

**FACULTY OF LAW**

**LETTERS OF CREDIT - THE FRAUD EXCEPTION: A TIME FOR CONFORMITY**

A mini-thesis submitted in partial fulfilment of the requirements for the degree of LL.M in  
Mercantile and International Trade Law



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## KEY WORDS

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Letters of Credit

South African Letters of Credit law



Strict Compliance principle

The Fraud exception

Uniform Customs and Practice (UCP)

United Kingdom Letters of Credit law

United States of America Letters of Credit law

## LIST OF ACRONYMS

<b>BRICS</b>	Brazil, Russia, India, China, South Africa
<b>CCS</b>	Commercial Crime Services
<b>ICC</b>	International Chamber of Commerce
<b>NPC</b>	National People's Congress (China)
<b>PRC</b>	People's Republic of China
<b>SPC</b>	Supreme People's Court (China)
<b>UCC</b>	Uniform Commercial Code of the United States of America
<b>UCP</b>	Uniform Customs and Practice for Documentary Credits (without referring to any specific version of it)
<b>UCP 500</b>	1993 Version of the Uniform Customs and Practice for Documentary Credits
<b>UCP 600</b>	2007 Version of the Uniform Customs and Practice for Documentary Credits
<b>URCG</b>	1978 Uniform rules for Contract Guarantees, ICC Publication No 325

## DECLARATION

**I, Leon Andre Fieties**, declare that **Letters of Credit - The Fraud Exception: A Time for Conformity** is my own work and that it has not been submitted before for any degree or examination in any other university, and that all sources I have used or quoted have been indicated and acknowledged as complete references.

Signed:



NOVEMBER 2013

Signed:

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**Prof. Riekie Wandrag**

NOVEMBER 2013

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## **DEDICATION**

This work is dedicated to my God, my saviour and the source of my strength, and to Prof. Riekie Wandrag, who made me realise my true potential has no boundaries.



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# CHAPTER 1

## INTRODUCTION

### 1.1 Background

The classic justification for Letters of Credit is that it provides an effective assurance of payment from a financially responsible third party.<sup>1</sup> Cross-border transactions magnify the concern of non-payment from a buyer because litigation is not only costly but it also normally occurs in a foreign and unfamiliar forum.

Not only do Letters of Credit provide assurance to the seller that it will be paid, even if the buyer would not pay voluntarily but it also compensate for the weakness of relational ties between the buyer and the seller, should no such ties exist at the time the contract is established.

Another important characteristic of Letters of Credit and what gives its importance, is the issuing bank's ability to verify information about the purchaser and the transaction. This is done in two ways; firstly the willingness of the issuing bank to issue a Letter of Credit is an indication that the seller will not withhold payment for illegitimate reasons and secondly it verifies the legitimacy of the transaction as well as assists with the enforcement of currency controls<sup>2</sup> and laws against money laundering.

Because there is often an imbalance between parties in terms of information about each other at the time the transaction commences, Letters of Credit serves as a verification institution. It is submitted that this is the most important function of Letters of Credit.

### 1.2 Letters of Credit

Parties from different countries in an international sales transaction may or may not know each other on a private level. For some, it may be the first time doing face to face trade, while for others it may be an online deal and not as private as face to face. These reasons and a multitude more underline the intricate nature of international sale transactions. Therefore the

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<sup>1</sup> Brindle M and Cox R *Law of Bank Payments* 3 ed (2004) par 8-026 at 673.

<sup>2</sup> Schaffer Earle & Agusti *International Business Law and Its Environment* 4 ed (1999) 253.

parties need a form of protection in the event that one of the parties to the contract does not comply or fulfil their part of the obligation. The documentary Letter of credit serves as that security.<sup>3</sup>

On first sight one would assume that there is a sense of distrust among the parties but that is not the case as each party to the contract is only trying to protect its interests as far as the other's performance in terms of the agreement is concerned.

Firstly, the buyer has a fear of receiving goods of an incorrect quantity or quality, or not receiving goods at all.<sup>4</sup> The seller, on the other hand, fears non-payment, or that the buyer may refuse to accept the goods on a mere technicality.<sup>5</sup>

Secondly, legal recourse is normally expensive, intricate and drawn out as parties may not be familiar with the different jurisdictions.<sup>6</sup> Documentary Letters of Credit ease some of these fears due to the unique principles which form the basis of this instrument.

The Letter of Credit is always honoured where all the underlying principles and requirements have been satisfied by the parties except in the case of fraud.<sup>7</sup>

### **1.3 Principles underlying Documentary Letters of Credit**

There are two fundamental principles underlying documentary Letters of Credit namely the principle of independence and autonomy of the credit and the principle of strict compliance.<sup>8</sup> These doctrines are unique and are characteristics of this instrument.

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<sup>3</sup> Oelofse A N *The Law of Documentary Letters of Credit in Comparative Perspective* (1997) pages 3 to 6. See also, Day D M *The Law of International Trade* Second Edition (1993) pages 1 to 4, and 10 to 11.

<sup>4</sup> Oelofse A N *The Law of Documentary Letters of Credit in Comparative Perspective* (1997) pages 3 to 6. See also Day D M *The Law of International Trade* Second Edition (1993) pages 1 to 4, and 10 to 11.

<sup>5</sup> Langerich R *Documentary Credit in Practice* (2000) 30.

<sup>6</sup> Langerich R *Documentary Credit in Practice* (2000) 34.

<sup>7</sup> Garcia R 'The Autonomy Principle of Letters of Credit' (2009) 3 *Mexican Law Review* 67.

<sup>8</sup> Garcia R 'The Autonomy Principle of Letters of Credit' (2009) 3 *Mexican Law Review* 67.

### 1.3.1 Independence and Autonomy of the Credit

This principle underpins the character of the Letter of Credit in international trade as independent and separates the undertaking by the bank to pay the beneficiary<sup>9</sup> from the underlying contract or any other agreement.

The Uniform Customs and Practice for Documentary Credits (UCP) is a set of rules governing credits drafted by the International Chamber of Commerce (ICC). The UCP is periodically reviewed and updated by the ICC Banking Commission. Since 1993, the UCP 500 has applied, which governed all documentary credits that incorporated the UCP into their terms. As of 1 July 2007, however, the new revision came into force; the UCP 600.

All the undertakings in respect of the Letter of Credit between the parties are considered to be independent from each other under this doctrine as per Article 4(a) of the Uniform Customs and Practice (UCP) 600, which states that:

**‘a.** A credit by its nature is a separate transaction from the sale or other contract on which it may be based.

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

A beneficiary can in no case avail itself of the contractual relationships existing between banks or between the applicant and the issuing bank.

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

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<sup>9</sup> Dolan J F *The Law of Letters of Credit: Commercial and Standby Credit* (1996) 26.

As a result the duty by the bank to pay in cash or to accept and pay bills of exchange or drafts, or to fulfil any other obligation under the Letter of Credit, is not subject to claims of defences by the applicant resulting from its relationship with the issuing bank or with the beneficiary.<sup>10</sup> At the same time the beneficiary cannot avail itself of the contractual relationship existing between the applicant and the issuing bank.<sup>11</sup>

The issuing bank does not concern itself with the underlying dispute under this principle. It makes out payment under the Letter of Credit regardless of whether the underlying goods, that are the subject of the sales contract between the applicant and the beneficiary, conform to the conditions of sale.<sup>12</sup> All that matters is that all the conditions set out in the Letter of Credit are met. This means that the confirming bank is obligated to the advising bank and the beneficiary alone.

The principle serves as a deterrent in a situation where the applicant wants to litigate, due to the beneficiary breaching the contract, and the applicant seeks to interfere with the issuing banks payment to the beneficiary, even though all the conditions on the Letter of Credit have been met.<sup>13</sup> Similar in the case of *Ex Parte Sapan Trading (Pty) Ltd*<sup>14</sup> where the buyer tried to stop the issuing bank from paying the seller for breach of contract, by way of an interdict, the court held that the nature of a Letter of Credit is such that it is independent from the contract. Furthermore, the court held, that it will only order such an interdict in exceptional cases, such as fraud.

The applicant's only recourse lies with the issuing bank which can institute an action against the confirming bank for wrongful honour or dishonour of the draft.<sup>15</sup>

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<sup>10</sup> Raymond J *Documentary credits: The Law and Practice of Documentary Credits including Standby Credits and Demand Guarantees* (2001) 40.

<sup>11</sup> Hahn J 'Governing Laws on Letters of Credit under Uniform Commercial Code' (2007) 11(3) *Trade Journal* 118.

<sup>12</sup> Carlson D G & Widen W H *Letters of Credit, Voidable Preferences, and the Independence Principle* (1999) 54(4) *Business Lawyer* 166.

<sup>13</sup> Chan F H 'Documentary compliance under UCP: A Fault Finding Mission or a Mere Guessing Exercise' (2008) 5 *Trade Journal* 76.

<sup>14</sup> 1995(1) SA 218 (W).

<sup>15</sup> Kranovska D Impact of the Doctrine of Strict Compliance on a Letter of Credit available at [http://pure.au.dk/portal-asb-student/files/2543/Krazovska\\_MasterThesis.pdf](http://pure.au.dk/portal-asb-student/files/2543/Krazovska_MasterThesis.pdf) (accessed 2 Feb 2013).

### 1.3.2 Principle of Strict Compliance

This principle provides that the bank can reject any document which is not in strict conformity with the terms set out in the documentary Letter of Credit.<sup>16</sup>

The principle of strict documentary compliance requires not only that the tendered documents conform to the terms and conditions of the documentary Letter of Credit but also they appear on their face to be consistent with one another.<sup>17</sup> This requires that all the documents are consistent with one another in the sense that they make up a set which is apparently referring to the same container of goods.<sup>18</sup> A measure of certainty is needed because, if the documents are rejected, this is likely to cause delay and expense in selling the goods elsewhere.<sup>19</sup>

Therefore the overall effect of the principle of strict compliance is that the bank honouring the documentary Letter of Credit must strictly conform to the conditions set out in the Letter of Credit, and should the documents handed in by the beneficiary not meet this criteria then the bank must not pay out.<sup>20</sup> Therefore the required standard is that of strict conformity.

Thus when the Letter of Credit is free of any default, it must be honoured by the bank except where fraud has been committed. In such a case payment will not be made to the guilty beneficiary under the instrument.<sup>21</sup> In *Phillips & Another v Standard Bank of South Africa Ltd & Others*<sup>22</sup> a South African applicant had imported shoes from an Italian manufacturer, and sought an interdict to prevent Standard Bank from paying the manufacturer as it was discovered that some of the shoes were defective. The court rejected the application and held that it was a breach of contract between the parties and has nothing to do with the Letter of Credit.

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<sup>16</sup> Boaja M 'Payment Deployment through Documentary Letter of Credit' (2008) 13 (2) *Metalurgia International* 164.

<sup>17</sup> Mehta R 'Does UCP 600 Soften or End the Doctrine of Strict Compliance?' (2007) 101 *Newsletter* 78.

<sup>18</sup> Mehta R (2007) 78.

<sup>19</sup> Kranovska D Impact of the Doctrine of Strict Compliance on a Letter of Credit available at [http://pure.au.dk/portal-asb-student/files/2543/Krazovska\\_MasterThesis.pdf](http://pure.au.dk/portal-asb-student/files/2543/Krazovska_MasterThesis.pdf) (accessed 2 Feb 2013).

<sup>20</sup> Buckley R P & Goa X 'The Development of the Fraud rule in Letter of Credit law: The Journey so Far and the Road ahead' (2002) 23(4) *Journal of International Economic Law* 658.

<sup>21</sup> Janine L Do Fraudulent Documents Invalidate the Letter of Credit? available at <http://www.ens.co.za/images/news/ENS%20Legal%20Times%2011%20November%202011.pdf> (accessed 7 Feb 2013).

<sup>22</sup> *Phillips & Another v Standard Bank of South Africa Ltd & Others* 1985 (3) SA 301(W).

## 1.4 The Fraud Exception

The exception of fraud applies to both the principle of independence and autonomy as well as that of strict compliance.<sup>23</sup> Fraud generally refers to where a legal rule or interest is enforced in bad faith and that enforcement damages the interests of another individual or the interests of the public at large,<sup>24</sup> for example, the deliberate falsification of documents by the beneficiary in order to fulfil the conditions in the instrument. The UCP 600 does not contain any articles on forgery or fraud but Article 9 (a) and (b) of the ICC's Uniform Rules for Contract Guarantees (URCG)<sup>25</sup> deals with the obligation of banks to pay on presentation of documents that comply but may also refuse to pay in certain instances.<sup>26</sup>

The principle *fraus omnia corrumpit* is clearly grounded in ethics indicates that a beneficiary who is guilty of fraud is not entitled to payment under the instrument.<sup>27</sup> Documentary Letters of Credit secure a beneficiary's right to payment from the respective bank involved.<sup>28</sup> When the beneficiary presents a demand for payment, the fraud exception is often used to justify non-payment, where it is proved that the seller acted in bad faith and was aware of the material misrepresentation.<sup>29</sup> If the seller was unaware of the inaccuracy in the document, the exception does not arise.<sup>30</sup> Errors, misunderstandings and oversight do not invoke the exception.<sup>31</sup> Further, if fraud was committed by a third party, such as the loading agent who inserts an incorrect date of loading into the bill of lading, banks will still honour payment as it is not easy for the bank to distinguish whether the fraud was committed by the seller or by the third party.<sup>32</sup> Courts do not easily infer fraud, like in the case of *Discount Records Ltd v Barclays Bank Ltd and another*<sup>33</sup> the English judge said:

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<sup>23</sup> Dolan J F 'Tethering the Fraud Inquiry in Letters of Credit Law' (2006) 21 *Banking and Finance Law Review* 479, 480 and 485.

<sup>24</sup> Mohamed I 'Strict Compliance in Letters of Credit Transactions' available at <http://www.evancarmichael.com/Legal/2112/Strict-compliance-in-letters-of-credit-transactions.html> (accessed 11 Feb 2013).

<sup>25</sup> Kelly-Louw M 'International Measures to Prohibit Fraudulent Calls on Demand Guarantees and Standby Letters of credit' (2010) 1(1), *Geo. Mason J, Int'l Comm. L.*, 74.

<sup>26</sup> Burnett R *Law of International Business Transactions* 3 ed (2004).

<sup>27</sup> Richard K *Gutteridge and Megrah's Law of Banker Commercial Credit* (2008) 56.

<sup>28</sup> Garcia R 'The Autonomy Principle of Letters of Credit' (2009) 3 *Mexican Law Review* 67.

<sup>29</sup> Richard K (2008) 54.

<sup>30</sup> Mohamed I 'Strict Compliance in Letters of Credit Transactions' available at <http://www.evancarmichael.com/Legal/2112/Strict-compliance-in-letters-of-credit-transactions.html> (accessed 14 Feb 2013).

<sup>31</sup> *Phillips & Another v Standard Bank of South Africa Ltd & Others* 1985 (3) SA 301 (W).

<sup>32</sup> *Union Carriage & Wagon Co Ltd v Nedcor Bank Ltd* 1996 CLR 724 (W).

<sup>33</sup> *Discount Records Ltd v Barclays Bank Ltd and another* 1975 (1) All ER 1071.

‘I would be slow to interfere with bankers’ irrevocable credits, and not least in the sphere of international banking, unless a sufficiently grave cause is shown; for interventions by the court that are too ready or too frequent might gravely impair the reliance which quite properly, is placed on such credits.’

### **1.5 Aims of the Research**

National courts have approached the fraud rule in different ways and have required different standards of fraud in order to justify the disruption of the normal course of the documentary credit operation.

In the United States for example Letter of credit law has its statutory foundation in Article 5 of the Uniform Commercial Code (UCC), with a separate article on the fraud exception whereas in the United Kingdom there is no statutory equivalent of the fraud rule.<sup>34</sup> Here the fraud rule has developed in case law. British courts have continuously recognized the concept of the autonomy of the credit and have developed a very strict approach towards the fraud rule.

American and English courts differ substantially in their application of the fraud principle notwithstanding the fact that both are common law jurisdictions. Different approaches are also taken by courts in civil law countries, such as China when interpreting the fraud exception.

The aim of the research is to compare and contrast the different interpretations of the fraud exception in South Africa as a common law jurisdiction and China as a civil law jurisdiction. These similarities and differences will then be used to develop a set of rules applicable to the fraud principle which could be implemented into the UCP. This will form the academic aim of the research.

A secondary strategic aim is that the same set of rules can be used by banks, globally, when faced with the question of honouring a Letter of Credit where the fraud exception is an element to consider.

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<sup>34</sup> Burnett R *Law of International Business Transactions* 3 ed (2004).



## **1.6 Research Question**

Does the UCP offer a comprehensive regulatory framework for Letters of Credit by being silent on the fraud exception?

## **1.7 Research Methodology**

The thesis applies the descriptive method of research to give a brief picture of the history of documentary fraud under Letters of Credit. The literature study will include both primary and secondary sources.

The methodologies used in this thesis involve analysis of one of the primary sources, the Uniform Customs and Practice for Documentary Credits (UCP), the doctrine of strict compliance as well as the independence principle. The International Chamber of Commerce (ICC) has estimated that, despite the fact that the UCP rules have only a recommending nature, about 95% of credits worldwide are issued subject to the UCP. Therefore also the analysis performed in this thesis is based on the UCP, unless otherwise expressly provided. Other primary sources comprise of court decisions associated with the UCP rules and Letter of Credit surveys.

The primary sources will essentially consist of relevant legislation as well as case law. These will be employed to point out the differences and similarities between South African and Chinese law. The development of the fraud rule will be analysed through an in-depth perusal of United States and United Kingdom case law as South African courts decisions are greatly influenced by cases in these jurisdictions.

The secondary sources involve text books and review articles describing, explaining and evaluating the applicable rules and related court decisions as well as associated literature reflecting the view of experts.

Further, in order to reach the goals set in this thesis, researches from other scholars are referred to for a better explanation of the nature of documentary fraud. Current South African case law will be considered as a primary source because of the lack of legislation.

Because of the healthy and ever increasing trade relations between South African and Chinese companies and its duties and obligations in terms of their BRICS<sup>35</sup> relationship it seemed fit and proper to compare the domestic laws of these two jurisdictions that regulate Letters of Credit and their approaches to the fraud exception.

The study will also examine relevant legislation regulating Letters of Credit in China, such as Answers to the Questions of Foreign-related Commercial and Maritime Judicial Practice issued by the SPC, Civil Courts, the 4<sup>th</sup> Tribunal in 2004; Contract law 1999; Judicial Interpretation No. [2005] 13; Notice of the SPC on Prohibiting the Random Order of Stop Payment for Letters of Credit issued by SPC in 2003; Provisions of the SPC on Some Issues in the Adjudication of Letter of Credit-related Cases; The Answers to the Questions of Foreign-related Commercial and Maritime Judicial Practice (I), the SPC, 2004; The Civil Procedure Law 1991; The Criminal Law of PRC 1997 and The General Principles of the Civil Law 1987.

## **1.8 Chapter Outline**

This thesis is divided into five chapters. The first chapter provides a general overview of Letters of Credit and the principles guiding it. An explanation of what is understood under the expression “fraud rule”, which is followed by a summary of its historical origins in English and American case law in chapter two.

Chapter three gives an introduction to the fraud rule as applied in South Africa, the concept of fraud in a South African context, the standard of fraud, the time at which knowledge of fraud must be proved as well as how interdicts apply to fraud in Letters of Credit.

Chapter four provides an overview of the fraud rule as applied in China, its origins, statutory foundations, development and affiliations to other jurisdictions will be perused.

The last chapter is the conclusion. It points out differences and similarities between the approaches of South Africa and China and provides recommendations of how and why the UCP could provide rules that would provide guidance when dealing with the fraud exception. It also provides suggestions of how fraud can be minimised from the buyer’s as well as the bank’s perspective.

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<sup>35</sup> Brazil, Russia, India, China, South Africa.

## **1.9 Conclusion**

A comprehensive Letter of Credit regulatory framework is important for the effective operation of this method of payment in international trade.

The next chapter discusses the history, importance and development of Letter of Credit fraud exception and the laws governing it which will provide a basis for the need for a comprehensive regulatory framework that address all the aspects of Letters of Credit, including the fraud exception.



## CHAPTER 2

### HISTORY, IMPORTANCE AND DEVELOPMENT OF THE LETTER OF CREDIT FRAUD EXCEPTION AND THE LAWS GOVERNING IT

#### 2.1 Introduction

Fraud by the beneficiary is widely regarded as a defence against payment, irrespective of formal compliance with the terms and conditions in the Letter of Credit and it can be used as basis for interdict (injunction) relief. The definition of fraud may differ from jurisdiction to jurisdiction. The domestic law of each jurisdiction determines what kind of facts, what conduct and in which circumstances a demand for payment can be rendered as fraudulent to warrant judicial intervention.<sup>36</sup> It is the domestic court's duty to protect the interest of all bona fide parties.<sup>37</sup>

In this chapter the concept of fraud, standard of proof, substantive elements and the aspects of evidence of fraud as developed in case law in the United Kingdom and the United States of America are discussed. This is done to afford the reader insight into the background of the South African position in terms of the fraud exception and from where it developed its principles. Another reason for this comparison is that the UCC is applicable in the USA and the UCP in the UK. Furthermore fraud in the narrow sense – fraud in the documents – and fraud in the wide sense – fraud in the underlying contract – is also scrutinised.

#### 2.2 Rational of the Fraud Exception

The fraud rule can be said to be a rule under which payment may be stopped if fraud is committed in the transaction before payment is made, should the presenter not belong to a certain protected group.<sup>38</sup> This is irrespective of the fact that complying documents accompany such demand for payment.

