

Fraud Unravels All; Do Fraudulent Documents Invalidate A Letter of Credit?

Chathura Warnasuriya*

Abstract

Over the centuries, the banks and trade practitioners have developed practices and techniques for use in letters of credit in international trade finance. Those practices and were subsequently standardized by the Uniform Customs and Practice for Documentary Credit 600 (UCP 600). However, many aspects of Letters of Credit operation including fraud are not codified under the UCP. Diversified nature of National Laws in different countries can be source of confusion and problem when applying such rules. English law vigorously upholds the principle of autonomy in relation to letter of credit. Only exception to this is the 'Fraud Rule' which has been subject to various interpretations. This paper identifies applicable laws surrounding fraud exception while examining issues associated with it. Comparisons are made to applicable jurisdictions with particular emphasis on the provisions of the UCP 600. It is further aimed to identify flaws in existing legal regimes. Finally, a discussion is made to find possible avenues to redress any existing shortcomings with recommendations.

Introduction

It is a well-known fact that international trade contracts bear inherently more risk than the trade contracts entered into by parties from the same country. This is due to the differences in business methods and practices trade cultures of the parties involved, laws and regulations in the respective jurisdictions. Under these circumstances, it is

* Senior Lecturer, APIIT Law School, LLM– Wales, Ph.D– Brunel, Attorney at Law

very important for the seller to have the assurance that he will receive the payment for the goods dispatched and for the buyer to receive the goods has been ordered. One effective way of having such an assurance is to rely on a letter of credit as an international payment method.

Letters of Credit

As an important method of payment which facilitates international trade transactions, letters of credit (herein after also referred to as “the Credit”) have been described by English Judges as “the life blood of international commerce”.¹¹ It is the most preferred way of payment in international trade.¹² It is believed that this method of payment was formulated over 3000 years ago.¹³ These transactions are mainly preferred over single, short cross-border sales transactions, where the respective traders are unknown to each other.

In practice, where the parties have agreed to pay by way of a Letter of Credit, the buyer will apply to a bank for the issue of a Letter of Credit in which the seller is named as the beneficiary. The Letter of Credit will specify which documents must be furnished by the seller in order to obtain payment by the bank.

11 R D Harbottle Limited v National Westminster Bank [1977] 2 All ER 862.

12 Hans Van Houtte, *The Law of International Trade* (2nd edn, Sweet & Maxwell 2001) 8.02.

13 It is believed that the Phoenician merchants used letters of credit in extending their commerce to cities in the Mediterranean and The merchant bankers of Venice, Genoa, Florence, and other commercial cities of Europe freely used letters of credit in the fourteenth century - Mitchell J William, „Letter of Credit Applicant has no implied time limit to bring wrongful honour claim“, (2012) 71 St. John's Law Review 7.

The bank undertakes to make payment of a specified sum of money on presentation of the specified documents. There may be additional banks involved, such as the buyer's local bank, the advising bank or the confirming bank.

The documents will be presented and will commonly include the bill of lading or other transport documents, the insurance policy and the commercial invoice. Unfortunately, the presented documents can be forged and be fraudulent or can record details inaccurately. Such inaccuracy might be serious enough for the bank to reject their presentation and refuse the payment to the seller.

The Uniform Customs and Practice for Documentary Credits (UCP 600)

Over the centuries, the banks and trade practitioners have developed practices and techniques for use in letters of credit in international trade finance. Those practices and customs were subsequently standardized by the International Chamber of Commerce (ICC), by publishing the Uniform Customs and Practice for Documentary Credits (UCP) in the year 1933. The current version of the UCP was approved by the Banking Commission of the ICC at its meeting held in Paris on the 25th October 2006 and it came into effect from 1st of July 2007. The application of the UCP comes into effect, only if the parties to the credit incorporate them into their contract.¹⁴ Under

14 Uniform Customs and Practice for Documentary Credits 600, Article 1.

the English law, the UCP does not have the force of law¹⁵ and it can only be applied, if the parties have incorporated them into their contract.

However, as a practice, the British banks often incorporated the UCP into their contracts and consequently, the English Courts are familiar with the rules of the UCP and frequently interpret them.¹⁶

Throughout the period when letters of credit came into usage, the law applicable to letters of credit has been based on two major principles.¹⁷ From time to time, the interpretation of the law applicable to these principles became subject to minor changes. However, the core elements of these two principles still remain untouched.

