

GROUNDS FOR WITHHOLDING PAYMENT IN DOCUMENTARY CREDITS

by

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A thesis submitted to
The University of Birmingham
for the degree of
DOCTOR OF PHILOSOPHY

UNIVERSITY OF
BIRMINGHAM

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Acknowledgements

I would like to take the opportunity to thank those who made this thesis a possibility.

I am grateful to my supervisor, Mr Keith Uff, who has been supportive and encouraging throughout my thesis. He has been a great teacher to me, not just in law but in life.

I would also like to thank Birmingham Law School for providing me with the scholarship to study this PhD.

I am also thankful to the friends and family members who have shown interest in my PhD and believed in me. Writing this PhD was a challenging period but I was lucky to have the emotional support of many.

Most importantly, I am deeply indebted to my parents, who have provided me with an excellent education. My utmost gratitude goes to them for raising me and loving me.

ABSTRACT

The documentary credit has for a long time served as a very reliable form of financial instrument in the trading of international goods. The certainty of payment guaranteed under the documentary system is attributed to the autonomous nature of the credit contract, which is that it is independent of and unaffected by the contract of sale which it supports. So long as the documents which are presented strictly comply with the terms of the credit, the paying bank will be under an obligation to pay. However, documents which are non-compliant are also frequently presented in practice. The autonomous characteristic of the instrument also gives rise to problems because there are circumstances where, even though compliant documents are tendered, payment made under the credit would be unfair.

This thesis attempts to investigate the various grounds which could provide a basis for withholding payment under a documentary credit. From the perspective of all the main parties involved in a documentary credit transaction, issues relating to payment are of utmost importance. Discrepant documents and fraud, which are well established as valid grounds, will be examined. The thesis will also explore other possible grounds to withhold payment such as illegality, nullity, unconscionability and breach of negative stipulations which exist in the underlying contract connected to the credit. The parameters of these grounds will be identified and where appropriate, recommendations will be made.

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CHAPTER 1

INTRODUCTION TO DOCUMENTARY CREDITS

This chapter will begin by exploring the nature and function of the documentary credit (also known as letters of credit) and the relevant legal sources relating to the instrument. What will follow is an explanation of how documentary credit transactions work and the principles operative in such transactions. The writer will then examine the various types of credit, identifying their main features and the differences between them. Essentially, this chapter provides the background to understanding the analysis and ideas discussed in subsequent chapters of this thesis.

1.1 Definition

UCP 600 Article 2 defines credit as “any arrangement, however named or described, that is irrevocable and thereby constitutes a definite undertaking of the issuing bank to honour a complying presentation.” Another definition can be found in § 5-102(a)(10) of the Uniform Commercial Code (UCC):

“Letter of credit means a definite undertaking ... by an issuer to a beneficiary at the request or for the account of an applicant or, in the case of a financial institution, to itself or for its own account, to honor a documentary presentation by payment or delivery of an item of value.”

Whichever definition is used, the documentary credit is simply a written instrument which provides a promise by a bank to pay a sum of money, within a specified time, to a stated party on behalf of its customer provided that the terms and conditions specified in the credit are satisfied. Essentially, the terms and conditions of the credit involve the presentation of documents which evidence the shipping of goods of a certain specification by the seller.

1.2 The role of the documentary credit

In international sale transactions, the parties involved operate their business in different countries and the goods are transported across national borders. Immediate payment in exchange for goods is practically impossible. Various factors such as currency exchange restrictions, political risks and the physical distance between the parties create a lack of trust and uncertainty for the parties involved.

From a seller's point of view, he will be reluctant to incur expenses for the shipment of the goods and more importantly to part with his goods without an assurance of payment from the seller. Once the goods are exported to another country, it will be very inconvenient and expensive for him to repossess the goods and recover any unpaid purchase price from the buyer since any legal issues are likely to be governed by the law of another jurisdiction. From the buyer's point of view, he would certainly be unwilling to make payment before delivery without the assurance that goods will be delivered to him and that they will conform to the contract of sale. If the goods are not delivered to him, or the goods delivered do not conform to the contract of sale, he may face the difficulties and inconvenience of pursuing the seller in a foreign jurisdiction.

Therefore, a sophisticated tool such as the documentary credit was invented to finance international trade. As early as the twelfth century the documentary credit was used by merchants to reduce the various risks involved in trade.¹ The documentary credit is able to address effectively both the seller's and the buyer's concerns because the bank steps in, substituting the buyer as the party who will make payment to the seller. The bank is a suitable intermediary because of its sufficient credit standing and the banking facilities it possesses abroad. With the documentary credit, a seller is provided with security of payment since the bank is under a legal obligation to pay him so long as he presents documents which conform

¹ For a discussion of the history of the letter of credit, see Holdsworth, "The Origins and Early History of Negotiable Instruments (II)" (1915) 31 LQR 173; B. Kozolchyk, *Commercial Letters of Credit in the Americas- A Comparative Study of Contemporary Commercial Transactions* (Matthew Bende, New York 1966) 3.

to the conditions of the credit. As for the buyer, he can be assured that the goods which conform to their agreement are delivered before payment is made.

Despite the advantages offered, there remain some elements of risk in the use of the documentary credit for both the buyer and seller, as later chapters in this thesis will reveal. The security of payment provided to the seller is not absolute as documents are frequently rejected, whilst the buyer's assurance of the goods may be affected by fraud. There is a chance that the parties may still need to resort to litigating their disputes in a foreign court. Nevertheless, the documentary credit remains one of the most indispensable instruments in the financing of international trade and has been described as "the life blood of international commerce"².

1.3 The Uniform Customs and Practice

Due to the international operation of the documentary credit, it would benefit the commercial community tremendously if documentary credit transactions could be standardised by an adoption of an international code of practice. In 1933, the Uniform Customs and Practice for Documentary Credits (the UCP) was introduced by the International Chamber of Commerce (the ICC) to provide a set of uniform rules on many aspects of the documentary credit. The UCP reflects accepted banking custom and practice around the world and would logically be updated periodically. It was revised in 1951³, 1962⁴, 1974⁵, 1983⁶ and 1993⁷ and 2007⁸. The sixth revision, known as the UCP 600 is the one currently in use and came into force on 1st July 2007. The UCP 600 is also supplemented by the eUCP which sets out rules concerned with the presentation of electronic records, either alone or with paper-based records.

² *R.D.Harbottle (Mercantile) Ltd v. National Westminster Bank Ltd* [1978] Q.B 146, 155 per Kerr LJ.

³ UCP 222.

⁴ UCP 290.

⁵ UCP 400.

⁶ UCP 459.

⁷ UCP 500.

⁸ UCP 600.

It needs to be pointed out that the UCP is not a code having the force of law. It is an international agreement which will only apply if it is expressly incorporated into a credit contract. Article 1 UCP 600 provides the following:

The Uniform Customs and Practice for Documentary Credits, 2007 Revision, ICC Publication no. 600 ("UCP") are rules that apply to any documentary credit ("credit") (including, to the extent to which they may be applicable, any standby letter of credit) when the text of the credit expressly indicates that it is subject to these rules. They are binding on all parties thereto unless expressly modified or excluded by the credit.

Despite lacking the force of law, the UCP is undeniably of great importance in the practice of the documentary credit, as is evident by its incorporation into almost all documentary credits used in international trading. One commentator refers to it as “the most successful harmonizing measure in the history of international commerce, which has removed a plethora of technical problems that would have undermined the smooth operation of letter and credit.”⁹

Containing 39 Articles, the UCP 600 does not cover every possible area of dispute which may arise - for example, the effect of fraud is not comprehensively provided by the UCP. It was deliberately created this way as it is thought that many matters are most suitably decided by national courts.

1.4 Operation of the documentary credit

It is not the aim of this thesis to provide a detailed account of the mechanics of the documentary credit in practice.¹⁰ However, this section will go through the various stages in a documentary credit transaction to provide a general understanding of the way it works in international trading.

⁹ Xiang Gao, *The Fraud Rule in the Law of Letters of Credit: A Comparative Study* (1st edn, Kluwer Law International, London, 2003) 18.

¹⁰ For a detailed account see R Jack, *Documentary credits: the law and practice of documentary credits including standby credits and demand guarantees* (4th edn Tottel, Haywards Heath 2009); Richard King, *Gutteridge and Megrah's Law of Bankers' Commercial Credits* (8th edn, London, New York, Europa Publications, 2001).

The contract of sale

The documentary credit process begins with the buyer agreeing to purchase goods from the seller at an agreed price. The parties agree that the purchase price is to be paid by documentary credit. The sales agreement between the parties is commonly referred to as the underlying contract in documentary credit transactions. One leading expert cautions of ambiguity and recommends the underlying contract to set out in detail the description of the goods, quantity, unit price, the type of credit, the place where the credit is to be opened, advised or confirmed, the time by which it should be opened, the duration it is to be available and the documents which are required for payment to be made.¹¹

Application by buyer to his bank

To set up a documentary credit, the buyer (the applicant or account party) will apply to a bank in his country (the issuing bank) to issue a documentary credit in favour of the seller (the beneficiary). By issuing the credit, the issuing bank undertakes to make payment of a sum of money to the seller upon presentation of the specified documents. The buyer will need to provide precise instructions to his bank as to the type of credit he needs and the documents that the seller needs to submit in order to comply with the terms of the credit. Once the buyer's application of the credit is accepted, a contract is formed between the buyer and the issuing bank. The issuing bank must act in accordance with the instructions of the buyer in order to receive its reimbursement from the buyer.

Advising of the credit to the beneficiary

It is possible for an issuing bank to issue a documentary credit directly to the beneficiary. But, in international trading, this is almost never the case and the issuing bank will instruct a correspondent bank, which could be its branch or any other bank in the seller's location, to advise the seller of the opening of the credit in his favour. The responsibility of the correspondent bank is to:

¹¹ *R Jack* (n 10) 3.2.

- inform the beneficiary of the opening of the credit and its terms and conditions.
- receive documents and check that the documents are compliant
- make payment

If the seller has requested the buyer to open a confirmed credit, the correspondent bank is also the confirming bank, adding its own undertaking to honour a compliant presentation. On the other hand, in an unconfirmed credit, the correspondent bank merely acts as an advising bank.

Presentation of documents and payment

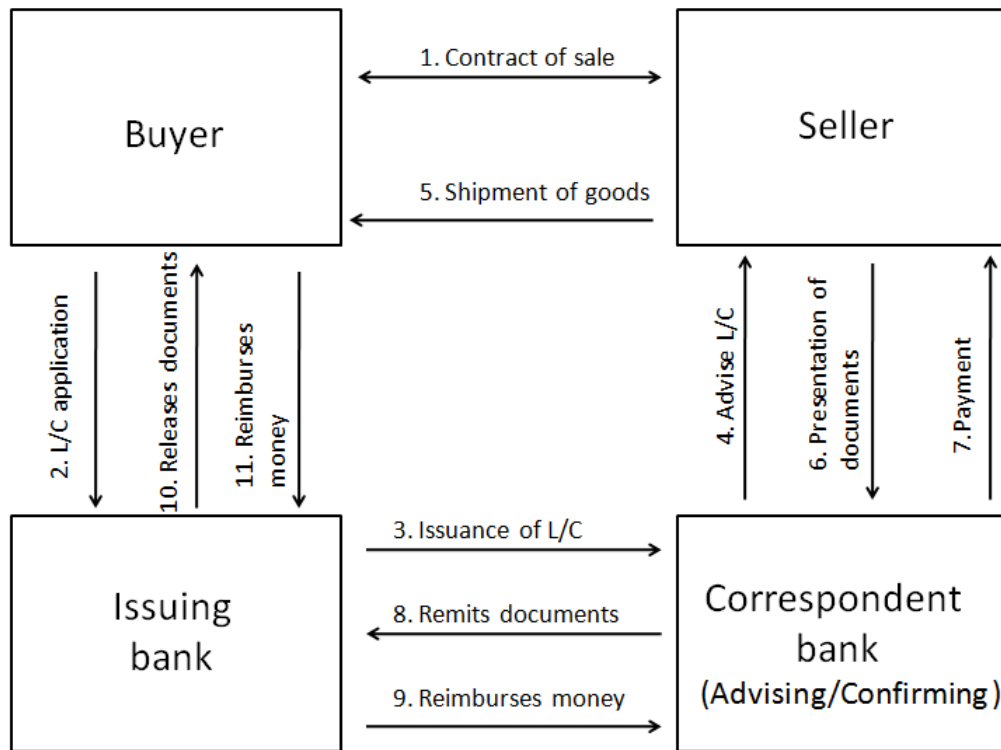
Once the seller has been notified by the correspondent bank of the opening of the credit, the seller will review the terms of the credit. Where the seller is not able to comply with any of the credit terms, he needs to contact the buyer to request an amendment. If the seller is certain that the credit terms conform to the terms of the underlying sales contract, he will dispatch the goods (or anything else required) to obtain the necessary documents. When all the necessary documents are obtained, he must submit the documents to the nominated bank (usually the same correspondent bank which advised the seller). This bank will inspect the submitted documents to ensure that they comply strictly with the terms of the credit. If the submitted documents are in order, the nominated bank/confirming bank is obliged to make payment to the seller.

Remittance of Documents

The documents relating to the goods will be remitted by the correspondent bank to the issuing bank, which will then examine the documents. Once satisfied that the documents are in order, the issuing bank will make payment to the correspondent bank.

Release of Documents

Finally, the issuing bank releases the documents to the buyer, who will reimburse the bank in any way agreed between them. As soon as the goods arrive in the buyer's country, the buyer can then obtain possession of the goods by presenting the bill of lading to the master of the ship.



Operation of the documentary credit

From the above account, it can be seen that a documentary credit transaction typically involves several legal relationships. Firstly, there is the underlying contract of sale between the buyer and the seller. Secondly, a contract is formed between the applicant (buyer) and the issuing bank pertaining to the issuance of the credit - the issuing bank agrees to pay upon presentation of the specified documents whilst the applicant agrees to reimburse the issuing bank for the money paid. Thirdly, a contract between the issuing bank and the beneficiary (seller) is established where the former agrees to pay the seller against presentation of

complying documents. Fourthly, a contract exists between the the issuing bank and the correspondent bank whereby the correspondent bank agrees to act in accordance with the instructions of the issuing bank whilst the issuing bank agrees to pay the correspondent bank. In the case of a confirmed credit, a fifth contract exists between the confirming bank and the beneficiary.

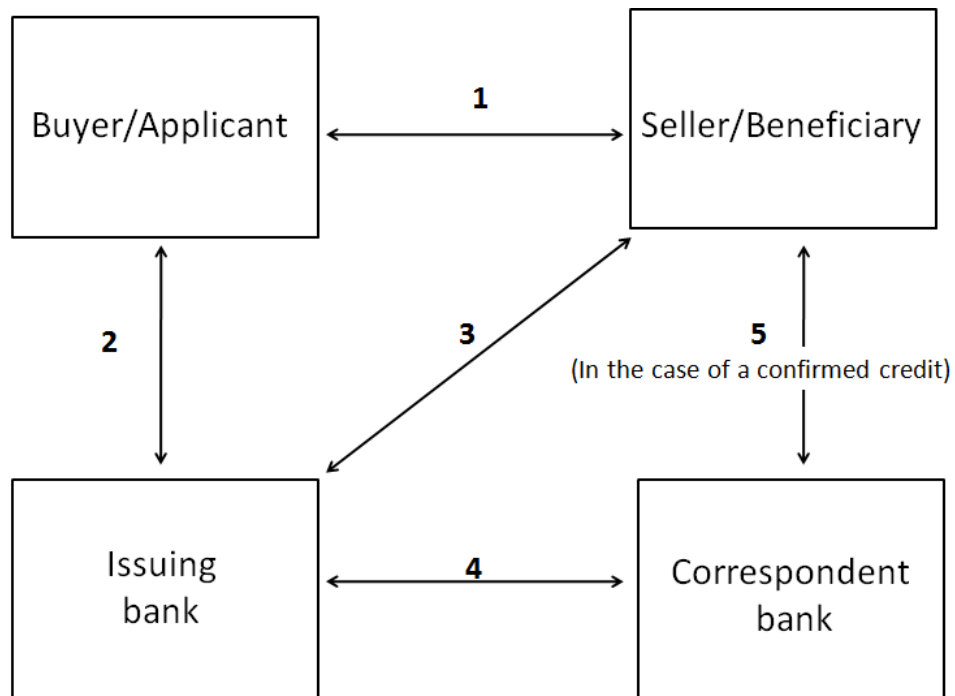
However, it should be noted that although term contract is used to reflect the binding nature of the undertakings, the third contract does not fit in with the traditional concepts of contract law:

“First, a letters of credit is issued by the issuer to the beneficiary. It takes effect from the moment when it is issued, and therefore the theory of offer and acceptance of contract law does not apply. Second, the letter of credit is an undertaking by the issuer to substitute its financial strength for that of the applicant and it does not need consideration from the beneficiary to the issuer for the credit to be binding.”¹²

The same can be said of the fifth contract. Many theories of formation of contract have been advanced for the legal enforceability of the bank’s obligation but it is commonly regarded that the documentary credit is a *sui generis* (of its own kind).¹³

¹² *Xiang Gao* (n 9) 14. See also M Clarke, "Bankers' Commercial Credits Among the High Trees" [1974] CLJ 260, 261

¹³ EP Ellinger, *Documentary Letters of Credit* (University of Singapore Press, Singapore 1970) Chapters III, IV and V; Mugasha, *The Law of Letters of Credit and Bank Guarantees* (The Federation Press, Sydney, 2003) 30; C Joseph, "Letters of Credit: The Developing Concepts and Financing Function" (1977) 94 Banking LJ 816 at 850.



Legal relationships arising from a documentary credit transaction

1.5 Fundamental Principles of the Documentary Credit

1.5.1 Principle of Autonomy

The most important principle which governs documentary credits is the principle of autonomy. It posits that a documentary credit is separate and independent from the underlying contract of sale between the seller and the buyer. It is also independent of the contract between the buyer

and the issuing bank. This principle has been judicially established for a long time.¹⁴ The UCP 600 also specifically incorporates this principle:

Article 4

Credits v. Contracts

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

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

Article 5

Documents v. Goods, Services or Performance

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

The consequence of the independence principle is that the conditions for a bank's obligation to pay are set out exclusively in the conditions of the credit. If the seller presents documents which strictly comply with the credit, the bank is under an obligation to pay the seller within the specified time limit, regardless of any disputes which may arise in the underlying contract of sale. If there is in fact a breach of the underlying contract of sale by the seller, the buyer's only recourse is to bring an action for damages. Similarly, the paying bank cannot refuse payment to the seller on the basis that the buyer has not put it in funds or that it has claims for damages or rights of set-off against the buyer.¹⁵ It follows from this that courts will not generally grant injunctions to enjoin payment under a documentary credit on any of these grounds.

¹⁴ *United City Merchants Ltd v Royal Bank of Canada* [1983] AC 168; *Tukan Timber Ltd v Barclays Bank Plc* [1987] 1 Lloyd's Rep 171; *Themehelp Ltd v West* [1996] QB 84; *Bank of Nova Scotia v. Angelica-Whitewear Ltd. and Angelica Corp.* [1987] 1 S.C.R. 59.

¹⁵ However, the paying bank may have a right to set off the amount that should be paid to the beneficiary against a claim it has against the beneficiary if this claim has arisen out of the same underlying contract which gave rise to the letter of credit - *Hong Kong and Shanghai Banking Corporation v Kloeckner & AG* [1990] 2 QB 514.

The autonomy principle was created and strictly adhered to in order to uphold the commercial utility of the documentary credit, ensuring that it functions as a fast and certain system of payment in international sales transaction. The principle provides a high degree of security and certainty for the seller. In any sale of goods transaction, there is always a possibility that the buyer will become insolvent or the possibility that he will attempt to avoid or delay payment or reduce the sale price, but the autonomy principle ensures that he will be paid regardless of any disputes which may arise under the underlying contract of sale.

However, the autonomy principle does create an element of risk for the buyer. For example, the seller may have perpetrated fraud but a strict adherence to the autonomy principle would mean that the seller would still have a right to be paid. Hence, over time, exceptions have been carved out from the autonomy principle, all of which will be discussed in subsequent chapters in this thesis. It suffices to mention here that the most recognised exception to the autonomy principle is in circumstances where a bank is alerted to fraud perpetrated by the seller.

1.5.2 Principle of Strict Compliance

The principle of strict compliance follows from the principle of autonomy although both principles remain distinguishable concepts. The principle of strict compliance requires sellers wishing to receive payment to tender documents which on their face comply strictly with the requirements stated in the credit. If the documents strictly conform to the requirements of the credit, the bank is under an obligation to pay. Conversely, the bank is under an obligation to reject payment if the documents do not strictly conform - it will not consider whether the discrepancies in the documents are material or minor, whether the discrepancies affect the value or effect of the documents, or whether the relevant stipulations in the documentary credit have any real purpose.

Moreover, the principle applies to all the contractual relationships arising from a documentary credit transaction. The issuing bank can refuse to reimburse the correspondent bank if the correspondent bank has made payment to the seller on acceptance of documents which do not strictly comply with the credit. If the issuing bank pays the correspondent bank

on acceptance of such documents, the buyer is under no obligation to reimburse the issuing bank.

It needs to be emphasised that the concept of strict compliance refers to documentary compliance and does not refer to whether the factual reality behind the documents complies strictly with the terms of the credit. Banks “must examine a presentation to determine, *on the basis of the documents alone*, whether or not the documents appear on their face to constitute a complying presentation”¹⁶ [emphasis added]. Banks are under no duty to investigate the facts asserted by the documents.¹⁷ Banks are not experts in the diverse trade they finance and would not have knowledge of the practice and terminology of any particular trade. If their legal obligation was otherwise, banks would be diverted from the performance of their main function. There is also no doubt that banks would increase their fees to be commensurate with the burden of these additional responsibilities and risks. As a result, the documentary credit would not be an affordable system of payment. The unsatisfactory effect of imposing such a duty on bankers was also acknowledged by Mocatta J in *United City Merchants v Royal Bank of Canada*:

“To hold to the contrary might greatly hold up the smooth running of international trade and might place on banks exceptionally onerous investigations, which they are ill fitted to perform.”¹⁸

Schmitthoff provides another rationalisation behind the principle, one which is based on the law of agency:

¹⁶ Article 14(a) UCP 600.

¹⁷ Article 34 UCP 600 : A bank assumes no liability or responsibility for the form, sufficiency, accuracy, genuineness, falsification or legal effect of any document..., or for the general or particular conditions stipulated in a document or superimposed thereon; nor does it assume any liability or responsibility for the description, quantity, weight, quality, condition, packing, delivery, value or existence of the goods, services or other performance represented by any document, or for the good faith or acts or omissions, solvency, performance or standing of the consignor, the carrier, the forwarder, the consignee or the insurer of the goods or any other person.

¹⁸ [1979] 1 Lloyd's Rep. 267, 278.

“...the advising bank is a special agent of the issuing bank and the latter is a special agent of the buyer. If an agent with limited authority acts outside that authority (in banking terminology: his mandate) the principal is entitled to disown the act of the agent, who cannot recover from him and has to bear the commercial risk of the transaction.”¹⁹

In short, the strict compliance principle ensures that banks do not act beyond the limits delineated in the credit.

Moreover, the principle offers protection to both sellers and buyers. A buyer can be assured that he will only be under an obligation to make payment if the seller has presented documentary proof that he has performed what was contractually required of him under the underlying contract. From the perspective of a seller, there is nothing unfair about the strict compliance principle because he has been given the conditions of the credit upfront and would have had opportunities to decide if the terms are consistent with the agreed arrangement and whether it would be possible for him to produce such documents. Moreover, even if his first presentation of documents is rejected, he may re-submit the documents again.²⁰ Sometimes for various reasons, a buyer may wish to get out of his agreement with the seller, most commonly where the market price of the goods is falling, but sellers are protected by the principle because a buyer is obliged to take delivery of compliant documents and will not be able to get out of his payment obligation.

One question which inevitably arises is the degree of strictness which is imposed by the law in relation to documentary compliance. The UCP 600 does not contain any express provision on the principle of strict compliance, but many of the UCP 600 rules on documentary compliance incorporate this principle, whilst some of the rules represent a more liberal approach to the strict compliance principle. Chapter 2 will discuss these provisions in detail

¹⁹ C Murray, D Holloway and D Timson-Hunt, *Schmitthoff's Export Trade-The Law and Practice of International Trade*, 11th edition Sweet & Maxwell, London 2007) 192.

²⁰ *Forbes, Forbes, Campbell & Co. v Pelling, Stanley & Co.* (1921) 9 Ll.L.Rep. 202. This must be done before the expiry date and within the transport document time limit.

and examines the type of discrepancies which would allow rejection of the presented documents.

1.6 Types of Documentary Credits

There are several types of credit, differing from each other in many respects such as the obligations of the bank, the method of payment, the manner in which the credit is issued or the existence of some other specific feature. It is important to be familiar with the types of credit because the varying rights and obligations in each category create different levels of risk for the parties involved.

1.6.1 Revocable or Irrevocable Credits

UCP 500 made an express distinction between revocable and irrevocable credits, with Article 8 UCP 500 stipulating that “a revocable Credit may be amended or cancelled by the Issuing Bank at any moment and without prior notice to the Beneficiary.” This means that, in a revocable credit, the issuing bank does not actually incur a legal commitment to the beneficiary.²¹ UCP 600 no longer mentions the revocable credit. Under UCP 600, a credit is now defined as an irrevocable arrangement.²² Accordingly, UCP 600 Article 3 states that, “A credit is irrevocable even if there is no indication to that effect.”²³ In contrast to a revocable credit, an irrevocable credit cannot be revoked or amended unilaterally. So long as the beneficiary tenders the correct documents, he will be guaranteed the correct amount of payment on time. The irrevocable credit being the default credit will further reduce the use of revocable credit, offering more assurance to sellers. Nevertheless, Article 1 of UCP 600

²¹ There are serious risks involved when a seller accepts a revocable credit - see *Cape Asbestos Co Ltd v Lloyds Bank Ltd* [1921] WN 274, where it was held that a bank is under no legal duty to inform the beneficiary with reasonable notice about the revocation of the credit.

²² UCP 600 Article 2:

Credit means any arrangement, however named or described, that is irrevocable and thereby constitutes a definite undertaking of the issuing bank to honour a complying presentation.

²³ Where a contract of sale does not indicate whether a revocable or irrevocable credit is should be opened, an irrevocable credit will be implied at common law see; *Giddens v Anglo-African Produce Ltd* (1923) 14 Ll.L. Rep. 230.

allows for modification or exclusions of UCP terms.²⁴ Parties should be aware that the use of revocable credit is still possible by the removal of some of the provisions that prevent revocation or are inconsistent with revocation.

1.6.2 Unconfirmed Credits and Confirmed Credits

A revocable credit is always unconfirmed but an irrevocable credit can be either confirmed or unconfirmed. The distinction between the unconfirmed and confirmed credit is attributed to the role taken by the correspondent bank in the seller's country.

In an unconfirmed credit, the correspondent bank is instructed by the issuing bank only to advise or notify the credit to the beneficiary. The correspondent bank here acts solely as the advising bank to inform the beneficiary of the terms and conditions of the credit. It is an agent of the issuing bank but does not itself provide an undertaking to pay.²⁵ It is only the issuing bank which undertakes to pay. Due to the lack of an undertaking by the advising bank, if the advising bank wrongfully rejects the documents presented, the beneficiary will have a legal remedy against the issuing bank but not the advising bank. This means that the seller will have to suffer the inconvenience of pursuing a legal action in a foreign jurisdiction since the issuing bank is usually not located in the seller's country of operation.

In a confirmed credit, the issuing bank requests the correspondent bank in the seller's country to add its own undertaking in addition to that of the issuing bank to pay against conforming documents.²⁶ In such circumstances, the correspondent bank is known as the confirming bank. It follows from this that the issuing bank and confirming bank's legal

²⁴ UCP 600 Article 1:

The Uniform Customs and Practice for Documentary Credits, 2007 Revision, ICC Publication no. 600 ("UCP") are rules that apply to any documentary credit ("credit") (including, to the extent to which they may be applicable, any standby letter of credit) when the text of the credit expressly indicates that it is subject to these rules. They are binding on all parties thereto unless expressly modified or excluded by the credit.

²⁵ UCP 600 Article 9(a) :

A credit and any amendment may be advised to a beneficiary through an advising bank. An advising bank that is not a confirming bank advises the credit and any amendment without any undertaking to honour or negotiate.

²⁶ UCP 600 Article 2 provides that, "Confirmation means a definite undertaking of the confirming bank, in addition to that of the issuing bank, to honour or negotiate a complying presentation.

obligations to pay are independent of each other. The advantage of this is that a beneficiary will have a contractual remedy against both the issuing bank and the confirming bank if payment is wrongly refused. A confirming bank bears the risk of non-reimbursement from the issuing bank and should not confirm the credit until it has properly evaluated the country and credit standing of the issuing bank.²⁷

Although more expensive, the irrevocable confirmed credit is more favourable to a seller since it offers the strongest level of security. Nevertheless, this extra cost may be unnecessary if the issuing bank is a credible multinational bank and is unlikely to default.

1.6.3 Credits with different methods of payment

1.6.3.1 Sight Credits

This type of credit is most commonly used. It is payable as soon as the relevant documents are presented. The bank must examine the documents within five banking days.²⁸ If the documents comply with the terms and conditions of the credit, payment is initiated immediately to the beneficiary.

1.6.3.2 Deferred Payment Credits

Under this type of credit, the issuing bank and any confirming bank undertakes to pay at a specified future date, known as the maturity date (for example, 90 days after the date of shipment) against submission of the prescribed documents within the expiry date of the credit. Deferred payment credit is commonly used where the buyer and seller are in a good business relationship. The seller grants the buyer a grace period to pay but is still guaranteed of payment by a certain date. Deferred payment credit not only offers cash flow benefits to the buyer but also provides certainty to him since, before parting with his funds, he is given

²⁷ The confirming bank may sue the issuing bank if the issuing bank defaults on payment but this may be futile in the case of an insolvent issuing bank.

²⁸ UCP 600 Article 14(b).

enough time to ascertain whether the goods which arrived comply with the specification of the sales agreement.

Unlike the acceptance credit, no drafts are involved in deferred payment credit, thus avoiding fees and duties charged by some countries on drafts. Despite there being no draft involved, the seller still has the opportunity to obtain funds before the maturity date by discounting his right to payment. As security for the advance, the beneficiary seller would assign the proceeds of the credit to the discounter.²⁹

1.6.3.3 Acceptance Credits

Just like the deferred payment credit, the acceptance credit has a maturity date which is stated in the credit and allows the buyer a period of time to pay. Under this type of credit, the beneficiary seller draws a time draft upon the issuing bank, confirming bank or any other bank specified in the terms of the credit. Upon presentation of the draft, and documents which comply with the credit terms, the bank will accept the draft. Payment will not be made immediately but instead will be made on the date of maturity. The accepted time draft is a very liquid instrument which allows the seller to discount it in the appropriate markets so that he can obtain payment before the maturity date. Where a “nominated bank does not accept a draft drawn on it or, having accepted a draft drawn on it, does not pay at maturity”, UCP 600 imposes an obligation on the issuing bank or confirming bank to pay.³⁰

1.6.3.4 Negotiation Credits

UCP 600 Article 2 provides the following:

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

²⁹ *Xiang Gao* (n 9) 151. See also *Banco Santander SA v. Bayfern Limited* (1999) 2 Lloyd's Rep. 239.

³⁰ UCP 600 Article 7(a)(v); UCP 600 Article 8(a)(i)(d).

A negotiation credit authorises a specific bank or any bank (in the case of a freely negotiable credit) to purchase drafts and/or documents under a credit. Therefore, the undertakings of the issuing bank (and the confirming bank if any) are extended to the negotiating bank. Typically, a negotiation credit contains a clause such as this:

“We hereby agree with drawers, endorsers and bona fide holders of Drafts/documents drawn under and in compliance with the terms of the Credit that such Drafts/documents shall be duly honoured on due presentation if (negotiated) or (presented at this office) on or before (the expiry date)”, or words of similar intent.³¹

A negotiation credit may require a draft, in which case the credit would allow the beneficiary to draw on the issuing bank or any other drawee stated on the credit. The negotiating bank purchases the draft together with the required documents at a discount and later forwards these documents to the issuing bank to be reimbursed. Where a draft is not required, the negotiating bank negotiates the documents only.³²

1.6.4 Transferable Credits

A middleman who obtains his goods from a supplier and sells them to his buyer will use a transferable credit to provide payment to his supplier. The advantage of this arrangement is that the buyer will not have knowledge of the supplier's prices because of the lack of direct contact between the buyer and the seller's supplier. This type of credit involves two beneficiaries and allows part or whole of the credit amount to be transferred from the first beneficiary to the second beneficiary. To open a transferable credit, the buyer of the goods will need to make a request with the issuing bank which will incorporate a provision in the credit terms allowing the transfer of a specified sum.³³ The middlemen, as the first beneficiary

³¹ Charles Del Busto, *ICC Guide to Documentary Credit Operations* (ICC Publications No. 515, Paris 1994) 39.

³² It is possible for letters of credit to be negotiated without drafts. See James E. Byrne “Negotiation in Letter of Credit Practice and Law: The Evolution of the Doctrine” (2007) 42 *Tex. Int'l L.J.* 561, 571. This is recognised by UCP 600 in the definition of negotiation in Article 2 – “purchase by the nominated bank of drafts (drawn on a bank other than the nominated bank) *and/or* documents”. [emphasis added]

³³ UCP 600 Article 38 (b) provides that, “Transferable credit means a credit that specifically states it is ‘transferable’.”

will then instruct the advising bank to effect a transfer of the credit to his supplier. After the supplier ships the goods, he will submit conforming documents to the advising bank. The receipt of the supplier's documents will be notified to the middleman, who will then present his documents. The advising bank replaces the supplier's invoice and draft with that of the middleman. The amount the middleman receives is the credit amount less the amount paid to the supplier.

1.6.5 Back-to-back Credits

Like the transferable credit, a back-to-back credit is primarily used by a seller to finance the purchase of goods from his supplier. The arrangement revolves around two irrevocable credits which are independent of each other. A buyer will firstly open a documentary credit in favour of the seller of the goods. Using this credit, the seller then requests his bank to issue a second credit in favour of his supplier. In essence, the first credit is security for the second credit. With the exception of the amount and the expiration date, the terms of the two documentary credits are mostly identical since they relate to the same shipment of goods.

The difference between back-to-back credit and transferable credit is that, in the latter, the rights under the existing credit are transferred. The back-to-back credit arrangement is also more flexible because the terms and conditions of the two credits can be varied. However, banks are reluctant to issue back-to-back credits because of the risk of loss in the event of a default under the first credit.

1.6.6 Revolving Credits

The revolving credit is used by sellers and buyers in a continuous business relationship which involves a series of shipments of goods. It provides for the authorisation to draw regularly over a specified period but yet restricts the amount available and frequency of the shipments. This type of credit offers the convenience of not having to arrange for a new credit for every shipment in a long term contract. There are two types of revolving credits. In the case of a cumulative revolving credit, any unused amount of credit over one period can be carried over

to the next period. In the case of a non-cumulative revolving credit, the unused credit amount during a period ceases and can no longer be used.

1.6.7 Red Clause Credits

Sometimes, a seller does not have the funds needed to produce or purchase items to fulfil an order. This is where a red clause credit is useful because it enables the seller to obtain the cash advance needed prior to shipment. The advance amount agreed by the buyer will be stipulated in the credit terms. This type of credit can only be used if the buyer is willing to provide finance to the seller before the actual shipment of the goods and incur the risk for all advanced credits. Once the buyer provides the instructions to the issuing bank, the issuing bank will authorise the correspondent bank to make advances to the seller in return for the beneficiary's undertaking to submit the required documents in accordance with the terms and conditions of the credit. When the goods are delivered, the seller presents the required documents to obtain the balance of the credit. The credit balance is calculated by deducting the advanced amount and the accrued interest. This type of credit is named a red clause credit because the clause authorising the correspondent bank to advance a certain amount to the beneficiary is traditionally typed or printed in red. This type of credit exposes the buyer to risks and is rarely used in practice.³⁴ If a fraudulent seller fails to deliver the goods, the correspondent bank still has a right of reimbursement from the issuing bank, which in turn has a right to demand reimbursement from the buyer.

1.6.8 Green Clause Credits

This type of credit works in similar way to the red clause credit and allows the seller to draw on the credit before actual shipment of the goods. However, in addition to giving a written undertaking to present the required documents, the seller needs to submit documentary proof that the goods have been warehoused in the name of the bank advancing payment.

³⁴ An example of a case involving a red clause credit is *Tukan Timber Ltd v Barclays Bank plc* [1987] 1 Lloyd's Rep 171.

1.6.9 Standby Credits

The difference between the traditional documentary credit and a standby credit is that the latter performs an entirely different function. Under a standby credit, the issuing bank provides an undertaking to pay in the event that its client fails to perform its contractual obligation to the beneficiary. It is never used as a main method of payment, but only as a backup method of payment which is to be drawn on only when the applicant fails to perform his part of the underlying contract with the beneficiary. Essentially, it performs the same function as a bank guarantee. It was created in America at a time where the banks in America were prohibited by law from issuing bank guarantees to third parties.³⁵

Because of its flexible nature, the standby credit can be used in a wide range of transactions such as international trading, loan transactions, construction contracts and leasing agreements. In international sales transactions, it is usually used to guarantee payment by the buyer. If the buyer pays in accordance within the specified time, the standby credit will not be drawn. If the buyer defaults in payment, the credit will be payable by presentation of a written demand or any other document specified in the terms of the credit.

The standby credit does share the same mechanism and structure as the documentary credit. Like the documentary credit, it is payable against presentation of documents specified in the terms of the standby credit, without requiring the bank to investigate the truth behind the documents i.e. the default in the underlying transaction. However, the required documents in standby credits are never transportation documents and very often what is needed is only a written unilateral statement by the beneficiary that the applicant has failed to perform his contractual obligations.³⁶ Unlike the documentary credit, the documents required do not represent any security in goods for the bank.

Both the UCP³⁷ and Article 5 UCC are applicable to standby credits. Because the UCP rules were primarily designed for documentary credits, a more usable regime was needed. The ICC

³⁵ Roeland Bertrams, *Bank Guarantees in International Trade* (3rd edn Paris; New York, ICC Publication 2004)

6.

³⁶ *Ibid.*

³⁷ UCP 600 Article 1:

published the Uniform Rules For Demand Guarantees (URDG)³⁸ which, although was specifically drafted for demand guarantees, is also applicable to standby credits.³⁹ Unlike the UCP, the URDG did not gain wide acceptance. Moreover, it was felt that the URDG, drafted specifically for demand guarantees, does not fit in comfortably with the standby credit.⁴⁰ The ICC later issued the International Standby Practices (ISP 98⁴¹), a new set of rules specifically created for standby credits which came into force on 1st January 1999. ISP 98 is only applicable to a standby credit if expressly incorporated into the contract. Alongside these ICC initiatives, the United Nations Commission on International Trade Law (UNCITRAL) also developed the United Nations Convention on Standby Letters of Credit and Bank Guarantee Convention 1989 which came into force on 1st January 2000. Its aim was to harmonise the law applicable to standby credits and bank guarantees but it has not been a huge success with only 8 nations so far having ratified it, none of which are the world's major trading nations.⁴² ISP 98 was designed to be compatible with the UNCITRAL Convention on Independent Guarantees and Standby Letters of Credit and today offers the most extensive legal framework for standby credits.

Although the focus of this thesis is on documentary credits, the risk of unconscionable calls particularly associated with this type of credit and similar types of independent guarantees will be discussed in Chapter 6 .

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

³⁸ICC Publication No. 458. The URDG replaces the Uniform Rules for Contract Guarantees (URCG). It is currently under revisions <<http://www.iccwbo.org/iccbdfie/index.html>> accessed 16th November 2009.

³⁹ This is because the definition of demand guarantees in Article 2 URDG is capable of including standby letters of credit.

⁴⁰ JF Dolan, "Analyzing Bank Drafted Standby Letter of Credit Rules: The International Standby Practice (ISP98)" [2000] 45 Wayne L. Rev. 1865, 143-144.

⁴¹ ICC Publication 590.

⁴²UNCITRAL, Status of 1995 United Nations Convention on Independent Guarantees and Stand-by Letters of Credit"<http://www.uncitral.org/uncitral/en/uncitral_texts/payments/1995Convention_guarantees_status.html> accessed 30th November 2009. See *Dolan*, "The UN Convention on International Independent Undertakings: Do States with Mature Letter of Credit Regimes Need It?" [1997] 13 Banking & Fin L.Rev.1.

CHAPTER 2

NON-CONFORMING DOCUMENTS¹

2.1 Introduction

As was revealed in the Chapter 1, the principle of strict compliance plays a very important role in the operation of documentary credits. Despite being indispensable, the principle does present some practical difficulties, primarily because the high frequency of non-conforming documents slows down the flow of international trade and increases the cost of using the documentary credit. In 2003, SITPRO's report revealed that numerous surveys which had been conducted suggested that 50-60% of documents presented to banks for payment are rejected on their first presentation.² Therefore, in practice, documentary discrepancy is the most common ground for refusing payment.

Chapter 1 explained the principle of strict compliance and the rationale behind its existence. The question of how strict is "strict compliance" is a contentious issue, hence the various standards of strict compliance will be explored. The writer will then evaluate the scope of the bank's duty to examine documents. This will be followed by an analysis of the various types of discrepancies. The scope of discrepancy in letters of credits transaction is extremely wide and it is not within the scope of this study to examine every possible discrepancy which could arise in practice. The aim of this chapter is to examine the most common discrepancies and some of the problematic issues pertaining to non-conforming documents. The writer will also discuss circumstances where payment can still be made despite the existence of discrepancies in documents tendered.

Throughout the chapter, the issues discussed will be examined in the light of the new UCP 600. Whenever relevant, comparisons will be made with UCP 500 in order to analyse the changes brought about by the new UCP and the extent to which it succeeds in solving discrepancy

¹ Some parts of this chapter have been published - Hang Yen Low, "UCP 600: the new rules on documentary compliance" [2010] 52 IJLM 193.

² SITPRO Ltd, *Report on the Use of Export Letters of Credit 2001-2002* (SITPRO Ltd, London 2003) 2.

problems existing under the old UCP. In fact, one of the main foci of the revision process was to address the persistent discrepancy issues and to reduce the incidence of rejection of documents. It is important to analyse the new revision since there are changes which will affect businesses engaged in international trading and the way banks facilitate the financing of goods. From a seller's perspective, understanding how documents will be compliant under the new UCP 600 is very important since rejection of documents can cause substantial monetary losses, delay in time and unwarranted litigation. It is also important for banks to study these changes, since the modifications will have an effect on their policies and credit operations and changes will have to be implemented accordingly.

2.2 Standard of compliance

Although the UCP does provide for the bank's duties to examine the document, it does not prescribe the standard required for compliance of documents. Rather, the standard of compliance has been a matter developed by case law throughout the years. The principle is well encapsulated by the words of Viscount Sumner in *Equitable Trust Co of New York v Dawson Partners Ltd*:

“There is no room for documents which are almost the same, or which will do just as well . . . Business could not proceed securely on any other lines. The bank's branch abroad, which knows nothing officially of the details of the transactions financed cannot take upon itself to decide what will do well enough, and what will not. If it does as it is told it is safe; if it declines to do anything else, it is safe; if it departs from the conditions laid down, it acts at its own risk.”³

A difficult question which arises is how strict is the standard of strict compliance. Case law demonstrates that different courts in different jurisdiction have in the past imposed different levels of strictness. The following discussion will discuss the two different standards which have been prevalent notwithstanding that there are other standards of compliance adopted by some judges in other common law systems.

³ (1927) 27 Lloyd's Rep 49, 52.

2.2.1 Literal compliance/Precise Mirror Image

Lord Summer's formulation in *Equitable Trust* appears to suggest the highest degree of compliance, which is that documents are required to correspond word- by- word, letter-by-letter with the credit terms. In other words, documents tendered must be a mirror image of the credit terms and even the slightest deviation can result in non-payment. Requiring this degree of compliance from beneficiaries is problematic in practice. One commentator states that:

“... any experienced banker knows, a word- by- word, letter-by-letter correspondence between the documents and the credit terms is a practical impossibility. Thus courts wedded to a mirror image version of strict compliance and reasonable care have failed to provide a functional standard of document verification.”⁴

Particularly, difficult issues arise in relation to abbreviations and typographical errors, both of which will be discussed in more detail further on in this chapter. This is because discrepancies may be so technical and minor that it does not affect the value of the goods at all and is will not concern any of the parties involved. A bank's customers will certainly not be happy and will be critical of its service if a bank rejects documents for a minor variation which is insignificant. Moreover, as Boris Kozolchyk points out “this standard is unhelpful when a credit requirement does not mean in the beneficiary's and confirming bank's place of business what it means in the customer's.”⁵ For example in *Equitable Trust*, the credit required a certificate of quality supplied by "experts" and signed by the Chamber of Commerce of Batavia. There was no Chamber of Commerce in Batavia although its equivalent was the Commercial Association of Batavia. Hence, the House of Lords accepted that the document conformed to the credit. It would certainly have been absurd if the House of Lords had still adhered to the standard of mirror image in such circumstances. There is also the possibility that banks or applicants will exploit the opportunity to reject documents based on minor irrelevant discrepancies.⁶ For example, this could happen where

⁴ Richard Morris, “Discrepancies: Has UCP 500 Wrought Any Improvement?” *Hong Kong Lawyer* (Dec 1998) at 62 <<http://sunzi1.lib.hku.hk/hkjo/view/15/1502320.pdf>> accessed 11 June 2008.

⁵ Boris Kozolchyk, “U.C.C. Article 5 Symposium Strict Compliance and the Reasonable Document Checker” *Brook.L.Rev.* (Spring, 1990) at 4 <<http://www.natlaw.com/strictcompl.pdf>>accessed 12 June 2008.

⁶ *Ibid.*, 5.

a bank fears the difficulty of getting its reimbursement from an insolvent customer or where an applicant is eager to get out of a bad bargain.

2.2.2 Substantial Compliance

Although the strict compliance principle is really the “cornerstone” of letters of credit, in certain circumstances it creates problems, raising questions about the justice of rigidly adhering to the principle. To avoid any inequitable result to the beneficiary, some courts developed the substantial compliance standard, which is a relaxation of the strict compliance principle. American courts apply the substantial compliance standard in a way such that documents will be accepted despite some deviation from the literal terms of the credit if compliance is apparent (i.e. the discrepancy does not create ambiguity) and the discrepancy does not mislead the document checker into thinking that there was compliance.⁷ The main disadvantage of this principle is that there is more subjectivity involved in the document checking process and offers less certainty to a buyer that the underlying contract has been performed as agreed. It seems to impose an additional obligation on banks as they may not be well-equipped to judge the impact of a minor deviation.

The principle of substantial compliance has also been applied to bank guarantees/performance bonds, where arguably the principle is more easily justified. This is because the type of documents which are required to be presented under such instruments are different from those required under a documentary credit; usually the documents required do not have any intrinsic value.⁸ Moreover, such documents presented under a bank guarantee/performance bond will not pass to third parties or be used in back-to back transactions, which is very often the case in documentary credit transactions.⁹ In *I.E. Contractors Ltd. v Lloyds Bank Plc. and Rafidain Bank*, Staughton LJ also took the view that there is less need for a doctrine of strict compliance in the case of performance bonds.¹⁰

⁷ *Datapoint Corp. v. M & I Bank*, 665 F. Supp. 722, 724 (W.D. Wis. 1987); *First Nat'l Bank of Atlanta v. Wynne*, 149 Ga. App. 811, 817, 256 S.W.2d 383, 387 (1979); *Flagship Cruises Ltd. v. New England Bank*, 569 F.2d 699, 705 (1st Cir. 1978).

⁸ Roeland Bertrams, *Bank Guarantees in International Trade* (3rd edn Paris; New York, ICC Publication 2004) 143.

⁹ *Ibid.*

¹⁰ [1990] 2 Lloyd's Rep. 496, 500.

2.3 Bank's duty to examine

Article 14 (a) of UCP 600 provides the following:

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

The bank should only concern itself with the underlying contract; confining the bank's examination to the documents means that the article remains consistent with the principle of autonomy. There was some debate as to whether the term "on their face" should be retained since it had been a cause for confusion leading to some banks examining only the front page of the document and not the reverse.¹¹ However, the new article has retained this phrase.

There is no longer a reference to the phrase "reasonable care" as found in Article 13(a) UCP 500, which was generally regarded as ambiguous.¹² The omission of reasonable care is probably for the best since it was not doing much under the old UCP. Under the old UCP, if documents did not strictly comply with the conditions of the credit but the bank failed to discover the discrepancy and made payment, the bank was not able to argue that it was still entitled to reimbursement on the ground that it had exercised reasonable care unless the terms of the credit were ambiguous, in which case the bank might argue that it had placed a reasonable interpretation upon the words used. Therefore in normal circumstances the sole consideration was whether the documents complied or not. The reasonable care argument could only be of relevance if there was a dispute on an ambiguous term in the credit.¹³ Moreover, it is also arguable that the duty of the bank to examine with reasonable care was contradictory to the

¹¹ C. Debattista, "Legislative techniques in international trade: madness or method?" [2002] J.B.L 626, 634-635.

¹² UCP 500 Article 13(a): Banks must examine all documents stipulated in the Credit with reasonable care to ascertain whether or not they appear on their face to be in compliance with the terms and conditions of the Credit. Compliance of the stipulated documents on their face with the terms and conditions of the Credit shall be determined by international standard banking practice as reflected in these Articles. Documents which appear on their face to be inconsistent with one another will be considered as not appearing on their face to be in compliance with the terms and conditions of the Credit.

¹³ Richard King, *Gutteridge and Megrah's Law of Bankers' Commercial Credits* (8th edn, Europa Publications, London 2001) 182.

reference to “on the face”, since exercising reasonable care means that the banks have a heavier responsibility in that they have to do more than ascertain whether documents appear on the face to comply with the credit.

However, since the new article provides that banks are obliged to examine documents, it is still the case that they must perform this duty with reasonable care and not act negligently. The reference to “on the face” merely means that the duty is not the more stringent duty which would require it to investigate the accuracy of the documents. Therefore, there is no need to refer to reasonable care. It is likely that this aspect of the new UCP will not change the number of documents rejected or the way banks perform their duties to examine documents.

2.3.1 Time to examine documents

The time taken to examine documents is an important matter for both sellers and buyers. All sellers hope for payment from banks as soon as possible for better business cash flow. Buyers also wish for the release of documents to claim the goods as soon as possible to avoid any extra cost such as storage charges. The new UCP 600 Article 14(b) states that:

“A nominated bank acting on its nomination, a confirming bank, if any, and the issuing bank shall each have a maximum of five banking days following the day of presentation to determine if a presentation is complying. This period is not curtailed or otherwise affected by the occurrence on or after the date of presentation of any expiry date or last day for presentation.”

This article changes the rule relating to the time for determining the compliance of documents in several ways. Firstly, the expression “reasonable time” in UCP 500 Article 13(b) has been removed.¹⁴ Secondly, the maximum number of days allowed for banks to determine compliance had been reduced from seven banking days to five banking days.¹⁵ Thirdly, there is a new

¹⁴ UCP 500 Article 13(b): The Issuing Bank, the Confirming Bank, if any, or a Nominated Bank acting on their behalf, shall each have a reasonable time, not to exceed seven banking days following the day of receipt of the documents, to examine the documents and determine whether to take up or refuse the documents and to inform the party from which it received the documents accordingly.

¹⁵ *Ibid.*

addition in the second part of Article 14 which provides that the maximum period for determining compliance is not affected by the date of expiry or latest date for presentation

“Reasonable time” in UCP 500 created much confusion and uncertainty since it is a concept which is inevitably flexible and open to different interpretations. Its removal was prompted because ICC national committees from around the world raised their dissatisfaction with the word “reasonable”. When the old UCP was in force, banks could not deliberately delay the examination of the documents till the seventh banking day since the old UCP provided that examination of documents must be completed within a “reasonable time”. If banks used the full 7 banking days to examine documents, this would in some cases be seen as unreasonable which would not allow banks to reject the documents. One possible interpretation of the new article is that the five banking days are an automatic free inspection period. This interpretation gives rise to the concern that banks may take things slowly and insist on five banking days in all cases to accept or reject the documents. This would mean that the new provision does not actually reduce the period from seven to five banking but increases it from “a reasonable time” to five banking days. In practice, banks do not usually need more than two days to review the documents. Therefore, five days is considered generous in most cases. On the other hand, the new article is also open to a different interpretation, because the word “maximum” suggests that in some cases the time within which the bank is allowed to examine documents is less than 5 days.¹⁶

If the second interpretation is adopted, it would mean reverting to the concept of reasonable time, making the deletion of reasonable time pointless. Considering that the removal of the phrase “reasonable time” stemmed from the drive to eliminate all ambiguities, the writer believes that the first interpretation is correct although it is not without its problem. The difficulty involved in checking compliance differs between different letters of credit; some could require only few documents whereas others could require hundreds. Banks could take up to a maximum of five banking days even in straightforward cases, yet beneficiaries could not claim that banks had not examined the documents within reasonable time. This provision could potentially worsen the cash flow management of sellers.

¹⁶James E. Byrne, *The Comparison of UCP600 & UCP500* (The Institute of International Banking Law & Practice, MD USA 2007) 133.

The rationale behind reducing seven banking days to five banking days was to speed up the average time taken by banks in clearing a letter of credit. Whilst the writer welcomes the deletion of the phrase “reasonable time”, the writer takes the view that the period of five banking days should be reduced to three banking days. Note that banks are allowed five banking days from the date of presentation to give a notice of rejection.¹⁷ Since banks can now delay examination until the fifth day, this means that if a bank examines documents on the fifth day, makes a determination to reject and gives notice on the fifth day, less time will be left for the discrepancy to be rectified (particularly pressing where the expiry date of the credit is nearing). Three banking days is ideal since there is a drive for quick completions and delivery in the trading community. A longer period could mean extra storage costs or potential damage to perishable goods. As it currently stands, if both the seller and buyer want to be sure of a shorter period for examination of documents, this can only be done by incorporating a term which provides for a shorter time for examination into the sale and credit agreements.

Traders need to pay special attention to the second part of Article 14(b) as it has important implications on the operation of letters of credit. If the letter of credit is about to expire, Article 14(b) allows the bank to examine documents in the usual manner and does not impose any obligation on them to expedite the process.¹⁸ It is over-simplified to say that all the beneficiary has to do is to make sure that he presents the documents at least 5 banking days before the expiry of the LC. There is always the possibility that the documents presented are discrepant. Therefore, a beneficiary should always try to ensure that presentation of documents is done early enough so that, if the documents are rejected, he has enough time to correct and re-present the documents. Since banks can take five days in all cases, the question also arises as to whether banks can refuse to examine documents if the beneficiary submits documents less than five days before the expiry date of the credit. Of course from a business point of view, this is a bad move as it could drive away prospective business for the bank. Beneficiaries should also take note of any holidays as the article states “five banking days”, which may have the effect of pushing the optimal date for presentation forward.

¹⁷ See 2.5.1.

¹⁸ *Commentary on UCP 600-Article-by-Article Analysis by the UCP 600 Drafting Group* (ICC, Paris 2007) 63.

Article 2 UCP 600 complicates the issue further by defining a banking day as “a day on which a bank is regularly open at the place at which an act subject to these rules is to be performed.” This definition is weak since it is not clear what is the precise meaning of “the place”. It seems to refer to the country in which the bank operates. Different departments in a bank may have different operating hours. Some may be closed on Saturday whilst some may open half-day on Saturdays. The UCP should be more specific by providing that a banking day is, “a day on which the credit management department is regularly open in that country.” The current definition makes it difficult for banks to determine the last date in which they are allowed to examine the documents. Equally, a beneficiary will find it difficult to ascertain the optimum date for presentation of documents.

2.4 Types of Discrepancies

This section explores the different types of discrepancies which may be found in credit documents.

2.4.1 Consistency

Rejection of documents based on inconsistent data was a troubling issue during the lifetime of the UCP 500 because a large number of documents were rejected on this ground. Some representatives from Asia even admitted that banks took advantage of this rule because of the additional income coming in from the re-examination of documents.¹⁹ The second part of Article 13(a) UCP 500 stated the following:

...Documents which appear on their face to be inconsistent with one another will be considered as not appearing on their face to be in compliance with the terms and conditions of the Credit.

Article 14 (d) UCP600 now stipulates that:

¹⁹Kreitman, R., “UCP 600: The End in Sight?” Mantissa Support (2005)
<<http://www.mantissa.co.uk/Support/nextucp3a.htm>>accessed 21 September 2008.

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

Similarly, the successor of Article 37(c) UCP 500, Article 14(e) UCP 600 no longer uses the language of “inconsistent” but instead now stipulates that, “In documents other than the commercial invoice, the description of the goods, services or performance, if stated, may be in general terms not conflicting with their description in the credit.”

The UCP does not explain the meaning of “not conflict/conflicting with” in more detail but the new provision re-establishes the position that documents do not have to be a mirror image of each other. It is highly likely that “not conflict with” means that documents are subjected to a less rigid standard than “inconsistent”, thereby having the effect of making it more difficult to find discrepancy on this ground. A discrepancy can only be found on this ground if the difference between the documents or data is one of substance and not merely a linguistic one.²⁰

The writer is not persuaded that the change in the wording brings significant improvement. The phrase “does not conflict” leaves room for subjectivity. So far, no guidance has been issued to clarify what kind of data would suffice as conflicting under the article so that documents could be rejected. In practice, non-identical data which conflict with each other could exist in varying degrees and therefore the position is not always straightforward. For example, does an invoice which states boxes and a bill of lading which states bags entitle banks to reject the documents? If the invoice describes the goods as “yellow geometric print fabric” and the bill of lading shows the goods as “yellow patterned fabric”, would a discrepancy be called on the grounds that the documents conflict with each other? The writer takes the view that in the first example, the documents are discrepant since the information about the form of packaging of the goods are obviously conflicting. Moreover, the packaging is not an insignificant aspect of the goods. As for the second example, it is arguable that the information are not “conflicting”. In the absence of

²⁰ AG Guest and others, Benjamin's Sale of Goods 7th ed: 1st supplement (Sweet & Maxwell Ltd 2008) para 23-236U.

ICC guidance, bankers and traders will have to use common sense and commercial knowledge to aid them in deciding whether the documents are indeed in conflict. Where highly technical/specialist data are involved, bankers themselves will not have the expertise to determine whether the data in fact conflict.

Article 14(g) UCP 600 provides that, “A document presented but not required by the credit will be disregarded and may be returned to the presenter.” Hence, if a bank comes across data in a non-stipulated document which conflict with data in another stipulated document (perhaps because the non-stipulated document was inadvertently presented), it cannot reject the documents on the ground of inconsistency. The position is different for data which is not required but exist in a stipulated document. The UCP 500 provided that documents must be consistent but Article 14(d) UCP 600 provides that data must be consistent with other data in the same document. As Prof Byrne states, “No distinction is made in UCP 600 Article 14(d) between data required by the credit and extraneous data either, apparently, requiring all data be examined, a major change from recent ICC Banking Commission opinions.”²¹ This aspect of the change provides banks with a wider scope for rejecting inconsistent documents, which is perplexing since the thrust of the revision was to reduce the number of discrepant documents.

