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**‘LETTERS OF CREDIT WITH FOCUS ON THE UCP 600 AND THE EXCEPTIONS
TO THE PRINCIPLE OF AUTONOMY WITH EMPHASIS ON THE “FRAUD
RULE” UNDER THE LAWS OF THE USA, THE UK AND THE RSA’**

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DECLARATION

I declare that ‘LETTERS OF CREDIT WITH FOCUS ON THE UCP 600 AND THE EXCEPTIONS TO THE PRINCIPLE OF AUTONOMY WITH EMPHASIS ON THE “FRAUD RULE” UNDER THE LAWS OF THE USA, THE UK AND THE RSA’ has not been submitted for any degree or examination in any university, and that all sources I have used or quoted have been indicated and acknowledged by complete references.

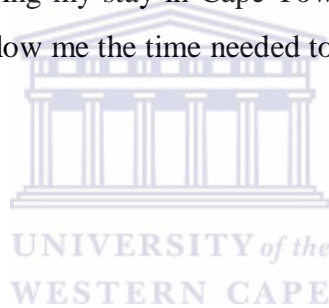
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KEYWORDS

- International trade;
- Letter of credit;
- Documentary credit;
- Standby letter of credit;
- Commercial letter of credit;
- Payment method;
- International Chamber of Commerce;
- Uniform Customs and Practice for Documentary Credits;
- International Standard Banking Practice;
- UNCITRAL-Convention;
- Strict compliance principle;
- Autonomy principle;
- Fraud;
- Fraud rule;



LIST OF ABBREVIATIONS

All ER	All England Law Reports
BURR	Burrow's Kings Bench Reports Tempore (Mansfield)
CA	Court of Appeal
CLC	Commercial Law Citation
CLD	Juta's Commercial Law Digest
CLR	Commercial Law Reports (Juta)
eUCP	Supplement to the Uniform Customs and Practice for Documentary Credits for Electronic Presentation (without referring to a specific version of it)
F Supp	Federal Supplement
F 2d	Federal Reporter, Second Series (part of the West's National Reporter Series)
HKLR	Hong Kong Law Reports
HL	House of Lords
ICC	International Chamber of Commerce
ISBP	International Standard Banking Practice for the Examination of Documents Under Documentary Credits (published in 2003)
ISP98	International Standby Practices
Lloyd's Rep	Lloyd's Law Reports
NYS	New York Supplement
NYS 2d	New York Supplement, Second Series
Prior UCC Article 5	Article 5 of the United States Uniform Commercial Code
QB	Queen's Bench
Revised UCC article 5	Article 5 of the United States Uniform Commercial Code of 1995
SA	South African Law Reports
UCC	Uniform Commercial Code of the United States of America
UCP	Uniform Customs and Practice for Documentary Credits (without referring to any specific version of it)
UCP 400	1983 Version of the Uniform Customs and Practice for Documentary Credits

UCP 500	1993 Version of the Uniform Customs and Practice for Documentary Credits
UCP 600	2007 Version of the Uniform Customs and Practice for Documentary Credits
UNCITRAL	United Nations Commission on International Trade Law
UNCITRAL Convention	United Nations Convention on Independent Guarantees and Stand-by Letters of Credit
URCG	1978 Uniform Rules for Contract Guarantees, ICC Publication No 325 (1978)
URDG	1992 Uniform Rules for Demand Guarantees, ICC Publication No 458 (1992)



CHAPTER ONE

INTRODUCTION

1. CHAPTER OVERVIEW

This mini-thesis is divided into the following five chapters.

1.1 Chapter I introduces the topic of the mini-thesis, starting with the history and function of letters of credit. Subsequently, the fundamentals and the working system of a typical letter credit transaction are discussed, followed by a description of the aims and significance of this mini-thesis and the research methodology.

1.2 Chapter II gives an overview of the main sources of letter of credit law and the obligations of the parties involved in a letter of credit transaction under the regime of the UCP 600.

1.3 Chapter III presents the key principles of letter of credit law and provides a general overview of exceptions to the principle of autonomy.

1.4 Chapter IV focuses on the fraud rule and how it is applied according to the laws of the USA, the UK and the RSA. This Chapter also deals with the question as to whether the fraud issue could be improved, if standard rules and guidelines were implemented in an international legal framework specifying the application of the fraud rule.

1.5 Chapter V provides a general summary and conclusions.

2. HISTORY AND BACKGROUND OF THE LETTER OF CREDIT

The term 'letter of credit' is derived from the French word 'accréditif', which means 'a power to do something', which in turn derives from the Latin word 'accreditivus', which means 'trust'.¹ The letter of credit is also referred to as documentary credit.²

Some academics believe that the sources of letters of credit can be traced back to early Egypt and Babylon, which already had a sufficient banking structure. Rufus Trimble e.g. refers to a clay promissory note of Babylon dating from 3000 B.C., which provided for the payment of

¹ Koudriachov SA 'The Application of the Letter of Credit Form of Payment in International Business Transactions' (2001) 10 *Currents International Trade Law Journal* 37 (hereinafter Koudriachov SA (2001)).

² The terms 'letter of credit' and 'documentary credit' are used interchangeably.

an amount and the interest on an explicit date.³ It is confirmed that banks in ancient Greece prepared letters of credit ‘on correspondents with the view to obviating the actual transport of specie on payment of accounts’.⁴

In the Middle Ages, apart from the bills of exchange, letters of credit were used as a way of pecuniary transport, as merchants faced two problems: (i) carrying along gold on trade missions was very unsafe; and (ii) the lack of a trade currency that was adequate to comply with the needs of merchants.⁵ Instead of carrying along gold on his journey a merchant would entrust his money to his bank and the bank would issue him a letter of credit to be honoured by the distant bank at the merchant’s destination.⁶ De Rover⁷ mentions letters of credit employed by the Medici Bank in Bruges and in Italy between 1385 and 1401, which set forth provisions similar to those of the contemporary letters of credit, e.g. it was regulated that (i) disbursement is to be made as demanded by a named beneficiary; (ii) disbursement may not exceed a particular amount; (iii) the payor shall obtain receipts from the beneficiary; (iv) disbursement is to be charged to the account of the issuer with the payor; (v) after receipt of a notification in writing from the payor that disbursement has been made, the issuer shall credit the payor’s account accordingly.⁸

In the following centuries the letter of credit became more and more important in international trade, with the British banks gaining a virtual monopoly on the issuing of letters of credit because of the fact that in international trade the Pound Sterling had become the most accepted currency and the bankers of London had gained an outstanding status in the area of international finance.⁹

Due to the ‘competition of factorage houses for business, which led to the issuance of promises to accept drafts against shipments’ the letter of credit appeared in the United States of America with increasing importance as a result of the increasing number of manufacturers and

³ Trimble RF ‘The Law Merchant and the Letters of Credit’, (1948) 61 *Harvard Law Review* 982-86 (hereinafter Trimble RF (1948)); see also Macintosh KL ‘Liberty, Trade, and the Uniform Commercial Code: When Should Default Rules Be Based on Business Practices?’ (1996) 38 *William & Mary Law Review* 1499 (hereafter Macintosh KL (1996)).

⁴ Trimble RF (1948) 984; see also Davidson A ‘The Evolution of Letters of Credit Transactions’ (1995) *Butterworths Journal of International Banking Financial Law* 128; Davidson A ‘Developments in the Utilisations of Letters of Credit Transactions’ (1995) *Butterworths Journal of International Banking Financial Law* 328.

⁵ Tóth Z ‘Documentary Credits in International Commercial Transactions with special Focus on the Fraud Rule’ (2006) at 1 (hereinafter Tóth Z (2006)).

⁶ Koudriachov SA (2001) 37.

⁷ de Roover R ‘Money, Banking and Credit in Medieval Bruges’ (1942) 2 *Journal of Economic History* (Suppl. Issue) 52, referred to by Tóth Z (2006) 2.

⁸ See also Trimble RF (1948) 985.

⁹ Tóth Z (2006) 2.

their connections with distant dealers, the specialisation of banking activities and the technological progress of communicating the contract terms by way of telegraph.¹⁰

Despite its long mercantile history the letter of credit has a much shorter legal history. *Pillans and Rose v Van Mierop and Hopkins*¹¹ is one of the first lawsuits involving a letter of credit and a landmark case in the UK's letter of credit law.¹² Cases such as *Orr & Barber v. Union Bank of Scotland*¹³, *The British Linen Company Bank v. The Caledonian Insurance Company*¹⁴ and *Re Agra & Masterman Bank v. Ex Parte Asiatic Banking Corporation*¹⁵ demonstrate that it is only since the second half of the 19th century when transactions similar to the modern commercial credit began to appear and that banks became properly involved in the utilisation of the credit arrangement.¹⁶

The law of letters of credit has developed largely through customs of international trade¹⁷, which mostly the International Chamber of Commerce has codified in the Uniform Customs and Practice, the Uniform Rules for Demand Guarantees, the Uniform Rules for Contract Guarantees and the International Standby Practice.¹⁸

3. LETTER OF CREDIT AS A MECHANISM FOR BALANCING INTERESTS

International sales transactions bring about various difficulties and risks due to the physical distance between parties¹⁹, different time zones and currencies, the need for additional conciliators,²⁰ the relevance of multiple jurisdictions nature of multi-jurisdictional transactions and the possibility of different legal rules applicable²¹ to the transaction as well as the fact that the parties do not generally know each other.²²

¹⁰ Kozolchyk B 'The Legal Nature of the Irrevocable Commercial Letter of Credit' (1965) *American Journal of Comparative Law* 398.

¹¹ *Pillans and Rose v Van Mierop and Hopkins* (1756) 97 Eng Rep 1035 (3 BURR 1666) (hereafter *Pillans and Rose v Van Mierop and Hopkins* (1756)); this case is discussed at Mitchell C & Mitchell P 'Landmark Cases in the Law of Contract' (2008).

¹² McCurdy W 'Commercial Letters of Credit' (1922) *Harvard Law Review* 539.

¹³ *Orr & Barber v Union Bank of Scotland*, (1854) H. L. p. 513.

¹⁴ *The British Linen Company Bank v. The Caledonian Insurance Company*, (1861) 4 Macq. H. L. Cas. 107; 4. L. T. 162.

¹⁵ *Re Agra & Masterman Bank v Ex Parte Asiatic Banking Corporation*, (1867) L. R. 2 Ch. App. p 391.

¹⁶ Adam MI 'The Perceived Problems in the Utilisation of Letters of Credit: A Comparative Study' (1991) 23.

¹⁷ Kozolchyk B 'Letters of Credit' in Ziegler JS (ed) 9 (1980) *International Encyclopaedia of Comparative Law* 10 (hereafter Kozolchyk B (1980)).

¹⁸ See Chapter II 1.

¹⁹ Garcia RLF 'The Autonomy Principle of Letters of Credit' (2009) *Mexican Law Review* 69 (hereafter Garcia RLF (2009)).

²⁰ Bollen R 'An Overview of the Operation of International Payment Systems with Special Reference to Australian Practice: Part 1' (2007) *Journal of International Banking Law and Regulation* 381 (hereafter Bollen R (2007)).

²¹ Bollen R (2007) 379.

²² Grassi PS 'Letter of Credit Transactions: The Banks' Position in Determining Documentary Compliance. A Comparative Evaluation under U.S., Swiss and German Law' (1995) *Pace International Law Review* 122 (hereafter Grassi PS (1995)).

Assume, for example that an exporter from Munich intends to sell hops to an unknown importer and beer producer in South Africa. Naturally, the parties' interests are contrary especially with regard to the timing of payment. Whilst it is preferable for the exporter to obtain payment preferably before the despatch of the hops, the importer will insist on postponing such payment ideally until after receiving the hops. The exporter is anxious that, after already bearing the costs of loading and shipping the hops, the importer may become insolvent or refuse to pay for the hops after the arrival in South Africa. The exporter may be forced to sue the importer in South Africa, i.e. in an unknown foreign jurisdiction. Additionally the exporter may be forced to dispose of the hops before they decay, again in an unknown country with unfamiliar customs and laws. In case the importer makes an advance payment of the purchase price he fears to take the risk that the exporter may not ship the amount or quality of hops contracted for or does not deliver any goods at all. Consequently the timing and the efficiency of the payment are crucial for the success of any sales transaction.

Letters of credit deal with these issues efficiently because, for international parties, they are issued in a transparent way, can be examined by the receiving party and lead to a reliable payment by the bank. Lord Wright described the letter of credit as a 'bridge between the period of the shipment and the time of obtaining payment against documents'.²³ The letter of credit allows the beneficiary to rely on the bank's instead of the importer's creditworthiness. Further it gives a payment guarantee, provided the exporter produces the required documentation.²⁴ Regardless of its costs and complex formal requirements the letter of credit plays a leading role in international sales transactions.²⁵ It is estimated that letters of credit transactions exceed USD 1 trillion per annum.²⁶ It is referred to as 'the life blood of international commerce'.²⁷

4. FUNDAMENTALS OF A LETTER OF CREDIT TRANSACTION

4.1 Definition of Letter of Credit

There is no universal one but rather multiple definitions of the letter of credit, depending on the set of rules applicable to the letter of credit transaction.²⁸ However, in simple terms a letter of credit is a written instrument employed in the event that someone ('applicant') undertakes

²³ *T. D Bailey, Son & Co. Y. Ross T. Smyth & Co. Ltd.* (1940) 56 T.L.R. 828.

²⁴ Bergami R 'Discrepant Documents and the Letter of Credit – The Banks' Obligations under UCP 500' (2003) *Vindobona Journal of International Commercial Law & Arbitration* 106 (hereafter Bergami R (2003)).

²⁵ Grassi PS (1995) 122.

²⁶ See Bergami R 'Will the UCP 600 Provide Solutions to Letter of Credit Transaction?' (2007) 3 *International Review of Business Research Papers* 41 referring to Klein CH 'Letter of Credit Law Developments' (2006) Jenner & Block LLP, Chicago 1.

²⁷ *Harbottle (RD) (Mercantile) Ltd v National Westminster Bank Ltd* [1978] 1 QB; [1977] 2 All ER 862 (CA).

²⁸ See Article 2 UCP 500; Article 2 UCP 600; section 5-102(10) UCC; Rule 1.01 ISP 98; Article 2 UNCITRAL Convention.

to pay another person ('beneficiary') under a given contract ('underlying contract'), provided the terms expressly specified in the letter of credit are met.²⁹

4.2 Main Operations of a Letter of Credit Transaction

The commercial letter of credit is the classic form of a letter of credit. According to the 'Uniform Customs and Practise for Documentary Credits' ('UCP')³⁰, which are the most acknowledged set of rules and adopted in virtually every letter of credit, basically operates as follows:³¹

There are at least three parties involved: the seller, who is also referred to as the exporter or beneficiary; the buyer, who is also referred to as the importer or applicant; and the issuing bank, which issues the letter of credit either at the request of the applicant or on its own behalf.³² Further the letter of credit consists of at least three different autonomous contracts:³³ First, the underlying contract (e.g., the purchase contract)³⁴ under which the seller agrees to sell the goods to the buyer and the buyer agrees to pay the seller the purchase price. Secondly, a contract between the buyer and the issuing bank under which the issuing bank agrees to issue the letter of credit for the benefit of the seller and the buyer agrees to reimburse the issuing bank for the payment made under the letter of credit plus a commission.³⁵ Thirdly, the issuing banks undertaking towards the beneficiary under which the issuing bank agrees to honour the beneficiary's draft provided it is accompanied by the required documents specified in the letter of credit.³⁶

In practice, however, the beneficiary generally does not deal directly with the issuing bank. The issuing bank regularly arranges for a bank in the beneficiary's country to advise the credit, i.e., to check the authenticity of the credit and hereafter deliver it to the beneficiary. The issuing bank in addition or alternatively may ask another bank in the beneficiary's coun-

²⁹ See Gao X & Buckley RP 'The Unique Jurisprudence of Letters of Credit: Its Origin and Sources' (2003) *San Diego International Law Journal* 95 (hereafter Gao X & Buckley RP (2003)) with reference to early common law definitions; see also Lipton JD 'Documentary Credit Law and Practice in the Global Information Age' (1999) *Fordham International Law Journal* 1972 (hereafter Lipton JD (1999)); further see Megrah M 'Risks Aspects of the Irrevocable Letter of Credit' (1982) *Arizona Law Review* 260.

³⁰ See Chapter II 1.1 for more details on the UCP 600.

³¹ See Figure 1 below.

³² See Article 2 UCP 600.

³³ Figure 2 below shows the establishment contracts of a typical letter of credit transaction.

³⁴ See Article 4 UCP 600.

³⁵ Wight R & Ward A 'The Advising Bank in Letter of Credit Transactions and the Assumption of Agency' (1993) *Journal of International Banking Law* 432 (hereafter Wight R & Ward A (1993)).

³⁶ See Article 7 UCP 600.

try to make the credit available upon the presentation of complying documents.³⁷ The bank that advises the letter of credit to the beneficiary is referred to as the ‘advising bank’ and the bank to which the beneficiary is to present the complying documents is referred to as the ‘nominated bank’. The advising bank acts as an agent of the issuing bank.³⁸ It advises the credit at the request of the issuing bank³⁹ without any undertaking to honour the credit.⁴⁰ ‘By advising the credit (...) the advising bank signifies that it has satisfied itself as to the apparent authenticity of the credit (...) and that the advice accurately reflects the terms and conditions of the credit’.⁴¹ The advising bank may offer payment to the beneficiary in addition to and independent of its advising obligation towards the issuing bank, to transmit the terms of the letter of credit to the beneficiary.⁴² However, unless the advising bank issues its own confirmation to a letter of credit, it does not become a party to the letter of credit and is therefore not obligated to honour the promise of payment it includes.⁴³ The advising bank can also take on the function of the nominated bank.⁴⁴

The issuing bank authorises the nominated bank to effect payment to the beneficiary under the letter of credit upon the presentation of the required documents (most importantly the bill of lading).⁴⁵ The nominated bank makes the credit available⁴⁶ to the beneficiary upon presentation of complying documents and gets reimbursed by the issuing bank⁴⁷, unless it is stipulated otherwise.⁴⁸

Sometimes the beneficiary asks another bank to confirm the letter of credit.⁴⁹ By confirming the issuing banks’ letter of credit, the confirming bank undertakes a primary and personal obligation towards the beneficiary in exactly the same terms as, but in addition to, that of the issuing bank.⁵⁰ Hence, the risk that either the applicant fails to pay the purchase price or the issuing bank fails to honour the credit is reduced by providing the beneficiary with a third and

³⁷ See Baker B ‘Exporting Against Letters of Credit’ available at <http://www.qfinance.com/contentFiles/QF02/g1xtn5q6/12/3/exporting-against-letters-of-credit.pdf> (accessed on 2 February 2013) 2 (hereafter Baker B (2013)).

³⁸ For more details see Wight R & Ward A (1993) 435; see also Mugasha A ‘*The Law of Letters of Credit and Bank Guarantees*’ (2003) 196 (hereafter Mugasha (2003)).

³⁹ Or at the request of a nominated bank.

⁴⁰ See Article 9 UCP 600.

⁴¹ Article 9(b) UCP 600; see Jeffery S ‘The New UCP 600’ (2007) *Banking & Finance Law Review* 196.

⁴² Längerich R ‘*Documentary Credits in Practice*’ (2000) 106 (hereafter Längerich (2000)).

⁴³ Wight R & Ward A (1993) 432.

⁴⁴ Zhou L ‘Legal Position Between Advising Bank and Confirmation Bank: Contrast and Comparison’ (2002) *Journal of International Banking Law* 225 (hereafter Zhou L (2002)).

⁴⁵ Längerich R (2000) 160.

⁴⁶ See Article 2 UCP 600.

⁴⁷ Article 7(c) UCP 600.

⁴⁸ See also Article 13(a) UCP 600 in connection with the URR 725.

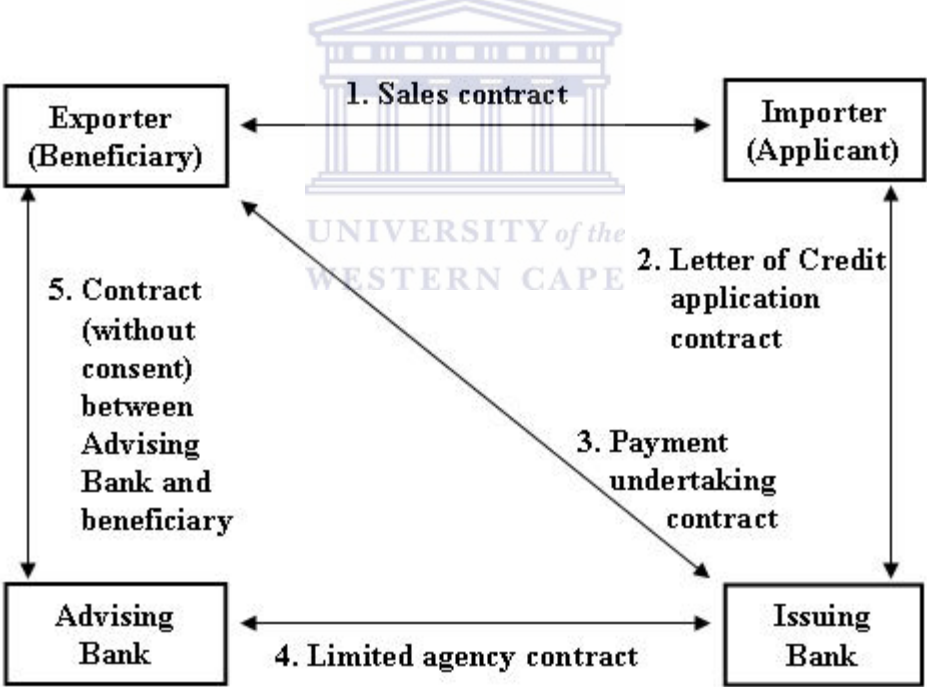
⁴⁹ See Article 2 UCP 600.

⁵⁰ Watson A ‘*Finance of International Trade*’ (1990) 144.

independent claim against the confirming bank.⁵¹ The beneficiary's interest of asking the confirming bank to confirm the letter of credit is that he might be anxious about the political or economic steadiness of the importer's country or the strength and reputation of the issuing bank.⁵² If the credit is available with any bank, the advising bank, the nominated bank or any other bank could confirm the credit on the request of the beneficiary.⁵³

To involve a nominated bank, confirming bank or advising bank is quite common because of the following benefits:⁵⁴ When the beneficiary obtains a credit to secure the payment for the shipment of goods to the applicant, the beneficiary can be confident that the credit is authentic, thus that it has been issued by the issuing bank. As the issuing bank is regularly not situated at the place of the beneficiary, the beneficiary is not aware of and cannot verify the authorised signatures of the issuing bank. Accordingly, the issuing bank will transmit the credit through one of its correspondent banks or even the beneficiary's own bank.

Figure 1: Letter of Credit establishment contracts⁵⁵

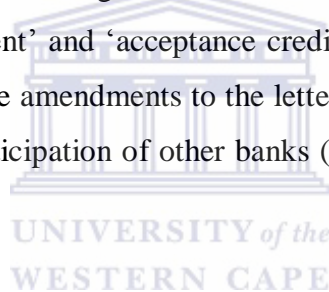


⁵¹ Längerich R (2000) 84.
⁵² For further reasons see U.S. Department of Commerce – International Trade Administration ‘Trade Finance Guide – A Quick Reference for U.S. Exporters’ (2007) available at http://trade.gov/media/publications/pdf/trade_finance_guide2007.pdf (accessed on 2 February 2013) 8.
⁵³ See Baker B (2013) 2.
⁵⁴ See Längerich R (2000) 104.
⁵⁵ Figure 1 is an extract from Bergami R (2011) 91; see also Burnett R ‘Law of International Business Transactions’ 3 ed (2004) 175.

4.3 Categories and Types of Letters of Credit

Letters of credit are categorised in many ways and into many different types. However, in a general sense they fall into two main categories, namely the ‘commercial’ letter of credit, which is a payment mechanism⁵⁶, and the ‘standby’ letter of credit⁵⁷, which is basically a guarantee to pay to benefit of the beneficiary.⁵⁸ Despite the similar legal nature of commercial and standby letters of credit, there are major differences between the two as regards the commercial purpose, the honouring of the credit and the risk involved.⁵⁹ For instance, the risk of fraudulent calls is much higher in a transaction regarding a standby letter of credit than a commercial letter.⁶⁰ That is because in a commercial letter of credit the beneficiary must provide a whole set of documents, which in general are produced and issued by third parties, unlike a standby letter of credit transaction where in general the beneficiary produces the documents.⁶¹

Letters of credit are also typified with regard to the manner of the honouring the credit (e.g. ‘sight payment’, ‘deferred payment’ and ‘acceptance credit’⁶²), the possibility of the issuing bank to withdraw from or to make amendments to the letter of credit (‘revocable and ‘irrevocable’ letters of credit⁶³), the participation of other banks (e.g. ‘confirmed’ letter of credit⁶⁴),



⁵⁶ Gao X & Buckley RP (2003) 100; see also Chapter I 3.2.

⁵⁷ For general information about standby letters of credit see Buckley RP ‘Potential Pitfalls with Letters of Credit’ (1990) 70 *Australian Law Journal* 227; for a discussion on the nature of standby credits and the difference between a standby credit and a conventional guarantee see Dolan JF ‘*The Law of Letters of Credit – Commercial and Standby Credits*’ 4 ed (2007) ch. 1.04 and 1.05 (hereafter Dolan JF (2007)).

⁵⁸ Standby letters of credit are said to be invented in the USA in the 1950s as a functional equivalent to guarantees, as U.S. banks in general were restricted from issuing guarantees (see Wood JS ‘Drafting Letters of Credit: Basic Issues under Article 5 of the Uniform Commercial Code, UCP 600, and ISP98’ (2008) *The Banking Law Journal* 103 (hereafter Wood JS (2008)); for a different view as regards the reason for the original development of standbys, see Byrne JF ‘Foreword to Boris Kozolchik, Bank Guarantee and Letters of Credit: Time for a Return to the Fold’ (1989) 11 *University of Pennsylvania Journal of International Business Law* 4). In general, standby letters of credit have a very broad scope of application (see Dolan JF (2007) ch. 1.04 and 1.24) and are categorised descriptively with regard to their operation in the underlying transaction. The preface to the ISP 98 (see below in Chapter II 1.3) gives various examples for such categories, e.g. ‘Performance Standbys’; ‘Advance Payment Standby’; ‘Big Bond/Tender Bond Standby’; ‘Counter Standby’; ‘Direct Pay’ standby; ‘Insurance Standby’ etc. A simple standby letter of credit basically operates within the same legal framework as the commercial letter of credit.

