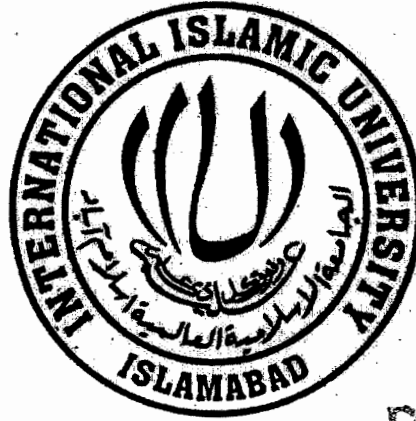


FRAUD EXCEPTION IN LETTER OF CREDIT

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*A dissertation submitted in partial fulfillment of the requirements for the
award of Master Degree in Corporate Law*

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It is certified that we have gone through the theses titled. "Fraud Exception in Letter of Credit" Submitted by Mr. Hafiz Muhammad Asghar Awan, student of LLM Corporate Law, Registration No. 220 FSL/LLMCL/F09, and we have come to the conclusion that the research work is up to the mark and fulfills all the requirements for the Master Degree in Law by the Faculty of Shariah & Law, International Islamic University Islamabad, and Viva voce exam has conducted and the candidate has successfully defended his these and is found fit for the award of LLM Degree in Law.

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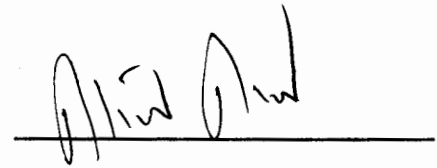
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DECLARATION

I, Hafiz Muhammad Asghar Awan having Registration No.220-FSL/LLMCL/FO9 Student of LL.M Corporate Law in International Islamic University Islamabad, do here by solemnly declare that the theses entitled(Fraud Exception in Letter of Credit) is submitted in partial fulfillment of the requirements for the award of Master degree in LL.M Corporate Law.

It is my original work and has not been submitted before, in this or other University, and Institution.

Hafiz Muhammad Asghar Awan

Registration No.220-FSL/LLMCL/FO9

List of Abbreviations

1. LOC. Letter of Credit
2. ICC. International Chamber of Commerce
3. UCP. Uniform Custom and Practice
4. UCC. Uniform Commercial Custom
5. UNICITRAL. United Nation Convention for Investment and Trade Law
6. ICLOCA. International Center for Letter of Credit Arbitration
7. FOB. Free On Board(named loading port)
8. CIF. Cost Insurance and Fright(named destination port)
9. CPT. Carriage paid To(named place of destination)
- 10.CIP. Carriage and Insurance Paid To
- 11.PFI. Pro-Forma Insurance
- 12.CI. Commercial Invoice
- 13.PO. Purchase Order
- 14.CTO. Container Terminal Order

DEDICATION

DEDICATED TO MY PARENTS

“My Lord! Bestow on them thy mercy even as they cherished me in childhood”

SURAH AL ISRA (VERSE: 24)

AKNOWLEDGEMENT

All praise is to almighty Allah the creator of this universe who enabled me to accomplish this research work.

I would like to acknowledge my deep sense of gratitude to my honorable and respectful supervisor Sir. Attaullah khan Mahmood for continuously providing all possible support and guidance.

In addition, I want to acknowledge all my teachers and friends who inspired me to choice and write my research paper on this topic.

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ABSTRACT

This thesis contributes to research on the application of the fraud rule in documentary credits under English law. The conflict between the fraud rule and the autonomy principle in documentary credits is an essential point in the thesis.

Most of the difficulties over the application of the fraud rule in documentary credits are caused by the solid position of the autonomy principle.

In the absence of relevant legislation the thesis focuses and relays on Uniform Custom and Practice Rules for Documentary Credit and on the development of case law.

The thesis starts by introducing the essentiality of the documentary credit with its all kinds in detail in light of case laws in different jurisdictions and rights and obligations which are emerged through studying the case law.

First chapter of this research paper also includes the discussion of separation between the documents and the goods (known as the autonomy principle) which is the fundamental principle of documentary credits may also cause problems such as frauds and abuse of the credit. The fraud rule was established to prevent the fraudulent seller from abusing the credit during transactions. It therefore conflicted with the autonomy principle from its inception.

The conflict between the fraud rule and the autonomy principle did not stop the application of the fraud rule in the world.

The second chapter of my thesis focuses on research on literal and technical explanation of fraud in the light of its significances and all possible kinds of the fraud rule in documentary credit in light of case laws and to explore a proper way to adapt the fraud exception into the documentary credits system in a manner which minimizes conflict with the autonomy principle.

Third chapter of the thesis focuses on analyzing the historical development of the fraud rule in the United States where the rule was born and follows with a comparison of its development and its application in United States and common law courts.

Chapter four of this research paper also provides guidance on application of documentary credit in Islamic banking and on application of fraud exception in it and on differences between applications of documentary credits in commercial and Islamic banks.

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Chapter 1

Introduction

The purpose of this study is to show why the modern business transaction at International level is requiring payment through the Letter of Credit and to suggest ways in which this is to be accomplished without favoring the developing nations.

To achieve this purpose the study of this theses deals in comprehensive and integrated manner in the light of the rules of uniform custom and practice and decided case laws with the issues like role of Doctrine of strict compliance in international business transaction and the application of Autonomy principle and to what extend the fraud will affect business transaction and what are the requirements of fraud to become a complete fraud in international business transaction which is also known as a fraud exception.

Separation between the documents and the goods (known as the autonomy principle) which is the fundamental principle of documentary.

Ideally the fraud rule may execute its best function to prevent frauds through international trade transactions.

The resolution of these issues through comparative study in Common Law and Islamic Law perspective has very much important in the eyes of Muslim scholars and economists because the resolution of these issues is necessary for the progress of Islamic commercial law and banking in the modern business transaction at international level.

Therefore the study of these issues will be the heart of my theses and integrated approach in treatment of these issues must be followed through legal analyses through the general principles of Islamic commercial law.

The detail reason for the modern business transactions requiring payment through the documentary credit as well as the methods adopted for accomplishing this will be elaborated throughout study but a preliminary explanation of the need of the letter of credit and method adopted to do so will help to determine the scope of this study.

Therefore the preliminary explanation follows.

1.1 Why Letter of Credit is Essential

In International Trade due to long period of destination and due to different location of the parties in a different Countries makes a difficulty for the parties to pay money against the purchased goods in the same session as it is practiced in ordinary business transaction or the seller can not deliver the goods in one hand and take money from the buyer with other hand.

It is always possible that the buyer has become insolvent or is not in a possession to pay an amount in full against the purchased goods when the purchased goods reached to his country.

To resolve this difficulty and to reduce a credit risk from the seller the letter of credit is introduced. The very object of letter of credit¹ is to provide a near fool proof method of placing money in the hand of beneficiary when he tenders all necessary documents which are in compliance to all requirements which are stipulated in letter of credit.

Therefore letter of credit is called (life blood of commerce) The value of this system is that it secures the interest of all concerned parties the seller has the assurance of his payment through reliable bank² which is in his own country that is known as confirming bank when he presents the correct documents to the confirming bank and it will examine the conformity of those documents with the stipulated terms of letter of credit.³

If those documents are in compliance with the stipulations of letter of credit then confirming bank will pay to the beneficiary without looking to the underlying transaction through this way the interest of beneficiary is saved.⁴

On the other hand the interest of confirming bank is also protected through the recognized right to retain the documents until it receives the payment from an issuing bank

¹ Black's law dictionary eight edition p.923

Under which the issuer (a bank) at the customer's request, agrees to honor a draft or other demand for payment made by a third party (the beneficiary) as long as the draft or demand complies with specified conditions, and regardless of whether any underlying agreement between the customer and the beneficiary is satisfied.

² Between trusted parties, when a letter of credit is not cost-effective, alternative may be sought to secure payment, in which payment through sight or draft time, is utilized. A draft is simply a check drawn on the account of the purchaser. A sight draft allows the seller to cash the draft immediately on presenting the documents to the bank. A time draft is like a postdated check, can be cashed only some after the presentation of a documents. Most commonly thirty, sixty, or ninety days

³CHARLES J. WOELFEL (*Encyclopedia of banking and finance*), tenth edition p.695

⁴ Dennis J. Murphy (*How to document International Commercial Transaction*) International law Quarterly, pp.70, 85, 1985

and issuing bank is allowed not to deliver the documents unless it receives its payment from a seller¹.

Nearly all arrangements and transactions for letter of credit will be regulated under the uniform custom and practice² for documentary credit³ which are published by International Chamber of Commerce⁴ and all those arrangements which are essential for the smooth working of the letter of credit are described in detail as follows.

1.2 How the Letter of Credit works in International Business Transaction.

As apparent from the brief description of letter of credit, that a letter of credit transaction involves number of stages and a number of under takings between the parties for the completion of the process of the letter of the credit to facilitates the modern business transaction in International Trade.⁵

The transaction normally would consist the following stages.

1.2.1 The seller and buyer to documentary arrangements in the sale contract.

1.2.2 The buyer then makes arrangement with his bank known as the issuing bank⁶ to open the letter of credit.⁷

The arrangement would include details about documents that need to be tendered by the seller to and all the specifications which would be entered in to the documents.

¹ Crol Murry, (*Expot Trade*) p230, Londen Savet and Maxwell, 2007

² UCP600, is the seventh version of the rules. The first version was issued was published in 1933, the second appeared in 1951, the third in 1962, the fourth in 1974, the fifth in 1983, the sixth UCP 500, IN 1993,

³ Documentary credit permits the accompanying draft, or bill of exchange to be transferred. This allows for the negotiation of draft at other bank. The issuing bank is required to reimburse any bank that negotiates the letter of credit.

⁴ ICC brochure 600, the UCP is available from the ICC and at <http://www.iccwbo.org>

⁵ . Dennis J. Murphy (*How to document International Commercial Transaction*) .International law Quarterly,p70, 85, 1985

⁶ The issuing bank's liability to pay and to be reimbursed from its customer becomes absolute upon the completion of the terms and conditions of the letter of credit. Under the provisions of the Uniform Customs and Practice for Documentary Credits, the bank is given a reasonable amount of time after receipt of the documents to honor the draft

⁷ Article, 8.3 of the UCP 600, is available from the ICC and at <http://www.iccwbo.org>

1.2.3 The seller will be informed that the letter of credit has been opened, either by the branch of the issuing bank in the seller's country or by another bank known as the advising bank¹ where the letter of credit is confirmed² by the confirming bank³ whether the contents of the bill of exchange⁴ are in compliance with the terms of the letter of credit or not.

1.2.4 The seller will ship the goods provided the letter of credit confirms to what the Parties agreed in their contract of sale and present the documents to the confirming⁵ bank.

1.2.5 When the seller will present the document to the confirming bank, it will examine those documents and if the documents confirm the terms of the letter of credit then the bank will accept the documents and pay the seller.⁶

1.2.6 The advising bank which has paid the seller will be reimbursed by the issuing bank and the issuing bank will be reimbursed by the buyer.⁷

In a documentary credit transaction there are also a same number of undertakings between the various parties to the transaction.

Thus the great utility of letter of credit under the regulation of UCP will be more understandable in the light of the following decided case laws.

¹ An advising bank, usually a foreign correspondent bank of the issuing bank will advise the beneficiary. Generally, the beneficiary would want to use a local bank to insure that the letter of credit is valid. In addition, the advising bank would be responsible for sending the documents to the issuing bank. The advising bank has no other obligation under the letter of credit. If the issuing bank does not pay the beneficiary, the advising bank is not obligated to pay.

² Article, 8.2 of the UCP 600, is available from the ICC and at <http://www.iccwbo.org>

³ The correspondent bank may confirm the letter of credit for the beneficiary. At the request of the issuing bank, the correspondent obligates itself to insure payment under the letter of credit. The confirming bank would not confirm the credit until it evaluated the country and bank where the letter of credit originates. The confirming bank is usually the advising bank.

⁴ The bill of exchange, some time referred as a draft, is a very old established method of transacting money and is governed by the Bills of Exchange Act 1882, which defines it as an unconditional order in writing, addressed by one person to another, signed by the person who made it, and requiring the person to whom it is addressed to pay on demand, or at a fixed determinable future time.

⁵ Article, 8.4 of the UCP 600, is available from the ICC and at <http://www.iccwbo.org>

⁶ Article, 8.5 of the UCP 600, is available from the ICC and at <http://www.iccwbo.org>

⁵ Ibid

⁷ Ibid

1.3 The Opening of a Letter of Credit

Arrangements for opening of letter of credit must be made by the buyer who will also give instructions about the documents that need to be tendered by the seller.¹

Opening of a letter of credit is generally regarded as a condition precedent to the delivery of the goods by the seller especially when the contract of sale stipulates a fixed date for opening the credit the letter of credit must be opened in due date.²

Therefore seller is not under an obligation to perform his side of bargain until the letter of credit is opened as it was decided.³

Some time the contract of sale does not expressly provide a date for opening of the letter of credit but stipulates a shipment period, in such a case letter of credit must be opened before the shipment as it was decided in the following cases.⁴

Pavia Company SpA v Thurmann- Neilseen A.E.R(1952) CIF

Contract provided for shipment from 1 February to 30 April. The contract was silent on the date for opening the letter of credit. The buyer opened the credit on 22 April, the seller sought damages for breach of contract on the ground that the buyer failed to open a credit before the shipment hence he was under an obligation to open it prior to the shipment.

On the other hand buyer argued that he saw no reason as to why the credit should be opened prior to the shipment because the purpose of credit is paying the seller on the tendering of documents and that is fulfilled⁵.

The Court however held in the favour of the seller on the ground that the object of the letter of credit is to assure the seller prior to shipment. Therefore the breach of contract is happened and damages are to be granted.

¹ Henry Harfield, (*Bank Credit and acceptance*) p 69, 15th edn, New York. Joon Willy sons, 1974

² *Ibd*

³ *Garcia v page Company Ltd, A.E.R (19360)*

⁴ *Plasticmoda SpA V Davidson Ltd,A.E.R (1952)*

⁵ Larry A.DiMatteo,Lucien J. Dhooge(*International Business Law*).A Transactional Approach.p375, London Sweet and Maxwell, 2007

1.4 Failure to Open a Letter of Credit

Where the buyer failed to open a credit as it was stipulated by the sale contract, then the seller can sue the buyer for damages¹ the damages awarded would include the profit of the seller if the contract had been successfully completed subject to the rule of remoteness of damages² and will be more specified in the following case.³

Tras Trust SPRL V Danubian Trading Co Ltd A. E.R (1952)

The contract was for the purchase of steel. The buyer did not open letter of credit on time, and the seller claimed lost profits as a damages but the buyer argued that only nominal damages were payable because the seller could have sold the steel at a profit in a market that was rising at that time.

The court held the decision in the favour of the seller on the ground that the arrangements were not a simply mode of paying the seller but a mechanism which provided the seller with security and the opportunity of rising credit for the purchase of material he may need to fulfill the sale contract.

1.5 Examination of Documents by the Seller and Confirming Bank.

The beneficiary should prepare and examine all the documents carefully before presentation to the paying bank to avoid any delay in receipt of payment commonly found discrepancies between the letter of credit and supporting documents include.⁴

Letter of Credit has expired prior to presentation of draft.

Bill of Lading evidences delivery prior to or after the date range stated in the credit.

Stale dated documents.

Changes included in the invoice not authorized in the credit are as under.

Inconsistent description of goods.

Insurance document errors.

Invoice amount not equal to draft amount.

Ports of loading and destination not as specified in the credit.

¹ Hadley v Baxendale A. E. R (1854)

² It is referred to such damage which is not occurred due to unusual combination of circumstances, which were beyond the control of the person, or such damages which are occurred due to negligence of the party, and such damage could be controlled.

³ LEO D'ARCY and CAROLE MURRAY(*The law and practice of international trade*)p34 tenth edition, pub. London sweet & Maxwell 2000

⁴ Rendell R S, New, ICC Rules Impact letter of credit.p28 (*International Financial Law Review*) 1993

Description of merchandise is not as stated in credit.

A document required by the credit is not presented.

Documents are inconsistent as to general information such as volume, quality etc.

Names of documents not exact as described in the credit. Beneficiary information must be exact. Invoice or statement is not signed as stipulated in the letter of credit.

When the documents are tendered by the seller to the confirming bank, then the bank is under an obligation to examine the documents weather those documents are on compliance with the terms of the letter of credit or not, and weather to accept or reject the documents.¹

The bank has reasonable time period to inspect, and examine the documents in deciding weather the is reasonable or not the court will consider the banking practice besides the other factors such as technical languages is used in the documents the length of the documents.²

Under the 1993 version of the UCP the banks have a maximum seven days to examine the documents, according to Article 13 (b)

“The issuing , and the confirming bank, and any other bank acting on their behalf shall each have a reasonable time, not exceed seven banking days following the day of receipt of the documents, to examine the documents and to determine weather to take up or to refuse the documents, and to inform the party from which it received the documents accordingly”³

When a discrepancy⁴ is detected by the negotiating bank a correction to the document may be allowed if it can be done quickly while remaining in the control of the bank if time is not a factor the exporter should request that the negotiating bank return the documents for corrections.⁵

If there is not enough time to make corrections the exporter should request that the negotiating bank send the documents to the issuing bank on an approval basis or notify the issuing bank by wire outline the discrepancies, and request authority to pay payment cannot be made until all parties have agreed to jointly waive the discrepancy.⁶

¹ Scihoff C M,(*Confirmation in Export Transaction*)p17, Journal of Business Law,1957

² Banker Trust Ltd V State Bank of India , A. I. R. (1991).

³ ICC brochure 1993, the UCP is available from the ICC and at <http://www.iccwbo.org>

³ CHARLES J. WOELFEL (*Encyclopedia of banking and finance*)p. 695 tenth edition

⁴ A discrepancy is an irregularity in the documents that causes them to be in non-compliance to the letter of credit

⁵ Larry A.DiMatteo,Lucien J. Dhooge(*International Business Law*).ATransactionalApproach.p355,London Sweet and Maxwell, 2007

⁶ Ibid

1. 5. 2 Sellers Duty to tender the Documents to the Advising Bank

When the seller is advised about opening of the letter of credit then his job will start and he must arrange shipment and he is under an obligation to tender the documents to the advising bank and the documents which are required to be tendered by the seller to the confirming bank or to advising bank are included.¹

Bill of Lading

Bills of lading usually include a brief description of goods providing the terms on which they are to be carried, the name of the carrying vessel and the port of discharge.²

Commercial Invoice

The invoice is a statement of the seller to a buyer describing what he has sold the price of the goods the weight lists and such other details including the shipping marks which appear on packages and on the bills of lading.³

Insurance Document

Documents showing a complete insurance cover that has been issued and duly signed by insurance company in accordance with stipulations contained in the credit against any loss or damage which may occur during shipment.⁴

Therefore the seller can not waive the requirement to tender the documents to the bank and tendering them to the buyer directly and demand payment from the buyer directly because under the rule of UCP payment is to be paid through the bank when they have agreed to open the credit.⁵

As it was decided in the following case of⁶

Soporoma SpA *V.* Marin and Animal by- Products Corporation A.E.R (1966)

¹Asrar H. Siddiqi (*Finance of foreign trade and foreign exchange*) second edition , p.143 publ. royal book company

² Larry A.DiMatteo,Lucien J. Dhooge(*International Business Law*) A Transactional Approach.p375, Londen Savet and Maxwell, 2007

³ Ibd

⁴ Ibd

⁵ By DR Indira Carr(*International Trade Law*) p 191, Londen Savet and Maxwell, 2007

⁶ Ibd

The seller tendered the documents to the confirming bank but the documents validly rejected and then the seller tendered the documents to the buyer directly which were also rejected by the buyer the seller sued the buyer.