One further issue which arises is how the new provision will be interpreted by the courts if data conflict with a non-documentary requirement, since under UCP 600 Article 14(h) banks are to disregard non-documentary requirements. C Debatista observes that there is some incompatibility between UCP 600 Article 14(d) and Article 14(h):

“When the Article says, for example, that the banks must compare data in each document with data ‘in the credit’, this must be referring to data which is not in “any other stipulated document”, i.e. in a non-documentary requirement. However, if this is so, then does this mean that data in a document conflicting with a non-documentary requirement in the credit would make the document discrepant? Or

²¹James E. Byrne, *The Comparison of UCP600 & UCP500* (The Institute of International Banking Law & Practice, MD USA 2007) 135.

would Art.14(h), requiring the banks to disregard non-documentary requirements, avoid this result?”²²

It is hoped that the ICC will issue a clarification as to what data “in the credit” refers to. Considering the drive to the 2007 revision was to reduce discrepancy, it is almost likely that it was not the intent of the UCP Drafting Group that banks check for inconsistency in non-documentary requirement.

In theory, the overall effect of the re-drafted article should be a watering-down of the consistency test. However, it is a possibility that bankers may still adopt a rigorous examination of tendered documents in practice, since, as the discussion before shows, banks now have to check for inconsistencies between data within the same document. Only time will tell but it will be disappointing if the revised article does not alleviate rejection of discrepant documents. If this is the case, then the article will need to be redrafted.

2.4.2 Linkage

Most writers treat consistency and linkage as the same issue but consistency and linkage are in fact capable of being differentiated. Linkage refers to the requirement that the documents tendered must relate the same batch of goods. In *Banque de l'Indochine et de Suez S.A. v J. H. Rayner (Mincing Lane) Ltd*, John Donaldson MR explained that, “There is, in my judgment, a real distinction between an identification of ‘the goods’, the subject matter of the transaction, and a description of those goods. The second sentence of art. 32 (c) [the equivalent of UCP 600 Article 14(e)] gives latitude in description, but not in identification.”²³ In this case, the bill of lading showed 40,000 polythene lined unmarked jute bags of white crystal sugar weighing 2018.6 tonnes gross loaded on *Markhor* at Antwerp bound for Djibouti in transit for The Yemen. The combined weight of the two quality certificates was the same as that stated in the bill of lading and, by calculating the net weights represented the same number of bags. However, one referred

²² C Debattista, “The new UCP 600: changes to the tender of the seller's shipping documents under letters of credit. *Journal of Business Law*” [2007] 4 JBL 329, 341.

²³ [1983] 1 Lloyd's Rep. 228, 233.

to the sugar having been loaded on the "m/v Markhor or substitute". As for the two certificates of origin, the quantities referred to are correct but one referred to consignment by "m/v Markhor or substitute", while the other to "Transports mixtes a destination Djibouti Port in Transit Yemen". The total quantities in the three EUR 1 certificates were correct, but one named Tate & Lyle for account their principals as consignees, another Rayners for account their principals and the third Rayners *simpliciter*. There is no indication of the method of transport in two of them, one says simply "Fer". One refers to preferential terms between France and Djibouti and the other to France and Yemen Nord. John Donaldson stated that he did not consider that these documents were necessarily inconsistent with each other but decided that "Clearly these certificates *could* relate to the goods, but they do not necessarily do so. This will not do."²⁴ Therefore, the advising bank was entitled to be paid by the beneficiary for the amount paid under reserve. The decision imposes a very high standard for identification of goods, as it was emphasised by the learned judge that "the identification must... be unequivocal."²⁵

Banque de l'Indochine was criticised for applying the requirement of identification too strictly.²⁶ R Jack also suggested that, "Perhaps 'necessarily'... should have been 'with reasonable certainty'."²⁷ In *Glencore International A. G. v Bank of China*, Rix J stated that he was more inclined to think that the linkage or identification test is intended to be less demanding than the "unequivocal" standard as put forward in *Banque de l'Indochine*.²⁸ Although he commented that it was unnecessary for him to decide this point²⁹, he concluded that, "[T]he goods described in

²⁴ *Ibid.*

²⁵ *Ibid.*

²⁶ C Murray, D Holloway and D Timson-Hunt, *Schmitthoff's Export Trade: The Law and Practice of International Trade* (11th edn Sweet & Maxwell, London 2007) 207.

²⁷ R Jack, *Documentary credits: the law and practice of documentary credits including standby credits and demand guarantees* (4th edn Tottel, Haywards Heath 2009) para 8.49.

²⁸ [1996] 1 Lloyd's Rep 135, 145. Rix J referred to No. 23 of Case Studies on Documentary Credits under UCP 500, where the packing list only indicated the quantity of the goods, the style number, and the invoice number corresponding with that of the commercial invoice but did not describe the goods shipped and invoiced. The ICC committee of experts wrote:

In this particular instance, a failure to give any description of the goods in the presented packing list cannot be construed as being a discrepancy. The reason being that there is a *sufficient link* between the data content in the commercial invoice and the packing list.

²⁹ This was because Bank of China did not include the issue of identification in its notice of refusal.

the packing list are to be unequivocally, albeit indirectly, identified with both the letter of credit goods and the goods shipped.”³⁰

It is the writer’s view that despite being capable of conceptual distinction, in practice, consistency and linkage are inter-related. It is true that consistency between, for example, a packing list and the other documents such as invoice and bill of lading, does not mean the goods indicated in the packing list are the same goods referred to in the other documents. Nevertheless, the more consistency in a set of documents, the more linkage between the documents and the more likely they are to refer to the same batch of goods. In other words, consistency between the documents may assist in the identification of goods.

How does one reconcile the requirement of identification with UCP 600 Article 14(d) which provides for the requirement of consistency? R Jack suggests three possible approaches³¹:

- a) there is no requirement for the identification of goods, only a requirement of consistency as provided by Article 14(d).
- b) the requirement of identification of goods is incorporated into Article 14(d).

³⁰ [1996] 1 Lloyd's Rep 135, 146. The learned judge supported his decision by these facts: “The packing list is headed "PT Indonesia Asahan Aluminium", which is of course the name of the shipper to be found in the bill of lading, as well as of the certifier of the certificate of weight/quantity. The packing list then gives, lot number by lot number, the bundle numbers which fall under each lot number, and the number of pieces which are in each bundle and the (net) weight of each bundle, as well as the total number of pieces and total net weight of the bundles within each lot number. At the end of the packing list are listed the final total number of bundles and pieces and the final total net weight of the parcel as a whole. Thus the packing list begins with lot number 84103: there are six bundles in lot number 84103; each bundle is made up of 44 pieces, and the individual weights of each bundle are given; the total number of pieces and total weight of the six bundles of lot number 84103 are then given as 264 and 6,001 (i.e. 6.001 tonnes) respectively. These figures are identical with the figures on the certificate of weight/quantity. Thus the latter document refers to each of the 27 different lot numbers to be found in the packing list, and in respect of each lot number sets out the number of bundles, number of pieces and net weight relevant to that lot number. In the case of lot number 84103 there are six bundles, 264 pieces and a net weight of 6,001 - identical to the figures on the packing list. The process is repeated lot number by lot number, with the figures on the certificate of weight/quantity reproducing the figures of the packing list. At the very end of the packing list the final totals of 797 bundles, 35,068 pieces and a net weight of 800,022 are given. The final totals of the certificate of weight/quantity are identical. The packing list also gives the total gross weight of 801.616 tonnes, which is identical to the figure for gross weight given in the bill of lading. The total number of bundles and the total net and gross weights are also reproduced in numerous other documents within the tender, including the commercial invoice itself. The certificate of weight/quantity refers to the commodity as "aluminium ingot ", the name of vessel as *Cheng Yun*, and to the number of the commercial invoice itself. Both the packing list and the certificate of weight/quantity are dated June 20, 1995.”

³¹ *R Jack* (n 27) para 8.49.

c) the requirement of identification of goods is not covered by the UCP but is one which has been established under common law.

Even the Court of Appeal in *Glencore* struggled with this point and recognised that this is a difficult matter.³² As it currently stands under English law, c) is most likely to be the correct approach although a) is likely to be the position under the UCP, hence the absence of an express provision on the requirement of identification of goods in the UCP.

2.4.3 Original Documents

Pre UCP 600, in *Glencore International AG v Bank of China*³³, the Court of Appeal held that a computer printout on non-headed paper which had been hand-signed but not marked as an original was not to be regarded as an original because Article 20(b) UCP 500³⁴ required documents produced by reprographic means to be marked as “original”. Later in *Kredietbank v Midland Bank*³⁵, the Court of Appeal took a less restrictive approach and held that an insurance policy which was not marked as an original but produced by a word processor and printed by a laser printer onto the insurance company's headed paper, with its logo is to be accepted as an original. The decision in *Glencore* was distinguished on the basis that it applied to documents which were obviously reprographic or carbon copies.³⁶ As a result of these two decisions, there was uncertainty as to what constituted original documents under Article 20(b) UCP 500.

³² Rix J in *Glencore International A. G. v Bank of China* [1996] 1 Lloyd's Rep 135,145 stated:

“The matter is not, however, without difficulty, because it can be argued on the one hand that Sir John Donaldson's doctrine of unequivocal and necessary identification is derived from the common law in the absence of contrary provisions in the UCP (see *Banque de l'Indochine v. Rayner* at p. 232, col. 2; p. 731E/H), that he considered that the 1974 Revision did not touch on the question of identification which therefore remained as it did at common law, and that the altered language of what is now art. 21 of the 1993 Revision, unlike the more precise language of art. 23 of the 1983 Revision, once again leaves the question of identification entirely outside the provisions of the UCP Code; and on the other hand that the “legislative history” of art. 21 shows a clear intention that Sir John Donaldson's doctrine of identification in its full apparent rigour has been modified and relaxed.”

³³ [1996] 1 Lloyd's Rep 135.

³⁴ UCP 500 Article 20(b):

Unless otherwise stipulated in the Credit, banks will also accept as an original document(s), a document(s) produced or appearing to have been produced:

- i. by reprographic, automated or computerized systems;
- ii. as carbon copies;

provided that it is marked as original and where necessary, appears to be signed.

A document may be signed by handwriting, by facsimile signature, by perforated signature, by stamp, by symbol, or by any other mechanical or electronic method of authentication.

³⁵ [1999] 1 All ER (Comm) 801.

³⁶ *Ibid*, 812.

Therefore, in July 1999, the ICC issued a policy statement to clarify this issue and this policy statement is now incorporated into Article 17 UCP 600.³⁷ Article 17 UCP 600 stipulates the following:

- a. At least one original of each document stipulated in the credit must be presented.
- b. A bank shall treat as an original any document bearing an apparently original signature, mark, stamp, or label of the issuer of the document, unless the document itself indicates that it is not original.
- c. Unless a document indicates otherwise, a bank will also accept a document as original if it:
 - i. appears to be written, typed, perforated or stamped by the document issuer's hand; or
 - ii. appears to be on the document issuer's original stationery; or
 - iii. states that it is original, unless the statement appears not to apply to the document presented.
- d. If a credit requires presentation of copies of documents, presentation of either originals or copies is permitted.
- e. If a credit requires presentation of multiple documents by using terms such as "in duplicate", "in two fold" or "in two copies", this will be satisfied by the presentation of at least one original and the remaining number in copies, except when the document itself indicates otherwise.

The position now is that the bank can no longer reject documents solely on the grounds that they were not marked as originals. If a document is presented, it will have to be regarded as an original if its appearance bore any of the characteristics provided in Article 17(b) and Article 17 (c) of UCP 600, unless the document itself indicates otherwise, for example if it was marked as a "copy". Note that both clauses use the word "or" so that if for example, an invoice which is not signed by the issuer but is written on the issuer's original stationery is presented, the bank will have to treat the invoice as an original. However, some documents like the bill of lading or insurance documents are exceptions and the relevant provisions of the UCP 600 stipulate that they must be signed.³⁸

³⁷ICC Commission on Banking Technique and Practice, "The determination of an Original document in the context of UCP 500" sub-Article 20(b)" ICC Document" n° 470/871 Rev.
<<http://www.iccwbo.org/collection4/folder165/id415/printpage.html?newsxml=&articlexml=>>accessed 21 May 2008.

³⁸ See UCP 600 Article 20 (a)(i) and Article 28(a).

Similarly, photocopies will not be treated as originals unless the photocopies accord with any of the characteristics stipulated in Article 17(b) and Article 17(c) of UCP 600. If a photocopy is just a photocopy of another document in its entirety, it will not be regarded as an original even if the document shows a signature, a stamp, has photocopied markings of the issuer's stationery or has an "original" mark since any of these applies to the document which had been photocopied. However if, for example, a document is a photocopy of another document, but has evidently been photocopied onto original stationery or has been completed by hand marking, then the document is regarded as an original document under the UCP.³⁹ In the instance where an original stamp is involved, this can be a dangerous rule which exposes the applicant and bank to fraud because a fraudulent party could create a document which appears to be a photocopied document, buy an "original" stamp, stamp it on that document and claim that it is an original document. If the applicant does not wish to accept photocopies of any documents, it will be safe practice for the credit to expressly provide that photocopies are not allowed.

Article 17(a) UCP 600 is a new clause, requiring a beneficiary to present at least one original of each required document. Unlike Article 20(c)(i) UCP 500⁴⁰, Article 17(d) UCP 600 expressly provides that originals can be presented if the letter of credit calls for copies. It really did not make sense to insist on a copy if an original document was presented since copies are much easier to be fraudulently produced. There is no longer a reference to reprographic, automated or computerised systems and carbon copies. Where multiple copies are required, the wording of Article 17 UCP 600 differs slightly from the stipulation in Article 20(c)(ii) UCP 500⁴¹. Under UCP 500, at least one original must be presented with the remainder copies, whereas under the new UCP at least one original is required, with the remainder either copies or originals.

³⁹See ICC Document n° 470/871 Rev., at Point 3.

<<http://www.iccwbo.org/collection4/folder165/id415/printpage.html?newsxml=&articlexml=>>accessed 21st December 2008.

⁴⁰UCP 500 Article 20(c)(i): Unless otherwise stipulated in the Credit, banks will accept as copy(ies), a document(s), either labelled copy or not marked as an original –a copy(ies) need not be signed.

⁴¹UCP 500 Article 20(c)(ii): Credits that require multiple document(s) such as "duplicate", "two fold", two copies" and the like, will be satisfied by the presentation of one original and the remaining number in copies except where the document itself indicates otherwise.

In comparison, the explanation of what constitute original documents under the UCP 600 is more detailed than the old UCP. The new rules on copies and multiple documents also accords with business sense and is more in line with banking practice.

2.4.4 Bills of Lading

Article 20 UCP 600 provides the following:

a. A bill of lading, however named, must appear to:

i. indicate the name of the carrier and be signed by:

- the carrier or a named agent for or on behalf of the carrier, or
- the master or a named agent for or on behalf of the master.

Any signature by the carrier, master or agent must be identified as that of the carrier, master or agent.

Any signature by an agent must indicate whether the agent has signed for or on behalf of the carrier or for or on behalf of the master.

ii. indicate that the goods have been shipped on board a named vessel at the port of loading stated in the credit by:

- pre-printed wording, or
- an on board notation indicating the date on which the goods have been shipped on board

The date of issuance of the bill of lading will be deemed to be the date of shipment unless the bill of lading contains an on board notation indicating the date of shipment, in which case the date stated in the on board notation will be deemed to be the date of shipment.

If the bill of lading contains the indication "intended vessel" or similar qualification in relation to the name of the vessel, an on board notation indicating the date of shipment and the name of the actual vessel is required.

iii. indicate shipment from the port of loading to the port of discharge stated in the credit.

If the bill of lading does not indicate the port of loading stated in the credit as the port of loading, or if it contains the indication "intended" or similar qualification in relation to the port of loading, an on board notation indicating the port of loading as stated in the credit, the date of shipment and the name of the vessel is required. This provision applies even when loading on board or shipment on a named vessel is indicated by pre-printed wording on the bill of lading.

- iv. be the sole original bill of lading or, if issued in more than one original, be the full set as indicated on the bill of lading.
- v. contain terms and conditions of carriage or make reference to another source containing the terms and conditions of carriage (short form or blank back bill of lading). Contents of terms and conditions of carriage will not be examined.
- vi. contain no indication that it is subject to a charter party.

The predecessor of the above provision, Article 23 UCP 500, adopted the heading “marine/ocean bill of lading“, but the new provision replaces this with the term “bill of lading”. However, the new UCP continues to categorise the different types of bill and in separate articles makes provision, in most respects similar to those applicable to bills of lading, for multimodal bills, non-negotiable sea waybills and charter party bills. This article will mainly discuss the traditional marine bill of lading but where the provisions of other bills are dissimilar on the same issue, the writer will highlight these differences.

2.4.4.1 Signatures

All bills of lading must be signed. Despite the removal of “or otherwise authenticated”, “authentication” and “authenticating” in all of the transport articles, there are no changes with respect to the way a bill of lading is to be signed.⁴² This is because Article 3 UCP 600 now

⁴² UCP 500 Article 23:

a. If a credit calls for a bill of lading covering a port-to-port shipment, banks will, unless otherwise stipulated in the Credit, accept a document, however named which:

i. appears on its face to indicate the name of the carrier and to have been signed or otherwise authenticated by:

-the carrier or a named agent for or on behalf of the carrier, or

-the master or a named agent for or on behalf of the master

Any signature or authentication of the carrier or the master, as the case may be. An agent signing or authenticating for the carrier or master must also indicate the name and the capacity of the party, i.e. carrier master, on whose behalf that agent is acting.

ii. indicates that the goods have been loaded on board, or shipped on a named vessel.

Loading on board or shipment on a named vessel may be indicated by pre-printed wording on the bill of lading that the goods have been loaded on board a named vessel or shipped on a named vessel, in which case the date of issuance of the bill of lading will be deemed to be the date of loading on board and the date of shipment.

In all other cases loading on board a named vessel must be evidenced by a notation on the bill of lading which gives the date on which the goods have been loaded on board, in which case the date of the board notation will be deemed to be the date of shipment.

If the bill of lading contains the indication “intended vessel” or similar qualification in relation to the vessel, loading on board a named vessel must be evidenced by an on board notation on the bill of lading which, in addition to the (footnote continues next page)

provides that “A document may be signed by handwriting, facsimile signature, perforated signature, stamp, symbol or any other mechanical or electronic method of authentication”. Article 20(a)(i) UCP 600 maintains the position of its predecessor in the following matters:

- a) The name of the carrier must be indicated on the bill of lading.
- b) A signature by the carrier or its agent or a signature by the master or its agent is required.
- c) A bill of lading with just a simple signature could be rejected since the article requires a signature to indicate the capacity of the signer.
- d) The words “named agent” means that the bill of lading must indicate the name of the agent.

Although all the other transport document provisions follow the above position, there is no provision in Article 22 UCP 600 requiring charterparty bills to name the carrier. There are also some differences as to who may sign for charterparty bills with Article 22(a)(i) UCP 600 providing that such bills must be signed by:

- a) the master or his agent; or
- b) the owner or his agent; or
- c) the charterer or his agent

date on which the goods have been loaded on board, also includes the name of the vessel on which the goods have been loaded, even if they have been loaded even if they have been loaded on vessel named as the “intended vessel”. If the bill of lading indicates a place of receipt or taking in charge different from the port of loading, the on board notation must also included the port of lading stipulated in the Credit and the name of the vessel on which the goods have been loaded, even if they have been loaded on the vessel named in the bill of lading. This provision also applies whenever loading on board the vessel is indicated by pre-printing wording on the bill of lading, and

- iii. indicates the port of loading and the port of discharge stipulated in the Credit, notwithstanding that it:
 - a. Indicates a place of taking in charge different from the port of loading and /or a place of final destination different from the port of discharge, and /or
 - b. contains the indication “intended” or similar qualification in relation to the port of loading and /or ports of discharge, as long as the document also states the ports of loading and /or discharge stipulated in the Credit, and
 - iv. consists of a sole original bill of lading, or if issued in more that one original. A full set as so issued, and
 - v. appears to contain all of the terms and conditions of carriage or some of such terms and conditions by reference to a source or document other that the bill of lading (short form/blank back bill of lading); banks will not examine the contents of such terms and conditions, and
 - vi. contains no indication that it is subject to a charter party and /or or no indication that the carrying vessel is propelled by sail only, and
 - vii. In all other respects meets the stipulations of the Credit.

This is a major change from UCP 500 where a charterer (could be the applicant or beneficiary depending on the terms shipment) was not allowed to sign a charterparty bill of lading. It is likely that in most circumstances, this option will not be utilised because an applicant would most likely not want to the beneficiary to sign and vice versa but would insist that a bill be signed by either the master or the owner. This is because it could have an impact on their legal interest in the event of damage to or loss of the cargo. Again, if the relevant parties do not wish for a charterer to sign, this needs to be expressly excluded in the credit.

2.4.4.2 Master's name need not be indicated

There is a fundamental change in all transport document articles in relation to the situation where an agent signs for or on behalf of a master. Unlike UCP 500, UCP 600 does not require an agent signing for or on behalf of the master to provide the name of the master.⁴³ This is a welcomed change since, in practice, it is often the case that an agent who signs on behalf of a master receives instructions from a head office and has never met the master.

2.4.4.3 Date of shipment

The position regarding the date of shipment remains unchanged from the old UCP. UCP 600 provides that the date of issuance of the bill of lading is the date of shipment. For multimodal bills, the date of issuance of the bill of lading is treated as “the date of dispatch, taking in charge or shipped on board and the date of shipment”⁴⁴. If the bills contain a separate dated on-board notation, then the on-board date will be regarded as the date of shipment, regardless of whether the on-board date is before or after the issuance date of the bill of lading.⁴⁵

2.4.4.4 Port of loading and port of discharge

As with UCP 500, all bills must show that the goods have been shipped from the port of loading to the port of discharge required by the credit or, where multimodal bills are concerned, it must

⁴³ UCP 600 Article 19(a)(i), Article 20(a)(i), Article 21(a)(i), Article 22(a)(i).

⁴⁴ UCP 600 Article 19(a)(ii).

⁴⁵ UCP 600 Article 19(a)(ii), Article 20(a)(ii), Article 21(a)(ii), Article 22(a)(ii).

indicate the “place of dispatch, taking in charge or shipment and the place of final destination stated in the credit”.⁴⁶ The difference lies in the fact that, unlike a multimodal bill, a port-to-port bill of lading relates to loading on board the named vessel at the port of loading stated in the credit and not to any pre-carriage of the goods from a place of receipt to the port of loading. However, for charter party bills, if a credit gives a geographical area or range of ports of loading and/or discharge, the charter party bill of lading may show the geographical area or range of ports as the port of discharge, e.g. “any Spanish port” but a named port of loading must still be indicated.⁴⁷ For non-negotiable sea waybills and the traditional marine bills, if the bill does not indicate the port of loading to the port of discharge stated in the credit or if it indicates an “intended” port of loading or discharge, then an on-board notation is required.⁴⁸ The on-board notation must indicate the port of loading stated in the documentary credit, the name of the vessel and the date of the shipment. The on-board notation should look like this:

“SHIPPED ON BOARD ON 27 JANUARY 2007
PORT OF LOADING: SINGAPORE
VESSEL NAME: ILI”

2.4.4.5 Vessel’s name

Article 19 (a)(iii) UCP 600 allows multimodal bills to contain the indication “intended vessel” or similar qualification in relation to the vessel but all the other bills of lading must also indicate the name of the vessel on which goods have been loaded.⁴⁹ There are no provisions in Article 22 UCP 600 regarding “intended vessel” since the nature of charterparty bills would require it to name the vessel.

With the exception of multimodal bills and charterparty bills, if “intended vessel” or similar qualification in relation to the name of vessel is indicated on all other types of bills of lading,

⁴⁶ UCP 600 Article 19(a)(iii), Article 20(a)(iii), Article 21(a)(iii), Article 22(a)(iii).

⁴⁷ UCP 600 Article 22(a)(iii).

⁴⁸ UCP 600 Article 20(a)(iii), Article 21(a)(iii).

⁴⁹ UCP 600 Article 20(a)(ii), Article 21(a)(ii), Article 22(a)(ii).

UCP 600 requires an “on board” notation indicating the date of shipment and the actual name of the vessel such as the following⁵⁰:

“SHIPPED ON BOARD ON 27 JANUARY 2007

VESSEL NAME: ILI”

2.4.4.6 Clean bills of ladings

Article 27 UCP 600 is the new revised article of the Article 32 UCP 500. The text of Article 27 UCP 600 is substantially shorter than the Article 32 UCP 500, but Article 27 UCP 600 does not change or create any new rules. It is still the case that banks will only accept clean transport documents. So long as a transport document bears “no clause or notation expressly declaring a defective condition of the goods or their packaging”⁵¹, document checkers will have to treat the document as a clean transport document. Article 27 UCP 600 expressly states that, “The word “clean” need not appear on a transport document even if a credit has a requirement for the transport document to be “clean on board.”” The need for amendment arose because Article 32 UCP 500 was not clear on this point and document checkers rejected documents which did not bear the word “clean”.

What happens if a credit requires a document to be “marked clean”? Would it mean that the required document must be marked clean? Since Article 1 UCP 600⁵² allows modification of UCP rules by express wording in the credit, arguably, a requirement for a clean bill of lading is different from a requirement for a bill of lading to be marked clean.

2.4.4.7 Transshipment

Following the revision, Article 20 UCP 600 provides the following:

⁵⁰ UCP600 Article 20(a)(ii), Article 21(a)(ii).

⁵¹ UCP 600 Article 27.

⁵² UCP 600 Article 1: The Uniform Customs and Practice for Documentary Credits, 2007 Revision, ICC Publication no. 600 ("UCP") are rules that apply to any documentary credit ("credit") (including, to the extent to which they may be applicable, any standby letter of credit) when the text of the credit expressly indicates that it is subject to these rules. They are binding on all parties thereto unless expressly modified or excluded by the credit.

- b. For the purpose of this article, transshipment means unloading from one vessel and reloading to another vessel during the carriage from the port of loading to the port of discharge stated in the credit.
- c. i. A bill of lading may indicate that the goods will or may be transhipped provided that the entire carriage is covered by one and the same bill of lading.
 - ii. A bill of lading indicating that transshipment will or may take place is acceptable, even if the credit prohibits transshipment, if the goods have been shipped in a container, trailer or LASH barge as evidenced by the bill of lading.
- d. Clauses in a bill of lading stating that the carrier reserves the right to tranship will be disregarded.

Transshipment has been re-defined by replacing “during the course of ocean carriage” in Article 23(b) UCP 500⁵³ with “during the carriage”. Article 20(c)(i) UCP 600 provides that transshipment is allowed so long as one bill of lading covers the entire carriage. This probably means that separate bill of ladings for each leg of a voyage will allow the bank to reject the documents. The writer interprets Article 20(c)(i) UCP 600 as reasserting for transshipment the rule in Article 20(a)(iii) UCP 600 that bills of lading must indicate shipment from the port of loading to the port of discharge stated in the credit. C Debattista raises the point that Article 20(c)(i) UCP 600 could possibly mean that the carriage must be covered by one bill of lading which does not contain a clause disclaiming the carrier’s liability after transshipment.⁵⁴ This, he argues, would be inconsistent with Article 20(a)(v) UCP 600, which provides that the contents of terms and conditions of carriage will not be examined. Although the position at common law is that the carrier must undertake responsibility for all journeys⁵⁵, even those after transshipment, this is unlikely to be the intended effect of Article 20(c)(i) UCP 600 since it does not refer to the

⁵³ UCP 500 Article 23:

- b. For the purpose of this Article, transshipment means unloading and reloading from one vessel to another vessel during the course of ocean carriage from the port of loading to the port of discharge stipulated in the Credit.
- c. Unless transshipment is prohibited by the terms of the Credit, banks will accept a bill of lading which indicates that the goods will be transhipped, provided that the entire ocean carriage is covered by one and the same bill of lading.
- d. Even if the Credit prohibits transshipment, banks will accept a bill of lading which:
 - i. indicated that the transshipment will take place as long as the relevant cargo is shipped in Container(s), trailer(s) and/or “LASH” barge(s) as evidenced by the bill of lading, provided that the entire ocean carriage is covered by one and the same bill of lading, and/or
 - ii. incorporates clauses stating that the carrier reserves the right to transship

⁵⁴C Debattista, “The new UCP 600: changes to the tender of the seller's shipping documents under letters of credit. *Journal of Business Law*” [2007] 4 JBL 329, 344.

⁵⁵ *Hansson v Hamel and Horley Ltd* [1922] 2 A.C. 36.

carrier's liability. If this was the intended meaning, then Article 20(c)(i) UCP 600 is very poorly drafted.

However, this means that the buyer is exposed to risks under the new UCP. It is possible that a bill of lading may be presented which satisfies Article 20(c)(i) UCP 600 (indicating shipment from the port of loading to the port of discharge), but yet at the same time also excludes the carrier's liability after transshipment. Such a bill of lading weakens the utility of the documentary credit to the buyer since he will not be able to bring any claims against the carrier for cargo lost or damaged after the port of transshipment. The buyer should therefore protect himself by expressly excluding the right of the carrier to exclude liability after transshipment.

Following Article 20(c)(ii) UCP 600, a prohibition of transshipment in the credit will not enable a bank to reject a bill of lading indicating transshipment if the bill of lading indicates that the goods are shipped in a container, trailer or LASH barge. This corresponds with shipping practice since it is very common that transshipment may take place if goods are shipped by any of these methods. Article 20(d) UCP 600 states that clauses in a bill of lading giving the carrier a right to transship are to be disregarded, the effect of which is that banks cannot reject a bill of lading merely on the basis that such clauses exist. It is not entirely clear what is the position if a credit expressly prohibits transshipment but the bill of lading contains such a clause. At first sight, it does seem as if banks will have to accept the documents (provided Article 20(a)(iii) UCP 600 is satisfied⁵⁶) since banks will have to treat such clauses as if they are non-existent. However, the predecessor of Article 20(d) UCP 600, Article 23(d) UCP 500 included the words "even if the credit prohibits transshipment"⁵⁷, as does Article 20(c)(ii) UCP 600. The deliberate omission of these words in Article 20(d) UCP 600 could mean that the intention of the drafters was that in relation to goods not shipped in a container, trailer or LASH barge, where there is a clause in the bill of lading giving the carrier a right to transship, an express prohibition of transshipment in the credit will make the bill of lading non-complying. This is a strict interpretation of Article 20(d) UCP 600 and would only be uncovered by a detailed analysis and comparison of both the new and old provisions. In the writer's opinion, this is unlikely to be the intended effect of Article

⁵⁶ See 2.4.4.4.

⁵⁷ UCP 500 Article 23 (n 53).

20(d) UCP 600 since meetings of the ICC Banking Commission revealed no underlying policy change regarding transshipment.

The complexity of the relevant provisions relating to transshipment means that extra care must be taken in the drafting process so that the intentions of a buyer who does not wish his goods to be transshipped are given effect. UCP 600 does seem to allow transshipment in some circumstances even when the credit expressly excludes transshipment. Therefore, express exclusion of transshipment in the credit is futile. The credit will need expressly to exclude the application of the relevant articles and the sale contract should also expressly allow the exclusion of these articles.

2.4.5 Insurance Documents

The rules on the compliance of insurance documents are covered by Article 28 UCP 600.⁵⁸ These provisions are rather straightforward and easy to follow, although one issue deserves to be

⁵⁸ UCP 600 Article 28:

- a. An insurance document, such as an insurance policy, an insurance certificate or a declaration under an open cover, must appear to be issued and signed by an insurance company, an underwriter or their agents or their proxies. Any signature by an agent or proxy must indicate whether the agent or proxy has signed for or on behalf of the insurance company or underwriter.
- b. When the insurance document indicates that it has been issued in more than one original, all originals must be presented.
- c. Cover notes will not be accepted.
- d. An insurance policy is acceptable in lieu of an insurance certificate or a declaration under an open cover.
- e. The date of the insurance document must be no later than the date of shipment, unless it appears from the insurance document that the cover is effective from a date not later than the date of shipment.
- f. i. The insurance document must indicate the amount of insurance coverage and be in the same currency as the credit
ii. A requirement in the credit for insurance coverage to be for a percentage of the value of the goods, of the invoice value or similar is deemed to be the minimum amount of coverage required.
If there is no indication in the credit of the insurance coverage required, the amount of insurance coverage must be at least 110% of the CIF or CIP value of the goods.
When the CIF or CIP value cannot be determined from the documents, the amount of insurance coverage must be calculated on the basis of the amount for which honour or negotiation is requested or the gross value of the goods as shown on the invoice, whichever is greater.
- iii. The insurance document must indicate that risks are covered at least between the place of taking in charge or shipment and the place of discharge or final destination as stated in the credit.
- g. A credit should state the type of insurance required and, if any, the additional risks to be covered. An insurance document will be accepted without regard to any risks that are not covered if the credit uses imprecise terms such as "usual risks" or "customary risks".

(footnote continues next page)

highlighted here. As is the case under UCP 500, if a credit stipulates for insurance against “all risks”, an insurance document, even if it does not contain the heading “all risks” and excludes certain risks, will be accepted if it contains any “all risks” notation or clause.⁵⁹ Following this, insurance against “all risks” does not mean that the goods are covered by insurance against every risk which may arise.⁶⁰ One question which arises from this is the extent to which such a document may exclude risks. One writer argues that “...the existence of an ‘all risk’ notation or clause is all the bank needs to see. If the buyer wishes to ensure that the goods are covered to his satisfaction, he ought to then ensure that the credit contains the degree of specificity which would serve his purpose.”⁶¹ On the other hand, R Jack comments that “if the cover provided is so cut down by the exclusions that it would clearly fall short of the cover to be reasonably expected for the transaction in question, it should be rejected.”⁶² It is argued here that the first approach should be the correct one, since insurance clauses are often technical and banks may not have the required expertise to evaluate whether the exclusions in an insurance document are so extensive as to defeat the purpose of the insurance to the trading parties. In practice, if a document checker notices extensive exclusions of this nature, it would be good practice to inform the seller of this, although he should be under no duty to do so. Moreover, if the policy contains exclusions to the extent that it does not provide the protection which is reasonably expected by the buyer, the buyer will be able to bring an action against the seller for breach of its contractual obligation in the event of loss.

Some of the new insurance provisions contain some changes, although they are not substantial. It is now expressly stated that an insurance document will include “an insurance policy, an insurance certificate or a declaration under an open cover”⁶³. Under the new

h. When a credit requires insurance against "all risks" and an insurance document is presented containing any "all risks" notation or clause, whether or not bearing the heading "all risks", the insurance document will be accepted without regard to any risks stated to be excluded.

i. An insurance document may contain reference to any exclusion clause.

j. An insurance document may indicate that the cover is subject to a franchise or excess (deductible).

⁵⁹ UCP 600 Article 28(h).

⁶⁰ This is consistent with the position at common law. See *Upjohn v. Hitchens* [1918] 2 K.B. 48; *British & Foreign Marine Insurance Co v Gaunt* [1921] 2 AC 41; *F.W. Berk & Co Ltd v Style* [1956] 1 Q.B. 180; *Mayban General Assurance BHD v Alstom Power Plants Ltd* [2004] 2 Lloyd's Rep. 609.

⁶¹ Ellinger, P., and Neo, D., *The Law And Practice Of Documentary Letters Of Credit* (Hart, Oxford 2010) 272.

⁶² *Jack* (n 27) 238.

⁶³ UCP 600 Article 28(a).

provisions, proxies are now allowed to sign insurance documents.⁶⁴ This is probably not a significant change since proxies are generally agents.⁶⁵ Moreover, an agent or proxy's signature must indicate whether he has "signed for or on behalf of the insurance company or underwriter"⁶⁶. One other change is that all cover notes are to be rejected under Article 28(c) UCP 600, since its predecessor only prohibited cover notes issued by brokers.⁶⁷ The new UCP also expressly provides that the risks included under the insurance document must cover, at the minimum, carriage between the two places stated in the credit⁶⁸, providing more assurance for buyers. There is also an additional provision, Article 28(i) UCP 600, which provides that reference to any exclusion clause in an insurance document is allowed. A seller should be wary of any term which excludes Article 28(i) UCP 600. The insurance industry revealed to the UCP 600 Drafting Group that every insurance document in the future would contain clauses excluding acts of terrorism and other types of standard exclusions.⁶⁹ An exclusion of this clause would make it impossible for the seller to supply complying documents⁷⁰ and may even provide opportunities for dishonest buyers to obtain goods without paying.

2.4.6 Non-Documentary Conditions

Non-documentary conditions are conditions of payment specified in a letter of credit which do not require the tender of documents. Non-documentary conditions are problematic because they require banks to investigate true facts, thereby undermining the documentary nature of letters of credit. Article 13(c) UCP 500 provided that banks "will deem such conditions as not stated and will disregard them." However, the position under the old UCP 500 was further complicated by ICC Commission on Banking Technique and Practice Position Paper (No. 3) which provided that banks could only disregard non-documentary conditions if there was no implicit connection between a non-documentary condition and a document to be tendered. This meant that under the

⁶⁴ UCP 600 Article 28(a).

⁶⁵ However, a technical distinction is made by some insurers in some countries – *Byrne* (n 21) 215.

⁶⁶ UCP 600 Article 28(a).

⁶⁷ UCP 500 Article 34(c).

⁶⁸ UCP 600 Article 28(f)(iii).

⁶⁹ *Commentary on UCP 600-Article-by-Article Analysis* (n 18) 133.

⁷⁰ R Kreitmen, "UCP 600: One year on (nearly)" <<http://www.mantissa.co.uk/support/OneYearOn.htm>> accessed 4th January 2010.

UCP 500, banks could sometimes reject documents based on a non-documentary condition. The following example from Position Paper (No. 3) is a good explanation of the previous position:

“For example, if a condition in the documentary credit states that the goods are to be of German origin and no Certificate of Origin is called for, the reference to 'German origin' would be deemed to be a non-documentary condition and disregarded in accordance with UCP 500 sub-Article 13(c). If, however, the same documentary credit stipulated a Certificate of Origin, then there would not be a non-documentary condition as the Certificate of Origin would have to evidence the German origin.”⁷¹

Article 14(h) UCP 600 retains the position of discouraging non-documentary conditions:

"If a credit contains a condition without stipulating the document to indicate compliance with the condition, banks will deem such condition as not stated and will disregard it."

Since Position Papers issued under the old UCP will be ignored, the position now would be slightly different from that under the old regime, even though Article 14(h) UCP 600 is nearly the same as its predecessor⁷². Banks should disregard all non-documentary conditions even if there is a connection between a non-documentary condition and a document which is required by the credit. Banks no longer have to check if a required document could be linked to the non-documentary condition.

One example of a non-documentary condition is in *Banque de l'Indochine et de Suez SA v JH Rayner (Mincing Lane) Ltd*⁷³ where the credit stipulated “Shipment to be effected on vessel belonging to shipping company, member of an International Shipping Conference” though no specific documentary proof was called for by the credit. The Court of Appeal held that the bank was entitled to ask for reasonable documentary evidence. Now, under UCP 600, the bank is to disregard this condition and should not ask for any documentary evidence. However, two Singaporean cases demonstrate that by resorting to ordinary rules of contractual construction,

⁷¹ ICC Commission on Banking Technique and Practice Position Paper (No. 3)

<<http://www.iccwbo.org/collection4/folder165/id357/printpage.html?newsxml=&articlexml=>>accessed 19 June 2009.

⁷² UCP 500 Article 13(c): If a Credit contains conditions without stating the document(s) to be presented in compliance therewith, banks will deem such conditions as not stated and will disregard them.

⁷³ [1983] Q.B. 711.

non-documentary conditions can still be enforced regardless of the provisions of the UCP. In *Kumagai-Zenecon Construction Pte Ltd v Arab Bank Plc*⁷⁴, a standby letter of credit was opened to secure any amount which the applicant was obliged to pay under judgment of the High Court as affirmed or varied by the Court of Appeal. The Court of Appeal ruled that the obligation of the applicant was to pay for the price of all the shares which the beneficiary had purchased “at a fair price to be fixed by independent valuers or at cost, whichever is higher”. A day before the expiry of the credit, the beneficiary made a written demand for payment for \$3,793,000, accompanied by copies of the High Court judgment and the Court of Appeal order but without any documents which supported the amount demanded. The bank refused to pay, on the ground that the sum demanded did not appear to be the sum payable under the applicant's obligations to the beneficiary following the judgments. The beneficiary sued for payment. The trial judge decided that the credit required the valuation report to be tendered as proof of the non-documentary condition and since this was not presented, the bank was entitled to reject the documents tendered. Judith Prakash J explained the following:

“It has to be remembered, however, that the provisions of UCP-500 were not expressly repeated in the credit. Instead they were incorporated by reference. It is a well known principle of construction of contracts that the express terms of [a] contract are capable of overriding terms incorporated by reference if inconsistent with such incorporated terms.”⁷⁵

The learned judge went on to say the following:

“Whilst I recognize the desirability of upholding the provisions of UCP-500 in general, it appeared to me that in this instance the circumstances were such that the credit could only be operated if the non-documentary conditions ie the ascertainment of the fact and quantum of [the applicant's] obligation were satisfied. Otherwise the

⁷⁴ [1997] 2 SLR 805; [1997] 3 S.L.R. 770.

⁷⁵ [1997] 2 SLR 805, [25].

credit did not make sense... I therefore found that in this case art 13c had been excluded by implication because of the express wording of cl 2 of the credit.”⁷⁶

The beneficiary appealed, arguing that the bank was not entitled to request the beneficiary to present the valuation report because UCP 500 Article 13(a) provides that extraneous documents "will not be examined" and that UCP 500 Art.13(c) provides that non-documentary conditions are to be ignored. Recognising the irreconcilable inconsistency between the operation of the credit and the UCP provisions, the Court of Appeal affirmed the trial judge’s adoption of the ordinary principle of construction of contracts to give effect to the non-documentary term of the credit.

In a later case, *Korea Exchange Bank v Standard Chartered Bank*⁷⁷, a credit was opened to finance the purchase of gas oil. One of the terms of the credit was “The amount of this letter of credit shall automatically fluctuate to cover any increase/decrease according to the price clause without further amendment to this credit”. The price clause referred to the market price of gas oil. The amount provided in the credit was US\$ 800,000. However, one clause in the credit provided for a tolerance of credit limit of plus or minus 10%. Standard Chartered (the negotiating Bank) paid upon presentation of tendered documents but Korea Exchange Bank (the issuing bank) refused to reimburse Standard Chartered, alleging various discrepancies. Standard Chartered obtained a summary judgment against Korea Exchange for dishonour and Korean Exchange appealed. On appeal, Korean Exchange argued only one discrepancy - the claim exceeded the upper limit of \$ 880,000. Korean Bank submitted, *inter alia* that the price clause and the fluctuation clause, being non-documentary, was to be ignored under Art 13(c) UCP 500. This was rejected by Andrew Ang J. He observed that the purpose of Article 13.c was to protect a negotiating bank (or, perhaps, a beneficiary) against the issuing Bank. In seeking to invoke Art 13(c) (the predecessor of Article 14(h) UCP 600), Korea Bank, as issuing bank, was “turning Article 13.c on its head”⁷⁸. Furthermore, he stated that without the price clause and the automatic fluctuation clause, the credit would be unworkable as the price for gas oil is not fixed but

⁷⁶ *Ibid*, [26].

⁷⁷ [2006] 1 SLR 565.

⁷⁸ *Ibid*, [30].

fluctuates with a benchmark.⁷⁹ The learned judge applied the approach in *Kumagai-Zenecon* and held that the clause provision would override the relevant provisions of UCP 500. It was held that the conflict between the terms of the credit could be resolved by the words "without further amendment to the credit" in the credit term, which meant that the fluctuation and price clauses prevailed over the tolerance limit clause.⁸⁰ Hence, the amount of payment claimed did not exceed the credit limit and the appeal was dismissed.

Such an approach certainly does offer a number of advantages. It accords with the reasonable commercial expectation of the parties, giving priority to the intention of all the parties involved in the transaction. It is also likely that in most cases, the production of the required document is not very difficult on the part of the beneficiary. However, the principle in these two cases renders Article 14(h) UCP 600 to be rather pointless because it is not the case that all non-documentary conditions are to be disregarded. It brings the position back to the one adopted by English courts in *Banque de l'Indochine*.⁸¹ The position under Article 14(h) UCP 600 is that an applicant who wishes to incorporate such conditions in the credit must expressly provide the document that is needed to be presented in order to satisfy the condition. For example, if the letter of credit states that goods must be shipped on a dry cargo vessel, then the letter of credit and the contract of sale should specify that "a vessel certification certificate indicating that the goods were shipped on a dry cargo vessel" is to be presented. Such express stipulation would safely convert a non-documentary condition into a documentary condition. As C Debattista pointed out, "The degree of forethought by both parties is even more necessary under the UCP600 than it was under the UCP500."⁸²

Adopting the principle adopted by the Singaporean courts means that the absolute prohibition of non-documentary conditions under Article 14(h) UCP 600 is very unlikely to succeed in

⁷⁹ *Ibid*, [33].

⁸⁰ *Ibid*, [23].

⁸¹ See page 48 for discussion of this case. Ebenezer Adodo, "Non-documentary requirements in letters of credit transactions: what is the bank's obligation today?" [2008] 2 JBL 103, 112 noted this too but pointed out that *Banque de l'Indochine* is even more liberal because it would allow *any* reasonable document as opposed to a specific type of document.

⁸² C Debattista, "The new UCP 600: changes to the tender of the seller's shipping documents under letters of credit. *Journal of Business Law*" [2007] 4 JBL 329, 336.

eradicating the problems of non-documentary conditions. The writer agrees with R Jack that the most practical solution is for banks to “not accept instructions to issue or to confirm credits containing non-documentary conditions”⁸³ but experience proves that mistakes can occur in practice. The position of non-documentary condition under UCP 600 is a positive change because it encourages all parties to deal only with documents, an attribute which strengthens the commercial efficacy of the letters of credit. It is argued here that in the interest of the letter of credit community, the argument that Article 14(h) UCP 600 is to give way to the express terms of the contract whenever there is a conflict between the two should not be accepted. After all, if the parties really did intend for documentary proof of a condition, they really should be specifying the relevant documents in the credit for the sake of clarify to all parties.

2.4.7 Addresses

One other significant change is the addition of a new provision concerning addresses of beneficiary and applicants. There was no equivalent provision to deal with non-identical addresses under the old UCP but Article 14(j) UCP 600 now provides the following:

When the addresses of the beneficiary and the applicant appear in any stipulated document, they need not be the same as those stated in the credit or in any other stipulated document, but must be within the same country as the respective addresses mentioned in the credit. Contact details (telefax, telephone, email and the like) stated as part of the beneficiary's and the applicant's address will be disregarded. However, when the address and contact details of the applicant appear as part of the consignee or notify party details on a transport document subject to articles 19, 20, 21, 22, 23, 24 or 25, they must be as stated in the credit

With the exception of transport documents, the new provision provides that the addresses of the beneficiary and applicant can vary. This is quite a divergence from the approach expounded by Viscount Summer in *Equitable Trust*.⁸⁴ Typographical errors with addresses are common since international trading inevitably involve addresses in foreign languages or and will sometimes involve the addresses of regional subsidiaries of a beneficiary. This modification moves one step

⁸³ *R Jack* (n 27) para 8.23.

⁸⁴ See page 24.

towards the aim of reducing the rejection of documents based on trivial technical errors. However, the modification does increase the risk of fraud and money laundering. Since the article also provides for a document checker to disregard other contact details, there is no other means to help him decide if two different addresses are in fact the same place. Addresses in the same country which are similar but not identical could in reality be of two entirely different places in the same country. Nevertheless, given that the addresses of the consignee or notify party in transport documents subject to Articles 19 - Article 25 will need to “as stated” in the credit, Article 14(j) UCP 600 had achieved its best in striking a balance between the aim to reduce rejection and avoiding fraud.

2.4.8 Description of Goods

2.4.8.1 Description of Goods in Invoices

Article 18(c) UCP 600 provides :

The description of the goods, services or performance in a commercial invoice must correspond with that appearing in the credit.

There are no changes from its predecessor.⁸⁵ The meaning of “correspond” is still uncertain. As one commentator, commenting on its predecessor rightfully puts it, “The question remains to what degree of correspondence?”⁸⁶ Does it mean a) the description of the goods in the invoice must be a mirror image of the stipulations in the credit or b) that the description of the goods in the invoice must not contradict the stipulations in the credit? Luckily, the latest ISBP, which applies to credit subject to UCP 600, offers some clarification on this matter:

ISBP

58) The description of the goods, services or performance in the invoice must correspond with the description in the credit. There is no requirement for a mirror image. For example, details of the goods

⁸⁵ Article 37 (c) UCP 500.

⁸⁶ Richard Morris, “Discrepancies: Has UCP 500 Wrought Any Improvement?” Hong Kong Lawyer (Dec 1998) 62,63 <<http://sunzi1.lib.hku.hk/hkjo/view/15/1502320.pdf>>accessed 30 June 2008.

may be stated in a number of areas within the invoice which, when collated together, represents a description of the goods corresponding to that in the credit.

Nevertheless, UCP 600 and ISBP do not provide guidance for the many aspects of discrepancies which can arise in the description of the goods in invoices. For example, in practice a bank may be tendered an invoice with a description which differs in singular /plural terms from the stipulation of the credit. Clive M. Schmitthoff discussed an example of such a discrepancy which in his view should be disregarded - a credit which states “20 cm pipe-cutting machinery” and an invoice which states “two 20 cm pipe-cutting machines.”⁸⁷ In his other example, where a credit stipulates “two machines” but the invoice specifies only “machinery,” he took the view that bank the documents should be rejected because “machinery” may cover only one machine.⁸⁸ It is really difficult to set hard and fast rules in this regard. The determination of whether a non-identical description in the invoice is a discrepancy is to be assisted by a combination of commercial judgment, common sense and the relevant case law.

In *Bank Melli Iran v Barclays Bank (Dominion, Colonial & Overseas)*⁸⁹ the credit provided for 60 “new Chevrolet trucks” but the invoices described the goods as ‘in new condition’. Barclays Bank accepted these documents but Bank Melli rejected the documents and refused to reimburse Barclays Bank, arguing that the documents were discrepant. It was held that there was a discrepancy because “in new condition” does not bear the same meaning as “new”. In *Astro Exitto Navegacion S.A. v. Chase Manhattan Bank N.A. (the Messiniaki Tolmi)*⁹⁰, it was held that the expressions "ex Berger Pilot " and "previous name Berger Pilot" meant the same thing. In *Glencore International AG v Bank of China*⁹¹ the credit stipulated for origin “Any Western Brand” but the invoice tendered stated “Any Western Brand-Indonesia (Inalum Brand)”. Sir Thomas Bingham M.R, delivering the judgment of the Court of Appeal, cited the observation of Sir Thomas Browne that “the same country is sometimes East and sometimes West and Persia

⁸⁷ Clive M. Schmitthoff, “Discrepancy of Documents in Letter of Credit Transactions” [1987] JBL 94, 97.

⁸⁸ *Ibid.*

⁸⁹ [1951] 2 Lloyd’s Rep 367.

⁹⁰ [1986] 1 Lloyd's Rep. 455.

⁹¹ [1996] C.L.C. 95.

though East unto Greece, yet it is West unto China”⁹². It was held that in this respect, there was no discrepancy:

“We cannot for our part accept that the additional words “Indonesia (Inalum brand)” were such as ... to call for further inquiry or are such as to invite litigation. It seems to us quite plain on the face of the document that the additional words were to indicate the precise brand of the goods, it being implicit that that brand fell within the broad generic description which was all that was required. The additional words could not, on any possible reading of the documents, have been intended to indicate that the goods did not or might not fall within the description “any western brand.”⁹³

In comparison to English courts, some common law courts seem to have adopted a stricter interpretation of UCP 600 Article 18(c)’s predecessor. In *Sunlight Distribution v Bank of Communications*⁹⁴, the credit stipulated for shipment of “MOTOROLA 8900X-2 (ETACS) PORTABLE RADIO TELEPHONE, 2600 UNITS.” The beneficiary presented the following two invoices:

Invoice 1		Invoice 2	
QUANTITY	DESCRIPTION	QUANTITY	DESCRIPTION
v2160 UNITS	S3410A MOTOROLA 8900X-2 (ETACS) PORTABLE RADIO TELEPHONE.	440 UNITS	S3410A MOTOROLA 8900X-2 (ETACS) PORTABLE RADIO TELEPHONE
2600	SNN4040A BATTERY BLACK HI-CAP	2	SNN4216A PROGRAMMING BATTERY FOR 8900X-2
52	S3410A MOTOROLA 8900X-2 (ETACS) PORTABLE RADIO TELEPHONE.	1	SNN4216A BATT TEST A/P SAM
52	SNN4040A BATTERY BLACK HI-CAP		

⁹²*Ibid*, 119.

⁹³*Ibid*.

⁹⁴ WL 46636 (S.D.N.Y.1995)

As can be seen from the above, both invoices provided full description of the goods in accordance with the terms of the credit. The problem was that they included additional terms which were not contained in the letter of credit (the terms bolded in the above invoices). The District Court of Southern District of New York held that the invoices were discrepant, adopting Professor Dolan's the approach that "anything beyond the slightest, most unmistakable deviations is simply not acceptable".⁹⁵

Dolan's interpretation was also adopted in *Rudy T. Oei and M.J.F.M. Kools, d/b/a Kools de Visser v. Citibank, N.A.*⁹⁶ where a presented invoice, which was original, stated "LEVI 501-0191,NEW, ORIGINALS, MADE IN USA LABELS" on one line, with the word "JEANS" typed right above the word "LEVI" while copies of the invoice did not include the word "JEANS". It was held to be non-conforming because the credit provided for an original and four copies which indicate shipment of "LEVI JEANS 501-0191, NEW, ORIGINALS, MADE IN US LABELS". It was held that there was wrongful honour of the credit. Although the result of the "mirror image" approach may be outlandish at times, it is submitted that this case was correctly decided since Levi produces other types of clothing and not merely jeans. Hence, "LEVI 501-0191,NEW, ORIGINALS, MADE IN USA LABELS" does not obviously represent the delivery of jeans.

The rigid "mirror image" approach adopted in some of the American cases discussed is not consistent with ISBP para 58. It is certainly true that there is a need to ensure shipment of the correct goods in documentary credit transaction and therefore one would normally assume that an exact description of the goods in the invoice can prevent fraud. But this idea is deceptive because in reality, the invoice is produced by the seller and he could always create an invoice detailing whatever he likes. Nevertheless, a seller should not be careless as it will avoid a lot of problems if the seller ensures that the invoice description matches the description which is provided in the credit. If the applicants really wish for invoices and other documents to describe the goods in accordance the stipulations of the credit verbatim, then this should be expressly specified in the

⁹⁵ J.F. Dolan, *The Law of Letters of Credit: Commercial and Standby Credits* (2nd edn Warren, Gorham & Lamont Inc, Boston 1991) at 6.04[1].

⁹⁶ 957 F.Supp. 492, S.D.N.Y., 1997.

credit instructions. Equally important is that the credit instructions should provide short and concise descriptions of the goods.

2.4.8.2 Description of Goods in Bills of Lading

The term “not inconsistent” in Article 37(c) UCP 500 is replaced, with Article 14(e) UCP 600 now providing as follows:

In documents other than the commercial invoice, the description of the goods, services, or performance, if stated, may be in general terms not conflicting with their description in the credit.

In *Soproma SpA v. Marine and Animal By-Products Corpn.*⁹⁷, the credit described the goods as Chilean Fish Full meal but the bill of lading, bore the description "Fishmeal". It was held that this was a sufficiently general description to comply with Article 33 UCP 400 (the equivalent of Article 14(e) UCP 600). “Anyone in the trade seeing a bill of lading would not expect to see more specific a description than "Fishmeal" and could not reasonably object to such a description”.⁹⁸ The bill of lading was however non-confirming in other respects. In an earlier case, *JH Rayner v Hambro's Bank*⁹⁹, the credit stipulated “coromandel groundnuts”, the invoice stated “coromandel groundnuts” while the bill of lading described “machine-shelled kernels with the margin containing the words, "O.T.C. C.R.S. Aarhus." The two terms were universally understood in the relevant trade as meaning the same thing and that "C.R.S." is short for "Coros" or "Coromandels" but the court upheld the bank’s rejection of the documents on the basis that the bank is not in the groundnut business, and should not be expected to have knowledge of the terms of that trade. In this case, no provision equivalent to Article 14(e) UCP 600 was incorporated into the contract. In view of Article 14(e) UCP 600, would the decision still be decided in favour of the bank today? The writer does not think that Article 14(e) UCP 600 would assist the applicant’s case. Although it may be argued that the real meaning of the two terms do not conflict (in actual fact they are the same), it remains the case that this is knowledge which the bank did not have at that time. R Jack also expressed the same view on the basis that “the two descriptions were inconsistent as a matter

⁹⁷ [1966] 1 Lloyd's Rep. 367.

⁹⁸ *Ibid*, 389 per McNair J.

⁹⁹ [1943] 1 K.B. 37.

of words and any special meaning in the trade was something which the bank was neither bound nor entitled to take into account.”¹⁰⁰

2.4.8.3 Reading together

Documents presented to the bank can be read together, as if they were one document. If all the documents when read together, fully describe the goods and there are no inconsistencies, then there will be no discrepancy. In *Midland Bank Ltd v Seymour*¹⁰¹, the credit stipulated “Hong Kong duck feathers –85% clean; 12 bales each weighing about 190lb; 5s per 1b.” but the bill of lading described the goods as “12 bales; Hong Kong duck feathers”. The invoice however, set out the full description of the goods as stated in the credit term. When all the documents tendered in the set were read together, they fully described the goods. The bank accepted the documents but the buyer then claimed, *inter alia*, that the bank should not have paid because the bill of lading did not fully describe the goods in accordance with the stipulations of the credit. It was held that it was unnecessary for each document to contain a full description of the goods. Devlin J gave the following reasons:

“Having to choose between those two constructions, in my judgment the one that construes the letter of credit as requiring merely that the set should contain all the particulars is the preferable one and the right one, and I arrive at that conclusion mainly on two grounds. The first is that that is the construction which, in my judgment, best fits the language that is used in the letter of credit. The letter of credit quite plainly treats the documents as a set and not as an individual document...The second consideration is this...If each document contains all, it would produce a state of affairs that would be most unusual. For instance, I suppose rarely if ever does one find the price of the goods set out in the bill of lading”¹⁰²

Although *Midland Bank* was not decided under the UCP, the “reading together principle” applied in this case is consistent with Art 14(e) UCP 600. In *Glencore International A. G. v Bank*

¹⁰⁰ *R Jack* (n 27) para 8.45.

¹⁰¹ [1955] 2 Lloyd's Rep 147.

¹⁰² *Ibid*, 152.

of *China*¹⁰³, the defendant alleged inter alia that the packing lists failed to describe the goods. However the packing lists, certificates of weight and quantity, and bills of lading together would provide a comprehensive description of the goods. The Court of Appeal applied *Midland Bank* and decided that the packing list was not to be read and considered in isolation from other documents tendered. This principle has also been adopted by American courts.¹⁰⁴

The writer wishes to highlight two issues arising from the principle in *Midland Bank*. To consider these issues, it is important to distinguish between two scenarios, one where documents other than the invoice are incomplete in description, and the other where the invoice itself is incomplete in description. Where documents other than the invoice provide incomplete description, does the “reading together” principle apply only if the goods are correctly described in the invoice? In *Midland Bank*, the courts seemed to have “read together” the bill of lading and the perfectly described invoice, whilst in *Glencore*, it was the packing lists, certificates of weight and quantity and bills of lading which were read together. It is submitted that documents can be read together only when the goods are correctly described in the invoice. Although it was argued in *Glencore* that description of the goods in the invoice was non compliant, the Court of Appeal decided that the invoice description was compliant.