⁵⁹ For a detailed discussion of these differences see Kelly-Louw M ‘Selective Legal Aspects of Bank Demand Guarantees’ (2008) 81 (hereafter Kelly-Louw M (2008)); see also Horn N ‘German Banking Law and Practice in International Perspective’ (2011) 196; Goode RM (1995) 730; Turner PS (1999) 459.

⁶⁰ The fraud issue will be dealt with in detail in Chapter III.3. and Chapter IV.

⁶¹ See Kelly-Louw M (2008) 82; Lipton JD (1999) 1976.

⁶² See Article 2 UCP 600.

⁶³ A revocable letter of credit can be amended, changed or even cancelled at any time without the beneficiary’s consent. Hence it doesn’t provide any security to the beneficiary, which the case of *Cape Asbestos Company, Limited v Lloyds Bank* [1921] WN 274 illustrated (the case is discussed by Ward W & Harfield H ‘Bank Credits and Acceptances’ (1958) 14 et seq). By contrast, irrevocable letters of credit can neither be amended nor cancelled without the parties’ prior agreement in writing (see Article 10 UCP 600). Revocable letters of credit *per definitionem* do not fall within the scope of UCP 600 (see Bergami R ‘UCP 600 rules – changing letter of credit business for international traders?’ (2009) *International Journal of Economics and Business Research* 200).

⁶⁴ See above I.3.2.

the renewal of a letter of credit (revolving letters of credit⁶⁵), and special forms of letters of credit (e.g. ‘Red Clause’⁶⁶; ‘Green Clause’⁶⁷; ‘transferable’ credits⁶⁸; ‘Back-to-Back’ letter of credit⁶⁹).⁷⁰

5. KEY PRINCIPLES OF A LETTER OF CREDIT

A letter of credit is characterised by two key principles; the principle of autonomy or independence and the principle of strict compliance.

5.1 Principle of Autonomy

The key element of any letter of credit, regardless of the set of rules applicable, and the reason for its widely spread use is the autonomy of the bank’s obligations from the underlying contract and other related contracts.⁷¹ This principle is referred to as ‘autonomy’ or ‘independence’ principle.⁷² Article 4 UCP 600 defines the autonomy principle as follows:

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

In addition, Article 5 UCP 600 states that ‘[b]anks deal with documents and not with goods, services or performance to which the documents may relate’. Accordingly, the issuing bank must honour the credit upon a complying presentation regardless of any non-fulfilment of the

⁶⁵ This credit is designed for continuous business relationships where parties carry out multiple shipments over an extended period of time; see Del Busto C (1994) 49; see also *Trans Global Alloy Ltd. v First National Bank* (1990) 564 So 2d 697.

⁶⁶ The ‘red clause’ originates from Australia or New Zealand and was designated for trading in wool; for more details see Längerich R ‘*Documentary Credits in Practice*’ (2009) ch. 19.1 (hereafter Längerich R (2009)); Nolan JL ‘*Australia Business: The Portable Encyclopedia for Doing Business With Australia*’ (1996) 239; Scotiabank – International Trade Finance Services ‘*Documentary Letter of Credit – A Practical Guide*’ 4; Platt G (ed) ‘*Guide to the Finance of International Trade*’ *The Journal of Commerce* 43.

⁶⁷ This special credit is deployed as third-party security in order for the beneficiary to pay its sub-supplier for the goods shipped to the applicant; for further reference see Jack R ‘*Documentary Credits - The Law and Practice of Documentary Credits Including Standby Credits and Performance Bonds*’ (1991) 30; Längerich R (2009) ch. 19.2.

⁶⁸ See Article 38(b) UCP 600; this credit also serves as third-party security, see Schmitthoff CM ‘*The Transferable Credit*’ *Journal of Business Law* (1988) 55 (hereafter Schmitthoff CM (1988)); Jack R ‘*Documentary Credits - The Law and Practice of Documentary Credits Including Standby Credits and Performance Bonds*’ (1991) 215.

⁶⁹ For further reference see Todd P ‘*Bills of Lading and Bankers’ Documentary Credits*’ (1990) 32; see also Nolan JL ‘*Australia Business: The Portable Encyclopedia for Doing Business With Australia*’ (1996) 239; Längerich R (2009) ch. 19.4.; Jack R ‘*Documentary Credits - The Law and Practice of Documentary Credits Including Standby Credits and Performance Bonds*’ (1991) 215.

⁷⁰ For a detailed discussion see Tóth Z (2006) 21-30; see also Ellinger EP ‘*Letter of Credit*’ in Horn N & Schmitthoff CM (ed.) ‘*The Transnational Law of International Commerce Transaction*’ Vol. 2 (1982) 246; Ward W & Harfield H ‘*Bank Credits and Acceptances*’ (1958) 14.

⁷¹ See Mugasha A (2003) 136 et seq. for a detailed discussion of the autonomy principle.

⁷² Leon C ‘*Letters of Credit: A Primer*’ (2012) 45 *Maryland Law Review* 442 (hereafter Leon C (2012)).

underlying contract.⁷³ Hence, the beneficiary has a guarantee for the purchase price from a secure source of credit, which is independent of any disputes with the applicant.⁷⁴

5.2 Principle of Strict Compliance

The principle of strict compliance⁷⁵ is contained, inter alia, in Articles 7(a), 8(a) and 15 UCP 600 and accords with the autonomy principle. It provides that the beneficiary must comply with documentary requirements specified in the letter of credit.⁷⁶ Whilst the autonomy principle gives advantages to the beneficiary ('pay first, argue later'⁷⁷), the strict compliance doctrine benefits the applicant insofar as he will have to reimburse the issuing bank only against presentation of complying documents, which are specified in the letter of credit.⁷⁸

6. PROBLEM STATEMENT

The autonomy principle takes a significant role within a letter of credit. The rationale behind it is to obtain a particular warranty that the issuer's undertaking will not in any way be influenced by or interfered with any irregularity with regard to the underlying contract.⁷⁹ Hence, legal commentators caution that the letter of credit is likely to collapse as a commercial payment device, if parties were to succeed easily in characterising underlying transaction disputes in the independent obligation payment transaction.⁸⁰

On the other hand, doubts have been raised as to whether it is sufficient to rely on documents only and to completely separate the underlying contract from the letter of credit commitment. Such concerns are based on studies that show that, without taking into account the underlying contract, the strict application of the autonomy principle promotes false calls, abuse and fraud.⁸¹ It is the common understanding that fraud prevention is a legitimate public concern and that courts should prevent unjust payment when there is clear evidence of fraudulent practices.⁸²

⁷³ Aicher RD 'Credit Enhancements: Letter of Credit, Guarantees, Insurance and Swaps (The Clash of Cultures)' (2004) *The Business Lawyer* 933; See also Squillante AM 'Letters of Credit: A Discourse, Part III' (1979) *Commercial Law Journal* 471.

⁷⁴ Leon C (2012) 442.

⁷⁵ The principle of compliance will be dealt with in detail in Chapter III.

⁷⁶ Zhang Y 'Approaches to Resolving the International Documentary Letters of Credit Fraud Issue' (2011) 19 (hereafter Zhang Y (2011)).

⁷⁷ Dalhuisen JH '*Dalhuisen on International Commercial, Financial and Trade Law*' 2 ed (2004) 470.

⁷⁸ Tóth Z (2006) 88.

⁷⁹ Garcia RLF (2009) 74; see also Dolan JF 'Tethering the Fraud Inquiry in Letter of Credit Law' (2006) *Banking and Finance Law Review* 449 (hereafter Dolan JF (2006)).

⁸⁰ Tóth Z (2006) 85.

⁸¹ Stewart H 'It is Insufficient to Rely on Documents' (2002) *Journal of Money Laundering Control* 225.

⁸² See Dolan JF (2006) 502; see also Fohler G '*Fraud in the Letter of Credit Transaction and its Possible Arbitration*' (1999) 62 with further reference.

7. AIMS AND SIGNIFICANCE OF THE RESEARCH

The aim of this thesis is to assess the potential need for and scope of exceptions to the autonomy principle of letters of credit, especially in cases of fraud. In this regard, care must be taken to the fact that the autonomy principle is a very sensitive factor for letter of credit transactions and ultimately a decisive factor for its significant role as payment method in international trade.⁸³ There is a wide spread recognition that in particular cases of fraud, exceptions to the autonomy principle are inevitable.⁸⁴ Yet legal commentators caution that if such exceptions were broadly applied, this would not only erode the autonomy principle but also ‘destroy’ it.⁸⁵ There is no international standard legal framework specifying when and under what conditions fraud exceptions are to be granted does not exist. It is argued that the fraud issue is ‘the province of the applicable law and of the courts of the forum’⁸⁶ and therefore it is claimed that national law should tackle the fraud issue.⁸⁷

Although courts have developed particular rules for fraud exceptions in order to narrow their application and to protect the autonomy principle, the scopes of these exceptions within the different jurisdictions varies enormously, even in countries with comparable legal systems, e.g. common law countries such as the United States of America, the United Kingdom⁸⁸ or the Republic of South Africa. This causes increasing legal uncertainties in international trade.⁸⁹ For instance, when deciding whether to finance an international sale of goods by means of a letter of credit, the seller is well advised to not only consider whether the issuing bank is trustworthy and whether the political circumstances in the country where the issuing bank is seated are stable. The seller must also take into account if and to what extent the respective jurisdiction governing any disputes in connection with the letter of credit transaction

⁸³ See Dolan JF ‘Commentary on Legislative Developments in Letter of Credit Law: An Interim Report’ (1993) *Banking & Finance Law Review* 63 (hereafter Dolan JF (1993)).

⁸⁴ However differences can be found between common law and civil law jurisdictions. Schwank concludes that there is a ‘greater willingness of the courts in civil law jurisdiction to interfere when there is evidence of abuse and fraud’ (Schwank F ‘New Trends in International Bank Guarantees’ (1987) *International Banking Law* 38). Dolan finds that although applying the fraud rule however, in common law jurisdictions courts ‘generally support the independence principle’ by means of having ‘attached to the fraud exception a number of rules narrowing it to the point that it is not destructive of the guarantee’s and the letter of credit’s independence’ (Dolan JF (2006) 486).

⁸⁵ Dolan JF (2006) 485.

⁸⁶ Goode RM ‘*Abstract Payment Undertakings and the Rules of the International Chamber of Commerce*’ (1995) 727 (hereafter Goode RM (1995)).

⁸⁷ Dolan JF (1993) 63.

⁸⁸ See Zhang Y (2011) 64 et seq. for a detailed discussion regarding the laws of the US, the UK and China; see also Kelly-Louw M (2008) for a discussion on the laws of the US, the UK and the RSA; each of the latter with further reference.

⁸⁹ See Koudriachov SA (2001) 41; see also Garcia RLF (2009) 79 et seq. with further examples.

respects the autonomy principle and the issuing bank's independent payment undertaking towards the beneficiary.⁹⁰

This thesis will explore on how the USA, the UK and the RSA as common law countries approach the fraud rule. Based on a comparative legal view it will be discussed as to whether the fraud issue could be improved, if standard rules and guidelines were created and implemented in an international framework such as the UCP 600.

8. RESEARCH QUESTIONS

In the light of the aforesaid, the following specific research questions will be addressed:

- 8.1** Why is it reasonable to grant fraud exceptions, bearing in mind the impacts to the principle of autonomy and the letter of credit working system?
- 8.2** How do the jurisdictions of the USA, the UK and the RSA approach the fraud rule?
- 8.3** Could the fraud issue be improved at an international level, if standard rules and guidelines regarding the fraud issue were included in a well-acknowledged international legal framework such as the UCP 600?

9. RESEARCH METHODOLOGY

This mini-thesis will review legal acts, text books, journal Articles, case law and other relevant publications on letters of credit in general and the autonomy principle and exceptions hereof in particular. The main sources of letter of credit law will be assessed to provide an overview of the general working system of a letter of credit transaction. Special focus will be given to the 2007 revision of the International Chamber Commerce's Uniform Customs and Practise for Documentary Credits (UCP 600). By means of a comparative law approach it will be examined if and to what extent the laws of the USA, the UK and the RSA allow for exceptions to the autonomy principle in cases of fraud.

⁹⁰ Garcia RLF (2009) 96.

CHAPTER TWO
SOURCES OF LETTER OF CREDIT LAW AND KEY OBLIGATIONS
OF THE PARTIES TO A LETTER OF CREDIT TRANSACTION
UNDER THE UCP 600

1. SOURCES OF LETTER OF CREDIT LAW

The letter of credit law has developed largely through customs of international trade⁹¹ and was highly influenced by the International Chamber of Commerce ('ICC'), which has codified many of these customs in the 'Uniform Customs and Practice for Documentary Credits' (hereinafter referred to 'UCP' or 'UCP 600', which is the latest version of the UCP), the 'Supplement to the Uniform Customs and Practice for Documentary Credit for Electronic Presentation' ('eUCP'), the 'International Standard Practice' (hereinafter referred to as 'ISP' or 'ISP 98', which is the latest version of the ISP), the 'Uniform Rules for Demand Guarantees' (hereinafter referred to as 'URDG' or 'URDG 758', which is the latest version of the URDG), the 'International Standard Banking Practice for the Examination of Documents under Documentary Credits subject to UCP 600' (hereafter referred to as 'ISBP'), and the 'Uniform Rules for Bank-to-Bank Reimbursements under Documentary Credits' (hereafter referred to as 'URR' or 'URR 725', which is the latest version of the URR). Further, the 'United Nations Convention on Independent Guarantees and Stand-by Letters of Credit' (hereinafter referred to as 'UNCITRAL-Convention'), the US 'Uniform Commercial Code' (hereinafter referred to as 'UCC') and, last but not least, national case law had great impact on the development of letter of credit law.⁹²

1.1 Uniform Customs and Practice for Documentary Credits

The Commission on Banking Technique and Practice of the International Chamber of Commerce drafted the first version of the UCP at the Vienna Conference in 1933.⁹³ The UCP evolved from the world banking community's recognition that uniform procedures needed to be established in order to govern the use of documentary credits.⁹⁴ To keep pace with the changes that took place in international trade and the progress made in technology the UCP

⁹¹ Kozolchik B (1980) 146.

⁹² Tóth Z (2006) 88.

⁹³ See ICC Brochure Nr. 82.

⁹⁴ See Chung SI 'Developing a Documentary Credit Dispute Resolution System: An ICC Perspective' (1995) 19 *Fordham International Law Journal* 1355.

were revised in 1951, 1962, 1974, 1983 and 1993.⁹⁵ In July 2007, the UCP 600 came into effect.⁹⁶ The UCP 600, which have been adopted worldwide either by the national banks' organisations⁹⁷ or by the individual banking institutions, are the most important rules governing letter of credit transactions.⁹⁸ Banking institutions in more than 160 countries refer to the UCP 600; as a consequence the UCP 600 governs virtually every international letter of credit transaction.⁹⁹ The UCP are neither an international convention, because they do not create a formal agreement between countries, nor are they considered a law because the ICC, a non-governmental organisation¹⁰⁰, does not have legislative authority.¹⁰¹ The UCP are rather a set of globally acknowledged banking customs and practices¹⁰² applicable to letters of credit solely by incorporation.¹⁰³

1.2 Supplement to the Uniform Customs and Practice for Documentary Credit for Electronic Presentation

In May 2000, the Banking Commission of the ICC authorised the creation of a working group to formulate rules applicable to electronic credits.¹⁰⁴ The main goal was to develop a set of rules applicable to letters of credit regardless of future technical developments.¹⁰⁵ The working group's efforts resulted in a supplementary revision to the UCP 600, the eUCP, which became effective on 1 April 2002.¹⁰⁶ The eUCP introduced the concept of 'mixed presentation' that allows the electronic or partial presentation of electronic records.¹⁰⁷

Despite this new set of rules merchants are facing difficulties in providing proper documentation for the letter of credit being honoured. According to Davidson the predicament of proving electronic documents in a letter of credit on the one hand, and the dilemma of courts fre-

⁹⁵ See UCP 600 at Introduction 11.

⁹⁶ Monteiro F 'The UCP 600 - Developments In Documentary Credit Law' (2007) *New Zealand Law Journal* available at <http://www.wilsonharle.com/the-ucp-60/#top> (accessed on 25 November 2012).

⁹⁷ E.g. in Germany, Switzerland and the United States of America. The UCP 600 are therefore generally adopted in letters of credit issued in Germany, Switzerland and the United States of America.

⁹⁸ Grassi PS (1995) 106.

⁹⁹ Del Busto C '*ICC Guide to Documentary Credit Operations, A Stage-by-Stage Presentation of the Documentary Credit Process*' ICC Publication No 515 3 (hereafter Del Busto C (1994)).

¹⁰⁰ See foreword to the UCP 600.

¹⁰¹ Ademola AO '*Letters of Credit: Tower of Babel or Jacob's Ladder? A Look at Whether Private Codifications of Commercial Usage Brings Us Any Closer to a Harmonised International Commercial Law*' (2008) (<http://www.dundee.ac.uk/cepmlp/gateway/index.php?news=29287>, accessed on 25 November 2012) 6.

¹⁰² Gao X '*The fraud rule in the law of Letters of Credit*' (2002) 18 (hereafter Gao X (2002)).

¹⁰³ Article 1 UCP 600 as the relevant provision insofar is as follows: 'The Uniform Customs and Practice for Documentary Credits, 2007 Revision, ICC Publication no. 600 ("UCP") are rules that apply to any documentary credit ("credit") (including, to the extent to which they may be applicable, any standby letter of credit) when the text of the credit expressly indicates that it is subject to these rules.'

¹⁰⁴ Byrne JE & Taylor D '*ICC Guide to the eUCP*' ICC Publication No. 639 (2002) 12.

¹⁰⁵ Tóth Z (2006) 9.

¹⁰⁶ Davidson A '*Electronic Records in Letters of Credit*' (2011) available at http://www.uncitral.org/pdf/english/colloquia/EC/UNCITRAL-paper_Feb2011-Alan-Davidson.pdf (accessed on 25 November 2012) 5.

¹⁰⁷ Tóth Z (2006) 9.

quently rejecting hard copies of electronic documents as evidence are just two examples of such difficulties.

1.3 International Standard Practice

The ISP 98, which came into force on 1 January 1999, is a set of private rules of practice that are intended to apply to standby letters of credit¹⁰⁸ and other similar undertakings.¹⁰⁹ It was approved by the International Financial Services Association ('IFSA') and the ICC Commission on Banking Technique and Practice, and issued as ICC publication No. 590.¹¹⁰ ISP 98 is first and foremost the product of American bankers and lawyers acting through the U.S. Council on International Banking (the predecessor of the International Financial Services Association).¹¹¹ Although the standby letter of credit is not only common amongst American companies but also became an internationally recognised banking product¹¹², before ISP 98, there were no special rules applicable to standby letters of credit. Until then, standby letters of credit had been issued largely subject to various versions of the UCP.¹¹³ However, because the UCP were originally written to apply to commercial letters of credit only, it was argued that many provisions of the UCP were either inapplicable or inappropriate for standby credits.¹¹⁴ Like the UCP and the URDG, the ISP 98 applies to any independent undertaking issued subject to it.¹¹⁵

1.4 Uniform Rules for Demand Guarantees

The URDG 758¹¹⁶, which became effective on 1 July 2010, set out special rules for demand guarantees. The former version, the URDG 458, was little used because the autonomy principle¹¹⁷ was not implemented. Instead, in order to request payment, the beneficiary had to present a judgment or arbitral award.¹¹⁸ In his report delivered at the ICC Banking Commission meeting held in Hong Kong on 3-4 November 1999 Katz found that the worldwide accep-

¹⁰⁸ See Chapter I 3.3.

¹⁰⁹ See Rule 1.01 of ISP98.

¹¹⁰ See preface to the ISP98.

¹¹¹ Wood JS (2008) 105.

¹¹² See preface to the ISP98.

¹¹³ Article 1 UCP 600 reads as follows: 'The Uniform Customs and Practice for Documentary Credits (...) are rules that apply to any documentary credit (...) (including, to the extent to which they may be applicable, any standby letter of credit) (...)'.
¹¹⁴ Turner PS 'New Rules For Standby Letters of Credit: The International Standby Practices' (1999) 14 *Banking & Finance Law Review* 459 (hereafter Turner PS (1999)).

¹¹⁵ See preface to the ISP98 and Rule 1.01 of ISP98.

¹¹⁶ The URDG 758 is the result of the ICC 2010 Revision and is published under the ICC Publication No. 758.

¹¹⁷ See Chapter III 1.2.

¹¹⁸ Wood JS (2008) 137.

tance of the URDG 458 was ‘disappointing’.¹¹⁹ The latest version of the URDG, the URDG 758, has been drafted based on the widely applicable UCP 600. The URDG are not a law but rather globally accepted banking customs, which set out the functions and obligations of the parties to a demand guarantee and reflect ‘best practice’ in the guarantee business.¹²⁰

1.5 International Standard Banking Practice for the Examination of Documents under Documentary Credits subject to UCP 600

The ISBP¹²¹ was updated to conform to the context of the UCP 600. It explains how practitioners apply the rules set out in UCP 600. The ICC describes the ISBP as an invaluable aid to banks, corporates, logistics specialists and insurance companies alike.¹²² The UCP 600 implies that the rules and regulations of the ISBP are to be followed.¹²³ The ISBP’s 185 sections specify the documents for which the UCP 600 transport Articles do not apply;¹²⁴ certain expressions which are not defined in the UCP 600;¹²⁵ how certain misspellings or typing errors shall be managed;¹²⁶ when to use an original and when to use a copy¹²⁷; how a document should be signed if not explicitly set out in the credit¹²⁸; and what a complete set of insurance documents looks like.¹²⁹

1.6 Uniform Rules for Bank-to-Bank Reimbursements under Documentary Credits

The URR 525 was developed by the ICC as set of rules to document worldwide practice to standardise the processing of bank-to-bank reimbursements. The UCP 600 were aligned with the URR 525 by means of the new Article 13(b) UCP 600.¹³⁰ However, the URR 525 needed to be renewed further. With effect from 1 October 2008, the URR 725 replaced the URR 525. The ICC stressed that the URR 725 should not be considered a revision of the URR 525, but rather an update to change the style to that of the UCP 600.¹³¹ The URR 725 is not incorporated into the UCP 600 and therefore only applies to bank-to-bank reimbursements when the

¹¹⁹ Katz R, Report delivered at the ICC Banking Commission meeting held in Hong Kong on 3-4 November 1999 (Hong Kong Meeting), reprinted in ICC Publication No 470/893 19.

¹²⁰ Baranello J ‘*Understanding the URDG 758*’ (2010) (<http://www.fpcc.com/DB/TreasuryPulse/Fall2010/Article4.html>, accessed on 26 December 2012).

¹²¹ The ISBP is published under the ICC Publication no. 645.

¹²² See Introduction of ISBP.

¹²³ The Introduction to the UCP 600 insofar states that ‘[t]his publication has evolved into a necessary companion to the UCP for determining compliance of documents with the terms of letters of credit’.

¹²⁴ See sections 19-20 ISBP.

¹²⁵ See section 21 of ISBP.

¹²⁶ See section 25 of ISBP.

¹²⁷ See sections 28-33 ISBP.

¹²⁸ See sections 37-40 ISBP.

¹²⁹ See sections 170-180 ISBP.

¹³⁰ It states that, ‘[i]f a credit does not state that reimbursement is subject to the ICC rules for bank-to-bank reimbursements, the following apply: (...)’.

¹³¹ See Introduction to URR 725.

text of the reimbursement agreement clearly indicates so.¹³² In the absence of such reference in a reimbursement agreement, Article 13 UCP 600 provides for the obligations of the banks regarding reimbursement.

1.7 United Nations Convention on Independent Guarantees and Stand-by Letters of Credit

The United Nations Commission on International Trade Law (UNCITRAL) prepared the UNCITRAL Convention,¹³³ which was adopted and opened for signature by the General Assembly dated 11 December 1995 by its resolution 50/48, dated 11 December 1995.¹³⁴ The UNCITRAL Convention applies to international independent undertakings, such as an independent guarantee or a standby letter of credit

[i]f the place of business of the guarantor/issuer at which the undertaking is issued is in a Contracting State¹³⁵, or [...] [i]f the rules of private international law lead to the application of the law of a Contracting State, unless the undertaking excludes the application of the Convention.¹³⁶

It also applies to international letters of credit expressly stating they are subject to the UNCITRAL Convention.¹³⁷ Not only does the UNCITRAL Convention conform to the UCP 600, ISP 98 and URDG 725, it also complements their function by dealing with issues beyond the scope of these rules.¹³⁸ In its section 19 for example, the UNCITRAL Convention deals with the question of fraudulent or abusive demands for payment and judicial remedies in such instances.

In June 1999, the Commission on Banking Technique and Practise of the ICC expressly recommended the application of the UNCITRAL Convention in its Policy Statement 'ICC endorsement of the UNCITRAL Convention on independent guarantees and stand-by letters of

¹³² See paragraph 1 of Article 1 URR 725.

¹³³ See note 1 of the Introduction of the 'Explanatory note by the UNCITRAL secretariat on the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit'.

¹³⁴ See A/RES/50/48, at http://www.un.org/ga/search/view_doc.asp?symbol=A/RES/50/48&Lang=E (accessed on 27 December 2012; see also Byrne JE 'Independent Guarantee Convention' in (1999) *Annual survey of Letter of Credit Law and Practice* 93 (Byrne JE ed., 1999); for a critical view see Dolan JF 'The UN Convention on International Independent Undertakings: Do States with Mature Letter-of-Credit Regimes need it?' in (1999) *Annual survey of Letter of Credit Law and Practice* 97 (Byrne JE ed., 1999) (hereafter Dolan JF (1999)); also published in (1998) 13 *Banking and Finance Law Review* 1 et seq.