The court held in the favour of the buyer stating that the second tender was invalid, because if it would go against the express terms of the letter of credit if it was not allowed by the buyer.

1.5. 3 waiving of the Right to Examine the Documents by the Seller.

As we have stated before that when there was contract of sale conditional with the opening of the letter of credit, but buyer failed to open a credit in the fixed time period or there was some deficiencies in the credit then the seller is not under obligation to tender the documents to the confirming bank.¹

Some time despite these deficiencies the seller do hi job and tender the documents it will be deemed that the seller has waived his right to comply the contract of sale, subsequently he can not revoke the waiver without giving the notice to the buyer as it was decided in the following case.

Panoutos vRaymond Hadley Corporation of New Yark(1917)²

The contract was for a number of shipments of flour the buyer agreed to open a confirmed letter of credit but subsequently he opened an unconfirmed credit instead.³

The seller was in knowledge of his defect despite this the seller made a few shipments on unconfirmed letter of credit but after word he repudiated the contract when an unconfirmed was provided for later shipments.

The court held that the seller could not revoke the waiver without giving the buyers reasonable notice. Similarly if there was some variation in the opening of credit seller is not under any obligation to tender the documents, but if the seller accepted the contract with variations then later on he ca not revoke such variations unilaterally as it was decided in the following case⁴

W J Alan and CO Ltd V EI Nasr Export and Trade Company A.E.R (1972)

¹ Ibid

² By DR Indira Carr(*International Trade Law*)p 199, London Savet and Maxwell, 2007

³ An unconfirmed credit is that credit which exclusively depends upon the issuing bank's obligation and the advising bank merely informs the beneficiary about the terms and conditions of the documentary credit without adding its own undertaking.

⁴ By DR Indira Carr(*International Trade Law*)p 202, London Savet and Maxwell, 2007

Under the terms of contract of sale payment was to take place in Kenyan shillings under the letter of credit but the credit which was opened stated that payment will be in sterling, the seller who did not object at first but later on sterling was devaluated and the seller claimed the damages for the differences in two currencies on the ground of the variation which was made in the credit by the buyer. The court of Appeal held that the contractual terms had been varied once after word it can not be revoked without giving notice to the other party.

Further more the restriction against the approaching directly to the buyer will not apply in the case of insolvency of the bank where the bank is not able to pay the amount to the seller because of insolvency in this kind of case the seller can go to the buyer directly for the payment.¹

1. 5. 4 Consequences of Acceptance of Documents without Due care

Generally the bank has a right to refuse a payment when it received the documents from the seller and it appears to the bank that the contents of the documents attached with the bill of exchange are not in compliance with the terms of the letter of the credit.²

Some time the bank loses his right to refusal, and waived its right to claim for strict compliance when it accepted the documents

Under the UCP rules³ the bank must examine the documents with due care to ascertain whether the documents are in compliance with the terms of the letter of the credit or not.

As it is decided in the following case⁴

Voest-Alpine- International V. Chase Manhattan Bank. A.E.R (1983)

Metal Scrap Trading Corporation is an Indian agency that had contracted to buy 7,000 tons from Vost Alpania in late Metal Scrap asked the bank of Baroda to issue letter of credit the credit was expressly made subject to the UCP.

The parties originally contemplated that Chase Manhattan bank would serve as an advising bank in transaction Chase was to review and examine the documents carefully which were submitted to it by the Indian corporation agency.

On February 13 two days before the expiration date of the credit Voest presented the drafts to Chase. The bill of lading were showing the date 31 January and the cargo certificate

¹ *W J Alan and CO Ltd V. El Nasr Export and Trade Company A.E.R (1972)*

² Dennis J. Murphy (How to document Commercial Transaction) p 70- 85

³ Article 13 (b) of the UCP 1993 version

⁴ Larry A. DiMatteo, Lucien J. Dhooge (*International Business Law*) *A Transactional Approach*, p381, London Sweet and Maxwell 2007

were showing the different date between February 2 and February 6 despite this large deficiency the Chase advised the bank of Baroda that the documents submitted by Voest are confirmed the.

But the bank of Baroda looks at the documents with more care than the Chase it promptly advised that the documents are not in compliance with the terms of the credit therefore it not honored the documents Voest presented the draft for payment Chase refused to pay then Voest file a suit against Chase on the ground that Chase was bound to examine the documents with due care and also argued that Chase is liable because it accepted them court held in the favor of Voest on the ground that the negligence was on the part of chase bank because it was bound to examine the documents with due care and unfortunately it failed to do so.

1. 6 Notice of Non Compliance by the Issuing Bank.

As we have stated that when an issuing bank dishonor the documents and refuse to pay then it is bound to inform the other party through the notice within seven days which must identifies all non compliance with the terms of credit and must specify the reason of non compliance.¹

Therefore the failure of issuing bank to give notice of the non compliance or to specify the reason of non compliance will stop the bank from claiming that documents were not in compliance with the term of credit and such failure also will stop the bank from reliance on these discrepancies² in a subsequence dishonor³.

Similarly the issuing bank must inform about non compliance of documents which are attached with the bill of lending otherwise it will loss to the right of claiming as it is decided in the case.⁴

According to Article 14 of UCP that the issuing may refuse the documents presented to it if it determine that the documents are not in compliance with the terms and conditions of the credit.

If the issuing bank refused then it must give notice to the other party other wise it will be bared from claiming of this ground.

¹ By DR Indira Carr, (*International Trade Law*) p 234 London Savet and Maxwell, 2007

²Ibd

³ Henry Harfieldd, (*Bank Credit and acceptance*) p 74, 15th edn, New Yark. Joon Willy sons, 1974

⁴ Hamilton Bank, N.A.V Kookmin Bank, 44 F Supp. 2d 653 (S. D. N. Y,1999

1.7 Doctrine of Strict Compliance in Letter of Credit

The legal principle is that the bank is entitled to reject the documents which do not strictly conform with the terms of the credit it conveniently referred to as doctrine of strict compliance.¹

The reason underlying this rule is that the advising bank is a special agent of issuing bank and the issuing bank is the agent of buyer if the agent with limited authority acts outside that authority or beyond his mandate the principle entitles to disown the act of the agent.

Therefore the bank has a right to reject the documents on the basis of strict compliance if these are not in conformity with the terms of letter credit even it can reject if those are similar but not in compliance.

It will be more explicit in the following case.²

Morlice Ltd V. E D and F Man, (1954)

The credit stipulated that the bill of lading will contain for five hundred bags but the banks rejected documents showed that tendered bill which refer to 4997 bags on the ground that it is not meeting the requirements of the letter of credit then the court upheld the arguments of the bank and the rejection was allowed.³

In other case ⁴ the bill of lading tendered by the seller referred machine-shelled groundnut kernels but the bank rejected the same which is coriander groundnut on the ground that it is not exactly the same which is mentioned in letter of credit.

In other words the bank trades in document not in goods.⁵

This sentiment is also expressed by the UCP in Article 4

*“ The parties to documentary credit deal, with documents, and not with goods, services, and other performance to which the document may rely”*⁶

The harsh of Doctrine of strict compliance is eased by the Article 37 of UCP in some cases when the description of the invoice and credit correspond.

The UCP also allows various tolerances in weight and value of the goods under Article 39 (b and c) respectively

¹ Larry A. DiMatteo, Lucien J. Dhooge (*International Business Law*) A Transactional Approach, p316, London Sweet and Maxwell, 2007

² *Ibid*

³ NICHOLAS L. DEAK and JOANNE C. CELUSAK (*International banking*) pub. New York institute of finance p.38

⁴ *JH Raymer and Company Ltd V. Hambrose Bank Ltd* A. E. R (1943)

⁵ *Suez SA V JH Raymer Ltd*, 1983

⁶ , Article, 4, of the UCP 600, is available from the ICC and at <http://www.iccwbo.org>

*'The doctrine of strict compliance will not apply in those cases where the instructions are not clean or ambiguous from the buyer to the issuing bank'*¹

As it was decided in the following case²

Midland Bank v Seymour A.E.R.(1955)

Instructions were given on the application forms. Under the description the quantity and price by the buyer entered were not clean though the entire description was possible when all the documents were read to gather.

The bank accepted the documents when the issuing sued for reimbursement the buyer argued that the documents were tendered did not confirmed to the description of the credit such as quantity and price of the goods.

The court held that the buyer did not stated clearly that the bill of lading should contain tall these detail.

Therefore the doctrine of strict compliance will no apply in such cases.

Similarly the doctrine of strict compliance will not apply in those cases where all the documents are linked to each other then there is in consistency in the contents of the bill of lading and the letter of credit.³

In Banue V. HJ Raymer A.E.R (1983)

The contract was for the sale of sugar according to the bill of lading, shipment had taken place on board Markhor, but according to one of certificate shipment had taken place on board of MV Markhor.

The court comes to the conclusion that the doctrine of strict compliance will not apply because of non consistency between the documents.

The requirements of consistency between the documents are also maintained by the UCP under the Article 21 which states.

"When documents other than transport documents, insurance documents, commercial invoices⁴ are called for, the credit should stipulate by whom such documents to be issued and

¹ UCP 600, is available from the ICC and at <http://www.iccwbo.org>

² NICHOLAS L. DEAK and JOANNE C. CELUSAK (*International banking*) pub. New York institute of finance p.40

³ Ibd

⁴ It includes a description of merchandise, price, FOB origin, and name and address of buyer and seller. The buyer and seller information must correspond exactly to the description in the letter of credit. Unless the letter of credit specifically states otherwise, a generic description of the merchandise is usually acceptable in the other accompanying documents.

their wording or data content. If credit does not so stipulate, bank will accept such documents as presented, provided that their data content is not inconsistent with any other stipulated documents presented”¹

1.8 Rejection of the Documents by the Confirming Bank.

When the confirming bank has rejected the documents then it must inform the reason for rejection. A number of possibilities are opened to the seller he could rectify the defect and re-tender the documents but he can do only in a stipulated time.²

It is also possible that the confirming bank may pay the seller on non conforming documents on indemnity³ for loss or damages the bank may suffer as a result of lack of conformity of the tendered documents.

Another alternative for the bank is to make the payment under reserve it means if the issuing bank will reject the documents then the confirming bank will be allowed to demand the money paid to the seller.⁴

Another important point that needs to be discussed is that the letter of credit is regarded as autonomous in character meaning there by that letter of credit is considered as independent, and separate from the contract of sale it is discussed in detail through describing reason and logic behind this principle as follows.

1.9 1. Autonomy of the Letter of Credit

As the bank's obligation to pay arises on the presentation of conforming documents not on delivery of the goods and the buyer can not prevent the bank from paying the seller where the goods for instance do not match the description of the contract of sale.⁵

The financial transaction is essentially independent from the underlying sales transaction. This characteristic of letter of credits is known as the autonomy principle.

That the credit transaction is separate from the sales contract is expressly set out in Articles 4 and 5 of UCP 600. Article 4 provides.

¹ UCP 600, is available from the ICC and at <http://www.iccwbo.org>

² Larry A. DiMatteo, Lucien J. Dhooge (*International Business Law*) A Transactional Approach, p323, London Sweet and Maxwell, 2007

³ Specifically indemnifies the purchaser against a certain stated circumstance. Indemnification is generally used to guaranty that shipping documents will be provided in good order when available.

⁴ Banque Suze V. JH Raymer Ltd, A. E.R (1983)

⁵ Dalhuisen Dalhuisen (*International Commercial, Financial and Trade Law*) 2nd ed.,n Hart Publishing, Oxford, 2004) 456-457

“A credit by its nature is separate from the sale or other contract on which it may be based. Banks are in no way concerned with or bound by such contract...Consequently, the undertaking of a bank to honour, to negotiate or to fulfill any other obligation under the credit, is not subject to claims or defaces by the applicant resulting from his relationships with the issuing bank or the beneficiary”¹

Article 5 further illustrates this point by adding

“Banks deal with documents and not with goods, services or performance to which the documents may relate.”²

The consequence of this principle is that the performance of the underlying transaction is irrelevant to the payment of the credit thus payment may be made on the documents even if the goods never arrive and the buyer has to seek damages from the carrier.

The reason and logic which justifies the autonomy of letters of credit is that letter of credit guarantee payment of the purchase price irrespective of the performance of the underlying transaction to which they relate.³

If the seller was not guaranteed payment their utility would be undermined.⁴

The efficacy of documentary credits has been described as (the life blood of international commerce) It is exactly the independence of letter of credit from the performance of the underlying contract which gives documentary credits their international commercial utility and efficacy.

The autonomy of the letter of credit from underlying transaction will be more explained from the following cases.⁵

Discount Records Ltd V. Barclays Bank Ltd .A.E.R(1975)

The contract was for the sale of records. On delivery the buyer discovered that some of boxes were empty, while others contained cassettes other than records.

The buyer file suit to get an injunction to stop the bank from paying the seller. Bu the court refuse to grant the injunction on the ground that the bank is obliged to pay when it received the tendered documents because bank trades in documents not in goods as we have stated above by the reference of Article 5 of UCP.

But the Mr Justice Megarry said

¹ ICC brochure 1993, the UCP is available from the ICC and at <http://www.iccwbo.org>

² *Ibd*

³ Henry Harfieldd, (*Bank Credit and acceptance*) p 87, 15th edn, New Yark. Joon Willy sons, 1974

⁴ Dalhuisen Dalhuisen (*International Commercial, Financial and Trade Law*) 2nd ed,n Hart Publishing, Oxford, 2004) 456-457

⁵ DR Indira Carr, (*International Trade Law*)p 194, London Sweet and Maxwell, 2007

*'that court would be willing to intervene only if a sufficiently grave cause was shown'*¹

Some other Jurist differs with the opinion of Megarry J and they argued

*'that to allow the buyer to stop the bank from paying the seller, where the goods are not in compliance with the description of the sale contract would seriously affect International Trade because the seller enter to a contract of sale on the bases of assurance, that he will be paid through the irrevocable letter of credit and may rely on provision of credit and purchase or manufacture the goods'*²

Therefore the intervention of the court would seriously affect the certainty of the payment that is normally associated with commercial credit.³

However payment by the bank will not affect the right of the buyer under the contract of sale to file a suit against the seller in breach of contract of sale.⁴

In my opinion this is not justified, that the sellers which are mostly developed nations are getting assurance and certainty of their payment through the provision of the credit.

On the other hand the buyers right to purchase, or to receive the described goods for which he is going to pay is not safe through the same letter of credit.

It is immoral illegal and against the natural justice that on the following groundes.

The interest of one party is certain and assured but the interest of other party is not certain and assured but the reality is that both the parties want assurance and to reserve their rights.

To provide a safe gaud to the seller from indulging him in to litigation, but on the other hand indulging the buyer (who has paid to get a described goods) in litigation to safe his interest from a court which is totally against the principle of Equality between the two contracting parties.

It is settled principle of Islamic law of contract that when there is fraud or misrepresentation and compulsion then the contract has no validity in the yes of shariah, but the above mentioned case is perfect example of misrepresentation because the transacted goods are not in compliance with the terms of letter of credit and that is against the principle of (Free mutual consent)⁵

¹ Ibid

² Ibid

³ NICHOLAS L. DEAK and JOANNE C. CELUSAK (*International banking.*)P 44, pub. New York institute of finance .2008

⁴ Maurice Megrah and F.R. Ryder Paget's(*Law of Banking*) p 55 ninth edition , pub. London Butterworth, 1982

⁵ Muhammad Taher Mansoori (*islamic Law of contract and business transaction*)p8,5th Eddition 2009,published by Shariah Academy

Therefore it requires to be cured and to be made in such way which treat both the parties equally through saving the rights of both and suggestion is made as under.

1. 9. 2 Issuing of Letter of Credit as a Reserved Credit.

Meaning there by the issuing bank will issue a letter of credit on behalf of the buyer in favor of the seller to provide him an assurance of payment through the bank when he fulfills the description of the letter of credit.¹

Otherwise the buyer's right is saved to demand back his amount from the bank because the purpose of issuing is failed due to negligence of the seller and the negligent party will suffer the loss and this view is supported by the decision of Kavaitian Court in the following case²

Power Curber, International Ltd V. National Bank of Kuwait SAK (1981

In this case power curber an American company sold machinery to a firm in Kuwait. An irrevocable letter of credit was issued by the national bank of Kuwait on behalf of the buyer Kuwaiti bank instructed the bank of America to advise the seller about the opening of the credit.

On delivery of the goods the buyer find deficiency in quality of goods therefore raised a counter claim against the seller and obtains an order from the Kuwaiti court on the ground of non compliance to restrain the bank from paying the seller.

The bank which had a registered office in London was sued by the American bank in English court the court in first instance as well as in the court of appeal held a decision in the favor of the seller by stating that the order obtained from Kuwaiti court did not affect the obligation of the bank to pay the seller on credit on the ground of the principle of autonomy of letter of credit from the contract of sale.

The courts regard letter of credit as autonomous only on the absence of fraud but where fraud is established the courts are willing to grant an injunction to prevent the bank from paying the seller on credit or to prevent the seller from drawing on credit and it is known as fraud exception which will be discussed in detail in the chapter of fraud.³

¹ NICHOLAS L. DEAK and JOANNE C. CELUSAK (*International banking*) P56, pub. New York institute of finance .2008

² Ibid

³ DR Indira Carr, (*International Trade Law*) p 1998 London Sweet and Maxwell, 2007

1.10 Kinds of Letter of Credit.

Letter of credit is classified into different types such as back to back credit revocable and irrevocable credit confirmed and unconfirmed credit and most importantly commercial and standby letter of credit. This chapter considers only a most important and more workable type of the credit which are described in detail as follows

1.10.1 Commercial Letter of Credit

A commercial letter of credit is a contractual agreement between banks known as the issuing bank on behalf of one of its customers authorizing another bank known as the advising or confirming bank to make payment to the beneficiary. The issuing bank on the request of its customer opens the letter of credit.¹

The issuing bank makes a commitment to honor drawings made under the credit. The beneficiary is normally the provider of goods or services.

Essentially the issuing bank replaces the bank's customer as the payee.

1.10.1.2 Elements of a Letter of Credit

As it is mentioned that letter of credit recognized as foolproof mechanism of payment from the seller but there are necessary elements of letter of credit which must be fulfilled which are described as under.²

A payment undertaking given by a bank (issuing bank)

On behalf of a buyer (applicant)

To pay a seller (beneficiary) for a given amount of money

On presentation of specified documents representing the supply of goods

Within specified time limits documents must conform to terms and conditions set out in the letter of credit documents to be presented at a specified place

¹ Ellanger E. P. (*Documentary credits and Fraudulent Documents*) current problems of International Trade financing, p278, National University of Singapore, 1990

² Larry A. DiMatteo, Lucien J. Dhooge (*International Business Law*) A Transactional Approach, p343, London Sweet and Maxwell, 2007

1. 10 .2 Standby Letter of Credit

The standby letter of credit serves a different function than the commercial letter of credit. The commercial letter of credit is the primary payment mechanism for a transaction the standby letter of credit serves as a secondary payment mechanism.¹

A bank will issue a standby letter of credit on behalf of a customer to provide assurances of his ability to perform under the terms of a contract between the beneficiaries. The parties involved with the transaction do not expect that the letter of credit will ever be drawn upon.