Where an invoice is incomplete in its description, does the principle in *Midland Bank* apply so that if information is missing in the invoice, this can be supplemented by information in other documents? One may argue that since the invoice can be easily corrected by the seller, if the other documents produced by other parties demonstrate that the correct goods have been shipped, then it is more practical to accept the documents. In *Courtaulds North America, Inc. v. North Carolina Nat. Bank*¹⁰⁵, the presented invoice stated “Imported Acrylic Yarn” instead of “100% Acrylic Yarn” but the packing list which was stapled to the invoice indicated that the packages contained “cartons marked: -100% acrylic”. It was held that the invoice was not compliant with the terms of the credit because the invoice is not to be read as one with the packing list. The United States Court of Appeals (Fourth Circuit) based this decision on the distinction made in the

¹⁰³ 1996] 1 Lloyd's Rep 135.

¹⁰⁴ *Laudisi v American Exchange National Bank* 239 NY 234 (1924); *Exotic Traders Far East Buying Office v Exotic Trading USA, Inc* 717 F. Supp. 14, 16(D. Mass. 1989).

¹⁰⁵ 528 F.2d 802.

UCP between 'invoice' and the 'remaining documents', stipulating that in the latter the description may be in general terms whilst in the invoice the goods must be described to correspond with the credit letter.¹⁰⁶ It is submitted that that the reasoning in this case is correct and still relevant under the current UCP since there has not been any substantive change in the relevant provisions. This perhaps explains why Article 18(c) UCP 600 and Article 14(e) UCP 600 are drafted in different language. One should not assume that “correspond” in Article 18(c) UCP 600 bears the same meaning as “not conflicting with” in Article 14(e) UCP 600.

2.4.9 De minimis rule

In *Moralice (London) Ltd. v. E. D. & F. Man*¹⁰⁷, the bill of lading showed 4,997 bags instead of 5000 bags as stated in the credit term. Even though the shortage was only 0.06%, it was held that there was a discrepancy because the *de minimis* rule does not apply to the tender of documents under a credit. Subsequently, in *Soproma S.P.A. v Marine & Animal by-Products Corporation*¹⁰⁸, a case concerning a credit which provided that the bills of lading should state that at the moment of loading the temperature of the fish meal does not exceed 37½° C but the presented bill of lading stated that the temperature did not exceed 100° F. The discrepancy in temperature was 0.5° F but there were many other discrepancies in the documents presented. Mr. Justice McNair applied *Moralice* but it should be highlighted that he expressly stated that he “should be reluctant to do so if it [the objection about the difference of 0.5° F] stood alone.”¹⁰⁹

Since then, this issue has been incorporated into the provisions of the UCP. Article 30(b) UCP 600 provides that:

A tolerance not to exceed 5% more or 5% less than the quantity of the goods is allowed, provided the credit does not state the quantity in terms of a stipulated number of packing units or individual items and the total amount of the drawings does not exceed the amount of the credit.

For example, a credit incorporating the UCP 600 stipulates for 1000 tons of sand and the full amount of the credit as USD 5000. The documents indicate 1050 tons of sand, drawing an

¹⁰⁶ 528 F.2d 802, 806.

¹⁰⁷ [1954] 2 Lloyd's Rep. 526.

¹⁰⁸ [1966] 1 Lloyd's Rep. 367.

¹⁰⁹ *Ibid*, 390.

amount of USD 4950. This is not a discrepancy because it is within the allowed tolerance provided by the above article. If, in a different example, the credit stipulates for 1000 units of conventional oven, the allowed tolerance of $\pm 5\%$ does not apply and no deviation in quantity is allowed under UCP 600. Also, if a credit specifically stipulates that the quantity of goods specified must not be exceeded or reduced, then any deviation in quantity will be a ground for rejection of the documents. Tolerance in quantity is to be distinguished from amount, for which a tolerance of -5% of the credit amount is allowed under UCP 600.¹¹⁰ It should also be noted that where the words “about” or “approximately” are used in connection with the amount of the credit or the quantity or unit price, a tolerance of $\pm 10\%$ is allowed.¹¹¹

2.4.10 Typographical errors

The literal compliance principle, if applied would not allow any latitude, even for typographical error. In *Bankers' Documentary Credits*, Gutteridge and Megrah commented that Lord Sumner's statement in *Equitable Trust* “does not extend to the dotting of I's and the crossing of T's or to obvious typographical errors in the credit or the documents.”¹¹² However, it can be argued that sometimes, even though an error might appear trivial on the face, in actual fact there is a major difference between what it represents and what the credit requires. For example, one commentator referred to a case where The Federal Court of Justice of Germany (“*Bundesgerichtshof*”) had to decide the meaning of “a-d” in a document since it could mean “a and d”, or “a up to d” (a,b,c,d).¹¹³ In situations where banks are confronted with typographical errors, it is best to request a waiver from the applicant although such a request is sometimes not possible in practice due to time constraints. The UCP does not provide any guidance on this issue but para 25 of ISBP provides some clarification:

A misspelling or typing error that does not affect the meaning of a word or the sentence in which it occurs does not make a document discrepant. For example, a description of the merchandise as "mashine" instead of "machine", "fountan pen" instead of "pen" or "modle" instead of "model" would

¹¹⁰ UCP 600 Article 30(c).

¹¹¹ UCP 600 Article 30(a).

¹¹² *Gutteridge and Megrah* (n 13) 120.

¹¹³ Andreas Karl, “Letters of Credit and The Doctrine of Strict Compliance” (Thesis, University of Uppsala 2004) at 24 <<http://www.juridicum.su.se/transport/forskning/Uppsatser/EssayKarl.pdf>> assessed 1 February 2008.

not make the document discrepant. However, a description as "model 123" instead of "model 321" would not be regarded as a typing error and would constitute a discrepancy.

In *Beyene v. Irving Trust Co.*¹¹⁴, the beneficiary sued the bank for refusing to pay under the letter of credit. The bank refused to pay on the basis that the presented bill of lading showed the party to be notified as "Mohammed Soran" instead of Mohammed Sofan". The Court of Appeals affirmed the District Court's decision that this misspelling entitled the bank to refuse to honour the credit. Circuit Judge Kearsse gave two excellent reasonings for the decision:

"First, this is not a case where the name intended is unmistakably clear despite what is obviously a typographical error, as might be the case if, for example, "Smith" were misspelled "Smithh." Nor have appellants claimed that in the Middle East "Soran" would obviously be recognized as an inadvertent misspelling of the surname "Sofan." Second, "Sofan" was not a name that was inconsequential to the document, for Sofan was the person to whom the shipper was to give notice of the arrival of the goods, and the misspelling of his name could well have resulted in his non receipt of the goods and his justifiable refusal to reimburse Irving for the credit."

In *Bank of Cochin Ltd v Manufacturers Hanover Trust Co*¹¹⁵, the issuing bank brought an action against the confirming bank for wrongful honour of the letter of credit against a set of documents showing "St. Lucia Enterprises" instead of "St. Lucia Enterprises Ltd", and insurance cover note number "4291" instead of "429711" as required under the credit. The documents turned out to be fraudulent with no shipment of goods and a seller which had disappeared. The Southern District Court of New York applied the second test and held that, although immaterial on its face, the incorrect insurance cover note number was not an inconsequential discrepancy because the mistake could have resulted in the insurer's justifiable refusal to honour the ultimate customer's insurance policy. In relation to the beneficiary's name, it was held that, although there does not appear to be any difference between "St. Lucia Enterprises" and "St. Lucia Enterprises Ltd", it is not clear that the "intended" party was paid since the difference in names could also

¹¹⁴ 762 F.2d 4 (2nd Cir. 1985).

¹¹⁵ 612 F.Supp. 1533, D.C.N.Y.,1985, affirmed by *Bank of Cochin, Ltd. v. Manufacturers Hanover Trust Co.*, 808 F.2d 209, 3 UCC Rep.Serv.2d 1489 (2nd Cir.(N.Y.) Dec 24, 1986) (NO. 64, 85-7664).

possibly be an indicia of unreliability or forgery.¹¹⁶ Therefore, the confirming bank was held to have paid wrongfully.¹¹⁷

In *United Bank Ltd v Banque Nationale de Paris*¹¹⁸, the High Court of Singapore upheld a bank's decision to reject documents stating the beneficiary's name as "Pan Associated Pte Ltd" as opposed to "Pan Associated Ltd" as stipulated in the terms of the credit. This was despite the existence of evidence that the Registrar of Companies would not, except with the consent of the Minister, register two companies with these similar names. In *Hanil Bank v. P.T. Bank Negara*¹¹⁹ the application form of the credit stated the beneficiary as *Sung Jun Electronics Co.Ltd* but the issuing bank mistakenly misspelled this resulting in the credit stipulating for *Sung Jin Electronics Co.Ltd*. The beneficiary did not request an amendment and subsequently sold the letter of credit to the plaintiff, Hanil Bank. Hanil Bank presented the documents to the issuing bank but the issuing bank refused to pay on the grounds that, inter alia, there was a discrepancy in the beneficiary's name. It was held that this discrepancy allowed the issuing bank to reject the documents. The beneficiary has the responsibility of inspecting the letter of credit because "the beneficiary is in the best position to determine whether a letter of credit meets the needs of the underlying commercial transaction and to request any necessary changes...."¹²⁰ Moreover, it was not claimed that "Sung Jin" is an obvious misspelling in Korea of "Sung Jun".¹²¹ Because the difference was only one incorrect letter and the fact that it was the issuing bank's mistake which triggered this discrepancy, there was a general feeling at that time that this decision was unsatisfactory.¹²² The standard of compliance in *United Bank* and *Hanil* is rather rigid if compared to that adopted in *Hing Yip Hing Fat Co Ltd v. The Daiwa Bank Ltd*¹²³, where it was held that a bill of exchange stating the drawee as "Cheergoal Industrial Limited" which should

¹¹⁶ *Ibid*, 1541.

¹¹⁷ However, it was held that issuing bank was precluded from asserting the confirming bank's wrongful honor because it failed to comply with the timely notice provisions of the UCP.

¹¹⁸ [1992] 2 SLR 64.

¹¹⁹ 2000 WL 254007.

¹²⁰ *Ibid*, 4-5, citing *Mutual Export Corp. v. Westpac Banking Corp* 983 F.2d 420 (2d Cir. 1993).

¹²¹ *Ibid*, 4.

¹²² See Kyle Roane, "Hanil Bank v. Pt. Bank Negara Indonesia (Persero): Continuing the Quandary of Documentary Compliance Under International Letters of Credit" 41 HOUS.L.Rev.1053 (2004).

¹²³ *Hing Yip Hing Fat Co Ltd v The Daiwa Bank Ltd* [1991] 2 H.K.L.R. 35

have been “Cheergoal Industries Limited” was not discrepant. Kaplan J gave the following reasons:

“Firstly the error is minor and it is the sort of mistake that can easily occur in a society where English is not the first language of 98% of the population. Secondly Daiwa knew exactly whom to contact and Mr. Cheung [deputy manager of the advising bank] took out the Cheergoal Industries Limited's card which shows the same address and he phoned the number on that card. He spoke to the manager who said he would wait till he received a written advice. Thirdly Daiwa repeated this error in their advice of discrepancies.”

These cases illustrate that different courts adopt different approaches and consider different factors in determining whether a typographical error constitutes a discrepancy. Some issues relating to typographical errors are covered by the UCP, for example, address and contact details are covered by Article 14(j) UCP 600. Where courts/banks are concerned with typographical errors not covered by the UCP, it is submitted that the determination of whether any typographical errors will justify a rejection of the document is to be determined by the two tests established in *Beyene*:

- a) Is the non-identical information obviously a typographical error?
- b) Is the error inconsequential to the document?

It is only when both questions are answered in the affirmative that the error will not be treated as a discrepancy. It is not always self-evident to a document checker as to whether a typographical error is inconsequential. It is submitted that a bank's determination of whether an error is inconsequential can be made objective if the courts consider factors such as the potential implication of the error, the importance of the document in question and the possibility of fraud. Linkage may also assist the document checker¹²⁴ - if all documents submitted in the set bear the same typographical error, then the error should be a discrepancy. Undoubtly, this imposes on

¹²⁴ *Voest-Alpine Trading USA Corp. v. Bank Of China* 167 F. Supp. 2d 940 (S.D. Tex. 2000); 288 F.3d 262 (5th Cir. 2002).

banks the responsibility of accessing the materiality of a typographical error and is open to the criticism that this places a heavy burden on the bank which has many documents to check in a limited time. However, this argument is really exaggerated- since banks profit from the business of financing documentary credits, it is justifiable that they should carry certain responsibilities.

2.4.11 Composite or multiple documents

If a credit calls for a few different types of documents to be presented, what is the position if two documents are merged into one document, but this one document fulfills the role of the two documents and would certainly be compliant if it were two separate documents. In one American case, *Richard v Royal Bank of Canada*¹²⁵, the conditions of the credit provided that drafts drawn must be accompanied by a few documents, amongst which was an invoice and a weight certificate. A weight certificate was not presented but the weight was given on the invoice presented and was approved by persons who were designated to approve the weight certificate. The Circuit Court of Appeals, Second Circuit affirmed the trial court's finding that the documents were sufficient.

Whilst the UCP does not expressly provide for this issue, the ISBP provides that a composite document which contains a) certification, declaration or b) packing list and weight list is acceptable provided that the relevant conditions are met.

ISBP

8) A certification, declaration or the like may either be a separate document or contained within another document as required by the credit. If the certification or declaration appears in another document which is signed and dated, any certification or declaration appearing on that document does not require a separate signature or date if the certification or declaration appears to have been given by the same entity that issued and signed the document.

42) Documents listed in a credit should be presented as separate documents. If a credit requires a packing list and a weight list, such requirement will be satisfied by presentation of two separate

¹²⁵ 23 F.2d 430 (1928).

documents, or by presentation of two original copies of a combined packing and weight list, provided such document states both packing and weight details.

Following the provisions of the ISBP, *Richard v Royal Bank of Canada* would certainly be decided in the same way. As yet, there are no English cases on this point. The approach in *Richard v Royal Bank of Canada* carries some risk and it is not recommend for it to be followed except where the conditions provided by para 8 and para 42 of ISBP are satisfied. The applicant may have good reasons for not wanting the documents to be composited. For example, he may wish the resell the goods and although it may still be possible to do so with the composite documents, it may make it more difficult for him. In the case where he is reselling the documents to multiple buyers and have several back-to-back credit to fulfill, the presentation of, for example, one certificate instead of two certificates as specified in the credit terms would be problematic.¹²⁶

In the contrary situation where multiple documents are presented in lieu of a single document, the position is rather unclear. In *Netherlands Trading Society v Wayne & Haylitt Co*¹²⁷, the Supreme Court of Hong Kong held that seven certificates (being combined jute mill and weight certificates) instead of a single original weight certificate, and a single original jute mills certificate were of compliance with the terms of the credit. The argument to reject multiple documents is much weaker than in the case of a composite document. For the sake of document checkers, the ICC should also clarify this point in the ISBP.

2.5 After examination of documents

Once a bank decides that the presented documents do not comply, it has a few courses of action available. This section will discuss the available options, some of which very usefully avoid the delays cause by rejection of the documents.

¹²⁶ EP Ellinger, *Documentary Letters of Credit – A Comparative Study* (University of Singapore Press, Singapore 1970) 296.

¹²⁷ (1952) 36 HKLR 109.

2.5.1 Notice of rejection

If a bank decides to reject the documents, it is under an obligation to give notice of rejection.

Article 16 (c) UCP 600 provides the following:

When a nominated bank acting on its nomination, a confirming bank, if any, or the issuing bank decides to refuse to honour or negotiate, it must give a single notice to that effect to the presenter.

The notice must state:

- i. that the bank is refusing to honour or negotiate; and
- ii. each discrepancy in respect of which the bank refuses to honour or negotiate; and
- iii. a) that the bank is holding the documents pending further instructions from the presenter; or
b) that the issuing bank is holding the documents until it receives a waiver from the applicant and agrees to accept it, or receives further instructions from the presenter prior to agreeing to accept a waiver; or
c) that the bank is returning the documents; or
d) that the bank is acting in accordance with instructions previously received from the presenter

Note that the new Article now provides that only one notice of rejection can be given. A bank which issues a notice of rejection must state all discrepancies in the notice and will not be allowed to claim additional discrepancies later on. Although the language of the above article is drafted in terms of what should be contained in a notice of rejection, what the article also does is provide the rights and options available to a bank when it rejects documents.

The major difference between the provisions of Article 14(d)(ii) UCP 500¹²⁸ and the above article is the latter offers banks two additional options found in Article 16(c)(iii)(b) and 16(c)(iii)(d). Under UCP 500, if the bank wants to seek for a waiver from the applicant, this

¹²⁸ UCP 500 Article 14(d):

- i. If the Issuing Bank and /or Confirming Bank, if any, or a Nominated Bank acting on their behalf, decides to refuse the documents, it must give notice to that effect by telecommunication or, if that is not possible, by other expeditious means, without delay but no later than the close of the seventh banking day following the day of receipt of the documents. Such notice shall be given to the bank from which it received the documents, or to the Beneficiary, if it received the documents directly from him.
- ii. Such notice must state all discrepancies in respect of which the bank refuses the documents and must also state whether it is holding the documents at the disposal of, or is returning them to, the presenter.

should be done before the notice of rejection is given.¹²⁹ During this period, a bank is faced with the task of seeking a waiver but risk failing to give notice without delay within the seven days after presentation, as required by Article 14(d)(ii) UCP 500. After a decision to reject, banks must give notice of rejection, stating either a) it holds the documents at the disposal of the presenter or b) return the documents to the presenter. It is not allowed to seek for a waiver unless he obtain approval from the presenter in order to seek for an applicant's waiver. As a result, some banks tried to delay giving notice whilst they seek for a waiver. Some banks attempted to give a qualified notice of rejection with a clause stating "Should the discrepancies be accepted by the Applicants, we shall release the documents to them without further notice to you unless your instructions to the contrary received prior to our payment" but this was ruled to be not enforceable as it is not in accordance with Article 14(d) UCP 500 and constitutes a threat of conversion of the presenter's documents.¹³⁰ The previous position was less than ideal because practically, most banks would want to hold on to the documents whilst attempting to seek a waiver from the applicant since most of the time, applicants would be willing to waive. Now, under Article 16(c)(iii)(b) UCP 600, banks give notice of rejection and choose to hold the documents pending the request for a waiver without having to seek for the presenter's consent. This change is useful because it accelerates and simplifies the process for all the parties involved.

Surprisingly, sometimes a beneficiary will not wish for the documents to be returned back, for example where the price of the goods had soared and the seller is able to sell the goods to another buyer for a much higher price. If such an event is a possibility, the beneficiary could utilise the Article 16(c)(iii) (d) option by providing instructions to the bank regarding how it should deal with rejected documents. This is an unwelcomed change since it allows a seller to take advantage of circumstances and avoid the transaction. The option is unnecessary and runs against the main benefits of the letter of credit, which provides certainty of payment to the seller and predictability of a transaction for the buyer.

¹²⁹*Ibid*; UCP 500 Article 14(c):

If the Issuing Bank determines that the documents appear on their face not be in compliance with the terms and conditions of the Credit, it may in its sole judgment approach the Applicant for a waiver of the discrepancy(ies). This does not, however, extend the period mentioned in sub-Article 13(b).

¹³⁰ *Crédit Industriel et Commercial v China Merchants Bank* [2002] C.L.C. 1263. It probably also constitutes a unilateral modification of the provisions of the UCP. See also *Voest-Alpine Trading USA Corp. v. Bank of China* 288 F.3d 262 (5th Cir. 2002).

Under UCP 500, notice must be given within seven banking days after presentation but this has now been replaced with five banking days. Under Article 14(d)(i) UCP 500, the giving of notice must be “without delay” but this requirement is now removed, and Article 16(d) UCP 600 now only states that notice must be given “no later than the close of the fifth banking day following the day of presentation”. The modification emanated from the difficulties involved in determining whether a bank’s action is without delay. As with the removal of the reasonable time requirement for a banks’ examination of documents,¹³¹ this modification would not completely eliminate the difficulties in determining the time of which notice must be given by the bank. Can banks give notice on the fifth banking day in all circumstances, thus allowing a bank to deliberately delay notice?¹³² It is most likely that the provisions will be interpreted as allowing banks five banking day in all circumstances.

Despite these issues, the upshot of the revision is a clearer and easier to understand rule. There are fewer restrictions for a bank dealing with documents which do not comply. The rules are also more in line with the realities in the banking industry.

2.5.2 Waiver

Acceptance/approval of a discrepancy is referred to as a “waiver”. The purpose of obtaining a waiver from the applicant is to transfer the risk of paying against non-compliant documents from the bank to the applicant. Article 16 (b) UCP 600 provides that:

When an issuing bank determines that a presentation does not comply, it may in its sole judgement approach the applicant for a waiver of the discrepancies. This does not, however, extend the period mentioned in sub-article 14 (b).

Although the process of obtaining a waiver is codified in the UCP, there is surprisingly little detail provided in relation to its procedure except that a bank which seeks to obtain a waiver must

¹³¹ See 2.3.1.

¹³²James E. Byrne, *The Comparison of UCP600 & UCP500* (The Institute of International Banking Law & Practice, MD USA 2007) 149.

still do so within the 5 banking days provided by Article 14(b) UCP 600. The ICC guidance “Discrepant Documents, Waiver and Notice” issued under UCP 500 provided clarification and should still be consulted because there are no substantive changes in the UCP 600 with respect to waivers.¹³³

According to the wording of Article 16(b) UCP 600, there is no obligation on the bank to request a waiver from the applicant - it is entirely at the bank’s discretion. Nevertheless, there is evidence that it is widespread practice for banks to consult applicants as to whether it wishes to waive the discrepancies.¹³⁴ A request for waiver from the applicant should really only be made when the bank has identified all discrepancies. Banks should not abdicate its responsibility of checking for conformity by releasing documents to applicants for examination. In *Bankers Trust Co v State Bank of India*, Lloyd LJ stated that “...on no view should a bank be allowed time to enable the buyers to examine the documents for the purpose of discovering further discrepancies”¹³⁵. On the other hand, Farquharson LJ took the view that sometimes this may be done where it is for “the purpose of seeking the applicant's opinion on the correct course to take in the light of discrepancies already found”¹³⁶. If applicants are allowed to examine documents, they may not perform this task properly and consequently there may be discrepancies which are overlooked. One commentator pointed out that if the applicant was allowed to examine the documents, if he wished to get out of its credit obligation, “[It] is likely that he will dig into facts extraneous to the documents, and raise matters which a reasonable document checker could not have conceivably raised in the diligent performance of its task. And such an unenviable result would undermine the autonomy doctrine, which is the very heart of the letter of credit that there are good reasons for this.”¹³⁷

If an issuing bank receives a waiver from the applicant and chooses to accept it, then payment will be made despite the existence of discrepancies in the document. However, it should be

¹³³ ICC Commission on Banking Technique and Practice, “Examination of Documents, Waiver of Discrepancies and Notice under UCP 500” Document 470/952rev2, April 9, 2002.

¹³⁴ *Bankers Trust Co v State Bank of India* [1991] 2 Lloyd's Rep. 443.

¹³⁵ *Ibid*, 452.

¹³⁶ *Ibid*, 455.

¹³⁷ Ebenezer Adodo “Conformity of Presentation Documents and a Rejection Notice in Letters of Credit Litigation: A Tale of Two Doctrines” 36 HKLJ 309, 327.

highlighted that even if an applicant's waiver is obtained, the bank is still the sole authority on this matter and is under no obligation to take up the applicant's decision.¹³⁸ A bank's waiver and the applicant's waiver are usually seen as hand-in-hand but there are good reasons to distinguish the two. If the applicant does not provide a waiver, the bank itself can also choose to waive a discrepancy. It is rare for banks to do so because any prudent bank knows that it does so at the risk of jeopardising its reimbursement agreement with the applicant

2.5.3 Ratification or estoppel

Even if a waiver is not obtained, there may be circumstances where either the applicant or even issuing bank may be deemed to have accepted discrepant documents by conduct. There is no need for express words as ratification or estoppel¹³⁹ can be inferred from the circumstances. Instances where the law may treat an applicant as having accepted discrepant documents are such as where an applicant negotiates the presented documents¹⁴⁰ or where the applicant re-sells the goods to a sub-purchaser¹⁴¹. In *Westminster Bank Ltd v. Banca National di Credito*¹⁴², Roche J stated the following when considering the issue of ratification by an issuing bank :

“If parties keep documents which are sent them, purporting to be sent them, or possibly sent them, in consequence of some mandate which they themselves have issued, and keep them for an unreasonable time, that may amount to a ratification of what has been done as being done within their mandate.”¹⁴³

In *Bank Melli Iran v Barclay 's Bank*¹⁴⁴, after Bank Melli (the issuing bank) received the presented documents, Barclay's Bank directed a request for a credit amount increase and Bank Melli authorised Barclay's Bank to increase the amount. Barclay's Bank subsequently made

¹³⁸ Document 470/952rev2 (n 133).

¹³⁹ Although ratification and estoppel are not strictly the same, they are not distinguished in the context of documentary credits - A Mugasha, *The Law of Letters of Credit and Bank Guarantees* (The Federation Press, Sydney, 2003) 133.

¹⁴⁰ *Ibid.*

¹⁴¹ *Friedlander v. Bank of Australasia* 8 CLR 85 (1909).

¹⁴² (1928) 32 Lloyd's Rep. 306.

¹⁴³ *Ibid.*, 312.

¹⁴⁴ [1951] 2 Lloyd's Rep 367.

payment but Bank Melli brought an action, claiming that Barclay's Bank were not entitled to debit Bank Melli with the sums paid because the documents presented were non-conforming. It was held that Barclays Bank paid against non-conforming documents but Bank Melli's actions in authorising the increase in the amount did not indicate any intention to reject the documents. Bank Melli, as principal in the transaction, had ratified the action of Barclay's Bank to pay against the documents tendered and was bound by it.

In America, if a bank does not state all the discrepancies in the notice of refusal in accordance with Article 16 UCP 600, the bank will be precluded from objecting against the documents on other grounds not included in the notice on the basis that it has waived its rights under the credit. "By formally placing its refusal on one ground, the defendant must be held to have waived all others"¹⁴⁵. UCC § 5-108 provides the following:

Except as otherwise provided in subsection (d), an issuer is precluded from asserting as a basis for dishonor any discrepancy if timely notice is not given, or any discrepancy not stated in the notice if timely notice is given.

On this issue there is a difference between English law and American law. In *Skandinaviska Kreditaktie Bolaget v Barclays Bank*¹⁴⁶ and *Kydon Compania Naviera S.A. v National Westminster Bank Ltd (The Lena)*¹⁴⁷, it was held that banks are allowed to raise additional grounds of discrepancies for rejection at a later time in addition to the discrepancies which it had already raised at an earlier time. It was pointed out by Clive M. Schmitthoff that these decisions are consistent with the general principle of contract law, where a new ground for the rejection of defective goods can be raised in addition to those initially raised.¹⁴⁸ Overall, the position in these English cases offers more protection to banks as opposed to the American position which offers more protection to buyers. However, the English position has changed since *Glencore International A. G. v Bank of China*, where the Court of Appeal held that only those

¹⁴⁵ *Bank of Taiwan v. Union National Bank* 1 F.2d 65, 66 (3rd Cir., 1924). See also *Continental National Bank v. National City Bank* 69 F.2d 312, 318-319 (9th Cir., 1934); *Barclays Bank v Mercantile National Bank* 481 F.2d 1224 (5th Cir., 1973).

¹⁴⁶ (1925) 22 Ll.LR 523.

¹⁴⁷ [1981] 1 Lloyd's Rep. 68.

¹⁴⁸ Clive M. Schmitthoff, "Discrepancy of Documents in Letter of Credit Transactions" [1987] JBL 94, 104.

discrepancies stated in the notice of rejection can be relied upon by the issuing bank which rejected the documents.¹⁴⁹ The writer agrees that this is the correct approach. Firstly, this promotes certainty for beneficiaries. Also, as R Jack stated, “One object of a speedy notification with grounds of refusal is to enable the beneficiary to rectify the discrepancies within the time limit of the credit; it would be unfair if he were then to be faced with further discrepancies.”¹⁵⁰ Secondly, this would make the position in England in harmony with the provisions of the UCP. As discussed earlier, Article 16(c)(ii) UCP 600 imposes an obligation on the bank to specify every discrepancy. Article 16(f) UCP 600 further provides that “If an issuing bank or a confirming bank fails to act in accordance with the provisions of this article, it shall be precluded from claiming that the documents do not constitute a complying presentation.”

2.5.4 Payment under reserve

One other option available to a bank which is faced with discrepant documents is to make payment under reserve, whereby a bank makes payment to the beneficiary subject to an agreement that the beneficiary will repay the bank in the event that the bank is not reimbursed. Practically, this option should only be considered where a) the beneficiary is in good financial position and b) the discrepancy is one which is minor so that there is a high possibility that the buyer will accept the documents.¹⁵¹ Although this course of action was expressly recognised in Article 14(f) UCP 500, this was not retained by UCP 600. The difficulty with payment under reserve is that there is no definition of this option under the UCP. Since it is not clear what are the exact circumstances which will entitle the bank to repayment, it is of utmost importance that parties put into writing the exact meaning of “under reserve”.

In *Banque de l'Indochine et de Suez S.A. v J. H. Rayner (Mincing Lane) Ltd*¹⁵², the Court of Appeal was confronted with the meaning of “payment under reserve” because the beneficiary, which received payment under reserve refused to repay the bank on the grounds that the

¹⁴⁹ [1996] 1 Lloyd's Rep 135,149.

¹⁵⁰ *R Jack* (n 27) para 5.65.

¹⁵¹ *Schmitthoff's Export Trade: The Law and Practice of International Trade* (11th edn Sweet & Maxwell, London 2007) 233.

¹⁵² [1983] 1 Lloyd's Rep. 228.

documents were complying. The Court of Appeal had to consider which of these meanings “under reserve” was intended by the parties?

- 1) Money is repayable if the issuing bank refuses to reimburse the confirming bank even where the documents were in fact compliant.
- 2) Money is repayable only if the issuing bank refuses to reimburse the confirming bank and it is established that the documents were not compliant.

In the High Court, Parker J decided that it was the second meaning but the Court of Appeal held that it was the first. The Court of Appeal decided that the second meaning is too legalistic:

“The commercial reality of the situation is that, while holding opposing views, both the bank and the beneficiary hope that, whichever of them is right, the issuing bank and the buyer abroad will raise no objection to the documents. It is therefore with this hope uppermost in its mind that the confirming bank agrees to pay, but only "under reserve." However, in agreeing to do so, the bank cannot realistically be taken to have agreed to become involved in legal proceedings, if the documents are rejected, by having to sue the beneficiary to recover the money and establishing that the documents did not comply with the credit, or possibly by suing the issuing bank on the ground that they did, after all, comply with it.”¹⁵³

This interpretation does allow applicants to take advantage of a situation where there is payment under reserve - by rejecting the documents with the subsequent effect of the issuing bank not paying the confirming bank. When this happens, the beneficiary will have to repay the confirming bank under reserve and subsequently sue the confirming bank for non-payment. However, Article 14(f) UCP 500 stipulated the following:

If the remitting bank draws the attention of the Issuing Bank and /or Confirming Bank, if any, to any discrepancy(ies) in the document(s) or advises such banks that it has paid,... under reserve or against an indemnity in respect of such discrepancy(ies), the Issuing Bank and/or Confirming Bank, if any, shall not be thereby relieved from any of their obligations under any provision of this article. Such

¹⁵³ *Ibid*, 234 per Kerr LJ.

reserve or indemnity concerns only the relations between the remitting bank and the party towards whom the reserve was made, or from whom, or on whose behalf, the indemnity was obtained.

Although this provision has been removed from UCP 600, it is nevertheless arguable that the issuing bank's duty to pay remains the same regardless of a "payment under reserve" agreement between the other parties. However, if an applicant refuses to accept the documents by pointing out discrepancies, it is highly likely that an issuing bank will follow the instructions of the applicant.¹⁵⁴ Of course, the applicant cannot manipulate the situation by refusing to pay even if the documents are compliant. Hence, the opportunities for buyers to take advantage do exist, but not to the full extent.

Sometimes, banks obtain an indemnity from the beneficiary, rather than pay under reserve which really has the same effect as payment under reserve except that there are usually time limits with indemnity.¹⁵⁵ Whichever is given, a beneficiary should be aware that, despite receiving payment, he could be liable to pay back the sum of money if the applicant rejects the documents. Hence, whether giving an indemnity or receiving payment under reserve, practically, the beneficiary should be in negotiation with the applicant to resolve any discrepancy issues.

2.6 Conclusion

There are many respects in which a document may not strictly comply with the conditions of the credit, allowing banks to refuse payment. Even though the principle of strict compliance is still regarded as the general standard for documentary compliance, the discussion so far illustrates that the standard of strict compliance does not apply to every type of discrepancies, and therefore banks can no longer apply a general standard in the documentary checking process. This is evidenced by the provisions of the UCP, ISBP and current banking practice. It is obvious that it is difficult in this area of law to delineate general rules in documentary compliance; there is always room for judgment where this issue is concerned. Certainly a literal compliance standard for every aspect of documents will not be the answer because it will defeat the feature of letter of credit as being as good as cash. The practical solution is for traders dealing with letters of credit

¹⁵⁴ R Jack (n 27) para 5.82.

¹⁵⁵ SITPRO International Trade Guides, Letters of Credit - Checklist and Guide for Exporters, at 12.

to have organised planning and proper staff training so as to ensure that there are no discrepancies in the documents. Nevertheless, this chapter has discussed the circumstances where, even if documents are found to be non-conforming, payment can still be made. With respect to the obligations of banks, it has also been shown that it is important for banks always to act in strict accordance with their duties, particularly in the examination of documents within the time limits and the giving of notice of rejection since these could all have an effect on their duty to pay.

UCP 500 has been substantially revised and some adaptation to the rules by the many parties involved in the documentary credit transaction will be needed. The revision does accomplish some of the objectives it set out to achieve. Overall, the new articles are simplified and provide a lot more clarification. The revised rules on transport documents are easier to understand and more in line with current shipping practice. The expanded explanation of what constitutes an original document eliminates the confusion existing under its predecessor as to what is an original document. The rules on multiple copies also accord with common sense. UCP 600 does provide sellers with more control and flexibility over the handling of their documents. The standard of documentary compliance has been lowered and the doctrine of strict compliance has been relaxed to reduce the number of discrepant documents. On the other hand, buyers are now exposed to some risks which previously did not exist. As for banks, their duties as document checkers are now less demanding as the requirement of consistency is watered down and rejection based on purely technical errors is restricted. However, banks will still have to be careful not too be lax in the documentary examination process as they could run the risk not being reimbursed.

Although some of the uncertainty and ambiguity have been removed, it has been shown that there still exist aspects of UCP 600 which do not achieve the required certainty for traders and financiers. The new UCP still allows a lot of scope for different interpretation of whether a document is compliant or not. Undoubtedly, some of the provisions will not be uniformly applied worldwide because national courts will interpret the rules differently. In comparison to UCP 500, the new rules are an improvement and provide solutions to some of the pressing issues which existed under the old UCP. There is still room for improvement but it is indeed very difficult to strike to balance the interest of banks, buyers and sellers respectively. If UCP 600 succeeds in

reducing rejection rate, it is highly possible for the letter of credit to survive as one of the most important method of payment in international trading.

CHAPTER 3

THE FRAUD EXCEPTION

3.1 Introduction

As was discussed in Chapter 1, the autonomy principle is regarded as the most sacrosanct concept in documentary credit transactions. Its function is to preserve the main function of the letter of credit – the guaranteeing of quick and reliable payment to the seller; but the certainty of quick payment carried with it the risk of fraudsters exploiting the letter of credit system in order to obtain monetary gains. There are circumstances where it is obvious that the seller's breach of contract is not one which could have occurred through mere negligence and in which a strict adherence to the autonomy principle would benefit fraudsters while denying justice to the other parties. Consequently, an exception to the autonomy principle, based upon the maxim *ex turpi causa non oritur actio* has been developed in order to deny payment under a letter of credit where fraud is proved. The basis of the fraud exception is that in cases of fraud the issuer of the letter of credit can refuse, or a court can restrain, payment under a letter of credit. However, it will be demonstrated that this departure from the autonomy principle remains minimal in order to maintain the commercial utility of letters of credit as an instrument for guaranteeing payment.

Despite being the most well established exception to the autonomy principle and the only exception recognised by nearly every jurisdiction in the world, it has been referred to as “the most controversial and confused area”¹. The overriding aim of this chapter is to provide a better understanding of the fraud rule and to identify any shortcomings in the application of the fraud rule to restrain payment. Where appropriate, suitable suggestions for reform of this area of law will be made.

The chapter will begin with a review of leading cases in common law jurisdictions on the fraud exception. The writer will then examine the scope of the fraud exception, which constitutes

¹ Note, "Fraud in the Transaction: Enjoining Letters of Credit During the Iranian Revolution" (1980) 93 Harv.L.Rev. 992, 995.

the main thrust of this chapter. Where relevant, contrasting judicial approaches in the application of the fraud exception will be highlighted. The section which follows will evaluate the changes brought about by the new UCP on the effect of fraud in relation to deferred payment credit. Lastly, the issue of fraud in electronic letters of credit will be explored.

3.2 Development of the Fraud Exception

Although the UNCITRAL Convention on Independent Guarantees and Stand-by Letters of Credit does contain provisions on fraud, the UCP and ISP98 do not contain an express provision on the fraud rule. In fact, the ICC Banking Commission had a long time ago expressed the view that the legal rules relating to fraud should be left to domestic courts:

“The ambit of this exception and the ensuing consequences for the beneficiary and/or the nominated bank may differ from one local jurisdiction to another. It is up to the Courts to fairly protect the interests of all bona fide parties concerned.”²

Following this, the fraud exception has always been a matter developed by national courts in their respective jurisdictions. Before proceeding to a detailed analysis of the scope of the fraud exception, it is important to gain some insights into some of the most important cases in common law jurisdictions which formed the foundations of this exception.³

3.2.1 America

It was in the United States where the foundations of the fraud exception were first enunciated in *Sztejn v. J. Henry Schroder Banking Corp.*⁴ a leading case in this area of law. In *Sztejn*, before payment had occurred, the buyer applied for an injunction to prohibit the issuing bank from paying the beneficiary of the credit upon discovery that the hog bristles purchased were not

² Opinions 1980-1981 no 399, R76 at 27.

³ For a detailed account, see Xiang Gao, *The Fraud Rule in the Law of Letters of Credit: A Comparative Study* (1st edn, Kluwer Law International, London, 2003).

⁴ 31 NYS (2d) 631 (Sup. Ct. N.Y. Cty 1941).

shipped. The buyer alleged that the seller had obtained the bill of lading by shipping cow hair and rubbish which did not in any way resemble the goods that were contracted for. The confirming bank filed a motion to dismiss claiming that its only concern was documentary compliance.

The New York court assumed the allegations of fraud to be true (because this was a procedural matter which required it to do so) and there was also no objection by the sellers to the allegation that the goods delivered were not those purchased under the contract. The only issue before the court was whether fraudulent conduct on the part of the seller could be a basis for preventing payment on the credit. Shientag J emphasised the importance of the autonomy principle but was of the opinion that the facts of the case presented before him was different:

“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.”⁵

This distinction led to his decision to grant an injunction to prohibit the issuing bank from paying. In considering whether the seller's fraud was a ground to grant an injunction, he weighted the interest of the banks involved:

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

⁵ *Ibid*, 634.

the letter of credit is the credit standing of the buyer, the security afforded by the merchandise is also taken into account. In fact, the letter of credit requires a bill of lading made out to the order of the bank and not the buyer. Although the bank is not interested in the exact detailed performance of the sales contract, it is vitally interested in assuring itself that there are some goods represented by the documents.”⁶

In relation to the confirming bank, he noted that:

“If it had appeared from the face of the complaint that the bank presenting the draft for payment was a holder in due course, its claim against the bank issuing the letter of credit would not be defeated even though the primary transaction was tainted with fraud.”⁷

On the basis of the pleadings, the confirming bank was not a holder in due course but was an agent for collection for the account of the seller charged with fraud. Therefore, the court rejected the confirming bank's motion to dismiss.

Since cases before *Sztejn* only considered disputes of fraud as a default under a contract⁸, it became a landmark decision which was considered by the courts of every common law jurisdiction in the development of the exception. The judgment was significant because it laid down the basic principles which formed the foundations of the fraud exception today. Mainly based on the *Sztejn* case, the fraud exception was later codified in the UCC. Article 5 UCC, which deals with the issue of fraud, was substantially revised in 1995.

Certainly there was a lot to be gained from the former provisions of Article 5⁹ but the relevant sections on the fraud rule were not without flaws and did not deal with some questions left

⁶ *Ibid*, 635.

⁷ *Ibid*.

⁸ See *Xiang Gao* (n 3).

⁹ Before the major revision in 1995, § 5-114(2) of the UCC provided the following:

Unless otherwise agreed when documents appear on their face to comply with the terms of the credit but a required document does not in fact conform to the warranties made on negotiation or transfer of a document of title (Section 7-507) or of a certified security (Section 8-306) or is forged or fraudulent or there is fraud in the transaction:
(a) the issuer must honor the draft or demand for payment if honor is demanded by a negotiating bank or other holder of the draft or demand which has taken the draft or demand under the credit and under circumstances which would make it a holder in due course (Section 3-302) and in an appropriate case would make it a person to whom a
(footnote continues next page)

unanswered by *Sztejn*. Over time, the following issues emerged to disturb the letter of credit community and the courts:

- In the absence of an injunction, was the issuer allowed to invoke the section to refuse payment? The use of the word “may” in the former §5-114(2)(b) suggested that the issuing bank is not obliged to refuse payment. Therefore, banks would normally pay and would be deemed to be in good faith despite notifications from their customers, but a customer could obtain an injunction from the courts to prevent the issuing bank from honouring the letter of credit.
- It was not known with certainty what was the meaning of fraud under §5-144(2) since no explanation or definition of fraud was provided. In other words, it was not very clear what type of misconduct on the part of the beneficiary would attract the protection of the section. *Sztejn* offers no answer on this issue since the particular nature of the proceedings in *Sztejn* led the court to assume that the allegations of fraud were true. Later cases provide some insight on this issue but the varying interpretations by the different courts did not provide any conclusive guidance.
- There was a debate as to whether the reference to “fraud in the transaction” meant the letter of credit transaction between the issuer of the credit and the buyer or the underlying transaction between the buyer and the seller. Article 5 and its official comments offered no explanation on this particular issue.

Forty years after the drafting of the first Article 5, a task force¹⁰ was appointed to identify the problems in this area. In 1995, the revised version of Article 5 was forwarded to state legislatures for enactment. The relevant provisions on fraud are now contained in §5-109, entitled “Fraud and Forgery”.¹¹ The wording of §5-109(a)(2) now expressly provides that the issuer can invoke the

document of title has been duly negotiated (Section 7-502) or a bona fide purchaser of a certificated security (Section 8-302); and

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

¹⁰ ABA Task Force on the Study of UCC Article 5.

¹¹ UCC §5-109 provides the following:

(footnote continues next page)

section to voluntarily dishonour a presentation of documents. One of the most useful clarifications provided by the revised provision is the express mention that fraud must be found either in the documents, or must have been committed by the beneficiary on the issuer or the applicant. This is more specific than “fraud in transaction” as found in the former provision since it provides guidance as to where fraud needs to be identified. The revised provision also makes it clear that documents must be materially fraudulent or any fraud by the beneficiary on the issuer or the applicant must be “material”, raising the threshold for an applicant to obtain an injunction. In addition, it establishes additional barriers to granting injunctive relief. Firstly, there are some adjustments in §5-109(a)(1) to the categories of protected parties against whom the fraud exception cannot be used. Secondly, it states that the court must make the findings specified in §5-109(2)(1)-(4) before granting an injunction. The revised Article 5 was a success and played a big part in catalysing the more refined fraud exception today.

3.2.2 England

In England, the fraud exception derived from *Sztejn* and until today is not incorporated into any legislation. It can be said that English law caught up with the development rather slowly as the

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- (a) If a presentation is made that appears on its face strictly to comply with the terms and conditions of the letter of credit, but a required document is forged or materially fraudulent, or honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant:
- (1) the issuer shall honor the presentation, if honor is demanded by:
 - (i) a nominated person who has given value in good faith and without notice of forgery or material fraud,
 - (ii) a confirmer who has honored its confirmation in good faith,
 - (iii) a holder in due course of a draft drawn under the letter of credit which was taken after acceptance by the issuer or nominated person, or
 - (iv) an assignee of the issuer's or nominated person's deferred obligation that was taken for value and without notice of forgery or material fraud after the obligation was incurred by the issuer or nominated person; and
 - (2) the issuer, acting in good faith, may honor or dishonor the presentation in any other case.
- (b) If an applicant claims that a required document is forged or materially fraudulent or that honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant, a court of competent jurisdiction may temporarily or permanently enjoin the issuer from honoring a presentation or grant similar relief against the issuer or other persons only if the court finds that:
- (1) the relief is not prohibited under the law applicable to an accepted draft or deferred obligation incurred by the issuer;
 - (2) a beneficiary, issuer, or nominated person who may be adversely affected is adequately protected against loss that it may suffer because the relief is granted;
 - (3) all of the conditions to entitle a person to the relief under the law of this State have been met; and
 - (4) on the basis of the information submitted to the court, the applicant is more likely than not to succeed under its claim of forgery or material fraud and the person demanding honor does not qualify for protection under subsection (a)(1).

fraud exception was only considered quite many years after *Sztejn*, in *Discount Records Ltd v Barclays Bank Ltd*¹². In this case, the plaintiffs purchased records and cassettes from a French company on the basis that payment was to be made by a confirmed irrevocable credit. Only a small proportion of the delivered goods complied with the terms of the contract while others were rubbish or were not as ordered. Therefore, the buyer applied for an injunction to restrain the conforming bank from paying on two grounds, one of which is based on the principle set out in *Sztejn*, that the sellers were guilty of fraud.¹³ The High Court distinguished *Sztejn* and refused to grant the injunction but accepted the fraud exception as applicable in English law. Megarry J held that although fraud was alleged, the evidence did not yet establish fraud, unlike in *Sztejn* where the motion to dismiss the complaint for failure to disclose a cause of action required the court to assume the truth of the allegation of fraud.¹⁴ Another reason for refusing the injunction was the possibility that the draft might be in the hands of a holder in due course.¹⁵ He was of the opinion that an injunction would only be granted if there was a sufficiently grave cause and concluded that it was not shown in this case.¹⁶

Discount Records set off the trend of English judges adopting a rigid style in their application of the fraud rule. The two cases which follow are regularly cited by counsels around the world to depict the traditional reluctance of English courts to interfere by way of an injunction, in the normal operation of the letter of credit. Although they dealt with performance guarantees, the same basic principles apply to documentary credits. In *RD Harbottle (Mercantile) Ltd v National Westminster Bank Ltd*¹⁷, the plaintiffs had entered into contracts of sale with Egyptian buyers which required the plaintiffs to procure a guarantee covering 5% of the purchase price in favour of the buyers. The buyers demanded payment under the guarantees and the plaintiffs sought declarations and injunctions against each defendants (the buyers, the Egyptian bank and the English bank) to restrain payment on the basis that there was no justification for the demand. The

¹² [1975] 1 Lloyd's Rep. 444.

¹³ The other ground was that there was a lack of correspondence between the documents and the goods which were delivered.

¹⁴ [1975] 1 Lloyd's Rep. 444, 447.

¹⁵ *Ibid.*

¹⁶ *Ibid.*, 448.

¹⁷ [1977] 2 All ER 862.

injunctions were granted *ex parte* but Kerr J discharged the injunctions on the inter partes hearing. He accepted the principle in *Sztejn* but asserted the following:

"Except possibly in clear cases of fraud of which the banks have notice, the courts will leave the merchants to settle their disputes under the contracts by litigation or arbitration as available to them or stipulated in the contracts. The courts are not concerned with their difficulties to enforce such claims; these are risks which the merchants take . . . The machinery and commitments of banks are on a different level. They must be allowed to be honoured, free from interference by courts. Otherwise, trust in international commerce could be irreparably damaged."¹⁸

In *Edward Owen Engineering Ltd v Barclays Bank International Ltd*¹⁹, the English plaintiff contracted to erect greenhouses in Libya for Libyan customers. Pursuant to the contract, the plaintiff agreed to provide a performance guarantee. After the plaintiff had granted a counter guarantee to the defendant bank, the latter, on their own responsibility and on the plaintiffs' behalf, gave a performance bond to the Libyan bank, in terms of which they confirmed that their guarantee was payable 'on demand without proof or conditions'. The Libyan bank then issued a corresponding guarantee bond in favour of the Libyan customers. The contract also provided for the Libyan customers to open an irrevocable letter of credit in favour of the plaintiff. When this did not transpire, the plaintiff informed the customers that the guarantee was in the circumstances ineffective, and treated the contract as repudiated. The customers then called on the bond but an injunction was sought by the plaintiff. An interim injunction was granted *ex parte* but was subsequently discharged. The plaintiff appealed but the Court of Appeal dismissed the appeal. Lord Denning MR, explained the position as follows:

"...the performance guarantee stands on a similar footing to a letter of credit. A bank which gives a performance guarantee must honour that guarantee according to its terms. It is not concerned in the least with the relations between the supplier and the customer; nor with the question whether the supplier has performed his contracted obligation or not; nor with the question whether the supplier is in default or not. The bank must pay according

¹⁸ *Ibid*, 870.

¹⁹ [1978] 1 QB 159.

to its guarantee, on demand, if so stipulated, without proof or conditions. The only exception is when there is a clear fraud of which the bank has notice."²⁰

The most pivotal English case on this subject is *United City Merchants (Investments) Ltd v Royal Bank of Canada*²¹. In this case, an employee of the loading brokers to the carriers fraudulently predated the bill of lading to 15 December when shipment had been made on 16 December. On presentation of the documents, the confirming bank refused to pay because it became aware that the shipment had not been made as shown on the bill of lading. In the High Court, Mocatta J made the finding that the loading agents were not acting on behalf of the sellers, and neither the sellers nor its assignee were aware of the alteration. For this reason, he held that the bank was not entitled to reject the documents. The Court of Appeal later reversed the decision, holding that so long as the bank knew of the forged document, the bank is entitled to withhold payment regardless of the fact that the seller was unaware of the fraud. On appeal to the House of Lords, Lord Diplock emphasised that a confirming bank deals with documents and not with goods but affirmed the fraud exception:

"To this general statement of principle [of independence] as to the contractual obligations of the confirming bank to the seller, there is one exception: that is, where the seller, for the purpose of drawing on the credit, fraudulently presents to the confirming bank documents that contain, expressly or by implication, material representations of fact that to his knowledge are untrue."²²

Following this, the application of the fraud exception is limited to cases where the beneficiary had knowledge of the fraud. Since the sellers in this case were not aware of the fraudulent alteration, Lord Diplock overruled the decision of the Court of Appeal and held that they should have been paid on presentation of the documents.

²⁰ *Ibid*, 171.

²¹ [1983] AC 168.

²² *Ibid*, 183.

3.2.3 Australia

As in England, the *Sztejn* principle is well accepted by the courts in Australia. Despite some difference in their approaches, Australian law is very similar to English law on this matter and English cases are cited habitually in Australian courts. The first case to recognise the fraud exception in Australia was *Contronic Distributors Pty Ltd v Bank of New South Wales*²³. In this case, Contronic wished to purchase goods to the value of \$2,508 from its supplier, GEC. However, GEC wanted some guarantee of payment for the goods which Contronic intended to buy and for goods delivered from previous transactions which had not been paid. Contronic opened a letter of credit for an amount of \$8,596 in favour of GEC, covering both the indebtedness and the goods it wished to purchase. GEC was aware of that the documents which were to be presented would reflect goods to the value of \$8,596 when in fact the value of the goods delivered were significantly less. The letter of credit was arranged by Balfour, Contronic's financier which later discovers the true facts before the documents were presented and sought an injunction to restrain the bank from paying under the letter of credit and GEC from presenting the documents. Helsham J granted the injunction stating:

In my view the law is perhaps now settled, and in any event would establish that a seller can be restrained from presenting a letter of credit for payment or having payment made against it in the event that the documents which are needed to require payment to be made are false to the knowledge of the seller.²⁴

This illustrates that the Australian courts, just like the English courts focuses on the state of mind of the beneficiary at the point of the presentation of the documents.

²³ [1984] 3 NSWLR 110.

²⁴ *Ibid*, 116.

3.2.4 Canada

Relying especially on the authority of *Sztejn* and *Edward Owen*, Canadian courts slowly recognised the fraud exception in letters of credit and performance guarantee cases.²⁵ The pivotal case in Canada which considered many fundamental aspects of the fraud rule is *Bank of Nova Scotia v Angelica-Whitewear*²⁶. In this case, Whitewear opened an irrevocable negotiation letter of credit with the Bank of Nova Scotia in favour of the beneficiary for the supply of men's industrial uniforms. There was a back-to-back credit arrangement, whereby, in order to finance the beneficiary's purchase from its Taiwan supplier, the beneficiary obtained a letter of credit from the negotiating bank (Shanghai Commercial Bank) based upon Whitewear's letter of credit. Two draws were made by the negotiating bank in this case. The first draw was honoured by the issuing bank and charged to Whitewear's account although Whitewear informed the bank to withhold further payments on the basis that a signature on one of the documents had been forged. As for the second draw, Whitewear informed the issuing bank that the documents submitted showed improperly inflated prices and also contained certain discrepancies and should not be honoured. However, after repeated demands, the bank paid the negotiating bank for the second draft and sued Whitewear for the balance owed. Whitewear counterclaimed, contending fraud and non-compliance of the documents with the terms and conditions of the letter of credit. At the Quebec Superior Court, the issuing bank was successful in its action for both draws. Whitewear later appealed in respect of the second draw and the Quebec Court of Appeal ruled in favour of Whitewear. On further appeal, Le Dain J in the Supreme Court of Canada expressly affirmed the fraud exception as part of Canadian law but held that the judgment of the Court of Appeal allowing Whitewear's appeal cannot be supported on the ground of fraud.²⁷ Even though the inflation of the prices constituted a sufficient fraud, it was found that there was no evidence to show that the particular fraud relating to the second payment had been brought to the bank's attention before payment, much less a finding that the fraud was sufficiently established to the

²⁵ *Lumcorp Ltd. v. C.I.B.C.*, [1977] Que. S.C. 993; *Planners Ltd. v. Commerce Masonry & Forming Ltd* (1979) 25 O.R. (2d) 167; *C.D.N. Research & Devs. Ltd. v. Bank of N.S.* (1980), 18 C.P.C. 62; *Rosen v. Pullen* (1981) 16 B.L.R. 28.

²⁶ [1987] 1 S.C.R. 59.

²⁷ However, the appeal was dismissed because the documents tendered did not strictly comply to the terms of the credit.

knowledge of the bank before payment so as to be clear or obvious to it.²⁸ In this case, the Supreme Court of Canada settled many important points of law relating to the fraud exception, many of which were not at issue. These issues will be dealt with in more detail within subsequent headings in this chapter.

3.3 The scope of the exception

From the discussion so far, it is evident that it is not easy for the fraud exception to be successfully argued. This section will identify the scope of this exception by evaluating the requirements which are to be satisfied so that the fraud exception could apply to withhold payment.

3.3.1 The location of fraud

When applying the fraud exception, this issue will arise inevitably since a documentary credit transaction is a complex transaction involving a number inextricably linked contracts. In essence, this concerns the question of whether the fraud exception applies to fraud in the documents and/or fraud in the underlying transaction.

In *Sztejn*, there was documentary fraud but Sheintag J also considered the performance of the underlying transaction in reaching his decision to grant the injunction. One is unable to state with certainty from the decision in *Sztejn* whether the fraud exception concerns fraud in documents or fraud in the underlying transaction but it is now settled that the fraud exception in America encompasses both. Official Comment 1 to UCC §5-109 states that, "The court must examine the underlying transaction when there is an allegation of material fraud, for only by examining that transaction can one determine whether a document is fraudulent or the beneficiary has committed fraud, and, if so, whether the fraud was material."

²⁸ [1987] 1 S.C.R. 59, [31].

In Australia, Young J observed in *Inflatable Toy Co. v. State Bank of New S. Wales*²⁹ that Lord Diplock's statement of what constitutes fraud has been regarded as too narrow. Contending that the concept of fraud should not be narrowly constrained, he stated the following:

“It is not merely a mechanical exercise of seeing whether the words in the documents are completely true or completely untrue to the knowledge of the seller; the question is really one of considering whether in all the circumstances the uttering of the documents involves actual fraud.”³⁰

Similarly, in Canada, Le Dain J expressly stated in *Angelica-Whitewear* that, “[T]he fraud exception to the autonomy of documentary letters of credit should not be confined to cases of fraud in the tendered documents but should include fraud in the underlying transaction of such a character as to make the demand or payment under the credit a fraudulent one.”³¹

Under English law, this issue is more debatable than that of other common law jurisdictions. In *United City Merchants*, the House of Lords was only confronted with the issue of fraud in documents but a later case involving a performance guarantee suggests a broader scope of the fraud exception. In *Themehelp Ltd v West*³², the plaintiff contracted to buy shares in a company from the defendants. The purchase price was to be paid by installments, the third and last being the largest secured by a performance guarantee issued by a third party. The purchase was negotiated on the assumption that the demand for the relevant product from a major customer, Sony, would be continued in the future. Before the final installment, the plaintiff started proceedings for rescission of the contract and damages. It was alleged that there was a fraudulent misrepresentation by the defendants, namely that the defendants knew that that Sony were in fact sourcing their products from a competitor at the time of contracting but concealed this fact from the plaintiff. The defendants denied the misrepresentation, claiming that the plaintiff was in default and that they were therefore entitled to claim under the guarantee. The plaintiff then applied for an interlocutory injunction to restrain the defendants from giving notice to the guarantor. An injunction was granted at first instance and later affirmed by the Court of Appeal.

²⁹[1994] 34 NSWLR 243.

³⁰*Ibid*, 251.

³¹[1987] 1 SCR59, 83.

³²[1996] Q.B. 84.

Upon examination of the facts of *Themehelp*, it is obvious that the fraud exception have been applied to fraud in the underlying transaction, outside the scope of *United Trading*. There was no fraud in the documents because the representation was not a condition of the demand guarantee and was only related to the underlying transaction between the seller and the buyer.³³ The dissenting judge, Evans LJ recognised the distinction, stating that only fraud in the calling down of the credit will justify an injunction.³⁴ He based his decision primarily on an examination of the beneficiary's right, emphasising that the contract was still binding even if the buyer's allegation regarding the fraudulent misrepresentation was sufficiently proved, since the buyers had taken no steps to rescind the contract or to restore the business to the sellers.³⁵ Hence, he decided that the buyer cannot prevent the sellers from recovering payment of that sum without acting unlawfully and in breach of the agreement.³⁶

Consistent with the maxim *ex turpi causa non oritur actio*, there is no reason why the beneficiary should be allowed to enforce payment just because the fraud is only found in the underlying transaction. In enforcing payment, there is still reliance on his own wrongdoing.³⁷ Moreover, it is sometimes very difficult to distinguish between fraud in the documents from fraud in the underlying contract. As illustrated by *Sztejn*, in the usual sale of goods case, it is difficult to determine whether there is fraud in the document without inquiring into whether there is fraud in the underlying transaction. If the fraud exception was not extended to fraud in the underlying transaction, one problem arises in determining how close the connection must be between the fraud and the issue of the credit in order for the exception to apply.³⁸ The only possible argument against allowing fraud in the underlying transaction is that it would widen the scope of the application of the fraud exception. It may be argued that the effect of which is the unnecessary interference with the international commercial transactions and lost of confidence in the letter of credit system. This argument is weak since there remain great difficulties in practice

³³ See Basil Coutsooudis, "Letters of credit and the Fraud Exception :A Comparative Analysis of the Laws of the United States of America, England and South Africa" [5.3.2]

<<http://www.lawonline.co.za/IntTradeLaw/letcredit.htm>> accessed 1 August 2009.