The purpose for the fraud rule is:

- to close a loophole in the law;
- to protect public policy for the control of fraud and

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<sup>36</sup> Bertrams R *Bank Guarantees in International Trade: The Law and Practice of Independent (First Demand) Guarantees and Standby Letters of Credit in Civil Law and Common Law Jurisdictions* 3 ed (2004) 353.

<sup>37</sup> ICC Publication No. 565, *Opinions of the ICC Banking Commission 1995-1996*, (1997), 22.

<sup>38</sup> Xiang G *The Fraud Rule in the Law of Letters of Credit: A Comparative Study* (2002) 29.

- to maintain the commercial utility of Letters of Credit.<sup>39</sup>

### 2.2.1 To Close a Loophole in the Law

The nature of Letters of Credit is such that all parties involve deals with documents only and not the goods or services that such documents relates to. Should the documents presented for payment be in strict compliance with the terms and conditions of the credit the issuer shall honour such demand notwithstanding any claims or disputes relevant parties may have. This is the situation irrespective if tendered documents are later found to be fraudulent. The only duty on the part of the issuer is to exercise reasonable care that the tendered documents prima facie comply with the terms and conditions of the credit. This is referred to the principle of autonomy.<sup>40</sup>

The foregoing principle, although serving commerce well and facilitating the commercial utility of Letters of Credit<sup>41</sup> can be counterproductive to the unique purpose of the principle. This occurs when fraud is involved in the transaction. The separation of the documents from the underlying transaction creates a loophole in law because all that is required are conforming documents, irrespective if the party claiming demand for payment did not conform to the terms and conditions of the underlying contract. A party can produce fraudulent documents or make fraudulent demands. The fraud rule does not completely plug this loophole but does minimise its effect.<sup>42</sup>

### 2.2.2 Public Policy for the Control of Fraud

The fraud rule is part of a comprehensive legal system that upholds the public policy of fighting crime including fraud.<sup>43</sup> In *Dynamics Corporation of America v The Citizens and Southern National Bank*<sup>44</sup> the court held that there is as much public interest in discouraging and limiting fraud as there is in encouraging and promoting the use of Letters of Credit.

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<sup>39</sup> Xiang G *The Fraud Rule in the Law of Letters of Credit: A Comparative Study* (2002) 30.

<sup>40</sup> Goode R 'Abstract Payment Undertakings in International Transactions' 1996 XXII *Brooklyn Journal of International Law* 1 at 12.

<sup>41</sup> Xiang G *The Fraud Rule in the Law of Letters of Credit: A Comparative Study* (2002) 30.

<sup>42</sup> Xiang G *The Fraud Rule in the Law of Letters of Credit: A Comparative Study* (2002) 30.

<sup>43</sup> Xiang G *The Fraud Rule in the Law of Letters of Credit: A Comparative Study* (2002) 30 - 31.

<sup>44</sup> 356 F Supp 991 (ND Ga 1973) 1000.

The rationale for the fraud exception is that it is not in the interest of justice for an unscrupulous beneficiary, who commits fraud, to gain payment by relying on the principle of autonomy.<sup>45</sup> In *United City Merchants v Royal Bank of Canada*<sup>46</sup> the court held that it will not allow their process to be used to carry out fraud. The court relied on the doctrine *ex turpi causa non oritur* or no action may be founded on illegal conduct. This is referred to as fraud unravels all.

### 2.2.3 Maintaining the Utility of Letters of Credit

Fraud poses a potential threat to the commercial utility of Letters of Credit.<sup>47</sup> What gives Letters of Credit its popular status are that it provide a fair balance of competing interest to the contracting parties. On the one hand it provides the beneficiary guaranteed and easy access to monies due and supplies the applicant with credit on the other. The applicant is for example protected against inappropriate calls on the credit, since it requires documentation indicating performance under the underlying contract, assisting the applicant realising his commercial goal.<sup>48</sup>

If one party defrauds the other it harms the other parties to the contract and undermines the balance referred to in the previous paragraph, as the seller may abscond leaving the buyer with no recourse. The banks interest may also be jeopardised since banks often agree to issue a Letter of Credit with a prerequisite that the goods will serve as security. Should the buyer abscond, without forwarding any goods, the banks security interest is compromised meaning the interest of the bank is thus damaged.<sup>49</sup>

Since the popularity of Letters of Credit is based on the good faith of its users this popularity will wither if fraud is prevalent and in the absence of a remedy. This will have a similar effect

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<sup>45</sup> Enonchong N 'The Autonomy Principle of Letters of Credit: An Illegality Exception?' 2006 *Lloyd's Maritime and Commercial Law Quarterly* 404 -405.

<sup>46</sup> *United City Merchants (Investments) Limited v Royal Bank of Canada* [1982] 2 All ER 720.

<sup>47</sup> Smith G W L 'Irrevocable Letters of Credit and Third Party Fraud: The American Accord' (1983) 24 *Virginia Journal of International Law* 55 96.

<sup>48</sup> Xiang G *The Fraud Rule in the Law of Letters of Credit: A Comparative Study* (2002) 31.

<sup>49</sup> Xiang G *The Fraud Rule in the Law of Letters of Credit: A Comparative Study* (2002) 31 - 32.

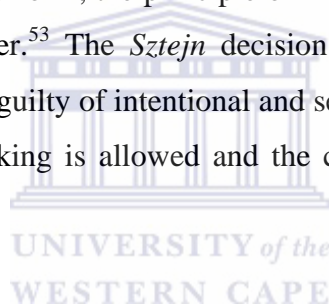
on the utility of Letters of Credit.<sup>50</sup> The fraud rule helps to maintain the utility of Letters of Credit as it has a limiting effect on fraudsters abusing Letters of Credit.<sup>51</sup>

## 2.3 The Development of the Fraud Rule through Case Law

The notion that fraud interferes with the usual rules of credit is ancient history. For the purposes of this thesis however the starting point will be the *Sztejn* case in 1941.<sup>52</sup> This case earmarks the start of real major development of the fraud rule as it is known today.

### 2.3.1 The *Sztejn* case

In the *Sztejn* case the Supreme Court of New York held that where the facts of the underlying contract indicates that the seller's failure amounts to more than a mere breach of warranty to the level of complete failure to perform, the principle of independence could not be extended to protect the unscrupulous seller.<sup>53</sup> The *Sztejn* decision can be interpreted to mean that should the beneficiary make him guilty of intentional and serious misconduct, an exception to the independence of the undertaking is allowed and the court may look beyond the prima facie conforming documents.



The *Sztejn* case is a landmark case and was the catalyst in the development of the fraud rule in Letters of Credit. The case had been codified in the Uniform Commercial Code (UCC) and courts (not only in the United States but all over the common world) cite it with approval and follow the principles developed in it.

#### Facts

Sztejn went into contract with an Indian company, Transea Traders Ltd, to buy bristles. Sztejn obtained a Letter of Credit from Schroder in favour of Transea Traders. Transea shipped fifty crates of material, procured the documents required by the Letter of Credit and drew a draft to the order of Chartered Bank. Chartered Bank in turn presented the draft, along with the required documents to Schroder for payment. Before payment could be effected Sztejn filed suit for a judgment declaring the Letter of Credit and the draft void and for

<sup>50</sup> Xiang G *The Fraud Rule in the Law of Letters of Credit: A Comparative Study* (2002) 32.

<sup>51</sup> Xiang G *The Fraud Rule in the Law of Letters of Credit: A Comparative Study* (2002) 32.

<sup>52</sup> *Sztejn v J Henry Schroder Banking Corp.* 31 N.Y.S 2d 631, 634 (1941).

<sup>53</sup> *Sztejn v J Henry Schroder Banking Corp.* 31 N.Y.S 2d 631, 634 (1941).

injunctive relief to prevent payment of such draft. Reasons offered by Sztejn was that Transea Trader Ltd 'filled the fifty crates with cow hair, other worthless material and rubbish with intent to simulate genuine merchandise and defraud the plaintiff ...'<sup>54</sup> Sztejn also alleged that Chartered Bank was merely a collecting bank for Transea Traders and not an innocent holder of the draft for value. Chartered Bank's defence was that as the plaintiff failed to state a course of action and that the complaint should be dismissed because 'the Chartered Bank is only concerned with the documents and on their face these conform to the requirements of the letter of credit.'<sup>55</sup>

### Judgment

Judge Shientag assumed that the allegations of the action were correct meaning that Transea was involved in a scheme to defraud Sztejn, the shipped goods were worthless rubbish and that Chartered Bank was not an innocent holder in due course but merely a collecting bank for Transea.<sup>56</sup>

Based on the fiction that fraud had been committed in the transaction the court denied Chartered Bank's motion to dismiss Sztejn's complaint and found in favour of Sztejn.<sup>57</sup> Shientag J acknowledged the importance of the principle of independence in the law of Letters of Credit, stating:<sup>58</sup>

'Of course, the application of this doctrine presupposes that the documents accompanying the draft are genuine and conform in terms to the requirements of the letter of credit . . .

However, I believe that a different situation is presented in the instant action. This is not a controversy between the buyer and seller concerning a mere breach of warranty regarding the quality of the merchandise; on the present motion, it must be assumed that the seller has intentionally failed to ship any goods ordered by the buyer. In such a situation, where the seller's fraud has been called to the bank's attention before the drafts and documents have been presented for payment, the principle of the independence of the bank's obligation under the letter of credit should not be extended to protect the unscrupulous seller. It is true that even though the documents

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<sup>54</sup> *Sztejn v J Henry Schroder Banking Corp.* 31 N.Y.S 2d 633 (1941).

<sup>55</sup> *Sztejn v J Henry Schroder Banking Corp.* 31 N.Y.S 2d 632 (1941).

<sup>56</sup> *Sztejn v J Henry Schroder Banking Corp.* 31 N.Y.S 2d 633 (1941).

<sup>57</sup> *Sztejn v J Henry Schroder Banking Corp.* 31 N.Y.S 2d 635 (1941).

<sup>58</sup> *Sztejn v J Henry Schroder Banking Corp.* 31 N.Y.S 2d 633 (1941).



are forged or fraudulent, if the issuing bank has already paid the draft before receiving notice of the seller's fraud, it will be protected if it exercised reasonable diligence before making such payment.'

*Sztejn* was the first case to state the elements of the fraud rule.<sup>59</sup> It established three principles:<sup>60</sup>

- Payment under a Letter of Credit may only be interrupted in a case of fraud and a mere allegation will not suffice.
- Payment under a Letter of Credit can only be interrupted when fraud is proven or established and a mere allegation of fraud will also not suffice.
- Payment should be made in accordance with the terms and conditions of the credit notwithstanding the existence of proven fraud, if the demand for payment is made by a holder in due course.

Because fraud was held to be proven in the *Sztejn* case all issues pertaining fraud was not dealt with. Some of these issues i.e. the concept of fraud, the standard of fraud and the time of which knowledge of fraud must be proved will now be discussed in terms of the law in the United States of America and the United Kingdom.

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## **2.4 The Position in the United States of America**

### **2.4.1 General Overview**

The law as it stands in the United States of America is codified in the Revised UCC Article 5 Section 5-109 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, materially fraudulent, or honour of the presentation would facilitate a material fraud by the beneficiary on the issuer or the applicant:
  - 1) The issuer shall honour the presentation, if honour is demanded by (i) a nominated person who has given value in good faith and without notice of forgery or material fraud, (ii) a confirmer who has honoured its

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<sup>59</sup> Jack R Malek A and Quest D *Documentary Credits: The Law and Practice of Documentary Credits including Standby Credits and Demand Guarantees* 3 ed (2001) par 9.6 at 261.

<sup>60</sup> Xiang G *The Fraud Rule in the Law of Letters of Credit: A Comparative Study* (2002) 42.

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

- 2) The issuer acting in good faith may honour or dishonour the presentation in any other case.
- b) If the applicant claims that a required document is forged or materially fraudulent or that honour of the presentation would facilitate a material fraud by the beneficiary on the issuer or the applicant, a court of competent jurisdiction may temporarily or permanently enjoin the issuer from honouring a presentation or grant similar relief against the issuer or other person only if the court finds that:
- 1) The relief is not prohibited under the law applicable to an accepted draft or deferred obligation incurred by the issuer;
  - 2) A beneficiary, issuer, or nominated person who may be adversely affected is adequately protected against loss that it may suffer because the relief is granted;
  - 3) All of the conditions to entitle a person to the relief under the law of this State have been met; and
  - 4) On the basis of the information submitted to the court the applicant is more likely than not to succeed under its claim of forgery or material fraud and the person demanding honour does not qualify for protection under subsection (a) (1).

#### **2.4.2 The Concept of Fraud: Fraud in the Narrow and Wide Sense**

There is no definition of fraud in the Revised UCC Article 5 Section 5-109 and courts apply the traditional concept of fraud which is: any deliberate misrepresentation of the truth of a fact with the intention to gain from another.<sup>61</sup>

The Revised UCC Article 5 Section 5-109 specifically indicates that the fraud exception will apply where a required document has been forged or is materially fraudulent – fraud in the

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<sup>61</sup> McCullough B V *Letters of Credit* (loose-leaf edition) para 5.04 [2] [C] [IV] at 5-23 – 5-24.

narrow sense – and also in the instance where there is fraud in the underlying transaction – fraud in the wide sense. Section 5-109 refers to a situation where ‘honour of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant.’<sup>62</sup> Because this exception is so widely phrased it can be deduced that it encompass fraud in the underlying transaction.

In terms of what constitutes fraud it was held in *Penn State Construction Inc v Cambria Savings and Loan Association*<sup>63</sup> that where a call was made in circumstances where the breach of the underlying contract relied on was caused by the beneficiary’s own breach of such contract, it constituted a fraudulent call. For courts to intervene on the basis of fraud it is not mandatory for the applicant to demonstrate that either the bank or the beneficiary acted deceitfully or with malicious intent.<sup>64</sup> The Revised UCC Article 5 Section 5-109 neither it’s Official Comment necessitate the beneficiary’s intention to defraud be proved, hence it can be deduced that material fraud in terms of this section is focussed on the severity of the effect of the fraud rather than the state of mind of the perpetrator.<sup>65</sup>

### 2.4.3 Standard of Proof

The Official Comment 1 to Section 5-109, Revised UCC Article 5 Section 5-109 provides that to invoke the fraud rule, the fraud involved has to be material. Xiang Gao<sup>66</sup> also state that ‘material fraud’ has been adopted as the standard of fraud under the fraud exception. Although Section 5-109 does not define ‘material fraud’ the Official Comment did make an attempt to explain it. It states that, out of necessity, courts must determine the breadth and width of materiality. It indicated that material fraud ‘requires that the fraudulent aspect of a document be material to a purchaser of that document or that the fraudulent act be significant to the participants in the underlying transaction.’<sup>67</sup>

Here also, neither the Revived UCC Article 5 Section 5-109 nor its Official Comment suggest it mandatory for the perpetrator’s intention to defraud be proved. Therefore it also

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<sup>62</sup> *Mid-America Tire Inc v PTZ Trading Ltd Import and Export Agents* 95 Ohio St 3d 367 (2002 Ohio – 2427) paras 117-133.

<sup>63</sup> *Penn State Construction Inc v Cambria Savings and Loan Association* 519 A 2d 1034 (1987).

<sup>64</sup> Xiang G *The Fraud Rule in the Law of Letters of Credit: A Comparative Study* (2002) 97.

<sup>65</sup> Buckley R P ‘The 1993 Revision of the Uniform Customs and Practice for Documentary Credits’ (1995) 6 *Journal of Banking and Finance Law and Practice* 77 at 97.

<sup>66</sup> Xiang G *The Fraud Rule in the Law of Letters of Credit: A Comparative Study* (2002) 84.

<sup>67</sup> Xiang G *The Fraud Rule in the Law of Letters of Credit: A Comparative Study* (2002) 84.

seems in this instance that the focus is more on the severity of the effect of the fraud on the underlying transaction rather than the state of mind of the perpetrator.<sup>68</sup>

Although Section 5-109 is clear that the standard of fraud to be used is material fraud, the interpretation of material fraud by the courts was mostly that of egregious fraud i.e. fraud which taints the entire transaction.<sup>69</sup>

In *Western Surety Co v Bank of Southern Oregon*<sup>70</sup> the court claimed it was adopting the standard of material fraud as set out in Section 5-109 but its approach was similar as that of courts dealing with egregious fraud.<sup>71</sup>

In *New Orleans Brass LLC v Whitney National Bank*<sup>72</sup> the court denied an application for an injunction which has its basis as that the documents submitted contained false representations and that drawing on the Letter of Credit would cause irreparable injury.<sup>73</sup> The Fourth Circuit Court upheld the decision of the court a quo on appeal citing a paragraph in *Ground Air Transfer Inc v Westates Airlines Inc*<sup>74</sup> which points to the fact that the fraud exception could only be invoked when the demand for payment had ‘absolutely no basis in fact’ or the beneficiary’s conduct had so ‘vitiating the entire transaction that the legitimate purpose of the independence of the issuer’s obligation would no longer be served’. This view is similar to the approach taken by the courts in egregious fraud cases.<sup>75</sup>

In *Mid-America Tire Inc v PTZ Trading Ltd Import and Export Agents*<sup>76</sup> the court a quo allowed an injunction on the basis of fraud in the underlying contract. The court of appeals in *Mid-America Tire Inc v PTZ Trading Ltd Import and Export Agents*<sup>77</sup> reversed the decision of the court a quo and held that material fraud ‘must be narrowly limited to situations of fraud in which the wrongdoing of the beneficiary ‘... vitiating the entire transaction’ and/or the demand for payment under the Letter of Credit ‘has absolutely no basis in fact’. If this is not the case

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<sup>68</sup> Buckley R P ‘The 1993 Revision of the Uniform Customs and Practice for Documentary Credits’ (1995) 6 *Journal of Banking and Finance Law and Practice* 77 at 97.

<sup>69</sup> Krimm J J ‘UCC – Letters of Credit and Fraud in the Transaction’ (1986) 60 *Tulane Law Review* 1088 at 1097-1098.

<sup>70</sup> *Western Surety Co v Bank of Southern Oregon* 257 F 3d 933 (9<sup>th</sup> Cir 2001), 44 UCC Rep Serv 2d (West) 1239, aff’d (2001) US App LEXIS 15565.

<sup>71</sup> Xiang G *The Fraud Rule in the Law of Letters of Credit: A Comparative Study* (2002) 84.

<sup>72</sup> *New Orleans Brass LLC v Whitney National Bank* 818 So 2d 1057.

<sup>73</sup> Xiang G *The Fraud Rule in the Law of Letters of Credit: A Comparative Study* (2002) 86-87.

<sup>74</sup> *Ground Air Transfer Inc v Westates Airlines Inc* 899 F 2d 1269 (1<sup>st</sup> Cir 1990) at 1272-1273.

<sup>75</sup> Xiang G *The Fraud Rule in the Law of Letters of Credit: A Comparative Study* (2002) 87.

<sup>76</sup> *Mid-America Tire Inc v PTZ Trading Ltd Import and Export Agents* (2000) 43 UCC Rep Serv 2n (Callaghan) 964.

<sup>77</sup> *Mid-America Tire Inc v PTZ Trading Ltd Import and Export Agents* (2000) 43 UCC Rep Serv 2d (Callaghan) 964.

the independence principle should take preference. According to Xiang this is the same approach to the standard of fraud as was adopted by the court in *New Orleans Brass v Whitney National Brass*.<sup>78</sup>

In the same case Valen J disagreed with the majority view and stated:

‘By committing fraud, it is my opinion that PTZ violated its obligations of “good faith, diligence, reasonableness and care” . . . if the beneficiary, PTZ, fails to act in good faith in its dealings and perpetrates a fraud upon the applicant . . . This approach is similar to that of constructive fraud.’<sup>79</sup>

The *Mid-American Tire Inc v PTZ Trading Ltd* case went on further appeal to the Ohio Supreme Court<sup>80</sup> where the judgment of the court of appeals was reversed. It stated:<sup>81</sup>

‘Thus, we hold that “material fraud” . . . means fraud that has so vitiated the entire transaction that the legitimate purpose of the independence of the issuer’s obligation can no longer be served.

The courts of appeals actually did rely on *Sztejn* . . . *Intraworld Indus* . . . and *Roman Ceramics Corp* . . . to establish its so-called “vitiation exception” but construed the exception so narrowly as to preclude relief where the beneficiary’s fraudulent conduct occurs solely in the underlying transaction. Thus, the court of appeals relied on the right cases for the wrong reasons.’

As can be seen from the cases above, courts in the United States when applying the standard of material fraud as per Section 5-109, take a similar approach as courts dealing with egregious fraud. According to this approach the fraud exception can only be invoked in situations where the demand for payment ‘has absolutely no basis in fact’. According to *Barnes and Byrne*<sup>82</sup> this is ‘an unduly narrow approach’.

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<sup>78</sup> *New Orleans Brass LLC v Whitney National Bank* 818 So 2d 1057 at p58.

<sup>79</sup> Xiang G *The Fraud Rule in the Law of Letters of Credit: A Comparative Study* (2002) 87.

<sup>80</sup> *Mid-America Tire Inc v PTZ Trading Ltd Import and Export Agents* 95 Ohio St 3d 367 (2002 – Ohio – 2427).

<sup>81</sup> *Mid-America Tire Inc v PTZ Trading Ltd Import and Export Agents* 95 Ohio St 3d 367 (2002-Ohio-2427) para 139-140.

<sup>82</sup> Barnes J G and Byrne J E ‘Letters of Credit; 2000 Cases’ (2000) 56 *Business Lawyer* 1805 at 1812.

