Documentary Letters of Credit as Security for Financial Obligations

Justice Andrew Rogers

A Judge of the Supreme Court of New South Wales

I have assumed that the draftsman of the title of this paper wished for a discussion of the circumstances in which, notwithstanding presentation of the documents called for by an irrevocable letter of credit, the apparent entitlement to payment may be displaced.

The primary question requiring discussion in this context is the effect of fraud on the part of the beneficiary. In *Societe Metallurgique D'Aubrives v. British Bank for Foreign Trade* [1922] 11 LlLR 168, Bailhache J, in an obiter dictum, which was no more than an aside, said (at 170):

> Did the person presenting (the letter of credit) misdescribe the goods in such a way as to be guilty of fraud? If that were so, then the bank in refusing to pay would be justified.

His Lordship cited no authority and gave no elaboration of this observation. The question received no further mention in English Courts for another thirty-five years.

In 1941, in *Sztejn v. J Henry Schroder Banking Corporation* 31 NYS 2d 631, Justice Shientag, a judge of the Supreme Court of New York, first gave considered recognition to the possibility that a customer, who procured the issue of a letter of credit by a bank, may be able to restrain payment by the bank. Since all subsequent discussion of this topic can be traced back to *Sztejn* and since section 5-114 of the Uniform Commercial Code is claimed to be a codification of the effect of *Sztejn* it is necessary to consider that decision in some little detail. First, it should be noted that it was an application by a defendant to have the proceedings dismissed on the basis that the initiating process disclosed no cause of action. In accordance with accepted legal theory both in this country and the United States that meant that, for the purpose of the application, the facts alleged in the initiating process were required to be considered to be made out. The facts, therefore, taken as true, were that the plaintiff ordered a quantity of bristles from one of the defendants, Transea Traders Limited, of India. The plaintiff obtained the issue by J Henry Schroder Banking Corporation of an irrevocable letter of credit to Transea. Transea filled some fifty crates with rubbish, placed them on a steamer and obtained a bill of lading. Transea then drew a draft under the letter of credit to the order of the Chartered Bank of India, Australia and China, which presented the draft along with the shipping documents to Schroder for payment. The judge described the nature of the proceedings before him as:

> The plaintiff prays for a judgment declaring the letter of credit and draft thereunder void and for injunctive relief to prevent the payment of the draft.

The second noteworthy feature of the decision is that nowhere in the judgment is there any suggestion that the plaintiff's standing as an applicant for relief was ever questioned. It is, of course, trite that any transaction involving the issue of a letter of credit involves the creation of a number of contractual relationships. There is the underlying contract which, in the case of the orthodox letters of credit, is usually between buyer and seller

of goods, whereby the seller agrees to payment under a letter of credit by presenting to the issuer the documents specified by the buyer. Then there is the contract between the buyer/customer and the bank/issuer which draws the letter of credit in favour of the seller/beneficiary. Then there is the obligation created between the bank issuing the letter of credit and the beneficiary of the letter of credit whereby the bank agrees to pay upon presentment of the specified documents. In this last-mentioned contractual relationship the buyer, the customer of the bank, has no role to play. The letter of credit contract is independent of the contract of sale between the beneficiary and the bank's customer. In the same way that the issuer cannot assert a breach of that latter contract as a defence to payment under letter of credit, the beneficiary cannot excuse deficiency in performance of the letter of credit terms by showing that performance accorded with the terms of the contract with the seller. Again, the beneficiary cannot compel payment by the issuer on the ground that the terms of the credit may be more onerous than those stipulated in the contract between issuer and bank's customer nor, finally, can the issuer justify non-payment on the basis of a breach of its contract with its customer. This being the accepted situation, one would have thought, with respect, that the customer has no basis for restraining performance of the contract between issuer and beneficiary to which it is not a party. Therefore, even though by reason of the nature of the proceedings the facts were required to be taken to have been admitted, the proceedings should, in fact, have been dismissed by the learned judge simply on the basis that Sztejn could not intervene to seek injunctive relief even if, assuming for the sake of argument, the issuer of the letter of credit could assert a defence to its liability to pay on the ground of the beneficiary's fraud. I am bound to say what authority there is in this country denies the proposition I have just stated. In *Contronic Distributors Pty Limited v. Bank of New South Wales* (Mr. Justice Helsham unreported 1975), the judge said:

> I believe that the person who will suffer the loss in the event of payment against false documents has a right, *and as much right as a buyer,* to seek an order to restrain the payment. (emphasis added)

In other words, his Honour regarded the status of a buyer as absolutely beyond question. With great respect, it is difficult to understand in principle why he took this view.