³⁴ [1996] Q.B. 84, 102.

³⁵ *Ibid.*

³⁶ *Ibid.*

³⁷ Jack, *Documentary credits: the law and practice of documentary credits including standby credits and demand guarantees* (4th edn Tottel, Haywards Heath 2009) 9.26.

³⁸ *Ibid.*

to successfully bring a case on the fraud exception. Even in common law jurisdictions which had extended the fraud exception to fraud in the underlying transaction, the number of successful cases remains very limited.

As it currently stands, this issue remains unsettled under English law. However, in light of the arguments above and the position of other common law jurisdictions on this matter, if English courts are faced with this issue in future, it is very likely that the fraud exception would be applied to fraud in the underlying transaction.

3.3.2 Standard of fraud

This is an issue central to understanding the limits of the fraud exception. In other words, what is inquired is the degree of misfeasance on the part of the beneficiary which is required in order for the fraud exception to apply. There is however immense difficulties in setting the required standard because of the broad circumstances where fraud can arise and the aim to fairly balance the interests of the parties involved. It is useful to start by investigating the varying standards adopted by different jurisdictions.³⁹

3.3.2.1 America

On this point, the principles established by American courts vary and are difficult to reconcile. Reported cases before the revision of the UCC differed in their treatment of this issue. In some cases, the courts stated that only extreme misconduct would suffice, using the term “egregious” to describe the nature of the fraud.⁴⁰ Some courts required an intention to misrepresent or an intention to defraud.⁴¹ Others adopted the opposite approach, requiring only “acts, omissions and concealments which involve a breach of legal or equitable duty, trust, or confidence, justly reposed, and are injurious to another, or by which an undue and unconscious advantage is

³⁹ Research on this issue was conducted by searches on Westlaw and reference to *Xiang Gao* (n 3) 65-99.

⁴⁰ *Intraworld Industries Inc v. Girard Trust Bank* 336 A.2d 316 (1975); *N Y Life Insurance Co v. Hartford National Bank & Trust Co* 378 A.2d 562 (1977); *First Arlington Nat. Bank v. Stathis* [1980] 90 Ill. App. 3d 802, 46 Ill Dec. 175,413 NE 2d, 1288, 32 UCCRS 260; *Stringer Construction Co. v. American Ins. Co.* [1981] 102 Ill. App. 3d 919, 58 Ill Dec. 59, 430, NE2d. 1, 32 UCCRS 1167, 25 ALR 4th. 230.

⁴¹ *West Virginia Housing v Stroka Development Fund* 415 F. Supp.1107 (W.D.Penn.1976); *Roman Ceramics Corp v People's National Bank* 714 F.2d 1207 (3d.Cir 1983).

taken”.⁴² Some cases adopted a “flexible standard” of fraud, setting a boundary of somewhere between “breach of warranty and outright fraudulent practice”.⁴³

The revised Article 5 now provides that “material fraud” is required to dishonour a letter of credit. Official Comment 1 para 2 states 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”. Official Comment 1 para 3 states that “material fraud by the beneficiary occurs only when the beneficiary has no colorable right to expect honor and where there is no basis in fact to support such a right to honor”. There is no express indication in the official comment that these two statements are to be read conjunctive or otherwise but Xiang Gao wrote that the former relates to letters of credit whereas the latter relates to standby letters of credit.⁴⁴ He does not provide any reasons for this account but this is probably correct since paragraph 3 refers to standby letters of credit cases.⁴⁵ Official Comment 1 para 4 goes on to citing previous cases, providing that a court can only enjoin payment if the fraud was “so serious as to make it obviously pointless and unjust to permit the beneficiary to obtain the money”⁴⁶, where the circumstances plainly show that the underlying contract forbids the beneficiary to call a letter of credit⁴⁷, where they show that the contract deprives the beneficiary of even a colorable right to do so⁴⁸, where the contract and circumstances reveal that the beneficiary's demand for payment has “absolutely no basis in fact”⁴⁹, where the beneficiary's conduct has “so vitiated the entire transaction that the legitimate purposes of the independence of the issuer's obligation would no longer be served”⁵⁰. After the revision, not many cases have dealt with the issue of what constitutes material fraud but the limited cases which did so were standby

⁴² *Dynamics Corp of America v. Citizens & Southern National Bank* 356 F. Supp. 991 (1973).

⁴³ *United Bank Ltd v. Cambridge Sporting Goods Corp* 392 N.Y.S.2d 265 (1976) 271.

⁴⁴ Xiang Gao (n 3) 84.

⁴⁵ *Intraworld Indus. v. Girard Trust Bank*, 336 A.2d 316 (Pa. 1975); *Roman Ceramics Corp. v. People's Nat. Bank* (C.A. 3 1983) 714 F.2d 1207; *Ground Air Transfer v. Westate's Airlines* (1990) 899 F 2d 1269.

⁴⁶ *Itek Corp v First Nat. Bank of Boston* 730 F.2d 19 (1st Cir.1984) 24-25.

⁴⁷ *Ibid*, 24.

⁴⁸ *Ibid*, 25.

⁴⁹ *Dynamics Corp. of America v. Citizens & Southern National Bank* 356 F. Supp 991 (N.D.Ga.1973), 999.

⁵⁰ *Itek Corp v First Nat. Bank of Boston* 730 F.2d at 25 (quoting *Roman Ceramics Corp. v. Peoples National Bank*, 714 F.2d 1207, 1212 n.12, 1215 (3d Cir. 1983) (quoting *Intraworld Indus.*, 336 A.2d at 324-25))

letters of credit cases.⁵¹ Since the revision, American courts have consistently cited egregious fraud cases when applying the standard of material fraud.⁵²

3.3.2.2 England

In *United City Merchants*, Lord Diplock limited the fraud exception to “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.”⁵³ Following *United City Merchants*, English courts have generally avoided defining what constitutes fraud. Rather, when identifying fraud in letters of credit, the courts have always emphasised on the *mens rea* - the state of mind of the beneficiary. Hence, there is uncertainty as to what constitute “material representation”. R Jack offers one possible suggestion:

“It is suggested that this must mean material to the bank’s duty to pay, so that if the document stated the truth the bank would be obliged and entitled to reject the documents. For example, if the bill of lading and the invoice in the *Sztejn* case had stated that the shipment consisted of cowhair and rubbish purporting to be bristles, they would not have conformed. And, in the *United City Merchants* case itself, if the bill of lading had had the correct date of shipment, it would have been outside the credit period.”⁵⁴

A similar idea was rejected by Lord Diplock in *United City Merchants*:

⁵¹ Xiang Gao and Ross P Buckley, “A Comparative Analysis of the Standard of Fraud Required Under the Fraud Rule in Letter of Credit Law 13 Duke J. of Comp. & Int’l L. 293, 319 explains that the limited cases testing the standard of fraud set out in s 5-109 as due to the fact that most of the cases tried until recently were still applying the previous UCC Article 5 because letters of credit involved in those cases were issued before Revised UCC Article 5 was The authors, citing J G Barnes & J E Byrne, ‘Letters of Credit: 1995 Cases’, 51 Business L 1417, 1425 (1996) explains that another reason may be that “the number of reported cases involving fraud declined significantly” following the promulgation of Revised UCC Article 5.

⁵² *Western Surety Co v. Bank of Southern Oregon* 257 F.3d 933; *New Orleans Brass v. Whitney National Bank and the Louisiana Stadium and Exposition District La.* App. LEXIS 1764 (2002); *Mid-America Tire v. PTZ Trading Ltd Import and Export Agents* 2000 Ohio App. LEXIS 5402.

⁵³ [1983] AC 168,183.

⁵⁴ *R Jack* (n 37) 9.17.

“It is conceded that to justify refusal the misstatement must be "material" but this invites the query: "material to what?" The suggested answer to this query was: a misstatement of a fact which if the true fact had been disclosed would have entitled the buyer to reject the goods; date of shipment (as in the instant case) or misdescription of the goods are examples. But this is to destroy the autonomy of the documentary credit which is its *raison d'être*; it is to make the seller's right to payment by the confirming bank dependent upon the buyer's rights against the seller under the terms of the contract for the sale of goods, of which the confirming bank will have no knowledge.”⁵⁵

R Jack's suggestion is not the same as but not too different from the one rejected by Lord Diplock since any facts which would allow the buyer to reject goods would also allow the bank to reject the documents but the converse is not true. R Jack's suggestion is certainly broader but it avoids Lord Diplock's argument that the autonomy principle will be destroyed. Following this suggestion, the seller's right to payment is still dependant on his right under the credit agreement with the bank and not on his right under the contract with the buyer. Later on in his judgment, Lord Diplock suggested the following:

“...[T]he answer to the question: "to what must the misstatement in the documents be material?" should be: "material to the price which the goods to which the documents relate would fetch on sale if, failing reimbursement by the buyer, the bank should be driven to realise its security.”⁵⁶

It may be difficult to determine whether a misrepresentation affects a bank's security whereas the determination of whether a document is compliant is an exercise which banks and courts are familiar with. R Jack's suggestion is much more viable than Lord Diplock's suggestion and offers more certainty. It is submitted that his suggestion should be adopted by the courts. As it currently stands, there is a lack of focus on the issue of what is material. It is observed that

⁵⁵ [1983] AC 168, 185.

⁵⁶ *Ibid*, 186.

although “material misrepresentation” is the established standard of fraud in England, a more accurate terminology to indicate the position as it is now is “intentional fraud”.

3.3.2.3 Australia

Granting an injunction in *Contronic Distributors Pty. Ltd. v. Bank of New South Wales*, Helsham J stated that, “a seller can be restrained from presenting a letter of credit for payment or having payment made against it in the event that the documents which are needed to require payment to be made are false to the knowledge of the seller.”⁵⁷ Some cases suggest that Australian courts are content with a lower level of misfeasance, such as where the beneficiary lacks honest belief⁵⁸ or was reckless and indifferent as to its truth⁵⁹. In recent years, Australian courts appeared to be willing to extend the fraud exception to unconscionable conduct in cases involving standby letters of credit.⁶⁰ This subject will be discussed in detail in Chapter 6. However, the focus on the mental state of mind remains the prevailing attitude in Australia.

3.3.2.4 Canada

In the past, Canadian courts when describing fraud have referred to “impropriety, dishonesty or deceit”, a demand that is “clearly untrue or false”, or “utterly without justification”, or where it is apparent there is “no right to payment”.⁶¹ “A legitimate dispute or disagreement over the interpretation of a contract, however one-sided that dispute may appear”⁶² does not suffice as fraud, nor does “mistake or error in interpreting the terms of a contract”⁶³. Although not at issue, in *Bank of Nova Scotia v Angelica-Whitewear*, LeDain J., for the unanimous court, agreed with *United City Merchants* and took up the view that the “fraud exception should be confined to

⁵⁷ [1984] 3 NSWLR 110,116.

⁵⁸ *Bush v National Australia Bank Ltd* (1992) 35 NSWLR 390, 402 (SC).

⁵⁹ *Austal Ships Pty Ltd v National Australia Bank Ltd*; unreported; SCT of WA (Templeman J); Library No 970037; 13 February 1997).

⁶⁰ *Hortico (Australia) Pty Ltd v Energy Equipment Co (Australia) Pty Ltd* (1985) 1 N.S.W.L.R. 545 (N.S.W.S. Ct.); *Inflatable Toy Co. v. State Bank of New S. Whales* (1994) 34 NSWLR 243 (N.S.W.S. Ct.); *Olex Focas v Skodaexport* (1996) 134 FLR 331 (V.S. Ct.).

⁶¹ *Cineplex Odeon Corp v 100 Bloor West General Partner Inc* [1993] O.J. No. 112 (Ont. Gen. Div.), [32].

⁶² *Ibid*, [31].

⁶³ *Washburn v. Wright* (1913), 31 O.L.R. 138 (App. Div.), 147.

fraud by the beneficiary of a credit and should not extend to fraud by a third party of which the beneficiary is innocent”.⁶⁴

3.3.2.5 Commentary

The discussion so far shows two different approaches to finding fraud. American courts adopt the approach of looking at the factual circumstances of the case, in particular the effect of the wrongdoing and the severity of the wrongdoing.⁶⁵ On the other hand, English courts focus on inquiring into the state of mind of the beneficiary in calling the letter of credit. Others like, Canada and Australia have in general, also required knowledge on the part of the beneficiary, although there are occasional suggestions of different notions of fraud. Overall, American courts adopt the least stringent concept of fraud. In *United Trading Corporation S.A. and Murray Clayton Ltd. v Allied Arab Bank Ltd*, Ackner LJ referred to some of the cases cited in the official comment to UCC §5-109⁶⁶ and made the observation that the American conception of fraud is far wider than that in the English jurisdiction, to the extent of including ordinary breach of contract.⁶⁷

One American writer argues that the English approach is better i.e. that for the purposes of injunctive relief, fraud should be found only where there is a dishonest intention on the part of the beneficiary.⁶⁸ Whilst the focus on intention or knowledge of fraud is certainly an approach English courts have consistently adhered to, it is submitted that English law should not limit the scope of this exception to actual knowledge. This is because any investigation into the state of mind of the beneficiary is not likely to be easy and may require extensive investigation. Proof of actual intention on the part of the beneficiary is difficult to establish in a full trial, let alone in a preliminary hearing. The relevant evidence on the issue of intention may be just the words of the alleging party. Due to these difficulties, the writer feels that if the law is to require only actual knowledge, the allocation of risk is unfairly in favour of the beneficiaries.

⁶⁴[1987] 1 S.C.R. 59, [18].

⁶⁵R.P. Buckley, “The 1993 Revision of the Uniform Customs and Practice for Documentary Credits” (1995) 6 JBFLP 77, 97.

⁶⁶*Dynamics Corporation of America v. the Citizens and Southern National Bank*. 356 F. Supp. 991 (1973); *Harris Corporation v. Nirt*, F. 2d 1344 (1982) and *Itek Corporation v. F. N. Bank of Boston*, 566 F. Supp. 1210 (1983).

⁶⁷[1985] 2 Lloyd's Rep. 554, 561.

⁶⁸Symons EL, “Letters of Credit: Fraud, Good Faith and the Basis for Injunctive Relief” (1980) 54 T.L.R. 338.

It is suggested here that the question the courts should be concerned with is not just “did the beneficiary actually know?” but should also include the additional question of “ought he know?” The idea is that the relevant state of mind will be found objectively, by directing the inquiry into factual circumstances of the case. This is also supported by the writings of Professor Ellinger and R Jack who interpreted knowledge as similar to the tort of deceit.⁶⁹ The tort of deceit contains the following elements: (1) knowing the representation to be false; (2) without belief in its truth; or (3) recklessly, careless whether it be true or false⁷⁰. “It may well be that where the party presenting the documents has some serious ground for suspicion of a document so that if he gave proper consideration to it he would realise that it most likely contained a false statement but shuts his eyes to that, this would be sufficient.”⁷¹

In a recent American case, *Levin v. Meagher*, Margulies J stated this:

“What unifies the various standards formulated in the cases cited in the official code comment is their requirement that fraud be determined by an objective examination of the circumstances, rather than by reference to the subjective beliefs of the beneficiary.”⁷²

The writer’s submission appears to be the same as the position adopted in America, albeit expressed in different terms. This means that if accepted, the fraud exception in England would be much more in line with the fraud exception in America. As explained by one American judge, an objective approach fits in comfortably with the fundamental principle which forms the mechanics of the letter of credit.

“The adoption of an objective standard is consistent with the contractual nature of letters of credit. Under such contracts, a beneficiary has the right to draw on the letter

⁶⁹ *R Jack* (n 37) 9.18; E.P. Ellinger, “Documentary Credits and Fraudulent Documents” in C.M. Chinkin *et al.* (ed), *Current Problems of International Trade Financing* (Butterworths, Singapore 1983) 161.

⁷⁰ *Derry v. Peek* [1884] A.C. 337, 374. However, Jack recognises that there is a distinction between the reckless presentation of documents and the tort of deceit in that the bank did not enter into the contract based on misrepresentation but is merely refusing to perform it.

⁷¹ *R Jack* (n 37) 9.18.

⁷² 2004 Cal. App. Unpub. LEXIS 7060, 18.

of credit only if certain conditions are met. If there is "no bona fide claim" that those conditions have been met-in other words, if it is clear that the beneficiary has no right to draw on the letter of credit-the beneficiary should not be permitted to draw on the line of credit merely because the beneficiary has formed a good faith but mistaken belief that conditions permitting a draw do exist."⁷³

One may argue that a beneficiary could have genuinely committed a mistake or was genuinely unaware of the misrepresentation but such an approach would have the result of unfairly punishing them. This concern is to a large extent unjustified since, as the discussion which follows will show, evidence has to satisfy a high evidential threshold. The evidence would need to show circumstances where it is hard to imagine that the beneficiary seller was not reckless and where there are strong reasons for him to be held responsible for his behavior.

3.3.3 Proof/evidence of Fraud

In order to rely on the fraud exception to withhold payment, any allegation of fraud must be supported by sufficient evidence. This issue is of particular importance because evidential threshold is the primary device used to limit the application of the fraud rule. Due to the different stages of proceedings where the fraud exception may be argued, it is useful to discuss this issue by drawing a distinction between a pre-trial hearing and a full trial hearing.

3.3.3.1 Pre-trial

3.3.3.1.1 Application for injunction

Since questions relating to the fraud exception are likely to arise primarily in applications for interim injunctions to restrain payment by the bank, where the evidence will be by affidavit or witness statement⁷⁴ and the decision will have to be taken without a full hearing on the merits, the

⁷³ *3Com Corp. v. Banco do Brasil, S.A.* (2nd Cir. 1999) 171 F.3d 739, 747 per S. Sotomayor J.

⁷⁴ An application for an interim injunction must be supported by evidence set out in either (1) a witness statement, or (2) a statement of case provided that it is accompanied by a statement of truth, or the application provided that it is verified by a statement of truth, unless the court, an Act, a rule or a practice direction requires evidence by affidavit. (CPR 25PD.3.2)

approach to the standard of proof assumes particular importance.⁷⁵ English courts generally require a high degree of proof for proceedings on this matter. It is difficult to see how the courts did not find established fraud in some of these cases even though the facts were very much in favour of the plaintiffs. For instance, in *Discount Records*, not only were the goods delivered later than the date stated in the invoice, there was evidence to show that 97% of the goods delivered were either not as ordered or rubbish. This evidence was in the form of the buyer's inspection of the goods in the presence of the issuing bank. In addition, at the hearing, one of the boxes was presented showing that it had been tempered with.⁷⁶ Despite all these facts, the High Court decided that the evidence had not satisfied the required standard. Megarry J also stated that it would be difficult to resolve an issue of fraud in any hearing to which the seller was not a party.⁷⁷ In *Harbottle*⁷⁸ and *Edward Owen*⁷⁹, the judges emphasised that the standard is that of "clearly established fraud" - in both case injunctions were refused because it was decided that fraud was alleged but not established.

Moreover, these cases do not reflect a one-off approach. In *Bolivinter Oil S.A. v Chase Manhattan Bank*⁸⁰, it was specifically stated that "...[T]he evidence must be clear, both as to the fact of fraud and as to the bank's knowledge".⁸¹ In *United Trading Corpn SA v Allied Arab Bank*⁸², Ackner LJ provided further explanation on this issue:

"We would expect the Court to require strong corroborative evidence of the allegation, usually in the form of contemporary documents, particularly those emanating from the buyer. In general, for the evidence of fraud to be clear, we would also expect the buyer to have been given an opportunity to answer the allegation and to have failed to provide any, or any adequate answer in circumstances where one could properly be expected. If the

⁷⁵ But the effect of granting an interim injunction will merely be to delay payment to the beneficiary if at trial his claim for payment is found to be justified.

⁷⁶ The numbers indicating the serial number of the records inside which appeared on the outside of the box had been pasted over with some semi-transparent material and different numbers had been put on the outside, the outside numbers corresponding with the order and the covered-up numbers not corresponding with the order.

⁷⁷ 1975] 1 Lloyd's Rep. 444, 448.

⁷⁸ [1977] 2 All ER 862.

⁷⁹ [1978] 1 QB 159.

⁸⁰ [1984] 1 Lloyd's Rep 251.

⁸¹ *Ibid*, 257 per Sir John Donaldson MR.

⁸² [1985] 2 Lloyd's Rep 554.

Court considers that on the material before it the only realistic inference to draw is that of fraud, then the seller would have made out a sufficient case of fraud.”⁸³

However, he warned of a too restrictive approach to evidence which will make the fraud exception meaningless and established this test: “Have the plaintiffs established that it is seriously arguable that, on the material available, the only realistic inference is that [the beneficiary] could not honestly have believed in the validity of its demands on the performance bonds?”⁸⁴. This has since been the test adopted in English cases where pre-trial injunctions are sought. One may question whether “the only realistic inference” standard set out in this case is a slightly lower threshold than the test of clear or established fraud. In *Turkiye Is Bankasi AS v Bank of China*⁸⁵, Waller J. took the view that there is no material difference between the two and it is argued here that this is correct.

English courts later appeared to have deviated from the traditional strict approach in *Themehelp Ltd. v. West & Others*⁸⁶, the facts of which have already been discussed.⁸⁷ The plaintiff in this case applied for an interlocutory injunction to restrain the defendants from giving notice to the guarantor, on the grounds that there was fraudulent misrepresentation. The plaintiff had to prove that in the course of negotiating the purchase of the shares, the defendants fraudulently concealed the fact that Sony would no longer be a major customer of the company. The Court of Appeal affirmed the trial judge’s finding that the plaintiff had satisfied the onus of proof, which is the establishment of a seriously arguable prospect at trial that the only realistic inference to draw is that the defendant were fraudulent⁸⁸ This is the same test set out in *United Trading Corpn* but the Court of Appeal in *Themehelp* was much more lenient in their approach and even accepted some of the hearsay evidence involved. In fact, the dissenting judge, Evans LJ decided that any finding of the alleged misrepresentation is unrealistic.⁸⁹

⁸³ *Ibid*, 561.

⁸⁴ *Ibid*.

⁸⁵ [1996] 2 Lloyd's Rep. 611, 616.

⁸⁶ *Themehelp* (n 32).

⁸⁷ See page 93 for facts of this case.

⁸⁸ Counsel for the buyers did not sought to argue in this appeal that the judge adopted the wrong test. Therefore the Court Of Appeal assumed that the correct test was adopted.

⁸⁹ *Themehelp* (n 32) 104. Evans LJ gave the following reasons:

(footnote continues next page)

In Canada, earlier cases took up the strict English approach of requiring clearly established fraud⁹⁰ but subsequently, in *CDN Research & Development Ltd. v. Bank of Nova Scotia* J Galligan established the test of a strong prima facie case of fraud⁹¹. This approach, which is less onerous than the English standard of proof, is also adopted by Australian courts.⁹² American courts have not formulated any test in relation to establishing proof of fraud. The reason behind this may be because preliminary proceedings in American fraud cases sometimes involve extensive and multiple hearings with delays.⁹³ Perhaps, this could also be partly due to American courts focusing more on the rules of procedural law governing the issuance of preliminary injunctive relief.

3.3.3.1.2 Summary judgment

When a bank refuses to pay on grounds of fraud, a beneficiary will often try to obtain a summary judgment against the bank to obtain quick payment. In *Solo Industries UK v Canara Bank*⁹⁴ a beneficiary made an application for summary judgment against a bank which refused to pay under a performance bond. The Court of Appeal had to consider the standard of proof which is to be applied in a summary judgment hearing where a bank is defending an application by the beneficiary for a summary judgment. Mance LJ drew a distinction between two types of cases:

“The plaintiffs purchased the defendants' shareholdings in the Shinecrest group of companies on terms negotiated over several months and set out in the share sale agreement dated 29 May 1992...Both parties were represented by experienced solicitors and each had access to financial advisers (Price Waterhouse for the defendants). The plaintiffs were acting in conjunction with their two bankers, 3i and Midland Montagu, and Mr Daniel of 3i accompanied Mr Adrian Evans, of the plaintiffs, to all meetings with the defendants except apparently a visit which Mr Evans made to the defendants on 27 April 1992 at which the allegedly fraudulent misrepresentation was made. Moreover, in January the plaintiffs ... received Price Waterhouse's update which included trading and financial forecasts on the express assumption that the Sony UK business would decline almost to zero. I find it difficult to accept that the plaintiffs, their bankers and advisers relied ultimately, even in part, on an oral assurance given by the second defendant to Mr Evans alone on 1 April, or that Mr Evans and Mr Daniel, of 3i, who visited Sony's offices at Staines in order to establish the company's trading prospects with Sony, failed to discover either what the prospects were or that Mr Rose, the senior executive to whom they spoke, was not the appropriate person within the Sony organisation for them to see (if such was the case), without realising that they had not done so.”

⁹⁰ *Lumcorp Ltd. v. Canadian Imperial Bank of Commerce*, [1977] Que. S.C. 993, and *Aspen Planners Ltd. v. Commerce Masonry & Forming Ltd. et al.* (1979), 100 D.L.R. (3d) 546, 25 O.R. (2d) 167, 7 B.L.R. 102 (H.C.).

⁹¹ (1980) 18 CPC 62.

⁹² *Hortico (Aust) Pty Ltd v Energy' Equipment Co (Aust) Pty Ltd* (1985) 1 NSWLR 545; *Inflatable Toy Co. v. State Bank of New S. Whales* (1994) 34 NSWLR 243, 251; Unreported, Supreme Court of Western Australia, 13 February 1997, 2221/1996.

⁹³ Roeland Bertrams, *Bank Guarantees in International Trade* (3rd edn Paris; New York, ICC Publication 2004) 359.

⁹⁴ [2001] 2 Lloyd's Rep. 578.

a) *Cases where it is alleged that the bond's issue had been obtained by fraud or misrepresentation*

Where the validity of a bond is challenged, the Court of Appeal in *Solo* held that the applicable test was the lower civil test - whether the bank had a “real prospect of successfully defending the claim”.⁹⁵ Mance LJ gave the following reason:

“The cash principle means that (short of established fraud) any claim that a bank may acquire against a beneficiary making a fraudulent demand must be pursued separately and subsequent to payment, and cannot normally be used as a defence or set-off to avoid payment. All that is clear. But such risks all arise out of and on the basis of the instruments issued. They assume the “integrity” of the instrument that the bank has issued. It does not follow that banks accept the risk that the instrument itself has been induced by conspiracy between, or misrepresentation by, their customers and the beneficiaries. The mere appearance of a valid instrument cannot commit a bank.”⁹⁶

Solo Industries fell within this category. Based on the evidence, the Court of Appeal held that the bank passed the test and refused summary judgment to the beneficiary.

b) *Cases where it is alleged that a fraudulent demand was made on the bond*

In such circumstances, it was held that the applicable standard is that of established fraud, or establishing that on the material available the only realistic inference is that the beneficiary could not honestly have believed in the validity of its demands on the performance bonds. The Civil Procedure Rules Part 24 test for summary judgment was rejected:

“If instruments such as letters of credit and performance bonds are to be treated as cash, they must be paid as cash by banks to beneficiaries. The courts in the

⁹⁵ Civil Procedure Rules 1998/3132, 24.2(a).

⁹⁶ [2001] 2 Lloyd's Rep. 578, 587.

Harbottle and Edward Owen cases emphasised this, and, in my view, set a higher standard than “a real prospect of success” in relation to all these situations.”⁹⁷

In a later case, *Banque Saudi Fransi v Lear Siegler Services Inc*⁹⁸, the Court of Appeal followed *Solo Industries* and held that the test of standard of proof at summary judgment on this matter was higher than that laid down by Civil Procedure Rules Part 24.⁹⁹

Very recently, in *Enka Insaat Ve Sanayi AS v Banca Popolare Dell'alto Adige SPA*¹⁰⁰, where banks which issued the guarantees sought to resist summary judgment on the basis that there was a fraudulent demand for payment, these cases were reviewed in the High Court and Teare J took the view that the test on a summary judgment application “is not entirely clear”.¹⁰¹ Rather than following *Solo* and *Banque Saudi Fransi*, Teare J established that the test to be applied is “whether there is a real prospect that the Banks will establish at trial that the only realistic inference is that the fraud exception applies”.¹⁰² He distinguished *Solo* and *Banque Saudi Fransi* on the basis that the courts in both cases were not considering a claim against a bank where the defence was that there was a fraudulent demand under a guarantee - the comment in *Solo* is *obiter dicta* whilst *Banque Saudi Fransi* concerned a claim against a person who has given a bank a counter indemnity under a performance bond. Although the test which was applied in *Enka* without doubt sets a lower standard than that established in *Solo* and *Banque Saudi Fransi*, it remains the case that this standard is still quite high, as evidenced by the banks’ failure to meet up to this standard in *Enka*.

⁹⁷ *Ibid*, 586.

⁹⁸ [2007] 2 Lloyd’s Rep. 47.

⁹⁹ *Ibid*, [16]. Interestingly, it was stated that the applicable test is different in a case which involved a claim against a person who had given a counter-indemnity. It was held that the test applied in such circumstances is that set out in CPR 24.2, which is whether the defendant had shown that there was a real prospect that it would be able to prove the fraud exception at trial.

¹⁰⁰ [2009] EWHC 2410 (Comm).

¹⁰¹ *Ibid*, [19].

¹⁰² *Ibid*, [24].

3.3.3.2 Full trial

In civil cases, the level of proof required to convince the court that a proposition is true is to prove it “on the balance of probabilities”. Professor Goode writes that this is the standard to be applied even at the trial of letters of credit cases, whilst emphasising however that “in fraud cases, this is at the high end of the scale”¹⁰³. This may be correct, since in *Themehelp Ltd v West Waite L.J* referred to the balance of probabilities standard as “weighing the evidence with due regard to the gravity of the particular allegation”¹⁰⁴. Xiang Gao, however, submits that due to the very small number of cases, it is too early to conclude that the balance of probabilities is to be applied in trials considering the fraud exception.¹⁰⁵ He points out that such a distinction is not drawn in the United States.¹⁰⁶ One English case which considered the fraud exception in a full trial is *Turkiye Is Bankasi AS v Bank of China*¹⁰⁷, where the Court of Appeal applied the “only realistic inference is that of fraud” test, with no reference to the “balance of probabilities” test.

Interestingly, in the Canadian case *Bank of Nova Scotia v Angelica-Whitewear*¹⁰⁸, Le Dain J adjusted the test from *CDN Research*, by distinguishing the proof of fraud required in an application for an interlocutory injunction to restrain payment on the ground of fraud from that of a case determining whether a draft was improperly paid by the issuing bank after notice of alleged fraud by the beneficiary:

“A strong prima facie case of fraud would appear to be a sufficient test on an application for an interlocutory injunction. Where, however, no such application was made and the issuing bank has had to exercise its own judgment as to whether or not to honour a draft, the test in my opinion should be the one laid down in *Edward Owen Engineering*, whether fraud was so established to the knowledge of the issuing

¹⁰³ R Goode, *Commercial law* (3rd edn Lexis Nexis, London 2004) 993.

¹⁰⁴ [1996] Q.B. 84, 99.

¹⁰⁵ *Xiang Gao* (n 3).

¹⁰⁶ He cites as support Official Comment 5 on UCC §5-109 which provides the following:

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

¹⁰⁷ *Turkiye* (n 85).

¹⁰⁸ (1987) 36 D.L.R 4th 161.

bank before payment of the draft as to make the fraud clear or obvious to the bank.”¹⁰⁹

He justifies this distinction by explaining the difficulty faced by the issuing bank at that point in comparison to that of a court in an application for an interlocutory injunction:

“In view of the strict obligation of the issuing bank to honour a draft that is accompanied by apparently conforming documents, the fact that the decision as to whether or not to pay must as a general rule be made fairly promptly, and the difficulty in many cases of forming an opinion, on which one would hazard a lawsuit, as to whether there has been fraud by the beneficiary of the credit, it would in my view be unfair and unreasonable to require anything less of the customer in the way of demonstration of an alleged fraud.”¹¹⁰

This approach of adopting a higher standard of proof of fraud at full trials was also adopted in Australia.¹¹¹

From the analysis so far, the logical conclusion to reach on this issue is that a higher standard of proof of fraud is applied in a full trial. This has been the English, Canadian and Australian position for some time although it may be argued that the exact standard of proof of fraud for applications for injunctions in these jurisdictions slightly differs. It is submitted here that there is no reason for a lower standard of proof to apply at trial. At trial, when considering the fraud exception, the courts will be looking retrospectively to the time when payment has been made or should have been made. In view of the difficulties faced by banks in making a quick decision at that point in time, the writer agrees with the reasoning of Le Dain J that there is a need for a higher standard of proof at a full trial. There is support for this in the judgment of Rix J in *Czarnikow-Rionda Sugar Trading Inc. v Standard Bank London Ltd* where the learned judge stated that “the claimant gets the benefit of a lower standard of proof for the purposes of a pre-trial hearing”¹¹². Despite this, English judges are close to being too rigid in the application of the

¹⁰⁹ *Ibid*, 177.

¹¹⁰ *Ibid*, 178.

¹¹¹ *Hortico (Australia) Pty Ltd v. Energy Equipment Co (Australia) Pty Ltd* (1985) 1 NSWLR 545 (SC).

¹¹² [1999] 2 Lloyd's Rep. 187, 202.

high standard of proof in pre-trial hearings and should be cautious in this regard. Otherwise, the fraud exception may not be able to serve its purpose, which is to prevent fraudulent parties from improperly receiving payment.

3.3.4 Relevant time of bank's knowledge of fraud

It has already been shown that for the fraud exception to be successfully invoked, it must be proven to a high standard that the bank has knowledge. It should be highlighted that the question of what is sufficient to constitute knowledge of fraud is different from the question of which point in time the bank is required to have knowledge. The former relates to the issue of standard of proof, an issue already discussed in the previous heading. In relation to establishing a beneficiary's knowledge of fraud, it is the time of presentation which is critical. However, in relation to establishing the bank's knowledge of fraud, the required timing is different. For the purpose of facilitating this discussion, a distinction is made between three different scenarios in which this issue may arise.

3.3.4.1 Where payment has been made

After payment, the bank's knowledge of fraud becomes relevant only because the applicant or another bank disputes its obligation to reimburse. If a bank had acquired evidence of fraud between the time of presentation and the date of payment but had gone ahead to make payment, it is only fair that the applicant or another bank should not be obliged to reimburse the bank for the amount paid. Similarly, if the evidence of fraud arises after payment, the bank should be entitled to reimbursement of the amount paid. In *United Trading Corporation SA v Allied Arab Bank Ltd*, Ackner LJ stated the following:

“It seems to us clear that, where payment has in fact been made, the bank's knowledge that the demand made by the beneficiary on the performance bond was fraudulent must exist prior to the actual payment to the beneficiary and that its knowledge at that date must be proved. Accordingly, if all a plaintiff can establish is such knowledge *after*

payment, then he has failed to establish his cause of action. The bank would not have been in breach of any duty in making the payment without the requisite knowledge...”¹¹³

If this was not the case, then banks could potentially suffer huge losses because of the fraudulent act of another party of which they were unaware at the time of payment. The argument that banks should have conducted an investigation is extremely weak because the commercial reality of the banking world means that banks cannot be expected to carry out an extensive investigation every time documents are presented to them. In *Turkiye Is Bankasi v. Bank of China*¹¹⁴, Waller J affirmed that a bank is under no obligation to investigate:

“It is simply not for a bank to make enquiries about the allegations that are being made one side against the other. If one side wishes to establish that a demand is fraudulent it must put the irrefutable evidence in front of the bank.”¹¹⁵

3.3.4.2 Where payment has not yet been made

If all the other requirements of the fraud exception are fulfilled and a bank has knowledge of fraud at the time of payment, it must not pay. If it does pay in such circumstances, it would be in breach of its mandate with its customer, hence exposing itself to non-reimbursement by the applicant.

Banks and applicants do not necessarily agree on whether payment should be made, understandably so since they have different underlying interests to protect. An applicant may need to seek an injunction to restrain payment if the paying bank takes the view that payment should be made. In *Bolivinter Oil v Chase Manhattan Bank*¹¹⁶, where the plaintiff appealed against the discharge of ex parte injunctions which had been previously granted, Sir John Donaldson M.R. stated that the following:

¹¹³ [1985] 2 Lloyd’s Rep 554, 560.

¹¹⁴ [1996] 2 Lloyd’s Rep. 611 affirmed in [1998] 1 Lloyd’s Rep. 251.

¹¹⁵ [1996] 2 Lloyd’s Rep. 611, 617.

¹¹⁶ [1984] 1 Lloyd’s Rep. 251.

“... if..., the principle is that "fraud unravels all" and if the issue is whether payment should now be made, it is nothing to the point that at an earlier stage the fraud was unknown to the payer and so could not begin its unravelling, if fraud is now known to him and has now unravelled his obligations.”¹¹⁷

Similarly, in *United Trading Corp SA v Allied Arab Bank Ltd*, Ackner LJ decided that fresh evidence which emerged by the time the appeal is heard was to be taken into account even though such evidence were not available previously.¹¹⁸

3.3.4.3 Where payment has been refused

A more complicated situation exists where a bank refuses payment but it is subsequently proven that there was no clear evidence of fraud at the time when payment was due. In such a situation, a beneficiary will often try to obtain a summary judgment against the bank to obtain quick payment. If the bank obtains evidence of clear fraud after the date of expected payment, can the bank raise evidence which was not available at the time of refusing payment to resist summary judgment? In *Balfour Beatty Civil Engineering Ltd. v. Technical & General Guarantee*, a surety appealed against a summary judgment granted in favour of the beneficiary of the performance bond. Waller LJ stated that, “If the evidence is now clear, then no judgment will be given in favour of the beneficiary because of the fact that the surety would be entitled to a judgment for the equivalent sum.”¹¹⁹ By this Waller LJ was referring to the surety’s counterclaim since it would have its own remedy against the beneficiary. In *Safa Ltd. v Banque Du Caire*¹²⁰, it was also held that the bank is able to rely on clear evidence of fraud which becomes available at the time of hearing but the Court of Appeal’s refusal to grant summary judgment in *Safa* was based on the surety’s right to set off rather than a counterclaim.¹²¹ In *Mahonia Ltd. v JP Morgan Chase Bank*, Colman J approached the matter differently:

¹¹⁷ *Ibid*, 256.

¹¹⁸ [1985] 2 Lloyd's Rep. 554, 560. The judgment is on two appeals, concerning the refusal of injunctive relief and the discharge of injunctions previously granted.

¹¹⁹ [2000] C.L.C. 252, 260. However, it was held that the surety did not have such evidence and the summary judgment was upheld.

¹²⁰ [2000] 2 Lloyd's Rep. 600.

¹²¹ *Ibid*, 607.

“...[I]t is, in my view, unnecessary to confine the surety’s position to one founded on a counterclaim for damages or circuity or potential circuity of action. As long as there is before the court evidence which establishes fraud by the beneficiary there is evidence sufficient to establish a straight defence based on ex turpi causa. For this purpose, I agree with Lord Justice Waller that the strength of the fraud case has to be tested on the evidence available at the hearing of the summary judgment application, as distinct from the time of demand.”¹²²

Professor Goode points out that, “It would be absurd if the court were to be compelled to give summary judgment to the beneficiary in the face of clear evidence of fraud merely because the evidence was not available at the time of demand”¹²³ This is very true, and for this reason alone Colman J was correct to have not considered the right to counterclaim or set-off. R Jack suggests another reason - the general rule in contractual disputes allows the bank to justify non-payment using any reasons known at trial. ¹²⁴ He pointed out that a bank could potentially abuse this precedent by refusing payment in a borderline fraud case. Nevertheless, he suggests that this is quite unlikely as the bank would be risking its reputation in making the decision not to pay.

3.3.5 Third Party Fraud

The following discussion explores the contentious issue of whether the scope of the fraud exception encompasses fraudulent conduct which is not perpetrated by the beneficiary. Although Lord Diplock famously stated that “fraud unravels all” in *United City Merchants*, in actual fact fraud does not unravel the legal position of all parties under English law. In *United City Merchants*, the House of Lords ruled that a bank was obliged to pay even though it had knowledge of the fraud because the beneficiary did not have knowledge of the fraud. The effect of *United City Merchants* is that the identity of the party who perpetrated the fraud is crucial – a

¹²² [2003] 2 Lloyd's Rep. 911, [34]

¹²³ R Goode (n 103) 992.

¹²⁴ R Jack (n 37) 9.58, citing H Beale, *Chitty on Contracts* (30th edn Sweet & Maxwell, London 2008) para 24-014.

document forged by a third party without the involvement of a beneficiary will not provide a ground to refuse payment under the fraud exception. This position is followed in other common law jurisdictions such as Canada¹²⁵ and Australia¹²⁶. § 5-109 UCC does not provide that the beneficiary's knowledge of the fraud is required in order for the fraud exception to intervene payment. So far there is no direct authority in American cases specifying that the fraud exception is limited to fraud of the beneficiary. Moreover, in demand guarantee cases, it has been expressly stated in American courts that there is no need to establish that the beneficiary acted "deceitfully or with malicious intent".¹²⁷ Therefore, American courts appear to differ in this respect from other common law jurisdictions.

There are many reasons why English law retains the requirement of beneficiary's knowledge in the fraud exception. The main justification is that it is in the interest of international trade to maintain the efficacy of the documentary credit as a system of payment. Beneficiaries choose the use of documentary credits because of the certainty of payment offered and should be able to rely on it. There is also the argument that it is rather unfair to refuse payment to an innocent beneficiary on the basis that a third party has forged a document. Moreover, forgery and fraud are certainly different kinds of wrongdoing, hence a good justification for each to be treated differently in the eyes of law. Arguably, the allocation of risk in the event of third party fraud should fall on the applicant because this is the risk that any applicant consents to by agreeing to pay by letter of credit.

3.3.5.1 The drawbacks of *United City Merchants*

The disadvantage of the judgment in *United City Merchants* is that it creates a rather absurd situation - a bank who obtains strong evidence before payment that a document is forged by a third party is still obliged to make payment, despite knowing that the documents are in fact

¹²⁵ *Angelica-Whitewear* (n 26). Although not at issue in this case, LeDain J., for the unanimous court, agreed with *United City Merchants* and took up the view that the "fraud exception should be confined to fraud by the beneficiary of a credit and should not extend to fraud by a third party of which the beneficiary is innocent".

¹²⁶ *Contronic Distributors Pty. Ltd. v. Bank of New South Wales* [1984] 3 NSWLR 110. See page 90 for a detailed discussion of this case.

¹²⁷ *Rockwell International Systems Inc v Citibank NA* 719 F.2d 583 (1983); *Harris Corp. v. National Iranian Radio and Television*, 691 F.2d 1344 (1982); *Dynamics Corp of America v. Citizens & Southern National Bank* 356 F. Supp. 991 (1973).

forged. Ultimately, the burden falls on the applicant who is to reimburse the bank. Such a rule could make this payment instrument a breeding ground for fraudsters. One commentator referred to letters of credit as a Crooks Charter.¹²⁸ Although circumstances where a beneficiary conspires with a third party would fall within the scope of the fraud rule, the evidential difficulties of proving the beneficiary's involvement in practice means that opportunities are created for beneficiaries to defraud banks. The act of fraud remains fraud and its effect on international trading is detrimental regardless of whoever perpetrates the fraud. The effect of fraud on the right to payment should have no correlation to the identity of the perpetrator.

Many commentators advocate that the requirement of beneficiary's fraud should be abolished.¹²⁹ The primary argument is that, despite being compliant on its face, a document forged by a third party is not genuinely conforming. As Professor Goode correctly states, "A fraudulently completed bill of lading does not become a conforming document merely because the fraud is that of a third party."¹³⁰ Take for example the bill of lading in *United City Merchants*. It is difficult to see how a bill of lading which had been deliberately modified to record the wrong shipping date is conforming when even minor errors in documents could provide a ground for rejection under the strict compliance rule. International trading often involves goods with volatile market value. Since the price of the goods could vary significantly from one day to another, an incorrect shipping date should not be seen as trivial. Furthermore, in *M. Golodetz & Co. Inc. v Czarnikow-Rionda Co. Inc*, Donaldson J stated that, "A tender of documents which, properly read and understood, call for further inquiry or are such as to invite litigation is clearly a bad tender."¹³¹

In his writings, Xiang Gao highlighted the importance of the maintaining a fair balance of the competing interests amongst the many parties involved in the letter of credit transaction:

¹²⁸ Ademun-Odeke, "Double Invoicing in International Trade; The Fraud and Nullity exceptions in Letters of Credit – Are the America Accord and the UCP 500 Crooks Charters?" (2006) 18 Denning L.J. 115.

¹²⁹ *Ibid* ; R Goode "Abstract payment undertakings" in P. Cane and J. Stapleton (eds), *Essays for Patrick Atiyah* (Clarendon, Oxford 1991) ; *Xiang Gao* (n 3) Chapter 5.

¹³⁰ R Goode, "Reflections on Letters of Credit -1" [1980] JBL 291, 294.

¹³¹ [1980] 1 W.L.R. 495, 510.

“The normal operation of the letter of credit not only provides the beneficiary with safe and rapid access to the purchase price or a sum of money when the applicant defaults, but also provides the applicant with credit and/or other commercial benefits and protects the applicant against improper calls on the credit by requiring the beneficiary to present *genuine* documents indicating that it has properly performed its obligations under the underlying transaction. If forged or fraudulent documents are allowed to trigger payment, the balance assumed in the letter of credit scheme will be undermined”¹³².

Also, the argument that it is unfair for an innocent beneficiary to be refused payment because of the fraud of a third party cannot always be sustained. Take for instance the example of a master who observes that the condition of the goods is not as it should be and inserts remarks into his mate’s receipt. The charterer is keen to have a clean bill of lading since a claused bill of lading is no good for the shipper. Therefore, the charterer provides a letter of indemnity to the master to cover him in the event of cargo claims in return for which the master issues a clean bill of lading. Meanwhile, the beneficiary of the credit (the shipper) is not aware of this. In this example, although the beneficiary was not the person perpetrating the fraud, it is hardly unfair to refuse payment to the beneficiary since the goods shipped were not in acceptable condition.

The UCP and other international regulations do not expressly deal with the issue of third party fraud. However, it is worthwhile to note here that Article 8 of the Provisions of the Supreme People’s Courts on Some Issues Concerning the Trial of Cases of Disputes over Letters of Credit (which took effect on 1st of January 2006) provides the following:

The letter of credit fraud shall be determined as constituted under any of the following circumstances:

- (i) The beneficiary has forged documents or presented documents containing fraudulent information;
- (ii) The beneficiary has intentionally failed to deliver goods or delivered goods with no value;

¹³² Xiang Gao, Ross P Buckley, “A Comparative Analysis of the Standard of Fraud Required Under the Fraud Rule in Letter of Credit Law” (2003 Oxford University Comparative Law Forum) <<http://ouclf.iuscomp.org/articles/gao-buckley.shtml#fn1>> accessed 2 September 2008.

(iii) The beneficiary has conspired with the applicant or a third party and presented fraudulent documents whereas there is no actual underlying transaction; or

(iv) Other circumstances of letter of credit fraud.

Whilst subsection (i)-(iii) focus on beneficiary's fraud, subsection (iv) appears to be a catch all clause with no reference to the beneficiary's involvement at all. This means that subsection (iv) may encompass circumstances where a beneficiary is innocent but a third party is fraudulent. It is likely that subsection (iv) would include such circumstances although Xiang Gao expresses his uncertainty as to the effect of this subsection¹³³

Upon review of the arguments presented for and against the extension of the fraud exception to third party fraud, it is submitted here that third party fraud should be included within the limits of the fraud rule. Nevertheless, as one commentator rightly points out, the principle in *United City Merchants* is influential and well entrenched even in other common law jurisdictions and a consideration of whether the fraud exception should be extended to third party fraud is likely to be futile.¹³⁴ It is hoped that English courts will review this issue. Otherwise the autonomy principle will continue to protect unscrupulous fraudsters, allowing them to obtain monetary gains out of the letter of credit system. Some of the arguments discussed in this section will be revisited in more detail in the discussion of null documents (Chapter 3).

3.3.6 Holders in due course

Following *Sztejn* and *United City Merchants*, it is clear that the fraud exception cannot be used against holders in due course. In England, holders in due course of a bill of exchange are protected from allegations of fraud by Section 38 of the Bills of Exchange Act 1882. Section 29(1) of the Act defines a holder in due course as follows:

A holder in due course is a holder who has taken a bill, complete and regular on the face of it, under the following conditions; namely,

¹³³ Xiang Gao, "The Fraud Rule in Law of Letters of Credit in the P.R.C" (2007) 41 Int'l Law 1067, 1080.

¹³⁴ Dora Neo, "A Nullity Exception" [2004] Sing. J.L.S. 46, 69.

(a) That he became the holder of it before it was overdue, and without notice that it had been previously dishonoured, if such was the fact:

(b) That he took the bill in good faith and for value, and that at the time the bill was negotiated to him he had no notice of any defect in the title of the person who negotiated it.

Article 2 UCP 600 provides that:

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

A negotiating bank becomes a holder in due course who is protected from the fraud of a beneficiary if he negotiates a negotiable instrument and is authorised to do so. Under a straight credit, an issuing bank's undertaking is only to a named beneficiary. On the other hand in a negotiation credit, the issuing bank's undertaking extends to another party who obtains the beneficiary's draft and documents through negotiation or purchase. Although straight letters of credit are frequently discounted in practice, the third party purchaser is not granted greater rights than a beneficiary by the issuer of the credit and hence would only be regarded as an assignee of proceeds to the credit.¹³⁵ Even with a negotiation credit, not all parties who negotiate are granted protected status.¹³⁶ In the case of a freely negotiable credit, any bank willing to negotiate can do so and will be eligible for protected status. But in the case of a restricted negotiation credit, the negotiation is restricted to a nominated bank, with protected status only available to the nominated bank.

Where a straight credit is involved, a bank should be careful about negotiation since it is not generally authorised to negotiate and does so on its own account. The risk thereby carried is particularly alarming in the discounting of deferred payment credit¹³⁷ since fraud could be discovered during the period between the purchase of the credit and the maturity date. In *Banco*

¹³⁵ *Xiang Gao* (n 3) 140; D Pawlowic "Letters of Credit: a Framework for Analysis of Transfer, Assignment, Negotiation and Transfer by Operation of Law" (1992) 39 Wayne L. Rev 1, 25.

¹³⁶ See James E. Byrne, "Negotiation in Letter of Credit Practice and Law: The Evolution of the Doctrine" (2007) 42 Tex. Int'l LJ 561, 579-593.

¹³⁷ For an explanation of deferred payment credits, see section 1.6.3.2.

*Santander SA v Bayfern Ltd*¹³⁸, English courts were confronted with the difficult question of whether a negotiating bank is entitled to reimbursement by the issuer if fraud is established during this period. UCP 600 now clearly provides on this issue. Before examining the new UCP provisions, it is useful to study the background behind these new provisions.

3.3.6.1 *Banco Santander SA v Bayfern Ltd*¹³⁹

In this case, Paribas issued a deferred payment letter of credit (subjected to UCP 500) in relation to the sale of oil in favour of Bayfern which was payable at 180 days from bills of lading date. The confirming bank, Santander, accepted the documents upon presentation by Bayfern, thereby agreeing to pay on the maturity date, 27th November 1998. Subsequently, before this date, Santander (without any knowledge of fraud at this point) made a discounted payment to Bayfern in consideration of which Bayfern wrote a letter assigning its rights under the letter of credit to Santander. After the documents were forwarded to Paribas, it informed Santander that documents accepted by Santander included forged documents and refused to reimburse Santander. Santander then sought summary judgment against Paribas. The Court of Appeal assumed for the purpose of the preliminary issues that Bayfern had been guilty of fraud and that the fraud was discovered by Paribas and Santander prior to 27 November 1998. In the Court of Appeal, the following issues were considered:

- 1) Was Santander making a claim as assignee of Bayfern? If so, is there any reason why Paribas should not have the fraud defence to that claim as they would have had against Bayfern?
- 2) Does Santander have a right to reimbursement under the UCP?

It was held that Santander was an assignee and that the fraud defence could be used against the assignee. Waller LJ drew a distinction between an acceptance credit and deferred payment credit. The former is a negotiable instrument which could be discounted or sold in the forfait market to

¹³⁸ [2000] C.L.C. 906.

¹³⁹ *Ibid.*

which s. 38 of the Bills of Exchange Act 1882 applies, providing that a holder in due course holds the bill free from any defect of title of prior parties.

“Thus holders in due course can sue on the drafts even if fraud is discovered prior to the maturity date of the draft. Furthermore, if a confirming bank who has accepted a bill becomes the holder and holds the bill at maturity, the bill is discharged by virtue of s. 61 of the Bills of Exchange Actsince that discharge is by law automatic, the fraud would not provide an answer, and that thus the confirming bank is in as good a position as a holder in due course, even if it purchases drafts accepted by it.”¹⁴⁰

He concluded that “if parties agree for whatever reason that they will not provide a negotiable instrument, and do not provide by terms of the trade or even by the express terms of the instrument itself the protection for assignees that a negotiable instrument would provide, they must live with the consequences.”¹⁴¹

As to the issue of reimbursement under UCP 500, Waller LJ asked the question of “what precisely the issuing bank has requested the confirming bank to do, and what the issuing bank has promised to do if the confirming bank does what is requested of it”.¹⁴² He decided that the request was for Santander to confirm that it would pay on 27th November 1998 and that Paribas promised to reimburse Santander for this payment. “There is no request from Paribas that Santander should discount or give any value for the documents prior to [maturity], and albeit it may not be a breach of mandate for Santander to do so, it is up to Santander whether it does so or not.”¹⁴³ If Santander had obtained Paribas's authority to discount and obtained confirmation of reimbursement if it did discount, the fraud exception would be inapplicable.¹⁴⁴

¹⁴⁰ *Ibid*, 911.

¹⁴¹ *Ibid*, 912.

¹⁴² *Ibid*, 914.

¹⁴³ *Ibid*, 915.

¹⁴⁴ *Ibid*, 915.

The decision caused a stir amongst the banking community because it was common practice before this case for banks to discount deferred payment letters of credit¹⁴⁵ but the decision means that by doing so they assume the risk of fraud on the part of beneficiary which is discovered before the maturity date of the credit. As a result, it was necessary for banks to review their practice of discounting this type of credit. Some common law courts adopt the same position¹⁴⁶ but the position of the law on this matter is different in America. After the revision, §5-109(a)(1) UCC stipulated that the following parties are protected from the fraud exception:

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

Accordingly, under the UCC, a case like *Banco Santander*, which fell into either (i) or (iv) would have been decided in favour of the confirming bank.

In response to the criticisms following *Banco Santander*, UCP 600 now contains the following articles, attempting to reverse the ruling in *Banco Santander*:

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

¹⁴⁵ Expert banking witness in *Banco Santander SA v Bayfern Ltd* [1999] C.L.C. 1321 testified that it was common market practice in London to discount deferred payment letters of credit.

¹⁴⁶ *Credit Agricole Indosuez v Banque Nationale de Paris* [2001] 2. S.L.R. 1; *Vereins-und Westbank AG v Veren Investments* 2000 (4) S.A. 238.

12(b) By nominating a bank to accept a draft or incur a deferred payment undertaking, an issuing bank authorizes that nominated bank to prepay or purchase a draft accepted or a deferred payment undertaking incurred by that nominated bank.

Following Article 12 UCP 600, nomination of a bank to incur a deferred payment undertaking automatically provides the nominated bank with authorisation to purchase the deferred payment, the authorisation which was absent in *Banco Santander*. Article 7 UCP 600 merely reinforces the consequence of Article 12, which is that the issuing bank is to reimburse the nominated bank even if it had discounted before the maturity date. In relation to deferred payment credit, the risk of fraud now falls on:

- a) The applicant (who is under an obligation to reimburse the issuing bank) or
- b) The issuing bank (in the event that it is not able to recover its reimbursement from the applicant).

Some commentators welcome this change¹⁴⁷ whilst some retained their reservations as to the benefit of these provisions.¹⁴⁸ The writer takes the view that these changes are not ideal for various reasons. There is no longer a straightforward option for parties to choose between either the negotiation credit or the deferred payment credit in accordance with their desired allocation of risk. Following the new provisions, the risk of fraud with respect to both types of credit falls on the issuing bank or the applicant. There exists the option of expressly excluding these provisions but there may be difficulties in getting the beneficiary to agree to such exclusions.¹⁴⁹ Although some expert evidence suggests the this allocation of risk was not the prevailing practice before *Banco Santander*, it is arguable that over time, *Banco Santander* and the cases following its ruling, together with the many commentaries which followed, would probably have raised the required awareness and created a new market practice in line with these decisions.¹⁵⁰ In the words of K Takahashi, "It[Article 12] has produced the undesirable result of effectively removing a useful option of risk apportionment."¹⁵¹ Issuing banks may also become reluctant to

¹⁴⁷ Ebenezer Adodo, "The Legal Effect of Nomination under the New UCP 600" [2008] J.I.B.L.R. 231.

¹⁴⁸ Janet Ulph, "The UCP 600: Documentary Credits in the 21st Century" [2007] J.B.L. 355, 374; K Takahashi, "The Introduction of Article 12(b) in the UCP 600: Was It Really a Step Forward?" [2009] J.I.B.L.R. 285.

¹⁴⁹ K Takahashi (n 148) 286.

¹⁵⁰ *Ibid.*

¹⁵¹ *Ibid.*

issue deferred payment credits using nominated banks due to the extra cost of fraud in the event of non-reimbursement from the applicant.¹⁵² This means that buyers will not be able to make use of the deferred payment credit which has the main advantage of allowing it a period of time to verify that there is no fraud before making payment.¹⁵³ The only advantage of these new provisions is that there is more harmonisation on this matter with the UCC.¹⁵⁴

Moreover, these new provisions are themselves problematic. It is not clear whether *Banco Santander* is effectively reversed since, unlike the UCC, UCP 600 does not expressly provide an assignee to be in the category of protected persons, but only provides for the authorisation issue in *Banco Santander*.¹⁵⁵ The case itself was decided on the assignment point whilst the authorisation point was considered as only a secondary argument. There is uncertainty as to who is to bear the risk of fraud which transpires before the date of maturity in the case of a nominated bank which is an assignee of the proceeds of the beneficiary. This uncertainty is well explained by D Horowitz :

... [A]s explained by the Court of Appeal in *Banco Santander*, assignment and prepayment are mutually exclusive possibilities. A confirming bank can either take an assignment of the proceeds under Art.39 of the UCP, and present for payment as assignee; or it can discharge its undertaking to the beneficiary (at a discount or in full) and present for reimbursement in its own right. Articles 7 and 12 arguably only cover the latter situation.¹⁵⁶

Hence, it may be that the new provisions do not fully protect the legal position of confirming banks which purchase deferred payment credits.

¹⁵² *Janet Ulph* (n 148) 374.

¹⁵³ Deborah Horowitz, “*Banco Santander and the UCP 600*” [2008] JBL 508, 524.

¹⁵⁴ However, the position of the UCC on this matter is itself subjected to criticism. One commentator argued for a change in the relevant statute of Florida which had adopted the provisions of UCC Article 5 - Eyal Berger, “Putting Florida Buyers on par with International Buyers: A Cost-Benefit Analysis of Revising Florida Statute 675.109(1)(A)(4)” 16 (2004) Fla. J. Int’l L. 529.