#### 2.4.4 The Bank's Knowledge of Fraud

Whether the bank was aware of the beneficiary's fraud was never an issue for consideration in the United States when courts consider whether or not to invoke the fraud exception.<sup>83</sup>

#### 2.4.5 Summary

The case that symbolises the start of real development of the fraud rule is *Sztejn v J Henry Schroder Banking Corporation*<sup>84</sup> which was later codified.<sup>85</sup>

The Revised UCC Article 5 Section 5-109 is the most comprehensive code of the fraud rule in the law of Letters of Credit in the common law world. This section cleared most of the uncertainty relating to the standard of fraud and the concept of fraud amongst others. With regard to the former the section provides that the standard of fraud to be applied is that of material fraud. The cases discussed clearly indicate that courts, when applying the standard of fraud, take a similar approach to courts when dealing with egregious fraud. This position is that the fraud exception can only be invoked if the demand for payment under the Letter of Credit has absolutely no basis in fact.

In *Mid-America Tire Inc v PTZ Trading Ltd Import and Export*<sup>86</sup> Valen J disagreed with the majority view and said that the standard of material fraud is equal to that of constructive fraud. This position is when a beneficiary violates his obligation of 'good faith, diligence reasonableness and care.

Although Revised UCC Article 5 Section 5-109 stipulates a uniform and appropriate standard of material fraud, the aforesaid makes it clear that there are still different views as to the standard of fraud.

In terms of the concept of fraud section 5-109 provides that fraud can relate to fraud in the documents (fraud in the narrow sense) as well as fraud in the underlying transaction (fraud in the wide sense).

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<sup>83</sup> Bertrams R *Bank Guarantees in International Trade: The Law and Practice of Independent (First Demand) Guarantees and Standby Letters of Credit in Civil Law and Common Law Jurisdictions* 3ed (2004) 416-417.

<sup>84</sup> *Sztejn v J Henry Schroder Banking Corporation* 31 NYS 2d 631 (1941).

<sup>85</sup> Prior UCC Article 5 Section 5-114(2).

<sup>86</sup> *Mid-America Tire Inc v PTZ Trading Ltd Import and Export* 43 UCC Rep Serv 2d 964 (2000).


Whether the bank was aware of the beneficiary's fraud is not a relevant issue in the United States and as far as the standard of proof is concerned US courts has a very relaxed approach. It can be said that the fraud exception in the United States is flexible.<sup>87</sup>

## 2.5 The Position in the United Kingdom

### 2.5.1 General Overview

The fraud rule, although not in a statutory provision but in the common law, is also recognized by the English courts. Despite its recognition the fraud rule has not often been applied by English courts. As Xiang Gao points out 'English courts have traditionally been very reluctant to interfere with the operation of a Letter of Credit and have adopted a relatively inflexible and narrow approach towards the application of the fraud rule'.<sup>88</sup>

Under English law, in case of presentation of facially conforming documents, payment can be refused invoking the fraud rule, if:

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- there is clear evidence of the fraud;
  - the bank has knowledge of the evidence of fraud;
  - the bank's awareness of the fraud was 'timely', and
  - the beneficiary is involved or has knowledge of the fraud.<sup>89</sup>

The fraud rule, in terms of commercial Letters of Credit, is not significantly developed in English law. The majority of cases involved demand guarantees<sup>90</sup>. The principles in demand guarantees is however applicable to commercial Letters of Credit<sup>91</sup> and therefore, although different issues arise in demand guarantees, cases involving such guarantees will also be perused in this chapter.

English courts do acknowledge that the independence principle has no effect where there is fraud in a Letter of Credit transaction. English courts were reluctant to interfere with the

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<sup>87</sup> *United Bank Ltd v Cambridge Sporting Goods Corp* 360 NE 2d 943 (NYCA 1976) 949.

<sup>88</sup> Xiang G *The Fraud Rule in the Law of Letters of Credit: A Comparative Study* (2002) 58.

<sup>89</sup> *United City Merchants (Investments) Limited v Royal Bank of Canada* [1982] 2 All ER 720.

<sup>90</sup> A demand guarantee is a written undertaking by a bank in favour of the buyer, payable on demand.

<sup>91</sup> Warne D and Elliott N *Banking Litigation* 2 ed (2005) 260.

operation of Letters of Credit and adopted a very inflexible and narrow approach when the fraud rule is to be applied.<sup>92</sup> Reasons for this approach were explained in *Hamzeh Malas and Sons v British Imex Industries Ltd.*<sup>93</sup> where the court held:

‘[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 on the banker an absolute obligation to pay, irrespective of any dispute there may be between the parties as to whether the goods are up to contract or not. An elaborate commercial system has been built up on the footing that bankers’ confirmed credits are of that character, and, in my judgment, it would be wrong for this court in the present case to interfere with that established practice ... That system of financing ... would break down completely if a dispute as between the vendor and the purchaser have the effect of “freezing,” if I may use that expression, the sum in respect of which the letter of credit was opened.’

English courts require that the plaintiff prove the existence of ‘clear’ or ‘obvious’ fraud which is also known to the issuer before the fraud rule can be invoked. *Discount Records v Barclays Bank*<sup>94</sup> was the first English case to cite *Sztejn* with approval and acknowledged the difficulty of meeting the high standard of proof that fraud requires in terms of Letters of Credit.

In *Discount Records v Barclays Bank*<sup>95</sup> the plaintiff buyers said that cartons shipped by the French sellers contained only a small quantity of the goods ordered. The containers were otherwise empty or stuffed with rubbish. The plaintiffs sought a pre-trial injunction against the bank restraining it from paying the French company under the Letter of Credit.

However it seems that the allegedly fraudulent sellers had already been paid by the discounting of a draft which had not yet fallen due. In those circumstances, all that the grant of an injunction would do is to prevent the bank from honouring its obligations. An injunction was refused.

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<sup>92</sup> Xiang G *The Fraud Rule in the Law of Letters of Credit: A Comparative Study* (2002) 48.

<sup>93</sup> *Hamzeh Malas and Sons v British Imex Industries Ltd* [1975] 1 Lloyd’s Rep 444 (ChD) ([1975] 1 WLR 315; and [1975] 1 All ER 1071).

<sup>94</sup> *Discount Records Limited v. Barclays Bank Limited* [1975] 1 All ER 1071.

<sup>95</sup> *Discount Records Limited v. Barclays Bank Limited* [1975] 1 All ER 1071.



In terms of the substantive concept of fraud it appears from case law<sup>96</sup> that English courts also employ a very restricted concept of fraud which according to Bertrams<sup>97</sup> is perhaps even narrower than the concepts in other jurisdictions.

In *Harbottle v National Westminster Bank*<sup>98</sup> the English plaintiffs entered into contracts of sale with Egyptian buyers. Each contract provided that the plaintiffs should provide a guarantee confirmed by a bank. The guarantees covered five percent of the purchase price in favour of the buyers. The plaintiffs said that the buyers had demanded payment under the guarantees without any justification. Justice Kerr stated that the plaintiffs ‘now even go so far as to say that the buyers’ demands were fraudulent.’ The Judge rejected that contention and later in his judgement stated that it was only in ‘exceptional cases’ that courts would interfere with the irrevocable obligations assumed by banks.

In *Edward Owen Engineering v Barclays Bank*<sup>99</sup> the Court of Appeal approved the decision of Sir Michael Kerr in the *Harbottle* case. The fraud exception was described in these terms by the Master of the Rolls, Lord Denning:

‘that case (the *Sztejn* case) shows that there is this exception to the strict rule: the bank ought not to pay under the credit if it knows that the documents are forged or that the request for payment is made fraudulently in circumstances where there is no right to payment’.

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<sup>96</sup> *R D Harbottle (Mercantile) Ltd v National Westminster Bank Ltd and Others* [1978] 1 QB 146 (CA) ([1977] 2 All ER 862 862 (CA)); *Edward Owen Engineering Ltd v Barclays Bank International Ltd and Another* [1978] 1 QB 159 (CA) ([1978] 1 Lloyd’s Rep 166 (CA); and [1978] 1 All ER 976 (CA)); *Howe Richardson Seale Co Ltd v Polimex Cekop and National Westminster Bank Ltd* [1978] 1 Lloyd’s Rep 161 (CA); *Intraco Ltd v Notis Shipping Corporation (The “Bhoja Trader”)* [1981] 2 Lloyd’s Rep 256 (CA); and *Bolivinter Oil SA v Chase Manhattan Bank Commercial Bank of Syria and General Company of Homes Refinery* [1984] 1 Lloyd’s Rep 251 (CA) ([1984] 1 All ER 351 (CA); and [1984] 1 WLR 392 (CA)).

<sup>97</sup> Bertrams *R Bank Guarantees and Standby Letters of Credit in Civil Law and Common Law Jurisdictions* 3 ed (2004) 345-346.

<sup>98</sup> *R D Harbottle (Mercantile) Ltd v National Westminster Bank Ltd and Others* [1978] 1 QB 146 (CA) ([1977] 2 All ER 862 862 (CA)).

<sup>99</sup> *Edward Owen Engineering Limited v Barclays Bank International Limited* [1978] 1 All ER 976 p982.

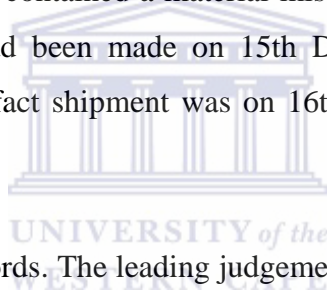
In the same case, Lord Justice Brown, referring to the fraud exception, stated:

‘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’.<sup>100</sup>

Lord Justice Geoffrey Lane at page 986 said that:

‘[T]he 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’.

The most prominent and recognised case on the fraud rule in English case law is *United City Merchants v Royal Bank of Canada*.<sup>101</sup> In this case the documents presented to the defendants, the confirming bank, contained a material mis-statement namely; that the bill of lading showed that shipment had been made on 15th December 1976 (the last date for payment of the credit) when in fact shipment was on 16th December. The defendant bank refused to pay.



The case went to the House of Lords. The leading judgement was given by Lord Diplock. He described the autonomous nature of the documentary credit: disputes as to the goods are irrelevant to the seller’s right to payment. However, he stated that:

‘to this general statement of principle as to the contractual obligations of the confirming bank and the seller, 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.’<sup>102</sup>

Lord Diplock referred to the *Sztejn* case and continued:

‘[T]he exception for fraud on the part of the beneficiary seeking to avail himself of the credit is a clear application of the maxim *ex turpi causa non oritur actio* or, if plain

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<sup>100</sup> *Edward Owen Engineering Limited v Barclays Bank International Limited* [1978] 1 All ER 976 p984.

<sup>101</sup> *United City Merchants (Investments) Limited v Royal Bank of Canada* [1982] 2 All ER 720.

<sup>102</sup> *United City Merchants (Investments) Limited v Royal Bank of Canada* [1982] 2 All ER 720.

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.’

Both *United City Merchants v Royal Bank of Canada* and *Edward Owen Engineering v Barclays Bank* confirm the existence of the fraud rule. In the United Kingdom the *Sztejn v J. Henry Schroeder Banking Corporation* case forms the foundation for this rule.<sup>103</sup>

In *Intraco Ltd v Notis Shipping Corporation (The ‘Bhoja Traders’)*<sup>104</sup> The Court of Appeal upheld the lower court’s decision to apply the general principle of non-interference with a beneficiary’s right to demand payment from a bank under its guarantee, unless fraud was involved. The Appeal Court<sup>105</sup> stated:

‘Irrevocable Letters of Credit and bank guarantees given in circumstances such that they are the equivalent of an irrevocable Letter of Credit have been said to be the life blood of commerce. Thrombosis will occur if, unless fraud is involved, the courts intervene and thereby disturb the mercantile practice of treating rights thereunder as being the equivalent of cash in hand.’

In the *Bolivinter*<sup>106</sup> case the Court of Appeal held that before the fraud rule can be applied there must be clear evidence as to:

- the fact of the fraud and
- the banks knowledge of the fraud at the time the demand was made.

As per the above cases it would appear that English courts have a very strict approach to the concept of fraud. In *United Trading Corporation SA and Murray Clayton Ltd v Allied Arab Bank Ltd and Others*<sup>107</sup> Ackner LJ observed:

‘There is no suggestion that this more liberal approach has resulted in the commercial dislocation which has, by implication at least, been suggested would result from rejecting the respondent's submissions as to the standard of proof required from the plaintiffs. Moreover, we would find it an unsatisfactory position if, having established an important exception to what had previously

<sup>103</sup> Xiang G *The Fraud Rule in the Law of Letters of Credit: A Comparative Study* (2002) 48.

<sup>104</sup> *Intraco Ltd v Notis Shipping Corporation (The ‘Bhoja Traders’)* [1981]2 Lloyd’s Rep 256 (CA).

<sup>105</sup> *Intraco Ltd v Notis Shipping Corporation (The ‘Bhoja Traders’)* [1981] 2 Lloyd’s Rep 256 (CA) 257.

<sup>106</sup> *Bolivinter Oil SA v Chase Manhattan Bank* [1984] 1 Lloyd’s Rep 251, [1984] 1 WLR 393, [1984]

1 All ER 352.

<sup>107</sup> *Intraco Ltd v Notis Shipping Corporation (The ‘Bhoja Traders’)* (1985) 2 Lloyd’s Rep 554 (CA) at 561.

been thought an absolute rule, the courts in practice were to adopt so restrictive an approach to the evidence required as to prevent themselves from intervening. Were this to be the case, impressive and high-sounding phrases such as "fraud unravels all" would become meaningless.'

This less strict approach is evident in earlier cases<sup>108</sup> as well as more recent cases<sup>109</sup> and can be interpreted as a move away from the strict non-interference approach.<sup>110</sup>

## 2.5.2 The Concept of Fraud: Fraud in the Narrow and Wide Sense

Fraud encompasses a myriad variety of different schemes but all have a common denominator which is dishonesty.<sup>111</sup> In *State Trading Corpn of India Ltd v ED and F Man (Sugar) Ltd and ANR*<sup>112</sup> Lord Denning MR stated the only necessary requisite is that the buyer, when giving notice of default, should honestly believe there had been a default on the part of the seller.

In *GKN Contractors Ltd v Lloyds Bank Plc*<sup>113</sup> the court held to the effect that an intention on the part of the beneficiary to mislead is intrinsic in the meaning of fraud and that another basis to depart from the independence principle is where the beneficiary wrongly believe a claim to be valid but the bank knows otherwise.<sup>114</sup>

In *Deutsche Ruckversicherung AG v Walbrook Insurance Co Ltd and Others; Group Josi Re (formally known as Group Josi Reassurance SA) v Walbrook Insurance Co Ltd and Others*<sup>115</sup> Phillips J stated that there is no fraud if the beneficiary has a bona fide claim to payment under the underlying contract<sup>116</sup> but such beneficiary will be committing fraud if a claim for

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<sup>108</sup> *Potton Homes Ltd v Coleman Contractors Ltd* (1984) 28 BLR (CA) and *Tulkan Timber Ltd v Barclays Bank Plc* (1987) 1 Lloyd's Rep 171 (QB).

<sup>109</sup> *Themehelp v West* (1996) QB 84 (CA) and *Kvaerner John Brown v Midlands Bank Plc* 91998) CLC 446.

<sup>110</sup> Xiang G *The Fraud Rule in the Law of Letters of Credit: A Comparative Study* (2002) 50.

<sup>111</sup> Warne D and Elliott N *Banking Litigation* 2 ed (2005) at 260.

<sup>112</sup> *State Trading Corpn of India Ltd v ED and F Man (Sugar) Ltd and ANR* (1981) Com LR 235 (CA).

<sup>113</sup> *GKN Contractors Ltd v Lloyds Bank Plc* (1985) 30 BLR 48 (CA).

<sup>114</sup> Ndekugri I 'Performance Bonds and Guarantees: Construction Owners and Professionals Beware' (November/December 1999) 125 *Journal of Construction Engineering and Management* 428 at 433.

<sup>115</sup> *Deutsche Ruckversicherung AG v Walbrook Insurance Co Ltd and Others; Group Josi Re (formally known as Group Josi Reassurance SA) v Walbrook Insurance Co Ltd and Others* (1994) 4 All ER 181 (QB).

<sup>116</sup> *Deutsche Ruckversicherung AG v Walbrook Insurance Co Ltd and Others; Group Josi Re (formally known as Group Josi Reassurance SA) v Walbrook Insurance Co Ltd and Others* (1994) 4 All ER 181 (QB) at 196E.

payment should be made knowingly it had no such entitlement.<sup>117</sup> Notwithstanding the aforesaid there is no mandatory obligation of actual proof of dishonest or male fide intentions of the beneficiary, or of his actual knowledge of non-entitlement. These are derived from the established facts as was the case in *Themehelp Ltd v West and Others*<sup>118</sup> and *Kvaerner John Brown v Midlands Bank Plc*.<sup>119</sup>

In *Deutsche Ruckversicherung AG v Walbrook Insurance Co Ltd and Others* there is indication that fraud is not limited to the documents alone (fraud in the narrow sense) but could also be in the underlying contracts (fraud in the wide sense). In *Themehelp Ltd v West and Others* the required document was not even presented which means that no fraudulent document was involved. The alleged fraud was that the beneficiary made misrepresentations in the underlying contract in the form of non-disclosure. The court however granted an interlocutory injunction.

In *United City Merchants v Royal Bank of Canada*<sup>120</sup> the court suggested that fraud means misrepresentation and that it is limited to fraud in the documents. It is submitted that because the basis of the fraud exception is public policy there is no reason why the maxim *ex turpi causa non oritur action* can also not be invoked. It is further submitted that fraud means fraud in the documents (fraud in the narrow sense) as well as fraud in the underlying contract (fraud in the wide sense).

### 2.5.3 Standard of Proof of Fraud

Like in civil cases the ordinary standard of proof, which is the balance of probabilities<sup>121</sup> also apply to a case of fraud. The difference though is that the court weighs the evidence with regard to the gravity of the allegation.<sup>122</sup> This is a very high degree of probability<sup>123</sup> as was held in

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<sup>117</sup> *Deutsche Ruckversicherung AG v Walbrook Insurance Co Ltd and Others; Group Josi Re (formally known as Group Josi Reassurance SA) v Walbrook Insurance Co Ltd and Others* (1994) 4 All ER 181 (QB) at 197E.

<sup>118</sup> *Themehelp Ltd v West and Others* (1996) QB 84 (CA).

<sup>119</sup> *Kvaerner John Brown v Midlands Bank Plc* (1998) CLC 446.

<sup>120</sup> *United City Merchants v Royal Bank of Canada* (1983) AC 168 (HC).

<sup>121</sup> Hugo C F *The Law Relating to Documentary Credits from a South African Perspective with Special Reference to the Legal Position of the Issuing and Confirming Banks* (published LLD, University of Stellenbosch) at 278.

<sup>122</sup> *Themehelp Ltd v West and Others* (1996) QB 84 (CA).

<sup>123</sup> Hugo C F *The Law Relating to Documentary Credits from a South African Perspective with Special Reference to the Legal Position of the Issuing and Confirming Banks* (published LLD, University of Stellenbosch (1996)) at 278.

*Rafsanjan Pistachio Producers Co-Operative v Bank Leumi (UK) Plc*<sup>124</sup> when Hirst J stated that ‘a very heavy burden of proof rests upon the defendants to establish their case to the highest level of probability’.

To prove fraud a general formula is used which dictates that:

- the fraud must be very clearly established, or
- the fraud must be clear and obvious, and
- the proof must be immediately available without the need for a lengthy and in-depth investigation into the underlying contract.<sup>125</sup>

The fact that a beneficiary made previous fraudulent demands for payment is not proof that a future demand under the same instrument will be fraudulent.<sup>126</sup>

In *United Trading Corporation SA and Murray Clayton Ltd v Allied Arab Bank Ltd and Others*<sup>127</sup> Ackner LJ provided specific guidance pertaining to the standard of evidence required and held:

‘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 (see *Bolivinter Oil S.A. v Chase Manhattan Bank N.A. . . .*). 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 the opportunity to answer the allegation and to have failed to provide any or any adequate answer in circumstances where one could properly be expected. If the Court considers that on the material before it the only realistic inference to draw is that of fraud, then the seller would have made out a significant case of fraud.’

#### **2.5.4 The Time at Which Knowledge of Fraud Must Be Proved**

The exact time at which the fraud must be clear to the beneficiary and the bank is important. There must be clear evidence of fraud at the time of presentation of the documents. In *United City*

<sup>124</sup> *Rafsanjan Pistachio Producers Co-Operative v Bank Leumi (UK) Plc* (1992) 1 Lloyd’s Rep 513 (QB) at 525.

<sup>125</sup> *Edward Owen Engineering Ltd v Barclays Bank International Ltd and Another* (1978) QB 159 (CA).

<sup>126</sup> Enonchong N ‘The Autonomy Principle of Letters of Credit: An Illegality Exception?’ 2006 *Lloyd’s Maritime and Commercial Law Quarterly* 85-86.

<sup>127</sup> *United Trading Corporation SA and Murray Clayton Ltd v Allied Arab Bank Ltd and Others* (1985) 2 Lloyd’s Rep 554 (CA).