The standby letter of credit assures the beneficiary of the performance of the customer's obligation. The bank is obligated to make payment if the documents presented comply with the terms of the letter of credit.²

1. 10 .3 Revocable Letter of Credit

Under a revocable letter of credit there is undertaking on part other issuing bank to pay the seller on presentation of a stipulated documents and a credit can be revoked at any time. This arrangement offers the least security to the seller because there is no guarantee that the bank will pay him when he tenders the stipulated documents.

More over the bank also is not under a legal obligation to inform the seller of the revocation of the letter of credit as it was decided in the following case.³

Cap Asbwstos Commpny Ltd V.Lloyds Bank Ltd A.E.R (1921)

The contract was for the sale of 30 tons of asbestos sheets. Lloyds Bank advised the seller that they had opened a credit in their favour and expressly stated that advice was not a confirmation of the credit.

The seller shipped 17 tons for which they were paid under the credit by the bank subsequent to the payment for the 1, tons Lloyds bank was instructed that the credit was cancelled by the buyers bank.

The advising unfortunately failed to inform the seller of the cancellation of the credit. The seller shipped the rest of the cargo and presented the documents to the bank who did not pay the seller on ground that the credit has been cancelled.

¹ Ibid

² David son A, (*Stand by letter of credit, and the fraud exception*, 128, Butterworths Journal of International Banking and Finance, 1995.

³ Larry A.DiMatteo,Lucien J. Dhooge(*International Business Law*) *A Transactional Approach*.p381, Londen Sweet and Maxwell, 2007

The seller file a suit against the bank on the ground that the bank was under obligation to inform him that the credit had been cancelled.

The court decided in the favor of the bank stating that the bank was not bound to inform the seller of the cancellation of the credit under the UCP rules.

According to Article 8 (a)

*'A revocable credit may be amended, cancelled by the issuing bank at any time, and without any prior notice to the seller'*¹

Under the above article the issuing is not dependent on instructions from the buyer to cancel the credit. It can cancel the credit on its own initiative.

Further more if the advising has paid the seller received the instruction from the issuing of the cancellation of the credit. In these cases the issuing bank must reimburse the advising bank under the UCP rules.

According to article 8 (b)

*"Reimburse another bank with revocable credit has been made available for the payment, acceptance, and such payment acceptance is made by such bank prior to receipt by it notice of amendment, or cancellation, against documents which appears on their face to be in compliance with the terms and conditions of the credit"*²

1. 10. 4 Irrevocable Unconfirmed Letters of Credits

Under an irrevocable credit arrangement, the issuing bank undertakes up to pay the seller when he presents the stipulated documents³ that comply with the terms of the credit under the UCP rules.

According to article 9(a)

*'Payment will normally be arranged in the buyers country through the advising bank , and advising bank acts as an agent of the issuing bank, and does not give an independent undertaking to pay the seller'*⁴

¹ ICC brochure 1993, the UCP is available from the ICC and at <http://www.iccwbo.org>

² Ibid.

³ Schithoff CM,(Confirmation in Export Transaction, p 17, Journal of Business Laws, 1957

⁴ ICC brochure 1993, the UCP is available from the ICC and at <http://www.iccwbo.org>

1. 10. 5 Confirmed Letter of Credit

A confirmed credit is the one which has been confirmed by the advising bank or confirming such credit the bank undertakes to pay the seller if the issuing bank defaults for any reason provided that the terms and conditions of the credit are complied with¹

Thus the confirmed credit is always irrevocable credit where the letter of credit is a confirmed credit the seller also receives an undertaking from the confirming bank which is situated in his own country.

The courts regard letters of credit as autonomous only in the absence of fraud where fraud is established the courts will be willing to grant the buyer an injunction to prevent the bank from paying the seller on credit, or to prevent the seller from drawing on credit and fraud rule is to be discussed in detail in next chapter.²

¹ Article 9 (b, of UCP 600.

² Larry A.DiMatteo,Lucien J. Dhooge(*International Business Law) A Transactional Approach*.p386, London Sweet and Maxwell, 2007

Chapter 2

2.1 Introduction of the Fraud Exception in Letter of Credit

Despite the bank's unconditional obligation to pay the seller upon presentation of the required documents the issuing bank is not bound to pay under the letter of credit when there has been fraud by the seller.¹ Fraud is a significant risk to the banks and buyers involved in credit transactions, and have been described as a cancer in international trade thus a bank may refuse payment if they have clear evidence of fraud.

Despite the fact that most Common Law jurisdictions recognize the fraud exception to the autonomy principle UCP 600, contains no definition of it or direct reference to it. In determining the scope of the fraud exception, articles 9 13 and 14 are relevant these govern both the liability of the issuing or confirming bank and the duty of strict compliance owed by the bank in determining whether or not to accept the documents.

The ambit of the fraud exception is a very controversial area of commercial law. It has been seen earlier that one of the maxim on which the letter of credit system is found is autonomous this means that the banks are bound to pay on tendering the documents and not involved in any dispute arising between the parties to the underlying transactions and the tendered documents.

Only one exception has been admitted to this rule the fraud exception which permits the courts to consider the evidence of fraud other than the actual terms and conditions of the credit and found on the maxim (*ex turpi causa non oritur actio*) Mean no actions arise out of wrong consideration.

Where it can be pleaded successfully the issuing bank under an irrevocable letter of credit or advising bank if it has added its confirmation should refuse to honor the undertaking which it has given to the beneficiary to pay or to accept or negotiate according to the terms of the credit.

¹ Zohrab (*Standby Letters of Credit: Autonomy*) [1996] NZLJ 417, 417 Goode Commercial Law (3rd ed, Penguin Books, London, 2004) 972.

69 Mahonia Ltd v JP Chase Morgan Bank [2003] 2 Lloyd's Rep 911 and Sirius International Insurance Co v FAI General Insurance Ltd [2004] 1 WLR 3251.

In circumstances where the documents are discrepant the defects are apparent on their face. We are dealing with circumstances in which the documents appear to be in order on their face but their tenders are tainted by fraud.

2. 2.1 Meaning and Definition of Fraud

An intentional perversion of truth for the purpose of inducing another person in reliance upon it to part with some valuable thing belonging to him or to surrender a legal right or in other worlds.

A false representation of a matter or fact, weather by words or by conduct, or misleading allegations or by concealment of that which should have been disclosed, which deceives or intended to deceive another by stating what is known to be false.¹

2. 2. 2 Essential Elements of Fraud

To constitute an actionable fraud there are certain elements which must be fulfilled, and those are described as under.²

It must appear that defendant made a material representation.

It must appear that it was false.

It was made recklessly without any knowledge of its truth.

That the defendant made it with intention that it should be acted on by the plaintiff.

That the plaintiff acted in reliance on it.

That the plaintiff here by suffered injury.

2. 2. 3. 1 Literal Meaning of Fraud in Letter of Credit.

The courts did refer to the Latin maxims (*fraus omnia corrumpit*). Mean fraud or to concealment of truth and (*ex turpi causa non oritur action*). Mean no actions arise out of wrong consideration. Which perhaps imply that, there must be something dishonest or morally wrong about the act in question before it will be called fraud in using the word fraud a definition that included knowledge on the part of the fraudster of the falseness of her representation or recklessness towards whether it was true or not.

¹ HENRY CAMPBELL BLACK, M. A(*Blacks Law Dictionary*, p 337, ABRIDED FIFTH EDITION

² HENRY CAMPBELL BLACK, M. A(*Blacks Law Dictionary*, p 14, ABRIDED FIFTH EDITION

2. 2. 3. 2 Technical Meaning of Fraud in Letter of Credits

The fraud is usually perpetrated by a presentation of false documents to the issuer of the credit, which false documents (especially in the case of standby credits) often contain (false) representations by the beneficiary to the issuer to the effect that the beneficiary is entitled to make demand.¹

A definition of fraud cited by the Supreme Court of Canada is a false representation of fact, made with a knowledge of its falsehood, or recklessly without belief in its truth, with the intention that it be acted upon by the complaining party and actually inducing him to act upon it would seem that most fraud in these cases is being perpetrated against the issuer.²

This fraud will usually relate to the documents themselves. They may be forged or untrue in relation to the goods to which they refer, however on their face they appear to be correct and good tender under the documentary credit.³

2. 3 Significances of Fraud Exception in Letter of credit

The allegation of fraud is normally raised by the buyer who will attempt to prevent the bank from honoring the credit or to prevent the seller from drawing on it.

The buyer may allege that the seller shipped the rubbish instead of confirming goods or that he shipped no goods at a specified time in letter of credit, or the bills of lading were forged or fraudulently false.⁴

In ascertaining whether the fraud exception applies, three sets of circumstances have to be established.

2. 3. 1 Fraud must be established to the knowledge of the Bank

Where there is only an allegation, communicated by the buyer to the bank that the fraud has occurred. This allegation may be found suspicious. Or the bank itself may entertain such suspicion. If no more can be established, the bank should pay unless a sufficiently grave cause is shown.⁵

¹ Larry A. DiMatteo, Lucien J. Dhooge (*International Business Law*) A Transactional Approach, p386, London Sweet and Maxwell, 2007

² PC per Lord Brightman; *Multiservice Bookbinding Ltd v Marden* [1979] Ch.84 at 110, [1978] 2

³ Crol Murry, (*Export Trade*) p237, London Sweet and Maxwell, 2007

⁴ By DR Indira Carr (*International Trade Law*) p 199, London Sweet and Maxwell, 2007

⁵ *Discount Records Ltd V Barclays Bank Ltd* (1975) 1 W. L. R. 315 at 320

The court of appeal stated in a case in which it refused an application for an injunction restraining the bank to pay.

The wholly exceptional case where an injunction may be granted is where it is proved that the bank knows that any demand for payment already made or which thereafter be made will be clearly fraudulent. But the evidence must be clear, both as to the fact of fraud and as to the knowledge of bank.¹

2. 3. 2. Absent of Evidence of Fraud in Letter of Credit

It is a settled principle of law that in such a circumstances which shows that demand meets the documentary requirements set out in letter of credit, and that circumstance negates any evidence of fraud then the beneficiary is entitled to be paid.

This is supported by the following case law which is decided by the Supreme Court of Canada.²

Lac du Bonnet (Rural Municipality) v. Lee River Estates Ltd.

The parties to this action entered into a development agreement relating to the development of a cottage lot subdivision by Lee River Estates Ltd. (Lee River) within the municipality. Pursuant to the development agreement Lee River provided a letter of credit to secure its obligations under the agreement.

The letter of credit was two paragraphs long³ the second paragraph stated as follows: The municipality may call upon it in whole or in part by written demand signed by the secretary treasure. The letter of credit is renewed from year to year unless the Credit Union gives 30 days advance notice of its intention not to renew. The expiry date will be September 1 1993.

The municipality demanded payment on the letter of credit and, subsequently, the applicant (Lee River) indicated it was contesting the calling of the credit. The issuer (Astra Credit Union) refused to pay. The municipality commenced these proceedings against Lee River for a declaration that it was entitled to payment under the letter of credit. Court held that Lee River argued that it was not in default under the development agreement and therefore the municipality was not entitled to call the letter of credit.

¹ *Bolivinter Oil SA V Cash Manhattan Bank N A*(1984) 1 W. L.R. 392

² By DR Indira Carr(*International Trade Law*)p 199, London Savet and Maxwell, 2007

³ E.L. Symons(*Letters of Credit Fraud Good Faith and the Basis for Injunctive Relief* p 112, London Savet and Maxwell, 2003

The court noted in some detail the principle of autonomy of letters of credit and stated that if Lee River takes the position that the municipality is not entitled to retain the funds payable under the letter of credit then its proper recourse is to commence proceedings against the municipality for damages for breach of contract not to attempt to stop payment under the letter of credit.

The court also stated that while the right to call the letter of credit arises on Lee River failing to comply with the contract payment under the letter of credit is not dependent on the municipality proving that non-compliance.

The court accordingly concluded that all of the arguments raised by Lee River that relate to the performance and/or default under the development agreement are irrelevant to the issue of Astra's obligation to pay under the letter of credit and declared that the municipality had the authority to call the letter of credit.

2. 3. 3 Fraud must not be done by Third Party

Where it is clearly established to the satisfaction of the bank that a fraud has occurred there is unambiguous evidence before the court for instance that the documents or some of them are fraudulent or forged. But there is no evidence before the bank which shows that the beneficiary the seller knew of that fraud.¹

In other words that the fraud must not be done by third party, but if that fraud is done by third party then the buyer is entitled for payment, as it was decided in the following case²

United city Merchants Ltd V Royl bank of Canada (1983 }

In this case the contract was for the sale of a fibre glass plant. Shipment under the terms had to take place by 15 December 1976. The cargo was shipped on 16 December 1976 but the bill of lading was back dated by the loading brokers. The seller was unaware of the loading broker's fraud. The bank having discovered the fraud refused to pay the seller. The seller brought an action against the bank for non payment against the documents under a confirmed irrevocable letter of credit.

The question before court was.

¹ Halsbury's Laws of England (Misrepresentation and Fraud) paragraph 756, per *Le Lieve v. Gould* [1893]1 QB 491 at 498, cf. *Derry v. Peek* (1889)

² Larry A.DiMatteo,Lucien J. Dhooge(*International Business Law*) A Transactional Approach,p375, London Savet and Maxwell, 2007

Whether the bank could refuse to pay against the documents that appeared to be in order on their face, but where the goods had not been as stipulated in the contract of sale. The House of Lords held that unless the seller was fraudulent or was privy to the fraud the bank could not refuse to payment.

Of course where the seller is himself fraudulent, or has knowledge of the fraud policy consideration would fully justify depriving the seller from benefiting from his fraud.

As Lord Diplock said

“This general statement of principle as to the contractual obligations of the confirming Bank to the seller, there one exception; that is, where the seller, for the purposing of Drawing on the credit, fraudulently presents to the confirming bank documents that Contain, expressly or by implication, material representation of fact that to his Knowledge is untrue”

The exception of fraud on the part of the beneficiary seeking to avail himself of the

Credit is clear application of the maxim(*ex turpio non oritur action*).¹

2. 3. 4 Presentations of Non Valuable Documents in good Faith

It is held by the court of appeal in the following case that the beneficiary who had presented documents in good faith was entitled to payment even if the documents had no commercial value and was nullity.²

Monrod V Grundkotter. 1. W. R. 1975

In this case Mantrod, who were the applicant in the credit, made a claim against Grundkotter defendant seeking a declaration from the court that no valid certificates of inspection had been issued which were capable of satisfying the letter of credits requirements. Grundkotter had presented documents which on their face complied with the terms of the credit, and there was no proof of fraud on their part.

The court of appeal concluded that the nullity of documents tendered did not therefore provide an independent ground for refusal of payment and exception to the principle of the autonomy of credit.

¹ Ibid

² Crol Murry, (*Expor Trade*) p237, London Sawet and Maxwell, 2007

2. 4 The Historical Development of the Fraud Rule

The fraud rule is originated in the world of business at international level in United States from the case of *Sztejn v J. Henry Schroder Banking Corporation*.¹

It is the landmark case for the application of the fraud rule not only in the United States, but also at international level. The precise circumstances in which the fraud rule would apply were left open in *Sztejn*.²

The application of the fraud rule was first supported by Judge Shientag's words in his judgment in this case which expressed the view that there is a difference between the situation where there is a mere breach of the warranty regarding the quality of the merchandise and where the seller has intentionally failed to ship any goods ordered by the buyer in the later situation where the seller's fraud had 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. *Sztejn v J. Henry Schroder Banking Corporation* was the first case which was decided on the basis of an independent rule under the law of letters of credit and the fraud rule. It pointed an independent way to applicants who have been defrauded by dishonest beneficiaries to protect their interests.

The seminal case is *Sztejn v. Henry Schroder Banking Corp.* In *Sztejn*, before the issuing bank made payment to the beneficiary, the applicant filed a suit seeking a declaration that the letter of credit and the draft there under were void, and for injunctive relief to prevent the issuer from paying the draft because the beneficiary allegedly shipped worthless materials in lieu of the goods that the applicant had bargained for.

The applicant/plaintiff also alleged that the confirming bank that presented the draft documents for payment to the issuing bank received notice of the beneficiary's active fraud before it accepted the draft.

The confirming bank filed a motion to dismiss claiming that its only concern was documentary compliance. In this landmark decision the Court assuming the facts in the most favorable light for the non-moving party, rejected the motion to dismiss.

The court held that 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

¹ International Maritime Bureau, ICC Commercial Crime Services, ICC Publication No 643;

² *Sztejn v J Henry Schroeder Banking Corporation*, 31 N.Y.S. 2d 631 (S. C.1941), hereafter referred to as the *Sztejn Case*.

independence of the bank's obligation under the letter of credit should not be extended to protect the unscrupulous seller.

The Court also noted that the confirming bank's motion to dismiss was denied because the Court was bound by the allegation that the confirming bank was not a holder in due course.

The Court stated. 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.

2. 5. Approach of Courts to Fraud Cases in Letter of Credit

In any case where the applicant or some other involved entity is alleging fraud in order to obtain an injunction restraining the issuer from paying¹ or enjoining a beneficiary from demanding or receiving payment under a letter of credit or in order to defend an action by the issuer for indemnification with respect to monies paid under a letter of credit or in order to sue the issuer for wrongly paying under the letter of credit, the court must resist the temptation to embark upon an examination of the underlying transaction.²

The person alleging fraud will no doubt place before the court an affidavit or other evidence which will describe in detail the relationship between the applicant and the beneficiary and the underlying transaction.

The court must recall that in any letter of credit scenario there are three sets of relationships applicant/beneficiary applicant/issuer and beneficiary/issuer.

In an injunction case it is the beneficiary/issuer relationship which is represented by the letter of credit issued by the issuer to the beneficiary itself that the applicant seeks to interfere with by having the court restrain payment under the credit. In a case where the issuer is suing for indemnification the right to indemnification while contractual to a certain extent also depends on the letter of credit.

Accordingly what the court should be focusing on initially is the letter of credit itself.
What does it say?
What are the requirements for drawing under the credit?
Is the UCP referred to?

¹ E.P. Ellinger, (*Documentary Credits and Fraudulent Documents Current Problems of International Trade Financing*), Singapore International Business Law Series, Vol. 1, 1983
Ibid,

Next, the court should examine the demand under the credit:

Does it meet the documentary compliance test?

If it does then the principle of autonomy of letters of credit compels the court to order the issuer to pay without any examination of the underlying transaction, unless the applicant for the injunction has alleged the only exception to the autonomy principle fraud.

If fraud has been alleged then in an injunction case, the court must ask itself whether a strong prima facie case of fraud has been proven by the applicant for the injunction.

In a case where the issuer is suing the applicant for reimbursement or is being sued by the beneficiary for payment because it did not pay on demand the court must ask itself whether the issuer had before it clear or obvious proof of fraud.¹

In examining the evidence before it the court must remind itself that fraud includes dishonesty, moral turpitude and knowledge of falseness or recklessness.