Doctrine of strict compliance

When documents are presented to the bank by the beneficiary for examination, the bank checks whether the documents satisfy the requirements stipulated in the terms of the credit. A minor discrepancy may tempt the bank to reject the presentation and refuse the payment.¹⁸ The adherence by the bank to examine the documents strictly

15 Royal Bank of Scotland V Cassa di Risparmio [1992] 1 Bank L.R. 251.

16 Leo D'Arcy, Carole Murray and Barbara Cleave, *Schmittoff's Export Trade, The Law and Practice of International Trade* (10th edn, Sweet & Maxwell 2000) 168.

17 Carole Murray, David Holloway and Darren Timson-Hunt, *Schmittoff's The Law and Practice of International Trade* (12th edn, Sweet & Maxwell 2012) 194.

18 Paul Todd, "Discrepancies between Bills of Lading and Letters of Credit" in *Letters of Credit Update* (Government Information Service, USA) 474. Where it says, the original common law position is that the triviality of a defect was irrelevant.

to ascertain whether the documents are in compliance is called the Doctrine of Strict Compliance. Over many years, the yardstick which measures the strictness of document examination standards had always been subject to controversy. The definitions given by the UCP in respect of this principle were often vague and were the cause of contention between parties. Whilst the majority of Courts have applied this principle in the strictest possible manner, some Courts have tended to take a much more lenient view by applying the substantial documents complying standards.

The Principle of Autonomy

Article 4(a) of the UCP 600 makes provision to cover this principle. In terms of this principle, letters of credit are totally separate from and independent of underlying sales contracts.¹⁹ Article 4(a) of the UCP 600 states that;

'a bank which operates a credit is in no way concerned with or bound by such contract, even if any reference whatsoever to it is included in the credit'.

The buyer cannot ask the bank or a Court to stop payment to the seller even if it is found that the goods delivered do not

conform to what had been stated in the underlying contract. The only exception to this is that, banks can and/or a Court may interfere to stop the payment if it is satisfactorily

¹⁹ HamzehMalas v British Imex Industries Limited [1958] 2QB 127.

proved that, despite the fact that documents are in compliance with the credit, the document(s) submitted are fraudulent and the seller was involved in such act.²⁰

However, it has to be cautious, when relying upon this concept, because, it may minimise the significance of Letters of Credit as a method of payment, if it supersedes every dispute arising under the underlying contract. It is often questioned, whether it is sufficient enough to rely only on documents regardless of the commitment laid in the commercial contract. In this context, the strict adherence to the rule is also often criticised as the „Autonomy Principle“ may pave the way to promote false calls, abuse and fraud.²¹

This examines the exceptions to the principle of autonomy in documentary credit transactions. Its conceptual nature arises because the credit contracted is said to be autonomous to the underlying contract or transaction upon which it is based.²² This paper adopts an approach that is analytical and not simply descriptive of the issues discussed. It critically examines the research topic and the issues raised there in, by principally analysing case laws, statutes and other legal instruments related to the issues under consideration. It also makes an extensive use of other secondary literature related to the topic.

20 Schmitthoff's (n7) 194.

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

22 *HamzehMalas& Sons v British Imex Industries Ltd.* [1958] 2 QB 127, *Howe Richardson Scale Co. Ltd v Polimex-Cekop* [1978] 1 Lloyd's Rep 161; *R D Harbottle (Mercantile) Ltd. v National Westminster Bank Ltd* [1978] QB 146.

To facilitate the discussion necessary to deal with the topic, the paper analyses:

- (a) The fraud exception to the principle of autonomy in documentary credit;
- (b) The reason why it established itself as a defence capable of displacing the autonomy doctrine;
- (c) Arguments in support of and against their recognition and whether their recognition in any way affects documentary credit practice;
- (d) An optimal set of rules related to the fraud exception that can be applicable all over the world.

The Fraud Exception

Fraud exception penetrates the heart of letters of credit, as it allows banks to withhold payment even where the presented documents appear on their face to comply with the credit. Neither the UCP nor any other set of rules recognise this rule as an effective force. Roy Goode explains²³ the reluctance of the ICC to include any provision regarding the fraud exception in the UCP as follows: -

“Although the ICC operates as an international organization, it is not a law-making institution despite its

23 Roy Goode, „Abstract Payment Undertakings in International Transactions: Symposium New Developments in the Law of Credit Enhancement-Domestic and International“ [1996] Brooklyn Journal of International Law 4.

organizational representation in world business and finance. The UCP's rules do not bear the force of law unless, as the rules themselves expressly provided, the parties to contracts incorporating them as terms of their contracts. Therefore, UCP has been made not to deal with such matters as the effect of fraud on a beneficiary's right to payment."

Under these circumstances, this exception is considered as one area where controversies and confusions remain.²⁴ It is also important to note that there are no clear standards that can draw a line between the fraud rule and the principle of autonomy. It is not well established when, where and under what conditions the fraud exception should be applied.