Notwithstanding this threshold problem, the only question which was in fact addressed in *Sztejn* was whether fraud on the part of the beneficiary/seller could work to relieve the issuer from the immediate obligation to pay. The judge recognised the long-standing principle that a letter of credit is independent of the underlying contract between the buyer and seller. Accordingly, as he rightly said, any possible breaches of warranty under the primary contract were quite irrelevant to the obligation to pay. However, he distinguished that situation from a case of established fraud. He relied upon a statement in *Old Colony Trust Co v. Lawyers' Title & Trust Co* 297 F 152. There the letter of credit required drafts to be drawn against "net landed weights". Net landed weights could only be ascertained after US Customs had weighed the goods to determine the duty payable. The weighing was not completed until after tender of the drafts and the expiration of the letter of credit. The invoices presented with the drafts stated that landed weights duty had been paid. That was obviously false. But the Court made it clear that was not the basis of its decision. The letter of credit also required a negotiable warehouse receipt. The warehouse receipts presented were untrue in stating that the goods were in the warehouse and the falsity was known to the defendant. Not only was there, therefore, a failure to comply with the terms of the letter of credit but the issue of the document was illegal. It was in that context that the Second Circuit Court of Appeals said (at 158):

> Obviously when the issuer of a letter of credit knows that a document, although correct in form, is, in point of act, false or illegal, *he cannot be called upon to recognise such a document as complying with the terms of a letter of credit.* (emphasis added)

With great respect to Justice Shientag his reliance upon that statement appears to me to have been misplaced. It is one thing to say that the documents presented in compliance with the requirements of the letter of credit have to be genuine and conform with the

requirements of the general law; it is quite another matter to say that fraud in the primary transaction may avoid the obligation under a letter of credit. Yet what the judge said was:

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

As a consequence of *Sztejn's* case, in general American jurisprudence has now accepted the following proposition:

> If presentment and demand is made by the beneficiary or his agent and there are no innocent third party holders in due course involved and prior to payment the bank is notified by its customer of fraud, forgery, or other defect not apparent on the face of the documents presened, the bank has the option of honouring or not honouring the demand, *although a court of appropriate jurisdiction may enjoin honour in such circumstance.* (emphasis added) *(Dynamics Corporation of America v. The Citizens and Southern National Bank* 356 FSupp 991).

The proposition is now enshrined in the Uniform Commercial Code section 5-114(2)(b). However, as will be seen, the adoption of this provision in the various States has not, in fact, been uniform with some startling results.

In none of the cases following *Sztejn* has the point been taken that the person who sought to "enjoin honour" had no standing to make such an application. It is interesting to observe that the doyen of the learning on letters of credit, Mr. Henry Harfield, although noting the point, nonetheless accepts the decision in *Sztejn.* He considers that the question of standing is no longer open in the light of section 5-114 of the Uniform Commercial Code. He then goes on:

> In any event, the court (in *Sztejn)* was concerned with issues of greater commercial significance — namely, whether there should or should not be a mechanical application of the doctrine that, in letter of credit transactions, the criterion is form and not ultimate truth. (95 *The Banking Law Journal* 596 at 603)

In his view, *Sztejn* is authority simply for the proposition that a document which falsifies the facts it purports to evidence is a non-conforming document. If this is the true explanation then, contrary to the view I have expressed, it applies the principle of the *Old Colony* case and is explicable as but an extreme example of failure to comply with the demands of the letter of credit. In the same way that a genuine and not a forged shipping document is required, so a truthful and not deliberately deceitful document is called for by the letter of credit. It seems to me that ultimately one has to face the fact that Sztejn made a policy choice. As another learned commentator on the US scene, John F. Battaile III, put it in "Guaranty Letters of Credit; Problems and Possibilities" (1974) 16 ArizLR 822 at 849:

> In such situations, justice requires that the submitting party not prevail. But this result can only be reached by factual inquiry in violation of basic letter of credit precepts — the doctrines of strict compliance and the independence of the bank's obligation. *Sztejn* faced this issue squarely and resolved the impasse by creating a limited exception which operates where the customer, seeking to enjoin payment, alleges the documents are fraudulent. Once fraud has been raised, the court must examine the facts of the alleged fraud rather than the purely legal question of whether the documents comply with the terms of the credit.