Simple proof of breach of contract is not fraud. Even an apparent absence of entitlement to demand payment should be examined closely the court should also examine the circumstances of the beneficiary. What are the chances of getting the money back from it if it is allowed to receive payment under the letter of credit?²

The reasons the beneficiary has for making demand in the alleged circumstances and whether the beneficiary sought legal advice on its entitlement to make demand before it did so.

The courts do not want to make themselves the dupes of unscrupulous beneficiaries of letters of credit. But on the other hand fraud is a serious allegation and the courts should not easily find that fraud exists.

Although it may seem easy on an application for an injunction to find that a strong prima facie case of fraud exists on the theory that the trial of the issue will in due course sort out the actual truth, it may be preferable in the interest of preserving the commercial utility of letters of credit, that the court be scrupulous in reaching its determination of whether the standard has been met.

¹ NICHOLAS L. DEAK and JOANNE C. CELUSAK (*International banking*) pub. New York institute of finance p.45

² Ibid

2. 6 Frauds in the Underlying Transaction

The United States case of *Sztejn v J Henry Schroder Banking Corp*¹ is generally accepted as the foundational authority on the fraud exception.

The plaintiff in this case had contracted to purchase a quantity of bristles from Tran Sea Traders Ltd. The purchase price was to be paid by letter of credit upon presentation of an invoice and bill of lading covering shipment of the goods.

The documents presented described the bristles called for by the letter of credit however the plaintiff alleged that Tran Sea had filled the crates with worthless material with intent to simulate genuine merchandise and defraud him as purchaser. The plaintiff thus applied for an injunction to prevent the bank from making payment on the letter of credit on the basis of the seller's fraud.

The court came to the conclusion that where a seller is fraudulent the independence of the bank's obligation under the letter of credit should not be extended to protect that unscrupulous seller. Thus the fraudulent beneficiary was not to benefit from his own fraud and the injunction was granted. The difficulty arising from *Sztejn* is that it is unclear whether it is a case of false documents or a case of fraud in the underlying transaction.

Although it is generally recognized as introducing the fraud on the documents exception Justice Sheintag looked to the performance of the underlying transaction in making his determination of documentary fraud.

This created the controversy between the two concepts of the fraud exception which are often difficult to distinguish. Since this case there has been much academic argument about the breadth of the fraud exception some take a narrow view that fraud is restricted to the credit transaction and others take a broad view that fraud in the underlying transaction is also included.

2. 7 Bank's Right of Refusal of Forged or False Documents

If under the law of the letters of credit without regard to the fact that documents are forged or false and invalid and as reflected in the UCM case banks are obliged to accept such documents banks may be placed under an unreasonable burden to honor a credit and accept

¹ (1941) 31 NY Supp 2d 631

fraudulently completed documents unless they are aware that the documents were also fraudulently completed by the seller/beneficiary itself.¹s

The status of documents as bank security is also a concern as raised by Griffith L.J. who stated in the Court of Appeal of the UCM case
What is the position if the bank is presented with documents that appear on their face to be in order but which the bank knows to be forgeries? The bank takes the documents as its security for payment.

It is not obliged to take worthless documents. If the bank knows that the documents are forgeries it must refuse to accept them if the documents presented are fraudulently false, they are not genuine conforming documents and the bank has no obligation to pay

2. 8. The Standard on an Action for Return of Monies Paid

An action by the issuer against the beneficiary for the return of monies paid allegedly as a result of fraud by the beneficiary the court did not expressly set out the standard of proof of fraud in the circumstances. But the court appeared to treat the case as an ordinary case of fraud that is the court appeared to use the normal standard for proof of fraud on a balance of probabilities but to be proved clearly and distinctly. Even if it is going too far to say that the court's decision is precedent for this statement.

I submit that this is the appropriate standard².

In a case where the applicant is suing the beneficiary for return of monies wrongly paid fraud is not an issue although if fraud exists the applicant is entitled to the return of the monies by the beneficiary. As seen in the York wood Homes case if the beneficiary has breached the underlying contract by demanding on the letter of credit when it has no entitlement to do so, then normal contract law will determine whether the remedy is the return or repayment of the monies received by the beneficiary.

2. 9 Reviews by the Issuer of Allegations of Fraud

If the applicant or another person alleges fraud to the issuer prior to payment under the letter of credit the Standard Trust case³ stands for the proposition that the issuer is not then

¹ Larry A.DiMatteo,Lucien J. Dhooge(*International Business Law*) A Transactional Approach.p378, Londen Savet and Maxwell, 2007

² Royal Bank v. Gentra Canada Investments Inc.1989

³ Standard Trust Co. (In Liquidation) v. Bank of Nova Scotia 1983

entitled to request copies of the underlying contract or other documents referred to in the demand for payment unless the letter of credit entitles the issuer to so ask.

Further the issuer cannot draw an adverse inference from any failure of the beneficiary to provide the documents requested by the issuer.

The letter that the applicant sent in the Standard Trust case, alleging a breach of contract by the beneficiary failed to meet this standard.

Century Property and Casualty Insurance Corp v. London Guarantee Insurance Company.

Royal Bank of Canada had issued a standby letter of credit in favour of London Guarantee Insurance Co. in the amount of \$2,250,000 (U.S.) at the request of Coscan Development Corporation. The plaintiff a re-insurer had arranged the letter of credit which was to stand as security for the obligations of Coscan under a performance bond facility provided to Coscan by London Guarantee.

On November 18 1999 London Guarantee sought to drawdown the complete amount of the letter of credit. On November 22, 1999, the plaintiff obtained an ex parte order enjoining the payment on the letter of credit. In this case the plaintiff was seeking to continue the injunction pending the trial of the action.

In the initial ex parte proceeding the material before the judge had made reference to the fact that the letter of credit stood as security for a performance bond on only one project and that only \$70,000 (U.S.) remained outstanding on that bond.

The judge found that to allow London¹ Guarantee to drawdown the whole \$2,250,000 (U.S.) without any justification would allow the plaintiff to be a victim of fraud.

Decision

On this application to continue the injunction, the material before the court indicated that the plaintiff had significantly misstated the issue in the initial hearing regarding the amount of the bonds.

In fact the bonds outstanding were in excess of \$30,000,000, and the plaintiff was mistaken in stating that the letter of credit secured only \$70,000 (U.S.) in bonds. It was also made clear that the letter of credit was to expire on December 1, 1999, and London Guarantee was therefore demanding under the letter of credit on the eve of its expiry, presumably in the belief that the letter of credit was not going to be renewed as it had been a number of times in the past.

¹ Zohrab, (Standby Letters of Credit: Autonomy) [1996] NZLJ 417, 417; Goode Commercial Law (3rd ed, Penguin Books, London, 2004) 972.

The plaintiff confirmed that it would agree to renew the letter of credit for another year the court was of the view that the misrepresentations by the plaintiff on the original injunction application were material and normally would have been fatal to the continuation of the injunction.

However the court was further of the view that a strong prima facie case of fraud had been made out, in that the plaintiff was demanding under the letter of credit even though there have been no default on any bond nor any demand for payment by a bond holder.

The court cited *Rosen v. Pullen* as authority for the proposition that calling upon a letter of credit in circumstances where there is no entitlement to do so establish a prima facie case of fraud.

The defendant put forward the position that, as the letter of credit was about to expire and the plaintiff had not agreed to renew it the court did not state whether the defendant had asked for a renewal and the plaintiff had refused it was entitled to demand under the letter of credit in order to avoid losing its security.

The defendant claimed to be simply replacing one form of security (the letter of credit) with cash which new form of security would continue to be held by the defendant as security for the obligations under the bonds.¹ The defendant was prepared to consent to an order to this effect.

However the court concluded that the defendant has failed to answer satisfactorily the complaint that it had no underlying right to claim the funds under the letter of credit without default or demand under the bond the court ordered the continuation of the injunction.

2. 10 Kinds of Fraud in Letter of Credit

It is pertinent to mention here some important kinds of fraud in letter of credit which has been developed in the light of decided case laws.

2. 10. 1 Egregious Fraud

The term egregious is not commonly used by courts in connection with letter of credit fraud but is a standard advocated by some commentators. The elements of egregious fraud are not entirely clear, but the term has been used to denote very serious misconduct in the context of letter of credit transactions.

¹ This was established in the case of *Safa Ltd. v Banque Du Caire* [2000] 2 Lloyd's Rep. 600.

One suggestion is that egregious fraud means a flagrant violation of the beneficiary's obligation under the letter of credit.

Another is that egregious fraud is a kind of outrageous conduct which shocks the conscience of the court.

Some commentators have used gross fraud interchangeably with egregious fraud.

In sum under the standard of egregious fraud simple intent to deceive is not sufficient it is the extreme or outrageous nature of the fraud¹ that matters. One oft-mentioned case for the standard of egregious fraud is as under.

Intraworld Industries Inc v. Girard Trust Bank.

Intraworld involved a contract under which a luxury Swiss hotel was leased. The applicant the lessee obtained a standby letter of credit in favor of the beneficiary the lesser to guarantee rental payment in advance.

Under the letter of credit, the issuer promised to pay a draft accompanied by the beneficiary's signed statement to the effect that the applicant had not paid an installment of rent due under the lease.

When a dispute arose and the beneficiary presented a draft accompanied by a statement conforming to the terms of the letter of credit, the applicant attempted to enjoin the bank from paying the beneficiary alleging that although the beneficiary's supporting documents on their face conformed to the credit they were false and fraudulent on the following grounds.

(1) No rent was due because the beneficiary had terminated the lease, which the beneficiary's statement failed to disclose.

(2) The beneficiary was not seeking rent at all but rather seeking the stipulated penalty.

After a hearing the Supreme Court of Pennsylvania found the facts were not as the applicant had claimed. Conversely the Court found that correspondence had been exchanged between the parties' lawyers when dispute arose and that one of the letters from the applicant's counsel to the beneficiary's stated that.

If the transfer of the rent should not be made in timely fashion your client is at liberty to obtain payment by way of the guarantee contract the letter of credit

The Court also found that the underlying contract provided that if the applicant should fail to pay the rent the beneficiary could not only draw under the letter of credit, but also terminate the lease immediately without further notice.

¹ Most recently Law Commission Consultation Paper No 189, The Il equality Defence: A Consultative Report (2009).

Accordingly the Court rejected the applicant's claim for an injunction against payment of the letter of credit reasoning.¹

In light of the basic rule of the independence of the issuer's engagement and the importance of this rule to the effectuation of the purposes of the letter of credit we think that the circumstances which will justify an injunction against honor must be narrowly limited to situations of fraud in which the wrongdoing of the beneficiary has so vitiated the entire transaction that the legitimate purposes of the independence of the issuer's obligation would no longer be served.

A court of equity has limited duty of guaranteeing that the beneficiary not be allowed to take unconscientiously advantage of the situation and run off with plaintiff's money on a pro forma declaration which has absolutely no basis in fact.

The idea that intentional fraud can invoke the fraud rule was articulated in the case of *NMC Enterprises Inc v. Columbia Broadcasting System Inc*, where the underlying contract was for the purchase of stereo receivers.

A commercial letter of credit was issued in favor of the defendant to finance the purchase.

The plaintiff the buyer sought a preliminary injunction restraining the defendant from presenting for payment or negotiating any drafts under the letter of credit.

The affidavit of the plaintiff's president averred that the technical performance specifications for the receivers were substantially below that specified in brochures that formed the basis of the bargain.²

These allegations were confirmed by a testing laboratory. One critical element of the case was an allegation that one of the beneficiary's officers had admitted the seller was aware of such non-conformity prior to the execution of the contract.

The New York Supreme Court, while acknowledging that questions as to quality or condition of the goods could not form the basis of the request for an injunction nevertheless granted the requested injunction and stated

Where no innocent third parties are involved and where the documents or the underlying transaction are tainted with intentional fraud, the draft need not be honored by the

¹ Larry A.DiMatteo,Lucien J. Dhooge(*International Business Law*) A Transactional Approach.p275, Londen Savet and Maxwell, 2007

² P. Lowe, (*Fraud and the Documentary Credit*) Report of the ICC International Maritime, Bureau, ICC Publications; Paris: 1994,

bank, even though documents conform on their face and the court may grant injunctive relief restraining such honor.

It seems that the standard of intentional fraud requires a misrepresentation made knowingly or recklessly with the intention of inducing another to rely thereon. It is thus similar to common law fraud requiring.

A false presentation of the fact

Knowledge or belief on the part of the defrauder

An intention to induce the other party to act or to refrain from action in reliance upon the misrepresentation If cases of common law fraud are treated as equivalent to cases of intentional fraud the number of cases supporting the standard of intentional fraud are significant.

The critical requirement for the application of the standard of intentional fraud is to prove the fraudster's intention or state of mind to defraud which is notoriously difficult. This is especially so in a standby letter of credit scenario where few documents are required to effect a call on a letter of credit.

However if the fraudster's intention can be proven the standard of intentional fraud does not seem to be as high as that of egregious fraud. So in NMC Enterprises the fraud rule was applied because the court was satisfied the buyer had proven that the seller knew of the inferior quality of the goods yet had induced the purchaser into the contract and drawn on the letter of credit.

Given that the purpose of the fraud rule is to stop dishonest beneficiaries from abusing the letter of credit system the standard of intentional fraud seems to be an appropriate one, even though the term is a general one and does not specifically reflect the characteristics of letters of credit.

2. 10. 2 Material Fraud

According to Lord Diplock material misrepresentation is the kind of fraud that can invoke the fraud rule under the English law. Jack writing as a scholar rather than a judge has interpreted material misrepresentation as follows.

The word misrepresentation is very close to a statement of the elements of fraudulent misrepresentation which constitute the tort of deceit.

The tort of deceit contains the following elements

Knowing the representation to be false

Without belief in its truth

Recklessly careless whether it be true or false¹

The word material means material to the bank's duty to pay, so that if the document stated the truth the bank would be obliged to reject the documents, which is close to the interpretation of material fraud in Official Comment on Revised UCC Article 5 in the United States.

However Jack's interpretation seems to be at odds with Lord Diplock's own words. 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 realize its security. But this would not justify the confirming bank's refusal to honor the credit in the instant case the realizable value on arrival at Callao of a glass fiber manufacturing plant made to the specification of the buyers could not be in any way affected by having been loaded on board a ship at Felixstowe on December 16, instead of December 15, 1976.¹⁷⁴

In accordance with Lord Diplock, the misrepresentation should be material to the real value of the goods. Predating the bill of lading in the case was not considered material because it did not affect the value of the goods. But according to Jack's scholar's interpretation, predating the bill of lading should be considered material because the bank would have been obliged to reject the documents if the bill of lading had stated the truth of the loading date.

2. 10. 3 Gross Equitable Fraud

The standard of gross equitable fraud was suggested in the following case.

*Hortico (Australia) Pty Ltd v. Energy Equipment Co (Australia) Pty Ltd*²

Where Energy Australia had a contract with Hortico for the design supply and installation of a boiler. Hortico arranged for the issuance of a bank guarantee in favor of Energy Australia.

Later the contract was terminated by both parties and Energy Australia made a demand on the guarantee for damages. Hortico brought the action to enjoin the payment under the guarantee alleging inter alia that the guarantee was contemplated only to be security for the performance of the contract by the plaintiff and not also for damages as the defendant claimed.

¹ Understanding the Threats and Reducing the Risk, A Special Report prepared by the ICC

² *Ibid*

The plaintiff's argument was dismissed by Young J of the Supreme Court of New South Wales. However, the respected judge said in obiter
With commercial transactions such as the present the courts have consistently taken a hands off approach, and it does not seem to me that anything short of actual fraud would warrant this Court in intervening, though it may be in some cases (not this one) the unconscionable conduct may be so gross as to lead to exercise of the discretionary power.¹

The view that gross equitable fraud might invoke the fraud rule was restated some ten years later by the same judge in the following case

Inflatable Toy Co v. State Bank of NSW.

In Inflatable the plaintiff, the buyer, ordered from the seller inflatable plastic toys to be delivered in installments and paid for by letters of credit. For one installment some discrepancies appeared between the documentation and the facts. The buyer accepted the discrepancies when the seller told it what had happened but changed its mind later and brought an action to prevent the issuer from paying the accepted bill of exchange alleging that the seller was guilty of fraud in presenting documents which it knew to be untrue. Young J rejected the buyer's claim.

But again as a passing dictum after citing *Sztejn*, *Hortico* and other cases relating to the fraud rule, he stated I should note in case what I said is read later too widely, that is still wise to keep open the possibility that unconscionable conduct may be an exception.

2. 10. 4 Letter of Credit Fraud

The concept of letter of credit fraud was explained in detail in the following case.

Emery-Waterhouse Co v. Rhode Island Hospital Trust National Bank²

Where a back to back letter of credit was involved In Emery-Waterhouse Hospital Trust National Bank financed the business of a stove importer Franklin. As security for the financing Franklin gave rights to its accounts receivable which were backed by letters of credit issued by banks of Franklin's customers? Emery a Franklin customer arranged with its own bank First National Bank of Boston to provide Franklin with a standby letter of credit guaranteeing Emery's purchases.

¹ Essays for Patrick Atiyah, Oxford University Press; New York 1991: 209-236, at 234

² Understanding the Threats and Reducing the Risk, A Special Report prepared by the ICC

The credit stated that to draw upon it Franklin must present First National Bank of Boston with a signed statement that the amount of your draft represents funds due you as a result of the failure of the Emery Company to pay invoices with its terms that demand for payment has been made and that payment has not been received by you

When Franklin became insolvent Hospital Trust National Bank took it over and asked a Donnelly to call upon letters of credit that named Franklin as a beneficiary.

Donnelly presented three drafts to First National Bank of Boston with documents apparently complying with the terms of the credit. First National Bank of Boston honored two of them immediately held up the third and notified Emery. Emery told both Hospital Trust National Bank and Franklin that it did not owe the money. Franklin's CEO told Hospital Trust National Bank that Emery did not owe the money.

Hospital Trust National Bank own investigation found the same result. Donnelly told Hospital Trust National Bank that it was wrong to draw the drafts on Emery in such circumstances. Hospital Trust National Bank nonetheless continued to press for payment and refused to return any of the money obtained.

Emery brought the action to recover the money paid, claiming that it owed nothing to Franklin and that Hospital Trust National Bank call was fraudulent. The trial court agreed and awarded the plaintiff punitive damages. Hospital Trust National Bank appealed. Affirming the judgment of the trial court the United States Court of Appeals for the First Circuit observed Hospital Trust Bank argues that even if the record contains facts showing a fraudulent document or fraud in the transaction we must pretend that it does not because the jury refused to find Hospital Trust Bank liable on Emery's separate charge of common law fraud.

The elements of common law fraud as charged by Emery however are significantly different from the elements of fraud in the statutory letter-of-credit exception. Even if we assumed that both required some showing of a false statement common law fraud as charged by Emery also requires a showing that Emery justifiably relied upon the false statement.

This is one of the most important cases with respect to the development of the notion of fraud under the fraud rule. It is clear that the beneficiary called on the letter of credit with absolutely no basis in fact but the court did not use egregious fraud or similar terms that arguably reflect an overly rigid attitude towards the fraud rule.

Nor did the court use the term intentional fraud although the beneficiary knowingly called on the letter of credit without a legitimate basis. It chose to use the phrase statutory letter of credit expression proper and responsive to the special characteristics of letters of

credit. This can be branded as a new page in the development of the standard of fraud in the fraud rule.¹

2. 10. 5 Constructive Frauds

The standard of constructive fraud was suggested in the following case.
Dynamics Corp of America V Citizens & Southern National Bank.