¹³⁵ The Convention has been ratified by and has already entered into force in Belarus, Ecuador, El Salvador, Gabon, Kuwait, Liberia, Panama and Tunisia. It has been signed but is not ratified in the United States of America; see http://www.uncitral.org/uncitral/en/uncitral_texts/payments/1995Convention_guarantees_status.html for further information.

¹³⁶ See Article 1.1 UNCITRAL Convention.

¹³⁷ See Article 1.2 UNCITRAL Convention.

¹³⁸ See note 5 of the Introduction of the 'Explanatory note by the UNCITRAL secretariat on the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit'.

credit' because it is aligned to the rules and regulations set out in the UCP 600 and other rules drafted by the ICC.¹³⁹

1.8 Uniform Commercial Code

The USA is the only common law jurisdiction with a broad and detailed regulation for letters of credit set forth in Article 5 of the UCC.¹⁴⁰ The UCC was created and endorsed by the National Conference of Commissioners of Uniform State Laws ('NCCUSL') and the American Law Institute for enactment by the legislatures of the states of the United States of America.¹⁴¹ A 'uniform law' is a scheme provided by the federal government to all states, which, by their sole discretion, can decide to adopt such law entirely or with modifications or not to adopt it at all. As of today, the revised Article 5 UCC has been adopted – with modifications – by all states and the District of Columbia.¹⁴²

Before the first version of the UCC came into force, the letter of credit was predominantly governed by common law decisions and the UCP.¹⁴³ During the 1940's and 1950's the drafters of the UCC by way of legal statutes undertook to regulate the letter of credit.¹⁴⁴ When Article 5 UCC was first published in the 1950's it was not a complete code.¹⁴⁵ It was revised several times until in 1995 when Article 5 UCC was last amended to cure the 'weakness, gaps and errors in the original statute which compromise its relevance'.¹⁴⁶ Prior to the revision of Article 5 UCC a task force, composed of prominent letter of credit specialists, was appointed to examine 'the case law, evolving technologies and changes in customs and practices'.¹⁴⁷ This task force made out numerous issues, discussed them and made suggestions for the revision of Article 5, which was completed in October 1995.¹⁴⁸ The official commentary to Article 5 states that 'Article 5 is consistent with and was influenced by the rules in the existing

¹³⁹ Policy statement (ICC endorsement of the UNCITRAL Convention on independent guarantees and stand-by letters of credit) of the Commission on Banking Technique and Practice of the ICC, dated 21 June 1999, at <http://www.iccwbo.org/Advocacy-Codes-and-Rules/Document-centre/1999/ICC-endorsement-of-the-UNCITRAL-Convention-on-independent-guarantees-and-stand-by-letters-of-credit>.

¹⁴⁰ Grassi PS (1995) 105.

¹⁴¹ For an overview of the history and development of Article 5 UCC see Macintosh KL (1996) 1499.

¹⁴² See <http://www.law.cornell.edu/uniform> (accessed on 27 December 2012), which also provides further information about the background and history of 'Uniform Law' in the United States of America.

¹⁴³ See Trimble RF (1948) 986-1003.

¹⁴⁴ Byrne JE 'The Revision of U.C.C. Article 5: A Strategy for Success, (1990) 56 *Brooklyn Law Review* 17.

¹⁴⁵ Gao X & Buckley RP (2003) 117.

¹⁴⁶ Report of the Task Force on the Study of U.C.C. Article 5 'An Examination of U.C.C. Article 5 (Letters of Credit)', reprinted in 45 *Business Law* 1532 (1990); see also Macintosh KL (1996) 1499 et seq.

¹⁴⁷ Prefatory Note (1995) to Article 5 UCC.

¹⁴⁸ Gao X & Buckley RP (2003) 118.

version of UCP'.¹⁴⁹ As with the ICC rules and regulations and the UNCITRAL-Convention, Article 5 UCC applies to all types of letters of credit, including standby credits.¹⁵⁰

2. THE PARTIES' OBLIGATIONS

As discussed earlier¹⁵¹ a letter of credit transaction typically involves the beneficiary, the applicant, the issuing bank, and the beneficiary's bank, which can act as advising bank and/or nominated bank and/or confirming bank.¹⁵² In the following, the key obligations of the parties involved will be discussed with a focus on the issuing bank, because the obligations of the nominated bank and the confirming bank are quite similar to the latter's obligations.

2.1 The Applicant's Obligations

The applicant is the party on 'whose request the credit is issued'.¹⁵³ He is obliged to lodge security as demanded by the issuing bank¹⁵⁴ and to reimburse and pay the issuing bank fees for payments made under the credit.¹⁵⁵

The applicant must apply for the credit in due time¹⁵⁶ to enable the beneficiary to fulfil its obligations under the sales contract.¹⁵⁷ In *Garcia v. Page & Co. Ltd* the court held that the buyer's failure to open the letter of credit in due time constituted a breach of the contract allowing the beneficiary to withdraw from the contract.¹⁵⁸ In *Pavia & Co SpA v Thurmann Nielsen* the underlying contract was silent as regards the opening time of the letter of credit and the beneficiary was granted a particular period of time for shipment.¹⁵⁹ Lord Denning held, on appeal,

[i]f the buyers were to fulfil their obligations, they had to make the credit available to the sellers at the very first date when the goods might lawfully have been shipped in compliance with the contract.¹⁶⁰

¹⁴⁹ UCC § 5-101 cmt. (1995).

¹⁵⁰ See section 5-103 UCC. Unlike the UCP, Article 5 UCC as well as the UNCITRAL-Convention are statutes of law and as such contain provisions regarding fraud and forgery. The fraud issue will be dealt with in detail in Chapter IV.

¹⁵¹ See Chapter I.3.2.

¹⁵² See Figure 1 above.

¹⁵³ See definition of 'Applicant' in Article 2 UCP 600.

¹⁵⁴ Dolan JF (2007) ch. 7-84.

¹⁵⁵ See *United City Merchants (Investment) Limited v Royal Bank of Canada* [1982] 2 All E.R. 725; See generally about the bank's right to reimbursement Barnes JG & Byrne JE 'Letters of Credit' 49 (1994) *The Business Lawyer* 1915; see also Kozolchuk B (1980) 45-50.

¹⁵⁶ Oelofse AN 'The Law of Documentary Letters of Credit in Comparative Perspective' (1997) 21 (hereafter Oelofse AN (1997)).

¹⁵⁷ Tóth Z (2006) 36-38.

¹⁵⁸ *Garcia v Page & Co. Ltd* [1936] Vol. 55 *Lloyd's Law Reports* 392.

¹⁵⁹ *Pavia & Co SpA v Thurmann Nielsen* [1952] Vol. 1 *Lloyd's Law Reports* 153.

¹⁶⁰ *Pavia & Co SpA v Thurmann Nielsen* [1952] Vol. 1 *Lloyd's Law Reports* 157.

If, however, the underlying contract provides for a particular date of shipment, the credit must be opened a reasonable time before that date, as the court held in the case of *Plasticmoda SpA v Davidson (Manchester) Ltd.*¹⁶¹ The duty to open the letter of credit a sufficient time before the date of shipment lies in the nature of any letter of credit transaction. The beneficiary must know ‘before he sends the goods to the docks that his payment will be secured by the credit for which it is stipulated’.¹⁶²

It is crucial for the applicant at the time of the application of a letter of credit to mirror exactly the sales contract agreement with regard to issues such as product, price, currency, terms of delivery, payment maturity, expiry date for the presentation and most importantly, documentary requirements to be met by the beneficiary in order for the credit to be honoured.¹⁶³ The applicant generally requests that the seller submits clean shipping documents proving that the goods have been delivered to a carrier; the seller’s commercial invoice listing the goods; the quantities, and the price of the goods; insurance documentation; certificates to prove quantity or quality; packing lists; and any further documentation necessary to demonstrate that the seller has complied with the terms of the underlying contract.¹⁶⁴

Once the letter of credit exists, the applicant does no longer participate in payment mechanism, unless the beneficiary presents discrepant documents to the issuing bank, in which case the latter may ask the applicant for a waiver before honouring the letter of credit.¹⁶⁵

2.2 The Beneficiary’s Obligations

The beneficiary must fulfil its obligation under the underlying sales contract. According to the United Nations Convention on Contracts for the International Sale of Goods (‘CISG’), in an international sales transaction the seller undertakes to ‘deliver the goods, hand over any documents relating to them and transfers the property in the goods, as required by the contract’.¹⁶⁶ In particular, the seller must hand over the goods to the agreed carrier at the agreed place¹⁶⁷ and, in order to be paid under the letter of credit, to present at the agreed time a complete set of strictly complying documents as required pursuant to the letter of credit, e.g.,

¹⁶¹ *Plasticmoda SpA v Davidson (Manchester) Ltd* [1952] Vol. 1 *Lloyd’s Law Reports* 527.

¹⁶² Murray C. et al, in Schmitthoff (ed) *Export Trade and Practice of International Trade* 12 ed (2012) 186.

¹⁶³ See Article 6 UCP 600.

¹⁶⁴ See Goode RM ‘Commercial Law’ (1995) 899-920 for more details.

¹⁶⁵ Bergami R (2011) 95.

¹⁶⁶ See Article 30 of the United Nations Convention on Contracts for the International Sale of Goods (hereafter CISG).

¹⁶⁷ Particular INCOTERMS, to which the parties of the sale commonly refer to, specify the details.

transport documents, commercial invoice, consular or customs invoice, certificate of origin, packing list, certificate of inspection, insurance document, bill of lading.¹⁶⁸

The (formal and legal) requirements of a letter of credit transaction can be very complex. Consequently, the beneficiary should examine the letter of credit carefully and get acquainted with the relevant and most important aspects of the transaction.¹⁶⁹ If the beneficiary cannot comply with a requirement, he should immediately ask the applicant to instruct the issuing bank to amend the letter of credit and should not proceed with shipment until he received such amendments.¹⁷⁰ Further, the beneficiary should review the applicable rules of the letter of credit carefully before presenting the required documents.¹⁷¹ In view of the UCP 600, the beneficiary should keep in mind the interpretation of particular terms of the letter of credit,¹⁷² the standards for examination of documents,¹⁷³ and the submission of original documents or copies^{174 175}.

2.3 The Issuing Bank's Obligations

The main obligations of the issuing bank are: (i) to establish the letter of credit at the request of the applicant¹⁷⁶; (ii) to make the credit available to the beneficiary, typically via an advising bank; (iii) to examine the presented documents¹⁷⁷; (iv) to either accept or reject the documents; (v) and to honour or dishonour the credit or, as the case may be, to reimburse the nominated bank¹⁷⁸ that has honoured a complying presentation.¹⁷⁹ The following obligations generally also apply accordingly to a nominated bank and/or confirming bank, if any.

¹⁶⁸ There is no limit to the number and variety of documents a letter of credit may specify. However, the said documents are commonly seen in letter of credit transactions, see e.g. Dolan JF (2007) ch. 1-66 et seq.

¹⁶⁹ For a checklist of what an exporter should look for when reviewing a letter of credit see Scotiabank – International Trade Finance Services 'Documentary Letter of Credit – A Practical Guide' 24 et seq.

¹⁷⁰ For details on how a letter of credit can be amended see Article 10 UCP 600.

¹⁷¹ See Wood JS (2008) 123. Wood further states that one would well advised to avoid the application of the extensive default rules set forth in ISP 98 Rule 3.04 on how and where presentation should be made if the credit is silent or vague on this issue, by ensuring that the credit clearly stipulates where, when, how and to whose attention documents are to be presented.

¹⁷² Article 3 UCP 600.

¹⁷³ Article 14 UCP 600.

¹⁷⁴ Article 17 UCP 600.

¹⁷⁵ Wood JS (2008) 123-124.

¹⁷⁶ See definition of 'Issuing Bank' in Article 2 UCP 600.

¹⁷⁷ See Article 14 UCP 600.

¹⁷⁸ See Article 7(c) UCP 600. One must note that issuing bank must honour the credit regardless of an engagement of, e.g. a nominated bank, as Article 6(a) UCP 600 states that 'a credit available with the nominated bank is also available with the issuing bank'.

¹⁷⁹ It should be noted that according to Article 6(a) UCP 600 'a credit available with the nominated bank is also available with the issuing bank'.

2.3.1 Examination of Documents

The obligations stated under (i) and (ii) are rather standard procedure and rarely subject to major problems or disputes. The discrepancy of documents provided by the beneficiaries upon first presentation and hence the rejection rate, which according to the ICC is to be up to 70%, is mainly associated with the documentary checking procedures of the banks (iii).¹⁸⁰ The issuing bank checks the delivered documents in order to decide ‘*on the basis of the documents alone*, whether or not the documents appear *on their face* to constitute a complying presentation’ (emphasis added).¹⁸¹ The Benchmark to decide whether or not the documents comply are the ‘terms and conditions of the credit, the applicable provisions of these rules and *international standard banking practice*’ (emphasis added).¹⁸²

The problem was that originally no such standard banking practise existed. Consequently ‘the lack of such a published practise has resulted in an environment where various banks have different rules on acceptability, or otherwise, of documents’.¹⁸³ As already stated¹⁸⁴ the ICC created the ISBP in order to explain how practitioners apply the practices rules set out in the UCP 600 and to harmonise the international standard banking practice. However, although it has been claimed that exporters should find that the ISBP ‘has become an invaluable aid to banks, corporates, logistics specialists and insurance companies alike’¹⁸⁵, the Secretary of the ICC Czech Republic Banking Commission rightly pointed out that

international standard banking practise in this context [UCP 600] does not mean the ICC publication containing the ISBP. It means international standard banking practise in the broader sense, which definitely includes, but is not limited to, the ISBP publication (amendments made).¹⁸⁶

The ICC was also criticised for having failed to establish a standard for documentary checks in letter of credit transactions, as the ISBP

have neither authority, nor mandatory application and, consequently, their relevance in reducing documentary discrepancy rates under Letters of Credit transactions is in doubt.¹⁸⁷

¹⁸⁰ Bergami R (2011) 95.

¹⁸¹ See Article 14(a) UCP 600.

¹⁸² See definition of ‘Complying presentation’ in Article 2 UCP 600.

¹⁸³ Walden J ‘Letters of Credit – International Standard Banking Practise (ISBP)’ (2003) *Credit Management* 23.

¹⁸⁴ See Chapter II 1.5.

¹⁸⁵ See Introduction to the 2007 revision of the ISBP (ICC Publication no. 645).

¹⁸⁶ See Andrieu P ‘Ambiguities in the New UCP’ (2007) *DCInsight* 18.

¹⁸⁷ See Bergami R (2011) 100.

Not only does Article 14(a) UCP 600 define ‘documents’ as the benchmark upon which banks decide whether or not a presentation is complying. Banks in general shall only ‘deal with documents and not with goods, services or performance to which the documents may relate’.¹⁸⁸ When checking documents, banks do not consider matters that are not relevant for the decision to accept or reject a presentation. Hence, a bank will dishonour a credit upon discrepant documents irrespective of the fact that it may be aware that the underlying sales contract was completely and correctly fulfilled. A bank also will generally honour a credit upon complying documents although it might be aware of a breach of contract.¹⁸⁹ The parties of the underlying contract should bear that in mind when dealing with a letter of credit.

Regardless of the foregoing, Article 14(d) UCP 600 stipulates that data in the documents, ‘when read in context with the credit, the document itself and international standard banking practice, need not be *identical* to, but must not conflict with, data in that document, any other stipulated document or the credit’ (emphasis added). This wording indicates that the documents presented to the issuing bank need not be ‘identical’ to the wording required by the credit, consequently, it is argued that the UCP 600 clarified the UCP 500, which did not provide guidance on what the standard of compliance should be.¹⁹⁰

Article 14(a) UCP 600 did not adopt the term ‘reasonable care’ in Article 13(a) UCP 500 as regards the standard on how documents are to be examined by the issuing bank. It is argued anyhow that this will unlikely affect the interpretation of the common law position, whereupon a bank, which has examined the documents with reasonable care, does not breach its duty under the letter of credit and will hence not be liable for honouring a credit upon an inconsistent presentation.¹⁹¹

Banks must check the documents presented and determine whether they comply with the requirements set out in the letter of credit within ‘a maximum of five banking days’.¹⁹² Under the regime of the UCP 500, the period was seven banking days, yet the bank had to check the

¹⁸⁸ Article 5 UCP 600.

¹⁸⁹ See Grassi PS (1995) 99.

¹⁹⁰ Pietrzak L ‘In the Right Direction: A First Look at the UCP 600 and the New Standards as Applied to Voest-Alpine’ (2007) *Asper Review of International Business and Trade Law* 189 (hereafter Pietrzak L (2007)). She states that courts have developed at least four standards of compliance under the regime of UCP 500: ‘(1) strict compliance; (2) flexible strict compliance; (3) substantial compliance; and (4) reasonable compliance’. Therefore, Pietrzak L (at page 194) considers the UCP 600 a ‘major achievement’ in this area, with the effect that the ‘standard of compliance is shifting from one of a strict compliance to semi-flexible compliance’.

¹⁹¹ Isaacs M & Barnett M (2007) 662.

¹⁹² Article 14(b) UCP 600.

documents within ‘reasonable time’.¹⁹³ It was subject to dispute whether a check of documents was still within reasonable time if a bank used the full seven banking days although it could have decided in less time.¹⁹⁴ The said issue is also discussed under the regime of Article 14(b) UCP 600, although the term ‘reasonable time’ has vanished. It is argued that the term ‘maximum’ indicates that documents must be examined promptly and there must not be a wilful delay.¹⁹⁵ This argument is convincing. If the ICC had actually intended to allow banks to use the full period of time, the word maximum would be superfluous. Therefore, banks are well advised to provide their decision to accept or reject the presentation within a reasonable time period that may be shorter than five days.¹⁹⁶

2.3.2 Acceptance or Refusal of a Presentation

Within the five-day period, the issuing bank must not only examine the presentation, but also decide whether to accept or reject it.¹⁹⁷ If the bank has decided to reject the presentation, it is also obliged to notify the beneficiary of such decision within the five-day period.¹⁹⁸

Said notice must state the decision,¹⁹⁹ the bank’s reasons for rejecting the presentation²⁰⁰ and further alternative actions that the bank may take, i.e. it will hold or return the documents, act in compliance with directives previously given to it by the beneficiary, or that the bank holds the documents until it receives a waiver from the applicant and agrees to accept it or receives further instructions from the beneficiary prior to agreeing to accept a waiver.²⁰¹ The notice shall be provided by telecommunication or, if not possible, by any other rapid means.²⁰²

In the event of a discrepant presentation the issuing bank may in its sole discretion ask the applicant for a waiver.²⁰³ The bank is however, not bound by such waiver and therefore may reject the inconsistent documents anyway.²⁰⁴ It must be noted that only the issuing bank may

¹⁹³ See Article 13(b) UCP 500 and the commentary of Bergami R ‘Discrepant Documents and the Letter of Credit – The Banks’ Obligations under UCP 500’ (2003) *Vindobona Journal of International Commercial Law & Arbitration* 110 (hereafter Bergami R (2003)).

¹⁹⁴ See Pietrzak L (2007) 192 with reference to the case of *DBJJJ, Inc. v. National City Bank*, 123 Cal. App. 4th 530 (2004).

¹⁹⁵ Isaacs M & Barnett M ‘International Trade Finance - Letters of Credit, UCP 600 and Examination of Documents’ (2007) *Journal of International Banking Law* 662 (hereafter Isaacs M & Barnett M (2007)).

¹⁹⁶ See *DBJJJ Inc. v. National City Bank* (2004), 123 Cal. App. 4th 530 inter alia for a detailed discussion on what factors to be considered and construed as reasonable.

¹⁹⁷ See Article 16(b) UCP 600 in conjunction with Article 14(b) UCP 600. This period will not be extended if the bank decides to ask the applicant for a waiver (see sub para. 2 of Article 16(b) UCP).

¹⁹⁸ Articles 16(c) and 16(d) UCP 600 in conjunction with Article 14(b) UCP 600.

¹⁹⁹ Article 16(c)(i) UCP 600.

²⁰⁰ Article 16(c)(ii) UCP 600.

²⁰¹ See Article 16(c)(iii) UCP 600.

²⁰² See Article 16(d) UCP 600; see Ellinger EP ‘Legal position of reimbursing bank’ (2007) *Journal of International Banking Law* 512 for options of communication.

²⁰³ Article 16(b) UCP 600.

²⁰⁴ Bergami R (2003) 114.

ask the applicant for a waiver.²⁰⁵ This follows from the wording of Article 16(b) UCP 600, the nature of the letter of credit and the fact the letter of credit is a contract between the issuing bank and the applicant.²⁰⁶ It is a common law principle that only the parties to the contract itself may amend a contract, hence decide on whether to grant a waiver or not.

If an issuing bank or a confirming bank fails to decide whether to accept or to reject the documentation or to notify the beneficiary within due time, it is 'precluded from claiming that the documents do not constitute a complying presentation'.²⁰⁷ The consequence of the latter is that the banks must honour the credit.²⁰⁸

2.3.3 Duty to Honour the Credit

Once the credit has been issued, the issuing bank is 'irrevocably bound' to honour the credit upon a complying presentation.²⁰⁹ The credit must also be honoured if a nominated bank or confirming bank is involved, and fails to pay or does not pay upon maturity²¹⁰ or, in case of negotiation,²¹¹ refuses to negotiate. The issuing bank must honour in any case of failure or default of other banks involved, regardless of the cause of such failure or default.²¹²

In the event that the credit was confirmed, the confirming bank is 'irrevocably bound to honour or negotiate as of the time it adds its confirmation to the credit' on a complying presentation.²¹³ As with the issuing bank the confirming bank must pay in case of a default of other banks involved, especially in case of default of a nominated bank, which honours the credit on behalf of the issuing bank or the confirming bank. For the avoidance of doubt, in the case of a default of the confirming bank, the issuing bank must honour the credit.

Except as expressly agreed to by the nominated bank and so communicated to the beneficiary or unless the nominated bank confirmed a credit, the nominated bank is not obliged to honour or negotiate a credit upon authorisation by the issuing bank to do so²¹⁴ or due to the reception, examination or forwarding of documents.²¹⁵

²⁰⁵ See Article 16(a) UCP 600.

²⁰⁶ See Figure 1 above.

²⁰⁷ See Article 16(f) UCP 600.

²⁰⁸ See Article 15(a) UCP 600 regarding the issuing bank respectively Article 15(b) UCP 600 regarding the confirming bank.

²⁰⁹ See Article 7(b) UCP 600 and Article 15(a) UCP 600.

²¹⁰ See Article 7(a)(i)-(iv) UCP 600.

²¹¹ 'Negotiation means the purchase by the nominated bank of drafts (drawn on a bank other than the nominated bank) and/or documents under a complying presentation, by advancing or agreeing to advance funds to the beneficiary on or before the banking day on which reimbursement is due to the nominated bank.' See Article 2 UCP 600.

²¹² See Article 7(a) (v) UCP 600.

²¹³ See Article 8(b) UCP 600 and Article 15(b) UCP 600.

²¹⁴ See Article 12(a)(b) UCP 600.

²¹⁵ See Article 12(c) UCP 600.

2.3.4 Duty to Reimburse the Nominated Bank

According to Article 7(c) UCP 600 the issuing bank must ‘reimburse a nominated bank that has honoured or negotiated a complying presentation and forwarded the documents to the issuing bank’ at maturity of the letter of credit. This applies regardless of ‘whether or not the nominated bank prepaid or purchased before maturity’. This obligation ‘is independent of the issuing bank’s undertaking to the beneficiary’.²¹⁶

The same applies with the confirming bank.²¹⁷

The 2007 revision of the UCP 600 resulted in an important improvement for the nominated bank as regards its claim for reimbursement against the issuing bank or the confirming bank. Under the UCP 500, a nominated bank discounting a ‘deferred payment credit’ carried the risk of any scam rising between payment and maturity of the credit, because it was not considered as authorised to negotiate the credit unless expressly stated in the credit.²¹⁸ In the case of *Banco Santander SA v Banque Paribas (Santander v BNP)* Waller LJ held:

In my view the position is that Santander [= nominated bank] had no authority to negotiate from Paribas [= issuing bank] to discount, and did not seek it. It was something they were entitled to do on their own account. If they had not chosen to discount and had waited [until maturity of the deferred payment credit] [...], they would have had a defence, and it is in those circumstances not open to them to claim reimbursement from Paribas (amendments made).²¹⁹

However, Article 12(b) UCP 600 provides for:

By nominating a bank to accept a draft or incur a deferred payment undertaking, an issuing bank authorises that nominated bank to prepay or purchase a draft accepted or a deferred payment undertaking incurred by that nominated bank.

Thus, Article 12(b) UCP 600 ‘rectified the obstacle of discounting’ to the effect that a nominated bank may claim reimbursement from the issuing bank in case of honouring a deferred payment undertaking before maturity.²²⁰

²¹⁶ See Article 7(c) UCP 600.

²¹⁷ See Article 8(c) UCP 600.

²¹⁸ Isaacs M & Barnett M (2007) 660.

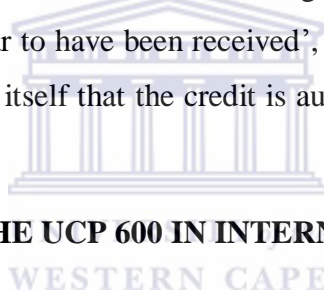
²¹⁹ *Banco Santander SA v Banque Paribas* [2000] 1 All ER (Comm) 776.

²²⁰ Isaacs M & Barnett M (2007) 660.

2.4 Advising Bank's Obligations

It is much more difficult to define the obligations of the advising bank, as the advising bank may take on different roles.²²¹ It may act as the 'nominated bank', which is authorised to pay, issue a deferred payment undertaking or accept drafts²²², the 'negotiating bank', which purchases the draft and the documents from the beneficiary²²³, and/or the 'confirming bank', which adds its own irrevocable undertaking to pay and must pay upon a complying presentation.²²⁴

In simple terms however, according to Article 9 UCP600 the advising bank establishes its bona fide without any obligation to honour the credit.²²⁵ It acts as an agent²²⁶ of the issuing bank and checks the authenticity of the credit.²²⁷ Once the advising bank is satisfied that the credit is accurate (e.g. that no pages are missing, the credit is duly signed) it notifies the beneficiary accordingly, hence it advises the letter of credit to the beneficiary.²²⁸ If the advising bank is not satisfied that the credit is authentic it must so give notice immediately to 'the bank from which the instructions appear to have been received', which is the issuing bank.²²⁹ If the advising bank is unable to satisfy itself that the credit is authentic, it must so notify the beneficiary.²³⁰



3. LEADING ROLE OF THE UCP 600 IN INTERNATIONAL SALES TRANSACTIONS

This chapter showed that the UCP 600 is the most widely used set of rules governing letter of credit transactions. This is because of its clear structure and because it best realises the international banking customs and practices. Further, the UCP 600 vividly describe the obligations of the parties involved in detail and therefore provide clear guidance on how to operate a letter of credit transaction.