Section 5-114 of the Uniform Commercial Code accepted the concept that an injunction may be granted, even though documents accurately reflect the facts they purport to reflect, if there is "fraud in the transaction". If one construes transaction as being the underlying contract, then the independence of letters of credit has been substantially eroded.

This is a position the American courts are apparently prepared to accept. Thus, in *United Bank Limited v. Cambridge Sporting Goods Corporation* 392 NYS 2d 265, the New York Court of Appeals said (at 270):

> Where 'fraud in the transaction' has been shown and the holder has not taken the draft in circumstances that would make it a holder in due course the customer may apply to enjoin the issuer from paying drafts drawn under the letter of credit (see 1955 Report on NY Law Rev Comm Vol 3 pp 1654-1559). This rule represents a codification of precode case law most eminently articulated in the landmark case of *Sztejn v Schroder Banking Corporation* 31 NYS 2nd 631, Shientag J, where it was held that the shipment of cow hair in place of bristles amounted to more than mere breach of warranty but fraud sufficient to constitute grounds of enjoining payment of drafts to one not a holder in due course. Even prior to the *Sztejn case*, forged or fraudulently procured documents were proper grounds for avoidance of payment of draft drawn under a letter of credit; and cases decided after the enactment of the code have cited *Sztejn* with approval.

The court seems to put *Sztejn* more on the basis that I have suggested of fraud in the underlying transaction but then seems to equate that with forged documents.

In the *United Bank* case itself, the court held that shipment of old, unpadded, ripped and mildewed gloves rather than the new boxing gloves ordered by Cambridge constituted "fraud in the transaction" within the meaning of the Uniform Commercial Code. The court went on (at 271):

> It should be noted that the drafters of Section 5-114, in their attempt to codify the *Sztejn* case and in utilising the term 'fraud in the transaction' have eschewed a dogmatic approach and adopted a flexible standard to be applied as the circumstances of a particular situation mandate. It can be difficult to draw a precise line between cases involving a breach of warranty (or a difference of opinion as to the quality of goods) and outright fraudulent practice on the part of the seller. To the extent, however, that Cambridge established that Duke (the supplier) was guilty of fraud in shipping, not merely non-conforming merchandise, but worthless fragments of boxing gloves, this case is similar to *Sztejn*.

The exact contours of "fraud in the transaction" are unsettled. In its analysis in *Intraworld Industries Inc. v. Girard Trust Bank* 336 A 2d 316 at 324, the Pennsylvania Supreme Court spoke of "situations of fraud in which the wrongdoing of the beneficiary has so vitiated the entire transaction that the legitimate purpose of the independence of the issuer's obligations would no longer be served". The exception of "fraud in the transaction" was much invoked in the plethora of litigation following the Iranian revolution. The litigation is examined in depth in "Fraud in the Transaction; Enjoining Letters of Credit during the Iranian Revolution" 93 HarvLR 992, and many other learned articles eg "The Role of Standby Letters of Credit in International Commerce; Reflections after Iran" (1980) 20 Virginia Jnl of Internat Law 460; "Letters of Credit; Injunction as a Remedy for Fraud" (1979) 63 Minnesota LR 487; "Standby Letters of Credit After Iran" (1982) Uni of Illinois LR 355. The views are in many respects difficult to reconcile and demonstrate that even with a code in place the room for argument and confusion persists (see "Enjoining the International Standby Letter of Credit" (1980) 21 Harv Internat LJ 189 at 203 et seq).

As I mentioned earlier, some of the States did not adopt the Model Uniform Commercial Code in its entirety. The California jurisdiction may enjoin such honor" from section 5-114(2)(b). It is interesting to note the reason assigned for this by the Official Comment:

> By giving the courts power to enjoin the honor of drafts drawn upon documents which appear to be regular on their face, the Commissioners on Uniform State Laws do violence to one of the basic concepts of the letter of credit, to wit, that the letter of credit agreement is independent of the underlying commercial transaction.