Where Dynamics the plaintiff and the Indian government entered into a contract whereby the former agreed to sell to the latter defense related equipment. The plaintiff agreed further to have the defendant bank issue standby letters of credit by which the issuer promised to pay drafts drawn by the Indian government and accompanied by the Indian government's certification in quite general terms that Dynamics had failed to carry out certain of its obligations under the underlying contract.²

While part of the contract remained unperformed war broke out between India and Pakistan. The US government announced an embargo on military supplies to the region, thereby making further delivery of the equipment impossible.

The Indian government thereafter refused to pay for some of the supplies previously delivered and presented a draft accompanied by a certificate purporting to comply with the terms of the letter of credit. The plaintiff filed a complaint seeking an injunction to prevent the issuer from honoring the draft alleging that the certificate provided by the Indian government was fraudulent in that the plaintiff had actually performed its obligations under the contract.

The United States District Court of Georgia granted the injunction and stated
The law of fraud is not static and the courts have over the years adapted it to the changing nature of commercial transactions in our society.

In a suit for equitable relief such as this one it is not necessary that plaintiff establish the elements of actionable fraud required in a suit for monetary damages.

Fraud has a broader meaning in equity and an intention to defraud or to misrepresent is not a necessary element. Fraud indeed in the sense of a court of equity properly includes all acts omissions and concealments which involve a breach of legal or equitable duty trust or confidence justly reposed and is injurious to another or by which an undue and unconscious advantage is taken of another.

¹ Halsbury's Laws of England (*Misrepresentation and Fraud*) paragraph 756, per *Le Lievre v. Gould* [1893]1 QB 491 at 498, cf. *Derry v. Peek* (1889)

² *Ibid*,

2. 11. Beneficiary Recklessness in Respect of Documents Fabricated by a Third Party

As Lord Herschell set out in the seminal case *Derry v. Peek*, Common law fraud requires proof that the maker of a statement made it either knowing it to be false Recklessly not caring whether it is true or false. Such fraud is notoriously difficult to prove as it requires evidence of a state of mind.

Recklessness is sufficient to make a man liable in damages for fraud. Here the plaintiffs intended their misrepresentation to deceive although they did not intend that the party deceived should ultimately go without just compensation.

This was supported by the recent English case.¹

Lambias Ltd v. Hong Kong & Shanghai Banking Corporation

It is another case on point, in which Goh Phai Cheng JC ruled that Where the seller-beneficiary while neither a direct nor deliberate perpetrator of the fraud or forgery was nonetheless in some way clearly responsible for the turn of events that led to the perpetration of the fraud or forgery and where no money has been paid out under the credit, there is no obligation on the part of the issuing bank or its agent to make any payment under the credit.² Here the court had clearly required that care and circumspection be taken in the tender of documents by a beneficiary. Justice Goh phai further stated that the law cannot condone actions which although not amounting to fraud per se are of such recklessness and haste that the documents produced as a result are clearly not in conformity with the requirements of the credit.

2. 12. Rejection of Documents on the basis of Nullity

The issue whether the banks are entitled to reject even obliged to reject a tender of documents on the basis that they are false

Rejection on the basis that a document is a nullity, which has little support in English authority derives some support in the following case law³

Lambias V. Hong Kong & Shanghai Banking Corporation

GohPhai Cheng JC stated that a forged document is a document that was a nullity

¹ Larry A.DiMatteo,Lucien J. Dhooge(*International Business Law*) A Transactional Approach,p375, London Savet and Maxwell, 2007

² G.A. Fellingner, (*Letters of Credit: The Autonomy Principle and the Fraud Exception*) p345 (1990)

³ H. Harfield, (*Enjoining Letter of Credit Transactions*) (1978) 95 *Banking L.J.* 596, at 608.

abinitio and that the bank was entitled to reject it even if the seller was not a party to the forgery. In the case of which requested the seller/beneficiary Lambias to provide a Quality and Weight Inspection Certificate

There was a specific requirement for such Quality and Weight Inspection Certificate to be signed by a specified person called YAU which however had been signed by an impostor.

The court held that the Quality and Weight Inspection was discrepant document and a nullity. The learned judicial commissioner analyzed the basic requirement of a Quality Weight Inspection certificate, and he said that.

The document has to be issued by the party required by the letter of credit. It has to state the necessary particulars to relate it to the goods which are the subject of the letter of credit.

It has to contain the necessary statement as to the quality or weight of the goods ostensibly inspected without meeting all above requirements the Quality Weight Inspection was a nullity abinitio.

The Court raised the question of differentiating forged documents from false documents. In the former situation, where the documents in question are forged the confirming bank that is aware of the forgery may refuse payment under the credit even if the presenter of the documents was innocent of the forgery and had no knowledge of the same on the ground that the documents tendered are not complete.

The latter situation, which was dealt with in the UCM Case was where the documents on their face conform to the credit but contain a statement of fact that is inaccurate so the confirming bank is not entitled to reject those documents unless there is some culpability on the part of the presenter of the documents who has fraudulently presented the documents with knowledge of the material misrepresentations of fact.

2. 13. Banks Obligation of Enquiry and of Duty of Care to the Applicant

The general rule with respect to fraud is that a bank is not responsible for payment against forged or false documents which appear on their face to be regular. This is also indicated in Article 15 of the UCP 500 which provides in part¹

Banks assume no liability or responsibility for the forms sufficiency accuracy genuineness falsification or legal effect of any documents. Accordingly, when a bank is informed of fraud it is not obliged actively to ascertain whether the alleged fraud can be

¹Crol Murry, (*Expot Trade*)p237, Londen Savet and Maxwell, 2007

proved. It may adopt a passive attitude and only evaluate the evidence placed before it by the buyer for instance in the UCM Case Ackner L.J. expressed the view that the issuer owed the applicant a duty of care.

However as the letter of credit system generally refuses to admit that there is any contractual relationship under the credit itself between the issuer and the applicant and in the general absence of a substantive duty of care of an issuer toward an applicant there is no basis for the applicant to sue the issuer for knowingly making payment over alleged fraudulent documents. An issuer therefore bears little risk of being found liable to the applicant for wrongful payment.

2. 14 Customer's Right of Recovery against the Bank

The Canadian Supreme Court in *Angelica-White wear* delineated the theory of the customer's right against an issuing bank where the bank has debited the applicant's account pursuant to an improper payment a draft under a letter of credit could be made the subject of an action for recovery of the amount of the debit.

The basis of right of recovery is that the customer was not obliged to reimburse the issuing bank because the bank by reason of the fraud exception if it applied, or by reason of documentary non compliance with the terms and conditions of the credit should not have accepted the document and paid the draft.¹

If a tender of documents does not strictly comply with the requirements of the commercial credit the banker is entitled to reject it. It does not matter whether the discrepancy is significant or minute. The rule *de minimus non curat lex* does not apply in commercial credit transactions. Moreover the person to whom the documents are tendered is entitled to raise any lawful objections against the documents even if in fact his objection is purely technical and the true motive for his rejection of the documents is to be found in a falling market.

The fact that he does not at the time of the rejection of the documents realize all the defenses available to him does not preclude him from setting up all of them at the trial. The court found in this case a discrepancy on the face of the bills of lading and held that the bank was not obliged and was not authorized to accept the documents and pay the draft of invoice.

In doing so the court held, the bank was in breach of its agreement with the applicant *White wear*. This court reasoned that the fact that *White wear* may not have been prejudiced

¹ Crol Murry, (*Expot Trade*)p239, London Savet and Maxwell, 2007

by the discrepancy, in the sense that its loss was not directly attributable to it is immaterial. This line of reasoning is also followed by the case of *Midland Bank, Ltd. v. Seymour* which held that the buyer's real reason or motives for invoking documentary non-compliance are immaterial.

Therefore the Supreme Court held that the applicant was entitled to the amount which was improperly paid and debited from its account because of the documentary non-compliance with the terms and conditions of the letter of credit and agreed with the decision of the court of appeal which held that the acceptance of the goods by the applicant did not constitute a waiver of the right to invoke irregularities affecting the documents accompanying the draft of invoice 0014.¹

2.15 Liability of a Bank for Contributory Negligence

If documents do not conform to the conditions of the letters of credit, they should not be acceptable. Further, dishonesty in stating the actual situation should potentially render a bank liable for contributory negligence and it is supported in the following case law.

Standard Chartered Bank v. Pakistan National Shipping Corporation & Others.

The plaintiff Standard Chartered Bank in order to claim reimbursement from the issuing bank Inco bank issued a false statement claiming that the documents required under the letter of credit had been presented by the beneficiary on time.

As Inco bank refused payment to SCB on the basis of entirely unrelated discrepancies, the court decided that SCB would have been liable if the issuing bank had based its rejection on SCB's dishonesty in stating the truth.

Therefore as PNSC had not refused payment on this basis, PNSC was unsuccessful in getting the damages payable to SCB reduced on the grounds of contributory negligence.

According to Ronald J. Mann's study out of the 343 discrepant files he reviewed the beneficiary presented documents late in 48 files (14%). This provides an idea of the frequency in which documents are being accepted on expired letters of credit.

Presumably the confirming bank or other paying bank in such a situation had misled the issuing bank and the buyer about the reality of the submission.

¹ *NMC Enterprises, Inc. v. Columbia Broadcasting System, Inc.* 14 UCC Rep. Serv. (Callaghan) 1427 (N.Y. Sup. Ct. 1974).

The court has indicated clearly that such behavior is not tolerable. Lord Justice Ward referred to SCB's false statement as scandalous attempts to deceive the issuing bank on the basis of a false statement that the documents were presented to them in time.

2. 16 Can Exemption Clauses Relieve the Bank of Liability?

According to the Supreme Court in *Angelica-Whitewear* which considered this question, the answer was a definitive no. The court considered the exemption clause in the agreement between the bank and White wear which read as follows¹

All users of the Credit shall be deemed to be agents for the Undersigned and neither the Bank nor its agents or correspondents shall be responsible for the negligence or fraudulence of any user of the Credit and the Bank shall not be in any way lessened or affected if any bill or document accepted, paid or acted upon is invalid insufficient fraudulent or forged or if any bill or document does not bear a reference or sufficient reference to the Credit.

The court held that such exemption clause would not relieve the bank of liability of the payment of the draft that is accompanied by the documents which are not in accordance with the terms and conditions of the letter of credit, and, therefore would not oblige the customer to reimburse the bank.

The court was of the opinion that such an intention was contrary to the fundamental principle of documentary credits and the stipulated obligation of reimbursement by the customer to the bank under Article 8 of the UCP 400.

2. 17 Extending Enquiry beyond the Documents and identification of an absence of good faith

As mentioned above a number of authorities suggest looking outside of the documents to determine whether there has been fraud in the transaction. In this context, identification of manifest lack of good faith in the transaction could be of assistance in uncovering the necessary element to constitute fraud and disqualifying relevant parties from reliance on the independence principle.²

Under the independence rule the bank is only concerned with the apparent good order of the documents not with the goods themselves, and its duty to pay is not conditioned on the performance of the underlying contract by the beneficiary-seller.

¹ Crol Murry, (*Expot Trade*) p245, Londen Savet and Maxwell, 2007

² *Ibd*

Therefore the law of the letter of credit has rarely permitted any claim by the applicant that the seller has shipped goods which are UN merchantable or short in quantity.

However the court in *Angelica-White wear* decided that "the fraud exception to the autonomy of documentary letters of credit should not be confined to cases of fraud in the tendered documents by the beneficiary it should include fraud in the underlying transaction of such a character as to make the demand for payment under the credit a fraudulent one.

Lord Denning M.R. in *Edward Owen Engineering* more over had already stated clearly the bank ought not to pay under the credit if it knows that the documents are forged or that the request for payment is made fraudulently in circumstances where there is no right to payment.

This suggests that the fraud exception is not limited to documentary fraud. As stated by *Le Dain J* the fraud exception to the autonomy of a documentary credit should extend to any act of the beneficiary of the credit; otherwise the effect would be to permit the beneficiary to obtain the benefit of the credit as a result of fraud.

2. 18. Good Faith as a Required Precondition to Receive Payment

Originally the beneficiary's right of payment was based only on demonstrating facially conforming documents as determined by banks. Now it appears that a new precondition has been added to facial compliance which is evident in the *Santander Case*, namely the beneficiary's good faith.

Good faith as a concept is very well entrenched in the civil law system and is also creeping into common law jurisprudence. The effect of *Santander* which is discussed in more detail under section 4.8 was to make good faith of the beneficiaries a precondition for payment under the letter of credit. As admitted by *Santander* it was felt in the industry that it was safe to discount credits and that banks or at least discounting bank are not concerned with the bona fides of the beneficiary.

The independence principle limits banks' responsibilities of checking the documents to their face only and endorses the right of payment to the beneficiary as long as they provide facially conforming documents.¹ Banks had rarely been asked to bear the risk of beneficiary's fraudulent performance of the underlying transaction and the risk has always been shifted to the applicants.

¹ *Royal Bank of Scotland v. Cassa di Risparmio delle Province Lombard* [1992] 1 Bank L.R. 251.

Santander could have won this case easily if the Court simply applied, as usual, the independence principle under which the court refrained from examining what lay beyond the documents.

By asserting itself to be a holder in due course, never identified clearly in the letter of credit transaction yet frequently resorted to by banks as a defense, the confirming bank claimed to be immune from any fraud claim.

Furthermore Santander was aware that the courts have been leaving letter of credit issues to banks to determine for fear of tampering with or even destroying the system underpinning international business transactions, Santander also claimed that discounting the deferred letter of credit was a customary practice for banks which supposedly facilitates international trading by assisting the beneficiary's cash flow

2. 19. The Bill of Lading and the Potential for Forgery

By mercantile custom, and by case law a bill of lading is a formal receipt by the ship owner acknowledging that goods alleged to be of the stated species, quantity and condition are shipped to a stated destination in a certain ship. Possession of the bill is in many respects equivalent to possession of the goods and the transfer of the bill of lading has normally the same effect as the delivery of the goods themselves.

With the rise of container transport however there has existed many unsolved legal problems.¹

When a container bill of lading is issued, the goods packed by the seller or shipper are not and cannot be ascertained or checked by the ship-master. It is doubtful whether such bill of lading still has the same value and security provided by a traditional bill of lading which was labeled as currency of trade, because it might not have any goods to support it at all.

The ICC International Maritime Bureau warns that there is no physical control over blank books of bills of lading and they are given away to the freight forwarders and other sub-contractors; a fraudulent seller does not need to go back to the ship master for stamp and signature.²

Therefore a bill of lading can be reproduced without great difficulty. Furthermore banks have no way to verify the stamp or signature of a bill of lading.

¹ European Asian Bank Ag v. Punjab & Sind Bank (No. 2) [1983] 1 W.L.R. 643

² E.L. Symons, Jr, (Letters of Credit Fraud Good Faith and the Basis for Injunctive Relief) p2564 Londen Savet and Maxwell, 2007

Sometimes a beneficiary can present an ostensibly clean bill of lading to a bank which has been obtained illegally. When cargoes are loaded on board and the ship-master discovers such cargoes in a damaged condition which will entitle the buyer to reject the goods, the Master has to put a clause on the bill of lading to reflect that.

However the shipper/seller knows that such bill of lading is not a conforming document under the letter of credit and will insist that the Master issue a clean bill of lading.

The shipper/seller thus will make a promise that should any claim be made arising from the condition of the cargo by the buyer the shipper will indemnify the ship-owner.

However such practice is illegal under English law and it is tantamount to a conspiracy to defraud the buyer into paying the full value of goods based upon the clean bill of Lading

A seller may forge a bill of lading in an attempt to compensate for unwelcome events of shipping reality such as delays in the arrival of the vessel at the load port congestion delays in the production of the cargoes and delays to the transport/arrival of the cargoes at the load port etc.

A seller would forge a bill of lading with the required shipping date or ask the carrier to pre-date a bill of lading in order to make sure the documents are complying on the face with the terms and conditions of the letter of credit.

As Schmitt off states the date of the bill of lading is material in three legal relationships: in the contract of carriage, in the contract of sale, and in relation to the banks if payment is arranged under a letter of credit.

Bills of lading issued after this date will not be acceptable under the letter of credit. If goods are loaded after the final date of shipment permitted under the letter of credit, and the bills of lading correctly reflect this date the seller will have to request that its buyer extends the final date of shipment in the letter of credit. Such a request could result in the buyer renegotiating the price or other terms of the contract.

An easier option for the unscrupulous seller rather than disturbing the letter of credit is to exert pressure on the shipping agent to pre-date the bill of lading, thus ensuring that its documents comply with the terms of the credit.

2. 20. Letters of indemnity

Normally, the beneficiary is required to present a whole set of documents in accordance with the terms and conditions of the letter of credit before it gets paid. Some banks reportedly separate this submission stage into two parts provisional submission for 90% of the letter of credit value and 10% for the subsequent submission.

A beneficiary can obtain payment after submitting merely an invoice and a letter of indemnity. A letter of indemnity provided by a beneficiary is to guarantee that the beneficiary will submit the required bill of lading certificate of quality and other documents at some later stage after being paid.¹

The letter gives the bank the right to negotiate documents and credit the proceeds to the beneficiary's account under reserve. In this way the bank assists the beneficiary by paying out in advance of the actual date of payment before all the documents are presented. Paying out the beneficiary under such circumstances raises serious issues under the general rules of documentary letters of credit.

This is because the beneficiary's right of payment should in theory only be derived from the submission of all required documents which have to meet all conditions of the letter of credit banks should ideally not make any payment to the beneficiary until all documents are submitted before the expiry date of the credit and all conditions are met.

In paying out the beneficiary, a bank in effect may be assuming that the beneficiary will, in addition to being able to submit all documents at a subsequent stage before the letter of credit expires be able to submit such documents which are definitely complying with the credit conditions.

Problems thus arise if the documents subsequently submitted are not conforming and have uncorrectable discrepancies. According to an explanation of the ICC Banking Committee the issuing bank in such a situation is not expected to raise any discrepancies in the shipping documents presented, as the credit has been fully utilized by the presentation of the invoice and the letter of indemnity as a result banks would presumably have to obtain a waiver from the applicant in respect of discrepancies.

2. 21. 1 Interlocutory Injunctions and their Role

Role of and criteria for granting interlocutory injunctions to enjoin payment where fraud is alleged in connection with the underlying contract.

There is no mention of fraud in the UCP. This was evidently because of the differing treatment by national courts of fraud under documentary credits. At any rate on a strict construction of UCP 500 fraud would not be a relevant consideration in the examination of documents.

¹ Crol Murry, (*Expot Trade*) p256, Londen Savet and Maxwell, 2007

This is arguably to an extent counter-balanced by the doctrine of strict compliance in UCP Articles 13 and 14 under which banks are obliged to refuse payment in case of documentary discrepancy.

The doctrine of strict compliance is of itself not a sufficient safeguard. Indeed as mentioned above, the ICC Banking Commission¹ in an opinion has acknowledged that there is an exception to the doctrine of strict compliance in many jurisdictions, namely for abuse of right or fraud and that it is up to the courts to fairly protect the interests of all bona fide parties concerned.

Notwithstanding the fact that documents may on their face be strictly compliant with the terms of the credit, payment can be refused by a bank or enjoined on the application of the buyer to a court under the fraud exception where here was clear evidence of fraud the bank has clear notice of this evidence of fraud the bank's awareness of the fraud was timely.