*Merchants v Royal Bank of Canada*<sup>128</sup> the court stressed the fact that it was the time that the documents presented under the Letter of Credit were not truthful that was critical.<sup>129</sup>

It is clear that the beneficiary must know of the fraud at the time of presentation, otherwise he cannot be party to the fraud. On the other hand, it is not so clear that the bank does not need to know of the fraud at the time of presentation. Because the fraud exception is based on public policy it would be irrational if the bank could not rely on the fraud exception if the demand were rejected on some other ground at the time of presentation and later but prior to the trial became aware of the beneficiary's fraud. A similar approach was followed in *Rafsanjan Pistachio Producers Co-Operation v Bank Leumi (UK) Plc.*<sup>130</sup>

In *Mahonia Ltd v JP Morgan Chase Bank and Another*<sup>131</sup> Colman J was of the opinion that it was never the intent of the earlier cases to restrict the time by which evidence of fraud had to be available to the point of negating evidence of fraud which became available after the presentation of the documents but before trial. It was rather to compel the bank to make a decision whether or not to pay soon after the presentation of the documents. The bank would normally only refuse payment if there is compelling evidence available at that stage. Should the bank refuse to pay due to a suspicion of fraud and is sued, evidence obtained, prior to the trial, that substantiate the fraud suspicion should be admissible.<sup>132</sup>

Previously the bank was obligated to honour a demand if such demand complied with the terms of the Letter of Credit .The only acceptable reason for the bank not to honour such demand was that at the time of the presentation the bank had clear evidence from which the only inference that could be drawn was that it was fraudulent. This situation changed to that the bank now may also refuse to honour a demand for payment relying on evidence obtained between the demand and the trial. Such evidence must be to the effect that:

- the demand was fraudulent; or
- the Letter of Credit was voidable for fraudulent misrepresentation when the demand was made.

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<sup>128</sup> *United City Merchants v Royal Bank of Canada* (1983) AC 168 (HL) ([1982] 2 Lloyd's Rep 1 (HL)).

<sup>129</sup> *United City Merchants v Royal Bank of Canada* (1996) 1 Lloyd's Rep 345 at 360.

<sup>130</sup> Warne D and Elliott N *Banking Litigation* 2 ed (2005) at 261-262.

<sup>131</sup> *Mahonia Ltd v JP Morgan Chase Bank and Another* (2003) 2 Lloyd's Rep 911 (QB (Com Ct)).

<sup>132</sup> Hugo C *Documentary Credits and Independent Guarantees* ABLU 2005 (a paper delivered at the 2005 Annual Banking Law Update held at the Indaba Hotel, Johannesburg on 20 April 2005 (unpaginated)).

### 2.5.5 Summary

The effect of fraud is that it stays the operation of the independence principle in Letters of Credit. This has been acknowledged by English courts as a matter of principle and the fraud exception is generally acknowledged in the United Kingdom. Notwithstanding this, the fraud rule has not been significantly developed with regard to Letters of Credit and most of the case law involves demand guarantees.

English courts adopted a very strict and narrow approach with regards to the concept of fraud and the evidence necessary to prove such fraud. This stringent view of courts in the United Kingdom and its reluctance to interfere with the operation of Letters of Credit is prevalent and widely demonstrated in case law as discussed above. It is clear that the courts view the nature of the banks' obligation as absolute and independent. A very heavy burden of proof is placed on the plaintiffs by courts in the United Kingdom requiring them to establish the existence of clear or obvious fraud which must also be known to the issuer before the fraud exception can be invoked. It is also common cause that the beneficiary must know of the fraud at the time of the presentation to be party to the fraud.

Although the ordinary standard of proof, which is a balance of probability, in civil cases also apply in a case of fraud, the courts in fraud cases weigh the evidence with due regard to the gravity of the particular allegation. The general accepted formula for evidence required to establish fraud is that it should be the only realistic inference to draw that the demand was fraudulent. Such proof must also be immediately available without the need for a lengthy and in-depth investigation into the underlying transaction. The only exception available to the bank for not honouring a demand for payment is if clear fraud exists, the beneficiary is party to such fraud and the bank had knowledge or notice of the fraud.

The manner in which the independence principle has been applied and the forbidding language used in the cases discussed above is indicative that the courts employ a very restricted concept of fraud when looking at the conceptive issues of fraud. Here also case law indicates a very reluctant attitude by courts to interfere with banks' payment obligations under Letters of Credit.

The exception, to the principle of independence of Letters of Credit, that the bank does not have to pay under a Letter of Credit if it knows that the documents presented to it were forged or that the



request for payment was made fraudulently in circumstances when there was no right to payment is recognised in English law.

What precise kind of factual scenario constitutes fraud was not yet sufficiently enough delved into and the substantive concept of fraud thus remains vague. Although there is a myriad of schemes that may constitute fraud, all of them have one common denominator which is dishonesty. What is also further clear is that fraud can be determined by reference to the underlying transaction. No mandatory obligation exists for actual proof of dishonest or mala fide intention on the part of the beneficiary or evidence of the beneficiary's actual knowledge of his non-entitlement to payment. In *United City Merchants v Royal Bank of Canada*<sup>133</sup> the court was of the opinion that fraud means misrepresentation and that it was restricted to fraud in the documents, meaning fraud in the narrow sense. To attempt an answer to the question if fraud has a wider meaning than misrepresentation, it is submitted that since the basis of the fraud exception is public policy there is no reason to limit its scope to misrepresentation, as to do that would mean to treat the maxim *ex turpi causa non oritur actio* with contempt. If a beneficiary's demand is fraudulent, in any shape or form, or forged, the fraud exception should be invoked.

The fraud exception under English law has a very high standard of proof which limits its availability. To invoke the exception the evidence of fraud must be clear or obvious. This requires the claimant to show that there is a real prospect of establishing on the available material the only realistic inference to draw is that of fraud. Alleging fraud or showing that there is good reason to suspect fraud would not suffice. Another requirement the claimant must show is that the bank was clearly aware of the fraud.<sup>134</sup> The fraud exception does not offer comprehensive enough protection against abusive calls as it is difficult:

- to establish the fraud and
- satisfying the balance of convenience test

and is thus very cumbersome to invoke in practice.

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<sup>133</sup> *United City Merchants v Royal Bank of Canada* (1983) AC 168 (HL) ([1982] 2 Lloyd's Rep 1 (HL) at 183F-G.

<sup>134</sup> Enonchong N 'The Autonomy Principle of Letters of Credit: An Illegality Exception?' 2006 *Lloyd's Maritime and Commercial Law Quarterly* 85-86.

## 2.6 Conclusion

The fraud rule in English law does not have a statutory provision but developed through case law. English courts adopted a very strict and narrow approach to the fraud concept and placed a heavy burden of proof on plaintiffs to establish the existence of fraud. In contrast, the United States of America codified the fraud rule and courts adopted a relaxed and wide approach to the exception, demonstrating its willingness to grant interim relief to plaintiffs, giving time for the allegation to be proved.

In the following chapter the South African position will be perused in relation to the elements that were discussed in the previous chapter.



## CHAPTER 3

### THE POSITION IN SOUTH AFRICA

#### 3.1 General Overview

The fraud rule in South Africa, like in the United Kingdom, has no statutory provisions but in common law established through case law. It must be noted that South African courts take English court cases as precedent where Letter of Credit disputes are concerned.

Only a few cases<sup>135</sup> in South African law deal with the fraud exception in Letters of Credit. It should however be borne in mind that the obligation of the bank to pay under a Letter of Credit could be compared with the payment obligation of an acceptor of a bill of exchange<sup>136</sup> or with a position of a bank that has guaranteed the payment of a cheque.<sup>137</sup> This leads to the conclusion that cases where the acceptor of a bill of exchange or a bank-guaranteed-cheque raises fraud as a defence against a holder<sup>138</sup> demanding payment, may also be related to cases where fraudulent demands for payment are made in Letters of Credit.<sup>139</sup> Malan and Pretorius are also of the opinion that a holder of a bill of exchange who demands payment fraudulently is acting contrary to his obligation of good faith and is abusing his right.

South African courts draw a distinct difference between fraud and an innocent breach of contract but have not indicated that it will not be prepared to interdict a bank from paying where the basis for such interdict is fraud by the beneficiary in the underlying transaction. To the contrary, evidence exists that South African courts will adopt a wide approach to fraud as an exception to stay the operation of the independence principle in Letters of Credit.<sup>140</sup>

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<sup>135</sup> *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); *ZZ 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); *Union Carriage and Wagon Company v Nedcor Bank Ltd and Another* 1996 CLR 724 (W) and *Vereins-UND Westbank AG v Veren Investments and Others* 2000 (4) SA 238 (W).

<sup>136</sup> Malan F R and Pretorius J T (assisted by S F du Toit) *Malan on Bills of Exchange, Cheques and Promissory Notes* 4 ed (2002) para 143-149.

<sup>137</sup> Malan F R and Pretorius J T (assisted by S F du Toit) *Malan on Bills of Exchange, Cheques and Promissory Notes* 4 ed (2002) para 196.

<sup>138</sup> Malan F R and Pretorius J T (assisted by S F du Toit) *Malan on Bills of Exchange, Cheques and Promissory Notes* 4 ed (2002) para 141-143.

<sup>139</sup> Malan F R and Pretorius J T (assisted by S F du Toit) *Malan on Bills of Exchange, Cheques and Promissory Notes* 4 ed (2002) para 143 at 225.

<sup>140</sup> Van Niekerk J P and Schulze W E *The South African Law of International Trade; Selected Topics* 2 ed (2006) at 314.

In *Phillips v Standard Bank*<sup>141</sup> Phillips imported shoes from an Italian manufacturer and exporter. Payment was secured by an irrevocable Letter of Credit issued by Standard Bank. The terms of the Letter of Credit deferred payment to a certain number of days after presentation of the required documents. On receipt of the goods Phillips discovered that the majority was materially defective. This discovery was made prior to payment in terms of the Letter of Credit. Phillips immediately raised his dissatisfaction with the manufacturer who was willing to consider his complaints but unwilling to postpone payment. Phillips made an application to court for the granting of an interim interdict against the bank prohibiting it from honouring the Letter of Credit.<sup>142</sup>

In giving judgment Goldstone J referred to well-known cases<sup>143</sup> in the United States of America and the United Kingdom dealing with the fundamental nature of Letters of Credit.<sup>144</sup> He held that the dicta in these cases correctly reflected South African law.<sup>145</sup> He furthermore confirmed that a Letter of Credit is independent and autonomous from the underlying transaction. Goldstone J was of the opinion that South African courts should recognise and give effect to the commercial purpose for which irrevocable Letters of Credit had been devised which was to facilitate international trade by assuring payment to the seller, before he part with his goods, and to guarantee that no dispute relating to his performance in terms of the contract will be a basis for non-payment or to delay payment.<sup>146</sup> Goldstone J was of the opinion that where an irrevocable Letter of Credit constituted an independent contract between the bank and the beneficiary, the applicant could not go beyond the required documents and caused payment to be stayed or delayed citing quality of goods or other alleged breaches by the beneficiary in the underlying transaction.<sup>147</sup> The court held that the facts of the case is consistent with an innocent breach of contract,<sup>148</sup> that no fraud on the part of the beneficiary was alleged by the applicant and dismissed the application for an interdict.<sup>149</sup> The court however omitted to mention under which precise conditions and to which extent it would consider the fraud exception.<sup>150</sup>

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<sup>141</sup> *Phillips v Standard Bank* 1985 (3) SA 301 W.

<sup>142</sup> *Phillips and Another v Standard Bank of South Africa Ltd and Others* 1985 (3) SA 301 W at 302A-D.

<sup>143</sup> *Sztejn v J Henry Schroder Bank Corporation* 31 NYS 2d 631 (1941) at 633-634 and *United City Merchants v Royal Bank of Canada* (1983) AC 168 (HL) ([1982] 2 Lloyd's Rep 1 (HL) at 183-184.

<sup>144</sup> *Phillips and Another v Standard Bank of South Africa Ltd and Others* 1985 (3) SA 301 W at 302J-303I, and 304B.

<sup>145</sup> *Phillips and Another v Standard Bank of South Africa Ltd and Others* 1985 (3) SA 301 W at 304B.

<sup>146</sup> *Phillips and Another v Standard Bank of South Africa Ltd and Others* 1985 (3) SA 301 W at 304C-D.

<sup>147</sup> *Phillips and Another v Standard Bank of South Africa Ltd and Others* 1985 (3) SA 301 W at 304D-E.

<sup>148</sup> *Phillips and Another v Standard Bank of South Africa Ltd and Others* 1985 (3) SA 301 W at 303I 304A.

<sup>149</sup> *Phillips and Another v Standard Bank of South Africa Ltd and Others* 1985 (3) SA 301 W at 304.

<sup>150</sup> Van Niekerk J P and Schulze W E *The South African Law of International Trade; Selected Topics* 2 ed (2006) at 314.

The *Phillips* case<sup>151</sup> is a clear indicator that South African courts distinguish between a mere breach of the underlying transaction by a beneficiary and fraud. It also indicates that the former will not necessarily entitle an applicant to stop payment in terms of the Letter of Credit by means of obtaining an interdict against the bank prohibiting it from honouring such demand for payment.<sup>152</sup> Unfortunately the *Phillips* case did not recognise any possible exceptions to the independent principle.<sup>153</sup>

In *Ex parte Sapan Trading (Pty) Ltd* 3 CLD 200 (W) Stegmann J held:<sup>154</sup>

‘It seems to me a necessary implication . . . that when a buyer such as the applicant promises to be bound irrevocably by the principles currently embodied in articles 3 and 4 of [1993] UCP [i.e. the independence principle and the principle that the parties deal in documents not in goods], he implicitly waives in advance any right which he may otherwise have acquired afterwards, on any ground (other than fraud on the part of the seller), to stop payment of the documentary credit by the issuing bank, or to interfere with the payment by attaching the seller’s claim to payment on the part of the issuing bank.’

Only in 1996 in *Loomcraft Fabrics v Nedbank*<sup>155</sup> the Appellate Division (now the Supreme Court of Appeal) pronounced on the principle of independence and its possible limitations in terms of Letters of Credit. The court commented specifically as to the limitations the fraud exception could impose on the independence principle.<sup>156</sup>

In *Loomcraft Fabrics v Nedbank*<sup>157</sup> a South African distribution company, Loomcraft Fabrics, had imported voile fabric from a Portuguese textile-manufacturing company, Perfel. Loomcraft secured payment by obtaining an irrevocable Letter of Credit in favour of Perfel at Nedbank. The Letter of Credit expired on 18 May 1992 and the latest date of shipment was 8 May 1992. The imported fabric arrived in Durban on 18 June 1992 and Loomcraft received it soon afterwards. The goods

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<sup>151</sup> *Phillips and Another v Standard Bank of South Africa Ltd and Others* 1985 (3) SA 301 W.

<sup>152</sup> Hugo C F *The Law Relating to Documentary Credits from a South African Perspective with Special Reference to the Legal Position of the Issuing and Confirming Banks* (published LLD, University of Stellenbosch (1996)) at 322.

<sup>153</sup> Oelofse A N *The Law of Documentary Letters of Credit in Comparative Perspective* (1997) at 464.

<sup>154</sup> This was the court of first instance at 224.

<sup>155</sup> *Loomcraft Fabrics v Nedbank* 1996 (1) SA 812 (A).

<sup>156</sup> Van Niekerk J P and Schulze W E *The South African Law of International Trade; Selected Topics* 2 ed (2006) at 314.

<sup>157</sup> *Loomcraft Fabrics v Nedbank* 1996 (1) SA 812 (A).

arrived later than Loomcraft expected and he was also dissatisfied with its quality.<sup>158</sup> On 4 August 1992 Loomcraft brought an urgent application in the Witwatersrand Local Division for an interdict restraining the bank from honouring payment under the Letter of Credit. The basis for the application was fraudulent misrepresentation by the beneficiary in the documents in terms of the date of shipment.<sup>159</sup>

The alleged fraud on the documents was in relation to the date stamped on the shipping documents as well as a dispute as to the actual place where shipping was executed. Originally 13 May 1992 was stamped on the bill of lading with the wording 'actually on board'. Subsequently this date was corrected to 8 May 1992 as the carrier realised that the goods were received earlier but the words 'actually on board' were not deleted.<sup>160</sup> Interim relief was granted but later, after the beneficiary filed opposing affidavits and arguments were heard by the court, set aside. The application for the granting of an interdict failed and leave to appeal was granted.<sup>161</sup>

The Appellate Division confirmed the independence principle and the bank's obligation to honour a demand for payment by the beneficiary if conforming documents are presented. The court held that only in exceptional circumstances the bank may escape liability to pay. One of these exceptional circumstances is proven fraud by the beneficiary.<sup>162</sup> The court clearly stipulated the requirements of fraud:

- fraud must be clearly established;
- the standard of proof is a balance of probabilities;
- the beneficiary or his agent must present documents with material misrepresentations;
- the beneficiary or his agent must have knowledge of the material misrepresentations;
- the documents must be presented to the bank with the purpose of drawing on the credit.

The court further held that fraud would not be inferred lightly<sup>163</sup> and mere error, misunderstanding or oversight would not amount to fraud.<sup>164</sup>

The court in the Loomcraft case was of the opinion that the facts before it constituted an error

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<sup>158</sup> *Loomcraft Fabrics v Nedbank* 1996 (1) SA 812 (A) at 814G-815B.

<sup>159</sup> *Loomcraft Fabrics v Nedbank* 1996 (1) SA 812 (A) at 815B-C.

<sup>160</sup> *Loomcraft Fabrics v Nedbank* 1996 (1) SA 812 (A) at 820-821.

<sup>161</sup> Van Niekerk J P and Schulze W E *The South African Law of International Trade; Selected Topics* 2 ed (2006) at 315.

<sup>162</sup> *Loomcraft Fabrics v Nedbank* 1996 (1) SA 812 (A) at 815F-J.

<sup>163</sup> *Loomcraft Fabrics v Nedbank* 1996 (1) SA 812 (A) at 816-817 and 822H.

<sup>164</sup> *Loomcraft Fabrics v Nedbank* 1996 (1) SA 812 (A) at 822G-H.

rather than fraud<sup>165</sup> and thus the appeal failed. Similar to the English case of *United City Merchants v Royal Bank of Canada*<sup>166</sup> the court followed a very narrow approach to the fraud exception.

Stegmann J in *Vereins-UND Westbank AG v Veren Investments*<sup>167</sup> also applied ‘the general rule’ as set out in the *Loomcraft case* that the bank has an obligation under an irrevocable Letter of Credit to pay the beneficiary on demand and on presentation of strictly conforming documents. The court held this contractual obligation of the bank towards the beneficiary is also totally independent from the underlying contract of sale between the seller and purchaser except in the case of proven fraud on the part of the beneficiary of which the bank had knowledge or was notified before payment. The court said the burden is on the bank to establish if the alleged fraud is sufficiently well established to justify not honouring a demand for payment under the Letter of Credit.<sup>168</sup>

The principle of independence and the bank’s liability to pay on presentation of strictly conforming documents except in exceptional circumstances that is proven fraud was also confirmed in *Koumantarakis Group CC v Mystic River Investments 45 (Pty) Ltd and Another*.<sup>169</sup>

In *Union Carriage v Nedcor Bank*<sup>170</sup> Union Carriage was an applicant of a standby Letter of Credit and two advance payment guarantees issued by Nedbank and Siemens was the beneficiary. Union Carriage applied for an interdict to prevent Siemens from obtaining payments under all three instruments. These three instruments were payable on the written statement of Siemens that Union Carriage was in breach of the underlying contract. Siemens claimed payment from Nedbank and submitted certificates to the effect that Union Carriage was in breach of the underlying contract.<sup>171</sup>

The court held that payment was guaranteed irrespective of disputes between the parties and if conditions in the credit were met, had to be honoured. Fraud was held to be an exception to this rule. The court further held since fraud, on the part of the beneficiary, were not alleged but in this case explicitly renounced on the part of the beneficiary, under the documentary credits, meant the

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<sup>165</sup> Van Niekerk J P and Schulze W E *The South African Law of International Trade; Selected Topics* 2 ed (2006) at 315.

<sup>166</sup> *United City Merchants v Royal Bank of Canada* (1983) AC 168 (HL) ([1982] 2 Lloyd’s Rep 1 (HL)).

<sup>167</sup> *Vereins-UND Westbank AG v Veren Investments* 2000 (4) SA 238 (w) para 63 at 263.

<sup>168</sup> *Stegmann J in Vereins-UND Westbank AG v Veren Investments* 2000 (4) SA 238 (w) para 130.

<sup>169</sup> *Koumantarakis Group CC v Mystic River Investments 45 (Pty) Ltd and Another* (2007) JOL 19699 (D) para 51.

<sup>170</sup> *Union Carriage v Nedcor Bank* 1996 CLR 724 (W).

<sup>171</sup> *Union Carriage v Nedcor Bank* 1996 CLR 724 (W) at 724-728.

court only had to determine whether the conditions under the credit had been complied with.<sup>172</sup> The court found the conditions for payment was met and refused to grant the interdict.<sup>173</sup> The court stated the fact that the interdict was to prevent the beneficiary from obtaining payment rather than to prevent the bank from honouring the demand for payment was of no consequence to its decision.<sup>174</sup>

What the court said by way of obiter dictum in *Union Carriage v Nedcor Bank*<sup>175</sup> is important. It held had the parties entered into a pactum de non cedendo and the beneficiary then demanded payment under the Letter of Credit, it could possibly have been guilty of fraud. This is a clear indication South African courts would be willing to look beyond the documents, into the underlying transaction, to determine fraud on the part of the beneficiary. This notion is contrary to the narrow interpretation of the fraud exception adopted in the English case *United City Merchants v Royal Bank of Canada*<sup>176</sup> and in turn adopted by the Appellate Division in the South African case *Loomcraft Fabrics v Nedbank*<sup>177</sup> discussed above. The approach in *Union Carriage v Nedbank*<sup>178</sup> is in accordance with the wider approach to the fraud exception as in some later English cases.<sup>179</sup> Since a pactum de non cedendo was not alleged it was not necessary for the court to determine whether or not it would grant an interdict with fraud as a basis.<sup>180</sup>

*Z Z Enterprises v Standard Bank*<sup>181</sup> involved an instrument known as a documentary collection. In a documentary collection, a bank collects payment on behalf of the seller by delivering the required documents to the buyer. The seller does not receive payment until payment was made to the remitting bank by the buyer. The bank does not guarantee payment but acts merely as an intermediary between the buyer and the seller in order to facilitate payment. Thus a documentary collection does not qualify as a Letter of Credit. The instrument is high risk since there is no guarantee to payment and is usually only used when the parties know each other and has a long

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<sup>172</sup> *Union Carriage v Nedcor Bank* 1996 CLR 724 (W) at 734-735.