Despite the lack of empathy to understand the importance of this exception by the ICC, the fraud rule has been playing a major role in letters of credit transactions for almost a century as custom and/or practice among banks and legal systems. If a banking system in a country has a custom and/or practice which can stop the payment on suspicion of a fraud and these practices are continuously used by them, there should be a discussion at the ICC on identifying optimal standards which can be applicable worldwide.

24 Ross P. Buckley and Xiang Gao, "Fraud in the transaction, Enjoining Letters of credit during Iran Revolution" (93 HLRV L. REV 992,995 The Development of the Fraud Rule in Letter of Credit Law) <[https://www.law.upenn.edu/journals/jil/articles/volume23/issue4/Buckle yGao23U.Pa.J.Int'lEcon.L.663\(2002\).pdf](https://www.law.upenn.edu/journals/jil/articles/volume23/issue4/Buckle yGao23U.Pa.J.Int'lEcon.L.663(2002).pdf)> accessed 10 October 2020.

In the light of the above, this discussion will not go so far as to suggest that the powers vested in the Courts to determine whether a fraud has been committed or is imminent should be transferred to the bank. However, there should be measures that a bank can take to minimise or deter the seller taking unfair advantage, which can subsequently amount to a fraud or an unfair request by the buyer to hold the payment on the ground of an alleged fraud.

The Fraud Exception under the English Law

In the United Kingdom, the fraud exception has not been codified as a rule. However, Courts generally tend to apply the rule where it is necessary. The traditional approaches taken by the Courts imply the reluctance of the Courts to interfere with the autonomy principle.²⁵

The narrow approach taken by the British Courts and their reluctance to interfere was greatly demonstrated in the judgment *Hamzeh Malas and Sons v British Imex Industries Limited*²⁶ where the Court of Appeal explained that;

'it is clear enough that the opening of a letter of credit confirms a bargain between the banker and the seller which makes the bank obliged to honour the payment irrespective of any dispute between the parties over the performance of the sales contract'.

²⁵ R D Harbottle (Mercantile) Ltd. v. National Westminster Bank Ltd [1977] 2 All E.R. 862(QB).

²⁶ [1958] 2 QB 129.

In light of the above-mentioned view, it is clear that, due to the general non-interference approach by the Courts in the United Kingdom the plaintiff has been saddled with the onerous responsibility to prove the cause of action in the case of a fraud.²⁷

This position is further established by the judgment made in *Edward Owen Engineering Limited V Barclays Bank International Limited*²⁸, where it was stated that, „to the general principle of independence, the only exception would be the established or obvious fraud to the knowledge of the bank“.

However, this traditional non-interference approach by the Courts has been fading away as time passed by. For example, in *The United Trading Corporation SA and Murray Clayton Ltd v Allied Arab Bank Limited*²⁹, the standards of evidence required to prove a fraud were scrutinized. The principles laid down in the judgment of this case serve as a formula, which can be utilised in respect of any dispute relating to fraud.³⁰ Lord Justice Ackner in his judgement, by way of obiter dicta, specified the standard of evidence as follows;

‘The evidence of fraud to be clear, the Court would also expect to give opportunity to parties involved to answer the allegations. If the Court is satisfied with the materials

27 Ross Buckley and Xiang Gao, „The Development of the Fraud Rule in Letter of Credit Law: The Journey so Far and the Road Ahead“ (2002) 23 University of Pennsylvania Journal of Economic Law 689.

28 [1977]1 All E.R. 976(C.A).

29 [1985] 2 Lloyd’s Law Reports 554.

30 *Turkiye IS Bankasi AS v Bank of China* [1996] 2 Lloyd’s Law Rep 611.

before it, then the buyer has made out a sufficient case of fraud.'

In the case of *United City Merchants (Investment) Limited V Royal Bank of Canada*³¹, Lord Diplock acknowledged the emphasis on fraud exception by stating, to the general acknowledgment on Independence principle, there is one exception where the seller for the purpose of receiving money on the letter of credit fraudulently submits the confirming bank documents that contain expressly or by implication, material representations of fact that to his knowledge are false. This exception has been well established in the USA as provided by the decision made in *Sztejn v. J. Henry Schroder Banking Corporation*³² and the fraud exception on the part of the beneficiary expecting to avail himself of the credit is a clear application of the *maxim ex turpicausa non orituractio*³³ or 'fraud unravels all'. The Court will interfere to stop the process being used by a dishonest person to carry out a fraud³⁴. At the conclusion, it was stated that, **“the beneficiary’s knowledge about the fraud is the key in determining either to apply the fraud exception or not”**.