In the context of the interlocutory injunction there is a fourth element that needs to be satisfied that the balance of convenience is in favour of granting an injunction restraining payment bearing in mind, according to established doctrine that the fraud exception will operate to stop payment only in exceptional circumstances

2. 21. 2 Examination of key Criteria in invoking the Fraud Exception in an Interlocutory Injunction Application

Traditionally courts held that the only relevant time at which the state of knowledge of an issuer of a letter of credit might be considered was when payment was made. Sir John Donaldson MR and Griffiths L.J. stated in *Bolivinter Oil SA v. Chase Manhattan Bank*

"Where the state of knowledge of a letter of credit issuer only falls to be considered when demand for payment is made they qualified this by saying that if the underlying principle was that fraud unravels all the timing should not be restricted to the time of payment".²

The issue of whether a relevant fraud has occurred has to be decided according to the facts then known to the court and it is irrelevant that an earlier stage the fraud was unknown to the bank.

¹ International Maritime Bureau, ICC Commercial Crime Services, ICC Publication No 643;Paris: 2002

² *Ibd*

On the other hand, in *United Trading Corp. v. Allied Arab Bank Ltd*, the court held that the bank's knowledge of the fraud as on the date of payment has to be established by the plaintiff

2. 21. 3 Standard of Proof for Bank's Knowledge

The alleged fraud of the beneficiary of a credit must be clearly established to justify a refusal by the issuing bank to honor a draft under the credit or to warrant an injunction to restrain it from doing so.¹

The meaning of established was delineated by Kerr J. in *Harbottle*, who held that the courts would not interfere with the irrevocable obligations of banks except in clear cases of fraud in which the banks had notice.

In *Edward Owen Engineering* the expressions used to characterizes the nature and proof of the fraud required to relieve a bank of its obligation under a letter of credit were obvious fraud to the knowledge of the bank clear fraud of which the bank has notice fraud that is very clearly established and fraud that is very clear to the bank.

In *United Trading* the court stated that to meet such standard of fraud the evidence must be clear in respect of the fact of fraud and the bank's knowledge of such fraud. A mere assertion or allegation of fraud would not be sufficient.

The only realistic inference for the court, taking into account the standard of a hypothetical reasonable banker possesses all of the relevant facts must be that the seller could not have reasonably believed in the validity of the documents that he submitted there could be no other explanation except for fraud.

In contrast to the English courts which have taken established fraud as the appropriate test in Canada a line of cases appear to adopt a test of a strong prima facie test of fraud which was regarded as less onerous and more appropriate on an application for an interlocutory injunction than the test of clearly established fraud.

Such a standard interestingly was the precursor to the currently used general standard of proof for interlocutory injunctions, which is that the material available to the court at the hearing of the application must disclose that the plaintiff has real prospects for succeeding in its claim for a permanent injunction at trial

¹ P. Lowe (Fraud and the Documentary Credit) Report of the ICC International Maritime Bureau, ICC Publications; Paris: 1994, at 7.

2. 22 Comparison of Applying Old and New Approaches in the Fraud Rule in Letter of Credit.

In contrast to the old approach of applying the fraud rule, the new approaches adopted a lower evidential requirement that of a seriously arguable case of fraud¹ instead of a clearly established fraud when applying the fraud rule in documentary credits cases in certain situations and those situations may be summarized as follows²

First where there the buyer asked for a injunction at the pre-trial stage to restrain the beneficiary from demanding payment before any question of the enforcement of the guarantee or credit the evidential requirement for granting the injunction to the buyer should be the establishment of a seriously arguable case of fraud on the part of the beneficiary.

Secondly where the bank was involved in the related underlying transaction, a lower requirement may be applied, instead of clearly proven fraud.

Thirdly where a beneficiary was seeking for a summary judgment to force the bank for payment and the bank had a claim with a real prospect of success, that there was a misrepresentation by the beneficiary directed at persuading the bank to enter to the letter of credit a lower standard may be applied.

Fourthly a bank may not be forced to pay by a summary judgment if it can establish a claim with a real prospect of success that the demand was fraudulent even if it had no clear evidence of fraud at the time of demand.

Those new approaches brought about much argument as to the application of the fraud rule however the thesis explains these new approaches as exceptions rather than conflicts to the traditional application.³An application of a lower evidential requirement while applying the fraud rule.

Also compared to the other three exceptions the fourth exception was a most controversial one.

The main idea of this requirement came from the old case of *Gian Singh & Co. Ltd. v Banque, Inc* where the plaintiff sued the bank because of a payment against a forgery document.

¹ S. H. Van Houten (*Letters of Credit and Fraud*) p344 (1984) 62 Can.

² *Mahonia Ltd v JP Chase Morgan Bank* [2003] 2 Lloyd's Rep 911 and *Sirius International Insurance Co v FAI General Insurance Ltd* [2004] 1 WLR 3251.

³ L. D'Arcy, C. Murray and B. Cleave, *Schmitthoff's Export Trade*, 10th ed., Steven & Sons; London: 2000, at 11-042

Mr. Justice Tan Ah Tah during the appeal confirmed that the forgery was proved but decided the bank was not liable because, the paying bank was in no position to be aware of the forgery.

Also in a recent case *Banque Saudi Fransi v Lear Siegler Services Inc* where a bank sought to get a summary judgment of reimbursement from the defendant the defendant refused the reimbursement by claiming there was a fraud of the beneficiary the summary judgment was granted and one of the reasons was that there was not a fraud come to the notice of the bank.

Chapter 3

Introduction

National courts have required different standards of fraud to justify non-payment or restraint of payment under a letter of credit in different jurisdictions. The UNCITRAL Convention has adopted its own position.

The issue is far from settled in any legal system. Based on an analysis of the law in the United States, United Kingdom, Canada, Australia, and under the Common Law Countries in the light of UN Convention, this thesis proposes a standard that is a distinct improvement on the various standards applied around the world and suggests a means for its implementation. The fraud rule allows the issuer of a letter of credit or a court to disrupt the payment of a letter of credit when fraud is involved.

The letters of credit is to provide an absolute assurance of payment to a seller provided the seller presents documents that comply with the terms of the credit. The fraud rule thus goes to the very heart of the letter of credit obligation.

The fraud rule is necessary to limit the activities of fraudsters but its scope must be carefully circumscribed so as not to deny commercial utility to an instrument that exists to serve as an assurance of payment.

This article explores the kind of fraud required to invoke the fraud rule or, in other words, what does fraud mean under the fraud rule in the law governing letters of credit? These theses will investigate how this question has been answered in the United States, the United Kingdom, Canada, and Australia, and under the UNCITRAL Convention.

3.2 Fraud Exception is Explained

Two key preliminary questions in respect of the ability to enjoin payment under a letter of credit revolve around.

The nature of fraud that is the subject of the fraud exception

The key issue of the type of conduct that is otherwise sufficient to give rise to an action to enjoin payment.¹

Both questions are addressed in the course of this section 4.3. For the purpose of the discussion to follow on a theoretical level the concepts of fraud in both common law and equity to the extent possible will be distinguished.

Firstly for the purpose of a representation upon which it is sought to base an action in deceit there is no distinction between legal and equitable fraud.

In general the key elements of an action for deceit are that there has been a statement of what is false or suppression of what is true fraudulently made with the intention of inducing another party to rely thereon.

The essential component of fraudulent misrepresentation is the element known as an intention to mislead or deceive. Mere non-belief in the truth is also indicative of fraud.

Actually in document of the misrepresented and materiality of the misrepresentation are also essential elements for the misrepresentation to draw civil consequences.

In another context however the term fraud has been extended in equity by the concept of constructive fraud which includes transactions so opposed to fair dealing between the parties that they ought not to be held binding.

Fraud in equity has also been extended to encompass unfair and unconscionable bargains so long as one of the parties has imposed the objectionable terms in a morally reprehensible manner.

The different approaches have been adopted in application of fraud rule in letter of credit in different circumstances which are described as follows.

3.3.1 Application of Fraud Rule in United State

The fraud exception is considered as having originally been established under an American Case *Sztejn v J. Henry Schroeder Banking Corporation*. In this case the issuing

¹ Understanding the Threats and Reducing the Risk, A Special Report prepared by the ICC

bank opened an irrevocable credit on Sztejn's account in favour of Tran Sea Trading Ltd covering a shipment of bristles.

Documents including bills of lading for bristles were presented to Transea's bank and were subsequently forwarded to the bank Schroeder's for reimbursement before payment however Sztejn applied for an injunction restraining payment on the ground that no bristles were in fact shipped but merely worthless rubbish. Shientag J stated the independence principle emphasizing that it could be a most unfortunate interference with business transactions if a bank before honoring drafts drawn upon it was obliged or even allowed to go behind the documents at the request of the buyer and the seller regarding the quality of the merchandise shipped as it served to deny the very function of the specified documents and the correspondence between the documents and the goods.¹

However Shientag J distinguished the case before him as one involving fraud by the beneficiary of the credit as follows

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

It is clear from the Sztejn opinion that the court was unwilling to use the independence principle in a situation where there is intentional fraud by the beneficiary. It is unfortunate, however, that such decision gave rise to arguments as to whether Sztejn was or should have been, regarded by the court as a case of false documents or a case of fraud in the underlying transaction.

In another U.S. case, *NMC Enterprises Inc. v. Columbia Broadcasting System Inc.* a preliminary injunction was granted to restrain an issuing bank from honoring a draft under a letter of credit. The applicant complained that the beneficiary's office had misrepresented the quality of the communications equipment and technical assistance and fraudulently induced the applicant to enter into the underlying transaction of sale which the beneficiary knew was false.

The court rejected the contention that the fraud exception recognized in Sztejn was confined to fraud intrinsic to the documents and did not extend to fraud in the underlying

¹ Crol Murry, (*Expot Trade*)p245, Londen Savet and Maxwell, 2007

transaction. It held that if the sales contract was tainted with fraud in its inducement any document required by the letter of credit to be submitted with the draft to show entitlement to payment was equally tainted.

It is submitted that this was an early case which equated the legal value of the documents with the actual performance of the underlying contract and indicated clearly that documents represent the beneficiary's entitlement for payment if the underlying contract is tainted with fraud the documents representing the reality of the performance of the contract are equally tainted and therefore not acceptable following this line of reasoning it might not be meaningful to argue whether a fraud is a documentary fraud or an underlying contract fraud.

3.3.2 In United Bank Limited v Cambridge Sporting Goods Corp

The court found the seller was in deceit and held that the fraud exception should be applied as the circumstances of the particular situation allow. In this case an American buyer entered into a contract with a Pakistani manufacturer for the purchase of boxing gloves. An irrevocable letter of credit was issued in favor of the seller.¹

The gloves which the manufacturer shipped were old unpadded ripped and mildewed rather than newly manufactured gloves as agreed upon.² The court in this case held that the act of sending not merely non-conforming merchandise, but seriously defective goods e.g. worthless fragments of boxing gloves supports the seller's intention of deceit and should be categorized within the scope of fraud.

It is evident from the above three cases that U.S. courts looked beyond the documents into the facts of the transaction to see whether the information provided in the documents was accurate. If there existed seller/beneficiaries' deceitful intention the courts decided to apply the fraud exception to deny the deceitful beneficiaries/sellers' entitlement for the payment under the letters of credit.³

These cases however are considered to reflect a less strict view of the fraud exception. One commentator has expressed the view that in the case of defective underlying goods where the seller presents conforming documents the bank should pay notwithstanding the defect because the seller has complied with the conditions set forth by the bank in the credit.

¹ Understanding the Threats and Reducing the Risk, A Special Report prepared by the ICC

² United Trading Corp. SA v. Allie Arab Bank Ltd. [1985] 2 Lloyd's Rep. 554 at 561.

³ *Sztejn v J Henry Schroeder Banking Corporation*, 31 N.Y.S. 2d 631 (S. C.1941), hereafter referred to as the *Sztejn Case*

On the other hand, the bank should be entitled to reject any payment demand based on the presentation of defective documents as in such a case the seller has failed to comply with the conditions set forth by the bank.

The authoritative Chitty on Contracts, Specific Contracts seems to support a documentary fraud approach in stating that "the seller has committed a fraud where he has tendered a forged document or a document which, to the seller's knowledge contains a false and fraudulent description of the goods.

3. 4. The Application of Fraud Rule in Canada

Canadian courts have generally focused on the standard of proof rather than the standard of fraud in their application of the fraud rule. When considering the kind of fraud that can invoke the fraud rule Canadian courts like their English counterparts are likely to ask whether clear or obvious fraud or a strong prima facie case of fraud has been shown not how serious the fraud was in the sense of the standard of fraud being discussed here.

Canadian courts have also considered whether the application of the fraud rule should be confined to cases of forged or fraudulent documents or extend to fraud in the underlying transaction.

This is well illustrated by the following case.

Bank of Nova Scotia v. Angelica-White wear Ltd.

In *Angelica Whitewear* the court considered four issues with respect to the application of the fraud rule, but the standard of fraud under discussion was not among them.¹

When the court was considering the alleged fraud in the case that is the inflation of the prices in the invoice by some \$17.00 per dozen above those agreed to in the sales contract, it was not interested in how serious the fraud was that.

Whether the fraud had been sufficiently established to the knowledge of the Bank before payment of the draft to make it clear or obvious to the Bank

Could be regarded as having made invoice 0014 a false document in so far as its representation of the applicable prices was concerned whether it is regarded as fraud in the performance of the underlying sales contract.

The court put the question simply was this fraud of the kind that comes within the fraud exception which seems to indicate that fraud is a simple concept, the meaning of which is known by everybody in Canada.

¹ Establishment Esefka International Anstalt v. Central Bank of Nigeria, [1979] 1 Lloyd's Rep

Due to the general approach of the Canadian courts towards the standard of fraud, the issue, even when it is mentioned in a Canadian case, has normally been addressed in a very simple way. For example, in *CND Research & Development Ltd v. Bank of Nova Scotia*, when issuing an injunction restraining the issuer from paying the demand, Gilligan J stated.

It is my opinion in this case an injunction ought to be granted in my view it ought to be granted for at least two reasons the first is that the plaintiff has made out a strong prima facie case that the demand made by the agent of the Ministry of War is fraudulent. Delivery has clearly been made and claim for a payment of a delivery guarantee necessarily implying that delivery was not made is clearly untrue and false.¹

However this issue has been said to have been dealt with in some depth in the case of *Cineplex Odeon Corp v. Bloor West General Partner Inc.* In *Cineplex*, a limited partnership was formed to develop a multifunctional complex. The parties had entered into a number of agreements according to which the plaintiff *Cineplex* provided a letter of credit to secure its obligations under certain agreements *Cineplex* defaulted in its obligation to build the project and the letter of credit was called upon.

The plaintiff moved to enjoin payment claiming that it was not in default in the obligation that the letter of credit was meant to guarantee, any draw by the defendants would be fraudulent and thus the fraud rule should be applied after reviewing the facts and the principle of independence before dismissing the plaintiff's motion Blair J pointed out.²

The Supreme Court of Canada settled the following with respect to the fraud exception

The exception applies to both cases of fraud in the tendered documents and fraud in the underlying transaction of such a character as to make the demand for payment under the credit a fraudulent one.

The fraud exception should not extend to fraud by a third party of which the beneficiary is innocent

On an application for an interlocutory injunction to restrain payment under a letter of credit because of alleged fraud the standard to be met by the applicant is a strong prima facie

¹ International Maritime Bureau, ICC Commercial Crime Services, ICC Publication No 643

² Note that *Le Dain J* did not agree with such reasoning and held that there was no reason for the bank to make any inquiry or to act on any assumption concerning the shipment covered by invoice 0014 by reason of what it had been informed concerning the shipment covered by a previous invoice merely for the words the amount claimed on the invoice 0014 was not correct

case of fraud¹ in an action for damages brought against an issuer for paying or not paying on a letter of credit after fraud was brought to the issuer's attention the standard to be met by the issuer is whether fraud was so established to the knowledge of the issuer before payment of the draft as to make the fraud clear or obvious to the issuer

In many of the cases the courts have found fact situations that involved demands that were clearly untrue or false or that were made when there was no right to payment to constitute fraud, without specific reference to a finding of fraudulent intent.²

But fraudulent intent being a subjective frame of mind will always be difficult to prove

I submit that these cases are essentially cases where the courts have inferred fraudulent intent from the fact that in the circumstances of each case there was no other explanation why the beneficiary who had no right to payment made a demand under the credit.

3. 5. 1 Application of Fraud under Common Law Countries

Under the common law the correct dating of the bill of lading is a matter of great importance with regard to three legal relationships: in the contract of carriage in the contract of sale as well as in relation to the banks if payment is paid under a letter of credit.

The correct date of a 'shipped' bill is the date when all the goods are loaded and it must not be dated earlier.

The seller/shipper under the contract of carriage is entitled to demand that the bill of lading is dated correctly. If the master or any agent of the carrier negligently misdates the bill they are liable in damages because there is an implied obligation that due care should be exercised in the dating of the bill.

Accordingly for example

Standard Chartered Bank v. Pakistan National Shipping Corporation³

The Court in this case held that PNSC was liable to the SCB, which relied upon the antedated bill of lading as being accurate, in damages for the tort in deceit in respect of any loss they suffered.

Therefore it is clear that the legal requirement for the accuracy of the date of a bill of lading determines that a bank is not obliged to and should not accept a bill of lading wrongfully dated.

¹ Bank of Nova Scotia v. Angelica-Whitewear Ltd., op.cit., 168

² P. Lowe (Fraud and the Documentary Credit Report) of the ICC International Maritime Bureau, ICC Publications; Paris: 1994, at 7

³ J.F. Dolan & P. van Huizen, (*International Rules for Letters of Credit*) *The UCP: A Final Report* 1993-1994, 9 Banking and Finance Law Review 173, at 177.

The innocent seller/shipper is entitled to claim damages from the ship-owner or carrier. Furthermore the tender of a wrongly dated bill of lading by the seller qualifies at least in a c.i.f. contract as a breach of condition and entitles the buyer to reject the bill and to treat the contract as repudiated even if the goods are in fact shipped within the contract time.

In the present case the issuer of the bill of lading deliberately backdated it in order to make the date conform to the shipment time under the letter of credit.

One should logically expect that such document would be considered as invalid and unacceptable under the law of letter of credit in order to be in line with the law of international sales of goods as well as law relating to carriage of goods by sea.

Hence Stephenson L.J. ruled that he was dealing with a clearly established case of fraud, that the documents were intentionally misleading and was not genuine documents against which the bank could be required to pay.

He acknowledged that the courts had a duty to assist the smooth functioning of international trade but not to the extent of assisting established and admitted fraud.

As mentioned above common law fraud essentially requires absence of an honest belief in the truth of what being represented or an absence of the intention to mislead or to deceive. Fraud in England and Australia in the context of letters of credit currently appears to be limited to this type of fraud.¹

The concept of good faith, to the extent that it is part of the fabric of letter of credit law is an essential element of the doctrinal theory underpinning letter of credit law particularly in the .It is argued that the correct applicable standard of good faith, which is the standard set down under Article 5 is subjective good faith honesty in fact in the conduct of the transaction concerned.