¹⁵⁵ *Deborah Horowitz* (n 153) 521; Dolan, “Negotiation Credits under UCP 600” (2007) 13(1) *DC Insight* 4.

¹⁵⁶ *Ibid.*

3.4 Additional Hurdles for Injunctions

The circumstances where the fraud exception may arise are such as the following:

- (a) An applicant seeking an injunction against the beneficiary from calling the credit on grounds of fraud.
- (b) An applicant seeking an injunction against the paying bank from making payment on grounds of fraud.
- (c) Where payment has been made and recovery is sought but either the beneficiary or the issuing bank disputes their obligation to reimburse on the grounds of fraud.

In relation to a) and b), there is a further hurdle which an applicant has to overcome - the balance of convenience test propounded in *American Cyanamid v Ethicon Ltd*¹⁵⁷, according to which the court has to determine whether one party risks being prejudiced should an injunction be granted. In this case, Lord Diplock said that “ It would be unwise to attempt even to list all the various matters which may need to be taken into consideration in deciding where the balance lies, let alone to suggest the relative weight to be attached to them. These will vary from case to case.”¹⁵⁸ If there is no imbalance, the courts should preserve the *status quo*, which is the state of affairs before the defendant embarked on the conduct sought to be restrained, provided the plaintiff did not delay his application for relief.

The *American Cyanamid* principles are also firmly adhered to in other common law jurisdictions. In relation to applications for injunctions involving letters of credit, it is often said that the test provides an extra benefit to banks because the balance of convenience is usually weighted against the applicant and that only in exceptional cases would the test be overcome. The test requires a consideration of whether damages would be an adequate remedy for the applicant. “If there is no breach of contract by the bank, there is no case for an injunction; if there is a breach of contract, the applicant will have a good claim for damages against the bank, so there is

¹⁵⁷ [1975] A.C. 396.

¹⁵⁸ *Ibid.*

no need for an injunction”.¹⁵⁹ Because of these reasons, in *Harbottle Ltd. v. The National Westminster Bank*, Kerr J expressed the view that an applicant seeking an injunction would face an “insuperable difficulty” and that the balance of convenience is “hopelessly weighted against the plaintiffs”.¹⁶⁰

Moreover, it seems that in determining the balance of convenience in the context of documentary credit, the courts will always have to consider the position of the bank if payment was restrained. Most of the time, an injunction would expose the bank to multiple suits and the consequential costs involved in defending them. In *Czarnikow v Standard Bank London Ltd*¹⁶¹, Rix J asserted that if a claimant could obtain a Mareva injunction against a beneficiary, the overriding interest to protect a bank’s reputation and the autonomy of banking commitments would always tip the balance against granting an injunction:

“Ex hypothesi, the bank would be entitled, in the absence of an injunction, to pay the beneficiary and would not be in breach of contract to the claimant in doing so. Why, therefore, should the interests of the claimant overtop the public and general interests in the maintenance of banking commitments and in the autonomy of such commitments? The preference of concern about the private loss of the defrauded claimant to the general weal might arguably in a particular case fall in favour of the former, if the claimant could be in no other way protected. But it seems to me that the presence of the Mareva injunction or freezing order, which the Courts can grant in a case of fraud even on a worldwide basis and even as merely ancillary relief to litigation abroad, militates very strongly against that argument.”¹⁶²

He noted that there were only two cases where an injunction had been upheld on an *inter partes* basis and there were problems with both.¹⁶³ One may question whether the consideration of

¹⁵⁹ [1985] 30 B.L.R. 48, 64 per Kerr J.

¹⁶⁰ *Ibid*, 155. Similar sentiments were expressed by the Ackner LJ in *United Trading Corporation S.A. and Murray Clayton Ltd. v Allied Arab Bank Ltd* [1985] 2 Lloyd’s Rep 554, 565.

¹⁶¹ [1999] 2 Lloyd’s Rep 187.

¹⁶² *Ibid*, 190.

¹⁶³ One of these two case is *Themehelp Ltd v West*[1996] Q.B. 84 where there was a concession that a claim against a beneficiary, as distinct from a claim against a bank, was not covered by prior authority. The other case is *Kvaerner John Brown Ltd v Midland Bank plc* [1998] CLC 446 where the balance of convenience test was not applied at all.

reputation of the bank is relevant where the injunction sought is one against the beneficiary. Rix J emphasised in this case that there was no difference between seeking an injunction against a bank and a beneficiary, approving the words of Staughton LJ in *Group Josi Re Co SA v Walbrook Insurance Co Ltd* that, “The effect on the life blood of commerce will be precisely the same whether the bank is restrained from paying or the beneficiary is restrained from asking for payment.”¹⁶⁴

In America, equitable rules require an applicant seeking a preliminary injunction to show:

(1) irreparable injury and either

(2) (a) probable success on the merits or

(b) sufficiently serious questions going to the merits to make them a fair ground for litigation and a balance of hardships tipping decidedly toward the preliminary relief.¹⁶⁵

Following § 5-109 (b)(3) UCC¹⁶⁶, these requirements are to also apply to the fraud exception. Generally, financial losses will not be regarded by the court as irreparable harm since this loss can be compensated if the applicant brings an action against the beneficiary under the underlying contract.¹⁶⁷ In 1979, the Iranian revolution resulted in the non-performance of many contracts by American parties in Iran, most of which were secured by standby letters of credit. Fearing and anticipating that the Iranian government would make calls on the standby credits, some American applicants sought injunctions to restrain the American banks from paying. The applicants based their claim on the argument that the financial loss they would suffer would be irreparable since there would be no real remedy for them in the Iranian courts.

In *KMW International v. Chase Manhattan Bank*¹⁶⁸ and *American Bell v. Islamic Republic*¹⁶⁹, the American courts rejected this argument on the basis that the claimants had assumed the

¹⁶⁴ [1999] 2 Lloyd's Rep 187, 190.

¹⁶⁵ *Caulfield v. Board of Education* 583 F.2d 605, 610 (2nd Cir. 1978); *Jackson Dairy, Inc. v. H. P. Hood & Sons, Inc.*, 596 F.2d 70, 72 (2d Cir. 1979).

¹⁶⁶ § 5-109 (b)(3) UCC provides that “ all of the conditions to entitle a person to the relief under the law of this State have been met.

¹⁶⁷ See *Jackson Dairy, Inc. v. H.P. Hood & Sons, Inc.*, 596 F.2d 70, 72 (2d Cir. 1979) (per curiam). *Hudson Tire Mart, Inc. v. Aetna Casualty & Surety Co.*, 518 F.2d 671, 675 (2d Cir. 1975); *Robert W. Stark Jr., Inc. v. New York Stock Exchange, Inc.*, 346 F.Supp. 217, 231 (S.D.N.Y.), Aff'd, 466 F.2d 743, 744 (2d Cir. 1972); *Shelley v. The Maccabees*, 183 F.Supp. 681, 684 (E.D.N.Y.1960).

¹⁶⁸ 606 F.2d 10 (2d Cir.1979).

¹⁶⁹ 474 F.Supp. 420 (S.D.N.Y 1979).

business risks of international transactions which included the possibility that, if a dispute arose and international litigation ensued, their funds would be paid out under the irrevocable letter of credit and held in foreign hands. In *American Bell*, the district judge even admitted that resorting to Iranian courts would be futile but decided that the claimant would be able to receive an adequate remedy in American courts. In both cases, it was held that the balance of hardship did not tip in favour of the claimants because the defendant banks would suffer loss of credibility in the international banking community, a factor also taken into great account by English courts in the balance of convenience test. However, in many cases with similar circumstances heard after the Iran hostage crisis¹⁷⁰, the courts held that Iranian courts were an unsuitable forum for obtaining any appropriate remedy because of Iran's hostility towards Americans.¹⁷¹ Therefore, in these cases, the risk of foreign litigation was enough to show irreparable harm. The inconsistency between the decisions in earlier and later cases may be justified by the differing circumstances before and after the taking of the hostages.

It seems that American and English courts take into account very similar considerations when deciding whether to grant an injunction to stop payment. The extreme difficulties in seeking an interim (interlocutory) injunction, caused by the application of these conventional requirements leads one to question whether it is appropriate for English courts to apply the *American Cyanamid* test in the context of the fraud exception. In *Brody, White & Co Inc v Chemet*¹⁷², the Singaporean Court of Appeal held that the balance of convenience test should be displaced in cases involving irrevocable letters of credit. In *Bocatra Construction Pte Ltd v Attorney General (No 2)*¹⁷³, the application of this test was also rejected in relation to performance bonds:

¹⁷⁰ This was a diplomatic crisis where 53 Americans were held hostage by Islamist students and militants following the seizure of the U.S. Embassy in Tehran on November 4, 1979.

¹⁷¹ *Harris Corp. v. National Iranian Radio and Television*, 691 F.2d 1344, 1356-57 (11th Cir.1982); *Itek Corp. v. First National Bank of Boston*, 511 F.Supp. 1341, 1349 (D.Mass.1981), vacated and remanded on other grounds, 704 F.2d 1 (1st Cir.1983); *American International Group, Inc. v. Islamic Republic of Iran*, 493 F.Supp. 522, 525 (D.D.C.1980); *Stromberg-Carlson Corp. v. Bank Melli Iran*, 467 F.Supp. 530, 532 n. 3 (S.D.N.Y.1979).

¹⁷² [1993] 1 SLR 65, 70.

¹⁷³ [1995] 2 SLR 733.

...If the appellants' arguments are accepted¹⁷⁴, this would mean that the court has to deal with both the equitable principle as well as the balance of convenience. To require such a 'double-barrelled' test would be dichotomous and illogical. In our opinion, whether there is fraud or unconscionability is the sole consideration in applications for injunctions restraining payment or calls on bonds to be granted. Once this can be established, there is no necessity to expend energies in addressing the superfluous question of 'balance of convenience'. It does not lie in the mouth of the defendant to claim that damages would still somehow be an adequate remedy.¹⁷⁵

This study has already highlighted the high standard of proof of fraud required in proceedings for interlocutory injunctions to interrupt payment in England. Given that this high standard is in place to curb the potential injustice caused to other parties in a documentary credit transaction, it is contended that the application of the *American Cyanamid* test is unnecessary. The stringency of this standard was clearly recognised by Karthigesu JA in *Bocatra (No 2)* :

“... [D]ispensing with consideration of the balance of convenience does not make an injunction any easier to obtain. Indeed, a higher degree of strictness applies, as the applicant will be required to establish a clear case of fraud or unconscionability in interlocutory proceedings. It is clear that mere allegations are insufficient.”¹⁷⁶

It is argued here that the Singaporean courts were right to reject the *American Cyanamid* test. In fact, the disposal of the *American Cyanamid* test should not be limited to cases involving irrevocable credits and performance bonds. The consideration of the bank's reputation in the balance of convenience test has the unfair effect of resulting in dismissal of applications involving all types of credit. The focus of the test is the balancing of the interests of the applicant against the interests of other parties involved. Consistent with the *ex turpi causa non oritur actio maxim*, if an applicant is able to prove to a high standard a clear case of fraud in these proceedings, surely this overrides the potential inconvenience caused to any of the parties

¹⁷⁴ The appellants argued that, on the balance of convenience, declaratory relief should have been granted since the appellants might suffer irreparable damage to their reputation as a consequence of a call for payment under the guarantee.

¹⁷⁵ *Bocatra* (n 173), [44-45].

¹⁷⁶ *Ibid*, [47].

involved. If an injunction is not to be granted even in the event of the applicant proving a clear case of fraud, this defeats the purpose of the existence of the fraud exception. To impose the *American Cyanamid* requirements is to make the fraud exception practically defunct. Arguably, if an applicant is able to show a clear case of fraud, then the balance of convenience is tipped in his favour. Ironically, the balance of convenience test is commonly referred to as the “balance of risk of injustice”¹⁷⁷ - isn't there a greater risk of injustice if upon proving a clear case of fraud, the injunction is still refused because of failure to satisfy this test? Also, more uncertainty persists as a result of the application of the *American Cyanamid* principles since judges have unfettered discretion in determining the relevant factors used to decide the balance of convenience. English law has already established that there are exceptions to the *American Cyanamid* principles in certain circumstances where there are other overriding interests.¹⁷⁸ In view of these arguments, the balance of convenience test should be abandoned in any application for an injunction to restrain payment on grounds of fraud.

3.5 Fraud in electronic letters of credit

Since banks deal with documents and not with goods, the documentary credit transaction is suitable to be operated electronically. Whilst the UCP has successfully governed documentary credit for some time, when the growth of the internet triggered the use of electronic documents, it became obvious that there was a need to update the rules to accommodate this development since the UCP was initially designed for paper documentary credits. Instead of revising the UCP, the ICC Banking Commission supplemented the UCP with another set of rules, known as the eUCP (Supplement to the Uniform Customs and Practice for Documentary Credits for Electronic Presentation). The eUCP 1.1 is the latest version, updated to be consistent with the provisions of UCP 600. The eUCP came into force on 1st of April, 2002 and provided a framework of rules for the presentation of electronic documents in documentary credit transactions. In order for the eUCP to apply, the credit must expressly stipulate that the eUCP

¹⁷⁷ *Cayne v Global Natural Resources plc* [1984] 1 All ER 225, 237; *Films Rover International Ltd v Cannon Film Sales Ltd* [1987] 1 WLR 672, 680.

¹⁷⁸ For example, defamation, covenants in restraint of trade, passing off cases etc. See Craig Osborne, *Civil Litigation* (OUP, Oxford 2006) .

is incorporated.¹⁷⁹ There is no need to expressly incorporate the UCP as all credits which are subjected to the eUCP are also subjected to the UCP.¹⁸⁰

The problem of fraud remains a major concern as the popularity of electronic credits continues to grow. One important question arises - does the presentation of documents electronically increase the risk of fraud? The main risk with paper documents is that important information like signatures, description of goods or any other contents of a document could be easily amendable by a fraudulent party, or that documents could even be destroyed. The time frame for completion of transactions involving paper documents is also longer, providing more opportunities for fraudulent acts. The inherent delays in the presentation of documents also mean that banks have very limited time to investigate even if they have suspected fraud.

There is a common fear amongst traders and banks that electronic credits will be subject to the same level of fraud and security breaches found in other systems of electronic financing, e.g credit cards and internet banking. This is partially justified, since electronic and computer systems can be quickly tampered with by those with specialist knowledge of computer systems. However, the eUCP provides some safeguard against fraud by requiring that an electronic record must be "capable of being authenticated as to the apparent identity of a sender and the apparent source of the data contained in it, and as to whether it has remained complete and unaltered".¹⁸¹ There is no definition of authentication in the eUCP and no explanation is offered as to how documents will be authenticated. However, many technical systems which securely create, store and authenticate documents are available to banks. These technological advances mean that an electronic letter of credit could be as safe, or even safer, than the traditional letter of credit.¹⁸² One such system is the Bolero¹⁸³ (Bill of Lading Electronic Registry Organization) internet world trade system, which is compliant with all the articles of the eUCP. It essentially provides a hosted and centralised electronic processing of letters of

¹⁷⁹ eUCP 1.1 Article e1b.

¹⁸⁰ eUCP 1.1 Article e2a.

¹⁸¹ eUCP 1.1 Article e3(b)(i).

¹⁸² See James E. Byrne, Dan Taylor, *ICC Guide to the eUCP*, ICC Publication No. 639 (2002), 18.

¹⁸³ Bolero was created in 1998 as a joint venture with SWIFT (Society for Worldwide Interbank Financial Telecommunication) and the Through Transport Club (an association specializing in transportation risk).

credit and documentation. It incorporates advanced encryption and claims to provide extensive safeguards against fraud in storing and transmitting any trade document in electronic form. Bolero also has a Title Registry which manages the creation and transfer of rights of Bolero bills of lading¹⁸⁴.

Since electronic credits cannot be signed in the usual way, one aspect of electronic credits which reduces the risk of fraud is the use of digital signatures. A digital signature has two major advantages: 1) it can effectively identify the signer of the document 2) it helps the receiver verify that the original contents of the document are unamended by persons other than the sender since it was created. It offers these security features because it was created using cryptography, the process of transforming ordinary information into unintelligible forms. There are two forms of cryptography, public key cryptography and symmetric-key cryptography. Digital signatures use the former which employs two algorithms using two different but mathematically linked "keys" which match to a combination.¹⁸⁵ One key, the private key, is kept secret by the sender (signer) and used to create the signature whilst the other corresponding key (the public key) is publicly available to decrypt and verify the signature. Nevertheless, the eUCP does not prescribe the technology method for digital signatures - "electronic signature means a data process attached to or logically associated with an electronic record and executed or adopted by a person in order to identify that person and to indicate that person's authentication of the electronic record".¹⁸⁶ This demonstrates that the drafters of the eUCP recognised the frequent changes and advancement of technology in this modern world.

A handwritten signature has safety problems because it is only manually added to a document and could be imitated by anyone easily. The details in the document could be altered with the handwritten signature still looking the same. On the other hand, a digital signature is intrinsically connected with the transmitted document and the signature will be affected if there are any alterations to the original document. Another added advantage of a digital signature is that if

¹⁸⁴ This was named as Bolero bill of lading because it does not fit the legal definition of a bill of lading. However, it performs the same function and has the same legal effect because all users on Bolero must become a member of the 'Bolero User Association' and contractually agree to adopt the Bolero Rulebook.

¹⁸⁵ Marianne M. Jennings, *Business: Its Legal, Ethical And Global Environment* (7th edn Thomson, USA 2005).

¹⁸⁶ eUCP 1.1 Article e3(b)(ii).

circumstances have changed and the signed document is now of no benefit to the signor, it is very difficult for him to deny that he had signed the document in order to escape his responsibility.

Despite the role of the internet in revolutionising many banking transactions, the use of electronic credits is not as prevalent as one would expect. This could be due to the fact that it is difficult to implement the relevant infrastructure to support electronic documents at all levels, from banks to every organisation in the logistic chain. There may also be difficulties in implementing the relevant infrastructure at the international level, which is essential since the operation of the letter of credit often transcend borders. In view of the prevailing problems of fraud and the many advantages offered by electronic documents in preventing fraud, the writer urges the ICC to be more proactive in promoting the use of electronic letters of credit in international trading. Moreover, if electronic credits are successfully integrated as a vital part of financing payment for international trading, receiving payment would most certainly be faster and the cost of using the letter of credit may even be cheaper in the long run.

3.6 Conclusion

It has been demonstrated that the documentary credit is surrounded by problems of fraud. Where the requirements of the fraud exception are met, a bank can refuse to make payment or an applicant (or another bank) can seek an injunction to restrain the paying bank from making payment. However, despite being the most established ground to refuse payment, the analysis of the relevant case law clearly shows that only in very few instances would the fraud exception be invoked successfully to refuse payment.

It is concluded that the fraud exception should not be limited to documentary fraud but should also encompass fraud in the underlying transaction. Not to do so would be to confine the application of the fraud exception narrowly and to defeat the objective of combating the proliferation of fraud. It is observed that, with the exception of America, most common law jurisdiction do not regard mere breaches of contract as sufficient to attract the fraud exception; an element of dishonesty and material fraud are required. Nevertheless, the issue of what constitutes material fraud remains to an extent difficult to clarify and will, in practice, be decided on a case-by-case basis.

From the analysis of the relevant case law, it is clear that the standard of proof in applications for injunctions is high. It is submitted that there is no reason for a lower standard of proof to be applied at a full trial. Further, the bank's knowledge of this strong evidence must be timely. It has also been argued that the balance of convenience test from *American Cyanamid* is unnecessary in the context of the fraud exception since there are other mechanisms in place which considerably restrict the scope of the fraud exception.

It has also been shown that the restriction in *United City Merchants* on the identity of the fraudulent party is not without its problems and can put banks in a very difficult position. Hence, the writer urges English courts to review *United City Merchants* so that third party fraud could fall within the ambit of the fraud exception. It is recognised that there is a need to not intervene with payment arrangements entered into in international trading, but this should also be balanced against the importance of effectively deterring fraud.

This chapter has also highlighted the new provisions in UCP 600 which reverse the effect of *Banco Santander*. As a consequence of these new provisions, a useful method of allocation of risk is removed. Furthermore, it is unclear if the new provisions will protect a confirming bank which takes on an assignment from the risk of any beneficiary fraud discovered between the date of early payment and the maturity date of the credit.

Finally, it has also been highlighted that electronic documentary credits are a useful solution to controlling the problem of fraud in international trading. There is a need to expand the use of electronic credits but practical challenges of implementing world wide use of paperless documents make the process a rather slow one. The law is now prepared to facilitate the use of electronic credits, although if electronic credits become a staple part of international trading, more legal problems may arise with the need to update the law.

CHAPTER 4

NULLITY

4.1 Introduction

Some cases have considered the question of whether “nullity” can be a ground for refusing payment under a documentary credit, although it is not clear what this word means. The precise meaning of nullity will be discussed later, but for present purposes we may take it to mean either some defect in a document presented by the beneficiary sufficiently serious to make it legally ineffective, or some defect in the underlying transaction sufficient to make it void rather than merely voidable. It follows from this that there is a distinction between a null document and a contract which is null. An underlying contract connected to a documentary credit may be null because of illegality¹ or mistake² but the discussion in this chapter focuses on the question of whether documentary nullity constitutes a ground for refusing payment. It will be argued that payment should be refused where null documents are presented under a credit but it will be demonstrated that this does not constitute an exception to the autonomy principle.

Documents which are null are not what they appear to be yet no version of the UCP provides for the effects of such documents. To understand the position of the law, this chapter begins with an analysis of the relevant cases which have considered this issue. Following this, the writer evaluates the arguments for recognising the tender of null documents as a ground for withholding payment. Finally, an attempt will also be made to analyse the circumstances which render a document to be null.

¹ The effect of illegality in the underlying transaction will be discussed in Chapter 5.

² There is no scope for a “mistake exception” to the autonomy principle since, if there was mistake in the underlying contract but documents which strictly comply with the conditions of the credit were presented under the credit, the facts would very likely fall under the fraud exception (see Chapter 3) or the unconscionability exception (see Chapter 6).

4.2 Documentary Nullity

So far, the effect of documentary nullity in the context of documentary credit has only been properly considered by English and Singaporean courts. The discussion in this section will begin with an analysis of the relevant English cases, followed by Singaporean cases.

4.2.1 England

In *United City Merchants (Investments) Ltd. v. Royal Bank of Canada*³, Lord Diplock expressly stated that he would leave open the question of the rights of a beneficiary against the confirming bank when a document presented by him is a nullity because unknown to him it was forged by some third party.⁴ The House of Lords did not have to decide on this point because, although the bill of lading was wrongly dated, it was a “valid transferable receipt for the goods giving the holder a right to claim them at their destination... and was evidence of the terms of the contract under which they were being carried.”⁵

Subsequently, in *Montrod Ltd v Grundkötter Fleischvertriebs GmbH*⁶, English courts were confronted with the issue of whether null documents would allow non-payment. This case concerned the sale of frozen pork which was financed by a documentary credit. The issuing bank, Standard Chartered, was acting on the instructions of another bank, Fibi Bank, which was instructed by Montrod. The credit provided for the presentation of a “certificate of inspection issued and signed by the credit applicant at his discretion on the goods quality and quantity in good order before shipment”. The underlying contract of sale of frozen pork was between the defendant seller and a Russian company, but the applicant was Montrod, a company which provided documentary credits for international trading transactions. This stipulation in the credit relating to the certificate of inspection was inserted so that Montrod could delay payment until it was put in funds to cover its liability under the credit. The beneficiary (the defendant seller) was informed by the buyers that that it could sign the inspection certificate on behalf of Montrod. After presentation of the documents, it was revealed that Montrod did not authorise the beneficiary to sign on its behalf and that the buyers were not entitled to speak for Montrod. The issuing bank made payment despite

³ [1983] 1 A.C. 168.

⁴ *Ibid*, 188.

⁵ *Ibid*, 188.

⁶ [2002] 3 All ER 697.

Montrod alleging that the documents were fraudulently created. Eventually, the buyers did not pay for the delivered goods. Montrod brought an action disputing its obligation to reimburse, advancing these arguments:

- 1) The beneficiary had acted fraudulently and hence the fraud exception should be applied.
- 2) The inspection certificate was a nullity, which worked in the same way as the fraud exception.

At first instance, HHJ Raymond Jack QC held that the fraud exception could not be relied upon to refuse payment because the beneficiary acted in good faith on the honest belief that it had authority to sign the certificates. He took the view that the UCP articles does not support a nullity exception - to interpret the provisions this way would be to go against the fundamental principle that banks consider the documents alone and should not take into account other matters such as the disputes between applicant and beneficiary.⁷ The learned judge concluded that there was also no nullity exception under English law:

“[I]t is unsupported by authority. It provides a further complication where simplicity and clarity are needed. There are problems in defining when a document is a nullity. The exception could have unfortunate consequences in relation to the rights of third parties.”⁸

Therefore, it was held that the seller was entitled to payment and that Standard Chartered should be reimbursed by the Fifi Bank, which in turn is entitled to reimbursement by Montrod. Montrod appealed on the nullity argument. The Court of Appeal affirmed the trial judge’s decision and held that nullity of documents was not a defence to payment. Potter LJ decided that there were sound policy reasons for rejecting the nullity argument:

“The creation of a general nullity exception, the formulation of which does not seem to me susceptible of precision, involves making undesirable inroads into the principles of autonomy and negotiability universally recognised in relation to letter of credit transactions. In the context of the fraud exception, the courts have made clear how difficult it is to invoke the exception and have been at pains to point out that banks deal in documents and questions of apparent conformity. In that context

⁷ [2001] C.L.C. 466, 477.

⁸ *Ibid.*

they have made clear that it is not for a bank to make its own inquiries about allegations of fraud brought to its notice; if a party wishes to establish that a demand is fraudulent it must place before the bank evidence of clear and obvious fraud... If a general nullity exception were to be introduced as part of English law it would place banks in a further dilemma as to the necessity to investigate facts, which they are not competent to do and from which UCP 500 is plainly concerned to exempt them. Further, such an exception would be likely to act unfairly upon beneficiaries participating in a chain of contracts in cases where their good faith is not in question. Such a development would thus undermine the system of financing international trade by means of documentary credits.”⁹

Surely the argument about placing banks in a dilemma to investigate the facts is unsustainable. Just like the fraud exception, recognition of null documents as a ground to refuse payment would only oblige a bank to refuse payment if, before the time of payment, it is established to the bank to a high degree of proof that a document is null. This was also the submission put forward by *Montrod*: “If, by the time of payment (or the time when a bank irrevocably commits itself to a third party who has taken in good faith, if earlier) the only reasonable inference is that one (or more) of the documents presented under the credit is not what it appears on its face to be, but is a nullity, then the bank is not obliged to make payment under the credit.”¹⁰ Even if nullity is accepted as a ground for refusing payment, a bank is still under no obligation to check for documentary nullity. Its obligation remains the same, which is to check for compliance on the face of the documents.

In *Montrod*, the Court of Appeal considered the claimant’s argument to refuse payment on the grounds of nullity as an extension of the fraud exception. This is itself problematic because the restrictions imposed by *United City Merchants* that a beneficiary must have knowledge for the fraud exception leaves nearly no room for the success of any nullity argument. As one commentator recognises, “The *United City Merchants* fraud exception creates difficulties for the development of a conceptually coherent nullity exception.”¹¹ Further, as shall be demonstrated in the analysis of what constitute null documents, null

⁹ [2002] 3 All ER 697, 713.

¹⁰ [2001] C.L.C. 466, 475.

¹¹ K Donnelly, “Nothing for nothing: A nullity exception in letters of credit?” [2008] JBL 316, 324. See also M Bridge, “Documents and contractual congruence in international trade” in S Worthington (ed), *Commercial Law and Commercial Practice* (Hart Publishing, London 2003) 236.

documents and forged documents are conceptually different. Hence, there are strong reasons to consider nullity as distinct ground to refuse payment.

4.2.2 Singapore

In the following two cases, the Singaporean courts did not have to decide the cases on the basis of nullity of documents although both judgments appeared to welcome the possibility of refusing payment on such grounds. In *Mees Pierson NV v Bay Pacific (S) Pte Ltd*¹², the seller tendered a health certificate which showed that it was issued by the Municipal Corporation of Greater Bombay but was in fact not issued by this institution. When the confirming bank sought to recover payment made to the seller under the credit, the bank's claim was dismissed on the basis that it had accepted the documents, made payment and had not given notice of rejection to the sellers within the period required under the UCP. However, Rajendran J stated *obiter* that if the bank knew of the actual fact regarding the certificate, it would be under no obligation to make payment.¹³ In *Lambias (Importers & Exporters) Co Pte Ltd v Hongkong*¹⁴, the quality and weight inspection certificate showed that it was issued and signed by the applicant, when in fact it was issued by the beneficiary. The certificate was to be countersigned by Mr Yau but was in fact signed by an imposter. The claim was dismissed by Goh JC mainly on the basis of discrepancies but he also made reference to the fact that the documents were null in his judgment.

It was not until *Beam Technology (Manufacturing) Pte Ltd v Standard Chartered Bank*¹⁵ that a Singaporean court made a determinative ruling on this issue. In this case, the underlying contract of sale of electronic component was financed by a letter of credit which stipulated for a full set of clean air waybills. The buyer notified the seller that the air waybill would be issued by their freight forwarders, "Link Express (S) Pte Ltd". Upon presentation of the air waybill, the confirming bank rejected it on the ground that it was a forgery because Link Express(S) Pte Ltd was a non-existing entity. The beneficiary bought an action against the bank for non-payment under the letter of credit but the Singapore High Court held that the bank was entitled to refuse payment. On Appeal, the court had to consider the issue of

¹² [2000] 4 SLR 393.

¹³ *Ibid*, [42].

¹⁴ [1993] 2 SLR 751.

¹⁵ [2003] 1 SLR 597.

whether forged or null documents can be relied on to refuse payment. For this application, it was assumed that the sellers did not carry out the forgery. The Court of Appeal considered all the English cases discussed above and came to the conclusion that there was no definite authority on “a nullity exception”.¹⁶ This was a rather surprising move, considering that the English Court of Appeal in *Montrod* was quite explicit in rejecting the argument that null documents provide a ground to refuse payment. The Singaporean Court of Appeal explained that *Montrod* was different from the facts in *Beam Technology* because the certificate of inspection required in *Montrod* was not “an essential document but one touching on the question as to the quality of the goods sold.”¹⁷ Persuaded by the views of the Court of Appeal in *United City Merchants*, Singaporean Court of Appeal held that the confirming bank was not obliged to pay if the air waybill is null.

“While the underlying principle is that the negotiating/confirming bank need not investigate the documents tendered, it is altogether a different proposition to say that the bank should ignore what is clearly a null and void document and proceed nevertheless to pay. Implicit in the requirement of a conforming document is the assumption that the document is true and genuine although under the UCP 500 and common law, and in the interest of international trade, the bank is not required to look beyond what appears on the surface of the documents. But to say that a bank, in the face of a forged null and void document (even though the beneficiary is not privy to that forgery), must still pay on the credit, defies reason and good sense. It amounts to saying that the scheme of things under the UCP 500 is only concerned with commas and full stops or some misdescriptions, and that the question as to the genuineness or otherwise of a material document, which was the cause for the issue of the LC, is of no consequence.”¹⁸

This argument is supported by Professor Goode’s writings where he wrote that, “A fraudulently completed bill of lading does not become a conforming document merely because the fraud is that of a third party.”

Further, Chao JA, went on to say that, “It is our opinion that the negotiating/confirming bank is not obliged to pay if it has established within the seven-day period that a material

¹⁶ *Ibid.*, 609.

¹⁷ *Ibid.*

¹⁸ *Ibid.*

document required under the credit is forged and null and void and notice of it is given within that period.”¹⁹ Following Article 14(b) UCP 600, the maximum time period for determining compliance of a document is no longer seven days, but is now five days. It should be highlighted that that, as with all the other grounds which allows refusal of payment, the time period is of utmost importance as it will determine the success of any claims. However, it is submitted here that this five day period should not be the critical time period. The relevant time period should be anytime before payment. If it is established to the bank *anytime* prior to payment that the documents are null, the bank should not be obliged to make payment. The arguments in favour of not paying against a null document remain with equal force even if the fact that the document is null is established to the bank after the five day time period (but before the time of payment). If however, this fact is only established to the knowledge of the bank after the time of payment, the bank should be entitled to reimbursement for the payment made.

4.3 Documentary nullity - not an exception to the autonomy principle

Commentators who have written on this subject discussed a nullity exception to the autonomy principle by reference to the cases analysed so far.²⁰ This is understandable since the term “nullity exception” was frequently referred to in the judgment of most of these cases, including the leading case *Beam Technology*. However, it is submitted here that conceptually, refusing payment on the grounds of documentary nullity does not constitute an exception to the autonomy principle. A null document provides a ground to refuse payment because, as referred to by Ackner LJ in Court of Appeal in *United City*, it is a “waste paper”²¹, it is invalid and would mean that a beneficiary have failed to submit one of the documents required by the credit terms.

Chao JA in *Beam Technology*, Ackner and Griffiths L.JJ. in the Court of Appeal in *United City* considered the issue of refusing payment in relation to null documents from the perspective of their conformity with the credit. It has already been argued in the previous chapter that payment should be refused where forged documents are presented by innocent beneficiaries on the basis of non-conformity. However, in relation to null documents, the

¹⁹ *Ibid*, 610.

²⁰ *K Donnelly* (n 11); Chin and Wong, “Autonomy- A nullity Exception at Last?” [2004] LMCLQ 14; Dora Neo, “A Nullity Exception” [2004] Sing. J.L.S 46.

²¹ [1982] Q.B. 208, 246.

arguments are even stronger. The argument is best encapsulated by the *obiter* comment of Rajendran J in *Mees Pierson*:

“... if the document tendered by the seller is a nullity, that document would have no legal effect. There would therefore be a failure by the seller to tender a document (in this case the Health Certificate) called for under the credit. That being so, the tender would be an incomplete tender.”²²

This, the writer submits is the correct analysis. Hence, as with any case of incomplete tender, refusing payment on the basis of a null document does not infringe the sacrosanct principle of autonomy. Payment is refused because the tendered documents do not comply with the conditions of the credit.

4.4 Documentary nullity as a ground of withholding payment: the rationale

4.4.1 Non-compliance

The discussion so far shows that, in essence, refusing payment on grounds of documentary nullity is based on the idea that null documents are not conforming documents, drawing no distinction between actual compliance and apparent compliance. This distinction is only drawn in terms of the bank's duties to examine the documents. Banks are only obliged to check for apparent compliance because it is to the benefit of all parties involved in international trading that banks are able to deal with the documents as quickly as possible. However, if a bank has knowledge of a null document but the law forces a bank to pay against this document presented by an innocent beneficiary merely because the document conforms on the face of it, Professor Goode argues that this “has the effect of extending to beneficiaries the benefit of a rule designed exclusively to safeguard the banks.”²³

D Neo also raises another related but different argument - since a bank is to make payment to the beneficiary upon presentation of conforming documents, if a bank pays against documents which it knows are not genuine, it breaches its mandate and is exposed to the risk

²² [2000] 4 SLR 393, [42].

²³ R Goode, *Commercial Law* (3rd edn, LexisNexis, London, 2004) 996.

of not being able to claim reimbursement.²⁴ If it does not pay, it could be sued by the beneficiary, with the consequence of risking its reputation with other customers. Hence, it is only logical that null documents be recognised as a ground for refusing payment, so as to relieve the banks of this dilemma. Additionally, it can be argued that if payment is to be made against documents which are not genuine, this is an unreasonable result which is not one which could have been intended by the parties to the contract.²⁵ If specific documents are required by the terms of the credit, it must be an implied term of the contract that payment should only be made against presentation of genuine documents.

4.4.2 A beneficiary does not share the status of a holder in due course

Although in *United Trading*, Lord Diplock did not have to decide whether documentary nullity could be a defence to payment, he gave the following explanation as to why it is more likely that he would not have supported this proposition:

I would not wish to be taken as accepting that the premiss as to forged documents is correct, even where the fact that the document is forged deprives it of all legal effect and makes it a nullity, and so worthless to the confirming bank as security for its advances to the buyer. This is certainly not so under the Uniform Commercial Code as against a person who has taken a draft drawn under the credit in circumstances that would make him a holder in due course, and I see no reason why, and there is nothing in the Uniform Commercial Code to suggest that, a seller/beneficiary who is ignorant of the forgery should be in any worse position because he has not negotiated the draft before presentation.²⁶

Subsequently, these reasons were also cited by Potter LJ in *Montrod* in rejecting the nullity argument advanced by the applicant in the case.

Professor Goode took the opposite view, arguing that “[I]t is trite law... that a holder in due course is in a favoured position and is insulated from defences not available even to other holders of the bill, let alone a seller whose documents and draft have been rejected”²⁷. In another article, he affirmed that, “The beneficiary under a credit is not like a holder in due

²⁴ Dora Neo, “A Nullity Exception” [2004] Sing. J.L.S 46, 64.

²⁵ *Ibid*, 65.

²⁶ [1983] 1 A.C. 168, 187.

²⁷ *R Goode* (n 23) 996.

course of a bill of exchange; he is only entitled to be paid if the documents are in order.”²⁸ In *Lambias*, Goh JC explained that a beneficiary who has not negotiated a draft should not be treated as being in the same position as a bona fide holder in due course because “...as a party to the underlying contract, he has an additional recourse against the buyer which is not open to a holder in due course.”²⁹

Although both Lord Diplock and R Jack submit that the beneficiary should not be in a worse position than the holder in due course, both do not support this submission with any reasons. On the contrary, Professor Goode and Goh JC both offer convincing reasons, which are based on the mechanics of the letter of credit in practice. The writer is not able to think of any reason why the beneficiary should be afforded the same status as a holder in due course. It is submitted here that Lord Diplock’s statement in *United Trading* should not be taken as good authority.

4.4.3 Protection of Banks

One advantage of recognising nullity as a defence to payment is the protection of the financial position of banks. The position of banks may be affected by null documents, as recognised by Ackner LJ in the Court of Appeal in *United City Merchants*:

“A banker ...ought not to be under an obligation to accept or pay against documents which he knows to be waste paper. To hold otherwise would be to deprive the banker of that security for his advances, which is a cardinal feature of the process of financing carried out by means of the credit”³⁰:

Griffiths LJ expressed the same concern: “The bank takes the documents as its security for payment. It is not obliged to take worthless documents.”³¹

On the contrary, Dolan commented that “It may be misleading to suggest that bank issuers are always concerned about their security interest in the goods. It is probably fair to say that

²⁸ R Goode, "Reflections on Letters of Credit - I" [1980] JBL 291, 294.

²⁹ [1993] 2 SLR 751, 763.

³⁰ [1982] Q.B. 208, 246.

³¹ *Ibid*, 254.

they do mind having the security interest but are more concerned about the applicant's ability to reimburse the issuer when it pays the beneficiary."³² K Donnelly also wrote that banks usually have a lien on the applicant's bank account or other additional security from the applicant.³³ The writer disagrees with these arguments because a lot of times additional security is not asked from the applicant, and even if it is required the additional security does not usually cover the total amount of the applicant's liability. Further, very often applicants would resist reimbursing banks where it is known that the documents are null, as in *Montrod* and *Beam Technology*. Hence, the documents still represent important security to bank. This issue of documentary security will be returned to later as it plays a vital role in the determination what constitutes a null document.

4.4.4 Fraud Prevention

For a long time, the problem of fraud in letters of credit transaction has been highlighted by many.

"There are many means that are available to criminal syndicates to launder their illegal gains. Letters of credit transactions, in my view, are an ideal vehicle for laundering illicit funds and have so far attracted little attention from the regulatory authorities. While in every other service provided by banks, under the anti-money laundering statutes, bankers are required by the law to comply with 'know your customer' regulations, bankers in documentary credits department remain consistent with the documentary and independent principle."³⁴

If payment could not be refused on the basis of null documents, fraudsters will be encouraged to continue with their illegal activities, at the expense of other innocent parties. At worst, the beneficiary could be an accomplice of such fraudsters, but because of the high standard of proof of fraud in applying the fraud exception, and the evidential difficulties of proving a beneficiary's involvement, the beneficiary will still be regarded as an innocent party by the courts. In the grand scheme of things, controlling the problem of fraud in international trading

³² JF Dolan, *The Law of Letters of Credit. Commercial and Standby Credits* (Revised ed Warren Gorham & Lamont Inc, Boston 1996) 8-23.

³³ K Donnelly (n 11) 337.

³⁴ Anonymous Author, "Money laundering and documentary credit transactions" (2002) 5 JMLC 192, 217 cited in Ademun-Odeke, "Double Invoicing in International Trade; The Fraud and Nullity exceptions in Letters of Credit – Are the America Accord and the UCP 500 Crooks Charters?" (2006) 18 Denning L.J. 115, 120.

should be given the most priority. It is important to control the extent and severity of these fraudulent activities so that parties do not lose confidence on the system and the use of letters of credit does not decline. If banks are not allowed to withhold payment when they have knowledge that a document is null, the autonomy principle may inadvertently be providing opportunities for fraudsters to manipulate the system. Even though null documents are not necessarily forged, there are opportunities for fraudsters to manipulate other innocent parties to create documents which are null.

4.4.5 Fairness

Ultimately, there is a question to be answered as to whether it is fairer for the bank/applicant or the beneficiary to bear the risk. From a lay person's point of view, it may appear unfair if a beneficiary seller who has actually delivered the goods does not receive payment. However, there are strong reasons to support the argument that the beneficiary should be the one to bear the risk. Firstly, the operation of the documentary credit is based on the duties of the beneficiary to present documents which comply with the conditions of the credit. If he fails to do this, why should the law not hold him responsible by bearing the risk of non-payment? In the Court of Appeal in *United City Merchants*, Stephenson LJ expressed this view:

“Banks trust beneficiaries to present honest documents; if beneficiaries go to others (as they have to) for the documents they present, it is important to all concerned that those documents should accord, not merely with the requirements of the credit but with the facts; and if they do not because of the intention of anyone concerned with them to deceive, I see good reason for the choice between two innocent parties putting the loss upon the beneficiary, not the bank or its customer.”³⁵

It really is unfair for the law to impose an obligation on a bank to pay, in the words of Rajendran J, “on terms less favourable to the bank than that envisaged under the credit arrangement”³⁶ merely because a beneficiary fails to perform his duty of submitting the right documents. Secondly, one has to go back to the point already mentioned about fraud prevention. If the law says that beneficiaries are to bear the risk in the event of presentation of null documents, beneficiaries will be more vigilant in verifying the authenticity of the

³⁵ [1982] Q.B. 208, 234.

³⁶ *Mees Pierson NV v Bay Pacific (S) Pte Ltd* [2000] 4 SLR 393, [40].

documents they tender.³⁷ In fact, amongst the many parties involved in a documentary credit transaction, there is no other party more apt to ensure the genuineness of the documents prior to presentation.

4.5 Meaning of Nullity

In *Montrod*, one of the criticisms Potter LJ directed towards a nullity exception was that it is a concept which is not “susceptible of precision”³⁸. Potter LJ was right to question this, because the issue of what constitutes nullity is in need of clarification. It is submitted that, despite it being a difficult concept, it is inherently more technical and more objective than the concept of unconscionability.³⁹ Some guidance can be obtained from Stephenson LJ’s judgment in *United City Merchants*:

“A document may tell a lie about itself, e.g., about the person who made it, or the time or place of making. If it tells a lie about the maker, it is a forgery; if it tells a lie about the time or place of making "where either is material," it is a forgery: Forgery Act 1913, section 1 (2). In the former case it may be a nullity, in the latter not⁴⁰. Or the document may tell a lie about its contents. Then it is no forgery, but the maker or utterer of it may commit a criminal offence of some kind of fraud. Or a document may be untrue in the sense of inaccurate by mistake and without any intention to deceive by its maker or anyone who puts it forward.”⁴¹

This statement shows that forgery, nullity and fraud are capable of conceptual distinction but may sometimes overlap e.g a document with a forged signature is both a forgery and a nullity. Using Stephenson LJ’s judgment to form the basis of his analysis, Professor Bridge illustrates the difference between forgery and nullity by referring to a falsely dated bill of lading, which would be a forgery but not a nullity and a bill of lading representing a phantom cargo, which

³⁷ *K Donnelly* (n 11) 339.

³⁸ [2002] 3 All ER 697, 713.

³⁹ See Chapter 6.

⁴⁰ *Kwei Tek Chao v. British Traders and Shippers Ltd.*[1954] 2 Q.B. 459 , 476; *Gian Singh & Co. Ltd. v. Banque de l'Indochine*[1974] 1 W.L.R. 1234 , 1238-1239.

⁴¹ [1982] Q.B. 208, 231.

would be a nullity but not a forgery?⁴² He argues in relation to a falsely dated bill of lading, e.g., one which is dated 31st July when in fact the goods were shipped on 1st August, that it is still a stipulated document since it bears the required date provided by the credit;⁴³ whereas for the bill of lading representing a phantom cargo, he argues that it cannot be a stipulated document, citing *Hindley & Co Ltd v East Indian Produce Co Ltd*⁴⁴, where Kerr J stated that bills of lading representing goods which had not been shipped at all is of an *a fortiori* nature in comparison to other documentary misstatements.⁴⁵ Firstly, the writer disagrees with Professor Bridges's view that a bill of lading representing a phantom cargo is a nullity but not a forgery. It is difficult to imagine how a bill of lading which represents a phantom cargo can exist without forgery being involved. Secondly, these examples, despite being helpful, do not really provide a principled distinction as to how to determine documentary nullity. How then does one determine nullity outside the obvious case of a bill of lading indicating a phantom shipment?

One alternative is to adopt the ordinary meaning of null documents - documents which are invalid or without legal force. This approach is attractive and, in the writer's view, should be the starting point in determining whether a document is null. In *Beam Technology*, Chao JA interpreted the Court of Appeal's judgment in *Montrod* as having decided that the certificate issued by the seller in *Montrod* in honest belief that he had authority could not be a nullity.⁴⁶ With due respect, the Court of Appeal in *Montrod* held that there was no nullity exception but did not make the finding that the document in question was not null. Moreover, most lawyers would regard a document which is signed by someone who does not have authority as without legal force. One should also note that Potter LJ stated the following in *Montrod*:

“While he [referring to Lord Diplock in *United City Merchants*] left open the position in relation to a forged document where the effect of the forgery was to render the document a 'nullity', there is nothing to suggest that he would have recognised any nullity exception as extending to a document which was not forged

⁴² M Bridge, “Documents and contractual congruence in international trade” in S Worthington (ed), *Commercial Law and Commercial Practice* (Hart Publishing, London 2003) 234.

⁴³ *Ibid.*

⁴⁴ [1973] 2 Lloyd's Rep 515.

⁴⁵ *M Bridge* (n 42) 234.

⁴⁶ 2003 1 SLR 597, [31].

(ie fraudulently produced) but was signed by the creator in honest error as to his authority; nor do I consider that such an exception should be recognised.”⁴⁷

This statement indicates that he regarded forgery as a prerequisite to refusing payment on the grounds of nullity. But a document may be devoid of legal effect if it was created by an innocent party who creates a document with the honest belief that he had the authority to do so, when in fact he does not. The decision only goes to show that judges do not consistently adhere to the ordinary meaning of nullity. The writer agrees with the views of other commentators that it should not matter whether the null document is caused by forgery or not.⁴⁸ This is consistent with the writer’s argument that null documents are to be rejected because they are an incomplete tender - whether caused by forgery or not, the tender is still incomplete.

However, even with the “ordinary meaning” approach, no clear dividing line can to be drawn and further guidance is needed to determine whether a document has legal force or not. One commentator also suggested that the extent and nature of falsity in a document should be considered in deciding whether a document has no legal effect.⁴⁹ This point is perhaps best demonstrated by *Lambias (Importers and Exporters) Co PTE Ltd v Hong Kong & Shanghai Banking Corpn*⁵⁰, where Goh JC took into account the following considerations in concluding that the quality and weight inspection certificate was a nullity:

“First, it was issued by the beneficiary instead of the applicant as required by the letter of credit. Secondly, it failed to state the necessary particulars to relate it to the goods which were the subject of the letter of credit. Thirdly, it failed to contain the necessary statement as to the quality or weight of the goods ostensibly inspected, and most important of all, it had been counter-signed by an imposter and not by Yau Tin Sang. *All these elements taken together make the QWI certificate a nullity ab initio.*”⁵¹[emphasis added]

In *Beam Technology*, Chao JA stated that the certificate in *Montrod* was not a nullity on the

⁴⁷ [2002] 3 All ER 697, 713.

⁴⁸ *K Donnelly* (n 11) 320.

⁴⁹ *Ibid.*

⁵⁰ [1993] 2 SLR 751.

⁵¹ *Ibid.*, 762-763.

grounds that it was not an essential document (the learned judge also uses the phrase “material document”).⁵² This introduces an entirely new approach to the meaning of nullity, one which is not consistent with the approach of Lord Diplock in *United City Merchants* where he treated a bill of lading with the wrong date of loading as not a nullity - no document can be more essential and material than the bill of lading in a documentary credit transaction. D Neo suggests that a stricter interpretation of essential/material document has the attraction of reducing the application of a nullity defence to payment, hence preserving the autonomy principle as much as possible. However, it is submitted that the “essential document” approach should be rejected. The main reason for this is the same point made in the previous paragraph - a tender is incomplete if *any* of the presented document (whether an essential document or not) is without legal effect. In the normal operation of documentary credits, the absence of any document, regardless of its importance will allow the bank to refuse payment.⁵³ Moreover, it may not be easy to draw a distinction between an essential document and a non-essential document in such transactions.

One possible approach to determine whether a document is null is to assess whether the bank’s security is affected by the document in question. In *Montrod*, Potter LJ described a null document as “a document which is worthless in the sense that it is not genuine and has no commercial value, whether as a security for the goods or otherwise”.⁵⁴ The question then arises as to how one evaluates whether the bank’s security is affected? Once again, reference should be made to Lord Diplock’s statement in *United City Merchants*, where he stated the following in relation to material misstatements:

“... the answer to the question: "to what must the misstatement in the documents be material?" should be: "material to the price which the goods to which the documents relate would fetch on sale if, failing reimbursement by the buyer, the bank should be driven to realise its security."⁵⁵

In *United City Merchants*, a distinction was drawn between a document which is a nullity and that which contained material misstatements. This distinction is correct since not all material

⁵² [2003] 1 SLR 597, 609.

⁵³ *D Neo* (n 24) 72.

⁵⁴ [2002] 3 All ER 697, 709.

⁵⁵ [1983] 1 A.C 168, 186.

misstatements in a document make it a nullity. However, null documents will often contain material misstatements. Hence, the above statement would surely provide some guidance in the determination of whether a document is null but should not be treated as conclusive. As was pointed out in *Mees Pierson*, documents may be null without affecting the security of the bank. Rajendran J treated the Health Certificate in *Mees Pierson* as null despite stating that “such a certificate is not a document of title and it cannot be so readily concluded that a forged Health Certificate would affect the bank's security interest”.⁵⁶

The circumstances where the issue of null documents may arise is really wider than one would normally expect. For example, in *Beam Technology*, the Singaporean Court of Appeal was confronted with an air waybill issued by Link Express (S) Pte Ltd, a non-existing freight forwarder but one which the buyer had specifically notified the seller to use. The Singapore Court of Appeal did not decide whether the document was null, stating that “the questions whether the air waybill constituted forgery and is null and void and whether it amounted to non-compliance with the credit terms, warrant, in the circumstances of the present case, further exploration.”⁵⁷ D Neo took this view:

“If the document that is presented is exactly what is required under the credit, it is arguable that the beneficiary is entitled to payment even if this document is a nullity and without legal effect. In other words, if what is stipulated under the credit can be none other than a null document (for instance because the company that is supposed to issue the document does not exist), there should be no exception to the autonomy principle.”⁵⁸

It is contended that this argument should be rejected. In accordance with the ordinary meaning of “null”, a document which has been issued by a non-existent entity is likely to be null. Many of the arguments advanced in favour of a nullity defence to payment also apply with equal force to such a document. Nevertheless, in these circumstances, it is likely that there is forgery. How can a document be produced by a company which does not exist except for someone forging the document? In such circumstances, if the fraud exception is extended to

⁵⁶ [2000] 4 SLR 393, 409.

⁵⁷ [2003] 1 SLR 597, 611.

⁵⁸ *D Neo* (n 24) 68.

third party fraud⁵⁹, payment may also be refused under the fraud exception although proving fraud may be a difficulty.

The discussion in this section shows that different courts have so far adopted different analyses of what constitutes a null document and that commentators may not always take the same view on this issue. However, the writer agrees with the following words of Chao JA in *Beam Technology*:

“While we recognise that there could be difficulties in determining under what circumstances a document would be considered material or a nullity, such a question can only be answered on the facts of each case. One cannot generalise. It is not possible to define when is a document a nullity. But it is really not that much more difficult to answer such questions than to determine what is reasonable, an exercise which the courts are all too familiar with.”⁶⁰

4.6 Conclusion

The cases discussed show that at present English law does not recognise documentary nullity as a defence to payment. This chapter has shown that there are strong arguments, based on theoretical and practical justifications, for recognising the presentation of null documents as a ground for withholding payment. It has been argued that a null document does not actually comply with the terms and conditions of a credit. It follows from this that refusing payment on the grounds of null documents is not a breach of the principle of autonomy, a principle governing the operation of the documentary credit which is regarded to be of utmost importance in ensuring certainty of payment of the instrument. Even if one takes the view that refusing payment on the grounds of null documents constitutes an exception to the autonomy principle, it should be recognised that it is necessary to maintain a balance in the enforcement of the autonomy principle. The principle of autonomy should be preserved but it should not be enforced to the extent of ignoring notions of justice and leaving a detrimental effect on the relevant parties involved in international trading.

⁵⁹ See 3.3.5.

⁶⁰ [2003] 1 SLR 597, 611.

This chapter has demonstrated that the main difficulty in recognising null documents as a ground to refuse payment is the determination of what constitutes a null document. Since nullity is a concept where it is difficult to formulate clear-cut principles, this presents an element of ambiguity, a drawback which is a small price to pay in view of the improvements it would bring to the documentary credit system. When the next opportunity presents itself, it is urged that English courts follow the bold move of Singaporean courts in recognising documentary nullity as a ground for refusing payment under a documentary credit. English courts should not be concerned that such a development would affect the smooth functioning of the documentary credit since, if a nullity defence is rejected, the lack of trust in the documentary credit system may continue and affect its future. Moreover, English courts have the ability to delineate the boundaries of a nullity defence to payment. Over time, when documentary nullity is well established as a ground to refuse payment, clearer guidance and principles will emerge.

CHAPTER 5

ILLEGALITY

5.1 Introduction

At common law, it is a well-established principle that contracts which are illegal or contrary to public policy are unenforceable.¹ The two maxims forming the basis of the courts' refusal to enforce such contracts are *ex turpi causa non oritur actio* (no court will lend its aid to a man who founds his action upon an immoral or an illegal act) and *in pari delicto, potior est conditio defendentis* (where both parties are equally wrongful the position of the defendant is the stronger). However, this branch of the law is not straightforward and until today, remains as complex as ever. This chapter aims to investigate one aspect of the subject - the position of the law when a documentary credit is tainted by illegality in the contract which it supports.

This chapter will begin by demonstrating that there are two ways illegality may arise in a documentary credit transaction; illegality in the credit or illegality in the underlying contract. The chapter will deal with the former briefly but its main focus is to investigate whether the latter is or should constitute an exception to the autonomy principle so that payment could be refused. This will be followed by an examination of the relevant judicial decisions on this matter. It will be argued that illegality should be established as ground for refusing payment, separate and distinct from fraud. In order for an illegality exception to be workable and of benefit the international trading community, it is necessary to confine the parameters of this exception. It will be contended that there are a few requirements which should be fulfilled in order for illegality to be successfully applied as an exception to the autonomy principle.

Because of the international nature of the documentary credit, the issue of applicable law will inevitably arise alongside a consideration of whether the illegality can be successfully invoked as a ground to withhold payment. At the end of the chapter, the writer investigates which country's

¹ There is much debate as to whether an illegal contract is void or unenforceable. See N Enonchong, *Illegal Transactions* (Lloyd's of London Press, London 1998) 29-31.

law is material for determining whether a contract is illegal. On this matter, the state of the law is complex but an attempt will be made to suggest a viable principle which is both simple and consistent with the approach of English cases.

5.2 What constitutes illegality?

A chapter on illegality would be incomplete without a discussion of what constitutes illegality but the inherent nature of the concept of illegality makes this task an extremely difficult one. In fact, this branch of the law is in such a confusing state that the law reform bodies of several Commonwealth jurisdictions such as England, New Zealand, Australia, Canada and British Columbia have conducted extensive reviews in the hope of systematically reforming the law relating to illegal transactions. It is also apparent that in discussing illegal transactions, different law reform bodies and writers of leading textbooks differ widely in their approach and scope. Although illegality can have an effect on trusts, this study is confined to those circumstances which may affect the legal enforcement of contracts.

At common law, it is generally agreed that the law adopts a wide view as to what amounts to an illegal contract.² It is not within the scope of this study to provide a detailed analysis of the relevant case law and the factual circumstances in which the courts have treated a transaction as illegal.³ However, it should be mentioned here that contracts may become illegal in a number of ways, involving either the commission of a crime or civil wrong, or a broad range of conduct which is regarded as contrary to public policy.⁴ Where the illegal element in the transaction involves the commission of a crime or civil wrong the illegality may be based upon the contravention of a statute or the common law. In such cases the contract is illegal in the strict sense that the contract is prohibited by positive law or the performance of the contract inevitably

² J. Beatson, *Anson's Law of Contract* (28th ed OUP, Oxford 2002) 348; G. H. Treitel and E. Peel, *Treitel on the Law of Contract* (12th Edition Sweet and Maxwell, London 2007) Chapter 11; *N Enonchong* (n 1) Chapter 1.

³ For a detailed analysis, see *N Enonchong* (n 1); MP Furmston, "The Analysis of Illegal Contracts" (1966) 16 U. Toronto L.J. 267.

⁴ The English Law commission also adopted a broad remit for their project on illegal transactions, including "any transaction which involves (in its formation, purpose or performance) the commission of a legal wrong (other than the mere breach of the transaction in question) or conduct which is otherwise contrary to public policy" – see The Law Commission Consultation Paper No 154, "Illegal Transactions: The Effect of Illegality on Contracts and Trusts" (1999) 2.

involves the doing of an act forbidden by the law. By contrast, in cases where the contract is alleged to be contrary to public policy, the performance of the contract involves conduct of which the law disapproves as being against public policy, even though that conduct is not strictly unlawful. The terms “illegality” or “illegal” is used in this chapter in a broad sense, encompassing all of these situations.

It is fair to say that it is public policy which has primarily contributed to making this area of the law so notoriously complex. The difficulty with public policy is that it offers very little certainty since the range of transactions contravening public policy which will be treated as “illegal” is potentially very wide. Burroughs J once described public policy as “a very unruly horse, and when once you get astride it you never know where it will carry you”.⁵ Also, the social, moral and economic values of a society can differ in different places and can change over time, thereby rendering it a concept which is constantly evolving.