<sup>173</sup> *Union Carriage v Nedcor Bank* 1996 CLR 724 (W) at 735.

<sup>174</sup> *Union Carriage v Nedcor Bank* 1996 CLR 724 (W) at 734.

<sup>175</sup> *Union Carriage v Nedcor Bank* 1996 CLR 724 (W).

<sup>176</sup> *United City Merchants v Royal Bank of Canada* [1982] 2 All ER 720.

<sup>177</sup> *Loomcraft Fabrics v Nedbank* 1996 (1) SA 812 (A).

<sup>178</sup> *Union Carriage v Nedbank* 1996 CLR 724 (W).

<sup>179</sup> *Deutsche Rückversicherung AG v Walbrook Insurance Co Ltd and Others; Group Josi Re (formally known as Group Josi Reassurance SA) v Walbrook Insurance Co Ltd and Others*(1994) 4 All ER 181 (QB) and *Themehelp Ltd v West and Others* (1996) QB 84 (CA).

<sup>180</sup> *Union Carriage v Nedcor Bank* 1996 CLR 724 (W) at 735.

<sup>181</sup> *Z Z Enterprises v Standard Bank* 1995 CLD 769 (W).



standing relationship.<sup>182</sup> Although *Z Z Enterprises v Standard Bank*<sup>183</sup> did not deal with a Letter of Credit but a documentary collection, it is relevant for purposes of dealing with documentary credits. This importance is to be found in the comments made by the court regarding documentary credits.

In *Z Z Enterprises v Standard Bank*<sup>184</sup> an application was brought for an interdict prohibiting the bank from paying under a documentary collection. The case concerned a dispute between a bank and its customer in connection with a documentary collection which was subject to the 1978 version of the ICC Uniform Rules for Collections.<sup>185</sup> *Z Z Enterprises* applied for an interdict and relied on the fraud of the beneficiary as basis for the application. The interdict was to prevent Standard Bank from making payment to an Indian remitting bank.

The obiter dictum in *Z Z Enterprises v Standard Bank*<sup>186</sup> refers to the independence principle as it relates to commercial Letters of Credit and remarked that courts should give effect to the commercial purpose for which Letters of Credit has been created. The court confirmed irrevocable Letters of Credit constituted an autonomous transaction between an issuing bank and the beneficiary. It further confirmed the applicant could not go behind the documents and suspends payment because of disputes concerning the quality of goods or other alleged breaches of contract by the beneficiary. Notwithstanding this the court said in appropriate circumstances there is no reason why the fraud exception would not be applicable in South African law. The court was of the opinion to invoke the fraud exception there must be 'clearly established' fraud.<sup>187</sup> The court found the alleged facts before it constituted a mere breach of contract and not fraud.<sup>188</sup> The application for an interdict was denied as *Z Z Enterprises* could not make out a prima facie case of fraud.<sup>189</sup>

The above case law indicates that in appropriate circumstances and where fraud has been proven on the part of the beneficiary South African courts will be inclined to interdict a bank under a

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<sup>182</sup> Van Wyk 'Letters of Credit and Attachment Proceedings' (September 1995) *De Rebus* 575 at 575.

<sup>183</sup> *United City Merchants v Royal Bank of Canada* 1995 CLD 769 (W).

<sup>184</sup> *Z Z Enterprises v Standard Bank* 1995 CLD 769 (W).

<sup>185</sup> I CC Publication No 322, Paris (1978).

<sup>186</sup> *Z Z Enterprises v Standard Bank* 1995 CLD 769 (W).

<sup>187</sup> Oelofse A N *Developments in the Law of Documentary Letters of Credit* ABLU 1996 (a paper delivered at the 1996 Annual Banking Law Update held at the Indaba Hotel, Johannesburg (unpaginated) note 81 at 14.

<sup>188</sup> *Z Z Enterprises v Standard Bank* 1995 CLD 769 (W) 783.

<sup>189</sup> *Z Z Enterprises v Standard Bank* 1995 CLD 769 (W) 778-784.

Letter of Credit prohibiting it to effect payment if fraud is prevalent.<sup>190</sup> What would constitute appropriate circumstances and what exact standard of proof is required is not clear yet. The fraud exception is still under developed in South African law and South African courts have not had enough opportunity to deal with the exception due to a lack of cases raising the exception. Taken the available case law on the fraud exception in South Africa it seems that South African courts, should other cases arise, would follow the strict approach to the exception as used by English courts.

### 3.2 The Concept of Fraud: Fraud in the Narrow and Wide Sense

Fraud in the narrow sense is fraud committed by the beneficiary or his agent in the documents and fraud in the wide sense is fraud in the underlying contract i.e. dispatching goods of an inferior quality as to what was agreed upon.<sup>191</sup>

In the United Kingdom the fraud exception in relation to commercial Letters of Credit are restricted to fraud in the narrow sense, meaning fraud which is committed in the documents. The authority for this approach is the House of Lords decision in *United City Merchants v Royal Bank of Canada*.<sup>192</sup> The more recent cases in England indicate that English courts are willing to move away from this approach.<sup>193</sup> These cases indicate the willingness of English courts to interpret the fraud exception in a wide sense, meaning they are willing to go beyond the documents and look at the beneficiary's conduct, in relation to the underlying transaction, to determine if he made himself guilty of fraud. The full scope of the fraud exception in terms of English law is yet to be determined.<sup>194</sup>

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<sup>190</sup> Van Niekerk J P and Schulze W E *The South African Law of International Trade; Selected Topics* 2 ed (2006) at 315.

<sup>191</sup> Van Niekerk J P and Schulze W E *The South African Law of International Trade; Selected Topics* 2 ed (2006) at 315.

<sup>192</sup> *United City Merchants v Royal Bank of Canada* (1983) AC 168 (HL) ([1982] 2 Lloyd's Rep 1 (HL)).

<sup>193</sup> *G K N Contractors Ltd v Lloyds Bank plc* (1985) 30 BCR 48 (ca); *Deutsche Rückversicherung A G v Walbrook Insurance Co Ltd and Others: Group Josi Re* (formerly known as *Group Josi Reassurance SA*) *V Walbrook Insurance Co Ltd and Others* (1996) 1 Lloyd's Rep 345 (CA) ([1996] 1 WLR 1152 (CA); AND [1996] 1 ALL ER 791 (CA); *Themehelp Ltd v West* {1996} QB 84 (CA); [1995] ALL ER 215 (CA) and [1995] 3 WLR 751 (CA); and *Balfour Beatty Civil Engineering and Another v Technical and General Guarantee Co Ltd* (2000) 68 Con LR 180 ([2000] CLC 252; and [2000] CILL 1574.

<sup>194</sup> Van Niekerk J P and Schulze W E *The South African Law of International Trade; Selected Topics* 2 ed (2006) at 316.

The Appellate Division of South Africa as per the *Loomcraft Fabrics v Nedbank*<sup>195</sup> judgment seemed to agree with the narrow approach adopted by the House of Lords in *United City Merchants v Royal Bank of Canada*.<sup>196</sup> The *Loomcraft Fabrics v Nedbank* case is a clear indication that South African courts are willing to invoke the fraud exception in a case of forgery or fraud relating to the documents.<sup>197</sup> It should however be borne in mind that the Appellate Division in *Loomcraft Fabrics v Nedbank* dealt with alleged fraud in the documents and was not asked for relief because of fraudulent conduct on the part of the beneficiary in the underlying contract. Hence the court found it not necessary to deal with fraud outside the scope of the documents.<sup>198</sup> It was argued that the *Loomcraft Fabrics v Nedbank* judgment cannot be regarded as the authority to determine the scope of the fraud exception because of this reason.<sup>199</sup>

It was also submitted that the court in *Loomcraft Fabrics v Nedbank* adopted the *United City Merchants v Royal Bank of Canada*<sup>200</sup> approach before the more recent English judgments<sup>201</sup> which showed a move away from the strict narrow approach towards a more flexible wider approach when interpreting the fraud exception. It could be argued that should the court in *Loomcraft Fabrics v Nedbank* have had insight into the more recent English judgments; it could have reached a conclusion which is more in line with these cases.

It is however only speculation to infer that South African courts will follow the approach of the more recent English cases. Although there are indications that it will follow a wide approach<sup>202</sup> when interpreting fraud, by the beneficiary, as an exception to the independence principle of Letters of Credit, there is also indications that South African courts would be reluctant to interdict a

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<sup>195</sup> *Loomcraft Fabrics v Nedbank* 1996 (1) SA 812 (A).

<sup>196</sup> Van Niekerk J P and Schulze W E *The South African Law of International Trade; Selected Topics* 2 ed (2006) at 315.

<sup>197</sup> Van Niekerk J P and Schulze W E *The South African Law of International Trade; Selected Topics* 2 ed (2006) at 316.

<sup>198</sup> Van Niekerk J P and Schulze W E *The South African Law of International Trade; Selected Topics* 2 ed (2006) at 316.

<sup>199</sup> Van Niekerk J P and Schulze W E *The South African Law of International Trade; Selected Topics* 2 ed (2006) at 317.

<sup>200</sup> *United City Merchants v Royal Bank of Canada* (1983) AC 168 (HL) ([1982] 2 Lloyd's Rep 1 (HL)).

<sup>201</sup> *G K N Contractors Ltd v Lloyds Bank plc* (1985) 30 BCR 48 (ca); *Deutsche Ruckversicherung A G v Walbrook Insurance Co Ltd and Others: Group Josi Re* (formerly known as *Group Josi Reassurance SA*) *V Walbrook Insurance Co Ltd and Others* (1996) 1 Lloyd's Rep 345 (CA) ([1996] 1 WLR 1152 (CA); AND [1996] 1 ALL ER 791 (CA); *Themehelp Ltd v West* {1996} QB 84 (CA); [1995] ALL ER 215 (CA) and [1995] 3 WLR 751 (CA); and *Balfour Beatty Civil Engineering and Another v Technical and General Guarantee Co Ltd* (2000) 68 Con LR 180 ([2000] CLC 252; and [2000] CILL 1574.

<sup>202</sup> *Union Carriage v Nedcor Bank* 1996 CLR 724 (W) at 735 and Van Niekerk J P and Schulze W E *The South African Law of International Trade; Selected Topics* 2 ed (2006) at 314.

bank from paying if the fraud constitutes the performance rendered by the beneficiary in the underlying contract.<sup>203</sup>

A compelling argument has been made by Van Niekerk and Schulze for South African courts to adopt a wide approach to the fraud exception in that:

- it would be in accordance with judicial developments elsewhere;
- it is only logical that should courts consider fraud on the documents it should also consider fraud in the underlying transaction;
- in adopting the wide approach the onus is on the applicant to allege and prove the fraud;
- there is no duty on the bank to investigate the possibility of fraud in the underlying transaction;
- if fraud is alleged by the applicant in the underlying transaction, the requirements established by the court in *Loomcraft Fabrics v Nedbank* would still have to be satisfied;
- the strict test for fraud established in *Loomcraft Fabrics v Nedbank* will have a limiting effect on frivolous and applicant-inspired litigation with its basis on the fraud exception.<sup>204</sup>

Van Niekerk and Schulze<sup>205</sup> are of the opinion South African banks would prefer courts to follow the narrow approach to the fraud exception as any exception to the independence principle create difficulties for banks especially those banks that offer documentary collections as instruments.

### 3.3 Standard of Fraud

In *Loomcraft Fabrics v Nedbank*<sup>206</sup> the Appellate Division held that the alleged fraud must be established clearly, the required burden of proof was the ordinary proof required in civil cases which must be discharged on a balance of probabilities and the court will not infer fraud lightly. The court in *Loomcraft Fabrics v Nedbank*<sup>207</sup> referred to *Gates v Gates*<sup>208</sup> where Watermeyer J A stated:

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<sup>203</sup> Van Niekerk J P and Schulze W E *The South African Law of International Trade; Selected Topics* 2 ed (2006) at 314.

<sup>204</sup> Van Niekerk J P and Schulze W E *The South African Law of International Trade; Selected Topics* 2 ed (2006) at 317.

<sup>205</sup> Van Niekerk J P and Schulze W E *The South African Law of International Trade; Selected Topics* 2 ed (2006) at 316.

<sup>206</sup> *Loomcraft Fabrics v Nedbank* 1996 (1) SA 812 (A).

<sup>207</sup> *Loomcraft Fabrics v Nedbank* 1996 (1) SA 812 (A) at 817F-G.

<sup>208</sup> *Gates v Gates* 1939 AD 150 @155.

‘It is true that in certain cases more especially in those which charges of criminal or moral conduct are made, it has repeatedly been said that such charges must be proved by the “clearest” evidence or “clear and satisfactory” evidence, or “clear and convincing” evidence, or some similar phrase. There is not, however, in truth any variation in the standard of proof required in such cases. The requirement is still proof sufficient to carry conviction to a reasonable mind, but the reasonable mind is not so easily convinced in such cases because in a civilised community there are moral and legal sanctions against immoral and criminal conduct and consequently probabilities against such conduct are stronger than they are against conduct which is not immoral or criminal.’

Reference was also made to *Gilbey Distillers and Vintners (Pty) Ltd and Others v Morris NO and Another*.<sup>209</sup> It can thus be said the approach of the Appellate Division in *Loomcraft Fabrics v Nedbank* to the proof of fraud is firmly established in South African law.<sup>210</sup> In *Z Z Enterprises v Standard Bank*<sup>211</sup> the court held ‘clearly established’ fraud as a requisite to invoke the fraud exception. It is the opinion of Van Niekerk and Schulze that the court in *Z Z Enterprises v Standard Bank* may have used the words ‘clearly established’ to invoke the fraud exception and to indicate that no prima facie right has been proved.<sup>212</sup> The degree of how convincing the evidence must be is still not established in South African law.<sup>213</sup> However, as stated above, the holder of a bill of exchange who enforces payment fraudulently is acting contrary to the demands of good faith and is abusing his right.<sup>214</sup>

In *Loomcraft Fabrics v Nedbank* the Appellate Division held that the burden of proof, in cases where the applicant sought to interdict the bank from paying on a Letter of Credit, is the ordinary proof required in civil cases. The court also held that fraud would not be inferred lightly. The latter statement, it could be argued, is because the court in fact does need a higher degree of evidence or something substantively more than the normal burden of proof, which is a balance of probabilities,

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<sup>209</sup> *Gilbey Distillers and Vintners (Pty) Ltd and Others v Morris NO and Another* 1990 (2) SA 217 (SE) at 226A.

<sup>210</sup> Hugo C F *The Law Relating to Documentary Credits from a South African Perspective with Special Reference to the Legal Position of the Issuing and Confirming Banks* (published LLD, University of Stellenbosch (1996)) at 324.

<sup>211</sup> *Z Z Enterprises v Standard Bank* 1995 CLD 769 (W).

<sup>212</sup> Van Niekerk J P and Schulze W E *The South African Law of International Trade; Selected Topics* 2 ed (2006) at 316.

<sup>213</sup> Oelofse A N *The Law of Documentary Letters of Credit in Comparative Perspective* (1997) at 480.

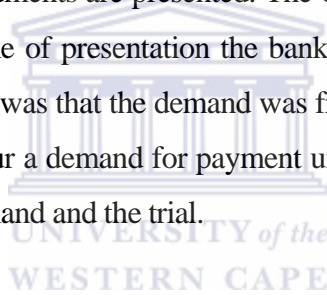
<sup>214</sup> Malan F R and Pretorius J T (assisted by S F du Toit) *Malan on Bills of Exchange, Cheques and Promissory Notes* 4 ed (2002) para 143 at 225.

or mere prima facie right to infer fraud.<sup>215</sup>

### **3.4 The Time at Which Knowledge of Fraud Must Be Proved**

The courts in South African cases which involve the fraud exception did not provide any guidance as to at what time the fraud had to be clear to the beneficiary and the bank. Although this situation created a lacuna in South African law, specifically in Letter of Credit cases which involve the fraud exception, it is submitted that South African courts would most probably follow the precedents set by English courts.

To summarise the English position discussed above, it will be remembered that English law demands clear evidence of fraud at the time of presentation of the documents.<sup>216</sup> The original position under English law was that banks were obliged to honour a demand for payment under a Letter of Credit if conforming documents are presented. The only acceptable reason not to honour such a demand was that at the time of presentation the bank had clear evidence from which the only inference that could be drawn was that the demand was fraudulent. The position subsequently changed to, the bank may dishonour a demand for payment under a Letter of Credit by relying on evidence obtained between the demand and the trial.



### **3.5 Fraud and Interdicts**

If fraud is established, the burden of proof is satisfied and the circumstances are conducive, South African courts will interdict a bank from honouring a payment obligation under a Letter of Credit<sup>217</sup> but only in exceptional circumstances.<sup>218</sup> Where fraud is discovered before payment by the bank the applicant of a Letter of Credit can either apply for an interdict prohibiting the bank from paying or prohibiting the beneficiary from making a demand or receiving payment or both. Should fraud only be discovered after the bank has honoured a demand for payment by the

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<sup>215</sup> Van Niekerk J P and Schulze W E *The South African Law of International Trade; Selected Topics* 2 ed (2006) at 315.

<sup>216</sup> *United City Merchants v Royal Bank of Canada* [1982] 2 All ER 720.

<sup>217</sup> Van Niekerk J P and Schulze W G *The South African Law of International Trade: Selected Topics* 2 ed (2006) at 315.

<sup>218</sup> *Union Carriage v Nedcor Bank* 1996 CLR (W) at 732 and *Loomcraft Fabrics v Nedbank* 1996 (1) SA 812 (A) at 816-817.

beneficiary, the applicant's recourse lies in civil litigation.<sup>219</sup> In either case the applicant may also apply for an anti-dissipation interdict restraining the beneficiary from dissipating his assets until the fraud issue is settled between the disputing parties.

*Phillips v Standard Bank*<sup>220</sup> and *Loomcraft Fabrics v Nedbank*<sup>221</sup> are two cases where the applicants brought applications to prohibit the banks from paying under Letters of Credit but were unsuccessful in both instances. In *Z Z Enterprises v Standard Bank*<sup>222</sup> the applicant brought an application for an interdict to restrain the bank from paying under a documentary collection.<sup>223</sup> In this case as well as in *Loomcraft Fabrics v Nedbank* the court held that for an application for an interdict to be successful the fraud of the beneficiary has to be clearly established. In these circumstances the court would be willing to grant such order but this may not always be the case and it is only suggestive value of the course a South African court might take in similar circumstances.

*Union Carriage v Nedcor Bank*<sup>224</sup> is the only case in South African law where an application for an interdict had been made restraining the beneficiary from receiving payment under a Letter of Credit. Although the application was unsuccessful the case serves as indication that South African courts would be willing to grant such interdicts where fraud is clearly established but only in most exceptional circumstances.<sup>225</sup>

An interim interdict is a court order which either preserves or restores the status quo pending the final determination of these rights. It does not involve nor affect a final determination of this right. An applicant applying for an interdict against a bank or beneficiary who proved established fraud would also have to satisfy the other requirements for an interim interdict. It must be remembered that the rules governing the requirements of granting an interdict is based on Roman-Dutch law<sup>226</sup> but English judgments dealing with injunctions influenced the practical application of these rules to a great extent.<sup>227</sup>

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<sup>219</sup> Van Niekerk J P and Schulze W G *The South African Law of International Trade: Selected Topics* 2 ed (2006) at 317.

<sup>220</sup> *Phillips v Standard Bank* 1985 (3) SA 301 (W).

<sup>221</sup> *Loomcraft Fabrics v Nedbank* 1996 (1) SA 812 (A).

<sup>222</sup> *Z Z Enterprises v Standard Bank* 1995 CLD 769 (W).

<sup>223</sup> Although this is not a Letter of Credit it is still relevant for purposes of dealing with documentary credits.

<sup>224</sup> *Union Carriage v Nedcor Bank* 1996 CLR 724 (w).

<sup>225</sup> *Union Carriage v Nedcor Bank* 1996 CLR 724 (w) at 732.

<sup>226</sup> *Setlogelo v Setlogelo* 1914 AD 221.

<sup>227</sup> Harms L T C *The Law of South Africa* (1998) 11 para 304 at 286.

The provisions regulating civil proceedings also govern the formalities relating to interdicts and to bring a successful application for an interim interdict the following requirements must also be met.<sup>228</sup>

- there is a prima facie right;<sup>229</sup>
- a well-grounded apprehension of irreparable harm if the interim relief is not granted and the ultimate relief is finally granted;
- a balance of convenience in favour of the granting of the interim interdict;
- the absence of any other satisfactory remedy.

These requirements were laid down by Corbett J in *L F Boshoff Investments (Pty) Ltd v Cape Town Municipality*.<sup>230</sup>

In *Z Z Enterprises v Standard Bank* established fraud was rebutted by the facts in that it was consistent with a mere breach of contract and did not constitute fraud. The application for an interdict failed because not just was prima facie fraud not established but also an apprehension of irreparable harm and the absence of another satisfactory remedy were not shown.<sup>231</sup>

To firstly prove established fraud and then the other requirements, just to obtain an interim interdict, seems a heavy burden on the applicant and are not easily done.