²²¹ See Bergami R (2011) 100 et seq. referring to Jimenez G 'ICC Guide to Export-Import Basics: The Legal, Financial and Transport Aspects of International Trade' (1997).

²²² See Article 12 UCP 600.

²²³ See definition of 'Negotiation' in Article 2 UCP 600.

²²⁴ See I.3.2.

²²⁵ See Venedikian HM and Warfield GA 'Export-Import Financing' 3 ed. (1992) 347.

²²⁶ However, this view has been challenged by Wight and Ward, who found that an examination of the supportive authority 'seems to cast doubt of that support' and that it was unlikely that the parties to the letter of credit transaction intend that the full legal consequences of an agency relationship should apply (Wight R & Ward A (1993) 433 and 435). Nonetheless, it is indicated that this view has received only 'little judicial consideration' and that in contrary most of the pertinent case law still considered that the relationship is that of an agency, with the issuing bank as principal and the advising bank as agent (See Zhou L (2002) 225-226 with further reference to case law and other commentators as support of her assumption).

²²⁷ See II.3.1 and Figure 1 above.

²²⁸ Isaacs M & Barnett M (2007) 661.

²²⁹ Article 9(f) UCP 600.

²³⁰ Article 9(f) UCP 600.

CHAPTER THREE

KEY PRINCIPLES OF A LETTER OF CREDIT AND EXCEPTIONS TO THE PRINCIPLE OF AUTONOMY

1. KEY PRINCIPLES

As already briefly discussed in Chapter I. 4., the key principles of any letter of credit are the principle of strict compliance and the principle of autonomy. Both principles serve and protect the commercial purpose of a letter of credit transaction that was enunciated best by Lord Diplock in the case of *United City Merchants (Investment) Limited v Royal Bank of Canada*:

The whole commercial purpose for which the system of confirmed irrevocable documentary credits has been developed in international trade is to give to the seller an assured right to be paid before he parts with control of the goods.²³¹

1.1 Strict Compliance Doctrine

According to the principle of strict compliance, the issuing bank undertakes to honour the credit exclusively upon documents, which on their face appear to constitute a complying presentation.²³² In practice, the most common discrepancies found in letter of credit transactions are inconsistent data,²³³ an incomplete set of transport documents,²³⁴ incorrect drafts (e.g. wrong amount), unsigned drafts, that the invoice does not describe goods in exact accordance with the letter of credit,²³⁵ insufficient insurance coverage,²³⁶ and documents, which are not duly signed.²³⁷

Not only does the principle of strict compliance benefit the bank, which only has to review whether the presentation complies with the terms and conditions of the letter of credit.²³⁸ It

²³¹ *United City Merchants (Investment) Limited v Royal Bank of Canada* [1982] 2 All E.R. 725.

²³² The principle of strict compliance is not contented in a single provision of UCP 600, but derives from a synopsis of various provisions such as Article 2 (as regards the definition of 'Complying presentation'); Article 7(a), Article 8(a)(c) and Article 15 (which provide for the banks undertaking to honour a complying presentation); Article 14 (which provides for the standard of examination of documents) and Article 34 (which expressly limits the banks' liabilities as regards other issues associated with documents such as their legal or commercial value whatsoever; see *Devlin J in Midland Bank Ltd v Seymour* [1955] 2 *Lloyd's Law Reports* 151).

²³³ See Article 14(d) UCP 600.

²³⁴ See Article 19 UCP 600 et seq.

²³⁵ See Article 18(c) UCP 600.

²³⁶ See Article 28 UCP 600.

²³⁷ See Baker (2013) 4 for further examples.

²³⁸ See Article 34 UCP 600; see also *Devlin J in Midland Bank Ltd v Seymour* [1955] 2 *Lloyd's Law Reports* 151.

also protects the applicant, whose primary interest is that the seller has shipped the goods as agreed before the applicant becomes bound to pay or to reimburse the bank.²³⁹

However, the principle of strict compliance does not prevent bad faith behaviour and abuse. The issuing bank for instance may refer to a technical incorrectness in the presentation, such as missing commas or asterisks,²⁴⁰ to avoid payment, or to protect its customer or itself from an insolvent customer.²⁴¹ Unsurprisingly, the question as to when a presentation is in compliance with the conditions laid out in the credit has been subject to intensive debate amongst scholars and, due to its practical relevance, also subject to intensive litigation.²⁴² The stumbling block is the question what level of discrepancy constitutes non-compliance:²⁴³ a typing error or misspelling²⁴⁴; a colloquial name not specified in the credit, but commonly known in the respective industry; a varied description of colour, e.g. a credit for '100 widgets in Olympic Gold' in the tendered documents stated as '100 widgets in Gold', or '100 widgets in Commonwealth Gold'; a credit for '7 1999 Porsche 911 vehicles coloured Frost White' in the invoice described as '7 1999 Porsche 911 vehicles coloured Snow White' or '7 1999 Porsche 911 vehicles coloured Powder White' or even '7 1999 Porsche 911 vehicles coloured Iceberg White?'²⁴⁵

It would go beyond the scope of this thesis to enter into a detailed discussion of the principle of strict compliance. Kozolchyk rightly concludes that 'as the volume of letter of credit litigation increases, so does the number of equitable exceptions and rival doctrines', e.g. 'de minimis discrepancies; functional legal equivalence of terms; waiver; estoppels and ratification; foreign law and banking usage'.²⁴⁶ McLaughlin names further exceptions such as 'the rule of

²³⁹ Tóth Z (2006) 88.

²⁴⁰ Kozolchyk B 'Strict Compliance and the Reasonable Document Checker' (1990) *Brooklyn Law Review* 54 (hereafter Kozolchyk B (1990)).

²⁴¹ Leon C (2012) 453.

²⁴² See Botosh HMS 'Striking the Balance Between the Consideration of Certainty and Fairness in the Law Governing Letters of Credit' (2000) 183-271 (hereafter Botosh HMS (2000)) for a detailed discussion of the different theories on how to define compliance providing an extensive overview of case law associated to this issue.

²⁴³ See Krazovska D (2008) for an extensive overview and discussion of the principle of strict compliance.

²⁴⁴ See Krazovska D (2008) 25-43 for a discussion of case law as to whether or not a misspelling or a typing errors constitute non-compliance; e.g. *Beyene v Irving Trust Co.* (New York, USA, 1985) 762F.2d 4, C.A.2 (N.Y.), 1985 (non-compliance due to the misspelling of the applicants name, instead of 'Mohammed Sofan' the bill of lading stated 'Mohammed Soran'); *Bank of Cochin Ltd. v. Manufacturers Hanover Trust Co.* (New York, USA, 1985) 612 F.Supp. 1533, D.C.N.Y, 1985 (non-compliance on the ground of misspelling of the companies name 'St. Lucia Enterprises' instead of 'St. Lucia Enterprises Inc. '); *Hing Yip Hing Fat Co Ltd v. The Daiwa Bank Ltd* (1991, Hong Kong) [1991] 2 HKLR 35, High Court, 1991 (the court held that the documents were compliant, although the Company's name was misspelled, 'Cheerogal Industrial Limited' instead of 'Cheergoal Industries Limited', on the ground of an 'obvious typographical error from the word 'industries'.

²⁴⁵ See Krazovska D (2008) 43-56 for a discussion of case law as to whether a deviation in the description of goods in commercial invoice constitute non-compliance; e.g. *Bank Melli Iran v. Barclays Bank (Dominion, Colonial & Overseas)* [1951] 2 *Lloyd's Law Reports* 367 (non-compliance on the ground that the letter of credit referred to '100 new Chevrolet trucks' whereas the invoice referred to 'Chevrolet trucks in new condition'; also see *Arkins J* (2000) 32.

²⁴⁶ Kozolchyk B (1990) 66.

contra proferentum; the render performance possible rule; the plain meaning rule; reformation of the written terms of the letter of credit; and the parol evidence rule.²⁴⁷

However, it seems worthwhile to have a brief look at the main theories on how to determine the level of compliance namely (i) the doctrine of strict compliance and (ii) the doctrine of substantial compliance²⁴⁸ each of the latter in consideration of the UCP 600.

1.1.1 Doctrine of Strict Compliance

The doctrine of strict compliance is self-explanatory, i.e. documents must strictly comply with the terms and conditions of the credit.²⁴⁹ Regardless of the enormous number of theoretical approaches to the exact definition or distinctiveness of the term ‘strict’, there is a general agreement that the wording of the UCP 600 does not require a ‘word-for-word compliance’.²⁵⁰ Woods rightly states that not only does Article 14 UCP 600 not use the term ‘strict’; the UCP 600 further contains provisions allowing for ‘insignificant inconsistencies or errors’.²⁵¹ In particular, discrepancy of documents is generally classified into two groups (i) ‘irrelevant irregularities’ of documents, which do not violate the principle of strict compliance, and (ii) ‘genuine’ or ‘material’ discrepancies of documents, which allow banks to dishonor the credit.²⁵²

Irrelevant Irregularities

Article 30(a) UCP 600 provides for a tolerance of ten percent if the credit uses the words ‘about’ or ‘approximately’ in connection with the ‘amount of the credit or the quantity or the unit price’. Article 30(b) UCP 600 provides for a tolerance of five percent ‘provided the credit does not state the quantity in terms of a stipulated number’. Another example can be found in Article 37(c) UCP 500 (=Article 14(e) and 18 (c) UCP 600) which reads as follows:

The description of the goods in the commercial invoice must correspond with the description in the Credit. In all other documents, the goods may be described “in general terms not inconsistent” with the description of the goods in the Credit.

²⁴⁷ See McLaughlin ‘On the Periphery of Letter of Credit Law: Softening the Rigors of Strict Compliance’ 106 (1989) *Banking Law Journal* 4, 10, 15, 17, 19 and 22.

²⁴⁸ See Botosh HMS 183 et seq. for a detailed discussion of said theories.

²⁴⁹ Botosh HMS (2000) 5.

²⁵⁰ Arkins J (2000) 33; see also Kozolchik B (1990) 51 referring to the case of *Equitable Trust Co. V Dawson Partner Ltd.* 27 *Lloyd’s List L.R.* 49 (H.L. 1927), which asked for the beneficiary’s tender of a certificate of quality signed by the Chamber of Commerce of Batavia, which did not exist, rather there was a Commercial Association of Batavia. The court found that evidence implied that the Commercial Association of Batavia could be considered as the equivalent of a chamber of commerce.

²⁵¹ Wood JS (2008) 106.

²⁵² See Schmitthoff CM ‘Discrepancy of Documents in Letter of Credit Transactions’ (1987) *Journal of Business Law* 95.

No 'strict' compliance is asked for as regards documents other than the commercial invoice. Hence the last sentence of Article 37(c) UCP 500 (= Article 14(e) UCP 600) suggests that

if, "properly read and understood", the word in the instruction and in the tendered documents have the same meaning, if they correspond though not being identical, the bank should not reject the documents.²⁵³

Material Discrepancies

The case of *Bank Melli Iran v. Barclays Bank (Dominion, Colonial & Overseas)*²⁵⁴ and *Courtaulds North America, Inc. v. North Carolina Nat. Bank*²⁵⁵ are examples where courts dishonoured the credit due to material discrepancies.²⁵⁶

In the former case, payment was authorised upon documents that included a commercial invoice indicating shipment of '100 new Chevrolet trucks'. However, the presented invoice referred to the Chevrolet trucks as 'in new condition'. The court held that 'in new condition' and 'new' was not the same.²⁵⁷

Subject of the case *Courtaulds North America, Inc. v. North Carolina Nat. Bank* was a letter of credit that demanded an invoice in triplicate stating that it covers '100% Acrylic Yarn'. However, the beneficiary presented invoices that stated that the goods were 'Imported Acrylic Yarn', which was the reason for the bank to dishonour the credit.²⁵⁸ The court held that:

Free of ineptness in wording the letter of credit dictated that each invoice express on its face that it covered 100% acrylic yarn. Nothing less is shown to be tolerated in the trade. No substitution and no equivalent, through interpretation or logic, will serve.²⁵⁹

Despite the fact that the invoices presented by the beneficiary were accompanied by packing slips which on their face revealed that the packages included 'cartons marked: -100% acrylic', the court held that the tendered documents could not be considered strictly compliant as the UCP expressly distinct between the 'invoice' and 'remaining documents',^{260 261}

²⁵³ Botosh HMS (2000) 189 referring to Murray C. et al, in Schmitthoff (ed) 'Export Trade and Practice of International Trade' 9 ed (1990) 411.

²⁵⁴ See *Bank Melli Iran v Barclays Bank (Dominion, Colonial & Overseas)* [1951] 2 Lloyd's Law Reports 367.

²⁵⁵ *Courtaulds North America, Inc. v North Carolina Nat. Bank* 528 F.2d 802, C.A.N.C 1975.

²⁵⁶ Krazovska D 'Impact of the Doctrine of Strict Compliance on a Letter of Credit Transaction' (2008), available at http://pure.au.dk/portal-asb-student/files/2543/Krazovska_MasterThesis.pdf (accessed 27 December 2012) 44 (hereafter Krazovska D (2008)).

²⁵⁷ *Bank Melli Iran v Barclays Bank (Dominion, Colonial & Overseas)* [1951] 2 Lloyd's Law Reports 375.

²⁵⁸ *Courtaulds North America, Inc. v. North Carolina Nat. Bank* 528 F.2d 802, C.A.N.C 1975 803.

²⁵⁹ *Courtaulds North America, Inc. v. North Carolina Nat. Bank* 528 F.2d 802, C.A.N.C 1975 806.

²⁶⁰ See Article 14(e) UCP 600, which reads 'documents other than the commercial invoice'.

²⁶¹ *Courtaulds North America, Inc. v North Carolina Nat. Bank* 528 F.2d 802, C.A.N.C 1975 806; Krazovska D (2008) 45.

1.1.2 Substantial Compliance

Due to the fact that the strict compliance doctrine not only protects the bank's and applicant's interest, but cannot prevent abuse, a few courts have adopted the so-called 'substantial performance'²⁶² test as a balancing of interests.²⁶³ This test requires bankers 'to look beyond the face of the documents, investigate the realities of the transaction, and weigh the credibility of documents, customers and beneficiaries'.²⁶⁴ Accordingly, a material conformance to the terms of the letter of credit is sufficient to oblige the bank to honour the credit.

This test has been criticised for its inconsistency with the issuing banks 'ministerial function' and that it undercuts the certainty of the transaction.²⁶⁵ Besides, the 'substantial compliance' test conflicts with Article 5 UCP 600, which states that '[b]anks deal with documents and not with goods, services or performance to which the documents may relate'. However, Lord Sumner quite aptly describes the weakness of the 'substantial performance' text by stating that '[t]here is no room for documents which are almost the same, or which will do just as well'.²⁶⁶

1.2 Autonomy Principle

The principle of autonomy plays a significant role within the letter of credit working system, because it promotes the efficiency of international trade.²⁶⁷ According to this principle 'banks are in no way concerned with or bound by' the underlying sales contract.²⁶⁸ This provides for the beneficiary to get paid upon a complying presentation,²⁶⁹ regardless of any dispute that may arise in respect of the underlying contract. The letter of credit is designed as a 'pay first, argue later'²⁷⁰ device that promotes the efficiency of international trade.²⁷¹ Due to its important role within the letter of credit working system,²⁷² the principle of autonomy is described

²⁶² See, e.g. *Tosco Corp. v FDIC*, 723 F.2d 1242 (6th Cir. 1983); *Crocker Commercial Serv. Inc. v Countryside Bank*, 538 F. Supp. 1360 (N.D. Ill. 1981); *First Arlington Nat'l Bank v Stathis*, 90 Ill. App. 3d 802, 413 N.E.2d. 1288 (1980) referred to by Leon C (2012) 453.

²⁶³ Leon C (2012) 453.

²⁶⁴ Hotchkiss C 'Strict Compliance in Letter-of-Credit Law: How Uniform is the Uniform Commercial Code?' (1991) 23 *Uniform Commercial Code Law Journal* 295.

²⁶⁵ Dolan JF 'Strict Compliance With Letters of Credit: Striking a Fair Balance' 102 (1985) *Banking Law Journal* 32; see also Leon C (2012) 454.

²⁶⁶ *Equitable Trust Company of New York v Dawson Partners Ltd* [1927] 2 *Lloyd's Law Reports* 52.

²⁶⁷ See Ortego JJ. & Krinick EH (1998) 487; Chatterjee C & Lefcovitch A (2003) 72.

²⁶⁸ Article 4(a) UCP 600.

²⁶⁹ See e.g. Article 7(a) UCP 600.

²⁷⁰ *Eakin v Continental Illinois National Bank & Trust Co.* (1989) 875 F.2d 114 at 116.

²⁷¹ See Dolan JF (2006) 480.

²⁷² See Ortego JJ & Krinick EH 'Letters of Credit: Benefits and Drawbacks of the Independence Principle' 115 (1998) *Banking Law Journal* 487 (hereafter Ortego JJ & Krinick EH (1998)); Chatterjee C & Lefcovitch A 'The Principle of Autonomy of Letters of Credit is Sacrosanct in Nature' (2003) *Journal of International Banking Regulation* 72 (hereafter Chatterjee C & Lefcovitch A (2003)).

as the ‘cornerstone of the commercial vitality of the letters of credit’²⁷³ or the ‘engine room behind the letter of credit’²⁷⁴ and is upheld by prominent domestic and international legal frameworks.²⁷⁵ Three key functions of the autonomy principle have been identified.²⁷⁶

1.2.1 Payment Function

The principle of autonomy underlines the letter of credit’s capacity as ‘pay now, argue later’ device, reducing the risks in the underlying contract by substituting each party’s liabilities,²⁷⁷ so that the beneficiary receives payment and the issuing bank is reimbursed by or given recourse against the applicant regardless of any dispute related to the underlying contract.²⁷⁸ Hence, the applicant cannot by means of counterclaim either delay or prevent payment under the credit.²⁷⁹ Instead, such counterclaims are subject to subsequent litigation with the beneficiary.²⁸⁰

1.2.2 Commercial Function

The autonomy principle further has a commercial function.²⁸¹ On the one hand, the ministerial functions of checking documents²⁸² and transferring funds²⁸³ are conferred to the issuing bank to determine whether the bank is obligated to make the payment.²⁸⁴ On the other hand, the issuing bank is assured to be reimbursed by the applicant²⁸⁵ solely based on the documents provided by the beneficiary.²⁸⁶

²⁷³ *Ward Petroleum Corp. v Federal Deposit Ins. Corp.* (1990) 903 F.2d 1299.

²⁷⁴ *Arkins J* (2000) 31.

²⁷⁵ See inter alia Article 4 UCP 600; Article 2(b) URDG; Articles 2 and 3 UNCITRAL-Convention; sections 5-109 (1)(a), 5-114 (1) and 5-103(d) UCC.

²⁷⁶ *Garcia RLF* (2009) 76 et seq.

²⁷⁷ *McCormack G* ‘Subrogation and Bankers’ Autonomous Undertakings’ (2000) *Law Quarterly Review* 45 (*McCormack G* (2000)).

²⁷⁸ *Buckley RP & Gao X* ‘The Development of the Fraud Rule in Letter of Credit Law: The Journey so Far and the Road Ahead’ 23 (2002) *University of Pennsylvania Journal of Economic Law* 663 (hereafter *Buckley RP & Gao X* (2002)).

²⁷⁹ See *Schmitthoff CM* (1988) 51.

²⁸⁰ See *Sappideen R* ‘International Commercial Letters of Credit: Balancing the Rights of Buyers and Sellers in Insolvency’ (2006) *Journal of Business Law* 146.

²⁸¹ See *Alces PA* ‘An Essay in Independence, Interdependence and the Surety Principle’ (2003) *University of Illinois Law Review* 452 and 466 (also available at <http://scholarship.law.wm.edu/cgi/viewcontent.cgi?Article=1309&context=facpubs>, accessed on 3 December 2012) referring to *American Bell Int’l, Inc. v Islamic Republic of Iran* (1979) 474 F. Supp. 426.

²⁸² *Hare C* ‘Not so Black and White: The Limits of the Autonomy Principle’ (2004) *The Cambridge Law Journal* 288 (hereafter *Hare C* (2004)).

²⁸³ *McCormack G* (2000) 41.

²⁸⁴ *Hare C* (2004) 289.

²⁸⁵ *Koudriachov SA* (2001) 41.

²⁸⁶ See *Demir-Araz Y* ‘International Trade, Maritime Fraud and Documentary Credits’ (2002) *International Trade Law & Regulation* 129; the latter applies due to the limitation of the bank’s liability according to Article 34 UCP 600.

1.2.3 Financing Function

Finally, the financing function itself provides for two benefits to the parties of a letter of credit. First, it protects the parties of a letter of credit from any interference from being reimbursed by the issuing bank after paying the beneficiary,²⁸⁷ and secondly, it supports the beneficiary to leverage other transactions by virtue of the credit to the benefit of the beneficiary under the letter of credit.²⁸⁸

2. EXCEPTIONS TO THE PRINCIPLE OF AUTONOMY

The fact that the principle of autonomy plays a very important and dominant role within the letter of credit working system does not make it a dogma and hence immune against litigation. Courts are regularly asked to award injunctions to enjoin banks from honouring a credit, e.g. in cases of fraud. In such instances courts must decide whether to respect and apply the principle of autonomy or rather grant an injunction to prevent an innocent party from fraud, taking into consideration public policies, statutes, public interest and third party rights.²⁸⁹ This tension has been well summarised by Justice Le Dain in the case of *Bank of Nova Scotia v Angelica-Whitewear Ltd.* as follows:

The potential scope of the fraud exception must not be a means of creating serious uncertainty and lack of confidence in the operation of letter of credit transactions; at the same time the application of the principle of autonomy must not serve to encourage or facilitate fraud in such transactions.²⁹⁰

Whilst the fraud rule in general is well established and recognised²⁹¹, there are no standard rules²⁹² as to when and under what conditions it should supersede the principle of autonomy.²⁹³ Recent studies²⁹⁴ have shown that fraudulent behaviour is not the only reason on the ground of which courts rule that the autonomy principle could be superseded. For instance,

²⁸⁷ Yafrich M 'Third Party's Attachment on Letter of Credit Proceeds' (2001) *Journal of Business Law* 159; Rendell RS 'Fraud and Injunctive Relief' (1990-1991) *Brooklyn Law Review* 113.

²⁸⁸ Garcia RLF (2009) 77.

²⁸⁹ Garcia RLF (2009) 69.

²⁹⁰ *Angelica-Whitewear Ltd. v Bank of Nova Scotia* 36 D.L.R. (4th) 161, EYB 1987-67726 168.

²⁹¹ Gao X 'The Fraud Rule in the Law of Letters of Credit: A Comparative Study' (2002) is the most comprehensive study as regards the issue of the fraud rule; see also Buckley RP & Gao X 'The Development of the Fraud Rule in Letter of Credit Law: The Journey so Far and the Road Ahead' 23 (2002) *University of Pennsylvania Journal of Economic Law* 663; for a detailed discussion of the fraud rule with regard to bank demand guarantees see Kelly-Louw M (2008) ch 5; see further van Niekerk JP & Schulze WG 'The South African Law of International Trade: Selected Topics' 2 ed (2006) 313 (hereafter van Niekerk JP & Schulze WG (2006)); Dolan JF (2006) 479.

²⁹² See Gao X & Buckley RP (2003) 293 et seq. for an attempt to explore the kind of fraud required to invoke the fraud rule.

²⁹³ The fraud rule will be dealt with in detail in Chapter IV.

²⁹⁴ Enonchong N 'The Autonomy Principle of Letters of Credit: An Illegality Exception?' (2006) *Lloyd's Maritime and Commercial Law Quarterly* 404 (hereafter Enonchong N (2006)); Botosh HMS (2000) 135-150; Garcia RLF (2009) 67; see Kelly-Louw M (2008) 162 footnote 8 with further references as regards other exceptions to the principle of autonomy.

illegality²⁹⁵, nullity²⁹⁶, unconscionable conduct²⁹⁷, interim court relief (e.g. ‘Mareva Injunction’)²⁹⁸, etc. are also considered as possible exceptions to the autonomy principle.²⁹⁹ However, Dolan rightly points out that those exceptions

tend to have limited application, and, to date, have not threatened the efficacy of independent obligations as commercial devices to the extent the fraud exceptions have done and threaten to do.³⁰⁰

Therefore and, as further discussion of these exceptions fall beyond the scope of this thesis, focus will be given to the fraud rule.

3. FRAUD RULE

3.1 Rationale for the Fraud Rule

The fraud rule ‘goes to the very heart’ of the letter of credit, as it allows the issuing bank or a court to examine the facts behind a complying presentation and to disrupt payment if fraud is committed in the transaction.³⁰¹ The fraud rule is ‘the most controversial and confused area’ in letter of credit law.³⁰² Gao³⁰³ has identified three main reasons for the existence and the necessity of the fraud rule: (1) to close a loophole in the law; (2) to uphold the public policy of limiting fraud; and (3) to maintain the commercial utility of letters of credit.³⁰⁴

²⁹⁵ See Enonchong N (2006) 404.

²⁹⁶ The nullity exception has recently been discussed in the United Kingdom and Singapore; see Hooley R ‘Fraud and Letters of Credit: Is there a nullity Exception?’ (2002) 61 *Cambridge Law Journal* 279 for a detailed discussion with further reference to other Articles and case law regarding this exception; also Garcia RLF (2009) 87 et seq.

²⁹⁷ See Aijaz H ‘Unconscionability as an Exception to the Independence Principle – A Study of Singaporean Caselaw’ (2000) available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1689309 (accessed on 2 January 2013); see also Wong ASP ‘Restraining a Call on a Performance Bond : Should “Fraud or Unconscionability” be the New Orthodoxy?’ 12 (2000) *Singapore Academy of Law Journal* 153 et seq.