It appears that the British Courts adopt a different approach when the buyer brings an action to stop the payment over

31 [1979] 1 Lloyd's Law Reports 267 (QB).

32 [1941]31 NYS 2d 631.

33 Legal doctrine which states that a plaintiff will be unable to pursue legal remedy if it arises in connection with his own illegal act. Particularly relevant in the law of contract, tort and trusts.

34 [1983] 1 A.C. 168.

an allegation of fraud. If it is needed to apply for an injunction to prevent the bank from paying the beneficiary, the evidence to be placed before the Court must be sufficient enough to establish the fraud. If the bank has stopped the payment to the beneficiary on the basis of a fraud, the bank has to justify its decision to the Court with evidence that satisfy with the balance of probabilities that the beneficiary was guilty of fraud. Therefore, it can be stated that, under the English law, the application of the fraud rule is very narrow as against the Autonomy principle. In summary, under English law, to establish a fraud, the plaintiff is required to establish before the Court a **clear and obvious**³⁵ fraud which the bank **must have knowledge** of and a mere allegation of fraud is not sufficient enough.³⁶ In addition, the **beneficiary must have knowledge of the fraud**³⁷ at the time of presenting documents to the bank for examination. Finally, to prove the fraud, the allegation must be supported with **strong corroborative evidence**³⁸, usually in the form of contemporary documents.

General guidelines to determine frauds

It is important to note that, irrespective of the fact that the UCP does not recognize the fraud exception, the rule still applies to the cases where the respective letters of credit

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

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

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

38 *United Trading Corporation* (n18) 561.

were issued subject to the provisions of the UCP. The lack of cover provided by the UCP leaves a vacuum over the issue of how a bank should act when a complaint is made regarding a fraudulent document. Due to that reason, various methods are used by banks to decide whether to hold the payment when a suspicion is raised. There was no reported case, where the court had refused to apply the fraud rule citing the reason that the UCP does not recognize it. Therefore, it must be acknowledged that the Fraud Exception has become a part and parcel of the law relating to letters of credit.

This paper suggests that, banks should have a set of standardized general guidelines as to steps they should take when they are presented with a suspicious document or fraud claim. However, it is suggested that, the application of fraud exception should be limited only to the documents submitted for the examination. The reason behind this is to leave any dispute over the performance of the underlying sales contract outside the purview of the banker's duties. In Addition, it is not suggested that banks should hold inquiries on the performance of the sales agreement and act as a Court house. The only element suggested by this article is the measures that can be taken to prevent the bank from making payment to the beneficiary on forged documents or to prevent banks claiming that documents are forged when the beneficiary has nothing to do with the alleged fraudulent act. In addition, this will help to minimize the amount of erroneous interpretation on fraud exception.

The suggested guidelines-

A) *If a presentation of a document for examination appears, on its face, to be strictly complying with the terms and conditions of the letter of credit, but it is clear to the issuer that such document is forged and the fraudulent document has been presented with the knowledge of the beneficiary and thereby honouring such presentation would facilitate the fraudulent act committed by the beneficiary, the issuer shall not honour the demand of payment.*

B) *However, the issuer shall honour the presentation if the demand is made by:*³⁹

- (a) A nominated person who has given value in good faith and without notice of forgery,*
- (b) A confirmer who has honoured its confirmation in good faith,*
- (c) 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*
- (d) An assignee of the issuer or nominated person's deferred obligation that was taken for value and without notice of forgery or material fraud after the obligation was incurred by the issuer or nominated person*

It must be noted that, the pursuit of certainty, while

³⁹ Extracted from Article 5- 109 of the Uniform Commercial Code (USA).

preserving a legitimate and crucial aspect of letters of credit law, need not completely disregard the consideration of fairness. This research paper has made an endeavour to argue that there should be a standard set of rules to determine fraud when alarms are raised. The courts should be motivated by fairness to avoid irretrievable injustice. The decisions made by courts, which seek to preserve and promote the legitimate expectation of commercial parties, most often run contrary to established authorities. They also remind us the need of a flexible approach to the autonomy doctrine and its exceptions. It has been stated that, the autonomy doctrine as an assurance of payment inflexibly detached from the underlying contract upon which it is based would sometimes present situations where the approach does not live up to commercial realities.⁴⁰ Unless, the existing perception of the autonomy principle is discontinued, it would hinder the smooth operation of letters of credit as a viable method of payment in international trade.

40 Chumah Amaefule, „The exception to the principle of autonomy of documentary credit“ (University of Birmingham Research Archive, August 2011)<the exceptions to the principle of autonomy of documentary credits (bham.ac.uk)> Accessed on 14 October 2020.