### 3.6 Summary

English courts' unwillingness to interfere with banks' payment obligations under Letters of Credit where fraud is involved was evident from as early as the 1970s. Although presented with ample opportunities, English courts did not pronounce on the limits and application of the fraud exception. This led to the fraud exception being rather underdeveloped. This affect South Africa as its courts look at English jurisprudence for guidance especially in Letter of Credit disputes.

Although in 1985 the South African court in *Phillips v Standard Bank*<sup>232</sup> referred to fraud, it was

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<sup>228</sup> *Z Z Enterprises v Standard Bank of South Africa Ltd* 1995 CLD 769 (W) 783-784.

<sup>229</sup> Smallberger JA in *Simon No v Air Operations*.

<sup>230</sup> *L F Boshoff Investments (Pty) Ltd v Cape Town Municipality* 1969 (2) SA 256 (C).

<sup>231</sup> *Z Z Enterprises v Standard Bank of South Africa Ltd* 1995 CLD 769 (W) 783-784: the court held that the applicant could have recovered the money sought from its foreign contract partner.

<sup>232</sup> *Phillips v Standard Bank* 1985 (3) SA 301 (W).



not until 1995 in *Loomcraft Fabrics v Nedbank*<sup>233</sup> that the Appellate Division acknowledged and dealt with the fraud exception in Letters of Credit. The Appellate Division in *Loomcraft Fabrics v Nedbank* provided a basis for the fraud exception and indicated that South African courts would interfere with the operation of the independence principle and issue interdicts restraining payment by banks if fraud was clearly established. The other indication was that South African courts would invoke the fraud exception where the required documents was forged or falsified. In other words the court was clear that the fraud exception in relation to Letters of Credit would be triggered where there was fraud in the narrow sense.

There has been no further development of the fraud rule since the *Loomcraft Fabrics v Nedbank*<sup>234</sup> case which makes the application of the fraud rule uncharted ground and creates uncertainty of how South African courts would implement it. One of the uncertainties is that South African courts had not indicated that they will not be prepared to interdict a bank from paying for fraud by the beneficiary in the underlying contract. Although in *Union Carriage v Nedcor Bank*<sup>235</sup> the court, by way of obiter dictum, held that had the parties entered into a pactum de non cedendo and the beneficiary then demanded payment under the Letter of Credit, it could possibly have been guilty of fraud. This is a clear indication that South African courts would be willing to look beyond the documents and acknowledge fraud in the wide sense as a valid exception to the independence principle of Letters of Credit.

From the available case law on the fraud exception in relation to Letters of Credit in South Africa, a strong parallel with English law in South African courts' application of the exception can be sensed. The scope of the fraud rule in South African law still creates a major uncertainty. The obligation of the bank to pay under a Letter of Credit is comparable to the payment obligation of an acceptor of a bill of exchange or that of a bank of a bank-guaranteed cheque. Therefore decisions where the fraud exception has been raised against the payment obligation of the acceptor of a bill of exchange or the bank of a bank-guaranteed cheque should offer some guidance to South African courts when dealing with fraud in relation to Letters of Credit.<sup>236</sup>

A mere breach of contract of sale would not suffice as a ground for staying payment in relation to

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<sup>233</sup> *Loomcraft Fabrics v Nedbank* 1996 (1) SA 812 (A).

<sup>234</sup> *Loomcraft fabrics v Nedbank* 1996 (1) SA 812 (A).

<sup>235</sup> *Carriage v Nedcor Bank* 1996 CLR 724 (W).

<sup>236</sup> Malan F R and Pretorius J T (assisted by S F du Toit) *Malan on Bills of Exchange, Cheques and Promissory Notes* 4 ed (2002) para 143 at 225.

Letters of Credit by interdicting the bank, prohibiting it from honouring payment. This principle was established in *Phillips v Standard Bank*<sup>237</sup> in 1985. If the breach of contract involves fraud on the part of the beneficiary the position might be different. Indications exist that South African courts would accept fraud in the wide sense as an exception to the independence principle in Letters of Credit.

### **3.7 Conclusion**

South African Letter of Credit fraud is under developed, as courts have not had enough opportunities to adjudicate on this issue. This put South African law in a state of limbo in terms of certainty where Letter of Credit fraud exception rules are concerned.

The next chapter will discuss the position in China.



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<sup>237</sup> *Phillips v Standard Bank* 1985 (3) SA 301 (W).

## CHAPTER 4

### THE POSITION IN CHINA

#### 4.1 The Legal System in China

China has a different legal system as compared to South Africa which takes its stance from the United Kingdom in that China's law is based on statutes and thus the approach to the fraud exception in terms of Letters of Credit will differ from the approach adopted above.

The sources of Chinese law include the Constitution of PRC (People's Republic of China) 1982, National People's Congress (NPC) statutory law and other legislative enactments, international treaties, etc.<sup>238</sup> The NPC is China's national legislature and is the supreme source of law in China. Any laws (basic or other) issued by the NPC or its standing Committee are the highest form of law after the Constitution.<sup>239</sup> China's cabinet, the State Council, together with its subordinate ministries and administrative departments are authorised to issue administrative regulations and measures and adopt regulations necessary to implement laws passed by the NPC.<sup>240</sup>

Courts in China are established and supervised by the NPC.<sup>241</sup> Basic, intermediate and higher courts function at local and provincial levels, whereas the Supreme Court and special courts function at national level. Beside the SPC, Maritime courts, which forms part of the special courts, also has power to adjudicate Letter of Credit disputes.<sup>242</sup> Letter of Credit disputes in China should be adjudicated at least by Intermediate courts.<sup>243</sup>

Although China follows the principle of two instances of trials for trial adjudication, first instance and appeal,<sup>244</sup> and higher courts can exercise their power in final judgments of appellate cases creating a binding effect on lower courts, it does not have a formal system of judicial precedent.<sup>245</sup> Notwithstanding the aforesaid lower courts in China often follow judicial interpretations issued by the SPC. The NPC also has authority to interpret statutes<sup>246</sup>

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<sup>238</sup> Shen Z *Jurisprudence* 3 ed (2009) 263-270.

<sup>239</sup> The Constitution 182, article 58, 59 and 100.

<sup>240</sup> The Constitution 182, article 85 and 89, The Legislation law, article 56.

<sup>241</sup> The Constitution 182, article 128.

<sup>242</sup> The provisions of the SPC on Some Issues Concerning the Jurisdiction of Civil and Commercial cases Involving Foreign Elements, articles 1 and 3.

<sup>243</sup> The provisions of the SPC on Some Issues Concerning the Jurisdiction of Civil and Commercial cases Involving Foreign Elements, articles 1 and 3.

<sup>244</sup> The Organic Law, article 12.

<sup>245</sup> Zhang Y 'Reflection on Case Guidance System' (2008) 8 *Journal of Law Application* 34.

<sup>246</sup> The Constitution 182, article 57 and 58.

and the People's Congress at local level has legislative authority as long as its regulations do not conflict with national legislation.<sup>247</sup> The forms of judicial interpretations vary<sup>248</sup> and its functions are wide, to the extent that it may amend a particular statute or even create new statutory provisions.<sup>249</sup>

#### 4.2 Letters of Credit Fraud under Criminal Law

Article 13 of the 'Provision on Penalising Crime on Disrupting Financial Order' stipulates fraud in Letters of Credit is a crime and applies to the rules of economic crimes in criminal law. Letters of Credit is listed separately in China's new criminal law.<sup>250</sup> Article 195 on the crime of Letter of Credit fraud provides the following acts as criminal:

- using a forged or altered Letter of Credit or any of its attached bills or documents;
- using an invalidated Letter of Credit;
- obtaining Letters of Credit fraudulently;
- other types of Letter of Credit fraud.<sup>251</sup>

Crimes in China are approached by analysing four elements – subject, subjective element, object and objective element.<sup>252</sup> Subjects who may commit Letter of Credit fraud include natural persons, with Chinese nationality, foreigners and people without nationality,<sup>253</sup> and legal persons.<sup>254</sup> The subjective element is the intention of illegally possessing the properties of others under the Letter of credit. Intention is limited to direct intention and does not include indirect intention or negligence.<sup>255</sup> The object of Letter of Credit fraud is the harm to the national administering system of the Letter of Credit and public and private property rights.<sup>256</sup> The objective element of Letter of Credit fraud crime includes fraud in the narrow

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<sup>247</sup> The Constitution 182, article 96, 100, 107 and 108.

<sup>248</sup> Brown R 'Understanding Chinese Courts and Legal Process: Law with Chinese Characteristics' 1997 *Kluwer Law International* 69.

<sup>249</sup> Chen Chunlong 'Status and Function of Judicial Interpretation in China' (2003) 1 *China Legal Science Magazine* 24.

<sup>250</sup> The Criminal Law of PRC of 14 March 1997.

<sup>251</sup> Other types of Letter of Credit fraud refer to Letter of Credit soft clauses' fraud.

<sup>252</sup> Wang Z *Criminal Law* 3 ed (2007) 60-61.

<sup>253</sup> PRC Criminal Law, article 8.

<sup>254</sup> PRC Criminal Law, article 200 contains the sanctions of Letter of Credit fraud with regard to legal persons.

<sup>255</sup> Sui Q *Theory and Practice of Dealing with Financial Crime Cases* 1 ed (2006) 130-133.

<sup>256</sup> Wei D and Tang L *Financial Crime Identification and Investigation* (2001) 275.

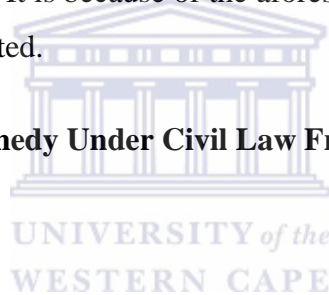
sense (i.e. fraud in the documents) and fraud in the wide sense (fraud in the underlying transaction).<sup>257</sup>

In China Letter of Credit fraud is a conduct crime hence whether actual harm is caused or not is of no consequence.<sup>258</sup> The criminal punishment of Letter of Credit fraud varies depending on the amount involved and can be a fixed-term imprisonment or criminal detention plus a fine. As the amount involved in the Letter of Credit fraud increase, the fixed-term imprisonment and possible fine also increase. According to article 199 life imprisonment or even the death penalty can be imposed depending if the amount involved is particularly large and especially heavy losses are caused to the interests of the State and the people.

The initiation of criminal proceedings in China has the consequence of suspending civil proceedings that may be instituted in terms of the same matter. The approach of the criminal law regime furthermore does not provide an effective remedy for victims of Letter of Credit fraud through public prosecution. It is because of the aforesaid reasons that remedies in terms of civil law will now be investigated.

### **4.3 Letters of Credit Fraud Remedy Under Civil Law Framework**

#### **4.3.1 General Overview**



The law of China is largely codified. To illuminate the process of developing Letters of Credit fraud exception rules, relevant court cases will be examined. Letters of Credit fraud exception rules in China are discussed in terms of legal transplant as the development of Chinese law is mainly a process of transplantation.<sup>259</sup> Legal transplant can be described as the reception of laws from a foreign legal system.

Judgments of cases discussed is purely to recognise the problems and difficulties of handling Letter of Credit fraud disputes where no rules exist over the Letter of Credit issue and to identify an appropriate approach to the Letters of Credit exception rules. New provisions are

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<sup>257</sup> Hou F *Research on Crimes Concerning Letters of Credit and Credit Cards* 1 ed (2005) 27-65.

<sup>258</sup> The amount involved should not be totally ignored, according to article 13 of Criminal Law: Nie L (2000) 'Discussion of Letter of Credit fraud' (2000) 5 *Law Review* (Bimonthly) 31, 36.

<sup>259</sup> Zhu N 'A Case Study of Legal Transplant: The Possibility of Efficient Breach in China' (2005) 36 *Georgetown Journal of International Law* 1145.

formulated to address these problems and the correct approaches in relevant court judgments form part of the new provisions.

### 4.3.2 Approach towards Letter of Credit Fraud Exception Rules in China

Letters of Credit is widely used in China's foreign trade and used in about 80 percent of all transactions involving international payment instruments<sup>260</sup> but according to Nie Letter of Credit usage is dramatically decreasing in China.<sup>261</sup>

### 4.4 Types of Letter of Credit Fraud in China

There are five main types of fraud in China. There is however also other (newer) types of fraud emerging in China.<sup>262</sup> The main types of fraud are:

- When the beneficiary presents fraudulent documents to the bank to demand payment.<sup>263</sup>
- The buyer and the seller conspire to defraud the issuing bank by presenting forged documents.<sup>264</sup>
- The use of a false or a blank-out Letter of Credit or to obtain through deceitful means.<sup>265</sup>
- Back-dated bills of lading, ante-dated bills of lading and re-issued bills of lading.<sup>266</sup>
- Letter of Credit soft clauses fraud. Here the buyer takes advantage of some clauses in the Letter of Credit to defraud the seller. This type of fraud will now be discussed in greater detail.

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<sup>260</sup> Liang S *Documentary Credits and Foreign Trade* 1 ed (2007) 51.

<sup>261</sup> Nie Q 'The Cause and Effect of the Weakness of Letter of Credit and Counter Strategy in Chinese Foreign Trade' (2006) 1 *Academic Research* (Integrated edition) 80.

<sup>262</sup> Cao Y 'New Trend and Corresponding Solutions to Letters of Credit Fraud' (2006) 11 *Practice in Foreign Economic Relations and Trade* 51-52.

<sup>263</sup> Wang J 'Seller's Letter of Credit Fraud against Buyer and Prevention' (2009) 12 *Practice in Foreign Economic Relations and Trade* 64-65.

<sup>264</sup> Li J 'Study on the Legal Problem of Letter of Credit Fraud in International Trade' 2005 *Market Modernisation* Dec. (1<sup>st</sup> Issue) (Sum. No. 451), 46.

<sup>265</sup> Tan X 'Discussion on Letter of Credit Fraud Types, Forms and Preventative Measures' (2005) 26 *Journal of Dalian University* 74, 76.

<sup>266</sup> Gu M *International Trade Fraud and Prevention* (1993) 59-62.

## 4.5 Soft Clauses

According to the Bank of China, the fraud of Letter of Credit soft clauses has led to a loss of millions of dollars.<sup>267</sup> For a beneficiary to obtain payment in terms of Letters of Credit, conforming documents must be presented to the issuing bank. These documents are normally obtainable when clauses in the Letter of Credit are satisfied. These clauses in turn are normally satisfied by the beneficiary itself in the execution of the underlying contract.

Other Letter of Credit clauses, which require special documents to be presented by the beneficiary, for payment to be effected are known as soft clauses. These special documents may be the buyer's receipt of goods, inspection of goods issued by the buyer or the clause may indicate that the Letter of Credit will take effect under some conditions. The primary characteristic of these clauses are that its satisfaction depends entirely or partially on the buyer or other parties and not on the beneficiary's performance of the underlying contract.<sup>268</sup>

Not all soft clauses of Letters of Credit constitute fraud but are instead incorporated in Letters of Credit to accommodate business practices in different countries or facilitate agreements between contracting parties.<sup>269</sup> To determine if a soft clause is fraud the point of departure will be to identify and discuss the main types of Letter of Credit soft clauses. Soft clauses in China are classified into categories:

### Category 1: Conditions for a Valid Letter of Credit

This is where a condition is incorporated in the Letter of Credit by means of a clause. What essentially happens is the clause transforms an irrevocable Letter of Credit into a conditional Letter of Credit.<sup>270</sup> Some Letters of Credit are valid with some conditions<sup>271</sup> such as an authorised certificate from the importer's government. These conditions can be controlled by the buyer or a third party in the buyer's country.

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<sup>267</sup> Cai L and Liu B *International Trade Fraud and Prevention* (1997) 278.

<sup>268</sup> Dong G and Li D (2006) 'Discussion on Letter of Credit Risk and Prevention' (2006) 2 *Market Modernisation*, 14.

<sup>269</sup> Leng H and Jiang X 'Soft Clauses and Forgery – Two Means of Letter of Credit Fraud' (2000) 5 *China Foreign Exchange Management* 33.

<sup>270</sup> Qu X *Finance and Financial Crime* 1 ed (2003) 340-341.

<sup>271</sup> Wu C 'Risk and Prevention of Letters of Credit Soft Clauses' (2005) 12 *Economic Forum* 32.

Other soft clauses reflect the condition in the Letter of Credit amendment. In terms of these clauses the buyer decides whether or not the Letter of Credit will be effective. These clauses are generally not valid because no guarantee is provided to the beneficiary.<sup>272</sup>

#### Category 2: Obstacles to Obtain Documents

Here, obstacles are created for the beneficiary to obtain conforming documents in terms of the Letter of Credit. In this scenario the documents presented must include an inspection certificate or cargo receipt signed by the buyer or a person appointed by the buyer.<sup>273</sup>

#### Category 3; Other Types of Letter of Credit Soft Clauses

Here different types of soft clauses may be combined in the same Letter of Credit. This is where for example category 1 and category 2 are combined in a clause in a Letter of Credit. This can make the Letter of Credit ineffective or the buyer can control the Letter of Credit payment. It is also possible that the Letter of Credit payment can be changed to a conditional commercial payment which is controlled by the buyer.

#### **4.5.1 The Approach of the Courts in China towards Letter of Credit Soft Clauses**

The SPC dealt with cases involving Letter of Credit soft clauses under the principle of contract law. It confirmed the validity of the Letter of Credit soft clauses by regarding it as an agreement between parties. In China, conflicting judicial views between civil and criminal law exist with regard to Letter of Credit soft clauses. Courts in civil cases do not regard Letter of Credit soft clauses as possible Letter of Credit fraud, whereas in terms of PRC Criminal law 1997<sup>274</sup> other types of Letter of Credit fraud are explained as the fraud of soft clauses in the Letter of Credit. Hence the argument that soft clauses are not a form of Letter of Credit fraud<sup>275</sup> and criminal law in China wrongly regulated Letter of Credit soft clauses as fraud, find reference.<sup>276</sup>

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<sup>272</sup> These clauses could be valid if some conditions are satisfied.

<sup>273</sup> Liu A 'Main Forms and Preventative Measures of Letter of Credit Soft Clauses' (2009) 11 *Commercial Accounting* 33-34.

<sup>274</sup> Article 195 (4).

<sup>275</sup> Yang J 'Clarifying Soft clauses in Letters of Credit' (2002) 23 *Journal of Southwest University for Nationalities, Philosophy and Social Sciences* 190-192.

<sup>276</sup> Jin S and Li J *The Law of Letters of Credit* 1 ed (2004) 766.



It should be borne in mind that Letter of Credit soft clauses are not inherently fraudulent. Letter of Credit soft clauses are protective measures implemented by the buyer against Letter of Credit fraud. Therefore Letter of Credit soft clauses cannot totally be prohibited. It should however be remembered that Letter of Credit soft clauses can be abused by the buyer to commit fraud. Ultimately it is the seller's discretion to accept Letters of Credit soft clauses or not.

## **4.6 Development of Letter of Credit Fraud Exception Rules in China**

### **4.6.1 Legislation**

As discussed earlier, the national laws of a country apply to Letter of Credit fraud. In China, several laws deal with Letter of Credit fraud in civil cases. The General Principles of the Civil Law of the PRC article 4 provides that in civil actions, the principles of voluntariness, fairness, giving compensation of an equal value, honesty and credibility shall be observed. Another source for general principles is the PRC contract laws which state that a contract may be void as a result of fraud.<sup>277</sup> According to PRC contract law parties also have a general duty of good faith in conducting and performing contracts.<sup>278</sup>

Several documents were created specifically for Letters of Credit and Letter of Credit fraud in China. The following documents were issued by the SPC specifically to deal with Letter of Credit fraud:

- The 1989 SPC Memorandum concerning Economic Disputes involving Foreign Elements.<sup>279</sup> Under this document:
  - i. The principle of no court order is established.  
This determines the autonomy of the Letter of Credit contract and non-interference by the court should be observed in normal Letter of Credit disputes.
  - ii. Sufficient evidence of Letter of Credit fraud and the immunisation of fraud exception.

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<sup>277</sup> Contract law 1999, article 54.

<sup>278</sup> Contract law 1999 article 6.

<sup>279</sup> Jaing N 'Application of Fraud Exception in Documentary Letters of Credit' (2003) 4 *People Justice* 33, 34. The relevance of this document is with regard to whether a case is Letter of Credit fraud or not.

If sufficient evidence exist that the seller is committing fraud by using the Letter of Credit and payment was not effected yet by the bank, the court may stay the payment under the request of the applicants. Payment shall not be stayed by the court once the issuing bank has accepted the draft because then the bank's obligation to honour the payment become unconditional.

iii. When issuing a court order to stay payment in terms of a Letter of Credit a court must be cautious and is obliged to contact the bank involved, and even consult a higher court if necessary. Because the legitimacy of this document is questionable<sup>280</sup> the value of this memorandum is of a consulting nature and cannot be cited as authority in judgments or orders.

- Notice No.321 in 1998.

This is a guideline on the problem of freezing Letters of Credit payments. It confirms the sufficient evidence of Letter of Credit fraud and the immunisation of fraud exception discussed in (1) (ii) above.

- Notice of the SPC on Prohibiting the Random Order of Stop Payment for Letters of Credit.<sup>281</sup>

This document concerned the adverse influence abroad by randomly-issued stop payment orders by Chinese courts, and its purpose was to maintain the international reputation of the courts and the banks in China. It confirmed:

- I. The independence principle of Letters of Credit
- II. The sufficient evidence of Letters of Credit rule.