²⁹⁸ Garcia RLF (2009) 92; see also Crerar DA ‘Mareva Freezing Orders and Non-Party Financial Institutions: A practical Guide’ *Banking and Finance Law Review* (2006) 173; Faul W & Malan FR ‘The Mareva Injunction’ 2 (1990) *South African Mercantile Law Journal* 305; O’Driscoll PS ‘Performance Bonds, Banker’s Guarantees and the Mareva Injunction’ 7 (1985) *Northwestern Journal of International Law & Business* 398.

²⁹⁹ For more details see Enonchong N (2006) 404; Enonchong N ‘The Problem of Abusive Calls on Demand Guarantees’ (2007) *Lloyd’s Maritime and Commercial Law Quarterly* 83; Bailey J ‘Unconditional Bank Guarantees’ (2003) 20 *International Construction Law Review* 240; Botosh HMS (2000) 135-150; Kelly-Louw M (2008) 257 et seq. and 287 et seq.; Loh Q & Wu TH ‘Injunctions Restraining Calls on Performance Bonds - Is Fraud the Only Ground in Singapore?’ (2000) *Lloyd’s Maritime and Commercial Law Quarterly* 348.

³⁰⁰ Dolan JF (2006) 485.

³⁰¹ Gao X & Buckley RP (2003) 293.

³⁰² See Buckley RP & Gao X (2002) 663 referring to Anon ‘“Fraud in the Transaction”: Enjoining Letters of Credit during the Iranian Revolution’ 93 (1980) *Harvard Law Review* 92.

³⁰³ Gao X (2002) 29 and 98.

³⁰⁴ Buckley RP & Gao X (2002) 663.

3.1.1 Closing a Loophole in Law

The autonomy principle creates a loophole for perpetrators of fraud to abuse the system and get paid without having performed their own duties under the underlying contract, e.g. the shipment of the agreed goods, by presenting forged or fraudulent documents that appear on their face to be complying with the conditions set forth in the credit.³⁰⁵ Therefore, doubts have been that the strict application of the autonomy principle and the complete separation of the underlying contract promote false calls, abuse and fraud, which is one reason for the development of the fraud rule.³⁰⁶ Although the fraud rule may not prevent every injustice that fraud can cause, it does shrink the loophole caused by the autonomy principle.³⁰⁷

3.1.2 Public Policy of Limiting Fraud

Another reason for the development of the fraud rule lies in the general concern of public policy to control and combat fraud or, as aptly put by Judge Edenfield in the case of *Dynamics Corporation of America v The Citizens and Southern National Bank* ‘there is as much public interest in discouraging fraud as in encouraging the use of letters of credit’.³⁰⁸ A perpetrator of fraud should not be in the position to rely on the principle of autonomy and at the same time obtain payment upon forged documents or falsifications.³⁰⁹ In the case of *United City Merchants (Investment) Limited v Royal Bank of Canada*³¹⁰ Lord Diplock stressed that the basis for the fraud rule is that the courts will not allow their process to be used by a dishonest person to carry out a fraud, relying on the doctrine of *ex turbi causa non oritur*³¹¹. Thus the fraud rule is considered a part of a ‘sound legal system that upholds the public policy of limiting fraud.’³¹²

3.1.3 Maintain the Commercial Utility of the Letter of Credit

The description of the letter of credit working system and its operations have shown³¹³ that the commercial utility of a letter of credit is that it fairly balances the competing interests of the parties involved.³¹⁴ The beneficiary is provided with a prompt and safe payment with the

³⁰⁵ Gao X (2002) 30.

³⁰⁶ Stewart H ‘It is Insufficient to Rely on Documents’ (2002) *Journal of Money Laundering Control* 225.

³⁰⁷ Gao X (2002) 30.

³⁰⁸ *Dynamics Corporation of America v The Citizens and Southern National Bank* (1973) 356 F.Supp. 1000.

³⁰⁹ Kurkela MS ‘Letters of Credit and Bank Guarantees Under International Trade Law’ 2 ed (2008) 181.

³¹⁰ *United City Merchants (Investment) Limited v Royal Bank of Canada* [1982] 2 All E.R. 725.

³¹¹ *Ex turpi causa non-oritur actio* means ‘no action can be based on a disreputable cause’, see Law J & Martin EA ‘A Dictionary of Law’ 7 ed (2009).

³¹² Gao X (2002) 30.

³¹³ See Chapter 4.2 Main Operations of a Letter of Credit Transaction I.3.2.

³¹⁴ See Chapter I.2.

applicant's creditworthiness substituted by that of a bank. The applicant's interests are safeguarded by means of certain documents to be tendered by the beneficiary in order for the credit to be honoured. For instance, the bill of lading not only indicates that the agreed goods have been shipped³¹⁵ and the beneficiary has duly performed its duties under the underlying contract. It further embodies an economic value as the owner of the bill of lading is empowered to dispose of or transfer the goods covered thereby to third parties.³¹⁶ The issuing bank will receive a fee for its document checking services and, in many cases, will be provided with the goods serving as security for honouring the letter of credit.³¹⁷

If the beneficiary shipped nothing but worthless rubbish, not only would the applicant be hurt because he must reimburse the issuing bank without receiving the agreed goods, the issuing bank's security interest in the goods would fail as well. Consequently, Gao points out that the balance in the letter of credit scheme is undermined and the faith of the users, upon which the letter of credit is based, will fade, as will the commercial utility of the letter of credit, if the possibility of abuse or fraud in the letter of credit system is not tackled.³¹⁸ Kozolchyk argues similarly:

The certainty of payment of a letter of credit is crucial for those who, as beneficiaries, supply their money, goods or services to applicants. The question thus arises: "Why not make the letter of credit draft or demand for payment injunction-proof?" Yet what about the applicant? To leave the applicant without a remedy against fraud would equally frustrate the applicant's expectations of the letter of credit. After all, why should a good faith applicant agree to procure the issuance of a letter of credit and reimburse the issuing bank if the letter of credit becomes an automatic unstoppable vehicle for the perpetration of fraud? As is true with other commercial legal institutions, an approach that favors one party at the expense of the other undermines the viability of the institution.³¹⁹

Some may find it not necessary to protect the applicant and the issuing bank at the cost of superseding the autonomy principle by means of a fraud injunction, because each of the latter could take action against the beneficiary for fraud. However, this is not considered a valuable alternative as the perpetrator of fraud regularly 'absconds before the fraud or forgery is dis-

³¹⁵ See Article 20(ii) UCP 600.

³¹⁶ Kelly-Louw M (2008) 82.

³¹⁷ Buckley RP & Gao X (2002) 667.

³¹⁸ Buckley RP & Gao X (2002) 667.

³¹⁹ Kozolchyk B 'The Immunization of Fraudulent Procured Letter of Credit Acceptances: All Services Exportacao, Importacao Comercio, S.A. v Banco Bamerindus Do Brazil, S.A. and First Commercial v Gotham Originals' (1992) 58 *Brooklyn Law Review* 370.

covered.³²⁰ Shrinking the loophole of the autonomy principle, thus limiting the opportunities to abuse the letter of credit working system, maintains the commercial utility of the letter of credit by means of upholding the balance of competing interests of the parties involved.³²¹

3.2 Overview of the Historical Background of the Fraud Rule until *Sztejn v Henry Schroder Banking Corporation*

The occurrence of fraud is ‘timeless and universal’.³²² The international trade community has been facing this problem for decades if not for centuries. It is claimed that ‘defrauding banks is an activity which is no doubt as old as banking itself’.³²³

3.2.1 *Pillans and Rose v Van Mierop and Hopkins*

The English case *Pillans and Rose v Van Mierop and Hopkins*³²⁴ is said to be one of the first cases in letter of credit law dealing with the matter of fraud. Pillans and Rose (plaintiffs) were merchant bankers in Rotterdam. White, an Irish merchant, wanted to draw on Pillans and Rose a sum of 800 pounds. Pillans and Rose agreed to accept such draw under the condition that White provided security by means of a confirmed credit of a good house in London. Van Mierop and Hopkins (defendants), a big London company, confirmed the credit as requested, i.e. the defendants undertook to guarantee a pre-existing duty of White to pay Pillans and Rose. However, before the bills were drawn on Van Mierop and Hopkins, White went insolvent. Subsequently, Van Mierop and Hopkins refused to pay on the grounds that Pillans and Rose had provided no consideration for the guarantee, because there was the rule that past consideration is not a good consideration.³²⁵

First, a verdict was made in favour of the defendants. On appeal, Lord Mansfield on the ground that the transaction was a commercial one³²⁶ rejected the defendants’ argument that their promise to the plaintiffs was void as the consideration under the transaction was not appropriate.³²⁷ However, Lord Mansfield argued that the defendants’ dishonouring of the credit could have been justified, if fraud had been involved in the transaction.³²⁸ The defendants

³²⁰ Ellinger P ‘Documentary Credits and Fraudulent Documents’ in Chinkin CM, Davidson RJ et al.eds. ‘Current Problems of International Trade Financing’ (1983) 191.

³²¹ Gao X (2002) 32; see also Chapter 1.2.

³²² Leigh LH ‘The Control of the Commercial Fraud’ (1982) 3.

³²³ Jones S ‘Reports on court Cases Dealing with L/C Fraud’ (1990) Vol 5 No 2 *DCInsight* referred to by Tóth Z (2006) 98.

³²⁴ See *Pillans and Rose v Van Mierop and Hopkins* (1756) 1035; for a detailed discussion of the case see Gao X (2002) 33-34; Kelly-Louw M (2008) 173-174.

³²⁵ *Pillans and Rose v Van Mierop and Hopkins* (1756) 1035.

³²⁶ *Pillans and Rose v Van Mierop and Hopkins* (1756) 1035.

³²⁷ *Pillans and Rose v Van Mierop and Hopkins* (1756) 1038.

³²⁸ *Pillans and Rose v Van Mierop and Hopkins* (1756) 1036.

argued that White as well as the plaintiffs had fraudulently concealed certain facts from them.³²⁹ Lord Mansfield rejected that argument stating:

If there was any kind of fraud in this transaction, the collusion and mala fides would have vacated the [the credit]. But from these letters it seems to me clear, that there was none. [...] Both the plaintiffs and White wrote to Van Mierop and Company. They answered, “that they would honour the plaintiffs’ draughts.” So that the defendants assent to the proposal made by White, and ratify it. And it does not seem at all that the plaintiffs then doubted of White’s sufficiency, or meant to conceal anything from the defendants. (amendments made)³³⁰

Regardless of the fact that the letter of credit at the time of the decision was still in its infancy and the fraud rule was not explored in any detail, the decision in *Pillans and Rose v Van Mierop and Hopkins* clearly communicated that fraudulent conduct would not be tolerated in letter of credit law.³³¹

3.2.2 *Higgins v Steinhardter*

The parties in the case of *Higgins v. Steinhardter*³³² were in dispute about a purchase of walnuts by Higgins, which had to be shipped on or before the 7 November 1918. The parties agreed that payment was to be made by a letter of credit issued by Monroe & Co. The plaintiff claimed that shipment was not made until December 1918 and that the bill of lading was forged and predated to 30 October 1918. The plaintiff brought an action in order to restrain Monroe & Co. from honouring the credit. When he informed the issuing bank of the potential fraud, the bank replied that it is obliged to effect payment upon presentation of a facially conforming bill of lading. An injunction was granted and Judge Finch explained:

It is clear that the plaintiff authorized a credit to apply only to a shipment made on or before November 7th, and hence, if shipment was made subsequent to that date, a payment made against said credit would be unauthorized. It became an unused credit, cancelled by limitation of time.³³³

Accordingly, the court’s judgment was not made on the ground of fraud, but rather on the breach of the underlying contract and the unauthorised nature of the credit due to the lapse of time. Gao assumes that the case was decided at a time when letters of credit were just devel-

³²⁹ *Pillans and Rose v Van Mierop and Hopkins* (1756) 1037.

³³⁰ *Pillans and Rose v Van Mierop and Hopkins* (1756) 1038.

³³¹ Gao X (2002) 33-34.

³³² *Higgins v. Steinhardter* [1919] 175 NYS 279; for a detailed discussion of this case see Gao X (2002) 34; see also Kelly-Louw M (2008) 174-175.

³³³ *Higgins v. Steinhardter* [1919] 175 NYS 279.

oping into their modern form and were the fraud rule was still ‘so embryonic’ that not even the ‘financial centres like New York’ contemplated the relevance of fraud, even though the predating could have been a ‘clear ground for the plaintiff’s pleading’.³³⁴

3.2.3 *Societe Metallurgique D’aubrives and Villerupt v British Bank for Foreign Trade*

In the case of *Societe Metallurgique D’aubrives and Villerupt v British Bank for Foreign Trade*³³⁵ fraud was neither involved nor was it alleged by the plaintiff. Yet, the court clearly indicated that it would have been willing to interfere with the payment had the transaction been fraudulent.³³⁶ This follows from a statement of Justice Bailhache who mentioned the issue of fraud in *dicta*:³³⁷

There was a good deal of evidence given as to the actual quality of the iron, and in any action against a bank for failure to honour credit for goods which are not in order the question of quality only comes in on one or other of two ways. First of all, did the person presenting mis-describe the goods in such a way as to be guilty of fraud. If that were so, *than the bank in refusing to pay would be justified*. But nothing of that sort is suggested in this case (italics added).³³⁸

However, it remained unclear how the court would have made its judgement had fraud been found in the case.³³⁹

3.2.4 *Old Colony Trust Co v Lawyers’ Title and Trust Co*

The case of *Old Colony Trust Co v Lawyers’ Title and Trust Co*³⁴⁰ is similar to the *Higgs v Steinhardter* case, because both cases involved fraudulent documents, all plaintiffs argued that the defendants breached their duties under the underlying contract and both courts indicated to allow an interruption of payment under letters of credit in case of fraud.³⁴¹ However, whilst the court in the *Higgs v Steinhardter* case argued that payment against a fraudulent document would be ‘unauthorized’³⁴² the court in *Old Colony* held

³³⁴ Buckley RP & Gao X (2002) 670-671.

³³⁵ *Societe Metallurgique v British Bank for Foreign Trade* [1922] 11 *Lloyds Law Reports* 168.

³³⁶ *Tóth Z* (2006) 100.

³³⁷ Kelly-Louw M (2008) 175.

³³⁸ *Societe Metallurgique v British Bank for Foreign Trade* [1922] 11 *Lloyds Law Reports* 170.

³³⁹ Buckley RP & Gao X (2002) 672.

³⁴⁰ *Old Colony Trust Co v Lawyers’ Title and Trust Co* (1924) 297 F 152; for a comprehensive discussion see Gao X (2002) 36-37.

³⁴¹ Kelly-Louw M (2008) 177.

³⁴² *Higgins v. Steinhardter* [1919] 175 NYS 279.

[o]bviously, when the issuer of a letter of credit knows that a document, although correct in form, is, in point of fact, false or illegal, he cannot be called upon to recognize such document *as complying with the terms of the letter of credit* (emphasis added).³⁴³

3.2.5 *Maurice O’Meara Co v National Park Bank of New York*

In the case of *Maurice O’Meara Co v National Park Bank of New York*³⁴⁴ the parties were in dispute about the quality of the goods (newsprint paper) delivered. Although the plaintiff (beneficiary) presented documents that complied on their face, the defendant bank refused to honour the credit on the ground that a reasonable doubt had arisen in relation to the quality of the paper.³⁴⁵ The plaintiff brought an action against the defendant bank for damages suffered due to the dishonouring of the credit. The court decided – by means of a majority judgment – to the benefit of the plaintiff on the ground that the drafts and accompanying documents were the only concern of the defendant bank. The court held that

If the drafts, when presented, were accompanied by the proper documents, then it was *absolutely bound* to make the payment under the letter of credit, irrespective of whether it knew, or had reasons to believe, that the paper was not of the tensile strength contracted for [...]. To hold otherwise is to read into the letter of credit something, which is not there, and this the court ought not to do, since it would impose upon a bank a duty, which in many cases would defeat the primary purpose of such letter of credit. *This primary purpose is an assurance to the seller of merchandise of prompt payment against documents* (italics added and amendments made).³⁴⁶

This statement is a clear adherence of the majority judgment to the autonomy principle.³⁴⁷

Alike the majority judgment, Judge Cardozo affirmed the general rule that it is none of the banks business to investigate the performance of the underlying contract. However, Justice Cardozo dissented from the majority view by stating:

[I]f it [the bank] chooses to investigate and discovers thereby that the merchandise tendered is not in truth the merchandise that the documents describe, it may be forced by the delinquent seller to make payment of the price irrespective of its knowledge. [...] We are to bear in mind that this controversy [...] arises between the bank and a seller who has misrepresented the se-

³⁴³ *Old Colony Trust Co v Lawyers’ Title and Trust Co* (1924) 297 F 158.

³⁴⁴ *Maurice O’Meara Co v National Park Bank of New York* 146 NE 636 (1925); this case is discussed by see Gao X (2002) 37-39; see also Kelly-Louw M (2008) 177-178 who is making reference to the following Articles: Anon ‘Banks and Banking – Letters of Credit – Defences Available to Bank’ (1925) 25 *Columbia Law Review* 829; Anon ‘The Rights of the Seller Under a Documentary Letter of Credit’ (1925) 34 *Yale Law Journal* 775; Anon ‘Banks and Banking – Letters of Credit – Issuing Bank’s Liability’ (1925) 9 *Minnesota Law Review* 657; see also Tóth Z (2006) 108-110.

³⁴⁵ See *Maurice O’Meara Co v National Park Bank of New York* 146 NE 636 (1925) at 639.

³⁴⁶ *Maurice O’Meara Co v National Park Bank of New York* 146 NE 636 (1925) at 639.

³⁴⁷ Tóth Z (2006) 109.

curity upon which advances are demanded. *Between parties so situated payment may be resisted if the documents are false.*

I think we lose sight of the true nature of the transaction when we view the bank as acting upon the credit of its customer to the exclusion of all else. It acts not merely upon the credit of its customer, but upon the credit also of the merchandise, which is to be tendered as security. [...] I cannot accept the statement of the majority opinion that the bank was not concerned with any question as to the character of the paper. If that is so, the bales tendered might have been rags instead of paper, and still the bank would have been helpless, though it had knowledge of the truth, if the documents tendered by the seller were sufficient on their face (italics added and amendments made).³⁴⁸

The reasoning in this case is apparently more sophisticated than in earlier cases and also more significant for the development of the fraud rule, because it is not only reflecting that a ‘payment may be resisted if the documents are false’ but it also considers the interest of an innocent third party, or a ‘holder of the drafts who has taken them without notice and for value’.³⁴⁹ Therefore, parallels are drawn to the reasoning of a modern letter of credit fraud case where the court generally emphasises the importance of the principle of autonomy before taking into account the elements of the fraud rule.³⁵⁰

3.2.6 Conclusions on the Early Developments of the Fraud Rule

Although the issue of fraud was first raised in the case of *Pillans* in the 1760s, it took a long time until the cases *Higgins*, *Societe Metallurgique*, *Old Colony* and particularly *Maurice O’Meara* clearly indicated that the documents presented by the beneficiary under a letter of credit had to be ‘genuine and honest’ and the issuing bank should not be forced to accept documents that it knew to be false or fraudulent. Gao concludes that all the ‘bricks and mortar for the building of the fraud rule’ were assembled by the decision of *Maurice O’Meara* and that *Sztejn v J. Henry Schroeder Banking Corp* helped to build the structure.³⁵¹

³⁴⁸ *Maurice O’Meara Co v National Park Bank of New York* 146 NE 636 (1925) 641; this view has been criticised by Anon ‘The Rights of the Seller Under a Documentary Letter of Credit’ (1925) 34 *Yale Law Journal* 781 cited by Kelly-Louw M (2008) 178.

³⁴⁹ Buckley RP & Gao X (2002) 675.

³⁵⁰ Gao X (2002) 38.

³⁵¹ Buckley RP & Gao X (2002) 675.

3.3 The Landmark Case of *Sztejn v Henry Schroder Banking Corporation*

Amongst all letter of credit fraud cases the case of *Sztejn v Henry Schroder Banking Corporation*³⁵² is considered the landmark case in the development of the fraud rule in the law of letters of credit.³⁵³ The *Sztejn* case has not only been codified in the 1962 version of the UCC³⁵⁴ and has been followed in the subsequent fraud cases in the USA but also been referred to and cited with approval outside the USA.³⁵⁵ It shaped the fraud rule in ‘virtually all jurisdictions’.³⁵⁶

3.3.1 Facts

Sztejn (plaintiff) bought bristles from Transea Traders Ltd. (seller), a company from India. The parties agreed to finance the purchase price by a letter of credit. Sztejn asked Henry Schroder Banking Corporation (issuer) to issue an irrevocable letter of credit to the benefit of Transea (seller and beneficiary). The letter of credit provided that payment shall be made by the issuer upon shipment of the agreed goods, the presentation of an invoice and a bill of lading.³⁵⁷ Transea brought fifty cases of material on board a steamship, procured the documents required by the letter of credit, and drew a draft to the order of Chartered Bank (presenting bank), which presented the draft to Henry Schroder Banking Corporation for payment along with the required documents. Before payment was made, Sztejn filed an action for a judgment declaring the letter of credit and draft thereunder null and void, and for an injunctive relief to prevent the issuer from paying the draft, alleging that the beneficiary had filled the cases with cowhair, other worthless material and rubbish with the intent to simulate genuine merchandise and defraud the plaintiff.³⁵⁸ Sztejn further claimed that the presenting bank was merely a collecting bank for the seller, not an innocent holder of the draft for value. Chartered Bank instituted a motion to dismiss the supplemental complaint action of Sztejn on the ground that it failed to state a cause of action because ‘the Chartered Bank is only concerned with the documents and on their face these conform to the requirements of the letter of credit.’³⁵⁹

³⁵² *Sztejn v Henry Schroder Banking Corporation* 31 NYS 2d 631 (1941); see comprehensive discussion of this case by Gao X (2002) 39-42; Buckley RP & Gao X (2002) 676-681; Gao X & Buckley RP (2003) 296-298; Dolan JF (2006) 487-490; Kelly-Louw M 179-183; Dolan JF (2007) ch. 4-30 and 7-65 until 7-70; Tóth Z (2006) 110; Zhang Y (2011) 73-74 with further references.

³⁵³ Buckley RP & Gao X (2002) 676.

³⁵⁴ The fraud rule was located at Article 5 section 5-114(2) UCC. In the current revised version (1995) of the UCC, fraud and forgery are set forth in Article 5 section 5-109.

³⁵⁵ Kelly-Louw M (2008) 179.

³⁵⁶ Gao X & Buckley RP (2003) 295.

³⁵⁷ *Sztejn v Henry Schroder Banking Corporation* 31 NYS 2d 631 (1941) 633.

³⁵⁸ *Sztejn v Henry Schroder Banking Corporation* 31 NYS 2d 631 (1941) 633.

³⁵⁹ *Sztejn v Henry Schroder Banking Corporation* 31 NYS 2d 631 (1941) 632.

3.3.2 The Judgement

For the purpose of hearing the motion, Justice Shientag of the Supreme Court of New York County assumed that all allegations in the complaint were true, namely, that

Transea was engaged in a scheme to defraud the plaintiff [Sztejn] [...], that the merchandise shipped by Transea is worthless rubbish and that the Chartered Bank is not an innocent holder of the draft for value but is merely attempting to procure payment of the draft for Transea's account (amendments made).³⁶⁰

The Court rejected Chartered Bank's motion to dismiss the plaintiff's complaint, which was based on the allegation that fraud had been commenced, on the 'established' fact that fraud had been committed in the transaction, and ruled in favour of Sztejn. Before reaching his decision, Justice Shientag underlined the significance of the principle of autonomy in letter of credit law, which is to 'preserve the efficiency of the letter of credit as an instrument for the financing of trade' and 'to furnish the seller with a ready means of obtaining prompt payment for his merchandise'. He further indicated that

[i]t would be a most unfortunate interference with business transactions if a bank before honoring drafts drawn upon it was obliged or even allowed to go behind the documents, at the request of the buyer and enter into controversies between the buyer and the seller regarding the quality of the merchandise shipped. If the buyer and the seller intended the bank to do this they could have so provided in the letter of credit itself, and in the absence of such a provision, the court will not demand or even permit the bank to delay paying drafts which are proper in form (amendments made).³⁶¹

Subsequently, however, Justice Shientag gave reasons as to why the principle of autonomy has to be superseded in cases of fraud:

Of course, the application of [the principle of independence] presupposes that the documents accompanying the draft are *genuine and conform* in terms to the requirements of the letter of credit [...]. However, I believe that a different situation is presented in the instant action. This is not a controversy between the buyer and seller concerning a *mere breach of warranty* regarding the quality of the merchandise; on the present motion, it must be assumed that the seller has intentionally failed to ship any goods ordered by the buyer. In such a situation, where the seller's fraud has been called to the bank's attention before the drafts and documents have been presented for payment, the principle of the independence of the bank's obligation

³⁶⁰ *Sztejn v Henry Schroder Banking Corporation* 31 NYS 2d 631 (1941) 633.

³⁶¹ *Sztejn v Henry Schroder Banking Corporation* 31 NYS 2d 631 (1941) 633.

under the letter of credit *should not be extended to protect the unscrupulous seller*. [...] Although our courts have used broad language to the effect that a letter of credit is independent of the primary contract between the buyer and seller, that language was used in cases concerning *alleged breaches of warranty*; no case has been brought to my attention on this point involving an *intentional fraud* on the part of the seller which was brought to the bank's notice with the request that it withhold payment of the draft on this account (italics added; citations omitted; amendments made).³⁶²

It is remarkable that Justice Shientag not only established the basis upon which the payment under the letter of credit should be stopped in case of fraud, but also well considered the interests of the other parties involved, the issuing bank and the presenting bank. He held that the fraudulent conduct of the seller might also work to the disadvantage of the issuing bank's security interest:³⁶³

While the primary factor in the issuance of the letter of credit is the credit standing of the buyer, the security afforded by the merchandise is also taken into account. In fact, the letter of credit requires a bill of lading made out to the order of the bank and not the buyer. Although the bank is not interested in the exact detailed performance of the sales contract, it is vitally interested in assuring itself that there are some goods represented by the documents.³⁶⁴

With regard to the interest of the Chartered Bank, Justice Shientag continued:

No *hardship* will be caused by permitting the bank to refuse payment where *fraud is claimed*, where the merchandise is not merely inferior in quality but consists of worthless rubbish, where the draft and the accompanying documents are in the hands of one who *stands in the same position as the fraudulent seller*, where the bank *has been given notice of the fraud before being presented with the drafts and documents for payment*, and where the *bank itself does not wish to pay* pending an adjudication of the rights and obligations of the other parties. [...] On this motion only the complaint is before me and I am bound by its allegation that the Chartered Bank is *not a holder in due course* but is a mere agent for collection for the account of the seller charged with fraud. Therefore, the Chartered Bank's motion to dismiss the complaint must be denied. *If it had appeared from the face of the complaint that the bank presenting the draft for payment was a holder in due course, its claim against the bank issuing the letter of credit would not be defeated even though the primary transaction was tainted with fraud* (italics added; citations omitted).³⁶⁵

³⁶² *Sztejn v Henry Schroder Banking Corporation* 31 NYS 2d 631 (1941) 634-635.