“Rules which rest on the foundation of public policy, not being rules which belong to the fixed customary law, are capable, on proper occasion, of expansion or modification. Circumstances may change and make a commercial practice expedient which formerly was mischievous to commerce.”⁶

In the writer’s opinion, a descriptive definition of illegal contracts does not at all shed light on this matter. Since transactions which may be illegal are very wide ranging, it is submitted that with regard to the issue of what constitutes illegality, it is important to maintain some flexibility and not set hard and fast rules. Nevertheless, it is contended in this chapter that the doctrine of public policy can be applied in a way which provides a measure of legal certainty. It follows from this that, in the context of letters of credit, it is possible to shape the parameters of an illegality exception so that it promotes predictability. As Lord Denning M.R. said, “With a good man in the saddle, the unruly horse can be kept in control. It can jump over obstacles. It can leap the fences put up by fictions and come down on the side of justice.”⁷

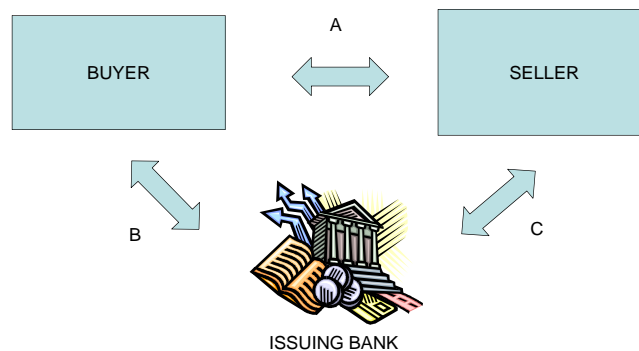
⁵ *Richardson v Mellish* (1824) 2 Bing 229 at 252; 130 ER 294, 303.

⁶ *Maxim Nordenfelt Guns and Ammunition Co v Nordenfelt* [1893] 1 Ch. 630, 661, per Bowen LJ.

⁷ *Enderby Town Football Club Ltd v. The Football Association Ltd* [1971] Ch 591, 606.

5.3 Two categories of illegality in documentary credit transactions

As explained in Chapter 1, a documentary credit transaction typically involves a number of contracts.⁸ Essentially, a distinction is made between the following two categories in accordance with the *locus* of the illegal element. Although other contracts are involved, the diagram shows only three contracts, because typically the illegal element is likely to exist in any of these three contracts.



5.3.1 Illegality in the documentary credit itself

There many ways in which a letter of credit may be illegal. First, the issuing of the credit may be illegal. The issuing bank may have breached lending limits when issuing the credit. At times of war or diplomatic crisis, a government might put a ban on banks to prevent them from issuing letters of credit in favour of nationals of certain countries. If an issuing bank does not comply with national law in issuing the letter of credit, then the issuance of the letter of credit is illegal. Second, a situation may also arise where, although the issuance of the letter of credit does not violate the law, by the time of payment, the circumstances had changed, rendering payment to the beneficiary to be illegal under the applicable law.⁹ This could be due to the government placing a

⁸ See section 1.4.

⁹ See *Chuidian v. Philippine National Bank* 734 F.Supp. 415 (C.D.Cal.1990), *aff'd*, 976 F.2d 561 (9th Cir.1992); *Rabobank v. Bank of China* 848 HKCU 1.

prohibition on the issuing bank from making payment to beneficiaries of some payment instruments. For example, after Iranian militants took over the American embassy on Nov 4, 1979, the American government imposed harsh economic sanctions against Iran, freezing approximately \$12 billion of Iranian assets. Payment to Iran was prohibited and issuing banks were ordered to pay into blocked accounts.

In both of the above circumstances, the effect of the illegality is straightforward. Since the illegality affects the credit itself (contract B or C), performance of the credit contract cannot be enforced. This is nothing new but a mere application of the existing principle at common law that a legal right can be denied on grounds of illegality. No question arises as to whether an exception should be made to the autonomy principle.

5.3.2 Illegality in the underlying transaction

This refers to cases where the underlying contract (contract A) perpetrates an illegal scheme or contravenes public policy. Here, the documentary credit is not intrinsically illegal. Rather, the credit, because of its connection with a transaction having an illegal purpose, is infected by that purpose. In such circumstances, there are good reasons to not pay the beneficiary but the autonomy principle will protect the beneficiary. As discussed in Chapter 1, the autonomy principle posits that any defence or claims under the underlying contract will have no effect on the paying bank's obligation to pay. This means that if no exception is made, the beneficiary will be paid under the terms of the credit regardless of the illegality in the underlying contract.

The question therefore arises as to whether illegality in the underlying transaction should be recognised as an exception to the principle of autonomy so that payment under the credit can be refused. The ensuing discussion in this chapter will concern circumstances of this type. There has been some recognition of illegality as an exception to the autonomy principle in a few jurisdictions, but existing cases on this point are very limited.

5.4 Illegality as an exception to the autonomy principle

5.4.1 English law

In England, the courts have for a long time refused to enforce a collateral contract which was itself legal, but which is founded upon another illegal contract.¹⁰ Similarly, there is some judicial indication that a documentary credit which is founded upon an illegal contract may be unenforceable. One of the earliest cases dealing with documentary credits which were affected by illegality is *United City Merchants v Royal Bank of Canada*¹¹, a case already discussed in Chapter 3. As the analysis of the case unfolds, it will be seen that it is debatable as to whether it is good authority for the proposition that illegality is an exception to the autonomy principle.

In this case, an English company selling manufacturing equipment to a Peruvian company agreed to invoice the buyer at double the actual sale price and to remit within 10 days one half of the amount drawn under the letter of credit for each of the three instalments to the buyer's dollar account in Miami, Florida. This enabled the buyer to exchange Peruvian currency for the excess amount in breach of Peruvian exchange control regulations. The seller sued the confirming bank when it refused to pay upon presentation of documents. Two issues arose in this case, one was a defence based upon fraud, and the other was the effect of the illegality on the enforceability of the letter of credit. At first instance, Mocatta J held that the entire agreement between the buyer and the seller was a "monetary transaction in disguise" and was therefore unenforceable under the Bretton Woods Agreements Order in Council 1946 which gave the force of law in England to Article VIII section 2 (b) of the Bretton Woods Agreement. On appeal, the Court of Appeal had to consider whether the letter of credit was an exchange contract because it was the contract that was sued upon. Stephenson L.J. held that, when considered in isolation, the letter of credit contract was not an exchange contract, but the Bretton Woods Agreements Order in Council, and public policy based on international comity, required the courts to consider all the circumstances of the contract embodied in the letter of credit:

"But it [the letter of credit] has come into existence to pay the dollars required by the

¹⁰ *Fisher v Bridges* (1854) 3 El. & Bl. 642; *Geere v Charles Mare* (1863) 2 H & C 339; *Bigos v Bousted* [1951] 1 All E.R. 92; *Spector v Ageda* [1971] 3 WLR 498 and *Mansouri v Singh* [1986] 1 WLR 1393.

¹¹ [1983] 1 AC 168.

underlying contract of sale. It is a necessary step on the way towards an ultimate exchange of United States dollars for Peruvian soles. It is part and parcel of a scheme to defeat the Peruvian exchange control regulations”¹²

Hence, the letter of credit was held to be a monetary transaction in disguise and was unenforceable, but the Court of Appeal was of the view that the claimants should be allowed to recover that part of the transaction which did not breach exchange control regulations. The House of Lords, although reversing the Court of Appeal’s decision on the fraud issue¹³, affirmed this part of the decision on the basis that there was no difficulty in identifying the monetary transaction that was concealed by the credit and the underlying contract of sale. In the House of Lords, Lord Diplock emphasised that an exchange contract which breached the exchange control regulations of a member state is not strictly illegal under English law but that the effect of breaching Peruvian exchange control regulations was the same as that of an illegal contract, which is that it is unenforceable by the courts.¹⁴

Although, following *United City Merchants*, payment under a credit is likely to be refused in cases where the underlying contract contravenes currency exchange regulations, the decision itself is not authority for the proposition that illegality in the underlying contract constitutes an exception to the autonomy principle. As explained in a later case, the letter of credit in *United City Merchants* was “part of the whole transaction so that the prohibition directly attacked the enforceability of the letter of credit”.¹⁵ Hence, both the underlying contract and the letter of credit were illegal, the result of which was that there was no need to infringe the autonomy principle to refuse payment in *United City Merchants*.¹⁶ Moreover, nowhere in the judgment contained an explicit recognition of an illegality exception to the autonomy principle.

Another English case which hinted at a possibility of an illegality exception in English law is

¹² *United City Merchants (Investments) Ltd v Royal Bank of Canada* [1982] Q.B. 208, 220.

¹³ See Chapter 3.

¹⁴ [1983] 1 A.C. 168,189.

¹⁵ *Group Josi Re v Walbrook Insurance Co. Ltd* [1996] 1 Lloyd's Rep. 345, 353 per Staughton LJ.

¹⁶ N Enonchong, “The Autonomy Principle of Letters of Credit: An Illegality Exception?” [2006] LMCLQ 404, 407.

*Group Josi Re v Walbrook Insurance Co. Ltd*¹⁷. In this case the plaintiff was a reinsurer who entered into numerous reinsurance contracts with the defendant, a company which underwrote original risks on behalf of a number of other companies and also arranged reinsurance for them. The plaintiff opened a letter of credit in favour of the defendant whereby the defendant had to present debit notes to draw on the credit. The plaintiff later applied for an injunction to prevent the defendant from presenting the debit notes for payment under credit, alleging, amongst other things, that the reinsurance contracts were illegal as it was prohibited by statute from carrying on insurance business in Great Britain. At first instance, the application was rejected. In the Court of Appeal, Staughton LJ stated this:

“... established fraud is not necessarily the only exception. It seems to me that there must be cases when illegality can affect a letter of credit... Turning to the present case, if the reinsurance contracts are illegal, and if the letters of credit are being used as a means of paying sums due under those contracts, and if all that is clearly established, would the Court restrain the bank from making payment or the beneficiary from demanding it? In my judgment the Court would do so.”¹⁸

However, it was held by the Court of Appeal that s. 132(6) of the Financial Services Act 1986 provided that the effect of contravening s. 2 of the Insurance Companies Acts 1982 Act was to make a contract of insurance illegal, void and unenforceable on the part of the insurer only, but the insured could still enforce the contract against the insurer.¹⁹ Since performance of the contract of reinsurance by the reinsurer was not illegal, the appeal was dismissed.

In another English case, *Mahonia Ltd v. West LB AG*²⁰, JP Morgan, Enron and Chase entered into swap transactions. Pursuant to these transactions, Enron agreed to pay JP Morgan the sum of approximately \$356 million after six months, part of which (\$165 million) was secured by a letter of credit issued by West LB in favour of Mahonia. Subsequently Enron filed for Chapter 11 bankruptcy protection, an event of default under the credit and Mahonia then made a demand under the credit. West LB refused to make payment, claiming that the credit was tainted with illegality because a number of the swap transactions constituted a loan which should have been

¹⁷ [1996] 1 Lloyd's Rep. 345.

¹⁸ *Ibid*, 362.

¹⁹ *Ibid*, 364.

²⁰ [2004] EWHC 1938.

accounted for as such, and that the existence of the three limbs of the composite transaction and its nature as a loan should have been disclosed prior to its issue of the credit. It was alleged that this was a breach of US General Accepted Accounting Principles (“GAAP”) and the US Securities Exchange Act 1934. Initially, an application for summary judgment was made by Mahonia to strike out West LB’s defence regarding its refusal to honour the credit based on illegality, but the court dismissed the application, holding that there was a strong arguable case for West LB.

When the case went to full trial, Cooke J held that the accounting of these transactions did not contravene US GAAP and US securities law. He also did not find any conspiracy between Enron, Mahonia and Chase to devise the transactions to enable Enron to account wrongfully, nor that there was an unlawful purpose behind the three swaps or the letter of credit. He also could not find evidence of misrepresentation to West as to the nature of the underlying transaction or the true purpose of the letter of credit. Therefore, the illegality defence was not available to the bank. Interestingly, despite the ruling, Cooke J went on to assert in the closing paragraphs of the decision that he was willing to recognise illegality as a ground for withholding payment in letters of credit:

“...If the L/C had played a part in an overall scheme of the magnitude alleged, to deliberately mislead by wrongful accounting, contrary to section 10(b) of the Exchange Act 1934, and Chase and Mahonia had been complicit therein, public policy would, in my view have required the court not to lend its aid to the enforcement of the L/C ... ”²¹

It is observed that whilst there is an indication of a willingness to accept illegality in the underlying contract as a ground to refuse payment, English courts have not used this ground to refuse payment in any of these cases. This shows that it is certainly not easy for payment to be refused if the illegal element exists in the underlying contract. Moreover, clearer judicial guidelines are needed since the scope of the illegality exception is still vague.

²¹ *Ibid*, [432].

At this point, it is also appropriate to refer to the very recent high profile case, *Stone Rolls Ltd v Moore Stephenson*²². The case did not involve illegality as a ground to refuse payment under a letter of credit but should be noted because it demonstrates a strong willingness on the part of English judges to allow the doctrine of illegality to defeat legal claims. In this case, the sole director of Stone & Rolls Ltd, Mr Stojevic, had used the company to perform several letters of credit frauds against banks. One of the main victims, Komercni Bank SA obtained judgments against the company and Mr Stojevic for deceit, but the company could not pay and became insolvent. The liquidators of the company sued their auditors, alleging negligence for failing to detect and prevent the director's fraudulent activities. The auditors applied to strike out the claim, relying upon the maxim *ex turpi causa non oritur actio*. Although the company and Mr Stojevic are separate legal entities, the House of Lords, by a 3:2 majority, upheld the Court of Appeal's decision that the case be struck out. They made the finding that Stone & Rolls Ltd was not merely vicariously but also primarily liable for the director's fraud. Because it was exclusively managed and owned by the director, awareness of the fraudulent activities was imputed to the company. This is a landmark case which illustrates the operation of the *ex turpi causa* defence in negligence claims against auditors. Nevertheless, the decision does not significantly broaden the illegality defence for auditors, since it is limited to circumstances involving fraud perpetrated in a "one man company".

5.4.2 America

The UCC is silent on this matter but some American courts have examined the effects of illegality on payment under a letter of credit. These cases primarily concerned preferential transfers or penalty clauses which violate common law.

5.4.2.1 Preferential transfers

In *American Bank of Martin County v Leasing Service Corporation (In re Air Conditioning, Inc. of Stuart)*²³, the beneficiary of the letter of credit was a creditor who leased a computer system to the applicant, its debtor. Initially, to secure its performance under the lease, the debtor granted the

²² [2009] 1 AC 1391.

²³ 845 F2d 293 (11th Cir 1988).

creditor a security interest in everything it owned. When the debtor defaulted on payment, the parties came to another arrangement whereby the debtor opened a \$20,000 letter of credit at the American Bank in favour of the creditor. The debtor gave a promissory note with a security interest in a \$20,000 certificate of deposit to the American Bank. However, only a month later, the debtor petitioned for bankruptcy under Chapter 11. The bankruptcy court found that the transfer of the certificate of deposit to the bank as collateral for the credit was “to or for the benefit” of the creditor (the beneficiary of the credit) and therefore constituted a voidable preferential transfer under 11 U.S.C.S. § 547(b). Since the certificate of deposit and the letter of credit both form a single contemporaneous transaction, American Bank effectively had a security interest in the certificate of deposit which was immune from preference attack under U.S.C. § 547(c)(1) (1982). Therefore, the bankruptcy court nullified the letter of credit and ordered American Bank to surrender the certificate of deposit to the trustee.

On subsequent appeals, both the district court and the Eleventh Circuit affirmed the finding of a preference in favour of the creditor but decided that the letter of credit should not have been nullified. Instead, they ruled that Sec. 550(a)(1) of the Bankruptcy Code allowed the trustee to recover from the creditor the certificate of deposit. It expressly provides that a trustee can recover the value of the preferential transfer from "the initial transferee of such transfer or the entity for whose benefit such transfer was made....".By utilising Sec.550(a)(1), the letter of credit was able to operate as normal, thereby upholding the independence principle and the sanctity of letters of credit as vital instruments of commerce whilst preventing the creditor from obtaining the preferential transfer of the debtor's assets.

Two important points arises from the examination of the above case. Firstly, what would be decided if a case with similar facts was heard in a jurisdiction which did not have the equivalent of Sec. 550(a)(1) of the Bankruptcy Code? The law of restitution may be the solution to achieving the same outcome, whilst still maintaining the independence of the letter of credit. However, for similar reasons to those which make an illegal contract unenforceable, the maxim *in pari delicto, potior est conditio defendentis* (where the parties are in equal fault, the defendant's position is stronger) operates so that restitution of benefits conferred under illegal

contracts is generally denied. Some exceptions to this general rule apply²⁴, but in the context of a letter of credit transaction, the exception which is of most relevance is a withdrawal from the illegal contract (the doctrine of *locus poenitentiae*). The applicant may be able to recover the money paid under the credit if he withdraws from underlying contract before the illegal contract is executed. This has been interpreted quite liberally in the past and it seems that restitution will be allowed so long as the illegal purpose had not yet been effected. In *Tribe v Tribe*, Nourse LJ stated that “In a property transfer case the exception applies if the illegal purpose has not been carried into effect in any way”.²⁵ Following this, it is probably the case that in circumstances where a letter of credit has been used to effect a preferential transfer, an applicant would have to withdraw from the underlying contract before payment is made to the beneficiary. Once payment is made, a preferential transfer has been made, and the illegal purpose would have been carried out.²⁶

Secondly, it is important to note that the letter of credit in this case had a collateral, pledged by the debtor as security for the credit, and was found to constitute property of the debtor’s estate. In this case, the Circuit Judge expressly stated that the letter of credit and its proceeds are not property of the estate.²⁷ This means that in a factually similar case without a collateral, the court would not have been able to find a preferential transfer of the “property of the estate”, with the result that a creditor would be able to escape a preference attack in respect of a letter of credit which was issued during the preference period. This is an opportunity for a creditor to avoid bankruptcy laws since it is possible for a creditor to request the applicant that it does not provide a collateral in consideration for the issuance of the letter of credit. Although any bank would be hesitant to issue a credit without security, in practice letters of credit are often issued without security for the full amount for long term customers of the bank. In such circumstances, an illegality exception to the autonomy principle would avoid the unfair result but whether American courts would be willing to create a new exception is in doubt.

²⁴ The exceptions are :a) Withdrawal from the illegal contract b) where the parties are not equally guilty c) where the claimant can establish his proprietary claim without relying on the illegal contract.

²⁵ [1966] Ch 107, 121.

²⁶ The same conclusion would be reached under the law of restitution in America - see Gerald T. McLaughlin, “Letters of Credit and Illegal Contracts: The Limits of the Independence Principle” (1989) 49 Ohio St. L.J. 1197, 1227.

²⁷ *American Bank of Martin County* (n 23), [18].

5.4.2.2 Penalty Clauses

In *New York Life Insurance Company v. Hartford National Bank & Trust Company*²⁸, the applicant entered into a mortgage loan commitment with the plaintiff (the beneficiary) which required that \$180,000 in cash be deposited with the plaintiff to satisfy a liquidated damages provision of the agreement. In lieu of the cash sum, the plaintiff agreed to accept an irrevocable letter of credit which the applicant opened in the plaintiff's favour at the defendant bank. When the applicant failed to tender the cash sum before the commitment expired, the plaintiff presented the defendant with a draft on the credit but the defendant dishonoured the draft. The beneficiary brought an action for wrongful dishonour and the defendant raised several defences, one of which was that the liquidated damages clause of the mortgage loan commitment between beneficiary and the applicant was an unenforceable and illegal penalty. The Superior Court of Connecticut granted an interlocutory summary judgment to the beneficiary as to the liability of the defendant bank for wrongful dishonour of the demand for payment, stating that even if the defence was proven, it would not excuse the defendant bank from its duty to honour the demand for payment. However, the beneficiary was only awarded nominal damages. On appeal, the Supreme Court of Connecticut affirmed the summary judgment but reversed the award of damages, holding that the beneficiary was entitled to the whole amount of the dishonoured draft. Speziale, Associate Justice ruled that only in rare situations of egregious fraud can the bank go behind confirming documents and went on to assert the following:

“ ...the question of whether this commitment's liquidated damages clause was a penalty were claims relating to the mortgage loan commitment contract between TVC [the applicant] and New York Life which, as discussed previously, was entirely separate and independent from the letter of credit arrangement involving Hartford National and New York Life. In the present case, these allegations were not proper defenses to the issuer's obligation to honor the draft pursuant to the letter of credit.”²⁹

²⁸ 173 Conn. 492 (1977).

²⁹ *Ibid*, 502.

Similarly in *Prudential Insurance Co. of America v. Marquette National Bank*³⁰, the plaintiff made a loan to the applicant, whereby they agreed on a loan commitment agreement. The applicant opened a standby letter of credit in favour of the plaintiff at the defendant bank, which is to serve as the loan commitment standby fee as required by the loan commitment agreement. Subsequently, the applicant failed to take out the loan and the plaintiff presented a draft for payment. The defendant bank refused to honour the draft, arguing that the commitment standby fee as required by the underlying contract was an illegal penalty provision. The plaintiff filed a motion for summary judgment and the District Court of Minnesota granted summary judgment in favour of the plaintiff. Donald D. Alsop J upheld the autonomy principle, emphasising that "the contract of McGlynn-Garmaker Company [the applicant] with plaintiff is independent of the obligations of defendant as issuer of the letter of credit and that the alleged illegality of the commitment standby fee is not a defense which may be asserted by defendant in this action."³¹

It appears from these cases that, in America, illegality in the underlying contract will not have any effect on payment under a letter of credit. If the two cases discussed in this section were heard in England, it is highly likely that English judges would reach the same decision, especially since penalty clauses are unenforceable under English law only due to the intervention of equity, not on the basis of the maxim *ex turpi causa*.

5.4.3 Canada

Although Canadian courts have never directly considered the issue of an illegality exception, the conventional position seems to be that illegality in the underlying contract will not allow the withdrawal of payment. Mr. Justice Riddell's following explanation of fraud in *Washburn v. Wright*³², which specifically differentiated fraud from illegality, is well cited in Canadian cases:

"Fraud is not mistake, error in interpreting a contract; fraud is "something dishonest and morally wrong, and much mischief is...done, as well as much unnecessary pain

³⁰ 419 F. Supp. 734 (D. Minn. 1976).

³¹ *Ibid*, 735.

³² (1913) 31 O.L.R. 138 (App. Div).

inflicted, by its use where 'illegality' and 'illegal' are the really appropriate expressions:"³³

The closest a Canadian court came to considering illegality as a ground to stop payment was in the case of *Morguard Bank of Canada v. Reigate Resources (Canada) Ltd*³⁴. In this case, Reigate has arranged with Morguard bank for the issuance of a letter of credit in favour of The Canada Trust Company, who was trustee for holders of the Series A Tender Shares. Security was granted for the letter of credit which was for an amount equal to the aggregate dividend requirement during the first five years that the shares were outstanding. Reigate agreed to provide the trustee with directors' resolutions authorising the payment of the fixed cash dividends when due and to provide cheques made payable to the holders of the shares. If Reigate failed to do this, then the trustee would make a call under the letter of credit. Reigate did pay the dividends to shareholders but Morguard sought an order determining whether the agreement was legal and what would be the result if no declaration of dividend was made by the directors and a call was made by the trustee on the credit.

Power J held that the agreement to pay shareholders of Series A tender shares with funds received under the credit would not contravene s. 40 of the Business Corporations Act and therefore the application by Morguard being premature, was dismissed. Power J stated this: "The letter of credit is a separate and distinct agreement and is not tainted with illegality in *this circumstance* [emphasis added]."³⁵ It is difficult to ascertain whether he would have been willing to recognise illegality as a ground to prevent payment. On the one hand, there is a sense from the judgment that he was not against an illegality exception, since he may have been referring to the circumstances of the particular case. Further, he made the finding that "It is not possible to determine whether the agreement will be performed in a manner contrary to the Act at this time."³⁶ On the other hand, he stated that, "The historical use of the letter of credit as a commercial document is such that its character stands above the undercurrent of equities that may

³³ *Ibid*, 147.

³⁴ (1985) 40 Alta. L.R. (2d) 77.

³⁵ *Ibid*, [19].

³⁶ *Ibid*, [21].

exist between Morguard and Reigate.”³⁷ Nevertheless, his *obiter* statement has been interpreted as a rejection of an illegality exception.³⁸

5.4.4 UNCITRAL Convention on Independent Guarantees and Stand-by Letters of Credit

Although the UCP does not deal with the issue of the effect of illegality in the underlying contract, the UNCITRAL Convention took the initiative to make provisions on this issue in relation to independent guarantees. The UNCITRAL Convention provides for an illegality exception only to the extent that injunctions to withhold payment³⁹ or Mareva injunctions⁴⁰ may be granted where “the underlying obligation of the principal/applicant has been declared invalid by a court or arbitral tribunal, unless the undertaking indicates that such contingency falls within the risk to be covered by the undertaking”⁴¹. The writer does not advocate this approach because the inherent delays involved in waiting for a declaration by a court or arbitral tribunal would significantly reduce the objective of an illegality exception. As with the fraud exception, a bank which is in possession of very strong evidence that the underlying contract is illegal should be able to invoke the illegality exception to refuse payment at the time of payment. Similarly, a bank should also be able to apply for an injunction before a full trial which determines the illegality of the underlying contract is held. The effort to incorporate this issue by itself is commendable but the relevant provisions of the UNCITRAL Convention are lacking in depth and fail adequately to deal with many aspects of the exception.⁴²

5.5 Arguments for and against an illegality exception

One of the objectives of the law is to deter and punish unlawful conduct. If the law enforced the right to be paid under a documentary credit which assists an illegality, this would have the opposite effect, providing opportunities for parties to use the documentary credit to benefit from an illegal transaction. Professor Atiyah argues that the threat of unenforceability can sometimes

³⁷ *Ibid*, [19].

³⁸ *Morguard Trust Co v Royal Bank of Canada* (1988) ACWS (3d) 416; *N Enonchong* (n 16) 409.

³⁹ Article 20(1)(a) of UNCITRAL Convention on Independent Guarantees and Stand-by Letters of Credit.

⁴⁰ Article 20(1)(b) of UNCITRAL Convention on Independent Guarantees and Stand-by Letters of Credit.

⁴¹ Article 19(2)(b) of UNCITRAL Convention on Independent Guarantees and Stand-by Letters of Credit.

⁴² For a critical analysis of the provisions, see Michelle Kelly-Louw, “Selective legal aspects of bank demand guarantees” (PhD thesis, University of South Africa 2008).

have a more deterrent effect than criminal law.⁴³ This argument is particularly appropriate where a documentary credit has been utilised to guarantee payment for a transaction which is not strictly illegal, but is contrary to public policy. In such circumstances, there is no other deterrence apart from the deterrence provided by the risk of the courts refusing to enforce payment. The consequence of having his right to payment refused by the court can also be seen as a form a punishment for a beneficiary's participation in the illegal transaction.

Moreover, since the purpose of law is to promote justice, the court's dignity is only upheld if it is not seen as giving effect to a contract which has been tainted by an illegal element. This can only be achieved if the courts maintain a balance, since there are other underlying policy considerations which mean that courts should not refuse to enforce payment under a documentary credit merely because of some minor technical breaches of the law (this point will be returned to in the subsequent discussion). This is best captured by the words of Taylor J in the Canadian case *Mack v Enns*, when referring to the *ex turpi causa* maxim:

“The purpose of the rule today must be to defend the integrity of the legal system, and the repute in which the courts ought to be held by law-abiding members of the community. It is properly applied in those circumstances in which it would be manifestly unacceptable to fair-minded, or right-thinking, people that a court should lend assistance to a plaintiff who has defied the law.”⁴⁴

In comparison to the fraud exception, there are a lot of similarities between an illegality exception and the fraud exception. The fraud exception and the illegality exception are both derived from the same maxim. In terms of moral blameworthiness, a fraudulent act could be on the same level as an illegal act. Since the fraud exception has achieved worldwide recognition as an exception to the autonomy principle, there is no reason why illegality should be treated differently by the law. The scope of this exception can be laid out clearly and applied analogously to the fraud exception, hence the exception will not involve more difficulties than the fraud exception as one might expect.⁴⁵ Just as with the fraud exception, the bank is under no duty to

⁴³ P S Atiyah, *An Introduction to the Law of Contract* (6th ed OUP ,Oxford 2006) 342.

⁴⁴ (1981) 30 B.C.L.R. 337, 345.

⁴⁵ The same approach has been argued by *N Enonchong* (n 16).

look for illegality in the transaction. Its responsibilities are confined to the examination of the presented documents.⁴⁶

The only difference between an illegality defence and the fraud exception is, as the American lawyer, J Barnes states, "...the public policies to be applied are much more varied and unrelated to the purpose of the L/C."⁴⁷ The direct of result of this is that there will be uncertainty as to when an illegality exception can be invoked. In the general law of contract, the same uncertainty has plagued the doctrine of illegality yet this has not deterred English courts from developing the doctrine. He recognises the same problem with the fraud exception, stating that, "Even those who recognize that the fraud/abuse defence is peculiar to L/C law and are experienced in applying the fraud exception sometimes disagree on whether a particular drawing crosses the line."⁴⁸ However, as with the fraud exception, the interest of justice and fairness means that this is an inevitable disadvantage of an illegality exception which one needs to overlook.

J Barnes further highlights that "LCs supporting obligations to pay for an investment security, to pay executive compensation on termination, to pay liquidated damages, to pay for a covenant not to compete, etc., would appear to be more vulnerable to defences based on illegality than on L/C fraud".⁴⁹ Whilst this is true, the extent maybe inflated because these obligations are likely to exist in standby letters of credit - the use of standby letters of credit is not as commonplace in England as in America. Furthermore, despite these types of transaction being more vulnerable, the scope is limited by the many requirements proposed in this chapter, amongst which is the requirement of a serious offence. Accordingly, the number of cases where illegality may be successfully argued to refuse payment is limited and should not be a lot more than cases where fraud is successfully argued. The risk of an illegality exception, on its own, undermining the importance of the letter of credit as an international method of payment is minimal.⁵⁰

⁴⁶ *N Enonchong* (n 16) 412.

⁴⁷ J Barnes, "The UCP in court "Illegality" as excusing dishonour of L/C obligations" <<http://www.iccbooks.com/Home/UCPCourtIllegality.aspx>> accessed 11 June 2009.

⁴⁸ *Ibid.*

⁴⁹ *Ibid.*

⁵⁰ *N Enonchong* (n 16) 412.

5.6 Scope of the exception

In their first report on illegal transactions, the English Law Commission recommended that the courts be given a statutory discretion to decide whether the claimant's involvement in some form of illegality should act as a defence to a claim, and in exercising this discretion the courts should take into account a list of factors.⁵¹ In their subsequent report, they moved away from recommending legislative reform for the law of illegality as it applied to contract, but recommended that what judges need to do is to base their decisions on the policy factors which lie behind the illegality defence and explain their reasoning accordingly.⁵² Whilst the Law Commission's recommendation might be plausible for general application to illegal contracts, it is the writer's opinion that they are not suitable in the context of a documentary credit transaction. Because the main advantage offered by a letter of credit is that it offers certainty of transaction and security, any exception created to the autonomy principle has to be well-structured so as to provide certainty. Therefore, the writer proposes some requirements which should be established for the illegality exception to be successfully invoked before payment to the beneficiary can be refused.⁵³ It is emphasised here that this idea is not the same as the approach recommended by the Law Commission in their first report because these are hurdles rather than mere factors which should be taken into consideration. With these requirements in place, the courts will be able to maintain a balance between two competing interest - achieving justice by preventing one party from gaining a benefit from their own illegal conduct and enforcing the normal legal rights arising under contracts which have been freely entered into.

5.6.1 Knowledge of the beneficiary

The issue of the beneficiary's knowledge, despite its importance, has so far received little analysis in the judgments of cases where illegality has been considered as an exception to the autonomy principle. In *Group Josi*, counsel for both the plaintiff and defendant contested on the type of knowledge which was required. The defendant's counsel contended that "the principle applies only where, to the knowledge of both parties, the collateral transaction is entered into

⁵¹ *The Law Commission* (n 4).

⁵² The Law Commission Consultation Paper No 189, "The Illegality Defence" (2009).

⁵³ These requirements were also advocated by Nelson Enonchong to limit the scope of the exception.

with the common purpose of performing an illegal contract”, whilst the plaintiff’s counsel submitted that “it is sufficient if the parties are aware of the facts which give rise to the illegality.”⁵⁴ Staughton LJ expressed the difficulty involved since the relevant cases do not discuss this point but concluded that it was unnecessary in this case to decide the knowledge required in order for the illegality of the underlying contract to taint the collateral contract.⁵⁵

In *Mahonia*, Cooke J held that one of the reasons why the illegality defence failed was “because Mahonia was not privy to any unlawful purpose, having no knowledge of any element of wrongful accounting”⁵⁶. There is no direct judicial authority on this point but in *Spector v Ageda*⁵⁷, Megarry J referred to the following passage from an old edition of *Cheshire and Fifoot's Law of Contract*⁵⁸:

If, for example, A and B borrow £500 from C in order to pay a loss that they have suffered on an illegal transaction, C cannot recover the loan if he was aware of the purpose upon which it was to be expended, but presumably he will succeed if he proves his ignorance of that purpose order to discharge an existing loan that was wholly or partly illegal was itself tainted with illegality.⁵⁹

In this case, Megarry J did not decide the issue of whether the plaintiff needed to demonstrate knowledge. Nevertheless, it is contended here that in relation to this issue, there is a distinction to be made between two different types of illegal contracts. This follows from the position in the general law of contract where the relevance of the state of mind of a party depends upon which category of illegal contract is in question. Essentially, the distinction concerns the time at which the contract becomes illegal.

⁵⁴ [1996] 1 Lloyd's Rep. 345, 353.

⁵⁵ *Ibid*, 353-354.

⁵⁶ [2004] EWHC 1938 (Comm), [423].

⁵⁷ [1973] Ch. 30.

⁵⁸ G. C Cheshire, C. H. S. Fifoot, *Cheshire and Fifoot's Law of Contract* (7th ed Butterworths, London 1969) 307.

⁵⁹ [1973] Ch. 30, 42. See also *Cannan v. Bryce* (1819) 3 B. & Ald. 179; *Catlin v Bell* (1815) 4 Camp 183; *Fielding & Platt Ltd v Najjar* [1969] 1 WLR 357, 362.

5.6.1.1 Contracts which are illegal at the time of formation

Contracts which are illegal at the time of formation are illegal per se and given the strictest treatment by the courts. The contract will be unenforceable by either party regardless of whether one or both of the parties were not aware of the fact that the contract is against the law. Where the contract is illegal per se, knowledge will be imputed even if it was not actual. In such circumstances, neither party has any rights or remedies. The contract is void *ab initio*. For example, in *Re Mahmoud and Ispahani*⁶⁰, a contract for the sale of linseed oil was concluded without a licence at a time when both the selling and buying of linseed oil otherwise than under licence were prohibited by statute. The seller had a licence whilst the buyer had misrepresented that he had a licence. The seller had acted honestly and had thought that the buyer had a licence, but the Court of Appeal held that the seller was not allowed to recover damages for the buyer's non-acceptance.

Applying this principle by analogy to a documentary credit transaction it is submitted that, if the underlying transaction is illegal in its formation, there is no requirement that the beneficiary must have actual knowledge of the illegality of the underlying transaction since knowledge will be imputed. The transaction will be void in any event. For example, a seller contracts with a

buyer to supply pharmaceutical products, to be paid for by a documentary credit opened in favour of the seller. A statute prohibits the selling of these goods except by an authorised manufacturer - the seller therefore lacks the necessary authority to sell the products. In such circumstances, a bank does not need to prove that the plaintiff seller had knowledge of the illegal act in order successfully to invoke the illegality exception to refuse payment. However, the bank will still need to establish the other requirements, as submitted in the remaining discussion.

5.6.1.2 Contracts which are illegal as performed or which achieve an illegal purpose

A contract in this category is not illegal on its face, but becomes illegal because it was made with the intention of achieving an illegal purpose or because it falls to be performed in an illegal

⁶⁰ [1921] 2 KB 716.

manner. In such circumstances, the enforceability of the contract is dependent on the intention and knowledge of the parties. If both parties intended and knew about the illegal purpose or illegal performance, then it is unenforceable by both parties. If one party entered into a contract with an intention of achieving an illegal purpose, or performs it in an illegal manner, and the other party was unaware of his intention to this effect, the innocent party is able to enforce the contract but the guilty party is not able to do so.⁶¹

*Marles v. Philip Trant & Sons*⁶² is a good example of a case where the contract was tainted with illegality because it was performed in an illegal manner. In this case, the contract of sale between the claimant and defendant was for spring wheat. The seller delivered winter wheat, which breached the agreement but the contract was still lawful as formed. However, the seller failed to deliver an invoice together with the goods, which was required by statute⁶³, and this constituted an illegal performance of the contract. The buyer was allowed to recover damages for breach of the contract because of his innocence.⁶⁴ Following this, it is submitted that in a documentary credit transaction where the underlying contract is illegal because it furthers an illegal purpose, or is performed in an illegal manner, the beneficiary's knowledge of the illegality needs to be established in order for the illegality exception to deny the beneficiary's right to be paid under the credit.⁶⁵ Otherwise, the illegality exception would fail.

5.6.2 Character/seriousness of the offence

Not all illegal acts are of the same gravity. For example, in terms of moral culpability, there is a significant difference between a contract of sale of illegal drugs and a contract of sale which involves goods which do not meet the requirements of import regulations. This issue is not always straightforward and, as discussed earlier, public policy can differ in different countries.

⁶¹ *Anderson Ltd v Daniel* [1924] 1 KB 138; *Alexander v Rayson* [1936] 1 KB 169, 182; *St John Shipping Corporation v. Joseph Rank Ltd* [1957] 1 QB 267, 283 per Devlin J.

⁶² [1954] 1 Q.B. 29.

⁶³ Section 1(1) of the Seeds Act 1920.

⁶⁴ The provision under the Seeds Act specified that the liability of the sellers to a fine for their own failure to deliver a statement was "without prejudice to any civil liability". However, the *ratio decidendi* of the case was that the sellers' illegality did not affect an innocent buyer's rights.

⁶⁵ N Enonchong also submits that a beneficiary's knowledge of the illegality is a requirement of an illegality exception. However, he submits this as a requirement for all cases, making no distinction between contracts which are illegal at the time of formation and contracts which are illegal as performed – see N Enonchong (n 16) 417-418.

What might be considered as sufficiently serious in one country may not be regarded as so by another jurisdiction.

In the majority of English cases where the courts have had to decide the issue of whether an illegality could defeat a contractual claim, the judiciary did not openly recognise the need to consider the gravity of the illegality involved. In fact, this aspect of the law was criticised by the English Law Commission which recommended that judges should always take into account the seriousness of the illegal conduct when deciding such issues.⁶⁶ But it was not always the case that English courts disregarded this factor. In *St John Shipping Corporation v Joseph Rank Ltd*⁶⁷, Devlin J showed that he was reluctant to invalidate a contract for an illegality which is minor in nature: “It may be questionable also whether public policy is well served by driving from the seat of judgment everyone who has been guilty of a minor transgression.”⁶⁸ There was also a subtle expression of this in *Mahonia* where Cooke J stated the following:

“...[T]he Court ought not and will not lend its aid to enforce a contract, a security or something akin to a security for a contract, where the underlying purpose of that contract is contrary to the law of a friendly foreign state where performance is to occur *and the gravity of that unlawfulness is such as to engage public policy considerations.*”⁶⁹ [emphasis added]

The same notion has also been expressed in American law:

“However, courts in recent years have moved away from applying such formal tests (the Armstrong test) to decide whether to enforce a contract tainted with illegality. Instead, they look directly at the extent and seriousness of the illegal conduct and its relationship to the contract at issue.”⁷⁰

⁶⁶ *The Law Commission Consultation Paper No 154* (n 4) 102.

⁶⁷ [1957] 1 QB 267.

⁶⁸ *Ibid*, 288-289.

⁶⁹ *Mahonia Limited v JP Morgan Chase Bank* [2004] EWHC 1938 (Comm), [431].

⁷⁰ *Marvin v Tenna Corporation* 560 F.2d 761, [17].

Ordinary notions of justice presume that a sanction or penalty should be proportionate to an illegal act. Withholding payment to the beneficiary is not a trivial decision and has significant commercial consequences on all parties involved in a documentary credit transaction. This argument, together with the general disposition of the courts in restricting the success of the fraud exception leads to the writer's proposition that not all prohibited conduct, but only seriously illegal conduct, will fall within the scope of an illegality exception. Otherwise, the commercial utility of the documentary credit will be severely affected. The inevitable question arising from this proposition is: how would the courts distinguish between different categories of illegal conduct? This is a very difficult question to answer for two reasons. Firstly, there is limited guidance on this point because of the small number of cases where illegality has been raised as a defence to a claim for payment under a letter of credit. Secondly, the range of illegal conduct which could affect a documentary credit transaction is extremely wide-ranging.

Where the underlying contract is truly criminal or morally repugnant, the position is rather straightforward. A good example of this is the hypothetical contract referred to by Staughton LJ in *Group Josi*:

“Take for example a contract for the sale of arms to Iraq, at a time when such a sale is illegal. The contract provides for the opening of a letter of credit, to operate on presentation of a bill of lading for 1000 kalashnikov rifles to be carried to the port of Basra.”⁷¹

In a case such as this, the illegality is obviously grave and there is no reason why the courts should still enforce payment. There are few difficulties in identifying contracts like this. The determination of whether the illegal element in a contract is serious enough to attract the illegality exception becomes a lot more complex where it involves statutory illegality of a technical nature. In the general law of contract, this has also proven to be difficult, and it is likely that the same problems would arise in the application of the illegality exception to documentary credits. How should the courts classify a contract as involving a trivial/technical breach so that it does not attract the illegality exception? Different approaches have been adopted so far.

⁷¹ *Group Josi Re v Walbrook Insurance Co. Ltd* [1996] 1 Lloyd's Rep. 345, 362.

In *St John Shipping*, Devlin J considered the proportionality of the offence in relation to the commercial inconvenience which would result.⁷² Devlin J also approached the case by construing the statute to determine whether the intention of parliament was to prohibit such contracts or to impose fines upon those who breached its provisions and concluded that the objective of the statute was the latter.⁷³ In *Mahonia*, Cooke J distinguished breaches of section 13 (a) or 13 (b) from section 10 (b) and 20 (e) of the US Securities Exchange Act 1934 on the basis that breaches of the former will not give rise to unenforceability because it does not involve an element of deceit or intentional wrongdoing, whereas breaches of the latter involves planned deliberate large scale mis-accounting which will provide a defence to payment.⁷⁴ Here, it seems that the test he establishes is one which focuses on the extent of the participation of the beneficiary. Although the writer appreciates the learned judge's effort in highlighting that not all breaches of statutory provisions will constitute a ground for refusing payment, this test really does not provide any more clarification as to what types of illegality are sufficiently serious so as to deprive a claimant of his rights. It is argued here that the issue of a beneficiary's knowledge of the illegality should be distinguished from the issue of the seriousness of the illegality. A beneficiary's knowledge is a pre-requisite to attract an illegality exception, but even if this requirement is satisfied, it does not necessary follow that the illegality is serious enough to justify the refusal of payment under a credit.

To ensure utmost consistency and certainty, the courts could, rather than engaging on a random moral judgment, adopt a systematic methodology to lay down a clear set of identifiable categories which would be sufficiently serious to invoke the illegality exception. One possibility is to restrict the illegality defence only to crimes or indictable offences.⁷⁵ One other alternative method is to categorise minor and major transgressions according to the penalties which can be

⁷²[1957] 1 QB 267, 289.

⁷³ This approach have also been adopted by Australian courts. - *Dalgety and New Zealand Loan Co v C Imeson Pty Ltd* [1964] NSW 638 ;*Yango Pastoral Co v First Chicago Australia* (1978) 139 CLR 410; *Farrow v Edgar* (1993) 114 ALR 1.

⁷⁴ [2004] EWHC 1938, [429].

⁷⁵ "The simplest case is an agreement to commit a crime or indictable offence: 'If one bind himself to kill a man, burn a house, maintain a suite, or the like, it is void.' " Frederick Pollock, *Pollock's Principles of Contract* (13th edn Stevens & Sons, London 1950) 262 citing Shepp. Touchst. 370.

imposed upon violation of the law.⁷⁶ So for example, breaches of statutes which involve fines above a specified amount may attract the illegality exception whilst those below the specified amount will not. Both of these methods would enable a very clear dividing line to be drawn. The first suggestion to restrict the scope of an illegality exception to crimes or indictable offences is probably not suitable because it is too restrictive and there may well be other offences such as statutory offences or conduct contravening public policy where there are strong arguments for refusing payment despite them not being a crime or indictable offence. The latter method, despite being systematic, is inflexible with the potential of creating injustice in its application since it would also exclude many illegal acts. One solution to this is to maintain that exceptions can be made to these categories and that there is a rebuttable presumption so as to allow some element of moral judgment. However, the writer does not advocate that any of these approaches be adopted because the many circumstances which may violate public policy mean that it is crucial to retain flexibility. Moreover, if any of these methodologies were adopted, it would be difficult to provide a rational account of why public policy is excluded from the scope of the illegality exception. Nevertheless, it is suggested that the criminal element of an offence and the level of punishment imposed by the law are factors which should be considered in the determination of whether an illegality is serious enough to fall within the scope of the illegality exception.

It should be noted that where contravention of statutes are concerned, a separate issue which may confront the courts is the extent to which the contract contravenes the statute. This is related to, but not exactly the same as, the issue just discussed. To illustrate this point, reference must be made to *St John Shipping*, where Devlin J recognises what would be a startling result if "a shipowner who accidentally overloads by a fraction of an inch will not be able to recover from any of the shippers or consignees a penny of the freight"⁷⁷. In this regard, the courts should determine the issue with a common sense approach. Common sense would dictate that where the degree of transgression is so minor, this should not result in the refusal of payment to the beneficiary.

⁷⁶*N Enonchong* (n 16) 417.

⁷⁷*St John Shipping* (n 67) 281.

5.6.3 Close relationship between a documentary credit and the illegality

When confronted with an illegality defence, common law judges have in the past discussed the relationship between the contract and the illegal conduct. In *St John Shipping*, Devlin J distinguished between “a contract which has as its object the doing of the very act forbidden by the statute, and a contract whose performance involves an illegality only incidentally”⁷⁸.

“The rights which cannot be enforced must be those "directly resulting" from the crime. That means, I think, that for a right to money or to property to be unenforceable the property or money must be identifiable as something to which, but for the crime, the plaintiff would have had no right or title.”⁷⁹

Clearly, he felt that it was necessary to establish the connection between the contract and the illegality.

Where the courts are dealing with a linked contract which is by itself strictly legal, but may be tainted by illegality of another contract, this issue becomes more acute. In *Fisher v. Bridges*⁸⁰, a case concerning a deed which promised payment for the sale of a land for an illegal purpose, Jervis CJ refused to enforce the deed and stated the following:

“It is clear that the covenant was given for payment of the purchase money. *It springs from, and is a creature of, the illegal agreement*; and, as the law would not enforce the original illegal contract, so neither will it allow the parties to enforce a security for the purchase money, which by the original bargain was tainted with illegality.”⁸¹[emphasis added]

It is contended that a documentary credit would have to be sufficiently linked to the illegality in the underlying contract if it is to be tainted so as to attract the illegality exception. It is of course important to restrict the tainting concept, particularly where it concerns a financial instrument of

⁷⁸ *Ibid*, 291.

⁷⁹ *Ibid*, 292.

⁸⁰ (1854) 3 El. & Bl. 642.

⁸¹ *Ibid*, 649.

commercial importance. It is impossible to draw a clear line between those which are sufficiently linked and those which are not. Nevertheless, guidance can be sought from some cases.

In *Group Josi Staughton LJ* stated *obiter* that if the reinsurance contracts were illegal, he was willing to restrain payment “because they were being used to carry out an illegal transaction”.⁸² This leads to one commentator arguing that, “...[I]t is only in very rare situations that the letter of credit would not be found to play an integral part in the underlying transaction. Payment is, after all, virtually always an integral part of commercial or financial transactions.”⁸³ In the writer’s view, this is not true because payment may not necessarily be integral to the illegal element. For example, in a case where the terms of the underlying sale contract involves a covenant which breaches a statutory provision, payment under the credit may not be sufficiently connected to the illegality in the underlying contract to justify non-payment under the credit.

In *Mahonia*, Colman J suggested that a letter of credit would be tainted if “it plays from the outset an integral part in the illegal transaction”.⁸⁴ When the case went to full trial, Cooke J also adopted a very similar approach and considered the following (some of which overlap):

- Whether the letter of credit was brought into existence for the very purpose of being part of what was an unlawful scheme.⁸⁵
- whether the letters of credit was part of the overall arrangements and shared the same common purpose”⁸⁶
- whether the letter of credit was opened in consideration of obligations contained in the ENAC/Mahonia Swap⁸⁷
- whether the letter of credit played a part in an overall scheme of the magnitude.⁸⁸

In addition, Cooke J introduced a slightly different element. He asked whether, without the

⁸²[1996] 1 Lloyd's Rep. 345, 362.

⁸³J Chuah, “Documentary and illegality in the underlying transaction” JIML 9(6) [2003] 518, 520.

⁸⁴*Mahonia Ltd v JPMorgan Chase Bank* [2003] EWHC 1927 (Comm), [66].

⁸⁵[2004] EWHC 1938 (Comm), 427.

⁸⁶*Ibid*, 429.

⁸⁷*Ibid*. See page 160 for a detailed account of the facts of this case.

⁸⁸*Ibid*, 432.

letter of credit, the transaction would not have gone ahead.⁸⁹ On the hypothesis that there was deliberate false accounting, he concluded that it would not since the letter of credit in the case was akin to a form of security for the performance of the ENAC/Mahonia Swap. One leading commentator, N Enonchong has strongly criticised this test: “The mere fact that the parties to the illegal venture decided to carry it out using a letter of credit when they could still have gone ahead with the venture without the letter of credit is not a sound basis for holding that therefore the letter of credit is not sufficiently connected to the illegality.”⁹⁰ The writer agrees with his criticism to a certain extent, since even if the illegal transaction could have been performed in another manner and could go ahead without the letter of credit (perhaps through the use of another payment instrument), the fact remains that the letter of credit in *Mahonia* was still used to carry out the illegal purpose. Despite this criticism, it is certainly true that if the illegal purpose could not be carried out by any other means (if it would not have gone ahead without the letter of credit), then the letter of credit is without doubt closely connected to the illegality. There is therefore something of value to be taken from Cooke J’s test. It is proposed here that this test should be refined: A letter of credit is sufficiently connected to the illegality if, without the letter of credit, the illegality in the underlying transaction could not be executed. However, in the converse situation, where the illegal venture could still go ahead without the letter of credit, it does not necessarily follow that a letter of credit is not closely linked to the illegality.

N Enonchong further suggests there is no need for a separate test to establish the closeness of the illegality and a letter of credit:

“If the beneficiary was aware of the illegal purpose of the underlying contract, then that should be enough to establish a sufficient connection between the illegality and the letter of credit issued in respect of the transaction. And vice versa.”⁹¹

However, such an approach is very much based on the idea of moral punishment, placing emphasis on the state of mind of the beneficiary. The writer disagrees with this, primarily because the very essence of an illegality exception is based on the idea that the documentary

⁸⁹ *Ibid*, 429.

⁹⁰ *N Enonchong* (n 16) 421.

⁹¹ *Ibid*.

credit contract, despite being a separate contract in itself, is tainted by the illegality of the underlying contract because it is linked to the underlying contract.

It is argued here that this suggestion would reduce the level of uncertainty but some uncertainty would still linger because of the evidential difficulties in establishing the beneficiary's state of mind. Not every concept should be abandoned at the expense of certainty, especially since there are good reasons to retain the requirement of close linkage. It is also possible to limit the uncertain effects of this requirement. Despite the differences in the language adopted, the approach adopted by the courts in *Group Josi* and *Mahonia* are the same. All the different formulations used to determine whether a letter of credit was sufficiently connected so as to be tainted have focused on identifying what function the letter of credit had in relation to the alleged illegality. This includes Cooke J's consideration of whether the transaction would have gone ahead without the letter of credit, which might at first sight appear to be radical. As the writer sees it, such an approach denotes common sense. Since the courts will not enforce illegal contracts, the courts certainly should not enforce a credit which has an important role in any illegal transaction, in circumstances where it is very difficult to separate the good from the bad.

5.6.3.1 Non-reliance rule

The long established rule from *Bowmakers Ltd v Barnet Instruments Ltd*⁹² posits that a party can enforce his legal or equitable right if he does not have to "plead or prove" an illegal act in order to establish the cause of action. In this case, the defendant, Barnet, hire-purchased machine tools from Bowmaker under three separate hire purchase agreements. Barnet made some but not all of the agreed payments. Barnet also sold two of the machines and refused to deliver up the remaining machine to the plaintiff on demand. The hire-purchase agreements contravened wartime maximum price rules and licence regulations. Barnet argued that the hire purchase agreement was an illegal contract which should not be enforced by the courts. The Court of Appeal held that the plaintiff could claim damages in the tort of conversion in respect of all three machine tools on the basis that they could rely on their basic right of ownership and did not have to rely on the illegal contract. The wrongful sale by Barnet terminated its right to retain

⁹² [1945] KB 65.

possession as enjoyed by a hirer of goods and allowed the plaintiff to regain their right to immediate possession.

The *Bowmaker* rule was subsequently affirmed by the House of Lords in *Tinsley v Milligan*⁹³, where two women purchased a house with joint funds, intending to share the ownership of the house. They registered the legal title to the house only in Tinsley's name so that Milligan could make fraudulent claims for housing benefit from the DSS. When the relationship ended, the House of Lords had to decide whether the illegality should affect Milligan's claim that Tinsley held the house on trust for the benefit of both of them. The majority of the House of Lords adopted the *Bowmaker* rule and allowed Milligan's claim for equitable title of the house because she did not have to rely on the illegality. She could prove title by proving a contributory payment and a common intention upon which both of them acted.

The non-reliance rule has been the subject of debate and controversy.⁹⁴ It is deceptively simple and its application can often be difficult and produce varying results. For example, if the couple in *Tinsley* had been husband and wife and the house had been purchased in the wife's name only, the application of the rule would bring a different result. The husband would not have been allowed to enforce his interest in the property because he would have been required to rebut the presumption of advancement. He would have needed to submit evidence rebutting the presumption of gift, and in doing so, would have needed to rely on evidence of the illegality in order to rebut this.⁹⁵ Despite this, the rule seems to have been universally applied in all common law jurisdictions in the law of contract and trusts. In fact, its application has also been extended to letter of credit cases where the courts have had to consider whether illegality was an exception to the autonomy principle. In *Group Josi*, at first instance, Clarke J rejected the defendant's argument that the rule was inapplicable. On appeal, Staughton LJ affirmed this and applied the *Bowmaker* rule to the facts presented to him. He concluded that the defendants would need to base their case on the illegal contract because, to draw down on the credit, they must present a debit note to the bank, which covered the liability for outstanding loss reserves under the

⁹³ [1994] 1 AC 340.

⁹⁴ H. Stowe "The Unruly Horse Has Bolted: *Tinsley v Milligan*" (1994) 57 M.L.R. 441; N. Enonchong "Illegality: The Fading Flame of Public Policy" (1994) 14 O.J.L.S. 295.

⁹⁵ *Tinsley* (n 93) 372.

umbrella quota share facilities.⁹⁶ The non-reliance test is likely to retain its significance in the illegality doctrine especially since it found support in the recent decision of the House of Lords in *Stone & Rolls Ltd v Moore Stephenson*.⁹⁷

N Enonchong submits that the *Bowmaker* rule should have no relevance in establishing the closeness between the letter of credit and the illegality of the underlying contract.⁹⁸ He bases his argument on two grounds. The first ground is the uncertainty of the ambit of the test - does the rule prevent the claimant from relying on his own illegality, or from relying on the illegal transaction?⁹⁹ The second ground is that the application of this rule would effectively make the illegality exception pointless because the exception would have no effect in practice.¹⁰⁰ It is N Enonchong's second ground which the writer feels forms a strong basis for abandonment of this test for the illegality exception. The paradigm case of a documentary credit transaction involves an underlying contract which is a contract of sale of goods. In sale of goods cases, the application of the rule would always allow the beneficiary to enforce his right to be paid. Applying the *Bowmaker* rule would bring the undesirable result that a beneficiary, regardless of any illegality, would always have a claim to payment if he has delivered the goods and provided the necessary documents.¹⁰¹ Although it was decided in *Group Josi* that the beneficiary had to rely on the illegality in order to make its claim, the facts of *Group Josi*, as N Enonchong rightly points out, "were exceptional".¹⁰²

5.6.4 Proof/evidence of illegality

By analogous application, the required evidence to support any allegation of illegality should be the same as that required under the fraud exception. It is unnecessary to embark on a repetitive discussion since Chapter 3 has already discussed the relevant standard of proof in a pre-trial and full trial hearing.¹⁰³ It suffices to say here that the standard of proof is very high.

⁹⁶ [1996] 1 Lloyd's Rep. 345, 363.

⁹⁷ [2009] 1 AC 1391.

⁹⁸ *N. Enonchong* (n 16) 419.

⁹⁹ *Ibid.*

¹⁰⁰ *Ibid.*

¹⁰¹ *Ibid.*

¹⁰² *Ibid.*

¹⁰³ See 3.2.3.

5.6.5 Relevant time of bank's knowledge of illegality

Just like the fraud exception, in order for the illegality exception to be successfully argued, the bank has to have evidence of the illegality at the correct time.¹⁰⁴ *Mahonia* is the only case so far which has considered this issue in relation to the illegality exception. Cooke J stated in *Mahonia* that the defendant bank was “entitled to resist enforcement at this stage [full trial] of the proceedings without knowing of any basis for resisting the demand under the L/C at the time when it refused to pay.”¹⁰⁵ This follows closely the position of the fraud exception as discussed in Chapter 3.¹⁰⁶

5.7 Illegality and conflicts of laws

In order to refuse payment on the grounds of illegality (either because the underlying contract is illegal or because the documentary credit itself is illegal), it is necessary to establish that there is an illegal element in the transaction in question. This inevitably leads to the question of which country's law is material in establishing illegality. When a documentary credit is used in a sale of goods transaction on the home market, it is unlikely that issues of conflicts of laws will arise because the legal system applicable to the contract of sale or the documentary credit is unlikely to be that of a foreign system. However, when it is used in international trading, the documentary credit will transcend national borders and involve various parties in different countries. This partly explains the many efforts which have been made to achieve international uniformity. Despite the widespread adoption of the UCP, conflict of laws issues will inevitably arise. Issues of conflict of laws are often difficult, but an already difficult subject is made even more complex by the many autonomous, yet linked, contractual relationships arising from a documentary credit transaction. The two main aspects to a conflict of law case are a) jurisdiction and b) applicable law. The former is not within the scope of this study, but “the plaintiff, in the absence of a choice-of-court agreement, may have a multiple choice as to the court where he may bring the action”¹⁰⁷.

¹⁰⁴See 3.2.4.

¹⁰⁵[2004] EWHC 1938, [433].

¹⁰⁶See 3.3.4.3.

¹⁰⁷M. Kurkela, *Letters of credit and bank guarantees under international trade law* (2nd ed OUP, New York 2008) 338.