- Answers to the Questions of Foreign-related Commercial and Maritime Judicial Practice (1).<sup>282</sup>

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<sup>280</sup> Tai B 'On the Legal Sources of the Application of Letter of Credit Fraud Exception in Mainland China' (2005) 12 *Journal of International Economic Law (Chief Ed.)* 258.

<sup>281</sup> Issued by SPC in 2003.

<sup>282</sup> Issued by the SPC, Civil Courts, the 4<sup>th</sup> Tribunal in 2004.

This document was aimed to reinforce uniform standards of Law Enforcement and all courts could use it as authority. Only questions 59 – 61 relates to Letter of Credit fraud thus only these will be discussed.

Questions 59 – What kind of circumstances constitute Letter of Credit fraud?

This document recognise that there is no uniform international standard in terms of Letter of Credit fraud but Letter of Credit fraud do stay the operation of the independence principle applicable to Letters of Credit. It also recognises fraud can be in the narrow sense and the wide sense. Although both may lead to the defeat of the contract purpose, a serious quality problem in terms of the latter do not constitute Letter of Credit fraud.

Question 60 - In which circumstances can the Letter of Credit payment not be prohibited although Letter of Credit fraud is constituted?

- The issuing bank or holder in due course pays in good faith.
- The nominated party by the issuing bank made payment according to the issuing bank's construction without the knowledge of fraud.
- The confirming bank makes payment in good faith.
- The negotiating bank negotiated in good faith.
- The second beneficiary of a transferable Letter of Credit paid in good faith.

Question 61 – Under what conditions can a Letter of Credit payment be prohibited?

- The court must have jurisdiction.
- The applicant must provide security and sufficient evidence to prove fraud.
- There must be a possibility of irreparable damage.
- Relevant procedures in PRC Civil Procedure Law must be followed.

**4.6.2 The Provisions of the SPC on Some Issues in the Adjudication of Letter of Credit-related Cases<sup>283</sup>**

This is a judicial interpretation which provides guidance in the adjudication of Letter of Credit related cases. It gives guidance according to the rules and principles in the General Principles of the Civil Law of the PRC, Contract Law of the PRC and Civil Procedure Law of

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<sup>283</sup> Judicial Interpretation No. [2005] 13.

the PRC as well as the UCP. Clarification is also given on issues such as the standards of document examination, circumstances of the fraud exception and conditions and procedures when applying for an order to suspend payment.

The above discussed documents provide guidance to courts in China when dealing with Letter of Credit disputes and to do so in a fairly structured manner.

#### **4.6.3 Court Cases Prior 2006**

The following court cases were not directly accessed but were extensively discussed by Yanan Zhang in a doctoral dissertation named, ‘Approaches to Resolving the International Documentary Letters of Credit Fraud Issue’, which subsequently became a book.<sup>284</sup>

These court cases were adjudicated before the new provisions came into operation in China but are important to the extent that it was the catalysis for creating the new provisions as they are known today. The purposes served by perusing these court cases are multi fold:

- To identify problems associated with freezing orders
- How the courts adapted this procedure to accommodate Letter of Credit transactions
- What constitutes Letter of Credit fraud and how the rules regulating the Letter of Credit fraud exception were established
- How to apply the new provisions to the Letter of Credit fraud exception.

The cases will be discussed in categories, for easy identification as to where in the Letter of Credit process the dispute fits in.

#### **Buyer v Seller**

In this scenario the seller may be acting alone or in collusion with the carrier when defrauding the buyer. Here the concept of fraud is in a narrow sense, meaning in the documents itself.

In *Hainan Province Timber Company, China (Timber) v Titan Shipping Ltd. (Titan) Singapore and Tatpin Private Ltd. Singapore (Tatpin)*<sup>285</sup> the seller colluded with the carrier to

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<sup>284</sup> Zhang Y *Dissertations in Social Sciences and Business Studies* No. 15, 2011.

<sup>285</sup> *Hainan Province Timber Company, China (Timber) v Titan Shipping Ltd. (Titan) Singapore and Tatpin (Private) Ltd. Singapore (Tatpin)* [1990] Guangzhou City, Maritime Court, trial date was 29 June, 1990.

defraud the buyer by forging a clean bill of lading. The plaintiff claimed damages on the grounds that the underlying contract and the bill of lading were invalid and applied for a preservation order to freeze the Letter of Credit payment. This case proved that where fraud was established the civil remedy in substantial law is the annulment of the contract and claim for damages. The legal procedure is the preservation order of property to freeze the Letter of Credit payment.

In *Xiamen Xianyu Free Trade Zone Zhongbao Material Import and Export Co. Ltd. (Zhongbao) v Hong Kong Billion Gold International Ltd. (Billion Gold), Hong Kong Winwick Shipping Co. Ltd., and Rishelle Navigation Shipping Co. Ltd.*<sup>286</sup> the seller failed to deliver any goods but colluded with the carrier to present forged documents to obtain Letter of Credit payment. The court erred by not considering the immunisation of the Letter of Credit fraud exception although Letter of Credit fraud was established.

In *Shenzhen Branch Sanhe Bank, Hunan Import and Export Corporation Boneng Petrol Chemical Company (Boneng) v Hong Kong Changshun Development Co. Ltd (Changshun), Changshun Trading Company, Changsha Branch Bank of Communications (Changsha Branch), et.al*<sup>287</sup> the court stated that where a bank suffered loss due to its own negligence, in a case where fraudulent documents are presented to demand payment, the legal liability shall be determined according to the principle of fault. In causa it was the Shenzhen branch's fault that it made payment without checking the conformity of the documents presented. Hence the Shenzhen branch should bear the loss.

In *Fengyi International Trade Company, Tianjin, China (Fengyi) v Aslchem International Inc., Canada (Aslchem)*<sup>288</sup> the court a quo and the appeal court concluded that the Letter of Credit fraud exception apply where substantial fraud is proved in the underlying sales contract as a precondition to applying the Letter of Credit fraud exception. In causa there was not sufficient evidence to establish such fraud.

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<sup>286</sup> *Xiamen Xianyu Free Trade Zone Zhongbao Material Import and Export Co. Ltd. (Zhongbao) v Hong Kong Billion Gold International Ltd. (Billion Gold), Hong Kong Winwick Shipping Co. Ltd., and Rishelle Navigation Shipping Co. Ltd.* [1996] Xiamen City, Maritime Court, First Instance, No. 074.

<sup>287</sup> *Shenzhen Branch Sanhe Bank, Hunan Import and Export Corporation Boneng Petrol Chemical Company (Boneng) v Hong Kong Changshun Development Co. Ltd (Changshun), Changshun Trading Company, Changsha Branch Bank of Communications (Changsha Branch), et.al* [1999] SPC, Civil judgment, (1999), Economic Tribunal, Final, No. 86; judgment was issued on 31 December, 2000.

<sup>288</sup> *Fengyi International Trade Company, Tianjin, China (Fengyi) v Aslchem International Inc., Canada (Aslchem)* [2004] Tianjin, Higher Court, Civil Judgment, (2004) Civil, Tribunal No. 4, Final, No. 021; judgment was issued on 10 June, 2005.

In *Fujian Metals & Minerals Import & Export Company, China (Fujian Company) v Srilanka AMM Industry Ltd. (AMM), third party - Xiamen Branch, China Merchants Bank Co. Ltd (Xiamen Branch)*<sup>289</sup> the court confirmed that where there is Letter of Credit fraud the Letter of Credit and the underlying transaction may be considered. In causa a serious shortage of the contracted goods were delivered and the court had to distinguish between Letter of Credit fraud and normal breach of contract. It held that the difference of the weight of goods stipulated in the bill of lading and what was actually delivered constitutes a serious false representation. This can be attributed to documentary fraud or fraud in the narrow sense.

The delivering of a serious shortage of goods on the other hand is fraud in the performance of the underlying contract in other words fraud in the wide sense. In this case fraud had been established in both the narrow and wide sense and payment could be stayed in accordance to the Letter of Credit exception rules.

#### Seller v Bank

In these cases the seller sued the bank due to non-payment. The banks based its refusal to pay on either fraud and/or discrepancies. The primary aim of the courts is to determine if a breach of contract on its facts constituted fraud.

In *Xian Medicine & Health Products Import & Export Company (Xian Company) v Australia and New Zealand Banking Group Limited (Australia and New Zealand Bank)*<sup>290</sup> the court found that where a beneficiary was not part of the fraud (an antedated bill of lading accepted by the buyer) the beneficiary had no intention to commit fraud nor conducted any fraudulent act. In these circumstances the fraud exception does not find application.

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<sup>289</sup> *Fujian Metals and Minerals Import and Export Company, China (Fujian Company) v Srilanka AMM Industry Ltd. (AMM), Third party - Xiamen Branch, China Merchants Bank Co., Ltd. (Xiamen Branch)* [2004] Fujian Province, Xiamen City, Intermediate Court, (2004), Civil Tribunal, First Instance, No. 352; judgment was issued on 2 December, 2005.

<sup>290</sup> *Xian Medicine and Health Products Import & Export Company (Xian Company) v Australia and New Zealand Banking Group Limited (Australia and New Zealand Bank)* [1997] Shanghai City, (1997), Intermediate Court No. 2, Economic Tribunal, First Instance, No. 842; judgment was issued on 25 September, 2000.

From *Newco Commodities AD (Newco) v Huichun Sub-branch of Jilin Province Branch of the Construction Bank of China (Huichun sub-branch)*<sup>291</sup> it can be deduced that Letter of Credit fraud disputes are often linked and entangled with dishonouring Letter of Credit Payment issues. In both Letter of Credit fraud disputes and dishonouring Letter of Credit payment issues of Letter of Credit fraud as well as Letter of Credit fraud exception rules could be present.

In *Liaoning Province Textile Import & Export Corp., China (Textile) v Istituto Bancario San Paolo DI-Toriuo, Italia (Paolo Bank)*<sup>292</sup> the court confirmed the independence of the Letter of Credit from the underlying transaction in that it held that a normal breach of contract does not constitute Letter of Credit fraud and therefore the Letter of Credit fraud exception rules do not apply.

In *Credit Bank, Italy v Harbin Economic Technology Development Trading Company, China (Harbin Company)*<sup>293</sup> the court held that the establishment of fraud is necessary to obtain a freezing order from court.

In *Kuchifuku Foods Company, China (Kuchifuku) v Industrial Bank of Korea and Nuclear Power Plant Sub-branch of the Bank of China (Nuclear Power)*<sup>294</sup> the court was clear that the establishment of Letter of Credit fraud exception requires clear and sufficient evidence of fraud and that the beneficiary should know and participate in the fraud. It also held that fraud committed by a third party does not fulfil the requirements of Letter of Credit fraud exception.

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<sup>291</sup> *Newco Commodities AD (Newco) v Huichun Sub-branch of Jilin Province Branch of the Construction Bank of China (Huichun Sub-branch)* [1998] Civil Judgment of the SPC, Final Judgment of the Economic Tribunal No. 336 (1998).

<sup>292</sup> *Liaoning Province Textile Import and Export Corp., China (Textile) v Istituto Bancario San Paolo DI-Toriuo, Italia (Paolo Bank)* [1999] Peking City, Intermediate Court No. 2, civil judgment, (1999), Economic Tribunal, First Instance, No. 1636; judgment was issued on 9 June, 2000.

<sup>293</sup> *Credit Bank, Italy v Harbin Economic Technology Development Trading Company, China (Harbin Company)* [2000] Peking City, Higher Court, (2000), Final, No. 376, judgment was issued on 20 November, 2000.

<sup>294</sup> *Kuchifuku Foods Company, China (Kuchifuku) v Industrial Bank of Korea and Nuclear Power Plant Sub-branch of the Bank of China (Nuclear Power)* [2003] Higher Court of Jiangsu Province, Civil, Tribunal No. 3, Final, No. 52 (2003).

In *Dalian Zhongken Xinyuan International Trading Company, China (Xinyuan Company) v Xinhuan Bank, Korea (Xihan Bank)*<sup>295</sup> the court confirmed the independence principle and held that a bank is obliged to honour a Letter of Credit payment demand in the absence of clear and sufficient evidence to prove fraud.

#### Bank v Bank

In *Tokai Bank Kobe Subbranch (Tokai Kobe) v Agricultural Bank of China Nanjing Branch, China (Nanjing Branch)*<sup>296</sup> the bank confirmed the independence principle where the disputing parties are both banks and indicated that the Letter of Credit payment will not be affected if the negotiating bank negotiated the Letter of Credit in good faith.

In *Jiangbei Bank of China (Jiangbei Branch) v Fandong Agricultural Bank (Fandong Branch), et al*<sup>297</sup> the court held that although Letter of Credit fraud had been established, the rule of Letter of Credit fraud exception could not be applied as a remedy for the bank as the bank had already effected payment.

#### Seller v Buyer

In *Korea Shinho Co. v Sichuan Province Euro-Asia Jingmao, China (Jingmao)*<sup>298</sup> the primary question was whether an arbitration clause in the underlying sales contract that governs any dispute could apply to the Letter of Credit. The court confirmed the independence principle of Letters of Credit which means that any arbitration clause in the underlying contract would not be of any relevance except where fraud is involved. The court also held that substantial or serious fraud requires higher standards of proof than usual civil disputes.

#### Bank v Buyer

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<sup>295</sup> *Dalian Zhongken Xinyuan International Trading Company, China (Xinyuan Company) v Xinhuan Bank, Korea (Xihan Bank)* [2004] Tianjin, intermediate Court No. 1, Civil Judgment, (2004), Tribunal No. 3, First Instance, No. 105; judgment was issued on 7 June, 2005.

<sup>296</sup> *Tokai Bank Kobe Sub branch (Tokai Kobe) v Agricultural Bank of China Nanjing Branch, China (Nanjing Branch)* [1999] Civil Judgment of Nanjing Intermediate People's Court, First Instance Judgment No. 106 (1999); judgment was issued on 6 January, 2000.

<sup>297</sup> *Jiangbei Bank of China (Jiangbei Branch) v Fandong Agricultural Bank (Fandong Branch), et al* [2005] Administrative Judgment of the SPC, No. 21 (2005).

<sup>298</sup> *Korea Shinho Co. v Sichuan Province Euro-Asia Jingmao, China (Jingmao)* [2000] Civil Order of the SPC, Final Order of the Economic Tribunal of No. 155 (2000).



In *China Investment Bank v Hualong Construction (Hualong)*<sup>299</sup> the issuing bank sued the Letter of Credit applicant for reimbursement. The Letter of Credit applicant claimed that payment should have been dishonoured by the bank due to fraud in the underlying contract. He claimed the quality of the goods supplied by the seller was deficient.

The court upheld the principle of autonomy of Letters of Credit and the scope of the fraud exception which determine that disputes in the underlying contract i.e. the quality of goods, cannot be a basis to apply for a court order under the Letter of Credit fraud exception rules.

#### Bank v Seller

In *Qingdao Sub-branch of China Merchants Bank, China (Qingdao Branch) v Sung Chang Rubber Company, Korea (Sung Chang Korea), Yulsan Shipping and Air Cargo Transport Company, Korea (Yulsan)*<sup>300</sup> the court held that a Letter of Credit relationship is essentially a civil relationship and acts<sup>301</sup> committed under a Letter of Credit belong to civil acts. The court held that the Letter of Credit fraud exception rule conforms to China's relevant laws and regulations and parties must follow the principle of good faith and other relevant laws.

#### **4.6.4 New Letter of Credit Fraud Exception Rules in China in 2006**

The most prevalent document on Letters of Credit in China is the Provisions of the Supreme People's Court on some issues in the Adjudication of Letter of Credit-related Cases.<sup>302</sup> China had unspecific rules pertaining Letters of Credit hence courts had different opinions as to how to deal with Letter of Credit-related cases. This resulted that China's banking community strongly demanded the drafting of judicial provisions on Letters of Credit. The only recourse for parties involved in a Letter of Credit fraud dispute was a freezing order which did not provide adequate enough protection for prohibiting payment.

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<sup>299</sup> *China Investment Bank v Hualong Construction (Hualong)* [2002] Civil Judgment of the SPC, Final Judgment of the Economic Tribunal No. 208 (1999); Decision No. 21 of 2002.

<sup>300</sup> *Qingdao Sub branch of China Merchants Bank, China (Qingdao Branch) v Sung Chang Rubber Company, Korea (Sung Chang Korea), Yulsan Shipping and Air Cargo Transport Company, Korea (Yulsan)* [2003] Q ingdao Maritime Court, Civil Judgment, (2003) Q ingdao Maritime First Instance No. 73, judgment was delivered on 2 June, 2004.

<sup>301</sup> The beneficiary submitting specified documents to the paying bank, the issuing bank making payment or acceptance.

<sup>302</sup> Judicial Interpretation No. [2005] 13.

In earlier years some courts stayed Letter of Credit payment based purely on the applicant's application and not on Letter of Credit fraud. In causa banks had no discretion but were obliged to dishonour Letter of Credit payments. The consequence was that the level of credibility of banks in China was lowered by an international evaluative institution, which increased financial costs and reduced income of business. This is also known as the so-called invisible losses.<sup>303</sup> Obviously China's banks reputations' in the international banking community was negatively affected.<sup>304</sup>

The provisions created were based on the General Principles of the Civil Law of the PRC and Civil Procedural Law and Contract Law of the PRC. References were also made to international practices where relevant, especially as reflected in the UCP. Although the provisions cover a vast area of Letter of Credit law the focus of this thesis will be directed at the rules relating to the Letter of Credit fraud exception.

#### **4.6.5 Articles Relating to the Letter of Credit Exception Rules**

##### Article 8: Letter of Credit Fraud

This article concerns Letter of Credit fraud and finds its basis on principles and elements of civil fraud as in the General Principles of the Civil Law of the PRC.<sup>305</sup> According to Article 8 the following circumstances constitute fraud:

- the beneficiary has forged or incorporated false contents in any of the presented documents;
- the beneficiary, in bad faith, delivers no goods or delivers goods of no value;
- the beneficiary, in conspiracy with the applicant or any third party (parties), presents documents while no real underlying transactions exist;
- other circumstances where fraud under a Letter of Credit may be found.

##### Article 9: Stop payment Order

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<sup>303</sup> Wang L *Case Studies on Legal Risk Control of Banks* (2004) 194.

<sup>304</sup> Liu Y 'Study on Documentary Letter of Credit Fraud' (2005) 5 *Hebei Finance* 39.

<sup>305</sup> Huan H 'Discussion on Principle of Letter of Credit Fraud Exception' (2007) 7 *China Water Transport* 239.

The “stop payment order” was specifically formalised by the SPC for dealing with Letter of Credit dispute cases. Article 9 and 15 concerns this instrument but article 15 will be discussed below.

According to article 9 the applicant of a Letter of Credit, the issuing bank or any other stakeholder may apply to a competent People’s Court for an order to suspend payment under a Letter of Credit. The only two requirements that needs satisfaction for a successful application is the presence of any one or more circumstances mentioned in article 8 and the determination that payment will lead to irreparable damage to such an applicant’s interests. According to Zhang this article does not provide a legal basis for such a remedy but does however provide a judicial remedy to Letter of Credit fraud.<sup>306</sup>

#### Article 10: Immunisation of the Letter of Credit Fraud Exception

This is the exception to the Letter of Credit fraud exception and serves to protect third parties whilst encouraging them to participate in Letter of Credit transactions.<sup>307</sup> Under article 10 circumstances, the court cannot order suspension or termination of Letter of Credit payments if payment has been honoured in good faith by the issuing, paying, confirming and/or negotiating bank. According to article 10:

‘Upon determining that Letter of Credit fraud exists, the People’s Court shall render an order to suspend or judgment to terminate payment under the Letter of Credit, except in any of the following circumstances:

- A party nominated or authorized by the issuing bank has made payment in good faith according to the issuing bank’s instructions;
- The issuing bank or a party nominated or authorized by it has accepted the draft under the Letter of Credit in good faith;
- The confirming bank has paid in good faith;
- The negotiating bank has negotiated in good faith.’

#### Article 11: Conditions for Stop-payment Order

This article states the conditions to be met when applying for the suspension of a Letter of Credit payment. The application will only be successful if a combination of several circumstances is satisfied. Article 11 states:

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<sup>306</sup> Zhang S ‘Definition of Letter of Credit Fraud and Relevant Problems’ (2006) 2 *Law Science Magazine* 119.

<sup>307</sup> Li J ‘Letter of Credit Fraud Exception: Several Issues in Operation’ (2002) 2 *International Financial Study* 75-76.

‘Application for suspension of Letter of Credit payment filed by a party prior to initiating a suit shall be accepted by the People’s Court, provided that the following conditions are met:

- The court which accepts the application has jurisdiction over the dispute on which the application is based;
- The evidence provided by the applying party demonstrates the existence of any of the circumstances stipulated in Article 8;
- The applying party’s legal rights and interests would be irreparably damaged if payment under the Letter of Credit were not suspended;
- The applying party has provided reliable and sufficient security;
- No circumstances stipulated in Article 10 exist.

Application for suspension of payment under a Letter of Credit during the course of litigation shall comply with the second, third, fourth and fifth conditions of the preceding paragraph.’

#### Article 15: Stop-payment Order

Article 15 stipulates that a judgment shall be made to terminate payment under a Letter of Credit if:

- A substantive trial determined that Letter of Credit fraud is established; and
- none of the circumstances stipulated in Article 10 are present.

The aforesaid shall constitute a final judgment to terminate a Letter of Credit payment.

#### **4.7 Effectiveness of the New Provisions**

The primary question is whether the Letter of Credit fraud exception rules in the New Provisions in China is effective or not. To answer this question the effect of a legal transplant must be evaluated. For legal transplant to be effective real effects on legal problems should be visible, if not these transplanted rules will only be ‘laws on paper’ as oppose to ‘laws in action’.

