods before they are shipped to confirm the quality of the goods, and that party is required to issue a certificate which will be one of the documents required by the bank for payment. The method of paying this third party is according to the agreement between the parties. There are a number of internationally known firms that do this, for example Lloyd’s.

\begin{footnotesize}
\textsuperscript{103} Normally no person would accept this since it means that the payment will be in the hands of the applicant.
\textsuperscript{104} Gutteridge and Megrah’s Law of Bankers’ Commercial Credits op cit p. 50
\end{footnotesize}
In order to minimize and prevent commercial crime, the ICC has set up three units called the International Maritime Bureau (IMB), the Counterfeiting Intelligence Bureau, and the Commercial Crime Bureau. The major part of their work is to provide businesses with the type of knowledge that would help to introduce precautionary procedures.

These are all remedies or ways to minimize the possibility of fraud. But if fraud has already been committed then there are remedies available. For example, compensation through the criminal process. But although this is available very few successful prosecutions are ever brought, partially because of jurisdictional problems. It is more successful and profitable using the civil law and attempt to trace and freeze the assets of the beneficiary, or require an injunction to stop the beneficiary from dealing under the LC.

As mentioned earlier, the bank has the right or is actually under the duty to reject the documents if they are discrepant. In which case the bank refuses to accept the documents, state each discrepancy, and either holds the documents and approaches the applicant for a waiver of the discrepancies, or return the documents to the presenter.105

What is the position of the seller in cases where he is denied payment under the credit, either for presenting discrepant documents or in some cases for the bank being insolvent? It is a known fact that letters of credit are actually conditional and not absolute payment.

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105 Article 16(a) UCP 600
2/ Illegality Exception to The Independence Principle:

The most recognizable exception is the fraud exception; some lawyers in the United City Merchants\textsuperscript{106} even went to the extent of alleging that the only accepted exception to the independence principle is fraud.

Although the illegality exception is not as highlighted as the fraud exception, it is still one of the defences or exceptions which look beyond the letters of credit to the underlying agreement between the parties, and thus an exception to the independence principle.

The most important case considering this exception is the United City Merchants (Investments) Limited and Glass Fibres and Equipment Ltd v. Royal Bank of Canada, Vitrorefuerzos S.A and Banco Continental S.A.\textsuperscript{107}

When deciding the case Mocatta J. separated the hearings based on the two different aspects of the case, the fraud exception\textsuperscript{108}, and illegality. The illegality aspect of the case arose when it was argued that the transaction in question was in part a monetary transaction in disguise. In the financial agreement between the parties the amounts invoiced for goods sold and delivered were inflated by a margin of 100%. Vitro intended to take to itself almost one half of the amounts to be paid in the form of dollars paid to an account in Miami, in order to transfer funds out of Peru, which was contrary to the exchange control regulations of the Peruvian government, and thus alleged to be a monetary transaction in disguise.

Since both countries, Peru and Britain, were signatories to the Bretton Woods Agreement, it would be a violation of Britain’s undertaking in terms

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{106} Infra p.31
\item \textsuperscript{107} (1983) AC 168
\item \textsuperscript{108} Infra p.31
\end{itemize}
\end{footnotesize}
of the Agreement. Thus, the argument that the court was obliged to refuse to enforce the transaction.

Counsel for the bank readily accepted the proposition that the transaction could not be divided, that the good part of the transaction which was considered legal in accordance to the exchange control regulations of the Peruvian government could not be separated from that which was considered illegal, and that accordingly, the Court should refuse to enforce the entire transaction.

**Queen’s Bench Decision:**

Mocatta J. was of the opinion that the parties had inflated the purchase price in respect of the goods, and that the buyer would have repaid to the seller 50% of the value invoiced in US dollars. He further held that the purchasers were quite willing to ignore such a transaction.

He then approached the subject of the independence principle, the documents presented were on their face compliant and conforming documents, allowing a defence of illegality would be considered a further exception to the independence principle.

Mocatta J. refused to enforce the terms of the letter of credit. He furthermore, refused to sever the agreement, and thus refused to enforce payment of the portion of purchase price which was not objectionable. He held that it was not possible to sever the agreement, and thus undertook not to enforce the whole of the agreement.

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109 Article 8 of the Bretton Woods Agreement provides that any such exchange contracts involving the currency of any member, and which are contrary to the exchange control regulations of the member, shall be unenforceable in the territories of any member.
The decision was subsequently appealed before the Court of Appeal.