³⁶³ See Buckley RP & Gao X (2002) 676-679.

³⁶⁴ *Sztejn v Henry Schroder Banking Corporation* 31 NYS 2d 631 (1941) 635.

³⁶⁵ *Sztejn v Henry Schroder Banking Corporation* 31 NYS 2d 631 (1941) 635.

4. SIGNIFICANCE OF *SZTEJN* FOR THE FURTHER DEVELOPMENT OF THE FRAUD RULE

The *Sztejn* case has provided a clear guidance for future fraud cases as it dealt with a typical fraud situation.³⁶⁶ It illustrated how a frustrated applicant, who has been defrauded by a dishonest beneficiary, can rely on the fraud rule to protect its interest. According to *Sztejn* the following conditions apply:³⁶⁷

- (1) A letter of credit may be dishonoured only in cases of fraud, not upon a mere (allegation of) breach of contract.
- (2) A letter of credit may be dishonoured when fraud is proven or established, not upon mere allegation of fraud.
- (3) However, the credit should be honoured in accordance with its terms, notwithstanding the existence of the proven fraud, if a holder in due course or a presenter with similar status makes demand for payment.

Notwithstanding the ground breaking influence of the *Sztejn* case for the development of the fraud rule and regardless of the fact that the above principles have been adopted in many jurisdictions in the common law world,³⁶⁸ it has to be noted that the complaints and allegations made by *Sztejn* were deemed to be true and the court took those allegations as established facts, as the matter came before the court on a motion to dismiss.³⁶⁹ Thus, issues such as the extent and onus of proof and the standard or degree of fraud³⁷⁰ in the application of the fraud rule were avoided, which comprises the restriction of the *Sztejn* case.³⁷¹

³⁶⁶ See Kelly-Louw M (2008) 181.

³⁶⁷ See Gao X (2002) 42.

³⁶⁸ See Kelly-Louw M (2008) 181.

³⁶⁹ Dolan JF (2006) 488.

³⁷⁰ See Gao X & Buckley RP (2003) 293 for an attempt to explore the kind of fraud required to invoke the fraud rule.

³⁷¹ Gao X (2002) 42.

CHAPTER FOUR

COMPARATIVE LAW PERSPECTIVE ON THE APPLICATION OF THE FRAUD RULE AND REFLECTIONS ON THE ADVANTAGES AND DISADVANTAGES OF IMPLEMENTING STANDARD RULES AT INTERNATIONAL LEVEL

1. INTRODUCTION

Whilst many legal problems are the same wherever they occur,³⁷² the solution of such problems often deviates from jurisdiction to jurisdiction.³⁷³ To improve such problems, it seems to be inevitable to examine the different approaches at international level. The fraud rule is a perfect example for this assumption. English case law for instance is mainly based on developments in the USA, e.g. in the English landmark case of *United City Merchants (Investment) Limited v Royal Bank of Canada*³⁷⁴, the courts heavily relied on the American case of *Sztejn v Henry Schroder Banking Corporation*. English case law in turn is of major significance³⁷⁵ to the law of the Republic of South Africa because it is influential on the South African judiciary.³⁷⁶ However, a comparative law perspective on the development of the fraud rule under the laws of the USA, the UK and the RSA will show that although the legal systems of the comparators are to some degree comparable, there are nevertheless significant deviations as regards the application of the fraud rule. This leads to legal uncertainties, which again can be harmful for the letter of credit as significant payment method in international trade.

This chapter gives a general overview of the basic principles and the main differences regarding the application of the fraud rule under the jurisdictions of the USA, the UK and the RSA.³⁷⁷ This chapter will also reflect on the advantages and disadvantages of standard rules

³⁷² Gordley J (1995) 'Comparative Legal Research: Its Function in the Development of Harmonized Law' (1995) 43 *American Journal of Comparative Law* 560.

³⁷³ Zhang Y (2011) 64.

³⁷⁴ *United City Merchants (Investment) Limited v Royal Bank of Canada* [1982] 2 All E.R. 720.

³⁷⁵ See Coutsoudis B 'Letters of Credit in International Trade' (2012) 9 (hereafter Coutsoudis B (2012)).

³⁷⁶ See *Phillips and another v Standard Bank of South Africa Ltd and others* (1985) (3) SA 301 (W); *Ex Parte Sapan Trading (Pty) Ltd* 1995 (1) SA 218 (W); *Loomcraft Fabrics CC v Nedbank Ltd and another* 1996 (1) SA 812 (A); and *Union Carriage and Wagon Company Ltd v Nedcor Bank Ltd* 1996 CLR 724 (W); each of the letter strongly referred to English case law with approval, e.g. *Phillips and another v Standard Bank of South Africa Ltd and others* specifically referred to the case of *United City Merchants (Investment) Limited v Royal Bank of Canada* and *Sztejn* stating that the dicta in these cases correctly reflect the South African law (*Phillips and another v Standard Bank of South Africa Ltd and others* (1985) (3) SA 301 (W) at 304B).

³⁷⁷ For a comprehensive study on the different approaches regarding the fraud rule under the Law of the United States, England and South Africa see Kelly-Louw M (2008) 135-255; Coutsoudis B (2012) also reflects the different approaches regarding the fraud rule under the laws of the United States, England and South Africa; Zhang Y 'Approaches to Resolving the International Documentary Letters of Credit Fraud Issue' (2011) examines the fraud rule considering the international frameworks (UCP 600 and UNCITRAL Convention) and the national laws of England and the United States; The most com-

and guidelines for the application of the fraud rule, in order to prevent fraud at international level.

2. THE FRAUD RULE ACCORDING TO AMERICAN LAW

In the USA, the fraud rule was developed in three phases: the pre-UCC position, the Prior UCC Article 5 position, and the Revised UCC Article 5 position.³⁷⁸

2.1 The Pre-UCC Position

The pre-UCC position was dominated by the *Sztejn* case, which has already been discussed in detail in Chapter III.³⁷⁹

2.2 The Prior UCC Article 5 Position

The fraud rule developed from *Sztejn* and was later codified in prior UCC Article 5 section 5-114(2)³⁸⁰ which reads as follows:

Unless otherwise agreed when documents appear on their face to comply with the terms of a credit but a required document does not in fact conform to the warranties made on negotiation or transfer of a document of title (Section 7-507) or of a certificated security (Section 8-108) or is *forged or fraudulent* or there is *fraud in the transaction*:

(a) the issuer must honor the draft or demand for payment if honor is demanded by a negotiating bank or other holder of the draft or demand which has taken the draft or demand under the credit and under circumstances which would make it a holder in due course (Section 3-302) and in an appropriate case would make it a person to whom a document of title has been duly negotiated (Section 7-502) or a bona fide purchaser of a certificated security (Section 8-302); and

prehensive and well appreciated study on the fraud rule provides Gao X 'The Fraud Rule in the Law of Letters of Credit: A Comparative Study' (2002); see further Gao X & Buckley RP 'A Comparative Analysis of the Standard of Fraud Required Under the Fraud Rule in Letter of Credit Law' 13 (2003) *Duke Journal of Comparative & International Law* 293; Buckley RP & Gao X 'The Development of the Fraud Rule in Letter of Credit Law: The Journey so Far and the Road Ahead' (2002) 23 *University of Pennsylvania Journal of Economic Law* 663; for a discussion of the fraud rule from an international perspective see, amongst others, Kelly-Louw M 'International Measures to Prohibit Fraudulent Calls on Demand Guarantees and Standby Letters of Credits' 1 (2010) *George Mason Journal of International Commercial Law* 74 (hereafter Kelly-Louw M (2010)); Gao X 'The Fraud Rule under the UN Convention on Independent Guarantees and Standby Letters of Credit: A Significant Contribution from an International Perspective' 1 (2010) *George Mason Journal of International Commercial Law* 48 (hereafter Gao X (2010)); Davidson A 'Fraud and the UN Convention on Independent Guarantees and Standby Letters of Credit' 1 (2010) *George Mason Journal of International Commercial Law* 25 (hereafter Davidson A (2010)); for an comprehensive and critical view on the on the application of the further in the United States see Dolan JF (2006) 479.

³⁷⁸ See Gao X & Buckley RP (2003) 294.

³⁷⁹ See Chapter III.2.3.

³⁸⁰ Kelly-Louw M (2008) 211.

(b) in all other cases as against its customer, an issuer acting in good faith may honor the draft or demand for payment despite notification from the customer of *fraud, forgery* or other defect not apparent on the face of the documents but a court of appropriate jurisdiction may enjoin such honor (italics added).

Gao considers the codification of the fraud rule in the UCC Article 5 more significant than the *Sztejn* case itself for the following reasons:³⁸¹ (i) The victims of letter of credit fraud could effectively protect their interest by using the ‘weapon of the fraud rule’ as codified in UCC Article 5 instead of having to rely on other principles such as the law of contracts (as in the case of *Higgins v. Steinharterter*³⁸²); or by arguing that the documents were non-conforming (as in the case of *Old Colony Trust Co v Lawyers’ Title and Trust Co*³⁸³); (ii) Section 5-114(2)(b) indicates when to apply the fraud rule, namely if (a) ‘documents appear on their face to comply with the terms of a credit but a required document [...] is forged [...] or there is fraud in the transaction’ and (b) ‘fraud was brought to the attention of the issuer’. However, Gao also indicates that the prior UCC Article 5 was not flawless as it did not provide ‘a hint as to what type of fraud gave the bank an option to pay or not to pay’.³⁸⁴ As a consequence, different ‘standards of fraud’³⁸⁵ were applied in subsequent court decisions, which led to confusion among courts and letter of credit users.³⁸⁶

Another problem with the prior UCC Article 5 was that the fraud rule should be applied ‘when [...] a required document [...] is forged or fraudulent or there is fraud in the transaction’.³⁸⁷ The phrase ‘fraud in the transaction’ was rather vague, because it was not apparent whether the ‘transaction’ referred to the letter of credit, to the underlying contract or to

³⁸¹ Gao X (2002) 43.

³⁸² *Higgins v. Steinharterter* [1919] 175 NYS 279.

³⁸³ *Old Colony Trust Co v Lawyers’ Title and Trust Co* (1924) 297 F 152.

³⁸⁴ Gao X (2002) 43; see also *West Virginia Hous. Dev. Fund v Sroka*, 415 F. Supp. 1107 (W.D. Pa. 1976) 1114.

³⁸⁵ These standards are summarised and discussed by Gao X & Buckley RP (2003) 298 et seq; e.g. ‘egregious fraud’, which was used to denote very serious misconduct (*Intraworld Industries v Girard Trust Bank* 336 A.2d 316 (Pa.1975)); ‘intentional fraud’ (*NMC Enterprises v Columbia Broadcasting System, Inc.* 14 U.C.C. REP. SERV. 1427 (N.Y.Sup. Ct. 1974); *American Bell International v Islamic Republic of Iran* 474 F. Supp. 420 (S.D.N.Y. 1979)); ‘letter of credit fraud’ was a dissociation from the ‘common law fraud’, the elements of which were considered significantly different and not suitable for letter of credit transactions (*Emery-Waterhouse Co v Rhode Island Hospital Trust National Bank* 757 F.2d 399 (1st Cir.1985)); the term ‘flexible standard’ was used in *United Bank Ltd v Cambridge Sporting Goods Corp* (392 N.Y.S.2d 265, 271 (N.Y. 1976) were the court held that ‘the drafters of section 5-114 (...) have eschewed a dogmatic approach and adopted a flexible standard to be applied as (...) [i]t can be difficult to draw a precise line between cases involving breach of warranty (...) and outright fraudulent practices on the part of the seller’; the standard of ‘constructive fraud’ was suggested in *Dynamics Corporation of America v The Citizens and Southern Bank* (356 F. Supp. 991 (N.D Ga. 1973) 999) were the court held that fraud ‘includes all acts, omissions and concealments, which involve a breach of legal or equitable duty, trust, or confidence, justly reposed, and are injurious to another, or by which an undue and unconscious advantage is taken of another. This standard was rejected, as it was ‘unquestionable to low’ and ultimately vitiated the reliability and commercial utility of the letter of credit (see Gao X & Buckley RP (2003) 309).

³⁸⁶ Buckley RP & Gao X (2002) 684.

³⁸⁷ See Prior UCC Article 5 section 5-114(2).

both.³⁸⁸ Dolan took the position that courts should limit their examination of fraud to the letter of credit transaction on the ground that opening the ‘inquiry would yield decisions corrosive of independent obligations’.³⁸⁹ To underline this position, Dolan referred to the case of *Asbury Park & Ocean Grove Bank v National City Bank*³⁹⁰ where Justice Shientag, who also made the decision in the *Sztejn* case, expressed his concern that an inquiry into the underlying transaction might jeopardise the letter of credit, because ‘the efficiency of the letter of credit as an instrument for financing trade is the primary consideration’.³⁹¹ However, Dolan himself concluded that according to the predominant position not only in the USA (especially in the *Sztejn* case) but also in other common law and civil law jurisdictions, the underlying transaction is also generally open to the fraud inquiry.³⁹² This applies particularly due to the fact that the prior UCC Article 5 made a clear distinction between documents that are fraudulent, and fraud that is present in the underlying transaction. The term ‘fraud in the transaction’ is apparently used as a ‘flexible standard to be applied as the circumstances of a particular situation mandate’.³⁹³

2.3 Revised UCC Article 5

The Prior UCC Article 5 was revised in 1995 to rectify the ‘weaknesses, gaps, and errors in the original statute which compromise its relevance’ and to meet the challenges of the constant development of letters of credit.³⁹⁴ The fraud rule is now embodied in Article 5 section 5-109 UCC which reads as follows:

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

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

³⁸⁸ See Kelly-Louw M (2008) 216.

³⁸⁹ See Dolan JF (2006) 488.

³⁹⁰ *Asbury Park & Ocean Grove Bank v National City Bank* 35 N.Y.S.2d 985 (Sup. Ct. 1942).

³⁹¹ There is further case law in support of that position, e.g. *Dynamics Corporation of America v The Citizens and Southern Bank*, 356 F. Supp. 991 (N.D Ga. 1973); *Intraworld Industries v Girard Trust Bank* 336 A.2d 316 (Pa.1975).

³⁹² Dolan JF (2006) 489.

³⁹³ See *United Bank Ltd v Cambridge Sporting Goods Corp* (392 N.Y.S.2d 265 (N.Y. 1976) 271.

³⁹⁴ See Gao X (2002) 45.

son's deferred obligation that was taken for value and *without notice of forgery or material fraud* after the obligation was incurred by the issuer or nominated person; and

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

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

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

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

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

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

The Revised UCC Article 5 section 5-109 significantly changed the fraud rule³⁹⁵; it was fine-tuned in several respects.³⁹⁶ The key changes are:

Section 5-109 states that, when fraud is found, the normal operation of a letter of credit may be disrupted in two different ways: the issuer may refuse to honour a presentation³⁹⁷, and the applicant may ask a court to prohibit the payment or presentation.³⁹⁸

Further, section 5-109 addresses two of the most controversial issues regarding the application of the fraud rule. First, the 'standard of fraud', which requires fraud to be 'material', and the concept of fraud, as the section clarifies that the fraud within its meaning includes fraud in the underlying contract.³⁹⁹ This is particularly pointed out in the Official Comment 2 on the Re-

³⁹⁵ For more details see Gao X (2002) 45 et seq.; Gao X & Buckley RP (2003) 315 et seq.; Kelly-Louw M (2008) 222 et seq.

³⁹⁶ See Buckley RP & Gao X (2002) 686.

³⁹⁷ Section 5-109(a)(2); see also Official Comment 2 on Revised UCC Article 5 section 5-109.

³⁹⁸ Section 5-109(b); Gao X (2002) 46.

³⁹⁹ See Kelly-Louw M (2008) 222 who refers to the Official Comment 1 on the Revised UCC Article 5, which read: 'This recodification makes clear that fraud must be found either in the documents or must have been committed by the beneficiary on the issuer or applicant.'

vised UCC Article 5 that states that ‘[...] courts must examine the underlying contract when there is an allegation of material fraud [...]’.

Moreover, section 5-109(a)(1) now names four types of parties to whom the fraud rule does not apply, namely (i) a nominated person who has given value in good faith and without notice of the fraud; (ii) a confirmer who has honoured its confirmation in good faith; (iii) a holder in due course of a draft drawn under the letter of credit which was taken after acceptance by the issuer or nominated person; and (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.

Unlike the prior UCC Article 5 section 5-114(2), which named three groups of parties to be protected under the fraud rule, only one of which proved to be relevant, all four groups named under the revised UCC Article 5, section 5-109 are relevant for the fraud rule, which has been considered a ‘great improvement’.⁴⁰⁰

Finally, section 5-109(b) specifies four prerequisites that must be met when a court issues an injunction. They serve to decrease the frequency with which the fraud rule has been used since the late 1970s and indicate that the ‘standard for injunctive relief is high’ under the revised UCC Article 5⁴⁰¹ and that the burden remains with the applicant ‘to show by evidence and not by mere allegation’ that the relief is warranted.⁴⁰²

2.4 Conclusion on the Position of the USA Regarding the Fraud Rule

According to the revised UCC Article 5, in the United States the fraud rule provides for the following:⁴⁰³

- (1) When fraud is involved in a letter of credit transaction payment can be stopped either because the issuer dishonours the presentation⁴⁰⁴ or by way of a court order, provided that the following four procedural conditions are met: (i) the relief is not prohibited under applicable law; (ii) any adversely affected person must be adequately protected against any loss; (iii) all conditions to entitle a person to the relief have been met; (iv)

⁴⁰⁰ Buckley RP & Gao X (2002) 687.

⁴⁰¹ See Official Comment 4 to section 5-109.

⁴⁰² Gao X (2002) 47.

⁴⁰³ Gao X (2010) 59.

⁴⁰⁴ Article 5 § 5-109(a)(2) UCC (1995).

the applicant is more likely than not to succeed under its claim of forgery or material fraud.⁴⁰⁵

- (2) The applicant or any other person who wants to prevent the honouring of the credit has established 'material' fraud.⁴⁰⁶
- (3) The demand for payment is not made by an innocent party such as (i) a nominated person who has given value in good faith without notice of fraud; (ii) a confirmer, who made its confirmation in good faith; (iii) a holder in due course; or (iv) an assignee of the issuer's or nominated person's deferred obligation that was taken for good value and without notice of fraud.⁴⁰⁷

The fraud rule as set forth in the revised UCC Article 5 section 5-109 not only restates the three basic principles of the fraud rule established in the *Sztejn*⁴⁰⁸ case but also significantly improves the findings in this case in a number of respects. It is therefore referred to as the 'most comprehensive code of the fraud rule in the law of letters of credit in the common law world.'⁴⁰⁹

3. THE FRAUD RULE ACCORDING TO ENGLISH LAW

The UK has not codified the fraud rule. Yet it is also generally acknowledged in the UK.⁴¹⁰ However, the English courts have traditionally been very reluctant to interfere with the principle of autonomy and have adopted a consistent and strict approach towards the application of the fraud rule.⁴¹¹ In the following, some of the leading English cases will be discussed in order to identify the core elements of the fraud rule under English law.

3.1 *Hamzeh Malas and Sons v British Imex Industries Ltd*

In *Hamzeh Malas and Sons v British Imex Industries Ltd* the Court of Appeal explained the general – narrow – approach of English courts as regards the application of the fraud rule:

[I]t seems to be plain enough that the opening of a confirmed letter of credit constitutes a bargain between the banker and the vendor of the goods, which imposes upon the banker an *absolute obligation to pay, irrespective of any dispute there may be between the parties as to*

⁴⁰⁵ Article 5 § 5-109(b) UCC (1995).

⁴⁰⁶ Article 5 § 5-109(a)-(b) UCC (1995).

⁴⁰⁷ Article 5 § 5-109(a)(1) UCC (1995).

⁴⁰⁸ See Chapter III.2.3.3.

⁴⁰⁹ Kelly-Louw M (2008) 242.

⁴¹⁰ Zhang Y (2011) 77.

⁴¹¹ Gao X (2002) 48.

whether the goods are up to contract or not. An elaborate commercial system has been built up on the footing that bankers' confirmed credits are of that character, and, in my judgment, *it would be wrong for this court in the present case to interfere with that established practice* [...] That system [...] would break down completely if a dispute as between the vendor and the purchaser was to have the effect of “freezing,” if I may use that expression, the sum in respect of which the letter of credit was opened (italics added; amendments made).⁴¹²

3.2 *Harbottle (RD) (Mercantile) Ltd v National Westminster Bank Ltd*

Judge Kerr further explained this strict approach in the case of *Harbottle (RD) (Mercantile) Ltd v National Westminster Bank Ltd*:

It is only in *exceptional cases that the courts will interfere with the machinery of irrevocable obligations* assumed by banks. They are the *life-blood of international commerce*. Such obligations are regarded as collateral to the underlying rights and obligations between the merchants at either end of the banking chain. Except possibly in clear cases of fraud of which the banks have notice, the courts will leave the merchants to settle their disputes under the contracts by litigation or arbitration as available to them or stipulated in the contracts [...] Otherwise, *trust in international commerce could be irreparably damaged* (italics added; amendments made).⁴¹³

3.3 *Edward Owen Engineering Ltd v Barclays Bank International Ltd*

Maintaining this narrow approach towards the application of the fraud rule, in *Edward Owen Engineering Ltd v Barclays Bank International Ltd* the court imposed a great burden of proof on the plaintiff in order to invoke the fraud rule.⁴¹⁴ Although with reference to the *Sztejn* case the court clearly acknowledged the circumstances in which the fraud rule applies, Lord Justice Brown concluded that the

exception is that where the documents under the credit are presented by the beneficiary himself and the bank knows when the documents are presented that they are forged or fraudulent, the bank is entitled to refuse payment.⁴¹⁵

⁴¹² *Hamzeh Malas and Sons v British Imex Industries Ltd* [1958] 2 QB 129.

⁴¹³ *Harbottle (RD) (Mercantile) Ltd v National Westminster Bank Ltd* [1978] 1 QB 146.

⁴¹⁴ See *Edward Owen Engineering Ltd v Barclays Bank International Ltd. and Another* [1978] 1 QB 159 (CA) (published in [1978] 1 *Lloyd's Law Reports* 166 (CA); and [1978] All ER 976 (CA)); see also *Harbottle (RD) (Mercantile) Ltd v National Westminster Bank Ltd* [1978] 1 QB 146; [1977] 2 All ER 862 (CA); *Bolivinter Oil SA v Chase Manhattan Bank, Commercial Bank of Syria and General Company of Homes Refinery* [1984] 1 *Lloyd's Law Reports* 251 (CA); see Kelly-Louw M (2008) 184 referring to above cases; and Gao X (2002) 48.

⁴¹⁵ *Edward Owen Engineering Ltd v Barclays Bank International Ltd. and Another* [1978] All ER 982.

The court nevertheless narrowed the scope of the application of the fraud rule, as Lord Justice Geogery Lane observed that

‘the only circumstances which would justify the bank not complying with the demand [...] is this, if it had been *clear* and *obvious* to the bank that the buyer had been guilty of fraud (emphasis added (italics added; amendments made)).⁴¹⁶

3.4 *Discount Records Ltd. v Barclays Bank Ltd*

The difficulty of meeting this high standard of proof was shown in the case of *Discount Records Ltd. v. Barclays Bank Ltd*⁴¹⁷, probably the first English case to cite and approve *Sztejn*.⁴¹⁸

An English buyer (plaintiff) entered into a contract with a French seller to purchase gramophone records and cassettes. The buyer applied with Barclays Bank (issuing bank and defendant) to open a documentary credit for the benefit of the seller. The seller shipped goods asserting to be the agreed goods, and tendered the draft with documents regular on their face to the confirming bank in Paris, which accepted the draft. On arrival, the buyer checked the goods in the presence of a representative of the issuing bank, who in court revealed that most of the goods were either ‘rubbish’ or not as ordered and that the latter were either rejects or unsalable. By referring to *Sztejn*, the buyer attempted to enjoin the issuing bank from honouring the credit on the ground that the seller perpetrated a fraud.⁴¹⁹

Judge Megarry of the Chancery Division rejected the buyer’s claim stating that the case differed from *Sztejn*. He stressed that in *Sztejn* the proceedings consisted of a motion to dismiss the formal complaint on the ground that it disclosed no cause of action, which was why the court could assume that the facts stated in the complaint were true. The complaint alleged fraud; hence the court was dealing with a case of established fraud. To the contrary, in the present case there was no established fraud but ‘merely an allegation of fraud’. Therefore, Judge Megarry held that the defendants, who were not concerned with that matter, had understandably adduced no evidence on the issue of fraud. The Judge stressed that it seemed unlikely that any action to which the seller was not a party would contain the evidence required resolving this issue. Therefore, Judge Megarry found that this was a case in which

⁴¹⁶ *Edward Owen Engineering Ltd v Barclays Bank International Ltd. and Another* [1978] All ER 986.

⁴¹⁷ *Discount Records Ltd. v Barclays Bank Ltd* [1975] 1 *Lloyd’s Law Reports* 444 (Ch D); see Gao X (2002) 49 for a detailed discussion of the case.

⁴¹⁸ Zhang Y (2011) 80.