The rationale for the adoption of the subjective rather than the objective standard is that, because of the separation of the underlying contract of sale from the banks' obligation to the beneficiary of the letter of credit the justifiable expectation of the issuer and the customer with regard to the letter of credit is not the absence of breach of contract or negligence but only the absence of fraud and that on this basis good faith is only absent if fraud is present.²

¹ Larry A.DiMatteo,Lucien J. Dhooge(*International Business Law) A Transactional Approach*,p389, London Sweet and Maxwell, 2007

² Dalhuisen Dalhuisen on International Commercial, Financial and Trade Law 2nd ed,n Hart Publishing, Oxford, 2004) 456-457

The fraud exception should however at least include the concept of unconscionable conduct as well as common law fraud unconscionable conduct could be present in circumstances where intentional fraud is absent.

In this sense equitable fraud as well as common law fraud should both be considered to fall within what is considered to be an absence of subjective good faith.

It will be discussed further below whether in the context of letters of credit, the concept of good faith should also encompass fair dealing thereby rendering absence of good faith either as a separate exception to the fraud exception or alternatively as an additional requirement to documentary compliance as a precondition to entitlement to payment under a letter of credit.

3.5. 2 The Historical Development of the Fraud Rule U.K

The first case which considered fraud as an exception to the principle of autonomy in United Kingdom was.

Discount Record Ltd V Barclays Bank Ltd (1975)

The case of Discount Records Ltd v. Barclays Bank Ltd and another is a good illustration of this restrictive approach. The plaintiffs ordered from a French company 'Promodisc' 8,625 discs and 825 cassettes.

The credit issued by Barclays Bank (Barclays) was an irrevocable confirmed credit. The credit stated the shipment must be made no later than 30th May 1974. The maturity date under the credit was 20th July 1974.

Even though Prosodic made out an invoice for the abovementioned goods which was supposedly shipped before on 20th May they were actually not shipped until 12th June.

The plaintiff had also found that out of the 8,625 records ordered, only 275 were delivered as per order the rest were not as ordered and were either rejects or un salable.

Then the plaintiffs presented this evidence and sought an injunction on July 11th before the maturity date alleging fraud.

The counsel for the plaintiffs brought before the court issues such as a lack of correspondence between the documents and the goods the discrepancies reflected in the bill of lading regarding the delayed shipping date and inflated invoice compared with what actually sent. The counsel for the defendant avoided dealing with the issues raised by the plaintiff and however asserted that a bill of exchange which has already been accepted by the Discount Bank.

That bill may well have been negotiated it may indeed have passed into the hands of a holder in due course.

The court denied the applicant's application for the injunction and held that even if an injunction were granted it would not prevent the French company from being paid since as a bill of exchange had been accepted by the Discount Bank it might already have passed into the hands of a holder in due course.

Megarry J. stated that the reason why the defendant banks understandably adduce no evidence on the issue of fraud was because banks are not concerned with such matters.

Even though the court discussed the rule that fraud unravels all Megarry J. held that this was not a clearly established fraud case and the court would be slow to interfere with bankers' irrevocable credits unless a sufficiently grave cause is shown.¹

It is doubtful whether the real reason for the court not rendering injunctive relief to the applicant was based on the court's conclusion that there was no fraud it seems that the court firstly did not think that it was possible to conclude clearly established fraud without the presence of the beneficiary.

Megarry J when dealing with the issue of allegation of fraud asserted that it seems unlikely that any action to which Promo disc (the alleged fraudulent beneficiary) was not a party would contain the evidence required to resolve this issue.

Accordingly the matter has to be dealt with on the footing that this is a case in which fraud is alleged but has not been established.

Secondly it was clear that the court was concerned about the legal effect an injunction would have on a deferred payment credit even though the application was brought before the maturity date of such credit.

Such was the restrictiveness of this position in practice that Ackner L.J. felt obliged to point out in one case United Trading Corp that an excessively strict requirement with respect to proof of fraud makes it completely impossible for the courts to apply the fraud exception to the principle of independence.

The learned Judge gave the following guidance for the degree of proof for establishing fraud² Megarry J however came to the conclusion that the mere allegation of fraud on the part of the seller was insufficient to issue an injunction and that fraud must be proven.

The fraud rule was first accepted in the United Kingdom in *Discount Records Ltd v Barclays Bank Ltd*³ and *Barclays Bank International Ltd*.

¹ *Ibid*

² ² NICHOLAS L. DEAK and JOANNE C. CELUSAK (*International banking*) pub. New York institute of finance p.46

³ All ER 489 at 502 per Browne-Wilkinson J.20 (1975)

The autonomy principle although given a very strong position in the UCP did not prevent the application of the fraud rule in the United Kingdom. Megarry J in his judgment, admitted the authority of the United States case *Sztejn v J. Henry Schroeder Banking Corporation*.

The different standard for the application of the fraud rule was also apparent in this case. In this case it was proved by the plaintiff that a great proportion of the shipment was either rubbish or empty cartons and the evidence was affirmed by the judge.

However there was still no established fraud, but merely an allegation of fraud the reason was mainly because Promo disc alleged fraudster was not a party and so the matter was not dealt with on that footing.

The involvement of the beneficiary was seen as the central criterion for the application of the fraud rule. The fraud rule may not be accepted no matter how material the fraud is if there is a lack of the beneficiary's involvement of the fraud.

Although Discount Records Ltd applied the fraud rule at a comparatively high standard, it was the well-known case of *United City Merchants (Investments) Ltd. v Royal Bank of Canada* which pressed the application of the fraud rule to a very narrow scope in the United Kingdom.

3. 5. 3 Fraud Exception in England the Traditional Position

England as most other countries does not have legislation dealing with documentary letters of credit. In England, even though the UCP does not have the force of law, it is generally applied and interpreted by courts when the parties have embodied it into their contracts.

English courts which regarded *Sztejn* as the source of the fraud exception to the issuer's duty to pay against conforming documents, generally have required established fraud before they would issue an interlocutory injunction.

Applicants in English courts however had found it difficult to meet such burden of proof as demonstrated in the following case until recent decisions that further developed the law of letter of credit.¹

The English system had been considered as having adopted a somewhat strict view of the fraud exception and there has been particular emphasis on the importance to intentional

¹ NICHOLAS L. DEAK and JOANNE C. CELUSAK (*International banking*) pub. New York institute of finance p.78

commerce of the principle of the autonomy of documentary credits. In *Malas (Hamzeh Malas & Sons) v. British Imex Industries Ltd.* Jenkins LJ. Said, vitiated the entire transaction that the legitimate purposes of the independence of the issuer's obligation would no longer be served it seems to be plain that the opening of a confirmed letter of credit constitutes a bargain between the banker and the vendor of the goods which imposes on the banker an absolute obligation to pay irrespective of any dispute which there may be between the parties on the question whether the goods are up to contract or not.

An elaborate commercial system has been built up on the footing that the bankers' confirmed credits are of that character and in my judgment it would be wrong for this court in the present case to interfere with that established practice.

The courts in England moreover required that the alleged fraud of the beneficiary of a credit must be clearly established to the knowledge of the bank to justify a refusal by the issuing bank to honor a draft under the credit or to warrant an interlocutory injunction to restrain it from doing so.

We could expect the court to require strong Corroborative evidence for the allegation usually in the form of contemporary documents particularly emanating from the buyer.

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

The English courts traditionally have also taken rather a restrictive approach as to whether fraud extends not just to fraud on the documents but also fraud on the transaction.

As mentioned earlier Lord Denning M.R. required the correct correspondence between the documents and the seller's underlying contractual liability in *Establishment Esekfa International Anstalt v. Central Bank of Nigeria*.⁶⁷ In the House of Lords decision of *United City Merchants* Lord Dip lock reasoned that to this general statement of principle as to the contractual obligations of the confirming bank to the seller there is an established exception: that is where the seller for the purpose of drawing on the credit fraudulently presents to the confirming bank documents that contain, expressly or by implication, material representations of fact that to his knowledge are untrue.¹

However he further reasoned that the bank's right to refuse payment should not depend on information obtained other than by examining the documents themselves. Otherwise the principle of independence would be violated If the documents are valid on their

¹ Anthony Connerty cited in (The Fraud Exception) *Legal Analysis of the English Law Approach* in *Trade Finance Fraud - Understanding the Threats and Reducing the Risk*, op.cit, at 61.

face and the beneficiary-seller is innocent then the efficacy of the operation of the letter of credit requires that the bank pays.

3. 5. 4 The Standard of Applying the Fraud Rule in United Kingdom

After the decision of Lord Diplock in *The American Accord* may be summarized as follows.

First the fraud has to be clearly established; a mere allegation of fraud is not sufficient

Secondly the fraud has to be known to the bank; it is not the bank's responsibility to examine the fraud in the transaction or then inside genuineness of the documents.

Thirdly the intention of the beneficiary is also one of the essentials of the application of the fraud rule.¹

The three conditions for the application of fraud rule in English courts made the application in practice of the fraud rule in documentary credit extremely rare. But it still established the basis of the applying of the fraud rule in English courts.² And from the late 1990s English courts started to consider details of the application and some of the possible exceptions emerged during the application of the fraud exception. Those exceptions are discussed deeply in this thesis to challenge the traditional standard of the application.

3. 5. 5 Application of the Fraud Rule in Australia

Australian courts while recognising the importance of the independence principle, accept the *Sztejn* Case as being the law in Australia. *Contronic Distributors Pty Ltd. v. Bank of New South Wales* which could be described as the first case in which the fraud exception was acknowledged in an Australian court Helsham J of the NSW Supreme Court granted an injunction on the basis that a seller can be restrained from presenting a letter of credit for payment or having payment made against the letter of credit] in the event that the documents which are needed to require payment to be made are false to the knowledge of the seller.

The case of *The Inflatable Toy Company Pty Ltd. v State Bank of New South Wales Ltd.* indicated a willingness to look beyond the documents into the underlying transaction; Young J said 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

¹ G.A. Fellinger, (*Letters of Credit: The Autonomy Principle and the Fraud Exception* (1990)

² H. Harfield, (*Enjoining Letter of Credit Transactions*) (1978) 95 *Banking L.J.* 596

question is really one of considering whether in all the circumstances, the uttering of the documents involves actual fraud.

Young J. further suggested that there is a possibility that the fraud exception does extend so far as to allow for a case where there has been complete and utter non-performance of the underlying sale of goods contract.

The Inflatable Toy Case thereby indicated that the fraud exception includes not only documentary fraud but also underlying transactional fraud and required that the plaintiff to demonstrate a clear case of actual fraud.

In this case the plaintiff was the applicant-buyer who purchased a considerable quantity of inflatable plastic toys including banana men and inflatable pools. Judge Young stated the independence principle and accepted the judgment of the Sztejn Case as the fraud exception to the independence principle. He however also repeated what he said in the Hortico Case the courts have consistently taken a hands off approach.

Courts in intervening though it may be that in some cases unconscionable conduct may be so gross as to lead to exercise of the discretionary power based on the fact that there had existed evidence of clear communication between the beneficiary-seller and the applicant-buyer about the inconsistency in the numbers of the actual banana men and pools shipped and the numbers indicated on the shipping documents, and based on the plaintiff's waiver in writing, Judge Young held that this case does not demonstrate a clear case of actual fraud required by the authorities thus the plaintiff must fail.¹

This case clearly shows that the intention of the relevant party is an important factor for courts in resorting to the fraud exception. If the parties know what the commercial reality was and were prepared to accept it, there would be no fraud.

It appears that even in respect of the traditional positions; there was already some divergence in different courts' understandings of the situations where the fraud exception was applicable.

The analysis in the following sections suggests that the fraud exception must be augmented as in its current state it has proven woefully inadequate to address the challenges that fraud is currently posing to the letter of credit system

¹ Ibid

3. 6 Application of Fraud Rule in Singapore

In formulating the fraud exception, the Singaporean courts have also considered clear fraud as a ground for granting an injunction against payment of a commercial letter of credit. This is however a very recent development in the following case law.

Brody, White & Co Inc v Chemet Handel Trading Pte Ltd

The court held that clear fraud in the documents alone would be sufficient to constitute an exception to the autonomy principle and that fraud in respect of the underlying transaction would not affect the credit contract between the seller and issuing bank¹.

This case thus followed the strict approach expounded in *United City Merchants*

Only a few years later the same court handed down the judgment of *Bocotra Construction Pte Ltd v Attorney-General*.

The court examined the considerations that ought to be made in applications for injunctions restraining payment of bank guarantees. It concluded that the sole consideration to be made is whether there is clear fraud

This seems to assume that a claim of unconscionable behavior on the part of the beneficiary would be grounds for the granting of an injunction to prevent payment. The judgment gives no authority for this development of the law, nor any justification.

As a ground enabling a bank to enjoin payment under a letter of credit, clear fraud requires the bank to look past the documents and into the underlying transaction to determine whether there has been some unconscionable conduct on the part of the beneficiary this defeats the autonomy principle by allowing contractual issues to interfere with the credit transaction.

3. 7. The Position of Fraud Rule in L/C under the UN Convention

The United Nations Convention on Independent Guarantees and Standby Letters of Credit (UN Convention) has taken a different approach to fraud from that of Revised UCC Article 5. While the latter has provided a general standard of fraud for the application of the fraud rule material fraud the former has avoided terms fraud and abuse of right and adumbrated in Article 19 three substantive grounds to invoke the fraud rule.²

1. Any document is not genuine or has been falsified

¹ R.J. Mann (Symposium Empirical Research in Commercial Transactions) II. Transactional Design the Role of Letters of Credit in Payment Transactions", 98 Mich. L. Rev. 2494, August, 2000

² International Maritime Bureau, ICC Commercial Crime Services, ICC Publication No 643

2. No payment is due on the basis asserted in the demand and the supporting documents.

3. Judging by the type and purpose of the undertaking the demand has no conceivable basis.

As for demands that have no conceivable basis Article 19(2) of the Convention further refined this as follows.

1. The contingency or risk against which the undertaking was designed to secure the beneficiary has undoubtedly not materialized.

2. The undertaking obligation of the principal/applicant has been declared invalid by a court or arbitral tribunal; unless the undertaking indicates that such contingency falls within the risk to be covered by the undertaking.

3. The underlying obligation has undoubtedly been fulfilled to the satisfaction of the beneficiary.

4. Fulfillment of the underlying obligation has clearly been prevented by willful misconduct of the beneficiary

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

This list may not be exhaustive but it is an impressive and encouraging way in which to define the kind of misconduct that may invoke the fraud rule. It undoubtedly stands as the most detailed provision so far with respect to clarification of the misconduct that may bring the fraud rule into play.

These provisions are clear and narrow in scope and provide an excellent international standard. They will undoubtedly provide good guidance for courts to enhance their application of the fraud rule.

While the Convention requires manifest and clear evidence to invoke the fraud rule, it does not mention that the wrongdoer's intention should be proven. Reading the text, the Convention, like Revised UCC Article 5 seems to emphasize more the nature of the misconduct rather than the fraudster's state of mind.

However having rules is one thing; properly implementing them is another, because implementation of the rules is in the hands of individual courts. As courts may still apply the standard of proof of some English judgments the real value of these rules remains to be seen.

3. 8. The Wide Approach in Applying the Fraud Rule in L/C

The wide approach is that fraud in the underlying transaction as well as fraud in the documents is sufficient grounds for declining payment or granting an injunction under a commercial letter of credit.

This approach is favored by several academics as well as the North American Courts.¹ The main justification for this conception seems to be the prevention of the proliferation of fraud, particularly fraud in the underlying transaction.

It is argued that the proliferation of fraud threatens the utility of letters of credit as much as, if not more than, court injunctions.

On the other hand it is not the place of banks to act as international policemen. If we view the fraud exception as based on (*ex turpi causa*) maxim as set out in *United City Merchants* it is hard to see why only fraud in the documents should be prevented and not wider fraud.

This appears to be a strong point but when we consider this point from the contractual approach expounded in *Czarnikow* this argument becomes irrelevant as it is not for the courts to reassign the contractual allocations of risk between the parties. If the exception is based upon the bank's mandate the exception will be limited to the documents as they are within the bank's knowledge and expertise.

The applicant is not deprived of alternative avenues of justice which do not undermine the credit contract they can file suit against the fraudulent beneficiary in order to recover any damages incurred.

Another more academic argument in favor of the wide conception is that the narrow exception is illusory. It is illusory because the credit transaction is so closely related to the underlying transaction that allegations that the documents are false or forged cannot be assessed merely by examining the documents but instead one must look to the beneficiary's performance of the actual contract.²

At first blush this argument is hard to set aside; again, however, this argument can be dealt with by approaching it from the contractual point of view.

¹ *Banco Santander SA v. Banque Paribas*, [2000] 1 All ER (Comm) 776, retrieved on 17 February 2001 at <http://www.lexis.com>. See J. Bryne and C. Byrnes, eds. 2001 Annual Survey of Letter of Credit Law and Practice, Montgomery; Institute of International Banking Law and Practice: 2001, at 288.

167 *Banco Santander SA v. Bayern Limited and others* (1999) 2 Lloyd's Rep 239., at 14 of the Lexis version

² ² NICHOLAS L. DEAK and JOANNE C. CELUSAK (*International banking*) pub. New York institute of finance p.89

If we look upon the fraud exception as part of the doctrine of strict compliance then it is clear that only fraud that is clear from the face of the documents will justify a refusal of payment on the part of the bank banks after all are not expected to be experts on fraud in trade transactions; indeed it is outside of their liability and concern to examine extrinsic evidence that would indicate fraudulent statements within correct documents.

Proponents of this view have also justified it by pointing out that the innocent applicant may have no other remedy against the fraudulent beneficiary, thus this cause of action ought to be wider to allow injunctions in more cases this argument is not compelling as when a merchant decides to trade with another merchant and to arrange finance by way of a letter of credit, they are taking on the risk that the other merchant may be fraudulent.

They choose to use a credit transaction because they know that payment will be guaranteed as long as the documents are strictly compliant with the credit. As these transactions are to be treated like cash the applicant's correct cause of action in matters concerning the beneficiary is against the beneficiary alone and should not concern the credit transaction.

The parties have thus contractually allocated risk as between themselves, and the courts should not seek to interfere with this nor be concerned with the difficulties of proper remedies. This argument fits well with the Czarnikow approach in that the only time that the bank has contractually agreed to take on the risk is when they pay in circumstances that are beyond its mandate i.e. in the face of clear fraud in the documents or on non-conforming documents.

3. 9 The Narrow Approach in Applying the Fraud rule in L/C

The narrow approach favored by the English courts is also supported by several academics, the overwhelming rationalization for the narrow approach lies in an explanation of the nature of credits. It has been repeated throughout this paper that documentary credits rely on their independence from the underlying contracts for their very utility.

To allow a party to block payment on the basis of a breach of the underlying contract undermines the parties' expectations and the contractual allocation of risk. The position ought to be the same whether restraining the bank from making payment or the beneficiary from claiming payment as the effect on the credit contract is the same.

It is noted however that in Sirius underlying contractual matters were permitted to interrupt the credit contract.¹

The narrow formulation is justified practically as the bank deals exclusively with the documents alone. Therefore the only kind of fraud that a bank is entitled to consider as sufficient to justify a refusal to make payment is that which is clear on the face of the documents. The bank is capable of identifying clear fraud in the documents as part of the duty to ensure strict compliance.

This is what an applicant would have intended when giving power to the bank to pay on presentation of conforming documents.

Another argument used as justification for the strict approach is that the wider application of the exception is damaging to the reputation of banks.