**Court of Appeal Decision:-**

The counsel for the plaintiffs argued that the court must uphold the independence principle and look only to the letters of credit, and not the underlying transaction. It was argued that even if the underlying transaction was an exchange contract, this should not render the letter of credit unenforceable. It was further argued in the alternative that the part of the transaction which was not objectionable should have been enforced.

It was also alleged that the only accepted exception to the independence principle was fraud. The respondent’s attorneys, on the other hand, suggested that it was wrong to look at a letter of credit in isolation of the underlying transaction when considering whether or not a letter of credit is to be enforced. The counsel argued that if in fact the letter of credit was enforced despite the fact that the underlying agreement was unenforceable due to provisions of the Bretton Woods Agreement, this would in effect make the Agreement ineffective.

Stephenson L.J. gave the judgment of the court, he found sufficient grounds to hold that the present transaction partly constituted an exchange control transaction, and furthermore that it violated the exchange control regulations of Peru. He then considered whether he was bound to ignore the exchange control violation on the basis of the independence principle. In other words, whether the Court should look beyond the letter of credit and look to the underlying transaction which constituted the exchange control
violation, and thus refuse to apply the independence principle and accordingly refuse to enforce the letter of credit.\textsuperscript{110}

He, therefore, came to the conclusion that, “The Court could carry out its double duty in this case by enforcing the part of the agreement which does not offend against the law of Peru, and refusing to enforce the part of it which is a disguised monetary transaction by which currencies were exchanged in breach of law.”

The Court thus agreed with the view of the Court of Appeal, that there is nothing in the Bretton Woods Agreement that prevents the payment under the documentary credit being enforceable to the extent that the payment was legal. It accordingly gave judgment in favour of the sellers, for that part of the transaction which was not a monetary transaction in disguise.

As mentioned earlier, illegality is not a much known exception to the independence principle, so there are not so many reported cases concerning this exception. However, there is a case that is some what recent:

\textit{Mahonia Ltd v JP Morgan Chase Bank (2003)}\textsuperscript{111}

The facts of the case are as follows, on 28\textsuperscript{th} of September 2001, Mahonia, the beneficiary, Chase Bank, the presenting bank, and Enron North American Corp. (ENAC), the applicant, undertook three swap transactions, which were circular in nature. This was a cosmetic device to provide Enron Corporation with a loan of US\$350 million which Enron did not have to record in its accounts as a debt. This was in breach of the US

\textsuperscript{110} International trade requires the enforcement of letters of credit, but international comity requires the enforcement of the Bretton Woods Agreement.

\textsuperscript{111} Leading Court Cases on Letters of Credit by King Tak Fung, ICC publications Chapter 7
securities and other laws. As a condition of entering into these three swaps, Chase required Enron to provide security by way of two LCs issued in favour of Mahonia for a total amount of US$315 million.

The issuing bank, West LB AG, issued an irrevocable transferable standby LC effective 9th of October 2001, available at sight for US$165 million. Another LC for US$150 million was provided by a syndicate of banks led by Chase. On 2nd of December 2001, Enron filed for voluntary Chapter 11 bankruptcy. On 5th of December 2001, Chase presented the documents on behalf of Mahonia and demanded payment. West LB refused to make payment, probably because Enron has entered bankruptcy proceedings. However, neither on the date of presentation nor on the last date for making payment was West LB aware of the details of the swap transactions, nor did it have clear evidence that the transaction was illegal. In the subsequent proceedings, the Bank claimed illegality as its defence to the beneficiary’s claim for payment under the LC. Mahonia initiated this action to strike out West LB’s illegality defence.

West LB alleged that both the LCs and the swaps were entered into for illegal purposes, that of providing a structure upon which Enron’s misleading accounts were founded. The question that arose here was whether the English courts could refuse to enforce the contracts whose purpose was to commit an act that was considered illegal in a foreign country. The court held that it could in fact refuse to enforce these contracts because the enforcement of such contracts would be contrary to public policy. The judge said:

112 The US securities law requires the loan of Enron to be recorded in its accounts as a debt, and by Enron failing to do so it was in breach if the US securities law but this is not considered illegal under the English law.
“Enron’s purpose in procuring the opening of the letter of credit, being to enable it to provide to Chase the security necessary to create by means of the three swaps a device for deceiving the SEC (of the US) and the public, the court would have held that to enforce the contract would be contrary to public policy.”