At common law, the law to be applied to a contract is referred to as the proper law. The Rome Convention and Rome 1 adopt the term applicable law or governing law but this is merely a difference in terminology. The widespread incorporation of the UCP does in fact alleviate conflict of laws issues but the UCP does not cover all matters since some matters are inherently national in character and would require national laws to be applied. UCP 600 does not contain any clauses concerning governing law or jurisdiction. Where a matter is not covered by the UCP, the proper law is the one expressly incorporated by the parties into the letter of credit.¹⁰⁸ With respect to a documentary credit transaction, M.Kurkela correctly observes the following:

“The choice of law made by the parties in one of these relationships does not as such extend to the other contractual relationships which may in turn be governed by another substantive law chosen by the parties thereto or determined by applicable conflict rules. Parts of one facility may thus be governed by different law endangering at least in theory the consistency and uniformity of the decisions in case of disagreement or dispute.”¹⁰⁹

Therefore, in order to discuss issues of applicable law in relation to documentary credits, it is necessary to discuss this according to the various contractual relationships arising from a documentary credit transaction. The ensuing discussion will only focus on three of these contractual relationships which are of most relevance since the existence of any illegality in these contracts may have an effect on payment.

5.7.1 Underlying contract of sale between the buyer and the seller

Since this chapter is based on the submission that illegality in the underlying contract can constitute an exception to the autonomy principle, the contract between the buyer and the seller is of much relevance. For this contractual relationship, the rules that will apply are the general conflict of law rules for contracts.

¹⁰⁸ Since the provisions of the UCP may be excluded, a choice of law clause may also stipulate that in the event of conflict, the law of the chosen jurisdiction is to override that of the UCP.

¹⁰⁹ *Ibid*, 337.

It is good practice for the buyer and seller to include in their agreement a clause specifying their choice of law. The position is a lot more complicated if the contract does not contain an express choice of law. Where there is no express choice of law in the underlying contract, the issue of the governing law for this relationship will have to be resolved by a jurisdiction's normal rules of conflict of law for contractual relationships. In the UK, the rules of the Rome Convention 1980 are to apply to issues of choice of law for contracts entered into after April 1, 1991. Contracts entered into before this date will be governed by the common law. The 1980 Rome Convention is replaced by a European legislative instrument, the European Regulation No 593/2008 (Rome 1) dated 17 June 2008, which is to apply to all contracts entered into after 17 December 2009. Just like the common law, the Convention provides the freedom for parties to a contract to choose the applicable law. They can do so by express words or their choice may be implied by the terms of the contract or the circumstances of the particular case.

At common law, in the absence of an express or implied choice of law, the courts will apply the system of law which it has its closest and most real connection to the transaction. A range of factors are taken into account, including place of performance, place of contracting, and residence of the parties even though generally, in sale of goods cases, there is a tendency to apply the law of the country of shipment.¹¹⁰ Under the Rome Convention 1980, the presumption in Article 4 (2)¹¹¹ is that the contract of sale will be governed by the law of the country where the seller is situated and the same presumption remains under Article 4 (1) of Rome 1.¹¹²

¹¹⁰ See AG Guest and others, *Benjamin's Sale of Goods* (7th edn Sweet & Maxwell, London 2008) Chapter 25, Section 2.

¹¹¹ Article 4 (2) Rome Convention 1980:

Subject to the provisions of paragraph 5 of this Article, it shall be presumed that the contract is most closely connected with the country where the party who is to effect the performance which is characteristic of the contract has, at the time of conclusion of the contract, his habitual residence, or, in the case of a body corporate or unincorporate, its central administration. However, if the contract is entered into in the course of that party's trade or profession, that country shall be the country in which the principal place of business is situated or, where under the terms of the contract the performance is to be effected through a place of business other than the principal place of business, the country in which that other place of business is situated.

¹¹² Article 4 (1) Rome 1:

To the extent that the law applicable to the contract has not been chosen in accordance with Article 3 and without prejudice to Articles 5 to 8, the law governing the contract shall be determined as follows:

(a) a contract for the sale of goods shall be governed by the law of the country where the seller has his habitual residence;...

Unlike English law, for commercial transactions governed by the Uniform Commercial Code, the power of the parties to choose a law is restricted by the requirement that the choice of law should have a reasonable relationship to the transaction. § 1-105(1) UCC provides the following:

Except as provided hereafter in this section, when a transaction bears a reasonable relation to this state and also to another state or nation the parties may agree that the law either of this state or of such other state or nation shall govern their rights and duties. Failing such agreement this Act applies to transactions bearing an appropriate relation to this state.¹¹³

At first sight, the difference between English law and American law may be striking in respect of their treatment of party autonomy. However, in *Vita Food Products Inc. v. Unus Shipping Co. Ltd*¹¹⁴, Lord Wright qualified the parties' freedom to choose a law under English law to a choice of law which is "bona fide and legal" and where there is "no reason for avoiding the choice on ground of public policy".¹¹⁵

5.7.1.1 Foreign illegality

Courts may be confronted with a situation where a documentary credit is opened to guarantee payment for a contract of sale which is governed by English law, but the performance of this underlying contract of sale contravenes the laws of another country. Would this constitute illegality under English law so that, if all the requirements of the illegality exception are established, payment can be refused under the credit? There is authority that the courts will not enforce a contract which is valid by its proper law if the contract violates the law of a friendly state.¹¹⁶ In *Foster v Driscoll*¹¹⁷, the parties agreed in a contract to import whisky into America which contravened the prohibition laws of America. However, the contract concerned was governed by English law. Subsequently, actions were brought in relation to various disputes

¹¹³ Section 187(2) Restatement (Second) Conflicts of Laws (1971) also provides that the expressly chosen law of a contract will apply unless:

"(a) the chosen state has no substantial relationship to the parties or the transaction and there is no other reasonable basis for the parties' choice, or

(b) application of the law of the chosen state would be contrary to a fundamental policy of a state which has a materially greater interest than the chosen state in the determination of the particular issue and which, under the rule of s 188, would be the state of the applicable law in the absence of an effective choice of law by the parties".

¹¹⁴ [1939] A.C. 277.

¹¹⁵ *Ibid*, 290.

¹¹⁶ See *N Enonchong* (n 1) 63.

¹¹⁷ [1929] 1 KB 470.

arising out of the contract. The contract was held to be void “as a matter of public policy based on international comity”¹¹⁸. Sankey LJ said:

“To sum up, in my view an English contract should and will be held invalid on account of illegality if the real object and intention of the parties necessitates them joining in an endeavour to perform in a foreign and friendly country some act which is illegal by the law of such country notwithstanding the fact that there may be, in certain event, alternative modes or places of performing, which permit the contract to be performed legally.”¹¹⁹

This principle was also applied in *Regazzoni v K.C. Sethia Ltd*¹²⁰, where the defendant seller agreed to sell and deliver half a million jute bags from India to Genoa. The parties to the contract contemplated that these bags “would be shipped from India and be made available in Genoa so that the plaintiff might make or fulfil a bargain of resale to a South African buying agency”. As both parties knew, at that time, an Indian ordinance prohibited the export of goods (directly or indirectly) to South Africa. When the seller did not deliver, the buyer brought an action for damages for breach of contract. The House of Lords applied the principle in *Foster v Driscoll*, basing its decision on public policy and international comity. The contract was unenforceable since its performance would involve doing an act in a foreign and friendly State which violates the law of that State.¹²¹

Article 21 of Rome 1 (which is very much the same as Article 16 of the Rome convention 1980) provides that:

The application of a provision of the law of any country specified by this Regulation may be refused only if such application is manifestly incompatible with the public policy (ordre public) of the forum.

¹¹⁸ *Ibid*, 496.

¹¹⁹ *Ibid*, 521.

¹²⁰ [1957] 3 W.L.R. 752.

¹²¹ See also *Ralli Brothers v Compania Naviera*[1920] 2 KB 287 but it is debatable as to whether this case is based on public policy or English domestic law of frustration.

Therefore, the implementation of the Rome Convention does not bring any changes to the common law position. It is important to note that principle established from these cases only applies where there is illegality under the law of the country of performance.¹²²

5.7.2 Contract between the issuing bank and the beneficiary

The issue of applicable law is likely to arise in this contractual relationship if the documentary credit in question is an unconfirmed credit or one where only one bank is involved (with no correspondent bank) since in these circumstances, payment is demanded directly from the issuing bank. This explains why the two cases which are about to be discussed both concerned credits which were unconfirmed.

In *Offshore International SA v Banco Central SA*¹²³, a Spanish contractor (second defendant) opened a standby letter of credit in favour of the plaintiff, which was incorporated in Panama. The credit served as a guarantee for the repayment of the advance payment made by the plaintiff to the Spanish contractor. The first defendant, a Spanish bank issued the credit and a New York bank advised but did not confirm the credit. There was no express provision as to the choice of law. Subsequently a dispute arose and at the hearing of the action, the court had to decide as a preliminary point whether the governing law was the law of New York or Spain. It was held that the governing law was the law of New York since this is where transaction had the closest and most real connection. Even though the letter of credit was opened by the Spanish bank, the credit was opened through a New York bank, payment was to be made in United States dollars and was only to be made against documents presented in New York. Ackner J stated the following:

“...very great inconvenience would arise, if the law of the issuing bank were to be considered as the proper law. The advising bank would have constantly to be seeking to apply a whole variety of foreign laws.”¹²⁴

This decision was applied in *Power Curber International Ltd v National Bank of Kuwait SAK*¹²⁵ which concerned an irrevocable letter of credit opened by a buyer in Kuwait in favour of

¹²² See *N Enonchong* (n 1) 64.

¹²³ [1976] 3 All E.R. 749.

¹²⁴ *Ibid*, 752.

¹²⁵ [1981] 2 Lloyd's Rep. 394.

the seller in America (the plaintiff) for the sale of machinery. The letter of credit was issued by the defendant bank who instructed the Bank of America in Florida, which acted through the North Carolina National Bank in North Carolina. Subsequently, the buyer filed a dispute in Kuwait against the seller regarding a claim for commission - a court order was obtained which prevented the issuing bank from making any further payment under the credit. The seller then issued proceedings in England against the issuing bank for the amount due under the credit. All three judges in the Court of Appeal applied *Offshore International* and came to the conclusion that the proper law was that of North Carolina since it was the place where payment was to be made against the presentation of documents. Lord Denning and Griffiths LJ found that the *lex situs* of a letter of credit is the place where it is payable against documents, rejecting the submission that payment would be unlawful because Kuwait was the *lex situs* of the debt.¹²⁶

When considering the applicable law in the contract between the issuing bank and the beneficiary, it is important to draw a distinction between credits where a correspondent bank is involved (such as in *Offshore* and *Power Curber*) and credits where the issuing bank is the only bank involved. If the issuing bank is the only bank involved, it is the issuing bank which will be accepting documents and making payment directly to the beneficiary. Therefore, in cases where the issuing bank is the only bank involved, the applicable law in this contractual relationship is that of the country of the issuing bank. Hence, the determination of the applicable law in this contractual relationship is dependent on whether a correspondent bank is involved in the transaction.

It is necessary at this stage to determine whether Rome 1 would also lead to the same conclusion. The only case which considered the Rome Convention 1980 is *Bank of Baroda v Vysya Bank Limited*¹²⁷. In this case, an Indian buyer agreed to purchase a consignment of Latvian steel through the seller's London office. A letter of credit was issued by Vysha Bank in India in favour of the seller, Granada. The credit was confirmed by the Bank of Baroda's London office since the seller had a London office. Bank of Baroda paid the beneficiary seller on presentation of

¹²⁶ However, Waterhouse J dissented on the point about the *lex situs* and stated the following at 401: "In the absence of any previous binding authority, I have not been persuaded that this debt due under an unconfirmed letter of credit can be regarded as situate in North Carolina merely because there was provision for payment at a branch of a bank used by the sellers in Charlotte..."

¹²⁷ [1994] 2 Lloyd's Rep 87.

documents but Vysha Bank later refused to reimburse them. Bank of Baroda then brought an action in England against Vysha Bank to seek for reimbursement. The High Court was confronted with issue of the law applicable to the relationship between the confirming bank and the issuing bank (this point will be discussed in the next section) but Mance J also considered, *obiter*, the relationship between a beneficiary and an issuing bank:

“As between the beneficiary and Vysya, the position under Art. 4(2) is that there is a presumption that Indian law applies. This presumption applies, although the performance which is characteristic of the contract is the issue of the letter of credit in London which was to be and was effected in London through National Westminster, initially at least as advising bank, with Bank of Baroda later adding its confirmation. Although such performance was to take place in London, art. 4(2) refers one back, *prima facie*, to India as the place of Vysya's central administration...In the present case the application of art. 4(2) would lead to an irregular and subjective position where the governing law of a letter of credit would vary according to whether one was looking at the position of the confirming or the issuing bank. It is of great importance to both beneficiaries and banks concerned in the issue and operation of international letters of credit that there should be clarity and simplicity in such matters. Article 4(5) provides the answer.”¹²⁸

The learned judge concluded that Article 4(5)¹²⁹ will be invoked to rebut the presumption in Art. 4(2) and concluded that English law applied to the contract between Vysya and the beneficiary. The position remains the same under Rome 1 since Article 4(3) of Rome 1¹³⁰ retains the power of the courts to override the presumption in Article 4(1) and Article 4(2) if it is 'manifestly more closely connected' to another country.

¹²⁸*Ibid*, 93.

¹²⁹ Article 4(5) Rome Convention:

Paragraph 2 shall not apply if the characteristic performance cannot be determined, and the presumptions in paragraphs 2, 3 and 4 shall be disregarded if it appears from the circumstances as a whole that the contract is more closely connected with another country.

¹³⁰ Article 4(3) Rome 1:

Where it is clear from all the circumstances of the case that the contract is manifestly more closely connected with a country other than that indicated in paragraphs 1 or 2, the law of that other country shall apply.

5.7.3 Contract between the confirming bank and the beneficiary

Like the relationship between the issuing bank and the beneficiary, it is assumed that a contract arises between the confirming bank and the beneficiary despite the lack of some of the important features which make up a contract.¹³¹ Following *Offshore* and *Power Curber*, this contract has its closest and most real connection with the country where the branch of the bank at which the payment was to be made to the beneficiary.¹³² Therefore, the applicable law in this contract will be the law of the country of the confirming bank. The position is the same under the Rome Convention 1980¹³³ and Rome I¹³⁴.

5.7.4 Contract between the issuing bank and the correspondent bank

Disputes in this contract are likely to arise because of issues of reimbursement or indemnity. Though this is not strictly within the scope of this chapter, it deserves to be mentioned because such disputes are often triggered by divergent views on the compliance of documents. The system of law which has the closest and most real connection is the law of the country where payment is to be made.¹³⁵ This means that it will be the law of the either the advising bank or the confirming bank.

In *Bank of Baroda v Vysha Bank Limited*¹³⁶, the facts of which have already been discussed¹³⁷, the High Court was confronted with the issue of the law applicable to the relationship between Bank of Baroda (the confirming bank) and Vysha (the issuing bank). On the application of the Article 4(2) of the Rome Convention, Mance J had to consider what performance is characteristic of the contract between the two parties. He reached the conclusion that the presumption in Article 4(2) would lead to the applicable law being that of English law, the law of the place of the confirming bank (Bank of Baroda):

¹³¹ See section 1.4.

¹³² Dicey and Morris, *Conflict of Laws*, 33-312. See also *European Asian Bank v. Punjab and Sind Bank* [1982] 2 Lloyd's Rep. 356; *Mannesman Handel AG v Kaunlaran Shipping Corporation* [1993] 1 Lloyd's Rep 89.

¹³³ *Bank of Baroda v Vysha Bank* [1994] 2 Lloyd's Rep. 87, 92; *Marconi Communications International Ltd v Pt Pan Indonesia Bank Ltd TBK* [2007] 2 Lloyd's Rep. 72, 84; *Bank of Credit & Commerce Hong Kong Ltd v Sonali Bank* [1995] 1 Lloyd's Rep 227, 237.

¹³⁴ Article 4(1) Rome I.

¹³⁵ *Dicey and Morris* (n 132) 33-312; *Habib Bank Ltd v Central Bank of Sudan* [2006] 2 Lloyd's Rep. 412, [44].

¹³⁶ [1994] 2 Lloyd's Rep. 87.

¹³⁷ See page 191.

“...under a contract between an issuing bank and a confirming bank the performance which is characteristic of the contract is the adding of its confirmation by the latter and its honouring of the obligations accepted thereby in relation to the beneficiary. The liability on the part of the issuing bank to reimburse or indemnify the confirming bank is consequential on the character of the contract; it does not itself characterize the contract.”¹³⁸

In addition, he based his decision on the fact that the relationship between issuing bank and conforming bank is one of agency, referring to the following example in the Giuliano-Lagarde Report:

“... in an agency contract concluded in France between a Belgian commercial agent and a French company, the characteristic performance being that of the agent, the contract will be governed by Belgian law if the agent has his place of business in Belgium.”¹³⁹

Where there is no confirming bank but an advising bank, the law of the country of the advising bank would apply since the characteristic performance is the advising of the credit and the handling of the documents¹⁴⁰ or one can reach this conclusion based on the view that the characteristic performance is that of the agent.¹⁴¹ The same conclusions would be reached under Rome 1 since the concept of “characteristic performance” is retained under Article 4(2) Rome 1.

5.7.5 Commentary

It is proposed that only one criterion, which is the place of payment, should be applied to determine the applicable law in the absence of an express choice of law. This would mean that a universal principle will apply to each of the different contractual relationship arising in a documentary credit transaction. This approach would also be consistent with the decision of English courts so far and the writings of authors on the issue of applicable law in relation to the

¹³⁸ [1994] 2 Lloyd's Rep. 87, 91.

¹³⁹ Journal officiel n° C 282 du 31/10/1980 p. 0001 – 0050.

¹⁴⁰ R Jack, *Documentary credits: the law and practice of documentary credits including standby credits and demand guarantees* (4th edn Tottel, Haywards Heath 2009) 406.

¹⁴¹ *Dacey and Morris* (n 132) 33-311.

various contracts under Australian¹⁴² and American¹⁴³ law. Nevertheless, there is contradictory American authority which decided that in the case of an unconfirmed credit, the place of performance is the place of issuance, resulting in the finding that applicable law is that of the country of place of issuance.¹⁴⁴

It may be true that sometimes, as in the case of an unconfirmed credit, the paying bank is not the bank that assumes the primary obligation towards the parties and that the primary obligation in a documentary credit transaction is completed when the issuing bank reimburses the advising bank. However, the primary function of a documentary credit is to pay the beneficiary upon presentation of the documents specified in the conditions of the credit. It is at the advising bank's site that inspection of the documents and payment takes place and therefore the place of payment should be treated as the place of performance. One other argument in favour of the proposition that the applicable law is that of the country of the place of payment is that this would prevent a situation arising where the applicable law of the contract between the beneficiary and the issuing bank is different from that of the contract between the beneficiary and the confirming bank. But this argument is weakened by the fact that the parties may stipulate different applicable laws for the various contractual relationships. R Jack advocates the same approach in relation to contracts between banks (issuing banks/confirming banks) and beneficiaries, arguing that it has the advantage that the banks which are examining the documents are able to apply their own law.¹⁴⁵ The only difference between his submission and the writer's is that the writer argues that this principle should be extended to all contractual relationships arising from a documentary credit transaction.

¹⁴² RN Purvis and R Darvas, *The law and practice of commercial letters of credit, shipping documents and termination of disputes in international trade* (Butterworths, Sydney 1975) 152.

¹⁴³ A N Oelofse, *The Law of Documentary Letters of Credit in Comparative Perspective* (Interlegal, Pretoria 1997) 526.

¹⁴⁴ *Sabolyk v. Morgan Guaranty Trust Co. of New York*, No. 84 Civ. 3179, 1984 WL 1275 (S.D.N.Y.1984) (unpublished decision); *RSB Manufacturing Corp. v. Bank of Baroda*, 15 B.R. 650 (S.D.N.Y.1981); *Chuidian v. Philippine Nat. Bank* 976 F.2d 561.

¹⁴⁵ R Jack, *Documentary credits: the law and practice of documentary credits including standby credits and demand guarantees* (4th edn Tottel, Haywards Heath 2009) 399.

5.8 Conclusion

It is obvious from the preceding discussion that the subject of illegality is riddled with uncertainty and confusion. This chapter has only attempted to examine this subject from one angle which is how the concept of illegality could operate in the context of documentary credit so as to refuse payment.

This chapter has demonstrated the distinction between a scenario where a documentary credit itself is illegal and one where the underlying contract is illegal so as possibly to taint the documentary credit. In the former, it is not open to doubt that payment may be refused without infringing the autonomy principle. In the later, there are strong arguments for the adoption of an illegality exception to the autonomy principle although, it is apparent from the analysis of the relevant decisions that that English courts will apply the illegality defence with much caution, just as with the fraud exception.

There is certainly a need to develop the illegality exception with more defined principles. When considering the illegality exception, the courts should apply the many requirements suggested and considered in great length in this chapter. These suggestions would procure some coherence and confine the scope of the exception. Undeniably, some uncertainty will persist due to the wide ranging circumstances which may face the courts and the need to maintain some flexibility of the law in this area.

It is not uncommon for issues of applicable law to arise in documentary credit transactions. Banks should incorporate a choice of law provision in the credit terms since, as the relevant cases show, the determination of the applicable law in the absence of a choice of law clause is far from simple. In the absence of an express choice of law, it has been contended that in all of the legal relationships arising from a documentary credit transaction, the applicable law is the law of the country of the place of payment. This submission, if accepted, will result in clarity and less confusion.

CHAPTER 6

AN UNCONSCIONABILITY EXCEPTION?¹

6.1 Introduction

Instruments which share similar characteristics to the documentary credit are the performance bond, demand bond, demand guarantee or performance guarantee. These instruments will be referred to in this study as “independent guarantees”, a term adopted by the UNICITRAL Convention of Independent Guarantees and Stand-by Letters. The characteristic of these instruments will be explained following this introduction, but it should be mentioned here that despite the similarities to the documentary credit, they perform an entirely different function, one which is the same as that served by the standby letter of credit, a subject which has been introduced in Chapter 1.² These instruments, just like the documentary credit, can dangerously expose an applicant to unfair calls. The UNCITRAL Convention contains stipulations to deal with this issue but the convention itself has not been ratified by many countries.³

In recent years, a few common law legal systems have adopted the concept of unconscionability as a ground for withholding payment in independent guarantees. It is important to observe any promising trends in the law of other jurisdictions since useful recommendations and guidance could be obtained from such an insight. This chapter has two objectives: to trace the development of the concept of unconscionability in independent guarantees and to examine whether unconscionability should be an additional and distinct ground for which payment under a documentary credit can be withheld.

¹ A version of this chapter has been published – Hang Yen Low, “Unconscionability as a Ground for Withholding Payment in Demand Guarantees: Should the exception be Extended to Letters of Credit” [2008] M.L.J.Supp. clxxxiii.
² See 1.6.9.

³ Only Belarus, Ecuador, El Salvador, Gabon, Kuwait, Liberia, Panama, Tunisia has ratified the convention – “Status of 1995 United Nations Convention on Independent Guarantees and Stand-by Letters of Credit” <http://www.uncitral.org/uncitral/en/uncitral_texts/payments/1995Convention_guarantees_status.html>accessed 30th November 2009.

The chapter will begin with a brief explanation of independent guarantees. Following that, the analysis will begin with a detailed examination of how various common law jurisdictions have used the concept of unconscionability to restrain payment in independent guarantees. This will be followed by a discussion of any similar development in English common law. Next the writer will consider the advantages and disadvantages of applying the unconscionability concept to documentary credits. Finally, the writer investigates to what extent the documentary credit resembles the independent guarantee for this purpose.

6.2 Independent Guarantees

An independent guarantee is an undertaking given by a bank to pay a sum of money to a beneficiary in the event that the applicant fails to perform as promised.⁴ It is not within the scope of this study to provide a detailed account of the operation of the instrument and the various types of independent guarantees.⁵ However, independent guarantees can be categorised into two main types. This is best explained by one prominent writer on this subject:

“The first type secures financial obligations and guarantees such as those of the buyer in respect of the purchase price arising from a contract of sale, or those of the employer for the payment of installments in connection with a construction contract, or those of the borrower for payment of principal sum and interest arising from credit facilities...The second type of guarantees provides security for non-financial

4 Article 2(1) UNCITRAL Convention of Independent Guarantees and Stand-by Letters provides a more detailed explanation:

“For the purposes of this Convention, an undertaking is an independent commitment, known in international practice as an independent guarantee or as a stand-by letter of credit, given by a bank or other institution or person ("guarantor/issuer") to pay to the beneficiary a certain or determinable amount upon simple demand or upon demand accompanied by other documents, in conformity with the terms and any documentary conditions of the undertaking, indicating, or from which it is to be inferred, that payment is due because of a default in the performance of an obligation, or because of another contingency, or for money borrowed or advanced, or on account of any mature indebtedness undertaken by the principal/applicant or another person.”

5 For a detailed account, see Roeland Bertrams, *Bank Guarantees in International Trade* (3rd edn Paris; New York, ICC Publication 2004).

obligations such as those of the seller for the delivery of goods, or those of the construction firm for the completion of the project.”⁶

In the event that the applicant defaults on performance, the beneficiary will need to present the documents specified in the guarantee to obtain payment. However, these instruments are often payable on presentation of only a written demand, without the need for additional documents proving default. There is nearly no difference between an independent guarantee and the standby letter of credit in terms of the applicable legal rules and the purpose they serve.

6.3 Recent Developments in Common law Systems

The courts in Singapore, Malaysia and Australia had all adopted an unconscionability exception in relation to independent guarantees and standby letters of credit. It is important to examine the approach of these courts before making any recommendations.

6.3.1 Singapore

In Singapore, a line of cases involving performance bonds establishes the position that fraud is not the sole ground for restraining payment. In *Royal Design Studio Pte Ltd v Chang Development*⁷, the plaintiff agreed to construct nine units of three- storey terrace houses for the defendant. Under the agreement the plaintiff would provide a performance bond of \$165,000 to the defendant, but subsequently this amount was reduced to \$120,000. A dispute arose between the parties and the plaintiff then obtained an injunction restraining the defendant from calling on the performance bond. An application for discharging the injunction was refused. In arriving at his decision, the judge considered various matters:

- a. The plaintiff had carried out a substantial part of the construction of the nine units of the terrace houses but could not proceed with the construction of the houses because the

⁶ *Ibid*, 37.

⁷ [1991] 2 MLJ 229.

defendant refused to make interim payments and the defendant's architect did not issue any further interim certificate.

- b. Under the agreement the plaintiff, on completion of the construction and issue of the temporary occupation licence, would be entitled to the 3½ units of the houses, and these 3½ units had been sold for a total amount of \$1.575m. The sales were made by the defendant and were yet to be completed, and the legal ownership of these units was still vested in the defendant. The defendant had paid to the plaintiff only \$948,021.21 and a considerable sum of money was still in the hands of the defendant, which, if upon resolution of the dispute, the plaintiff was found liable to pay damages to the defendant for breach of contract, could be applied by the defendant to set off such damages payable.
- c. Pursuant to the agreement, the director of the plaintiff had issued a personal guarantee to the defendant in the sum of \$1m and there was no suggestion that this guarantee was worthless.

There was no allegation or finding of fraud in this case. The decision departs from the English position where an injunction can only be granted in circumstances where fraud is established.

In *Kvaerner Singapore Pte Ltd v UDL Shipbuilding (Singapore) Pte Ltd*⁸, the defendant purchased a pumping and valve control system for \$1,000,000 from the plaintiff. Pursuant to the contract, the defendant paid a deposit of \$300,000 but subsequently did not open a letter of credit for the remainder of the purchase price as required under the contract. The plaintiff delivered to the defendant a performance bond for 30% of the price. The defendant subsequently demanded payment under the performance bond. The plaintiff applied for and obtained, ex parte, an injunction restraining the defendant from receiving payment under the performance bond. Selvam JC stated that: "The credit was also a condition precedent to the right to call on the performance bond. And it failed to fulfill the condition precedent. Accordingly it was eminently just and convenient to restrain a party from taking advantage of his own wrong."⁹ Approving of Eveleigh LJ's obiter dictum in *Potten Homes v Coleman Contractors Ltd*¹⁰, he was of the opinion that the fraud exception is "not an immutable principle of universal application" and "has no application

8 [1993] 3 SLR 350.

9 *Ibid*, 353.

10 (1984) 28 Build LR 19.

where the injunction is sought against a party to the underlying contract who seeks to take advantage of the performance guarantee where by his own violation he fails to perform a condition precedent.”¹¹

The door to a major breakthrough was really only opened in *Bocatra Construction Pte Ltd v Attorney General (No 2)*.¹² The appellant in this case was appointed by the Public Works Department (PWD) as contractor for certain works. They provided a performance guarantee but did not complete the works in time. Disputes arose and the parties subsequently referred them to arbitration. The PWD notified the bank and the appellant of their intention to call on the guarantee. The appellant obtained an interim order from the arbitrator but this was later set aside by the High Court. The appellant further appealed to the Court of Appeal seeking, *inter alia*, a declaration that the defendant was not entitled to call on the performance guarantee until the disputes were resolved by arbitration.¹³ In the Court of Appeal, Karthigesu JA rejected the approach in *Potten Homes* and *Royal Design* which suggested that “...the courts in exercising its equitable jurisdiction to grant an injunction restraining a call or payment on performance bonds, should not be precluded from adopting a broad approach, if the facts warrant it, to examine disputes relating to the underlying transaction.”¹⁴ Rejecting the appellants’ submissions, he asserted that, “...there is no distinction between the principles to be applied in cases dealing with attempts to restrain banks from making payment or those dealing with restraint of calls from calling for payment.”¹⁵ He further went on to emphasise that, “Whether there is fraud or unconscionability is the sole consideration in applications for injunctions restraining payment or calls on bonds to be granted.”¹⁶ However, the appellant did not allege that the government had acted without honest belief in its entitlement to make a call and therefore the appeal was dismissed.

11 [1993] 3 SLR 350, 353.

12 [1995] 2 SLR 733.

13 Under s 27(1)(b) Government Proceedings Act (Cap 121, 1985 Rev Ed), the appellant could only seek a declaration as to the rights of the parties but could not seek an injunction against the government.

14 *Bocatra* (n 12) 743.

15 *Bocatra* (n 12) 744.

16 *Bocatra* (n 12) 746.

There are two possible ways to interpret this decision:

1) Due to the express reference to unconscionability throughout the judgment, it could be that the court attempted to introduce unconscionability as an additional ground for restraining a call or payment on a bond. Although unconscionability was not accorded a full discussion in this case, one may assume that this was because the facts did not require it.

2) It could be that the court never intended to introduce unconscionability as a new ground. A detailed analysis of the judgment reveals that Karthigesu JA used the term “unconscionability” interchangeably with fraud. The parameters of the notion of unconscionability were not discussed at any point and no reasons were given as to why unconscionability should be an additional ground for injunctive relief. In fact, the approach adopted by the court in this case was not to investigate the facts relating to the underlying transaction. As observed by Adrian SP Wong, “The judgment was specifically tailored to dispel the notion that fraud was not the sole ground for an interim injunction.”¹⁷ Therefore, following this interpretation, *Bocatra* does not depart from the English position.

In *Raymond Construction Pte Ltd v Low Yang Tong and AGF Insurance (Singapore) Pte Ltd*¹⁸, the plaintiff undertook to build a house for the first defendant. Pursuant to the contract, the plaintiff procured for the first defendant a performance guarantee. There was a dispute subsequently and the first defendant called on the performance guarantee. The plaintiff obtained an injunction restraining the second defendant (the guarantor) from paying and the first defendant from receiving the sum. The first defendant subsequently applied to discharge the injunction. There was no evidence of fraud but Lai J was of the opinion that the plaintiff had provided considerable evidence that the first defendant acted unconscionably. He granted the interim injunction solely on the ground of unconscionability and very much influenced by the following facts:

- a. There was strong evidence that the first defendant would postpone meeting his financial commitments by employing various tactics, including the frequent drawing of defective

¹⁷Adrian SP Wong, ‘Restraining a Call on a Performance Bond: Should Fraud or Unconscionability be the New Orthodoxy?’ (2000) 12 SAcl.J 132.

¹⁸High Court Suit No. 1715 of 1995, 11 July 1996, unreported.

cheques and delays in his payments. There were also several bankruptcy notices issued against him and some outstanding amount for the architect's fees for the project which were not settled.

- b. An interim claim by the plaintiff which amounted to 30% of the contract price was not paid.
- c. The first defendant had requested the architect to withdraw a previous certificate of interim payment which was validly issued by the architect. The architect had no choice but to terminate his services.
- d. The first defendant had obstructed the plaintiff's work. He did not choose the marble, repeatedly changed his mind with respect to the marble newel post, kept changing the curvatures of the cornices, delayed his responsibility of the construction of the culvert to the house (which consequentially delayed the plaintiff's work) and prevented the plaintiff from installing the extra water tank by alleging trespass.
- e. The claims for damages were disproportionately high.

The High Court of Singapore seems to have adopted the first interpretation of *Bocatra* in this case since it cited *Bocatra* as the authority for the proposition that unconscionability can be a ground on which payment under a performance guarantee can be stopped.

In *New Civilbuild Pte Ltd v Guobena Sdn Bhd & Another*¹⁹, the law took a U-turn when unconscionability was expressly rejected by Lee JC as a separate ground for preventing the enforcement of a performance bond. After a thorough review of *Bocatra*, the learned judge adopted the second interpretation and stated the following:

“At no point did the court in *Bocatra* discuss the scope of this concept of unconscionability...I do not understand the court as having changed without a discussion of the basis for it. Given that the Court of Appeal had stated that the weight of authority

19 [1999] 1 SLR 374.

had suggested that fraud as the sole exception was well entrenched, I do not understand the court as having changed the law without a discussion of the basis for it.”²⁰

After a review of the leading English cases cited in *Bocatra*, he concluded that none of the cases were decided on the basis of unconscionability and that he was unable to find the term unconscionability mentioned in any of the cases.

Soon after *Civilbuild* was decided, unconscionability made a comeback in *Min Thai Holdings Pte Ltd v Sunlabel Pte Ltd*²¹. In *Min Thai*, the first defendant agreed to buy rice from the second defendant. The second defendant’s rice was supplied by the plaintiff from China. Under the contract, the plaintiff was to procure a performance guarantee in favour of the first defendant, payable upon default of delivery. Severe flooding took place in China causing the plaintiff to default on its delivery. The first defendant made a demand for payment under the performance bond even though the parties were at that point in the midst of discussing a solution. The plaintiff obtained an injunction from Rajendran J on the grounds that it would be unconscionable for the first defendant to enforce the performance guarantee. On appeal by the first defendant, Lai J upheld the injunction. In his finding of unconscionability, he took into account the following matters:

- 1) There was still a dispute about whether there was a breach of contract for failure to ship.
- 2) There was an issue as to whether the plaintiff’s performance of the contract was affected by force majeure.
- 3) As between the first defendant and the second defendant, there was a dispute as to the applicability of the ICC Force Majeure Conditions.
- 4) There was evidence that the plaintiff had attempted to find alternative sources, albeit of a lower grade, which admittedly the first defendant could reject.

²⁰ *Ibid*, [33]-[35].

²¹ [1999] 2 SLR 368.

He was of the opinion that the first defendant was perfectly entitled to make that call since there was an expiry date, but should have in all good conscience offered that the money remain in the bank pending the resolution of the disputes between the parties.²²

The real leap in the law came in *GHL Pte Ltd v Unitrack Building Construction Pte Ltd*.²³ In this case, the appellant (GHL) engaged the first respondent (Unitrack) to be the main contractors in the construction of a five-storey boarding house. The contract sum for the project was S\$5,781,400 which included a sum of S\$3,820,000 for sub-contractors' works. Pursuant to the contract, the Unitrack procured the issue of a performance bond from the second respondent (AFG Insurance Pte Ltd) for an amount equaling 10% of the contract sum. Unitrack kept the performance bond and did not deliver it to GHL. Subsequently, there was a written variation to the contract whereby it was agreed that the GHL would pay the sub-contractors directly and the contract sum would become S\$1,961,400. A dispute then arose and GHL purported to call on the performance bond. The Unitrack obtained an interim injunction against GHL and the bank. On appeal to the High Court, Rubin J found that there was no evidence of fraud on the part of GHL but affirmed the order on the basis that "the present endeavour by GHL to enforce a bond which it did not even bother to take possession of, was unjustifiable as well as unconscionable". On further appeal, the Court of Appeal dismissed the application. The Court of Appeal explicitly held that in the absence of fraud, unconscionability alone could constitute a ground for restraining a beneficiary from enforcing his rights to call for payment under a performance bond. It was held that the GHL's conduct was unconscionable because 10% of the revised contract sum amounted to only \$196,140 but the GHL was calling on the performance bond for the full amount of \$578,140 which represented 30% of the revised contract sum.

LP Thean JA, delivering the judgment of the Court of Appeal, noted that the term unconscionability was referred to in *Bocatra* on no less than three occasions and stated that:

"The concept of unconscionability was adopted after deliberation and not inadvertently as a result of a slip; nor was it intended to be used synonymously or interchangeably with

²² *Ibid*, [28]. As the writer comments later on in the article, this seems to take a rather broad view of what constitute unconscionability.

²³[1999] 4 SLR 604.

fraud. There is nothing in the judgment which can be said to indicate or suggest that the Court did not decide that unconscionability alone is not a separate ground as distinct from fraud. We accept that to that extent *Bocatra* is a departure, and if we may respectfully say so, a conscious departure, from the English position.”²⁴

The learned judge confirmed that *Royal Design* was decided on the ground of unconscionability although there was no express mention of the term unconscionability in that case. *Kvaerner* was confirmed as being decided partly on the ground of unconscionability and does not strictly comply with the fraud exception principle established in English cases.²⁵ The decision in *New Civilbuild* was expressly disapproved for the reasons mentioned above but *Raymond Construction* and *Min Thai* were cited with approval.

In *GHL*, LP Thean JA also approved of *Chartered Electronics Industries Pte Ltd v The Development Bank of Singapore*²⁶ although the case was not expressly referred to in *Bocatra*. In this case, the plaintiffs entered into a contract with overseas buyers for the supply of certain articles and, as security for the performance of the contract, the defendant bank at the instance of the plaintiffs issued a performance guarantee. A dispute subsequently arose. While the dispute was still in progress, the buyers called on the bond and the plaintiffs obtained *ex parte* two interim injunctions against the defendant bank, restraining them from paying on the guarantee. In *Chartered Electronics*, there was no evidence that the buyers made complaints about the delays in shipments or defects in the goods.²⁷ Chan J stated that:

“In the circumstances, there was strong evidence that the demand for payment of US\$407,040 under the performance guarantee was not made bona fide. There was no way that the buyers could have justified the demand for the amount since they had retained the second shipment valued at UD\$759,740.16.”²⁸

24 *Ibid*, [16].

25 *GHL* (n 23), [20].

26 [1999] 4 SLR 655.

27 With the exception of the second consignment, even so, the complaints were vague.

28 *Chartered Electronics Industries* (n 26), [45].

Chan J concluded that the plaintiffs had more than satisfied the test of a strong case of fraud and upheld the injunctions. But later, the Court of Appeal in *GHL* took the view that the term fraud was used in *Chartered Electronics* in a somewhat broad sense and not strictly in the sense applied in English cases. “Fraud in the common law sense involves more than mere absence of bona fides in the claim. It implies an element of deceit on the part of the beneficiary, that is to say a case where the beneficiary presents a claim on the performance bond which he knows at that time to be invalid or false.”²⁹ In effect, the Court of Appeal in *GHL* was saying that the decision in *Chartered Electronics* was not based on fraud but based on the ground of unconscionability.

The decision in *GHL* has an acute impact on the law in this area while at the same time clarifying the uncertain effect created by previous decisions of the Singaporean courts.

6.3.2 Malaysia

At one point in Malaysia, the law appeared to have also caught up with the development of the concept of unconscionability. In *Bains Harding (Malaysia) Sdn. Bhd v Arab-Malaysian Merchant Bank Bhd*³⁰, the plaintiff contracted with the defendants to carry out certain insulation and painting works as subcontractor to the defendants. Pursuant to the contract, two performance guarantees were issued by the plaintiff. The defendants subsequently terminated the contract pursuant to Art 20 of the contract which provided that the contractor had a right at any time, for any reason and at its absolute discretion to terminate the contract for convenience by notice in writing. It was not alleged by the defendants that the plaintiff was in default in its performance of the works. The plaintiff’s work was passed on to Meisei Corporation and the defendants demanded that the plaintiff pay its creditors (the lower-tier subcontractors), failing which the defendants would seek payment under the guarantees. The plaintiff argued that the defendants had terminated the contract because it had a financial connection with Meisei Corporation and that the guarantee was called on to pay off the lower-tier subcontractors so that Meisei Corporation could continue to utilise them to complete the works.

²⁹ *GHL* (n 23), [21]. *GNK Contractors Ltd v Lloyds Bank* (1985) 30 Build LR 48, 63 was cited as authority.

³⁰ [1996] 1 MLJ 425.

Richard Talalla J granted an interlocutory injunction to the plaintiff to restrain the defendants from receiving payment under the guarantees on the basis that the defendants were “guilty of fraud, have acted in bad faith and in an unconscionable manner”.³¹ It may be that the granting of the injunction was based on the fraud exception despite the reference to unconscionability. Richard Talalla J perhaps used the terms ‘fraud’ and ‘unconscionable manner’ interchangeably, without according them different meanings, like Karthigesu JA in *Bocatra*. However, the case can be construed as not being decided on the ground of fraud but on the ground of unconscionable conduct.³² The fraud exception in relation to independent guarantees traditionally encompasses the situation where the beneficiary presents a claim which he knows at the time to be an invalid claim. In other words, where there is either a fraudulent presentation of documents or the request for payment is made fraudulently under circumstances when there is no right to payment.³³ However, in this case, Richard Talalla J found fraud on the part of the defendants on the basis that they terminated the contract so that the plaintiff’s work could be passed on to Meisei Corporation, which could then benefit from the profits remaining from the contract. In his finding of fraud, he was also influenced by the defendants’ refusal to tell the court whether one or more of the defendants had an interest in Meisei, their refusal to disclose details of the contract with Meisei and that no reasons were given for such refusal. This is not within the scope of the fraud exception as understood from previous cases.

Another Malaysian case where unconscionability was expressly adopted as a ground for restraining payment is *The Radio and General Trading Co Sdn Bhd v Wayss & Freytag*³⁴. The plaintiff had contracted with the defendant to perform certain sub-contract works on the KL Telecommunication Towers. In accordance with the terms of the contract, the plaintiff furnished a performance bond for 30% of the sub-contract sum in favour of the defendant. Subsequently disputes arose over the completion of works which led to the defendant making a demand for payment under the performance bond. The plaintiff sought an injunction restraining the defendant from calling on the performance bond. The plaintiff alleged that it had substantially completed

31 *Ibid*, 443.

32 *Adrian SP Wong* (n 17) 160.

33 This is well established following *Edward Owen Engineering Ltd v Barclays Bank International* [1978] 1 Q.B. 159.

34 [1998] 1 MLJ 346.

the sub-contract works and that the unfinished portion was due to the defendant and their sub-contractors failing to complete their work on time and the variations requested by the defendant. Therefore, it was argued that the defendant did not have a right to call on the bond.

Kalamanathan JC adopted the approach of looking at the facts relating to the call on the performance bond. He found the call to be inequitable and was very much influenced by the fact that whilst the defendant had alleged that the works have not been completed, the plaintiff was able to produce a letter from the defendant to its architect giving notice that the works had been substantially completed and requiring them to issue a certificate of practical completion. Citing *Bocatra* as the authority that unconscionability is a ground for restraining payment, he found it unconscionable on the part of the defendant to call on the bond. He further stated that,

“In the circumstances and in line with the (then) Supreme Court decision in *Esso Petroleum Malaysia Inc v Kago Petroleum Sdn Bhd*³⁵, I hold that while an injunction cannot be issued against a bondsman, the plaintiff could not be prevented from applying for an interlocutory injunction against the beneficiary of the bond.”³⁶

Here, he is drawing a distinction between restraining a bank from paying and restraining the beneficiary from calling for payment. He is effectively saying that the unconscionable exception can only apply to injunctions restraining a beneficiary from calling on a bond. However, this conflicts the judgment of Karthigesu JA in *Bocatra* where it was expressly stated that the same principles apply for the two.³⁷

Subsequently, the unconscionability exception was not adopted by other high courts of Malaysia.³⁸ The development was halted by the decision of the Court of Appeal in *LEC Contractors (M) Sdn Bhd v Castle Inn Sdn Bhd*³⁹. In this case, the plaintiff had contracted with

35 [1995] 1 MLJ 149, 157.

36 *Radio and General Trading* (n 34) 357.

37 [1995] 2 SLR 733, [34].

38 *Transfeld Projects (M) Sdn Bhd v. Malaysian Airline System Bhd* [1999] 428 MLJU 1; *Murni Builders Sdn Bhd v. Legends Golf & Country Resort Bhd* [1999] MLJU 441.

39 [2000] 3 MLJ 339.

the first defendant to construct and complete a hotel and office development. Following the terms and conditions of the contract, the plaintiff procured a performance bond from the second defendant bank in favour of the first defendant. A dispute arose, prompting the plaintiff to demand arbitration proceedings. In the meantime, the plaintiff also took out a writ for a declaratory order and applied for an injunction to restrain the first defendant from demanding the RM4.8m from the second defendant under the performance bond. The trial judge refused to grant an injunction and the plaintiff appealed. The appeal was based in part upon the submission that the first defendant was guilty of fraud/unconscionable conduct because:

- The first defendant demanded payment under the bond when he was himself in breach
- The first defendant did not disclose to the second defendant the material fact that that the plaintiff was relieved from further performance of the contract following the termination of the contract.
- The first defendant had attempted to demand the payment of RM4.8m without going to arbitration or without adjudication by the courts of the disputes.

In the Court of Appeal, M Sidin JCA dismissed the submission on the following grounds:

“First of all we wish to point out that the authorities we have referred to above clearly indicated that in order to justify any injunction to stop payment there must be clear evidence of fraud on the part of the first defendant which comes to the knowledge of the second defendant. Bad faith or unconscionable conduct by itself is not fraud. The examples given by the authorities above are those where from the very beginning there was intention to defraud the bank such as where the seller from the beginning had the intention not to send the goods to the buyer. This is not the case here. In the present case, a genuine contract had been executed between the parties upon which the performance bond was given. From the record it is clear that works under the contract had commenced but then disputes between the parties arose and as a result of that the first defendant demanded payment under the performance bonds.”⁴⁰

⁴⁰ *Ibid*, 17.

It should be pointed out that the Court of Appeal did not at any point consider the two previous authorities, *Bains Harding* and *The Radio* even though they had been cited.⁴¹ The dictum in *LEC* obviously conflicts with that of the two previous cases but these decisions were not binding upon the Court of Appeal. The non-reference to the two previous authorities in the judgment may be explained by the fact that an approach of not referring to previous non-binding authorities, even when a decision has the effect of overruling previous decisions, is an acceptable judicial practice in Malaysia.⁴² With due respect, the judgment is disappointing in that it merely asserts the position that payment can be restrained only where there is evidence of fraud. Nowhere in the judgment was any explanation offered as to why unconscionability could not be a ground to restrain a call on a performance bond.

6.3.3 Australia

In Australia, the Trade Practices Act 1974 (TPA) exists to prevent anti-competitive conduct in business, and to provide for the protection of consumers from unfair commercial practices. The act gives some rights for private action with the Australian Competition and Consumer Commission being responsible for monitoring and enforcing activities under the Act. Part IV of the Act is comprehensive and far-reaching as it prohibits anti-competitive conduct of various kinds such as collusive agreements, misuse of market power, exclusive dealing and mergers that substantially lessen competition in a market. Despite various criticisms, the Act was amended in 1992 to introduce a new Part IVA entitled unconscionable conduct. Unconscionable conduct is prohibited by the TPA in both commercial dealings (s. 51AA and s. 51AC) and in consumer transactions (s. 51AB).

Two important decisions have since emerged, applying the provisions in the Act to find unconscionability in commercial transactions. However, even before these decisions, unconscionability had actually been considered in relation to independent guarantee and documentary credit transactions. In *Hortico (Australia) Pty Ltd v. Energy Equipment Co*

41 Private information.

42 Although such an approach is almost never taken by English judges.

(Australia) Pty Ltd, Young J expressed his view that “...in some cases the unconscionable conduct may be so gross as to lead to the exercise of the discretionary power.”⁴³ In *Inflatable Toy Company Pty Ltd v State Bank of NSW*, he again noted that, “...it is still wise to keep open the possibility that unconscionable conduct may be an exception.”⁴⁴

In *Olex Focus Pty Ltd v Skodaexport Co Ltd*⁴⁵, the plaintiff agreed to undertake certain works for the defendant (the head-contractor) on a pipeline that was being built in India. The defendant was required to pay the plaintiff certain advances. As security for the repayment of these advances by the plaintiff to the defendant, the plaintiffs provided unconditional bank guarantees known as mobilisation guarantees. The plaintiff also provided performance bonds by way of bank guarantees to the defendant to secure performance of their work. A dispute arose as to whether the work was properly done by the plaintiff despite certain delays. The defendant later threatened it would make a demand on the bank to pay amounts due under the guarantees that were provided unless the plaintiff reduced the outstanding amount for work done. The plaintiffs sought interlocutory injunctions to countermand the demands made, to restrain the defendant from making any further demand under any of the guarantees, and to restrain the bank from making any payment pursuant to any of the guarantees under:

- a) the general law, claiming that the threats amounted to fraud
- b) s. 51AA of TPA⁴⁶, claiming unconscionable conduct

Batt J held that the plaintiff was not entitled to any injunction under the general law as they did not establish a clear case of fraud. As for the allegations of unconscionability under s. 51AA, he distinguished the performance bonds from the mobilisation guarantees in his analysis. He declined to grant an injunction in respect of the performance bonds on the ground of unconscionability within the meaning of s. 51AA. After considering the nature and function of performance bonds, he was of the opinion that the calling of a performance bond in order to exert

43 (1985) 1 NSWLR 545, 554.

44 (1994) 34 NSWLR 243, 251.

45 [1998] 3 VR 380.

46 Section 51AA of Trade Practices Act 1974 provides the following:

(1) A corporation must not, in trade or commerce, engage in conduct that is unconscionable within the meaning of the unwritten law, from time to time, of the States and Territories.

(2) This section does not apply to conduct that is prohibited by section 51AB or 51AC.

commercial pressure on the account party so as to achieve an advantageous settlement of a dispute is not in itself unconscionable.⁴⁷

But in the case of the mobilisation guarantees the position was different. Ninety percent of the advances guaranteed had already been repaid. However, all the guarantees were called up at once even though the beneficiary's interest would have been protected by a partial demand or by a full demand under one of the guarantees. After examining the mobilisation advance guarantees, he stated that the "...defendant's conduct based on its legal rights, or on its perception of its legal rights, so far as that conduct relates to the mobilisation or procurement advance guarantee is, according to ordinary human standards, quite against conscience."⁴⁸ By calling on more money than was needed to protect itself, the defendant was abusing its position in the context of the Act and therefore an injunction was warranted. He granted an injunction, but this was limited to an amount equaling the advances that had already been repaid. The beneficiary was free to call upon the bonds for the amounts that had not been repaid. In other words, the injunction was constrained to something like \$5.2 million of the \$6.2 million outstanding under the mobilisation procurement guarantees. On appeal, the Court of Appeal refused to grant an injunction in respect of the performance bonds. Significantly, it was observed in this case that the effect of the legislation "is to work a substantial inroad into well-established common law autonomy of letters of credit and performance bonds and other bank guarantees".⁴⁹

In *Boral Formwork v Action Makers*⁵⁰, the defendant supplied scaffolding equipment to the plaintiff. Pursuant to the contract, the defendant was furnished with a standby letter of credit by the plaintiff. The equipment supplied was defective. The plaintiff wrote to the defendant's receivers setting out details of the defects and stating their preference of option (b) in clause 24.13, which permitted the plaintiffs to remedy the defects themselves and deduct the cost of doing so from the price. The receivers did not reply. The plaintiff performed remedial works and then sought an undertaking from the receivers that they would not exercise their rights under the

47 The judgments in *Woodhall Ltd v Pipeline Authority* (1979) 141 CLR 443 and *Burleigh Forest Estate Management Pty Ltd v Cigna Insurance Australia Ltd* [1992] 2 Qd R 54 support this view.

48 *Olex Focus* (n 45) 404.

49 *Olex Focus* (n 45) 404.

50 [2003] NSWSC 713.

credit. The receivers subsequently made a demand upon the bank under the credit for the full amount. The plaintiff sought to restrain the receivers from calling for payment and the issuer of the standby credit from paying out any amount in excess of the undisputed amount on the following grounds:

- a) The agreement contained an implied negative stipulation to the effect that the beneficiary will not call upon the financier to meet its obligation if there is a bona fide dispute between the beneficiary and the applicant. This was found to be absent here.
- b) The receivers acted unconscionably contrary to s. 51AA⁵¹ and s. 51AC⁵² of the TPA in demanding for payment.

By failing to respond to the plaintiff's correspondences, Austin J held that the defendants were estopped from denying that option (b) under clause 24.13 was selected.⁵³ The effect of the section was to bring into the statutory regime of the act the general equitable concepts of unconscionability. Therefore, the issue was whether the conduct in question was unconscionable within the meaning of the unwritten law of the New South Wales. Austin J observed that the principle of autonomy cannot override the statute.⁵⁴ He considered the decision in *Olex Focus*, but was of the opinion that although some of the considerations in *Olex Focus* were relevant, the plaintiff's claim to unconscionable conduct went beyond the matters considered in previous cases. "This is not just a matter of calling upon the irrevocable instrument in order to apply pressure to settle a dispute. It is a case where, effectively, the dispute had been settled by virtue of the administrative receivers' acquiescence in Boral undertaking repairs after its letter.....and then later, notwithstanding that acquiescence, Action Makers made a call on the letter of credit as if all those circumstances had not occurred."⁵⁵ He decided that it would be appropriate to make declarations and orders under s. 51AA.

51 Section 51AA Trade Practices Act 1974 (n 46).

52 Section 51AC(1) of Trade Practices Act 1974 provides the following:

A corporation must not, in trade or commerce, in connection with:

- (a) the supply or possible supply of goods or services to a corporation (other than a listed public company); or
- (b) the acquisition or possible acquisition of goods or services from a corporation (other than a listed public company);

engage in conduct that is, in all the circumstances, unconscionable.

53 *Boral Formwork* (n 50) [57].

54 *Boral Formwork* (n 50) [74].

55 *Boral Formwork* (n 50) [82].

Despite objections by the defendants, Austin J concluded that s.51AC applied. He concluded that since the dispute was effectively over and the disputed amount was no longer owed, it was unconscionable for the defendant's receivers to use their rights under the standby credit by certifying for payment of the whole amount. Since s 51AA(2) provides that s 51AA is not to be applied to conduct that is prohibited by s 51AC, he granted relief under s 51AC.

The decisions in *Olex Focus* and *Boral Formwork* triggered an alarm for all parties involved in such commercial transactions in Australia. In particular, commentators are most concerned with the diminution of the autonomy principle which serves the purpose of maintaining the commercial utility of such instruments.⁵⁶ Despite these concerns, this development seems settled in Australia now, with the Federal Court of Australia confirming in two recent cases that unconscionable conduct constitutes a ground to restrain payment (although there was no finding of unconscionable conduct on the facts of these cases).⁵⁷

Interestingly, one of these cases relates to a documentary credit. In *Orrcon Operations Pty Ltd v Capital Steel & Pipe Pty Ltd*⁵⁸, Orrcon opened a documentary credit in favour of Capital Steel which is to supply steel pipe to Orrcon, which would in turn supply them to the State of Queensland. Orrcon subsequently claimed that the goods delivered were defective because they did not comply with the specification.⁵⁹ Orrcon sought for injunctions against various parties⁶⁰ from making a call or making payment, claiming that Capital Steel was guilty of unconscionable conduct within s 51AA of the TPA on the basis that:

“1. Capital Steel's knowing failure to deliver steel pipe that complied with the specification ...;

56 Jeffrey J Browne, 'The Fraud Exception To Standby Letters Of Credit In Australia: Does It Embrace Statutory Unconscionability?' (1999) Bond L R 98; Healey D, 'Unconscionable Conduct in Commercial Dealings' (1993) 1 TPLJ 169.

57 *Clough Engineering Limited v Oil and Natural Gas Corporation Limited* [2008] FCAFC 136; *Orrcon Operations Pty Ltd v Capital Steel & Pipe Pty Ltd* [2007] FCA 1319.

58 *Orrcon* (n 57).

59 It was alleged that the pipes were not compliant in two ways:

- a. They did not have the reduced minimum specified mechanical properties because the yield strength of the pipe was consistently less than specified.
- b. The yield strength of the coils from which the pipes were manufactured were significantly variable through each coil.

60 In *Orrcon*, Capital Steel had assigned the proceeds of the credit to the advising bank.

and

2. Capital Steel making and seeking to rely on the first, second and third purported drawings down on the letter of credit; and

3. Capital Steel doing those things in circumstances where it lacked the financial capacity to repay those drawings down.”⁶¹

Besanko J was prepared to accept that a seller who presents documents under a credit with a level of knowledge about the goods and whether they comply with the contract could constitute unconscionable conduct within s 51AA.⁶² However, he held that the level of Capital Steel’s knowledge which Orrcon may establish at trial is insufficient to establish unconscionable conduct.⁶³ In relation to the third plea, Besanko J stated that it was not clear that it could be an element of unconscionable conduct under s 51AA.⁶⁴ Nevertheless, he held that in the circumstances of the case, “it would be odd if the financial position of Capital Steel was an element of unconscionable conduct” and that even if it was,” it cannot be sufficient by itself.”⁶⁵ Hence, the application for interlocutory relief was dismissed.

6.4 The Scope of Unconscionability

Despite attempting to posit unconscionability as an additional ground, it is evident that the Malaysian, Singaporean and Australian cases so far have failed to provide a clear and detailed analysis of the meaning of unconscionability. Equity is a system of law serving to modify the rigor of common law, where the application of its rules would operate harshly in a particular case. Therefore unconscionability, as an equitable concept, will inevitably be somewhat vague. However, in the context of demand guarantees and documentary credits, the concept of unconscionability is surrounded with so much vagueness that it is very difficult for practitioners to predict the outcome of any unconscionability case with any certainty. In this section, the writer

61 *Orrcon* (n 57), [51].

62 *Orrcon* (n 57), [70].

63 *Orrcon* (n 57), [87].

64 *Orrcon* (n 57), [91].

65 *Ibid.*

investigates what has been set out as the parameters of unconscionability by the courts of Malaysia, Singapore and Australia.

6.4.1 The scope of unconscionability in Singapore and Malaysia

In *Raymond Constuction*, Lai J attempted to define unconscionability as follows:

“The concept of unconscionability to me involves unfairness, as distinct from dishonesty or fraud, or conduct of a kind so reprehensible or lacking in good faith that a court of conscience would either restrain the party or refuse to assist the party. Mere breaches of contract by the party in question would not by themselves be unconscionable.⁶⁶”

However such a definition does not reduce the uncertainties in practice. What is more apposite is to deduce from the cases decided so far some guidance as to how and when the courts will apply unconscionability as an exception to the autonomy principle. Based on the decisions of the Singaporean and Malaysian courts, the following situations are predisposed to a finding that a call is unconscionable:

- Where the applicant’s non-performance of the contract was induced by the beneficiary’s very own actions, for example, in *Royal Design* where the cause of the non-performance was the beneficiary’s refusal to make the interim payments and in *Raymond Construction* where the beneficiary had repeatedly obstructed with the work of the account party.
- Where the beneficiary fails to fulfill his major obligation as stated in the contract. For example, in *Kvaerner*, where the beneficiary failed to open a letter of credit for the remainder of the purchase price as required under the contract.
- Where, related to the underlying contract, the beneficiary owes a substantial sum of money to the applicant. For example, in *Royal Design* where the account party was entitled to the sale amount of the 3 ½ units of houses but this was only partially paid by the beneficiary.