An injunction however should not affect a bank's reputation as they are absolutely bound to follow a court order thus can hardly be shunned for adhering to the injunction.

A better way of looking at this argument is the damage to international trade if parties cannot rely on the fact that documentary credits are a form of guaranteed payment then they are not likely to use them this would mean that parties who lack confidence in one another are unlikely to trade.

It is the credit instrument that allows such parties to contract and so without the essential characteristic of autonomy, these parties are left without a guarantee of performance of the other party. International trade would thus suffer.

As discussed earlier documentary credits are governed by the UCP which is binding as between the parties if expressly incorporated by the credit.²

The UCP applies in the overwhelming majority of cases and is thus the best indication of the contractual arrangements between the parties. Although the UCP does not formulate the fraud exception in its terms, it does give some guidance as to what the role of the issuing or confirming bank ought to be. Article 14 states that the compliance of the documents must be determined on the basis of the face of the documents alone.

Article 34 is the most relevant provision for assessing the liability of a bank and it states:

"Banks assume no liability or responsibility for the form sufficiency accuracy genuineness, falsification or legal effect of any documents nor do they assume any liability or responsibility

¹ Larry A.DiMatteo,Lucien J. Dhooge(*International Business Law*) *A Transactional Approach*.p391, Londen Sweet and Maxwell, 2007

² Trade Finance Fraud - Understanding the Threats and Reducing the Risk, A SpecialReport prepared by the ICC International Maritime Bureau, op.cit., at 17.

for the description quantity weight quality condition packing delivery value or existence of the goods represented by the documents or for the good faith or acts and/or omissions solvency performance or standing of the consignors the carriers the forwarders, the consignees, or the insurers of the goods or any other person whomsoever”¹

This makes it very clear that banks play a purely mechanical role in credit transactions; they ensure the documents are strictly compliant and are in no way liable for the content of those documents. Banks are not experts in trade transactions they are not qualified to evaluate evidence of fraud and they do not have the resources to ensure that the contents of the documents are accurate and the parties reliable.

The fraud rule becomes an exception to the traditional role of the banks set out in the UCP only if it allows the banks to look outside of the documents and to scrutinize the underlying transaction as expounded by the wider understanding.

However if looked at as a rule that is part of the compliance of documents it is not an exception at all. It is obvious that if a document is clearly forged or fraudulent, the bank is not mandated to accept it as the bank is required to ensure compliance and a forged document is surely not what is required by the credit. Thus only fraud that is clear to the bank from the face of the documents that it is bound to inspect will justify a refusal of payment as gleaned from Article 15.

¹ ICC brochure 1993, the UCP is available from the ICC and at <http://www.iccwbo.org>

Chapter 4

4.1. Introduction

Islamic banking refers to a system of banking, which is consistent with Islamic Shari'ah (Law) and guided by Islamic economics. Islamic law prohibits the payment and collection of riba (interest or usury).

The main argument against interest is that money is not used as a commodity with which to make a profit but that it should be earned on goods and services only, not on control of money itself.

Features of Islamic Banking are based on ethical principles. Islamic Shari'ah allows all economic activities in the framework of protecting public interest and safeguarding it Man may make profit from doing business.

However when this runs against Islamic ethics and morality it is outlawed. In addition for an investment to be legitimate one of the most important requirements is that its outcome must fulfill the reality of investment transactions and that it enables the Islamic Financial Institution to state what it expects to make in profits.

However this cannot be determined as a certainty or can one commit one's self to it or bear any loss sustained.

Main conditions governing Islamic investment include Money does not generate or beget money in itself but it becomes productive if it is involving an activity or work investment is subject to the rule of profit and loss sharing Investment in business activities is lawful but prohibitions should be avoided. Contracts must be free of gharar uncertainty fraud ignorance and the conditions which lead to disputes.

4. 2 Analyses of application of documentary credits in Islamic banks

Islamic banks just like others commercial banks issues documentary credits. The ways by which Islamic banks issues documentary credits is widely different from the way commercial banks issues documentary credits.

Such differences arise at the application of the documentary credit particularly when the bank is principal financier.

For example as we have explained earlier, customers of commercial banks seek from the bank to finance fully or partially a particular transaction like sale contract and get finance in the form of loan with interest that payable within specified date in future.

This practice of charging interest is riba which is repugnant with Islamic principles and therefore it is prohibited in Islam.

In other hand Islamic banks eliminated the concept of charging interest to their customers in dealing with documentary credits they entertained ways and system of applying documentary credits which is lawful according to Islamic principles.

Customers of Islamic banks are divided into two main categories¹.

1. Customers who pay fully in advance all the expenses of the transaction including sale price and other bank charges.

In this case the bank represents on behalf of its client merely as agent of customers who pay partially or do not pay at all the expenses of the transaction.

In the former case the customer seeks from the bank to pay the remaining amount of the money so that the bank will share the finance of that particular transaction while in the later case the customer requests from the bank to finance whole the transaction like the purchase of truck or motors and agrees with the bank to sell them on cost plus profit principle on deferred payment basis.

Following that division mentioned above, Islamic banks issue documentary credit on the basis of one of the following manner².

1. On the basis of Wakalah or contract of agency.
2. On the basis of Murabahah to the purchase order³.
3. On the basis of Musharakah contract.

We will introduce the above mentioned practice of Islamic banking in documentary credit very briefly.

4.3 Application of L/C on the bases of wakalah

Documentary credits can be issued under Wakalah contract (agency relationship) in which the role of the bank is to act on behalf of its customer as a paid agent after the applicant deposited full amount of the sale price of goods of import.

In this case the mere duty of the bank is to represent on behalf of the applicant until the operation of the documentary credit is over.

The example how the concept of wakalah is applied as documentary credit in an Islamic bank is as follow¹:

¹ Al masarif al islamoyah bayna nadariyah wa al tadbiiq by Dr.cabdirizaq rahim jadi al hayti p.410 pub.dar usamah li nashri wa al tawzic Jordan aman

² taqwiim ada al nashat al masrafy al islami p.162 by Dr. qhasan qalcawi and al ixtiraf fil mucamalat al maliyah, sharxu kitab abjidiyat al tijariyah al islamiyah p. 576 pub. Dar al diya

³ The current application of majority of Islamic banks is based on Murabaha contract like Qatar Islamic bank, Jordan Islamic bank, faisal Islamic bank in Egypt.. etc.

The customer request from the bank to issue or open documentary credit in favor of a seller (the beneficiary of the credit) for the payment of certain amount of money within specified time period and give the details of the goods to be imported and instructions required from the seller to comply with.

2. The bank provides documentary credit facility to his customer and requests him to pay in advance the sale price of the goods to be imported.

The bank issues documentary credit in favor of the beneficiary and forwards it to the advising or negotiating bank directing to pay the seller provided that the seller complies with instructions mentioned in the credit and present the stipulated documents.

The advising bank informs to the seller about opening documentary credit in his favor and asks him to present the specified documents within stipulated time in order to receive payment.

5. The seller ships the goods and tenders required documents to the advising or negotiating bank.

6. The advising or negotiating bank check documents whether they are in accordance with instructions of the credit and forwards to the issuing bank.

7. The advising or negotiating bank pays to the seller and gets reimbursement from the issuing bank.

8. Upon the receipt of documents, the issuing bank repays to the advising or negotiating bank utilizing the customer's deposit or fund and subsequently hands over documents of title to the customer in order to collect the goods.

9. The operation of documentary credit is over and the bank charges the customer fees and commissions for its services.

But in case of occurrence of fraud in documents or in transactions then the concept of gharar and fraud in Islamic law of contract will apply which will be explained after the short introduction of Islamic ways of finance at international level.

¹ Bank of Muamalat in Malaysia, available at www.muamalat.com

4. 4 Application of L/C on Murabahah base

Issuance of documentary credit on the basis of murabahah to the purchase order takes place as follow¹.

1. The customer approaches to the bank and request to purchase for him certain commodity promising that he will purchase them (probably on credit) in the stated cost price with profit margin on the basis of Murabahah to the purchase order.

He also provides the description of the required commodity.

2. If the bank agrees to his request, it starts to issue documentary credit and the purchase of required goods for himself. The actual contract of Murabahah will be concluded if the commodity is owned by the bank.

The bank also asks the client to give an undertaking to purchase the goods with stated profit margin.

In order to secure good performance by the Murabahah purchaser, the bank may ask him to furnish a security in the form of a mortgage.

3. After the bank has purchased required goods and taken possession of them, it enters into actual Murabahah contract with the client and hands over goods to the client.

4. In case of defect in the goods discovered later on, the Murabahah purchaser can return it to the bank and claim reimbursement.

This was the relationship between the Islamic bank and the importer or the applicant of the credit.

As far as the relationship between the Islamic bank and the advising bank is concerned, it is a relationship of lender and borrower with avoiding interest or riba.

Usually Islamic banks develop mutual relationship with other conventional banks based on free interest transaction like exchangeable deposit (Wadicah Mutabadillah).

For example Islamic banks deposit some amount of money in advising bank permitting to use free of interest.

If an Islamic bank is issued documentary credit in favor of overseas exporter, it forwards to the advising bank directing to pay the seller in its account or fund in the advising bank. However if the advising bank paid more than the Islamic bank's deposit or fund, the advising bank does not charge interest.

¹ See Mucamat al maliyah al mucasarah fil fiqh al islami by Dr. M.Usman Shabir pub. Dar al nafa'is p.285 and al ixtiraf fil mucamat al maliyah, sharxu kitab abjidiyat al tijariyah al islamiyah p. 576 pub. Dar al diya

4.5 Application of L/C on the bases of Musharakah

Islamic banks use Musharakah as a mode of financing in two ways.¹

1. Project financing

Islamic banks provide project finance on the basis of Musharakah. two or more of its customers approach the bank for finance of a specific project on the basis of Musharakah.

If the bank agreed with the customers to share the finance of the project, the bank and the other partners provide complete finance.

All parties including the bank have equal rights to participate in the management of the project and the profits are distributed according to the agreed ratio, which need not to be the same as the capital proportion.

In case of a loss, all parties share exactly in accordance to their proportion in which each partner provided for the finance of the project.

Thus, the bank before financing the project on Musharakah basis gets evaluated by its experts and if the bank found that such project is profitable enters into such agreement and issues documentary credit in order to complete the project.

Such type of Musharakah terminates with the completion of the project.

2. Financing of a single transaction

An Islamic bank also provides finance to the medium and small business traders.

The customers of the bank approach the bank and request to finance a purchase of certain commodity or goods on the basis of Musharakah.

If the bank considers that such transaction is profitable, than the bank provides finance to purchase the requested goods on the basis of Musharakah and issues documentary credit. If the goods are received and collected from the port the sale of that goods and subsequent profit are shared by the customers and bank according to pre agreed ratio.

In case a loss arises the bank and the customer share that loss in accordance with the ratio that each partner invested.

4.6. Fraud exception in documentary credit or in goods in Islamic banking.

We have mentioned earlier one of the principles in which the documentary credits are found and that is autonomy of the documentary credit.

This principle says that the bank which deals with documentary credit transaction will not involve in any dispute between the parties to the underlying sale contract or any other contracts.

¹ Ibid

The only exception to this principle is the fraud exception that the bank may refuse to the seller's request of getting payment if it is proved to its satisfaction that the seller is involved in a fraud.

This fraud is mostly related to the documents submitted by the seller to the bank. They may be forged or untrue in relation to the goods to which they refer, though on their face they may appear to be correct.

The applicant of the credit or the buyer usually raises this allegation of fraud in order to prevent the bank from paying the seller.

In this situation, the buyer may allege that the seller shipped defected goods instead of confirming goods as mentioned in the credit or that the bills of lading were forged or fraudulently false.

In this case it is not the obligation of the bank to ascertain or make sure whether the alleged fraud can be proved by the buyer but the bank may generally evaluate the evidence placed before it by the buyer.

In ascertaining alleged fraud, three situations must be classified.

1. Where there is allegation of fraud communicated by the buyer to the bank that the fraud has occurred and that allegation is found on mere suspicion or the bank itself found such fraud on the basis of suspicion, and no more facts can be established, bank should pay the seller. The reason is that mere suspicion may not be the basis of refusing to pay the seller unless there is clear evidence both as the fact of the fraud and as to the bank's knowledge.

2. Where it is clearly established to the satisfaction of the bank that the fraud has occurred and there is unambiguous evidence before it that the documents or some of the documents are forged but the circumstances show that the seller is not involved in that fraud for example there is a possibility that the fraud was committed by a third party e.g. a forwarder or loading broker, in this case the bank should pay the seller¹.

3. Where the bank has sufficient proof and evidence that a fraud has been committed and that the seller knew of this fraud for example, the seller himself tendered false documents or somebody else does this fraud with his knowledge, the bank should not have to pay the seller if both these facts are clearly established.

There are two main differences between applications of documentary credits in commercial and Islamic banks.

¹ united city merchants (investment) Ltd v. royal bank of Canada case 1983.

The house of lord held in this case that the bank should pay in spite of its knowledge of the fraud because not only the bank and the buyer but also the seller was deceived by the fraud of the third party.

1. The first difference is the question of liability that commercial banks are not liable in case of loss or destruction of goods of import before the delivery of such goods to the customer. This means that the customer is liable in case of loss or destruction of goods of import before it comes to his possession.

But as will as Islamic banking is concerned the tradition is different and the bank is liable any loss or destruction of goods of import before it hands over to the customer. The reason is that the goods are owned by the bank and in case of loss or destruction before it is delivered to customer, the bank is liable till the ownership is not passed to the customer.

The second difference relates the goods after their arrival, in commercial banks the duty of the bank is only confined to confirm whether the documents forwarded to him are in accordance with the instructions mentioned in the credit.

In case of defect in the commodity the buyer can not return it to the bank as the bank is not responsible. This means that in documentary credit operation, the bank deals with documents and not goods and services.

In Islamic banks the situation is different and the bank is liable in case a defect is discovered in the goods later on the buyer can return defected goods to the bank and claim reimbursement for that defect¹.

This means that the duty of the Islamic bank is to deliver to his customer requested goods in kind, quality and quantity.

4.7 Evidence to proof fraud in Documentary Credit

It is well known principle of common law and Islamic law of business that the burden of proof is on the party who is alleging that fraud is occurred in documents or in goods is required in law to proof his allegation in order to get remedy.

Therefore in any case where a fraud has been alleged either by the buyer, the applicant of the credit or the paying bank sufficient evidence must be brought by either party before the court of law in order to decide the case. Conditions which are necessary to prove all kinds of fraud in documentary credit and in transactions are similar between conventional banks and Islamic banks such as

- (a) A false presentation of the fact.
- (b) Knowledge or belief on the part of the defrauder.
- (c) Fraud must not be done by third party.

¹ Al masarif al islamiyah beyna nadariyah wa al tadbij by Dr.cabdulrasaq rahim publ.dar usamah li nashri wa tawsic aman Jordan 1998.

(d) Presentation of the documents in bad faith to defraud the opponent party.

There are two main differences between applications of documentary credits in commercial and Islamic banks. The first difference is the question of liability that commercial banks are not liable in case of loss or destruction of goods of import before the delivery of such goods to the customer. This means that the customer is liable in case of loss or destruction of goods of import before it comes to his possession.

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The second difference relates the goods after their arrival, in commercial banks the duty of the bank is only confined to confirm whether the documents forwarded to him are in accordance with the instructions mentioned in the credit. In case of defect in the commodity, the buyer can not return it to the bank as the bank is not responsible.

This means that in documentary credit the bank deals with documents and not goods and services but in Islamic banks the situation is different and the bank is liable in case a defect is discovered in the goods later on.

The buyer can return defected goods to the bank and claim re imbusement for that defect¹. This means that the duty of the Islamic bank is to deliver to his customer requested goods in kind, quality and quantity.

¹ Al masarif al islamiyah beyna nadariyah wa al tadbiq by Dr.cabdulrasaq rahim publ.dar usamah li nashri wa tawsic aman Jordan 1998.

CONCLUSION

The use of the letters of credit as a tool to reduce risk has grown substantially over the past decade. Letters of credit accomplish their purpose by substituting the credit of the bank for that of the customer for the purpose of facilitating trade

The fraud rule as an exception of documentary credits system, exists in international trade law for certain reasons. It prevents the fraudulent seller from abusing the credit it protects the buyer's rights under the sale contract it also efficiently protects the bank's security interests.

Although the conflict between the fraud rule and the autonomy principle is hard to ignore a proper method of application of the fraud rule may reduce the collision. The solid position of the autonomy principle in English courts is not necessary to hinder the efficiency of the fraud rule.

The new approaches which emerged during the 1990s are a good pattern of the application of the fraud rule in English law. Furthermore the illegality exception and the nullity exception are both possible exceptions under certain conditions in the documentary credits system.

Those exceptions in addition to the fraud rule may provide a better environment for the development of the documentary credits system. The payment system may be more functional with the protection of those exceptions.

Recourse and availability of injunctive relieve should be permitted to be effective ways to deter fraud. It is submitted that an extreme interpretation of the independence rule has resulted in a narrow application of the fraud exception in the letter of credit mechanism.

Such interpretation ignores the beneficiary's duty under a letter of credit to provide documents representing the contracted goods. It is with respect questionable whether some courts and merchants are aware that a letter of credit does not constitute payment itself and only offers a means of obtaining payment Without fulfilling his duty strictly by providing conforming documents according to the terms and conditions of a letter of credit and acting in good faith, a seller/beneficiary should not expect to be paid.

A bank should not be forced to pay against forged or false documents irrespective of whether the seller/beneficiary himself has committed the fraud or not.

It is submitted that whenever an allegation of fraud is brought to the attention of a bank or a court the independence rule should never be an obstacle for the courts to bring about justice and apply the rule of fairness and therefore restrain activities undertaken in bad faith.

It is entirely consistent with the independence principle to say that a beneficiary who practices fraud on the applicant or the issuer is not entitled to the payment under the credit

and it is also consistent with the strict compliance rule to say that a beneficiary who presents fraudulent or false documents has not complied with the credit.

The grant of an injunction is made in the exercise of the court's inherent power to prevent injustice arising as a result of fraud.

The one true option for the buyer/applicant to try to prevent payment of the credit once fraud is discovered is to appeal to a court for preliminary or interlocutory injunction prohibiting the bank from paying out under the credit.

The law perhaps should protect banks from being sued by the beneficiary when an applicant is applying for an injunction and the court is considering such application.

That is to say the law should ideally give the issuer the right to suspend the payment pending the decision of injunction.

If a buyer/applicant is making an unfounded allegation and the court does not think the applicant has a reasonable chance to succeed, the applicant should bear costs and interest in respect of any delay in payment that has incurred such an allocation of financial burden on the applicant for casual accusations of fraud when facing a falling market in certain goods can play an important role in constituting a disincentive to taking advantage of such system and of making sure that most such allegations are serious ones.

Only when applicants are given the opportunity to raise viable and achievable defenses against payment through injunction will the courts be able to play a role in the battle against the proliferation of fraudulent transactions thereby ensuring that justice is allowed to assume place in the letter of credit system.

Otherwise the letter of credit system will remain insulated from meaningful court intervention and from the benefits in the form of justice and equity that such intervention could bring.

I would like to conclude this research paper by saying that the fraud in letter of documentary credit, like other forms of crime is to be discouraged, through the awareness among the business community at international level and effective deterrent

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