⁴¹⁹ *Discount Records Ltd v Barclays Bank Ltd* [1975] 1 *Lloyd’s Law Reports* 444-446.

fraud was alleged but not established.⁴²⁰ In accordance with the case law in the UK as stated above, Judge Megarry pointed out that he would be reluctant to interfere with bankers' irrevocable credits unless a sufficiently grave cause was shown, as it would gravely impair the reliance which was placed on such credits, especially in the sphere of international banking.⁴²¹

It is quite remarkable that the court found there was no established fraud but merely an allegation of fraud although the buyer obtained its evidence in the presence of a third party, demonstrating that most of the shipment was either rubbish or empty cartons. It is concluded that with this approach, obtaining an injunction to prevent the payment of a letter of credit is practically impossible in most cases in England, despite the fact that English courts claim that they 'will not allow their process to be used by a dishonest person to carry out a fraud'.⁴²²

However, the court in *Discount Records Ltd. v Barclays Bank Ltd* also considered that the payment of the bank did not affect the buyer's interest because if the bank had wrongly paid the seller, the buyer could still demand damages from the bank.⁴²³ This line of reasoning meets the common law practice that a court will not issue an injunction unless it is an absolute and final remedy, and unless the applicant has no other legal recourse.⁴²⁴ However, as a consequence, the bank finds itself in a difficult situation, because if it refuses to pay without sufficient evidence of fraud, the bank is likely to be sued by the seller, but if it pays out in case of fraud, the buyer may not reimburse it.⁴²⁵

3.5 *United City Merchants (Investment) Limited v Royal Bank of Canada*

The most prominent English case on the fraud rule is the case *United City Merchants (Investment) Limited v Royal Bank of Canada*.⁴²⁶ The bank refused to honour the letter of credit on the grounds that the bill of lading had been fraudulently pre-dated by a third party, namely the shipping agent. The seller had no knowledge of it. The beneficiary brought an action against the confirming bank for wrongfully refusing to honour the letter of credit.⁴²⁷ The beneficiary

⁴²⁰ *Discount Records Ltd v Barclays Bank Ltd* [1975] 1 *Lloyd's Law Reports* 447.

⁴²¹ *Discount Records Ltd v Barclays Bank Ltd* [1975] 1 *Lloyd's Law Reports* 448.

⁴²² Gao X (2002) 49-50 referring to the case of *United City Merchants (Investment) Limited v Royal Bank of Canada* [1982] 2 All E.R. 720.

⁴²³ *Discount Records Ltd. v. Barclays Bank Ltd* [1975] 1 *Lloyd's Law Reports* 448.

⁴²⁴ See Zhang Y (2011) 81.

⁴²⁵ See Zhang Y (2011) 81.

⁴²⁶ *United City Merchants (Investment) Limited v Royal Bank of Canada* [1979] 1 *Lloyd's Law Reports* 267 (QB); on Appeal [1982] Q.B. 208; [1981] 3 W.L.R. 242; [1981] 3 All E.R. 142; [1981] 1 *Lloyd's Rep.* 604; reversed by House of Lords [1983] 1 A.C. 168; [1982] 2 W.L.R. 1039; [1982] 2 All E.R. 720; [1982] 2 *Lloyd's Rep.* 1; [1982] Com. L.R. 142; for a comprehensive discussion of this case see Gao X (2002) 121-134; see also Kelly-Louw M (2008) 187-190 with further references.

⁴²⁷ *United City Merchants (Investment) Limited v Royal Bank of Canada* [1983] 1 A.C. 168 at 180-182.

succeeded before the Queen's Bench Division where Justice Mocatta applied the fraud rule on the principle of *ex turpi causa non-oritur action*.⁴²⁸

The Court of Appeal applied a 'half-way house' position⁴²⁹ namely that as the date stamp was false, the bill of lading was a nullity and therefore the bank was entitled to refuse payment.⁴³⁰

The case finally went to the House of Lords, which held that the fraud exception did not apply in this case. The leading judgment of Lord Diplock strongly acknowledged the principle of autonomy:

[T]he parties [...] '*deal in documents and not in goods*' [...] 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, that bank is under a contractual obligation to the seller to honour the credit, notwithstanding 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 and to reject the goods and refuse to pay the seller the purchase price. The whole commercial purpose for which the system of confirmed irrevocable documentary credits has been developed in international trade is to give to the seller an assured right to be paid before he parts with control of the goods that does not permit of any dispute with the buyer as to the performance of the contract of sale being used as a ground for non-payment or reduction or deferment of payment [...] (emphasis added; amendments made).⁴³¹

Lord Diplock also clearly acknowledged the fraud rule:

To this general statement of principle [of independence] [...] there is one established exception: that is, where the seller, for the purpose of drawing on the credit, fraudulently presents to the confirming bank documents that contain, expressly or by implication, material representations of fact that to his knowledge are untrue. Although there does not appear among the English authorities any case in which this exception has been applied, it is well established in the American cases of which the leading or "landmark" case is *Sztejn v. J. Henry Schroder Banking Corporation*. [...] The exception for fraud on the part of the beneficiary seeking to avail himself of the credit is a clear application of the maxim *ex turpi causa non oritur actio* or, if

⁴²⁸ *United City Merchants (Investment) Limited v Royal Bank of Canada* [1979] 1 *Lloyd's Law Reports* 267 (QB).

⁴²⁹ Jack R, Malek A & Quest D 'Documentary Credits - The Law and Practice of Documentary Credits Including Standby Credits and Demand Guarantees' (2001) at 264.

⁴³⁰ *United City Merchants (Investment) Limited v Royal Bank of Canada* [1981] 1 *Lloyd's Rep.* 604.

⁴³¹ *United City Merchants (Investment) Limited v Royal Bank of Canada* [1983] 1 A.C. 168 at 183 D-F; see also Gao X (2002) 47-48.

plain English is to be preferred, “fraud unravels all.” *The courts will not allow their process to be used by a dishonest person to carry out a fraud* (italics added; amendments made).⁴³²

Hence, whether the beneficiary knew about the fraud became the key factor in determining whether or not to apply the fraud exception in this case.⁴³³ As the beneficiary was not aware that the bill of lading had been fraudulently pre-dated by the shipping agents, it did not participate in the fraud; as a consequence, the fraud rule did not apply.⁴³⁴

3.6 *United Trading Corporation SA and Murray Clayton Ltd v Allied Arab Bank Ltd*

The ‘sole realistic inference’ test as laid down in *United Trading Corporation SA and Murray Clayton Ltd v Allied Arab Bank Ltd*⁴³⁵ has become the generally accepted formula for the standard evidence that is required in order to establish fraud.⁴³⁶ The ordinary standard of proof in civil law cases is that of the balance of probabilities.⁴³⁷ This also applies in a case of fraud, however, the court weighs the evidence with due regard to the gravity of the particular allegations.⁴³⁸ As regards cases of fraud, a very high degree of probability is required.⁴³⁹ In *United Trading Corporation SA and Murray Clayton Ltd v Allied Arab Bank Ltd*, Lord Justice Ackner specified the standard of evidence as follows:

The evidence of fraud must be *clear*, both as to the fact of fraud and as to the bank’s knowledge. The mere assertion or allegation of fraud would not be sufficient. [...] We would expect the Court to require *strong corroborative evidence* of the allegation, usually in the form of *contemporary documents*, particularly those emanating from the buyer. In general, for the evidence of fraud to be clear, we would also expect the buyer to have been given an opportunity to answer the allegation and to have failed to provide any, or any adequate answer in circumstances where one could properly be expected. If the Court considers that *on the material be-*

⁴³² *United City Merchants (Investment) Limited v Royal Bank of Canada* [1983] 1 A.C. 168 at 183 F-184 B; see also Buckley RP & Gao X (2002) 688-689.

⁴³³ For further discussion see Zhang Y (2011) 85.

⁴³⁴ See Kelly-Louw M (2008) 189.

⁴³⁵ *United Trading Corporation SA and Murray Clayton Ltd v Allied Arab Bank Ltd* [1985] 2 Lloyd’s Law Reports 554 (CA).

⁴³⁶ See *Turkiye IS Bankasi AS v Bank of China* [1996] 2 Lloyd’s Rep 611 (QB (Com Ct)); and [1998] 1 Lloyd’s Rep 250 (CA); *Group Josi Re v Walbrook Insurance Co Ltd and Others* [1996] 1 Lloyd’s Rep 345 (CA) ([1996] 1 WLR 1152; and [1996] 1 All ER 791); *Themehelp Ltd v West and Others* [1996] QB 84 (CA) ([1995] All ER 215 (CA); and [1995] 3 WLR 751 (CA)); *Kvaerner John Brown v Midlands Bank Plc* [1998] CLC 446; *Czarnikow-Rionda Sugar Trading Inc v Standard Bank London* [1999] 2 Lloyd’s Rep 187 ([1999] Lloyd’s Rep Bank 197); *Balfour Beatty Civil Engineering v Technical and General Guarantee Co Ltd* (2000) 68 Con LR 180 ([2000] CLC 252; and [2000] CILL 1574); and *Solo Industries UK Ltd v Canara Bank* [2001] 2 Lloyd’s Rep 578 (CA) ([2001] 1 WLR 1800 (CA)); all cases cited via Kelly-Louw M (2008) 200 (footnote 235).

⁴³⁷ Hugo CF ‘*The Law Relating to Documentary Credits from a South African Perspective with Special Reference to the Legal Position of the Issuing and Confirming Banks*’ (1996) 278 (hereafter Hugo CF (1996)).

⁴³⁸ See Themehelp Ltd v West and Others [1996] QB 99; see also Kelly-Louw M (2008) 199.

⁴³⁹ Hugo CF (1996) 278.

*fore it the only realistic inference to draw is that of fraud, then the seller would have made out a sufficient case of fraud (italics added; amendments made).*⁴⁴⁰

3.7 Conclusion on the Position of the UK Regarding the Fraud Rule

In general it can be observed that, under the laws of the UK and contrary to the laws of the USA, the fraud is quite narrow and strict, as the autonomy principle is regarded paramount.⁴⁴¹ The fraud rule generally provides for the following:

- (1) The plaintiff must establish the existence of ‘clear’ and ‘obvious’ fraud of which the issuer of the credit must be aware, in order to invoke the fraud rule⁴⁴². A mere allegation of fraud does not suffice⁴⁴³.
- (2) The beneficiary must know of the fraud at the time of the presentation, as it would otherwise not be a party of the fraud.⁴⁴⁴
- (3) To prove fraud the fraud and the bank’s knowledge thereof, strong corroborative evidence of the allegation is required, usually in the form of contemporary documents, particularly emanating from the buyer. If the bank on that basis considered fraud the only realistic inference to draw, then the seller would have made out a sufficient case of fraud.⁴⁴⁵

4. THE FRAUD RULE ACCORDING TO SOUTH AFRICAN LAW

South African courts also acknowledge the fraud rule. However, there have only been a few reported South African court decisions.⁴⁴⁶

⁴⁴⁰ *United Trading Corporation SA and Murray Clayton Ltd v Allied Arab Bank Ltd* [1985] 2 *Lloyd’s Law Reports* 554 at 561.

⁴⁴¹ Zhang Y (2011) 112.

⁴⁴² See *Edward Owen Engineering Ltd v Barclays Bank International Ltd. and Another* [1978] All ER 986.

⁴⁴³ See *Discount Records Ltd. v. Barclays Bank Ltd* [1975] 1 *Lloyd’s Law Reports* 448.

⁴⁴⁴ See *United City Merchants (Investment) Limited v Royal Bank of Canada* [1983] 1 A.C. 184.

⁴⁴⁵ See *United Trading Corporation SA and Murray Clayton Ltd v Allied Arab Bank Ltd* [1985] 2 *Lloyd’s Law Reports* 561.

⁴⁴⁶ See *Phillips and another v Standard Bank of South Africa Ltd and others* (1985) (3) SA 301 (W) (see Dijkman JH ‘The Autonomy Principle in Documentary Letter of Credit Transactions: The First South African Decision’ (1985) 102 *South African Law Journal* 379; see also Oelofse AN (1997) 463–464); *Ex Parte Sapan Trading (Pty) Ltd* 1995 (1) SA 218 (W) (see Oelofse AN ‘Developments in the Law of Documentary Letters of Credit’ (1996) 8 *South African Mercantile Law Journal* 65–68 (hereafter Oelofse AN (1996))); *Z Z Enterprises v Standard Bank of South Africa Ltd* 1995 CLD 769 (W); *Loomcraft Fabrics CC v Nedbank Ltd and Another* 1996 (1) SA 812 (A) (discussed by Oelofse AN (1996) 302-305; Oelofse AN (1997) 470-474; see also Hugo CF (1996) 322–326; see further van Niekerk JP & Schulze WG (2006) 314-317); *Union Carriage and Wagon Company Ltd v Nedcor Bank Ltd* 1996 CLR 724 (W); and *Basil Read (Pty) Ltd v Nedbank Ltd and Another* (unpublished case Case no. 8283/12) [2012] ZAGPJHC 101; 2012 (6) SA 514 (GSJ).

4.1 *Phillips and another v Standard Bank of South Africa Ltd and others*

The case of *Phillips and another v Standard Bank of South Africa Ltd and others*⁴⁴⁷ is the first South African case referring to the issue of fraud in a letter of credit transaction. In this case the seller allegedly shipped non-conforming goods to the buyer (Phillips). After the buyer notified the seller of the non-conformity of goods, the seller agreed to consider the buyer's complaints upon receipt of details as to the defects from the buyer, but was nevertheless not prepared to postpone payment. The buyer approached the court to issue an interim interdict against Standard Bank in order to prevent the bank from honouring the credit.⁴⁴⁸ The court dismissed the action for an interdict on the following grounds:

Goldstone referred to the cases of *Sztejn*⁴⁴⁹ and *United City Merchants*⁴⁵⁰ and stated that the dicta correctly reflect South African law.⁴⁵¹ He stressed the importance of the independence principle and its commercial function in a letter of credit transaction making the credit a separate contract independent from the underlying contract, thus giving to the seller, before the shipment of goods, the guaranty that he will be paid regardless of any dispute as to his performance of the underlying contract.⁴⁵² Therefore, the applicant could not go beyond the documents and stop the payment because of complaints concerning the quality of the goods or other 'alleged breaches' of the underlying contract.⁴⁵³ The court came to the conclusion that the applicant did not show fraud on the part of the beneficiary and that the facts of this case were consistent with an 'innocent breach of contract'.⁴⁵⁴

By stating that a mere breach of contract will not allow the applicant to enjoin the bank from paying by way of an interdict,⁴⁵⁵ the court indirectly acknowledged that the fraud rule can apply under South African law. However, as it did not specify the extent to and the circumstances under which it would consider the applying the fraud rule⁴⁵⁶, it did not provide guidance on the prerequisite for applying the fraud rule under South African law.⁴⁵⁷

⁴⁴⁷ *Phillips and another v Standard Bank of South Africa Ltd and others* (1985) (3) SA 301 (W).

⁴⁴⁸ See *Phillips and another v Standard Bank of South Africa Ltd and others* (1985) (3) SA 301 (W) 302 A-D.

⁴⁴⁹ *Sztejn v Henry Schroder Banking Corporation* (1941) 31 NYS 2d 633-634.

⁴⁵⁰ *United City Merchants (Investment) Limited v Royal Bank of Canada* [1983] 1 A.C. 183-184 (HL).

⁴⁵¹ *Phillips and another v Standard Bank of South Africa Ltd and others* (1985) (3) SA 301 (W) 304 B.

⁴⁵² *Phillips and another v Standard Bank of South Africa Ltd and others* (1985) (3) SA 301 (W) 304 C-D.

⁴⁵³ *Phillips and another v Standard Bank of South Africa Ltd and others* (1985) (3) SA 301 (W) 304 D-E.

⁴⁵⁴ *Phillips and another v Standard Bank of South Africa Ltd and others* (1985) (3) SA 301 (W) 303 I-304 A.

⁴⁵⁵ See Hugo CF (1996) 322

⁴⁵⁶ See van Niekerk JP & Schulze WG (2006) 314.

⁴⁵⁷ See Oelofse AN (1997) 464.

4.2 *Loomcraft Fabrics CC v Nedbank Ltd and Another*

Some guidance as regards the recognition of the fraud rule was provided in *Loomcraft Fabrics CC v Nedbank Ltd and Another*⁴⁵⁸ when the South African Appellate Division for the first time had the opportunity to rule on the principle of autonomy and its possible limits in the context of fraud.⁴⁵⁹

In this case, Loomcraft (applicant), a South African distribution company, imported goods from Prefel (beneficiary), a Portuguese textile manufacturer. Loomcraft asked Nedbank to open an irrevocable letter of credit in favour of Prefel. The parties agreed that the letter of credit should expire on 18 May 1992 and that the latest date for the shipment of goods was 8 May 1992. However, the goods arrived later than the applicant had expected and it was further dissatisfied with the quality of goods. Therefore, the applicant sought to enjoin Nedbank from making a payment on the letter of credit, alleged fraud or more particularly, that the beneficiary had fraudulently predated the shipment on the bill of lading.⁴⁶⁰

Analogously to the case of *Phillips and another v Standard Bank of South Africa Ltd and others* the court (per Scott, who gave the unanimous judgment of the court) stressed the importance of the principle of autonomy by referring to classic English cases such as *Harbottle, Edward Owen Engineering*, and *Bolivinter Oil SA v Chase Manhattan Bank, Commercial Bank of Syria and General Company of Homes Refinery*.⁴⁶¹ In doing so, the court indicated its intention to consider the English case law as an influential guide for the fraud rule in South African law.⁴⁶² The English guidelines can safely be seen as authoritative to the position in South African law, particularly in respect of issues that have not yet been dealt with by the South African courts.⁴⁶³

Scott held that:

The system of irrevocable documentary credit is widely used for international trade, both in this country and abroad. Its essential feature is an establishment of contractual obligation on the part of the bank to pay the beneficiary under the credit, which is wholly independent of the underlying contract. [...] The unique value of a documentary credit is that whatever dispute

⁴⁵⁸ *Loomcraft Fabrics CC v Nedbank Ltd and Another* 1996 (1) SA 812 (A).

⁴⁵⁹ See van Niekerk JP & Schulze WG (2006) 314.

⁴⁶⁰ *Loomcraft Fabrics CC v Nedbank Ltd and Another* 1996 (1) SA 814 G- 815 E.

⁴⁶¹ See *Harbottle (RD) (Mercantile) Ltd v National Westminster Bank Ltd* [1978] 1 QB 146; [1977] 2 All ER 862 (CA); *Edward Owen Engineering Ltd v Barclays Bank International Ltd and Another* [1978] 1 QB 159 (CA) [1978] 1 Lloyd's Law Report 166 (CA); *Bolivinter Oil SA v Chase Manhattan Bank, Commercial Bank of Syria and General Company of Homes Refinery* [1984] 1 Lloyd's Law Reports 251 (CA).

⁴⁶² *Loomcraft Fabrics CC v Nedbank Ltd and Another* 1996 (1) SA 816 A - 817 G.

⁴⁶³ Coutsoudis B (2012) 47.

may subsequently arise between the issuing bank's customer and the beneficiary under the credit in relation to the performance [...] the bank undertakes to pay the beneficiary, provided only that the conditions specified in the credit are met. [...] The liability of the bank to the beneficiary to honour the credit arises upon presentment to the bank of the document specified in the credit. In the event of the document specified in the credit being so presented *the bank would only escape liability upon proof of fraud* on the part of the beneficiary (italics added, amendments made).⁴⁶⁴

Subsequently, the court stressed that applicant has to 'establish clearly' the beneficiary's fraud and that the burden of proof would be the same as in ordinary civil law cases, which had to be 'discharged on a balance of probabilities' and, as in any other case where fraud was alleged, 'fraud would not be inferred lightly'.⁴⁶⁵ The court indicated that in order for the applicant to succeed on the grounds of fraud, he had to prove that, when presenting the bills of lading to the bank, the beneficiary knew that they contained false representations of fact upon which the bank would rely. A mere error, misunderstanding or oversight, however unreasonable, could not amount to fraud.⁴⁶⁶ On the facts before it, the court ultimately took the view that there appeared to be an error rather than fraud.⁴⁶⁷

Thus, the court followed the narrow and very strict view as traditionally adopted by English courts, for instance in the cases of *United City Merchants or Edward Owen Engineering*.⁴⁶⁸

4.3 Z Z Enterprises v Standard Bank of South Africa Ltd

The case of *Z Z Enterprises v Standard Bank of South Africa Ltd*⁴⁶⁹ did not deal with a letter of credit transaction but with a documentary collection. However, the courts referred to documentary credits in finding its judgement.

In its judgment the court pointed out that the South African courts should give effect to the commercial purpose of letters of credit. The court stressed the autonomy of an irrevocable letter of credit and that the applicant could not go beyond the documents and enjoin the bank from paying simply because of complaints concerning the quality of the goods or other alleged breaches of contract by the beneficiary. However, the court also indicated that there was no reason why, in 'appropriate circumstances', the fraud exception should not apply under the

⁴⁶⁴ *Loomcraft Fabrics CC v Nedbank Ltd and Another* 1996 (1) SA 815 F - J.

⁴⁶⁵ See *Loomcraft Fabrics CC v Nedbank Ltd and Another* 1996 (1) SA 816 – 817.

⁴⁶⁶ See *Loomcraft Fabrics CC v Nedbank Ltd and Another* 1996 (1) SA 822 G-H.

⁴⁶⁷ Kelly-Louw M (2008) 248.

⁴⁶⁸ See van Niekerk JP & Schulze WG (2006) 314; see also Coutsoudis B (2012) 48.

⁴⁶⁹ *Z Z Enterprises v Standard Bank of South Africa Ltd* 1995 CLD 769 (W).

South African law.⁴⁷⁰ However, for the fraud exception to apply, fraud would have to be ‘clearly established’.⁴⁷¹

4.4 *Union Carriage and Wagon Company Ltd v Nedcor Bank Ltd*

The judgement in the case of *Union Carriage and Wagon Company Ltd v Nedcor Bank Ltd*⁴⁷² in general follows the line of reasoning in the above cases as regards the emphasis on the importance of the principle of autonomy. However, in an *obiter dictum* the court created a leeway to argue in favour of a broader formulation of the fraud rule.⁴⁷³ The court indicated that the beneficiary could be guilty of fraud, if the parties of the sale agreement entered into an agreement under which the beneficiary undertook not to draw on the letter of credit and had the beneficiary done so anyway.⁴⁷⁴

This *obiter dictum* on the one hand supports the view that fraud justifying interference with the beneficiary’s payment claim is not limited to the so-called documentary fraud.⁴⁷⁵ However, it must also be considered that this approach is contrary to the ‘narrow’ and very strict formulation of the fraud rule in the case of *United City Merchants*, which was apparently adopted by the South African Appellate Division in *Loomcraft Fabrics v Nedbank*.⁴⁷⁶

4.5 *Basil Read (Pty) Ltd v Nedbank Ltd and Another*

In this recent decision the South Gauteng High Court (per Saldulker J) referred to the case of *Loomcraft Fabrics* and based its judgement on the narrow formulation of the fraud as it stated:

Where an applicant seeks to interdict the performance of an established contractual obligation as the applicant does in casu, it must allege and prove that it has such a right, at least on a prima facie basis at the interim relief stage, or at least when seeking final relief. This applicant failed to establish on a prima facie basis. The payment of a demand on guaranty in the absence of fraud is valid, enforceable and most importantly lawful. The opposing party’s conduct appears to have been lawful. *The applicant has clearly not made out a case of fraud on the part of the opposing party on the papers before me* (italics added).⁴⁷⁷

⁴⁷⁰ See *ZZ Enterprises v Standard Bank of South Africa Ltd* 1995 CLD 780-783 (W).

⁴⁷¹ See Oelofse AN (1997) 477-478.

⁴⁷² *Union Carriage and Wagon Company Ltd v Nedcor Bank Ltd* (1996) CLR 724 (W).

⁴⁷³ See Coutsoudis B (2012) 49.

⁴⁷⁴ *Union Carriage and Wagon Company Ltd v Nedcor Bank Ltd* (1996) CLR 724 at 735 (W); Oelofse AN (1997) 475-477.

⁴⁷⁵ See Kelly-Louw M (2008) 248.

⁴⁷⁶ See *Loomcraft Fabrics CC v Nedbank Ltd and Another* 1996 (1) SA 812 at 816A; see also Kelly-Louw M (2008) 248.

⁴⁷⁷ *Basil Read (Pty) Ltd v Nedbank Ltd and Another* (unpublished case Case no. 8283/12) [2012] ZAGPJHC 101 (at paragraph 34); 2012 (6) SA 514 (GSJ).

4.6 Conclusions on the Position of South Africa Regarding the Fraud Rule

The above case law shows that the fraud rule has not yet been successfully raised in any South African lawsuit. However, courts have not been given the opportunity to properly deal with the fraud rule, given only the few cases until today. Naturally, the fraud rule is still developing and some say it is far away from being fully developed.⁴⁷⁸ Nevertheless the fraud rule is acknowledged as the case *Phillips and another v Standard Bank of South Africa Ltd and others*⁴⁷⁹ shows, where Goldstone indicated that the dicta of *Sztejn*⁴⁸⁰ and *United City Merchants*⁴⁸¹ correctly reflected the South African law.⁴⁸² Likewise, the court in *Z Z Enterprises v Standard Bank of South Africa Ltd*⁴⁸³ saw no reason that in ‘appropriate circumstances’, the fraud exception should not apply under South African law.⁴⁸⁴ In *Loomcraft Fabrics CC v Nedbank Ltd and Another*⁴⁸⁵ the court showed its intention to consider the English case law as an influential guide to the development of the law in South Africa⁴⁸⁶, particularly in respect of the fraud rule, an issue that had not been dealt with by the South African courts by then.⁴⁸⁷ The courts in South Africa tend to follow the narrow view as traditionally adopted by English courts.⁴⁸⁸ As of today, the fraud rule in South Africa apparently provides for the following:

- (1) As a key condition for the application of the fraud rule, the beneficiary’s fraud has to be ‘established clearly’ and a mere error, misunderstanding or oversight, however unreasonable, cannot amount to fraud.⁴⁸⁹
- (2) It is subject to further discussion as to whether the fraud rule is limited to the so-called documentary fraud.⁴⁹⁰ This discussion was triggered by the case of *Union Carriage and Wagon Company Ltd v Nedcor Bank Ltd*⁴⁹¹ where the court by way of an *obiter dictum* indicated otherwise.⁴⁹² However, this *obiter dictum* is contrary to the ‘narrow’ formulation of the fraud rule in the case of *United City Merchants*, which was adopted

⁴⁷⁸ See Kelly-Louw M (2008) 250.