To determine the legality of the transplant the manner the law was transplanted and how it was received is indicative of its success. The impact on the economic development is in turn

indicative of its impact on legality.<sup>308</sup> The legality is also more effective in countries which are familiar with the basic principles of the adapted law.<sup>309</sup>

In evaluating the New Provisions it will be noted that China's legal culture, legal framework as well as the experience captured in judicial practice was considered. A typical example of such consideration is how the injunction order was adapted to a stop-payment order whilst the procedure of the stop-payment order is based on the freezing order in Chinese legal procedural law.<sup>310</sup> The familiarity of the freezing order to the Chinese judicial and business communities breathed content into these communities.

The General Principles of Civil Law in China generally mirrors the definition of fraud which is familiar to Chinese communities dealing with Letter of Credit instruments. The circumstances of fraud in the New Provisions are not just trite law in the international community but it also addresses specific problems in China on a national level. This is the circumstances where a third party colludes with the beneficiary to commit fraud. The broadness of the provision is focused at addressing this specific very rampant Letter of Credit fraud problem in China.

Purposes for legal transplants are to either improve an existing legal system, replace ineffective rules or principles or to compensate for lacunas in existing regulations. The importance of Letter of Credit fraud rules in China is four fold:

- China has statutes that regulate Letters of Credit as oppose too many other countries.
- China's Letter of Credit rules and its application is in line with international practice. This creates the impression of legal uniformity and certainty which attracts international business hence the domestic economy benefits.
- The rules have the effect of standardising the manner courts deal with Letter of Credit disputes.
- The rules offer guidance when courts determine Letter of Credit fraud issues and stop-order payment procedures.

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<sup>308</sup> Berkowitz D Pistor K and Richard J (2003) 51 'The Transplant Effect' *Am J. Comp. L.* 136 pp 169-188.

<sup>309</sup> Berkowitz D Pistor K and Richard J (2003) 51 'The Transplant Effect' *Am J. Comp. L.* 136 pp 169-188.

<sup>310</sup> Mao Y and Cong B 'Reflection on Certain Legal Problems of Letter of Credit Fraud' (2007) 5 *Jiangxi Social Sciences* 174.

The New Provisions can thus be said to fill the gap between the unofficial documents and create an instrument for courts to utilise when dealing with the fraud issue in Letters of Credit. It would be fair to conclude that the legal transplant in China was successful notwithstanding the fact that it is far from perfect and still needs refining.

The New Provisions in China developed the legal landscape to such an extent that it is similar to the rules concerning Letters of Credit in developed countries.<sup>311</sup> On the one hand improper judicial intervention is curtailed, while a sound legal environment for the Letter of Credit system is created on the other. The provisions also have the potential to promote the reputation of banks and courts in China, which will enhance trust and confidence of conducting international business with potential business parties.

Transplanted rules are often expected to perform certain functions.<sup>312</sup> The question must then be if the transplanted rules performed the functions it was intended for? In other words, is it effective not only on paper but also in practice? This effectiveness can be measured by perusing the court cases where these rules were applied. With disappointment it is submitted that the relevant court cases are too few to conclusively state if the transplanted rules is an overwhelming success. What is encouraging though is that the cases where the New Provisions was applied, the desired effect was obtained.

#### **4.8 Summary**

Letter of Credit fraud exception rules in China can be summed up as follows:

- It involves Letter of Credit fraud by either the beneficiary forging the required documents without delivering goods or delivering goods of no value, the beneficiary colludes with a third party or the applicant, by forging the documents in the absence of an underlying contract, etc. It includes fraud in the narrow and wide sense.
- The standard of proof required for Letter of Credit fraud is the same as in civil litigation, on the balance of probabilities.

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<sup>311</sup> It should be remembered that China is a developing country and form part of the so-called BRICS-countries along with Brazil, Russia, India and South Africa.

<sup>312</sup> Berkowitz D Pistor K and Richard J 'The Transplant Effect' (2003) 51 *Am J. Comp. L.* 136 pp 165-166.

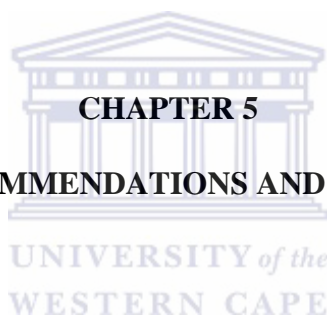
- It is obligatory to observe the rules of immunisation to the fraud exception as it offers protection to innocent third parties, third parties include banks which paid, accepted, or negotiated a Letter of Credit in good faith.
- The procedure of the stop payment order requires the applicant to provide sufficient security as is the case when applying for a freezing order.
- A defendant's legal rights or interests must stand the risk of being irreparably damaged if a stop payment order is not granted.

#### **4.9 Conclusion**

China's Letter of Credit law is comprehensive and well developed. It is submitted that although not thoroughly tested, the new provisions will provide adequate guidance to Chinese courts to effectively adjudicate future Letter of Credit disputes.

The following chapter will address differences and similarities between Letter of Credit fraud exception rules in South Africa and China. Suggestions for conformity of domestic laws will be offered as well as arguments for provisions, regulating the Letter of Credit fraud exception, to be included in the UCP.





## CHAPTER 5

### CONCLUSION, RECOMMENDATIONS AND INTERIM MEASURES

#### 5.1 Overview

China's legal system has a civil law tradition and is mostly codified as opposed to law which is derived from judicial decisions such as in the case in South Africa. Letter of Credit fraud exception rules developed through case law in South Africa whereas the courts in China dealt with Letter of Credit disputes without any specific rules or proper legal procedural instruments and had to develop the Letter of Credit fraud exception rules from the observation of documents issued by the SPC and previous court judgments.

The function of the Letter of Credit fraud exception rules is to deal with Letter of Credit fraud allegations in Letter of Credit fraud disputes. Because Letters of Credit are discussed in terms of international commercial transactions it creates the opportunity to compare Letter of Credit fraud rules in South Africa to Letter of Credit fraud rules in China, notwithstanding the fact that one belongs to a common law jurisdiction<sup>313</sup> and the other has a civil code.

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<sup>313</sup> This is notwithstanding the fact that South Africa actually has a hybrid legal system.



The Appellate Division of South Africa as per the *Loomcraft Fabrics v Nedbank*<sup>314</sup> judgment seemed to agree with the narrow approach adopted by the House of Lords in *United City Merchants v Royal Bank of Canada*.<sup>315</sup> The *Loomcraft Fabrics v Nedbank* case<sup>316</sup> is a clear indication that South African courts are willing to invoke the fraud exception in a case of forgery or fraud relating to the documents.

It was also submitted that the court in *Loomcraft Fabrics v Nedbank*<sup>317</sup> adopted a similar approach as was taken by the court in *United City Merchants v Royal Bank of Canada*<sup>318</sup> before the more recent English judgments,<sup>319</sup> which showed a move away from the strict narrow approach towards a more flexible wider approach when interpreting the fraud exception.

It is however only speculation to infer that South African courts will follow the approach of the more recent English cases. Although there are indications that it will follow a wide approach<sup>320</sup> when interpreting fraud, by the beneficiary, as an exception to the independence principle of Letters of Credit, there is also indications that South African courts will be reluctant to interdict a bank from paying if the fraud constitutes the performance rendered by the beneficiary in the underlying contract.<sup>321</sup>

China developed articles relating to the Letter of Credit exception rules. Article 8 of the articles relating to the Letter of Credit exception rules, in particular, concern Letters of Credit fraud and finds its basis on principles and elements of civil fraud as in the General Principles

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<sup>314</sup> *Loomcraft Fabrics v Nedbank* 1996 (1) SA 812 (A).

<sup>315</sup> Van Niekerk J P and Schulze W E *The South African Law of International Trade; Selected Topics* 2 ed (2006) at 315.

<sup>316</sup> 1996 (1) SA 812 (A).

<sup>317</sup> 1996 (1) SA 812 (A).

<sup>318</sup> (1983) AC 168 (HL) ([1982] 2 Lloyd's Rep 1 (HL)).

<sup>319</sup> *G K N Contractors Ltd v Lloyds Bank plc* (1985) 30 BCR 48 (ca); *Deutsche Ruckversicherung AG v Walbrook Insurance Co Ltd and Others: Group Josi Re (formerly known as Group Josi Reassurance SA) V Walbrook Insurance Co Ltd and Others* (1996) 1 Lloyd's Rep 345 (CA) ([1996] 1 WLR 1152 (CA); AND [1996] 1 ALL ER 791 (CA); *Themehelp Ltd v West* {1996} QB 84 (CA); [1995] ALL ER 215 (CA) and [1995] 3 WLR 751 (CA); and *Balfour*

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*Beatty Civil Engineering and Another v Technical and General Guarantee Co Ltd* (2000) 68 Con LR 180 ([2000] CLC 252; and [2000] CILL 1574.

<sup>320</sup> *Union Carriage v Nedcor Bank* 1996 CLR 724 (W) at 735 and Van Niekerk J P and Schulze W E *The South African Law of International Trade; Selected Topics* 2 ed (2006) at 314.

<sup>321</sup> Van Niekerk J P and Schulze W E *The South African Law of International Trade; Selected Topics* 2 ed (2006) at 314.

of the Civil Law of the PRC.<sup>322</sup> It is clear that China adopted a wide approach to the Letter of Credit fraud exception.

In *Loomcraft Fabrics v Nedbank*<sup>323</sup> the Appellate Division held that the alleged fraud must be established clearly, the required burden of proof is the ordinary proof required in civil cases which must be discharged on a balance of probabilities, the beneficiary or his agent must present documents with material misrepresentations, the beneficiary or his agent must have knowledge of the material misrepresentations, the documents must be presented to the bank with the purpose of drawing on the credit and the court will not infer fraud lightly. The degree of how convincing the evidence must be is still not established in South African law.<sup>324</sup> However, as stated above, the holder of a bill of exchange who enforces payment fraudulently is acting contrary to the demands of good faith and is abusing his right.<sup>325</sup>

In China the standard of balance of probabilities is also followed by courts in civil litigation. The difference is that the evidence of Letter of Credit fraud must be sufficient, the beneficiary knows and commits the fraud and the bank notices the fraud before paying. Another requirement of Chinese civil law and judicial practice, for a Letter of Credit fraud to be established, is that the subjective state of mind of the beneficiary must be 'intentional'.

South African case law indicates that in appropriate circumstances and where fraud has been proven on the part of the beneficiary, South African courts will be inclined to interdict a bank prohibiting it to effect payment if fraud is prevalent.<sup>326</sup> What constitute appropriate circumstances and what exact standard of proof is required, is not clear yet. The fraud exception is still under developed in South African law as South African courts did not have enough opportunities to deal with the exception due to a lack of cases where the exception is raised. Taken the available case law involving the fraud exception in South Africa, it seems that South African courts will follow the strict approach to the exception.

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<sup>322</sup> Huang H 'Discussion on Principle of Letter of Credit Fraud Exception' (2007) 7 *China Water Transport* 239.

<sup>323</sup> 1996 (1) SA 812 (A).

<sup>324</sup> Oelofse A N *The Law of Documentary Letters of Credit in Comparative Perspective* (1997) at 480.

<sup>325</sup> Malan F R and Pretorius J T (assisted by S F du Toit) *Malan on Bills of Exchange, Cheques and Promissory Notes* 4 ed (2002) para 143 at 225.

<sup>326</sup> Van Niekerk J P and Schulze W E *The South African Law of International Trade; Selected Topics* 2 ed (2006) at 315.

On the other hand, China regulates the interference with Letter of Credit payment through articles 9 and 15. Where article 9 stipulate the applicant of a Letter of Credit, the issuing bank or any other stakeholder may apply to a competent People's Court for an order to suspend payment under a Letter of Credit. Article 15 stipulates that a judgment shall be made to terminate payment under a Letter of Credit if a substantive trial determined that Letter of Credit fraud is established.

## **5.2 Reasons for Conformity**

The possibility that South African courts will favour a narrow approach to the fraud exception is a matter of concern.

The concern that a lenient approach, as is the case in China, will damage the international standing of banks lacks authority. It appears that should South Africa follow the strict approach not only will it be unfair to the buyer, who will be the victim of such fraud but it will be in direct contrast to the Chinese approach which embrace a wide approach.

Except for existing economic ties, the fact that China and South Africa are members of the BRIC-countries is another major reason why the domestic laws in terms of Letters of Credit, especially the fraud exception, should conform to one another. It is well known that Letters of Credit are being used extensively in international trade transactions as the preferred method of payment because of its attractiveness offered by the independence principle.<sup>327</sup> Because of this affiliation it is reasonable to expect that money would be made available to South African companies to enable them to pursue business contracts with their Chinese counterparts and vice versa. This will also increase the possibility of fraud disputes and if such is the case, conforming domestic laws will render court proceedings familiar and easier to deal with.

## **5.3 Recommendation for Incorporation: Broad Recommendation**

It is trite that the UCP was not designed to be law nor intended to be. It is a set of standard terms to be incorporated by reference into Letters of Credit by parties who preferred to do so.

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<sup>327</sup> Kappor P and Gray R *Maritime Fraud: An Overview*, Plymouth Polytechnic September 1985 at p. 8.

This is also stated in the preface of the UCP 600 to the effect that the UCP is not legislation but a compilation of rules created by the banking community for their industry.<sup>328</sup>

It could be asked whether the UCP is a code of the law or quasi law, customary practices, or just mutually consented regulations relating to Letters of Credit. However in fact, UCP is the governing law of the Letters of Credit.<sup>329</sup>

The Banking Commission of the ICC, which comprised of representatives of the banking community, originally drafted the UCP. This is of course indicative of the dominant role the banks and banking experts occupy. This dominance in the drafting process of the UCP could be compared to the authority of a legislature. It seems that the rules contained within the UCP favours banks more as compared to any other party involved in a Letter of Credit transaction. It limits interference of judiciaries thus protecting negligent bank behaviour. This makes it almost a risk free transaction for banks.

It is important to note that all parties to a Letter of Credit transaction which is subject to UCP regulations are conscious about the presence of these rules either by providing a copy of the clauses of the UCP or by giving a notice of the clauses. To enforce a clause the other party should be given reasonable notice. In practice however, buyers are assumed to have the notice of the UCP and that they are familiar with the provisions of the UCP. The application for the issuance of a Letter of Credit and the Letter of Credit document itself does not contain any attachment of the provisions of the UCP or any notice of clauses.<sup>330</sup>

The ICC's Commission on Banking Technique and Practice has the authority to interpret the UCP and may apply these interpretations to remedy problems in Letter of Credit dispute cases. The findings of the Commission are widely published and distributed, hence their interpretation is considered as an official interpretation of the UCP. The Commission can enhance, interpret, and or amend the provisions of the UCP. This gives it a similar status of certain courts in common law jurisdictions, i.e. South Africa and certain civil law jurisdictions, i.e. China. The banks which deal with the Letters of Credit, act upon these interpretations and any amendments.

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<sup>328</sup> The phrase 'a set of international rules to govern letter of credit operations' is used.

<sup>329</sup> The reasoning is that there is no alternative set of internationally recognised rules which can be incorporated in Letters of Credit, hence the UCP is the only 'international recognised law' available.

<sup>330</sup> Kappor P and Gray R *Maritime Fraud: An Overview*, Plymouth Polytechnic September 1985 at p. 13.

It is submitted that since the UCP 600 failed to address the fraud exception, after much anticipation that it would, the Commission should amend the provisions of the UCP 600 to include the exception. It should give clear guidance as to the criteria applicable when the fraud exception is called into play. Because of the wide usage of the UCP rules in international business transactions it makes sense for the UCP to give guidance pertaining rules for the usage of the fraud exception in Letters of Credit. Millions of dollars are lost yearly due to fraud in international business transactions<sup>331</sup> and the wide usage of Letters of Credit is an indication that the international business community regard the UCP as law and submit to its rules and regulations, irrespective of its status.<sup>332</sup>

It is submitted that the current UCP is not a comprehensive enough regulatory framework due to it being silent on the Letter of Credit fraud exception and it should be amended to give guidance on this concept.



## **5.4 Recommendations on Letter of Credit Usage: Specific Recommendations**

### **5.4.1 Use of Independent Inspectors**

A buyer may stipulate the use of independent opinions in the documentary credit. Independent survey firms can be used to determine the quality and quantity of goods and whether the goods have actually been loaded or not. This will drastically reduce the risk of fraud.

### **5.4.2 Check Capacity and Location of Contract Vessel**

The buyer could insist on the name of the ship to be used. This knowledge would enable the buyer to determine the availability and capacity of the vessel. The buyer could establish if the vessel is seaworthy, if it has the capacity to ferry the contracted goods and if it could accommodate the quantity of the contracted goods. All this can be achieved by reference to

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<sup>331</sup> Balancing rights and duties of parties in a letter of credit transaction available at <http://www.lawteacher.net/finance-law/essay/letter-of-credit.php> (accessed 23 October 2013).

<sup>332</sup> Foreword of the UCP 600 at par. 2.

standard Lloyd's information.<sup>333</sup> Lloyd's shipping intelligence can also be used to track the ship's current location hence enabling the buyer to calculate the ship's arrival at the port of loading. A reference to Lloyd's Shipping intelligence could also reveal if the vessel exists or not. Obviously such information is invaluable to a buyer and can seriously hamper the possibility of fraud.

#### **5.4.3 Checking the Credibility of the Seller**

If the seller is unknown to the buyer, the buyer should attempt to determine the credibility of the seller. This should be an easy process if the seller is a company. Registration at local regulatory bodies and compulsory accreditation by organisations, in terms of the industry the seller is involved in, could be a starting point. Reputable companies the seller previously dealt with, as well as the seller's bank, including other banks the seller dealt with, could indicate the possibility of fraud.



#### **5.4.4 Performance Bonds**

If a performance bond is issued in favour of the buyer, the seller guarantees to perform his obligations under the sales contract. Should the seller fail to perform such obligations the issuing bank of the performance bond is obliged to pay the buyer the agreed amount in the bond on mere demand of the buyer. This is the best method to secure the buyer's contract with the seller and if such guarantee is supported by a bank's unconditional undertaking, the possibility of fraud is restricted to a minimum.

#### **5.4.5 Deferred Letters of Credit**

Deferred Letters of Credit postpone the payment date, in other words it provides for maturity. The due date for payment is for a stipulated time after the required documents have been presented and after the Letter of Credit conditions have been complied with.

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<sup>333</sup> <http://www.lloydslistintelligence.com> (accessed 7 August 2013).

The beneficiary present the required documents in terms of the Letter of Credit to the confirming bank which, after checking, accepts it and presents it to the issuing bank if prima facie in order. The confirming bank pays on maturity and obtains reimbursement from the issuing bank. Should the confirming bank accept the documents presented by the beneficiary, the confirming bank is obliged to pay the beneficiary and the issuing bank is in turn obliged to reimburse the confirming bank. The only criteria are that both obligations are to be satisfied on maturity. Should the confirming bank fail to pay the beneficiary, the latter has a right to claim against the confirming bank. Should the issuing bank in turn fail to reimburse the confirming bank, the confirming bank has a right to claim against the issuing bank.

Should non-performance by the beneficiary, as stipulated in the underlying transaction, be discovered before the maturity date, it does not relieve the confirming bank of its obligation towards the beneficiary. However, if the bank discovers or are notified of a beneficiary's fraudulent behaviour in terms of the Letter of Credit the bank is entitled to refuse payment and if it does effect payment, despite such knowledge, it would not be entitled to reimbursement from the issuing bank.

Under a deferred Letter of Credit the issuing bank is not to pay out on the credit until the maturity date. This gives the applicant enough time to obtain evidence of fraud, should it form the basis of the dispute, on the part of the beneficiary to enable the issuing bank to stay payment. A deferred Letter of Credit and requiring confirming banks to enter into recourse arrangements with the seller, also balance the risk which is in other circumstances mostly on the buyer.

#### **5.4.6 International Chamber of Commerce Services**

Commercial Crime Services (CCS)<sup>334</sup> offers a valuable service to banks.<sup>335</sup> A bank sends the documents against which it will pay to the CCS which will check the authenticity of the documents and the transaction. Not just has the Commercial Crime Bureau a data base of information sourced from all over the world, but its members' in-depth understanding of the industry and experience in dealing with the authenticity of documents makes them experts in

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<sup>334</sup> This is a division of the International Chamber of Commerce (ICC).

<sup>335</sup> This is a free service to members.

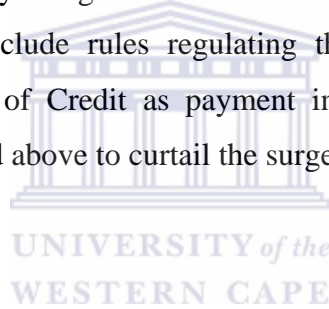
the field. What makes this service unique is that it complies with the swiftness requirement demanded by international trade.<sup>336</sup>

## 5.5 Bank's Contribution

Banks could contribute to the fight against fraud by offering a service of making a more in-depth examination of documents, beyond what is required by the UCP. They could also undertake to educate their staff in terms of how fraud is perpetrated in Letters of Credit and what to look out for. This will go a long way to help fight the forever rise of fraud in Letters of Credit.

## 5.6 Final Recommendations

It is finally submitted that the UCP does indeed not offer a comprehensive regulatory framework for Letters of Credit by being silent on the fraud exception. It is submitted that the UCP should be amended to include rules regulating the fraud exception. It is further submitted that users of Letters of Credit as payment instruments should implement the specific recommendations offered above to curtail the surge of fraud in Letters of Credit.



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<sup>336</sup> Reaction time to all applications is either in hours or at the latest two days.



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