But the main question was whether Mahonia could strike out the illegality defence and obtain a summary judgment against West LB. The judge summarized the case as follows:

“If a beneficiary should as a matter of public policy (ex turpi causa) be precluded from utilizing a letter of credit to benefit from his own fraud, it is hard to see why he should be permitted to use the courts to enforce part of an underlying transaction which would have been unenforceable on grounds of its illegality if no letter of credit had been involved, however, serious the material illegality involved. To prevent him doing so in an appropriately serious case such as one involving international crime could hardly be seen as a threat to the life blood of international commerce.

In the present case, I have therefore come to the conclusion that on the assumed facts there is at least a strongly arguable case that the letter of credit cannot be permitted to be enforced against the defendant bank. That represents at the very least a realistic prospect of success for the bank’s defence based on this point. Furthermore, the conclusion as to whether enforcement is permissible at least arguably depends on the gravity of the illegality alleged… the fact that the bank did not have clear evidence of such illegality at the date when payment had to be made would not prevent it having a good defence
on that basis if such clear evidence were to hand when the Court was called upon to decide the issue. For this purpose, I proceed on the basis that it now has sufficiently clear evidence as expressed in the pleading.

Accordingly, the claimant’s application to strike out the illegality defence and for summary judgment in respect of that defence will be dismissed. ”

The documentary credits and its independence principle have been adopted to facilitate the international commerce. But if the letter of credit transaction involved an international crime it could hardly be seen as a threat to the lifeblood of international trade to adopt the illegality as an exception.
3 Mistake:-

Unlike the fraud exception, this one is concerned with the law of contract not with the law of commercial credits.

There are three types of mistake:

1 *common mistake*: in which both parties make the same mistake. Each one of the parties knows the intention of the other party and accepts it, but each is mistaken about some underlying and fundamental principal, for example they are both unaware of the fact that the subject matter of the contract has perished. Lord Atkins approached the common mistake issue by saying:

“Mistake as to the quality of the thing contracted for raises more difficult questions. In such a case a mistake will not affect assent unless it is a mistake of both parties, and is as to the existence of some quality which makes the thing without the quality essentially different from the thing as it was believed to be.”

Through the interpretations of what the judges have said and done in a number of cases it appears that they have decided that a common mistake has no effect unless it is of such significance as to eliminate the subject matter of the agreement. Once this has been decided, the contract is considered void. Since the very nature of the contract of sale presupposes the existence of goods capable of delivery.

2 *mutual mistake*: in which both parties misunderstand each other and are at different positions, that is to say that each party is mistaken as to the

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113 In Bell v. Lever Brothers Ltd (1932) p. 218 as quoted by John N Adams and Roger Brownsword's Understanding Contract Law p.130
114 Cheshire, Fifoot and Furmston, Law of Contract p.255
other’s intention and neither party realises the misunderstanding. For example A intends to offer his Mercedes car for sale, while B believes that the offer relates to the BMW which is also owned by A. In such a case both parties have given genuine consent, but the issue that arises is not what the parties intended, but what a reasonable third party would infer from their words or conduct.

The court has to take the position of the third party and decide whether a sensible third party would take the agreement to mean what A understood it meant or what B understood it to mean, or in some cases whether any meaning could be made out of it at all. As Blackburn J put it:

“if whatever a man’s real intention may be, he so conducts himself that a reasonable man would believe that he was assenting to the terms proposed by the other party, and that the other party upon that belief enters into the contract with him, the man thus conducting himself would be equally bound as if he had intended to agree to the other party’s terms”115

This means that if a reasonable man would infer from the wording and conduct of the parties that a contract exists, then the court, not withstanding a material mistake, will hold that a contract in that sense is binding to both parties.116

3 Unilateral mistake: in this case only one of the parties is mistaken. The most distinguishing feature of this type of mistake is that the mistake of

115 Smith v. Hughes (1871) LR 6 QB 597
116 Of course there are some cases where it is impossible make a reasonable assumption that a definite agreement between the parties has been reached, the evidence would be so conflicting that a third party has nothing solid to make an assumption upon. In such a case the court will declare that no contract what so ever has been created.
the first party is known to the other party. It should be noted that a man is taken to have known what would have been obvious to a reasonable person in the light of the surrounding circumstances.