⁴⁷⁹ *Phillips and another v Standard Bank of South Africa Ltd and others* (1985) (3) SA 301 (W).

⁴⁸⁰ *Sztejn v Henry Schroder Banking Corporation* (1941) 31 NYS 2d 633-634.

⁴⁸¹ *United City Merchants (Investment) Limited v Royal Bank of Canada* [1983] 1 A.C. 183-184 (HL).

⁴⁸² *Phillips and another v Standard Bank of South Africa Ltd and others* (1985) (3) SA 301 (W) 304 B.

⁴⁸³ *Z Z Enterprises v Standard Bank of South Africa Ltd* 1995 CLD 769 (W)

⁴⁸⁴ See *Z Z Enterprises v Standard Bank of South Africa Ltd* 1995 CLD 780-783 (W).

⁴⁸⁵ *Loomcraft Fabrics CC v Nedbank Ltd and Another* 1996 (1) SA 812 (A).

⁴⁸⁶ See *Loomcraft Fabrics CC v Nedbank Ltd and Another* 1996 (1) SA 816 A - 817 G.

⁴⁸⁷ See *Coutsoudis B* (2012) 47.

⁴⁸⁸ See van Niekerk JP & Schulze WG (2006) 314; see also *Coutsoudis B* (2012) 48.

⁴⁸⁹ See e.g. *Loomcraft Fabrics CC v Nedbank Ltd and Another* 1996 (1) SA 822 G-H; see also *Z Z Enterprises v Standard Bank of South Africa Ltd* 1995 CLD 780-783 (W); see also Oelofse AN (1997) 477-478.

⁴⁹⁰ See Kelly-Louw M (2008) 248.

⁴⁹¹ *Union Carriage and Wagon Company Ltd v Nedcor Bank Ltd* (1996) CLR 724 (W).

⁴⁹² *Union Carriage and Wagon Company Ltd v Nedcor Bank Ltd* (1996) CLR 735 (W); see also Oelofse AN (1997) 475-477.

by the South African Appellate Division in *Loomcraft Fabrics v Nedbank*.⁴⁹³ *Basil Read (Pty) Ltd v Nedbank Ltd and Another* seems to have adopted the narrow formulation of the fraud rule as Saldulker J held that '[t]he applicant has clearly not made out a case of fraud on the part of the opposing party on the papers before me.'

5. FRAUD RULE AT INTERNATIONAL LEVEL

This chapter so far indicated that the fraud rule is applied differently in the jurisdictions of the USA, the UK and the RSA. Naturally, this leads to legal uncertainty. To improve this situation, the ICC⁴⁹⁴ and the UNCITRAL⁴⁹⁵ have both been active in dealing with the issue of fraud at international level.⁴⁹⁶ The UNCITRAL Convention has the most comprehensive approach and the most detailed provisions as regards the fraud rule.⁴⁹⁷ It identifies in Article 19 three substantive grounds to invoke the fraud rule giving the issuer, who is acting on good faith, the right to withhold payment if:

- (a) Any document is not genuine or has been falsified;
- (b) No payment is due on the basis asserted in the demand and the supporting documents; or
- (c) Judging by the type and purpose of the undertaking, the demand has no conceivable basis.

As for demands that have 'no conceivable basis', Article 19(2) of the UNCITRAL Convention further elaborates this element as follows:

- (a) The contingency or risk against which the undertaking was designed to secure the beneficiary has undoubtedly not materialized;
- (b) The undertaking obligation of the principal/applicant has been declared invalid by a court or arbitral tribunal; unless the undertaking indicates that such contingency falls within the risk to be covered by the undertaking;
- (c) The underlying obligation has undoubtedly been fulfilled to the satisfaction of the beneficiary;
- (d) Fulfilment of the underlying obligation has clearly been prevented by wilful misconduct of the beneficiary; or

⁴⁹³ See *Loomcraft Fabrics CC v Nedbank Ltd and Another* 1996 (1) SA 816A; see also Kelly-Louw M (2008) 248.

⁴⁹⁴ There are particularly two legal frameworks relevant with this regard the URDG (see Chapter II 1.4) and the ISP 98 (see Chapter 1.3).

⁴⁹⁵ See the UNCITRAL-Convention (Chapter II. 1.7).

⁴⁹⁶ For a comprehensive discussion see Kelly-Louw M (2008) 135-160; Kelly-Louw M (2010) 74-120; Davidson A (2010) 25-47; Gao X & Buckley RP (2003) 293 et seq.; Gao X (2010) 48-73.

⁴⁹⁷ Gao X & Buckley RP (2003) 333.

(e) In the case of a demand under a counter-guarantee, the beneficiary of the counter-guarantee has made payment in bad faith as guarantor/issuer of the undertaking to which the counter-guarantee relates.

Although the prerequisites are not exhaustive, it is an ‘impressive and encouraging way’ to set out the kind of misconduct that may trigger the fraud rule by allowing the issuer to withhold payment. The prerequisites as provided in the UNCITRAL Convention are considered clear and narrow in scope and provide an excellent international standard and guidance to courts for the application of the fraud rule.⁴⁹⁸ Although the adoption by a state has the effect of making the UNCITRAL Convention law, its dissemination is rather small, as the UNCITRAL Convention has only been adopted by a few states yet.⁴⁹⁹ Hence it does not apply to the majority of letter of credit fraud disputes, but merely provides guidance for national judgements on whether or not to interfere with the independent character of a letter of credit transaction.

Some commentators find that the provisions of the UNCITRAL Convention are rather vague due to the various difficulties of the independent undertaking practice.⁵⁰⁰ Therefore it is considered a better policy to leave it to the commercial markets to incorporate existing rules on fraud.⁵⁰¹

The UCP 600, which have been adopted worldwide and which are probably the most important rules governing the letter of credit, are totally silent with respect to the fraud rule.⁵⁰²

6. REFLECTIONS ON THE IDEA OF IMPLEMENTING MINIMUM STANDARDS FOR THE APPLICATION OF THE FRAUD RULE INTO THE UCP

Voices have been raised to implement standard fraud rules into the UCP 600:

The best place for the fraud rule to be so formulated is in the terms of the Uniform Customs and Practice for Documentary Credits that are incorporated by reference into virtually all credits issued worldwide. The publisher of the UCP, the International Chamber of Commerce, is

⁴⁹⁸ Gao X & Buckley RP (2003) 333.

⁴⁹⁹ See Chapter II 1.7; The UNCITRAL-Convention has been ratified in Belarus, Ecuador, El Salvador, Gabon, Kuwait, Liberia, Panama and Tunisia. It has been signed but is not ratified in the United States of America; see http://www.uncitral.org/uncitral/en/uncitral_texts/payments/1995Convention_guarantees_status.html for further information.

⁵⁰⁰ See Zhang Y (2011) 72.

⁵⁰¹ Dolan JF Dolan JF ‘The UN Convention on International Independent Undertakings: Do States with Mature Letter-of-Credit Regimes need it?’ (1997) 13 *Banking and Finance Law Review* 23 (hereafter Dolan JF (1997)).

⁵⁰² Buckley RP & Gao X (2002) 700.

the most qualified body to prescribe the fraud rule as it has the greatest expertise in letter of credit matters.⁵⁰³

However, as mentioned earlier, the UCP 600 is in fact completely silent on the issue of fraud and the fraud rule.⁵⁰⁴ This results from the fact that the UCP 600 and its predecessors were mainly drafted to provide a contractual framework for business relationships between issuers and beneficiaries and issuers and correspondent banks.⁵⁰⁵ As such a framework, the UCP 600 do not deal with the rights and duties of parties to the underlying contract, which are in general a matter of applicable national law.⁵⁰⁶ Articles 34, 7(c), 8(c) and 12(b) of UCP 600 to some extent deal with fraud issues but only with regards to bankers' responsibilities.⁵⁰⁷ Article 34 UCP 600 states that a 'bank assumes no liability or responsibility for the form, sufficiency, accuracy, genuineness, falsification or legal effect of any document.' Hence, it is observed that these general provisions aim to serve as 'rules of best banking practice and not as rules of law' and the fraud issue is regarded as 'the province of the applicable law and of the courts of the forum'.⁵⁰⁸ Ultimately it is argued that the drafters of the UCP 500 and the UCP 600 deliberately decided to leave out the fraud issue.⁵⁰⁹

However, the lack of standard rules at international level causes legal uncertainties, which in turn can be harmful to the letter of credit as common payment method in international trade. These uncertainties are due to the fact that the fraud issue is a very complex problem, which is handled differently from jurisdiction to jurisdiction⁵¹⁰ as the above comparison of the laws of the US, the UK and the RSA has shown.

The source of the problem to resolve the fraud issue at international level is the tension between the marketability of letters of credit on the one hand⁵¹¹ and the predictability for the business community on the other hand⁵¹². Both aspects are very sensitive factors that make it difficult to find a compromise by means of minimum standards for the application of the fraud rule at international level.

⁵⁰³ See Gao X & Buckley RP (2003) 335.

⁵⁰⁴ See Kelly-Louw M (2008) 136.

⁵⁰⁵ See Gao X (2002) 56.

⁵⁰⁶ See Kelly-Louw M (2010) 77; Gao X (2002) 56; see also Dolan JF (1997) 23.

⁵⁰⁷ See Byrne JE 'Negotiation in Letter of Credit Practice and Law: The Evolution of the Doctrine (2007) 42 *Texas International Law Journal* 584.

⁵⁰⁸ See Goode RM (1995) 727.

⁵⁰⁹ See Zhang Y (2011) 68, with further references in footnote 300.

⁵¹⁰ Ulph J 'The UCP 600: Documentary Credit in the Twenty-first Century' (2007) *Journal of Business Law* 371 (hereafter Ulph (2007)).

⁵¹¹ See Dolan JF (1993) 63.

⁵¹² See Gao X (2002) 57.

Hence, some academics have celebrated the inactive approach of the UCP 600 as a remarkable success on the ground that any attempt by the ICC to formulate a uniform fraud exception would automatically interfere with the marketability of credits issued by the jurisdiction's banks.⁵¹³ Supporters of that view concluded that the lack of a fraud rule in the UCP 600 is the intention of the drafters of the UCP 600 that the fraud issue should be dealt with under national law.⁵¹⁴

Supporters of the contrary opinion argue that it could hardly be denied what Buckley R suggests namely that

[t]he difficulty with leaving these issues to national law is that, except in the United States, such cases come so rarely before the courts that there are very limited opportunities to develop a coherent body of rules.⁵¹⁵

South Africa is a good example for that proposition with only a few cases that merely touched the surface of the fraud issue. Therefore, it is argued that the decision of the drafters of the UCP not to address the fraud issue 'reflected either an unwillingness to tackle a difficult but necessary issue or an outdated view of the limited scope of the UCP as merely a codification of bankers' practices rather than a dispositive regime of rules.'⁵¹⁶ In support of that view Gao argues that regardless of the fact that the UCP 600 are technically not law, they are treated as quasi-law by bankers and practitioners, because the UCP 600 are a set of acknowledged commercial customs, that in fact are incorporated into substantially all cross-border commercial letters of credit transaction.⁵¹⁷ He also stresses that a good commercial law is a law that best maximises certainty and predictability in trade. Gao further raises doubt that the UCP 600 meet this benchmark. He indicates that the drafters of the UCP 600 were aware of the fraud issue, yet they refused to provide the users of letters of credit with any guidance on how to deal with fraud issues they might encounter.⁵¹⁸ The lack of guidance would cause a certain degree of 'uncertainty and unpredictability'. What would make things even worse was that it was not to be expected in practice that each judge was an expert in the law of letters of credit or that good law was made within the short period of time that a case was before a court. To

⁵¹³ See Dolan JF (1993) 63; also see Barski KA 'Letters of Credit: A Comparison of Article 5 of the Uniform Commercial Code and the Uniform Customs and Practice for Documentary Credits' (1996) 41 *Loyola of Los Angeles Law Review* 751.

⁵¹⁴ Ulph J (2007) 371.

⁵¹⁵ Buckley RP 'The 1993 Revision of the Uniform Customs and Practice for Documentary Credits' (1995) 28 *George Washington Journal of International Law & Economics* 303 (hereafter Buckley RP (1995)).

⁵¹⁶ Buckley RP (1995) 302; see also Kelly-Louw M (2010) 77.

⁵¹⁷ See the full discussion at Gao X (2002) 56-57.

⁵¹⁸ Gao X (2002) 57.

the contrary, Gao assumes that in reality most trial judges have hardly had any experience with letters of credit matters.⁵¹⁹

Gao is right in that it is desirable for the drafters of the UCP, who are recognised experts on letter of credit, to create at least minimum standards for the issue of fraud.⁵²⁰ Although a detailed set of rules apparently would not be practical, guidance is better than nothing.⁵²¹ It has been claimed by Schmitthoff that it would have been desirable for the 1983 version of the UCP 400 to have dealt with the problem of fraud.⁵²² It is indeed unfortunate that the UCP 600 has again remained silent on the issue of fraud.⁵²³



⁵¹⁹ Gao X (2002) 57.

⁵²⁰ Gao X (2002) 57; See Kelly-Louw M (2010) 79.

⁵²¹ Gao X (2002) 57.

⁵²² Schmitthoff CM (1982) 321.

⁵²³ Kelly-Louw M (2010) 79.

CHAPTER FIVE

FINAL CONCLUSIONS

1. LETTER OF CREDIT BASICS

1.1 Working System of a Letter of Credit

A letter of credit is a basically a written instrument under which someone undertakes to pay another person under a given contract provided the terms of the credit are met.⁵²⁴ A letter of credit consists of at least the following three autonomous contracts:⁵²⁵ the underlying contract between the seller and the buyer; the application between the applicant and the issuing bank; and the issuing banks undertaking towards the beneficiary to honour the credit upon the presenting of complying documents. In many cases, the beneficiary does not deal directly with the issuing bank because another bank, the nominated bank, makes the credit available to the beneficiary.⁵²⁶ Sometimes another bank confirms the credit. As a consequence, the beneficiary gets an independent payment claim against the confirming bank, which must honour the credit on the same conditions as the issuing bank. If any, the advising bank checks the authenticity of the credit as an agent of the issuing bank and notifies the beneficiary, if the credit is accurate (e.g., no pages missing; duly signed).⁵²⁷

1.2 The Parties' Obligations

The applicant is obligated to apply for the letter of credit with the issuing bank in due time, to lodge security as demanded by the issuing bank and to reimburse and indemnify the issuing bank for payments made under the credit.⁵²⁸

The beneficiary must hand over the goods to the carrier at the stipulated place and, in order to be paid, present a complete set of complying documents, e.g. transport documents, commercial invoice, consular or customs invoice, certificate of origin, packing list, certificate of inspection, insurance document, bill of lading within the stipulated time frames.⁵²⁹

The main obligations of the issuing bank are, (i) to establish the letter of credit at the request of the applicant, (ii) to make the credit available to the beneficiary, (iii) to examine the pre-

⁵²⁴ See Chapter I.3.1.

⁵²⁵ See Chapter I.3.2.

⁵²⁶ See Chapter I.3.2.

⁵²⁷ See Chapter I.3.2.

⁵²⁸ See Chapter II.2.1.

⁵²⁹ See Chapter II.2.2.

sented documents, (iv) to either accept or reject the documents, and (v) to honour or dishonour the credit or to reimburse the nominated bank that has honoured a complying presentation.⁵³⁰ These obligations basically also apply for the nominated bank or confirming bank.⁵³¹

1.3 Key Principles of Letter of Credit Law

A letter of credit is characterised by two key principles: the principle of autonomy and the principle of strict compliance.

The autonomy principle provides that the beneficiary has a guarantee for the purchase price from a secure source of credit, which is independent of any disputes with the applicant.⁵³²

According to the principle of strict compliance the beneficiary must strictly comply with documentary requirements specified in the letter of credit. While the autonomy principle gives advantages to the beneficiary ('pay first, argue later'), the strict compliance doctrine benefits the applicant insofar as he will have to reimburse the issuing bank only against the presenting of documents that comply with the documents specified in the letter of credit.⁵³³

2. FRAUD RULE

2.1 The Fraud Rule According to the Laws of the USA

The fraud rule in the USA is codified in the Revised UCC Article 5⁵³⁴ and provides the following:⁵³⁵

1. When fraud is involved in a letter of credit transaction payment can be stopped either because the issuer dishonours the presentation or by way of a court order, provided that the following four procedural conditions are met: (i) the relief is not prohibited under applicable law; (ii) any adversely affected person must be adequately protected against any loss; (iii) all conditions to entitle a person to the relief have been met; (iv) the applicant is more likely than not to succeed under its claim of forgery or material fraud.
2. The applicant or any other person who wants to prevent the honouring of the credit has established 'material' fraud.

⁵³⁰ See Chapter II.2.3.

⁵³¹ See Chapter II.2.3.; also see II.2.4 for the obligations of the advising bank.

⁵³² See Chapter III.1.2.

⁵³³ See Chapter III.1.1.

⁵³⁴ See Chapter IV.2.3.

⁵³⁵ See Chapter IV.2.4.

3. The demand for payment is not made by an innocent party such as (i) a nominated person who has given value in good faith without notice of fraud; (ii) a confirmer, who made its confirmation in good faith; (iii) a holder in due course; or (iv) an assignee of the issuer's or nominated person's deferred obligation that was taken for good value and without notice of fraud.

2.2 The Fraud Rule According to the Laws of the UK

In the UK the fraud rule is not codified but also acknowledged by the courts. The fraud rule generally provides the following:⁵³⁶

1. The plaintiff must establish the existence of 'clear' and 'obvious' fraud of which the issuer of the credit must be aware, in order to invoke the fraud rule. A mere allegation of fraud does not suffice.
2. The beneficiary must know of the fraud at the time of the presentation, as it would otherwise not be a party of the fraud. Hence, the fraud rule applies only if the beneficiary had committed the fraud.⁵³⁷
3. To prove the fraud and the bank's knowledge thereof, strong corroborative evidence of the allegation is required, usually in the form of contemporary documents, particularly emanating from the buyer. If the bank on that basis were to consider fraud the only realistic inference to draw, then the seller would have made out a sufficient case of fraud.⁵³⁸

2.3 The Fraud Rule According to Laws of the RSA

The fraud rule under South African law is almost a theoretical concept. As a matter of fact, until today South African courts have not applied the fraud rule and it is yet not fully developed. However, the courts have established the following prerequisites for its application:

1. As a key condition for the application of the fraud rule the beneficiary's fraud would have to be 'established clearly' and a mere error, misunderstanding or oversight, however unreasonable, could not amount to fraud.
2. It is subject to further discussion whether the fraud rule is limited to the so-called documentary fraud. Whereas the case of *Union Carriage and Wagon*

⁵³⁶ See Chapter IV.3.1 – IV.3.6.

⁵³⁷ See the discussion of *United City Merchants (Investment) Limited v Royal Bank of Canada* under Chapter IV.3.5.

⁵³⁸ See Chapter IV.3.7.

Company Ltd v Nedcor Bank Ltd via obiter dictum indicated that fraud beyond documentary fraud was conceivable, the recent case of *Basil Read (Pty) Ltd v Nedbank Ltd and Another* suggests otherwise, as it adopted the narrow formulation of the fraud rule in the *United Merchants* case, which was adopted by South African courts.⁵³⁹

2.4 Differences of the Application of the Fraud Rule in the USA, the UK and the RSA

The main difference between the common law jurisdictions of the USA, the UK and the RSA is that the USA is the only country that has codified the fraud rule. The codified fraud rule gives practitioners a clearer guidance on how to react in the case of fraud, which in turn promotes a higher level of legal certainty.

Under English law, the fraud rule applies only if the beneficiary committed the fraud. American law does not state clearly who is to perpetrate fraud for the fraud rule to apply. American law seems to focus on the nature of the documents tendered, rather than the identity of the fraudulent party.⁵⁴⁰ The South African position in this regard is unclear. For instance in *Loomcraft Fabrics v Nedbank*⁵⁴¹ the court by way of an obiter dictum indicated that the fraud rule could apply in the event of a non-documentary fraud. This means that fraud may not necessarily be found in the documents but anywhere in the transaction and that the perpetrator of fraud may not only be the beneficiary but any other person involved in the transaction. By contrast, in *Basil Read (Pty) Ltd v Nedbank Ltd and Another* the court applied the classic narrow approach of the English courts, which means that the fraud must be found in the documents presented by the beneficiary.⁵⁴² However, the court did not indicate who is to perpetrate fraud in order for the fraud rule to apply.

Another difference between American law and English law is that under English law the bank must have knowledge of the beneficiary's fraud.⁵⁴³

Further, the standard of proof of fraud is much higher under English law than under American law, which has a rather 'flexible' approach.⁵⁴⁴ For example, in the American case *Harris Corporation v National Iranian Radio and Television* the court granted an injunction to prevent payment although the court found evidence only indicated that the beneficiary's demand 'was

⁵³⁹ See Chapter IV. 4.6.

⁵⁴⁰ Kelly-Louw M (2008) 243.

⁵⁴¹ See Chapter IV.4.2.

⁵⁴² See Chapter IV.4.5.

⁵⁴³ Kelly-Louw M (2008) 243.

⁵⁴⁴ See Chapter IV.2.2.; also see Kelly-Louw M (2008) 243.

made in a situation that was subtly suggestive of fraud'.⁵⁴⁵ Generally, the US courts grant temporary injunctions to prevent payment when fraud is suspected.⁵⁴⁶ By contrast, under English law a sufficient case of fraud is made out only, in the event that the bank knows of the fraud, the fraud is evidenced in form of contemporary documents and the court on this basis considers fraud the only realistic inference to draw.⁵⁴⁷

A further difference between the fraud rule under American law compared to the laws of the UK and the RSA is that under American law, even if the prerequisites of the fraud rule are met, the fraud rule still does not apply if this led to a disadvantage of certain 'innocent persons', e.g. a confirming bank who made its confirmation in good faith.⁵⁴⁸ This is because American law assumes that victims of fraud are not in as much need of protection as innocent parties involved in the transaction.⁵⁴⁹

3. PROPOSAL FOR A FRAUD RULE WITHIN THE UCP

The main differences of the application of the fraud rule in the jurisdictions of the USA, the UK and the RSA and the legal uncertainties caused hereby were discussed in detail. It was also observed that the ICC by means of the UNCITRAL Convention made huge efforts to resolve the fraud problem at an international level.⁵⁵⁰ However, the problem is that the dissemination of the UNCITRAL Convention is rather narrow, because only a few states have adopted it. Hence, the fraud rule as set forth herein, does not apply to the majority of letter of credit fraud disputes. On the other hand, the UCP 600 virtually apply to all letter of credit transactions, but they remain totally silent with regard to the fraud issue.⁵⁵¹ This leads to great legal uncertainties that interfere with the marketability of the letter of credit as payment method in international trade. The problem with leaving the fraud issue to national law is that, except in the USA, such cases come so rarely before the courts that there are very limited opportunities to develop a coherent body of rules. This is best demonstrated by the fraud rule under South African law, which is not fully developed by now, because there have only been a few lawsuits dealing with fraud in a letter of credit transaction. Another problem is that

⁵⁴⁵ *Harris Corporation v National Iranian Radio and Television* 691 F 2d 1344 (11th Cir 1982) 1356 referred to by Kelly-Louw (2008) 244.

⁵⁴⁶ For further reference see Garcia RLF (2009) 81.

⁵⁴⁷ See the discussion of the case *United Trading Corporation SA and Murray Clayton Ltd v Allied Arab Bank Ltd* under Chapter IV.3.6.

⁵⁴⁸ See Chapter IV.2.3.

⁵⁴⁹ See Chapter IV.2.3.

⁵⁵⁰ See Chapter IV. 5.

⁵⁵¹ See Chapter IV. 5.

judges, who are concerned with cases of fraud in a letter of credit transaction, are often not experts in the field of the letter of credit law, unlike the drafters of the UCP.⁵⁵²

It is therefore desirable that the drafter of the UCP implement minimum standards into the UCP specifying when the fraud rule should apply. Not only would this cause a higher level of legal certainty, but this could therefore also reduce the total number of lawsuits with regard to fraud. A starting point for the development of such minimum standards could be the fraud rule according to Article 19 of the UNCITRAL Convention, which the ICC recommends to apply due to its clear and narrow scope.⁵⁵³ The UNCITRAL Convention would be an excellent international standard and guidance for the application of the fraud rule.⁵⁵⁴ The drafters of the UCP should therefore consider to implement the three substantive grounds, set out in Article 19(1) of the UNCITRAL Convention, to invoke the fraud rule giving the issuer, who is acting on good faith, the right to withhold payment if:

- (a) Any document is not genuine or has been falsified;
- (b) No payment is due on the basis asserted in the demand and the supporting documents; or
- (c) Judging by the type and purpose of the undertaking, the demand has no conceivable basis.

Further and in accordance with Article 19(2) of the UNCITRAL Conventions, the term ‘no conceivable basis’, should be defined as follows:

- (a) The contingency or risk against which the undertaking was designed to secure the beneficiary has undoubtedly not materialized;
- (b) The undertaking obligation of the principal/applicant has been declared invalid by a court or arbitral tribunal; unless the undertaking indicates that such contingency falls within the risk to be covered by the undertaking;
- (c) The underlying obligation has undoubtedly been fulfilled to the satisfaction of the beneficiary;
- (d) Fulfilment of the underlying obligation has clearly been prevented by wilful misconduct of the beneficiary; or

⁵⁵² See Chapter IV.6.

⁵⁵³ See Chapter IV.5.

⁵⁵⁴ Gao X & Buckley RP (2003) 333.

(e) In the case of a demand under a counter-guarantee, the beneficiary of the counter-guarantee has made payment in bad faith as guarantor/issuer of the undertaking to which the counter-guarantee relates.

This narrow scope of the fraud rule would keep interferences with the autonomy principle at low level and therefore preserve the important role of the autonomy principle in the letter of credit working system. Further, even supporters of the view that the fraud rule should not be implemented at an international level, must acknowledge that the national laws would keep a significant influence on the decision on whether or not the fraud rule applies in the individual case, because the national laws would still set the standards of proof.



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