⁶⁶ *Raymond Construction* (n 18), [5].

- Where there is a genuine dispute as to whether the beneficiary has fulfilled his obligations under the contract. For example, there was a real issue in *Min Thai* as to whether the breach of contract was precipitated by a natural disaster and the applicability of the *force majeure* provisions.
- Where there is evidence that the beneficiary has an unhealthy financial record and a reputation of not honouring his financial commitments like the beneficiary in *Raymond Construction*.
- Where there is evidence that a call was made in order to obtain some other financial benefit. For example, the defendant in *Bains Harding* threatened to make a call on the performance bond unless the plaintiff paid the lower tier sub-contractors. There was evidence that this was done so that the sub-contractors could continue completing the works, and since defendant had a financial connection with the company which is to take over the plaintiff's work, the defendant could benefit financially from the call.
- Where, having regard to the factual circumstances of the case, the applicant does not owe the beneficiary the full amount as claimed under the call, for example in *GHL*, where the performance bonds were procured for a percentage of the contract sum and the contract price was subsequently revised, but the beneficiary called on the bond for the unrevised contract sum.

The writer takes the view that Singaporean courts have adopted a very liberal approach in applying unconscionability broadly to restrain payment. *Min Tai* manifestly illustrates this. On the facts of *Min Tai*, there is nothing to suggest that it was unconscionable for the beneficiary to call on the bond except for the fact that there were outstanding issues that had to be resolved at a proper trial. In my view, a finding that there is unconscionability on the part a beneficiary who calls a bond when there is still uncertainty as to whether there was a breach of contract is too radical a departure from the firmly rooted principles applicable to such transactions. Such a finding runs the risk of diminishing the usefulness of such payment instruments.

The Singaporean courts will, it seems investigate any allegations indicating unfairness and bad faith on the part of the beneficiary. In particular, the analysis above indicates that the Singaporean courts will look into any significant non-performance by the beneficiary or whether the beneficiary was calling the bond for an ulterior motive. Not only have the Singaporean courts

examined the underlying contracts, they also appear to have extended the examination of the relationship between the parties beyond the underlying contract by taking into account extrinsic information such as the beneficiary's financial record.⁶⁷ It is acceptable that the courts are involving themselves in disputes arising from the underlying contract as this is inevitable given the nature of the unconscionability exception. However, the writer is of the opinion that the Singaporean courts have gone too far in the factual considerations it has taken into account in applying the unconscionability exception.

6.4.2 The scope of unconscionability in Australia

In Australia, there is a continuing debate as to what is really implied by the unconscionability provisions of the TPA since the Act does not provide for a definition of unconscionability. In *Boral Formwork*, Batt J relied on the analysis of the Full Federal Court in *Hurley v McDonald's Australia Ltd*⁶⁸ where it was stated that,

“For conduct to be regarded as unconscionable, serious misconduct or something clearly unfair or unreasonable, must be demonstrated...Whatever ‘unconscionable’ means in sections 51AB and 51AC, the term carries the meaning given by the Shorter Oxford English Dictionary, namely, actions showing no regard for conscience, or that are irreconcilable with what is right or reasonable...The various synonyms used in relation to the term ‘unconscionable’ import a pejorative moral judgment ...”⁶⁹

6.4.2.1 S.51AA

S.51AA of the TPA provides a puzzling reference to “conduct that is unconscionable within the meaning of unwritten law.” This raises the difficult question of what is unconscionable conduct according to the “unwritten law”. Professor Buckley offers two possible interpretations of s 51AA.⁷⁰ One way to interpret it is that s 51AA was intended to merely import into the TPA the

⁶⁷ *Raymond Construction* (n 18).

⁶⁸ (2000) 22 ATPR 41-741.

⁶⁹ *Ibid* at 40, 585.

⁷⁰ Buckley R, ‘Unconscionability Amok, or Two Readily Distinguishable Cases?’ (1998) 26 ABLR 323, 324.

equitable doctrine of unconscionable conduct and provide the broad range of remedies available under the Act. By this he refers to the narrowly defined equitable doctrine of unconscionable dealing which requires the following⁷¹:

- the weaker party was in a position of special disability; and
- the stronger party knew about (or should have known about) the disability; and
- the stronger party took unfair advantage of its position.

His second alternative is to interpret s. 51AA broadly so that unconscionability merely means “grossly unfair or extremely inequitable”.

The first interpretation appears to presume that only one specific cause of action could possibly be within the reach of s. 51AA. However, it is possible that s. 51AA encompasses other conduct falling under specific equitable doctrines such as estoppel, undue influence, unilateral mistake or relief against forfeiture. Two cases yield support for this approach. In *ACCC V CG Berbatis Holdings v Pty Ltd*⁷², the High Court was not called upon to decide on this issue but Kirk J was of the view that s. 51AA can reach beyond the principle of unconscionable dealing. Agreeing with the comments of French J at first instance, he noted the following:

“.....the primary judge made three pertinent observations: first, that as a general proposition the object of equity's intervention is to prevent behaviour contrary to conscience, however, this does not mean that the prohibition in s 51AA encompasses all conduct that would attract the intervention of equity; secondly, that within the meaning of the ‘unwritten law’ the notion of unconscionable conduct has no ‘technical meaning’ and provides ‘a standard determined by judicial decision-making rather than a rule’; and thirdly that while the Explanatory Memorandum prepared in support of the clause in the Bill that became s 51AA of the Act specifically referred to the concept of unconscionable

71 This doctrine was affirmed and clarified by the High Court of Australia in *Blomley v Ryan* (1956) 99 CLR 362 and *Bank of Australia v Amadio* (1983) 151 CLR 447.

72 *Australian Competition and Consumer Commission v CG Berbatis Holdings Pty Ltd* [2003] HCA 18.

conduct explained in *Blomley* and *Amadio*, that ‘may turn out to have been an unduly narrow selection of case law’ ...”⁷³

In *ACCC v Samton Holdings Pty Ltd*⁷⁴, the Full Court of the Federal Court of Australia commented that, although the Explanatory Memorandum and the Second Reading Speech referred to the *Blomley* and *Amadio* cases, the terms of the section are not limited to the doctrine of unconscionable dealing:

“Although the section is confined by the parameters of the ‘unwritten law’, it is the unwritten law ‘from time to time’. Neither the Explanatory Memorandum nor the Second Reading Speech can be treated as imposing qualifications which are not found in the words of s. 51AA.”⁷⁵

However, having adopted a broader interpretation of the scope of s. 51AA, the court goes slightly backwards, affirming that establishing unconscionability requires more than mere unfairness: “On the other hand, equitable doctrine does not presently provide a remedy against conduct simply on the basis that it is unfair in the opinion of a judge. It cannot be applied to unconscionable conduct at large.”⁷⁶

6.4.2.2 S.51AC

Unlike s. 51AA, s. 51AC makes no reference to the unwritten law and merely refers to conduct that is “unconscionable”. One major difference between the two is that s. 51 AC provides a non-exhaustive list of matters that may be considered by the courts in determining whether conduct is unconscionable within the section.⁷⁷

⁷³ *Ibid*, [76].

⁷⁴ *ACCC v Samton Holdings Pty Ltd* [2002] FCA 62.

⁷⁵ *Ibid*, [50].

⁷⁶ *Ibid*.

⁷⁷ The list includes the relative bargaining strengths of the two parties; whether as a result of the stronger party’s conduct, the other was required to meet conditions not reasonably necessary to protect the stronger party’s legitimate interests; whether the target business could understand any related documentation that had been used; the use of any undue influence, pressure or unfair tactics by the stronger party; the amount for, and the circumstances under which, the target business could have bought/sold identical or equivalent goods or services from/to another supplier; comparative prices and terms for availability of goods and services elsewhere; the terms and circumstances in which the weaker party could have engaged in a similar transaction with another party; the extent to which the stronger

An examination of the legislative history and judicial decisions points to the conclusion that unconscionability has a broader meaning under s. 51AC than s. 51AA. Section 51AC was added to the TPA in 1998 following concerns that equity and the TPA did not adequately protect small businesses against unconscionable conduct.⁷⁸ Thus, the whole purpose of introducing s. 51AC was to enhance the ability of small businesses to seek redress for unfair and exploitative conduct against them in their business transactions with larger businesses.

In *Australian Competition and Consumer Commission v Simply No-Knead (Franchising) Pty Ltd*, Sundberg J said:

“...in my view ‘unconscionable’ in s 51AC is not limited to the cases of equitable or unwritten law unconscionability the subject of s 51AA. The principal pointer to an enlarged notion of unconscionability in s 51AC lies in the factors to which sub-s (3) permits the Court to have regard. Some of them describe conduct that goes beyond what would constitute unconscionability in equity. For example, factor (j) directs attention to the extent to which the supplier was willing to negotiate the terms and conditions of any contract for supply of the goods or services with the business consumer. Factor (g) relates to the requirements of any applicable industry code. Further, it is to be remembered that the list of factors in sub-s (3) is not exhaustive.”⁷⁹

party’s conduct was consistent with its conduct in similar transactions with other businesses; the requirements of any applicable industry code; the requirements of other any other industry code if the target business acted in the reasonable belief that the stronger party would comply with it; the extent to which the stronger party unreasonably failed to disclose any intended conduct that might affect the interests of the target business or any risks to the target business arising from that conduct which the stronger party should have foreseen would not be apparent to the target business; the extent to which the stronger business was willing to negotiate the terms of any supply contract with the target business; whether parties acted in good faith.

78 A number of reports highlighted the vulnerability to exploitation small businesses suffer at the hands of larger businesses eg. Senate Standing Committee on Legal and Constitutional Affairs, Parliament of Australia, Mergers, Monopolies & Acquisitions: Adequacy of Existing Legislative Controls (1991); House of Representatives Standing Committee on Industry, Science and Technology, Parliament of Australia, Finding a Balance: Towards Fair Trading in Australia (1997) (‘Reid Report’).

79 *ACCC v Simply No-Knead (Franchising) Pty Ltd* [2000] FCA 1365 at 31. Accordingly, his Honour concluded (at para51) that the evidence disclosed “an overwhelming case of unreasonable, unfair, bullying and thuggish behaviour in relation to each franchisee that amounts to unconscionable conduct...”.

In *ACCC v 4WD Systems Pty Ltd*⁸⁰, Selway J also interpreted s.51AC widely. He was of the opinion that unconscionability is not limited to the meaning of the word at common law or at equity.⁸¹ These judicial interpretations of s.51AC have also received the concurrence of various commentators.⁸²

At first sight s.51AC appears to provide a means whereby the commercial certainty of payment instruments may be completely undermined. However, since none of the factors listed in the section are conclusive, and are not mandatory, it is submitted that s.51AC can be cautiously applied so that it does not encroach upon the established system of these payment instruments. In particular, it does not preclude the courts prioritising the principle of autonomy as the most important consideration when exercising their discretionary powers to grant an injunction under s. 51AC. So far, the Australian courts have shown that they will adopt a well-balanced approach in applying s. 51AC to restrain payment and will only restrain payment in very exceptional circumstances.

Based on the decisions in Australian cases, the situation most predisposed to a finding that a call is unconscionable is where the beneficiary calls for the full amount of the guarantee but the applicant does not actually owe the beneficiary the full amount claimed, as in *Olex Focus* and *Boral Framework*. One notable difference between Singaporean and Australian courts on the application of the concept unconscionability is in situations where the beneficiary calls on the instrument at a time where there is an existing dispute as to whether there was any breach of the underlying contract. In *Min Thai*, there was a genuine dispute between the parties as to the performance of the underlying contract but the injunction was upheld by the Singaporean High Court on the basis that the demand was unconscionable.⁸³ In *Minson Constructions Pty Ltd v Aquatec Maxon Pty Ltd*⁸⁴, there was a genuine dispute concerning responsibility for defects in the civil works carried out by the plaintiff. However, the Supreme Court of Victoria allowed the call

80 *ACCC v 4WD Systems Pty Ltd* [2003] FCA 850.

81 *Ibid*, [183].

82 Joachim Dietrich, 'The meaning of unconscionable conduct under the Trade Practices Act 1972' (2001) 9 TPLJ 141, 144; Nicole Dean, 'ACCC v Berbatis Holdings' (2003) 197 ALR 153, 164.

83 See page 204.

84[1999] VSC 17.

on the performance guarantee, emphasising that the purpose of the guarantee was to provide security to the defendant so that a valid claim for damages would be secured.⁸⁵

At this point, one must not forget that a good proposition of the scope of unconscionability is incomplete without a consideration of its interaction with the fraud exception. The English courts had confined the fraud exception to merely common law fraud. Chapter 3 demonstrated that although the exception has been widely invoked in a number of cases, its narrow scope means that only in a small number of cases is the exception invoked successfully. It is important to bear in mind that a too narrow scope of unconscionability will render unconscionability useless as an exception to the autonomy principle.

However, it is submitted that the scope of unconscionability should only encompass situations where the call on the instrument is manifestly unfair to the beneficiary. Using the words of the trial judge, Carr J in *Samton*, “...if there is a scale by which to measure unreasonable behaviour by one person towards another, unconscionable is towards the extreme end of that scale.”⁸⁶ Furthermore, in *Clough Engineering Limited v Oil and Natural Gas Corporation Limited*, the Full Court asserted the following:

“Given the commercial purpose of such guarantees,...assuming the absence of fraud, there would seem to be very little, if any, scope for the application of equitable doctrines of unconscionable conduct to restrain the exercise by a party of its legal rights under such guarantees. There may be extreme cases which would merge into the area of bad faith exercises of the power...The wide purpose of the performance bank guarantees and their character as reflecting an allocation of risk and a provision of security to their holder militate against any argument as to disproportion in their exercise.”⁸⁷

I am inclined to agree with the approach of the Australian courts so far, which is not as expansive as the one adopted by the Singaporean courts. Australian judges have provided

⁸⁵ *Ibid*, [23].

⁸⁶ *ACCC v Samton Holdings Pty Ltd* [2000] FCA 1725, [83].

⁸⁷ FCAFC 136, [138].

a guiding yardstick to illustrate the scope of unconscionability but it does not in any way resolve the problem. If English law is to adopt unconscionability to change the law, it is very important that the judiciary clarify the boundaries of unconscionability in order to reduce unwanted litigation. After a consideration of a wide spectrum of possible scenarios, it is proposed that only the following situations should attract the ‘unconscionability’ exception:

- There is strong and undisputable evidence that there is a material breach of contract by the beneficiary. In practice, contracting parties often allege breaches of contract by each other when there are real and complex issues as to whether such allegations are true. A determination of these issues can only be resolved by a thorough assessment of the contract, the facts and the available evidence. Since the function of documentary credits is to guarantee payment of money on the presentation of the correct documents, beneficiaries should not be prevented from obtaining payment merely because of any allegation of breach.
- There is strong evidence to suggest that the beneficiary is calling the credit for an ulterior purpose which is to its own advantage.
- There is strong evidence that the amount called for under the credit is more than what the applicant owes to the beneficiary. For example, where the contract price is subsequently reduced by re-negotiation between the parties or where the courts resolve an existing dispute in favour of the applicant.

It is also submitted that the standard of proof to establish these allegations should be as high as that required to obtain injunctive relief under the fraud exception.⁸⁸

6.5 Similar position in England?

It is ironic that any notable development of the concept of unconscionability in payment instruments took place outside England because it was more than two decades ago when Eveleigh LJ first said in *Potton Homes Ltd v Coleman Contractors Ltd*. that, “... in principle, I do not

⁸⁸ See 3.3.3.

think it is possible to say that in no circumstances whatsoever, apart from fraud, will the court restrain the buyer.”⁸⁹

Although as a general rule fraud is the only exception to the autonomy principle, a lack of good faith has for a long time provided the basis for restraining a beneficiary from calling on a bond or guarantee. In *Eliau and Rabbath v Matsas*⁹⁰, the cargo owners gave a guarantee to the shipowners in order to obtain a discharge of a lien over its goods that the shipowners were exercising in respect of demurrage. A further lien was imposed over the goods for a different purpose and a further sum had to be put up to discharge the second lien. The shipowners then sought to enforce the guarantee in relation to the first demurrage claim but this was restrained by the Court of Appeal on application by the cargo owners. Danckwerts LJ stated the following:

“It seems to me that if the shipowners were entitled immediately after obtaining the undertaking to claim a fresh lien and use it for the purpose of the undertaking, it would amount at least to a breach of faith in regard to the arrangement between the parties. Whatever may be the final result of the case, it seems to me this is an instance where the court should interfere and prevent what might be an irretrievable injustice being done to the plaintiffs in the circumstances.”⁹¹

In *TTI Team Telecom International Limited, Axarte Limited v. Hutchison 3G UK Limited*⁹², the parties entered into a contract whereby the plaintiff provided complex software system to the defendant. Pursuant to the agreement, an advance payment bond was procured by the plaintiff. The plaintiff’s work was delayed for a variety of disputed reasons. The defendant then terminated the sales contract and gave notice of its intention to draw on the total amount of the bond. The plaintiff applied to the court for an injunction to prevent this from happening, contending that the call was not made in good faith, without a genuine intention to terminate or to call but with the ulterior motive to draw attention away from the fact that it had wanted a premature let out from the agreement and to reduce the scope of the software system to be supplied. Judge Thornton QC

89 (1984) 28 BLR 19, 20.

90 [1966] 2 Ll R 495.

91 *Ibid*, 498.

92 [2003] 1 All E.R. 914.

decided that these assertions were mere speculation without any factual basis and therefore rejected the argument.

However, despite the actual decision, he appeared to have accepted the contention that a breach of faith could be the basis for the courts to intervene to restrain a beneficiary from calling a bond. At one stage, he even elaborated on this point:

“The basis for a contention of a breach of faith must be established by clear evidence even for the purposes of interim relief. A breach of faith can arise in such situations as: a failure by the beneficiary to provide an essential element of the underlying contract on which the bond depends; a misuse by the beneficiary of the guarantee by failing to act in accordance with the purpose for which it was given; a total failure of consideration in the underlying contract; a threatened call by the beneficiary for an unconscionable ulterior motive; or a lack of an honest or bona fide belief by the beneficiary that the circumstances, such as poor performance, against which a performance bond has been provided, actually exist.”⁹³

It remains to be seen if lack of good faith will be applied as a general rule by the English courts to restrain payment. In the light of this case, the possible addition of an unconscionability exception is less audacious than it initially appears to be. This is because the breach of faith exception, as instigated in *TTI Team Telecom*, requires the court to look into all the relevant facts of the case. Many factual situations may well fall under both exceptions, since both the unconscionability exception and the breach of faith exception take into consideration concepts of fairness, conscience and good faith in determining whether an injunction should be granted.⁹⁴ The judgment in *TTI Team Telecom* reveals that the English position in this area of law is not such a far cry from that of Singapore, Malaysia and Australia as it appears to be.

⁹³ *Ibid*, [46(3)].

⁹⁴ M Bisley and J Mok, ‘Unconscionable demands under letters of credit, performance bonds and bank guarantees’ (2005) 16 JBFLP 197, 211.

6.6 An unconscionability exception for documentary credits?

6.6.1 The advantages

From the facts of the cases analysed so far, it is obvious that there exist situations where the call for payment under an independent guarantee is abusive but the beneficiary is within his legal right to do so. There is always the possibility that a beneficiary will call on the instrument even though the applicant has fully performed his contractual obligations. The guarantee could be called on for tactical reasons, such as to avoid further contractual obligations, or to vary the terms of a contract that has turned out unfavourably. In cases where disputes exist, the call could very likely be determinative of a quick settlement of the dispute to the disadvantage of the applicant. Although the terms of the contract sometimes allow the applicant to proceed to arbitration or litigation in order to pursue any claims, the applicant might not be capable financially of enduring the whole process of arbitration or litigation.

Similarly, in relation to documentary credits, abusive and unfair claims for payment could exist. Common sense would indicate that there is a need to do justice to the parties before the court but the various constraints of the fraud exception very often make it impossible to obtain an order to restrain payment. It should be noted that the possibility of abusive claims in relation to documentary credits is much more limited if compared to demand guarantees. This is because, in documentary credit transactions, the advising bank bears the heavy responsibility of checking if the documents presented comply with the terms of the credit. However, this does not mean that documentary credits are not at all susceptible to abusive and unfair calls. There are examples of situations where a draw down by a beneficiary of a documentary credit could be regarded as unconscionable or unfair but the law affords no protection to the applicant or the banking world.

The first example is where a third party, a loading broker who is not acting as the seller's agent, has changed the shipment date of a bill of lading in respect of perishable goods so as to make it comply with the credit and the seller becomes aware of this fact before the documents are presented to the bank but was not involved in the falsification of the shipment date. The seller then presents the document to the bank without mentioning the falsification. Following the

United City Merchants case, it is established that the fraud exception does not apply where the fraud is committed by a third party and the seller was unaware of the falsification before the document was presented. However, it is not clear whether the fraud exception can apply where a seller is not involved in the falsification of the document but becomes aware of the falsification before the document is presented to the bank, since the courts have not hitherto held that silence on the part of the beneficiary would suffice to invoke the fraud exception. Professor Bridge submits that under the fraud rule, the beneficiary would still be paid either because silence on the part the beneficiary is not fraudulent or because there has been no loss caused to the bank.⁹⁵ Although this scenario could fall under an unconscionability exception, the addition of an unconscionability exception is unnecessary because it would be possible for the courts to expand the fraud exception to encompass third party fraud⁹⁶ or to encompass a situation where the beneficiary presents, without any revelation, a document that has been falsified by another party when he is aware of this fact.

The second situation is where Company XYZ procures a documentary credit from Bank ABC for the purchase of goods from the seller. As payment for the credit, XYZ obtains a loan from Bank ABC, secured against XYZ's manufacturing equipment. However, the owners of XYZ have defrauded Bank ABC by transferring the assets to another company and somehow this information comes to the attention of the beneficiary. The bank later does not receive repayment of the loan. In such a situation, if the beneficiary presents complying documents, is the bank bound to pay since applicant fraud has been held to be outside the scope of the fraud rule?⁹⁷

However, it is submitted that it is unacceptable for the fraud exception to be expanded to apply to the second situation because the fraud in such a case does not relate to the genuineness of the documents presented but rather relates to the application process of the credit.⁹⁸ An unconscionability exception would be more comprehensive as it is able to apply to most

95 M. Bridge, *International Sale of Goods Law and Practice* (OUP, Oxford, 1999) 274. However, it is not always the case that such falsification will not affect the value of the goods.

96 See Chapter 3.

97 *Comdata Network Inc v. First Interstate Bank* (1993) 497 NW 2d 807.

98 Xiang Gao, *The Fraud Rule in the Law of Letters of Credit: A Comparative Study* (1st edn Kluwer Law International, London 2003) 117-121.

situations where an injustice had occurred. Unlike the fraud exception which is able to afford protection to the parties only in limited circumstances, an unconscionability exception has the flexibility to apply to more situations. Depending on the exact circumstances, it may be that in both of the hypothetical instances discussed, the conduct of the beneficiary may not be considered unconscionable by the courts. What is clear however is that, there is room for an unconscionability exception to be applied to documentary credits.

In addition, if a claim for an injunction was successful on the grounds of fraud on the part of the beneficiary, the injunction granted will usually be for the whole amount of the bond. In other words, the approach is all or nothing. In granting an injunction to restrain payment under a documentary credit, there could be considerations which dictate that an injunction should only be granted for part of the amount that had been called and unconscionability is a flexible concept which enables the courts to grant a partial injunction to achieve justice. In *Eltraco International Pte Ltd v CGH Development Pte Ltd*⁹⁹, the applicant objected to a call for the full amount of \$2,438,800 on the performance bonds. To ensure that the amount of the bond that was called on was not unconscionable, the court took into consideration the retention moneys held by the beneficiary, the amount of money owed to the applicant for some undisputed variation works and the amount claimed in the progress claim submitted by the applicant before coming to a decision that the beneficiary was only permitted to call on the bond for an amount of \$600,000. Therefore, the court was able to restrain a call on that part of the performance bond which it would be unconscionable to call on while allowing a perfectly legitimate call on the other part of the bond.

Finally, adopting unconscionability as an additional ground for restraining payment would also yield practical advantages for the legal system. The courts are able to achieve justice in the shortest amount of time, thereby saving on legal cost and time which is of course beneficial to all parties involved.

99 [2000] 4 SLR 290.

6.6.2 The disadvantages

The most cogent opposition to the arguments above is that an unconscionability exception will result in a significant increase in the number of injunctions granted. This leads to the further concern that the commercial utility of documentary credits will not be sustained. Documentary credits are not the cheapest method of payment but have attained their popularity because of the extra security and certainty it offers to sellers. With an additional exception to the autonomy principle, the instrument becomes less secure and certain. Buyers, sellers and the banks involved will have to be a lot more cautious in their dealings with documentary credits and this could very much reduce the demand for this kind of instrument. In particular, banks would not be able to execute their responsibilities with full confidence since they would not be able to make payment merely because the documents presented comply with the terms of the credit but might have to concern themselves with the facts of the underlying transaction if any allegations of unconscionability were to be made.

On the other hand, arguably such concerns are exaggerated since the courts can always restrict the scope of any unconscionability exception and apply it only to cases where there is severe injustice. Although the writer was able to give examples of situation which illustrates that there is room for an unconscionability exception in documentary credits, these scenarios would be very rare in practice. Therefore, even if an unconscionability exception was recognised in relation to documentary credits, the number of cases in which injunctions are granted based on such an exception will not be significant enough to reduce the standing of the instrument in the eyes of the commercial world.¹⁰⁰

An unconscionability exception might entail the courts involving themselves in any issues or disputes arising from the underlying contract of sale. Most of the time, the disputes that arises from a documentary credit transaction which would allow for an intervention based on the unconscionability ground are complex and would take a huge amount of time to be resolved. Not only is such an investigation not appropriate at the interlocutory stage, but the evidence

¹⁰⁰ In Singapore, there is lack of evidence to suggest that the unconscionability exception had resulted in the demand guarantee losing its importance in the marketplace.

necessary to resolve such disputes might require a full trial on the merits. Nelson Enonchong expressed a similar objection to an unconscionability exception for demand guarantees: “...the court will be required to look into the consequences of the breach to ascertain what loss if any the beneficiary has suffered or, where the beneficiary already holds some security, whether the cost of rectifying the breach exceeds the amount held by the beneficiary. Yet these are matters more properly dealt with in any dispute under the underlying contract.”¹⁰¹

One of the major benefits of using a documentary credit is that a beneficiary will still be in possession of his monies even in the event of any alleged breaches of the underlying contract. This is the long standing ‘cash in hand principle’ which means that a dissatisfied buyer is only able to recover any losses or damages for any breach of contract through arbitration or litigation later on. Arguably, an applicant who has voluntarily agreed to payment by documentary credit, perhaps after seeking independent advice, takes the risk of such a transaction and should not be allowed to go back on his promise. Similar arguments have also been expressed in relation to performance bonds: “If the account party voluntarily undertook the risk of unconditional payment, why should the courts intervene and assist him to go back on his promise when circumstances become unfavourable to him and he decides to go against what he originally contracted with the guarantor to do?”¹⁰² An unconscionability exception would provide opportunities for parties who had voluntarily entered into contracts to set them aside and avoid their contractual obligations whenever it would be advantageous for them to do so.

Despite its advantages in principle, the vagueness of the concept of unconscionability makes it difficult to apply to documentary credits in practice. At the moment, each case turns on its own facts because of the lack of guidelines in using unconscionability as a ground for granting injunctions. This, in addition to the concern raised earlier about the courts basing their decisions on documentary evidence such as affidavits or witness statement at the pre-trial stage without the benefit of full consideration of the relevant evidence, makes the process very unpredictable.

101 Nelson Enonchong, “The Problem of Abusive Calls on Demand Guarantees” [2007] LMCLQ 83, 105.

102 *Adrian Wong* (n 17) 185.

6.7 Comparison of documentary credits and independent guarantees

This section considers the question of whether documentary credits and independent guarantees should be treated in the same way by law. A conclusion that both instruments are different will support the argument that unconscionability as an exception to the autonomy principle should not be made applicable to documentary credits. The answer to this question requires an analysis of the characteristics of each instrument and the respective principles underlying their operation.

In the eyes of English law, the two are closely analogous. The well-established principle of autonomy does not only apply to documentary credits but to independent guarantees as well. An independent guarantee, like a documentary credit, is a separate transaction in that a bank's obligations to pay under the guarantee is unaffected by the underlying contract on which the guarantee is based. Similarly, the fraud exception is equally applicable to these two different forms of transactions.

“.....performance guarantee stands on a similar footing to a letter of credit. A bank which gives a performance guarantee must honour that guarantee according to its terms. It is not concerned in the least with the relations between the supplier and the customer; nor with the question whether the supplier has performed his contractual obligation or not; nor with the question whether the supplier is in default or not. The bank must pay according to its guarantee on demand, if so stipulated, without proof or conditions. The only exception is when there is a clear fraud of which the bank has notice.”¹⁰³

The purpose of both instruments is to ensure that the beneficiary will have a readily realisable security. As Professor RM Goode puts it, “Demand guarantees share with documentary credits the characteristic of being abstract payment undertakings, that is, they are promises of payment which are considered binding upon communication to the beneficiary without the need for acceptance, consideration, reliance, or solemnity of form ...”¹⁰⁴ The corollary of this is the established “cash-in-hand” principle. Both types of payment instruments are in most respects

¹⁰³ *Edward Owen v Barclays Bank International* [1978] 1 Lloyd's Rep. 166, 171 per Denning LJ.

¹⁰⁴ Professor RM Goode, “The New I.C.C Uniform Rules for Demand Guarantees” LMCLQ [1992] 190, 192.

regarded as being as good as cash because the beneficiary is able to receive promptly compensation for breach of contract without going through the tedious process of litigation, although his right to sue for further damages in excess of the amount of the credit/guarantee is unaffected. However, where the paid amount exceeds any loss suffered by the beneficiary, the excess amount may be recovered by the applicant in subsequent litigation.

The two types of instruments are further assimilated by the fact that independent guarantee cases are often cited in documentary credits cases on issues of autonomy and fraud and vice versa. This is particularly true in relation to performance bonds. For example, *Edward Owen Engineering Ltd v Barclays Bank International Ltd*, *Intraco Ltd v Notis Shipping Corpn*, *The Bhonja Trader*, *Bolivinter Oil SA v Chase Manhattan Bank* and *Turkiye Is Bankasi As v Bank of China* are performance bond cases which have all been cited in documentary credit cases. In fact, in most practitioner textbooks and academic discussions, the cases relating to these two forms of transaction are often discussed within the same framework.

However, there exists the question as to whether independent guarantees are really similar to documentary credits, as perceived in English law. Despite their apparent similarities, the two instruments fundamentally serve different commercial purposes. The documentary credit is a means for providing payment of the price of goods. It truly facilitates international trading and comes into play whenever the goods are to be delivered. Payment is wholly dependent on the documents tendered by the seller and therefore documents play a significant role in the operation of the system. The documentary credit does not guarantee the performance of the underlying contract - the performance of the underlying contract has no bearing on the bank's obligation to pay on the credit.

On the other hand, an independent guarantee does not serve as a mechanism for discharging payment of the price of goods or other performance. It protects a beneficiary from non-performance and financial risks should the seller/contractor default on the underlying contract. Unlike a documentary credit, an independent guarantee only comes into play when a beneficiary alleges breach of contract on the part of the applicant. It serves as a form of deterrent, discouraging the seller/contractor from defaulting on the contract and provides a form of

liquidated damages by way of compensation if the deterrent fails to prevent a breach of contract. Therefore, an independent guarantee is somewhat linked to the underlying contract.

Writing on letters of credit and performance bonds, C Debattista argues that the fundamental principles underlying the two instruments do not operate identically.¹⁰⁵ The decisions in letters of credit cases indicate that a heavy standard of proof is required for the fraud exception to apply. However, there are judicial suggestions that such a restrictive approach is not necessary in performance bonds. In *United Trading Corporation SA v Allied Arab Bank Ltd*, a case concerning performance bonds, Ackner L.J. stated the following:

“...We would find it an unsatisfactory position if, having established an important exception to what had previously 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.”¹⁰⁶

Not only do there exist objections to the restrictive approach of the fraud exception, a further criticism is that the fraud exception, which has been rigorously applied to performance bonds, is difficult to operate and serves no meaningful purpose in relation to performance bonds.¹⁰⁷ This is because most performance bonds do not require the presentation of documents. The beneficiary can make a demand for payment without having to prove that the applicant has defaulted in performance of the underlying contract. However, if one takes the view that the fraud exception also encompasses fraud in the underlying transaction¹⁰⁸, then this criticism has very much less force.

In addition, the application of the principle of strict compliance in letters of credit and performance bonds is different. In *Siporex Trade S.A. v. Banque Indosuez*, Hirst J stated that in a letter of credit, the bank is dealing with the very documents themselves, and is obliged to

105 C Debattista, “Performance Bonds and Letters of Credit: A Cracked Mirror Image” [1997] JBL 289.

106 [1985] 2 Lloyd's Rep. 554, 561.

107 *Debattista* (n 105) 304.

108 See 3.3.1.

compare with meticulous care those tendered with those described in the mandate, whereas in performance bonds the bank is dealing with no more than a statement in the form of a declaration to the effect that a certain event has occurred.¹⁰⁹

Contrary to Hirst J's comments, there exists a different judicial opinion, suggesting that the principle of strict compliance should be applied to performance bonds transactions. In *I.E. Contractors Ltd. v. Lloyds Bank Plc. and Rafidain Bank*, Leggatt J was of the opinion that the closeness of the analogy between the letters of credit and performance bonds is dependent on the actual requirements of the bond.¹¹⁰ Therefore, he regarded Hirst J's comments about the differences between the two as resulting from the wording of the particular bond which he had to consider. In this case, Leggatt J adopted a very strict approach:

“First, it (the court) must construe the performance bond itself, in order to see what the beneficiary has to do for the purpose of making a valid demand under it; and secondly, it must construe the call and any associated document, in order to see whether the beneficiary has done that which for the purpose of making a valid demand is required of him.”¹¹¹

The advantage of such a rigorous application of the principle of strict compliance is that sellers are better protected against the possibility of unfair calls.

6.8 Conclusion

The chapter has discussed the emerging trend of using the concept of unconscionability to restrain payment under independent guarantees. It is evident from the discussion that in Australia and Singapore, the trend is solidly developing whereas in Malaysia the trend is not followed habitually. This paper has also shown that English common law is not totally isolated from this development where independent guarantees are concerned.

109 [1986] 2 Lloyd's Rep. 146, 159.

110 [1989] 2 Lloyd's Rep. 205, 207.

111 *Ibid.*, 208.

The writer appreciates the effort of the relevant jurisdictions for bringing on the new development in this area of law. This radical development was obviously brought about at a time when such payment instruments are afflicted with problems of unfair and abusive calls. However, even the unconscionability exception as applied to independent guarantees in these jurisdictions is in need of much refinement.

It is observed that independent guarantees and documentary credits share certain similarities to a great extent. However, there is one significant difference - the documents against which these instruments are payable are fundamentally different. The inherent risk created by the lack of documents or the nature of the documents required under independent guarantees is precisely the reason why an unconscionability exception was instilled in the first place. In relation to documentary credits, the risk of unfair call is much lower. Furthermore, if the submission in Chapter 4 that the fraud exception should be extended is accepted by English courts, this would reduce the usefulness of an unconscionability ground to withhold payment.

The analysis has also demonstrated that there is room for an unconscionability exception to be applied to documentary credits. However the writer is of the opinion that the disadvantages of positing an unconscionability exception outweigh the advantages. Such an exception would in effect expose those involved in documentary credit transactions to wide ranging possibilities of delay in payment while disputes concerning unconscionable calls are resolved. Although the fraud exception has so far not undermined the importance of these instruments, an ill-defined unconscionability exception, might have the potential to do so. Even if the unconscionability exception was more clearly defined, its application to particular facts would not be straightforward and it would take time for a clear set of principles to emerge. If adopted as an exception by English courts, the initial stages of the development would be a very difficult period because of the uncertainty involved. Therefore, on balance, the writer is of the opinion that it would be safer for English law to take a conservative stand on this matter and not adopt an unconscionability exception where documentary credits are concerned.

CHAPTER 7

NEGATIVE STIPULATIONS IN THE UNDERLYING CONTRACT

7.1 Introduction

Occasionally, one may find that the terms of the underlying contract connected to a documentary credit contain provisions which restrict the circumstances under which a beneficiary is to be paid. This chapter examines the question of whether in such circumstances, these provisions may be relied on to withhold payment under the credit. In other words, will these provisions be enforced? The discussion which follows contains analysis of Australian and English cases, since it is in Australian and English courts where negative stipulations in the underlying contract have been vigorously argued as a basis to withhold payment.

7.2 Australia

Australian courts have shown that they are willing to enforce these provisions in cases involving independent guarantees. The first indication of this was in *Wood Hall Ltd v Pipeline Authority*¹, where Stephen J. in the High Court of Australia stated *obiter* that a beneficiary may not be entitled to payment if the provisions in an underlying contract qualify the right to call on the undertaking contained in a performance guarantee.² Subsequently, in some first instance decisions, Australian courts have granted injunctions to restrain payment under performance bonds/performance guarantees on this basis.³ Most recently, in *Clough Engineering Limited v Oil and Natural Gas Corporation Limited*⁴, the Full Court of the

¹ (1979) 141 CLR 443.

² *Ibid*, 459.

³ *Pearson Bridge (NSW) Pty Ltd v State Rail Authority of New South Wales* (1982) 1 ACLR 81; *Barclay Mowlem Construction Ltd v Simon Engineering (Australia) Pty Ltd* (1991) 23 NSWLR 451; *Reed Construction Services Pty Ltd v Kheng Seng (Australia) Pty Ltd* (1998) 15 BCL 158.

⁴ [2008] FCAFC 136.

Federal Court of Australia considered the right of a beneficiary (employer of a builder) to call upon performance guarantees provided by a builder of a construction contract. The applicant, Clough, argued that the underlying contract contained an express negative stipulation, which is that the beneficiary would not call on the performance guarantees unless there was an actual breach of the contract, as distinguished from events "bona fide believed" to be breaches. Clough argued that since there was a genuine dispute, an injunction should be granted to restrain the beneficiary from demanding payment and the banks from making payment under the guarantees. The Federal Court of Australia accepted that stipulations in the underlying contract could constitute a ground to restrict the rights of a beneficiary but preferred to refer to it as an "over-riding rule" rather than an exception.⁵ It is not clear what is meant by the use of the phrase "over-riding rule". However, because clause 3.3.1 of the construction contract required Clough to open an "unconditional and irrevocable" guarantee and the term "notwithstanding any disputes pending" existed in the guarantees,⁶ the Federal Court of Australia held that that the commercial purpose of the contract was to allocate the risk to Clough, who should be out of pocket notwithstanding that a genuine dispute exists. Hence, injunctive relief was refused despite the existence of disputes over breaches of contract.⁷ In this case, it was emphasised that "...[C]lear words will be required to support a construction which inhibits a beneficiary from calling on a performance guarantee where a breach is alleged in good faith, ie, non-fraudulently"⁸. It follows from this that any claim about an implied negative stipulation which qualifies the entitlement of a beneficiary to call on a guarantee will most likely be rejected by the courts.⁹

⁵ *Ibid*, [77].

⁶ In the construction of the contract, the Court said it also needed to consider the provisions of the performance guarantees.

⁷ Nevertheless, the Court found that Clough was in breach of its obligations under the contract by failing to deliver the certificates of insurance and failing to renew the performance guarantees.

⁸ [2008] FCAFC 136, [83].

⁹ *Deutsche Ruckversicherung v Walbrook Insurance* [1994] CLC 415; *Fletcher Construction Australia Ltd v Varnsdorf Pty Ltd* [1998] 3 VR 812; *Boral Formwork v Action Makers* [2003] NSWSC 713; *Orrcon Operations*

7.3 England

In England, there is some acknowledgment that the existence of a term restricting the circumstances in which a letter of credit could be drawn down could be a basis of upon which payment could be withheld. In *Sirius International Insurance Co Ltd v FAI General Insurance Ltd*¹⁰, Agnew, a Lloyd's syndicate, wished to be reinsured by FAI. Because Agnew was concerned about the solvency of FAI, Sirius agreed to reinsure Agnew subject to an agreement that FAI would reimburse Sirius if Agnew called on Sirius to pay. As security for the agreement between Sirius and FAI, a letter of credit was opened in favour of Sirius. In a separate side letter, there was a negative covenant term that Sirius would not pay a claim by Agnew nor draw on the letter of credit without FAI's consent. Agnew subsequently made a claim under the reinsurance contract but FAI disputed the claim. Sirius commenced arbitration proceedings on behalf of Agnew against FAI, claiming to be entitled to payment from FAI, which necessarily involved the determination of whether Sirius was liable to meet Agnew's claim. Later on, provisional liquidators of FAI were appointed which had the effect of automatically staying the arbitration proceedings. Sirius applied to lift the stay but the parties reached a compromise by a Tomlin Order, in which FAI admitted its liability to reimburse Agnew. Sirius then called upon the letter of credit, the proceeds of which were placed in an escrow account pursuant to the Tomlin Order. A preliminary issue then came before the court as to whether Sirius was entitled to the balance of the account. The issue was whether the condition of the side letter was satisfied. Sirius argued that:

- 1) The condition of the side letter had been satisfied by FAI's acknowledgment of indebtedness to Sirius in the Tomlin Order.
- 2) Even if the condition in the side letter was not satisfied, it was entitled to the proceeds of the letter of credit because the letter of credit was autonomous of any underlying agreement between Sirius and FAI.

At first instance, Jacob J decided that the condition in the side letter had been satisfied. As to the second argument, he stated that if the condition in the side letter was not satisfied, Sirius could be prevented from calling the letter of credit even though the conditions were not terms of the letter of credit itself. On appeal, the Court of Appeal held that Sirius was not

Pry Ltd v Capital Steel & Pipe Pry Limited [2007] FCA 1319; See also N Enonchong, "The Problem of Abusive Calls on Demand Guarantees" [2007] LMCLQ 83, 92.

¹⁰ [2004] UKHL 54.

entitled to the proceeds of the credit on both grounds. On the first issue, it was held that the condition in the side letter was not met because the acknowledgment in the Tomlin Order did not amount to FAI agreeing that Sirius should pay Agnew. On the second issue, the Court of Appeal reached the same conclusion as Jacob J. Despite affirming the autonomous nature of the letter of credit, May LJ stated that “There is no authority extending this autonomy for the benefit of the beneficiary of a letter of credit so as to entitle him as against the seller to draw the letter of credit when he is expressly not entitled to do so.”¹¹ Although not at issue, May LJ indicated that, had it been necessary to do so, he would have granted an injunction to restrain Sirius from drawing down on the credit. The House of Lords decided that Sirius was entitled to the proceeds of the credit by adopting a commercial approach in the construction of the Tomlin Order. The House of Lords did not resolve any issues regarding the effect of the autonomy principle on the express contractual restrictions between the parties.

Hence, the question as to whether under English law, a negative stipulation can be enforced so that payment under a credit can be withheld remains unclear, although there is authority supporting this in the decision of the Court of Appeal in *Sirius*. Even the authority of the Court of Appeal on this point remains debatable considering that May LJ had emphasised on the unique feature of the case in his judgment:

“...Here the relevant underlying agreement is, not the commercial transaction that the letter of credit was intended to support, as in the typical case the contract of sale or in the present case the retrocession treaties, but a related agreement regulating as between FAI and Sirius terms on which the letter of the credit would be established. The terms included express contractual restrictions on the circumstances in which Sirius would be entitled to draw on the letter of credit. To that extent the letter of credit was less than the equivalent of cash and Sirius' security was correspondingly restricted...”¹²

It is not clear whether the ruling of the Court of Appeal on this matter is limited to the unique facts of the case or whether this exception to the autonomy principle would extend to a negative stipulation in an underlying contract which is supported by a documentary credit. It

¹¹ [2003] 1 C.L.C. 1124, [26].

¹² *Ibid*, [27].

is submitted here that this exception should only be applied to cases similar to *Sirius*.¹³ In the case of negative stipulations which exist in an underlying contract of which the credit supports, the autonomy principle should prevail.

7.4 Commentary

One should consider the difficulties which would confront a paying bank if the law was to treat an express stipulation in the underlying contract as an exception to the principle of autonomy. Where a beneficiary presents documents which are compliant the bank is obliged to make payment. But, if the applicant then informs the bank that it should not pay, alleging breaches of these express stipulations in the underlying contract, this puts the bank in a dilemma. Just like the other exceptions to the autonomy principle, the applicant should establish to the bank, to a high standard of proof, that the conditions in these agreed terms had not been satisfied. However, as one commentator writing on demand guarantees highlights, there is a lot of uncertainty involved; firstly, in determining the existence of conditions which restrict the entitlement of the beneficiary to monies under a guarantee, and secondly in determining if the conditions are satisfied.¹⁴ On the first issue, much will depend on the method of interpretation used to construe the particular contract, a matter which has triggered a lot of litigation in the past. The uncertainty involves puts the bank in doubt as to whether to pay. Practically, the bank may need to conduct its own investigations (although it is not under a duty to do so) and even seek legal advice in order to form a correct judgment as to whether the applicant has established the allegation to a high standard of proof. If the bank withholds payment under the credit but it turns out that the evidence is insufficient, the commercial reputation of the bank will be affected.

It is also argued that withholding payment on the grounds of express stipulations in the underlying contract will be a step too far. The common intention of both the seller and buyer to elect the use of a documentary credit is mainly due to the advantage it offers as being as good as cash. In the other exceptions to the autonomy principle considered in this thesis, there is greater unfairness involved and stronger policy reasons which justify an inroad to the

¹³ In *Daewoo Engineering & Construction Co Ltd v The Titular Roman Catholic Archbishop of Kuala Lumpur* [2004] 7 MLJ 136, the High Court of Malaysia granted an interlocutory injunction to withhold payment under a performance guarantee on the basis of conditions which existed in the form of a letter from the applicant to the beneficiary. This case was decided before *Sirius* and does not provide any clarification on this issue.

¹⁴ *N Enonchong* (n 9) 95.

autonomy principle. However, in the case of express stipulations in the underlying contract, these can be avoided by the parties. In fact, if the law enforces these stipulations to the detriment of the autonomy principle, it will further encourage the insertion of these negative stipulations, which should really be discouraged. Otherwise, the number of injunctions granted will increase and the usefulness of the documentary credit will decline. Especially since documentary credits are typically used to support payment under a sale of goods, such an exception would defeat the whole purpose of the documentary credit in such transactions. In *Orrcon Operations Pty Ltd v Capital Steel & Pipe Pty Limited*¹⁵, the provisions in the underlying contract of sale was argued as a ground to refuse payment under a documentary credit. This argument was not successful in this case, although the Federal Court of Australia did not dispel that this exception could be applicable to contracts of sale. It is submitted that a negative stipulation exception in relation to documentary credits which support contracts of sale should be rejected.

7.5 Conclusion

There are considerable problems if negative stipulations of this kind are enforced in documentary credit transactions. Enforcement of these stipulations will effectively establish a further exception to the autonomy principle. Even if the scope of this exception can be confined strictly as in the case of the fraud exception, the practical consequences of encouraging the insertion of these terms could, in the long term affect the commercial viability of the documentary credit. Furthermore, this conclusion of not recommending a “negative stipulation exception” is consistent with the conclusion in Chapter 6 which rejects an unconscionability exception, since one may consider it unconscionable to call for payment in circumstances where there was a breach of the negative stipulations of the underlying contract. Under English law, the remnant of the Court of Appeal’s judgment in *Sirius* still exists. Hence, it is urged that English courts clarify this issue when the first opportunity arises and re-affirm the autonomy principle. Given that no principles of justice are involved here, it is clear that the interest of certainty should prevail.

¹⁵ [2007] FCA 1319.

CHAPTER 8

CONCLUSION

In Chapter 1 of this thesis, the writer provided an overview of the operation and function of the documentary credit. The chapter revealed the importance of the instrument in overcoming the risks involved in cross border trading transactions. The many types of documentary credits were discussed by reference to their characteristics and purpose. The choice of the correct type of credit is dependent on the specific circumstances of the case; it is important to choose the correct type of credit so as to ensure a seamless transaction and to obtain the best possible benefit from the instrument. It has also been shown that many complicated legal relationships arise from a documentary credit transaction, some of which do not fit into traditional concepts of a contract under the English common law. From the discussion in this chapter, it is evident that the principle of autonomy and the principle of strict compliance underpin the operation of the documentary credit, ensuring its success and attractiveness as an instrument of payment. However, by safeguarding the certainty of payment under a credit, these two fundamental principles also create unsatisfactory situations where some parties are able to benefit unfairly from the documentary credit system. As a result of this unfairness and abuse, the law has had to compromise these principles, by recognising that payment under a documentary credit can be withheld in certain circumstances. The focus of this thesis has been to examine the circumstances which provide a basis for withholding payment under a documentary credit. Throughout the analysis in this study it has been shown that some of these grounds for withholding payment constitute exceptions to the autonomy principle, whilst some others do not.

It is undisputed that the tender of non-compliant documents will provide a ground for refusing payment as this follows directly from the principle of strict compliance. Chapter 2 investigated the most common type of discrepancies which provide a ground for refusing payment and made recommendations for reform of the law where necessary. Although the principle of strict compliance is the guiding principle in the standard of compliance, the analysis of the relevant court decisions and the provisions of the UCP revealed that “strict compliance” has a different meaning in different types of documents. On this issue, the statement of Professor Schmitthoff that “This branch of law is too multiform to admit

generalisation” is most cogent.¹ Many problems may arise as a result of an overly strict or overly lenient application of the principle of strict compliance. Although the UCP 600 is not perfect, this study made the finding that the new UCP strikes a good balance between preserving the benefit of certainty and maintaining the interest of fairness. The relaxation of the rules of compliance and the additional options for which banks may deal with discrepant documents under UCP 600 may succeed in reducing the rejection rates of tendered documents. Nevertheless, despite the immense effort to achieve uniformity in this area, UCP 600 does not provide for every type of discrepancy which may arise in practice and some of its provisions are also exposed to uncertainty. It is certainly the case that discrepant documents cannot be eliminated but it most certainly can be reduced to a great extent if all sellers adopt practical measures such as understanding the law on documentary compliance and implementing appropriate training and strategy to handle documents within the many departments in their organisations so that common discrepancies can be prevented prior to the shipping of the goods.

Because fraudulent activities have dire consequences on international trading and affect the success of the documentary credit as a financial instrument, the law has for a long time established that, in limited circumstances, fraud could provide a valid ground to prevent payment under a credit. Chapter 3 examined the fraud rule, an exception to the autonomy principle which was created to prevent unscrupulous fraudsters from benefiting from the system. This study discovered that in England the fraud exception can only be applied to withhold payment under a credit in extremely limited circumstances due to the many requirements imposed on a party who wishes to rely on the exception. Whilst it is recognised that there is a need to preserve the integrity of the system and maintain the certainty of payment, the way in which the law restricts the fraud exception is so excessive to the extent of defeating the objective of the exception. It is recommended that the fraud exception be relaxed but only in the following manner, as suggested throughout Chapter 3:

- a) The ambit of the fraud exception should include both fraud in the documents and fraud in the underlying transaction. As *Sztejn* shows, the determination of whether there are fraudulent documents is intertwined with the question of whether there is

¹ Clive M. Schmitthoff, "Discrepancy of Documents in Letters of Credit Transactions" [1987] J.B.L 94, 110.

fraud in the underlying transaction. Nevertheless, there is some indication that English law is moving in this direction.

- b) In considering whether to grant an injunction to refuse payment under the fraud exception, the balance of convenience test as expounded in *American Cyanamid v Ethicon Ltd* should not be applied. It has been argued that this test lacks certainty and imposes an unnecessary hurdle since the applicants are already burdened with the requirement of proving fraud to an extremely high standard. Further, this argument is consistent with the *ex turpi causa non oritur action* maxim, which forms the conceptual basis of the fraud exception.
- c) The fraud exception to the autonomy principle should encompass fraud perpetrated by a third party. Due to the practical difficulties of establishing a beneficiary's involvement in a fraud, a loophole will continue to exist in the law which allows fraudsters to continue obtaining monetary gains from the use of the instrument if this proposal is not adopted. It has also been demonstrated that forged documents do not actually conform to the terms and conditions of the credit, supporting further the idea that forged documents should constitute a ground to refuse payment under a credit.
- d) If recommendation c) is not adopted, it is submitted that the requirement of knowledge should at least be relaxed by the adoption of the concept of constructive knowledge. This submission, which is in line with the position adopted in America, also stems from the difficulties of proving subjective knowledge on the part of a beneficiary.

Chapter 4 explored the question of whether documentary nullity constitutes a ground for refusing payment under a documentary credit. The analysis of the relevant English cases revealed that English law does not at present recognise documentary nullity as a defence to payment. It was recommended that documentary nullity be accepted as a separate ground to withhold payment under a credit and should not as be treated as an extension of the fraud exception. Many arguments were presented for this proposition in this chapter - the non-compliance of null documents; the difference between the status of the beneficiary and a holder in due course; the protection of the financial position of banks; the prevention of fraud and the fairness in imposing the risk on the beneficiary. The writer takes the view that documentary nullity does not constitute an exception to the autonomy principle since presentation of a null document is presentation of an incomplete tender with the beneficiary

having no right to payment because of a failure to comply with the terms and conditions of a credit. Although various approaches have been adopted by different judges and commentators in the determination of whether a document is null, it is acknowledged that it is not possible to define clearly what constitutes a null document other than that it is generally a document which is devoid of legal force. It was also highlighted that it is a common misconception to regard forgery as an essential ingredient of a null documents - the analysis in this chapter demonstrated that fraud, forgery and nullity are distinct concepts which may overlap.

In Chapter 5, the writer considered whether illegality provides a valid ground to withhold payment under a documentary credit. On this issue, it has been shown that it is important to distinguish between the following two instances:

- a) The documentary credit is illegal
- b) The underlying contract which a documentary credit supports is illegal

Withholding payment in a) is not a contentious issue since it is well established in the general law of contract that a contract which is illegal is void or unenforceable. However, whether payment can be refused in b) is open to debate. The refusal of payment on the basis of b) will constitute an exception to the autonomy principle since the documentary credit itself is not directly illegal and is traditionally seen as a separate contract from the underlying contract. From the discussion in this chapter, it is revealed that, unlike other jurisdictions, English law is slowly recognising an illegality exception, although the exception is in need of further refinement. Based on the relevant English cases, it has been suggested that the scope of the illegality exception be limited by the following requirements:

- a) Knowledge of the beneficiary of the illegality: Just like the treatment of illegal contracts under the general law of contract, this thesis drew a distinction between contracts which are illegal at the time of formation and contracts which are illegal as performed. In the former, it was submitted that knowledge of the beneficiary is not a requirement for an illegality exception to succeed. In the latter, it was submitted that knowledge of the beneficiary is a pre-requisite to attract the illegality exception.
- b) Serious illegal conduct: It was acknowledged that there are a few methodologies which could be adopted to distinguish between an illegality which is sufficiently

serious and one which is not serious enough to constitute a ground to withhold payment. However, this thesis did not advocate any of these possible means because it was concluded that it is in the interest of justice to maintain some flexibility in the determination of this matter. There are, however, a few considerations, such as the subjective intention of the beneficiary, the potential or actual consequences of the illegality and the extent of transgression which may be taken into account in the determination of this issue.

- c) Close relationship between the contract and conduct: It has been shown that this requirement strikes at the heart of an illegality exception because a documentary credit can only be tainted by an illegality in the underlying contract if the illegality in the underlying contract is sufficiently linked to the credit. It was suggested that the manner for establishing this is to focus on the function served by the credit in relation to the alleged illegality in the underlying contract.

As for the issue of determining which is the applicable law to establish illegality in the absence of an express choice of law, it is submitted that the applicable law should be the law of the place where payment is to be made under the credit. This principle, if applied to all the contractual relationships arising from a documentary credit transaction, would provide a consistent solution to an issue of law which is complicated and confusing.

Chapter 6 examined cases in some common law jurisdictions where payment was refused under independent guarantees on the grounds of unconscionability. The aim was to assess whether this recent development should be adopted in relation to documentary credits. It has been highlighted that independent guarantees such as performance bonds and demand guarantees perform a different function from the documentary credit, but share many characteristics and have the same fundamental principles underlying the operation of these instruments. The documentary credit is primarily used to finance international trade but has been used in a variety of ways in practice. Due to the varied circumstances in which the documentary credit may be put to use, and the complexities of its operation, there is certainly scope for an unconscionability exception to be applied to the documentary credit. The flexibility of the unconscionability concept means that any injustice or gap left by the fraud exception may be corrected. However, it was concluded that the adoption of an unconscionability exception should not be recommended. It is nearly impossible to delineate the ambit of an unconscionability exception with sufficient certainty – this presents a problem

in an area where certainty of outcome is regarded as a crucial objective. This significant weakening of the autonomy principle could also create cash flow problems to beneficiaries. Since unconscionable conduct is not as threatening to international trading as a fraudulent or illegal conduct, it does not provide as strong a rationale as fraudulent or illegal conduct to overcome the competing interest of certainty.

In Chapter 7, the writer investigates whether payment under a documentary credit may be affected by negative stipulations in the underlying contract which limit the right to call for payment. The discussion revealed that Australian courts have already recognised this as an exception to the autonomy principle, but the position on this issue remains unsettled under English law despite an indication of judicial willingness to accept this exception. It was not recommended in this thesis that breach of negative stipulation be recognised as an additional exception to the autonomy principle. Unlike the other grounds which provide a basis for withholding payment, accepting a “breach of negative stipulation exception” is different because it effectively allows parties advertently to derogate from the principle of autonomy. This exception does in fact overlap with the unconscionability exception and just like the unconscionability exception, the arguments in favour of recognising this as an exception do not carry with them the same force as those which exist in nullity, fraud and illegality.

It should be emphasised that the various grounds which were advocated in this thesis to provide a basis to withhold payment will not impose any extra burden on a paying bank. English law imposes a very high level of proof of fraud in all stages of proceedings where the fraud exception is argued. This is laudable and hence, as with the fraud exception, a bank is only under a duty to refuse payment where it is in possession of extremely strong facts which establish illegality or nullity at the time of payment. However, a bank is not under a duty to obtain evidence or investigate for illegality or nullity.

Finally, there are some unresolved complex issues related to the operation of the documentary credit which are not within the scope of this thesis. The following issues are suggested for future research:

- a) What are the actual effects of the new provisions of UCP 600? The new rules only came into force on July 1, 2007 but the writer would like to conduct an empirical research on this issue in future to investigate the overall success of the new rules.

- b) Could arbitration be an efficient means to resolve issues and disputes relating to payment under a credit? Currently, an arbitral regime is not incorporated under the UCP. This issue is important because arbitration, in the bigger picture, could potentially play a pivotal role in enhancing the reliability of the documentary credit and ensuring its longevity in international trading transactions.
- c) What are the effects of exclusion clauses which expressly restrict the effect of forgery, fraud or illegality? The effect of these clauses on the right to payment may differ in respect of different parties such as beneficiaries, assignees and transferees.
- d) Is there a cause of action under the principle in *Hedley Byrne & Co Ltd v Heller & Partners Ltd*² for a party involved in a documentary transaction who suffers financial loss following payment under a documentary credit?
- e) What are the typical characteristics of securities provided by an applicant of a credit? The corollary to this is the question of how much importance is placed by a bank on the security provided by an applicant in practice.

These issues were identified throughout this study because they share a common feature with the subject matter of this thesis which is that further clarification of these issues may provide important insights into understanding the rights and obligations of the various parties in relation to payment.

² [1964] AC 465.

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