Most cases of unilateral mistake are cases of mistaken identity. A clear example of this is when A, pretending to be X, makes an offer to B, which B accepts believing that A is in fact X. Later on B alleges that he would not have accepted the offer had he known A’s true identity. If this allegation is proved and B’s intention was known to A at the time of the acceptance, then there is no correspondence between offer and acceptance and therefore there is no contract. On the other hand, outward appearances can not be neglected since a contract had been concluded between the parties. The onus of rebutting this presumption lies upon the party that pleads mistake. He has to prove that:

- he intended to deal with some person other than the person with whom he in fact made a contract,
- the latter was aware of his intention,
- at the time of negotiations the identity of the other contracting party was of importance to him,
- reasonable steps were taken by him in order to verify the identity of that party.

As mentioned earlier this exception is related to the contract law and not to the law of commercial credits. But the bank may refuse to pay if the credit was issued as a result of a contract that contains a mistake on behalf of both parties. In addition to that, the bank may refuse to pay if the credit was

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117 If the other second party is ignorant of the first party’s mistake then it would be considered a mutual mistake.
118 Law of Contract op cit p.66, p.253 and 274
issued by reason of a unilateral mistake of the bank and the seller was aware of the mistake so that he draws against the credit in bad faith.\footnote{Gutteridge and Megrah’s op cit p. 8, p. 84}
Chapter Four

Conclusion

“The life blood of commerce”, this is how English judges have described letters of credit. Without this invaluable mechanism the international exchange of goods could not be carried out. Letters of credit are the creation of merchants and bankers. They are the common and universally used method of payment in international business transactions.

Everything in the Letter of Credit system turns to the documents. If they conform then the bank has to pay, even in most cases of fraud if the goods are worthless. If a single document is missing but the goods are perfect the seller cannot require the bank to pay, although he may have a right to claim directly from the buyer. In a nutshell, this is what the mechanism of LC is based on, and this is what this thesis discussed “The Independence Principle and Its Exceptions”.

Despite what most people think an LC is not an absolute form of payment, as the previous chapters have shown there are exceptions. For example, if fraud is apparent on the face of the documents then the doctrine of strict conformity does not apply. Different jurisdictions have different approaches to the fraud exception. The English courts, for example, have been zealous in this respect. When dealing with the UCP and the independence principle the English judges are very conservative. They are very cautious when applying exceptions to the Independence Principle. Its there opinion that injunctions should not be issued frequently and the independence principle should be dealt with carefully. One has yet to come
across a case where an English judge has issued an injunction to stop payment under the letter of credit.

On the other hand, the American approach is so much wider, that it covers fraud which has been committed in the underlying transaction. Furthermore, the American approach differs from the English one in that even if the fraud is committed by a third party it is ground enough to refuse payment. Meanwhile the English courts are of the opinion that the fraud has to be committed by the beneficiary. If it were committed by a third party and the beneficiary had no knowledge of the fraud then that does not give rise to the fraud exception.

Perhaps the difference between the American approach and the English one derives from the fact that in the United States American courts have wider interpretations. In addition to the UCP, they use the UCC. Its importance is apparent in two major points. The first is the method in which it deals with the fraud exception, and most importantly is that it derives its importance from it being a statute and not merely uniformed customs as is the case with the UCP. The UCC is codified, and all states have adopted it, thus it is a statute. While on the other hand the UCP’s application is contractual, both parties have to agree to adopt the UCP as the rules that govern their transaction.

The other exception was the illegality exception, it not as widely known or even used. The illegality exception is one of the cases where you look beyond the letter of credit into the underlying contract. It is one of the cases where the underlying contract affects the payment of the letter of credit, and by that undermines the independence principle. It is available as an exception, but it is not widely used or reported.
It is hard to see that a beneficiary could be able to use the courts in order to enforce a payment under a letter of credit, based on the independence principle, where the underlying contract is unenforceable due to its illegality (if there was no letter of credit involved.)

As with fraud, the illegality exception is a matter of public policy to prevent the beneficiary from using the letter of credit to benefit from his own illegality.

The third exception is the mutual mistake, it is not concerned with the law of commercial credits but rather with the law of contract. But none-the-less it is available as an exception.

Without the Independence principle the importance of letters of credit would diminish. But as it has been discussed earlier, this principle is not and cannot be absolute. When recognizing the exceptions discussed earlier it is clear that they actually protect the documentary credits from being used as a mechanism to defraud people. Thus keeping it as the best option to use a method of payment in international trade, and to deserve it name as *The Life Blood of International Commerce.*
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