A Federal District Court accordingly held in *Agnew v. FIDC* 548 F Supp 1234 that California State law did not permit injunctive relief even in the face of allegations of fraud.

Notwithstanding that *Sztejn* was decided in 1941, it was not until 1975 that the first reported case appears in which the fraud on the part of the seller was sought to be relied upon in an English court. In *Discount Records Limited v. Barclays Bank Limited* [1975] 1 All ER 1071, Mr. Justice Megarry found it unnecessary to determine whether or not the principle in *Sztejn* was correct or not and was content to hold that, in any event, the plaintiff's claim failed because it failed to establish fraud. There was merely an allegation of it. At 1075 His Lordship said:

> The *Sztejn* case is plainly distinguishable in relation both to established fraud and to the absence there of any possible holder in due course. I do not say that the doctrine of that case is wrong or that it is incapable of extension to cases in which fraud is alleged but has not been established provided a sufficient case is made out. That may or may not be the case.

In *Hamzeh Malas & Sons v. British Imex Industries Limited* [1958] 2 QB 127, the Court of Appeal merely left the question open.

The question was next examined by Mr. Justice Kerr in *R D Harbottle (Mercantile) Limited v. National Westminster Bank Limited* [1978] 1 QB 146. By contracts of sale between English vendors and Egyptian buyers, payment was to be made by irrevocable confirmed letters of credit. The vendor's obligations were to be secured by performance bonds established with two Egyptian banks. The plaintiff vendor instructed its own bank, the defendant, to confirm the guarantees to the Egyptian banks which, in turn, confirmed the guarantees to the buyers. Demands were made on the plaintiff's English bank and thereupon the plaintiff instituted proceedings against its own bank, the Egyptian banks and the buyers seeking, inter alia, injunctions restraining its own bank and the Egyptian banks from paying the buyers under the guarantees. At the hearing, the plaintiff contended that on the evidence the buyers were not entitled to payment under the guarantees and that, therefore, their demands for payment were fraudulent. The dispute came before Mr. Justice Kerr. So far as the point presently under consideration is concerned, his Lordship pointed out that here again it was not a case of an established fraud at all, his Lordship contemplated that in exceptional cases the courts might interfere even with the machinery of irrevocable obligations assumed by banks. He said (at 155):

> Except *possibly* in clear cases of fraud of which the banks have notice the courts will leave the merchants to settle their disputes under the contracts by litigation or arbitration as available to them or stipulated in the contracts. (emphasis added)

I should like to draw attention to the extremely tentative way that his Lordship couched the nature of the claimed exception now under consideration.

Much the same circumstances arose in a matter which came before the English Court of Appeal later that year: *Edward Owen Engineering Limited v. Barclays Bank International Limited* [1978] 1 QB 159. That was an appeal from Mr. Justice Kerr. The facts in this case were almost identical with the *Harbottle* case. The Lybian customer failed to supply an irrevocable letter of credit in accordance with the contract between customer and supplier. Nonetheless, it made a demand under a performance guarantee. The English supplier sought to enjoin the English bank from paying the Lybian bank conformably to the performance bonds. At first instance Mr. Justice Kerr held that the performance bonds must be honoured as between the banks and that the relations between the English supplier and the Lybian customer were no concern of the bank. The English supplier appealed. The appeal was dismissed. However, Lord Denning MR said that there was, in the case of "established or obvious fraud to the knowledge of the bank", an exception to the general principle that when a letter is issued and confirmed by a bank the bank must pay it if the documents are in order and the terms of the credit are satisfied. His Lordship approved the statement by Justice Shientag in *Sztejn's* case. He put it thus wise:

> 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 when there is no right to payment. (at 169)

If one may say so, the width of the language employed may be misleading. It seems to me to be much wider than warranted by *Sztejn*.

In the light of what I intend to say later it is opportune to mention that his Lordship distinguished the question before the court from the Mareva injunction cases. Browne LJ emphasised that the fraud must be very clearly established.

Finally, the House of Lords in *United City Merchants v. Royal Bank of Canada* [1983] AC 168 has firmly established that fraud by the seller displaces the liability of an issuing bank.

The letter of credit there in question was expressly made subject to the Uniform Customs and Practice for Documentary Credits 1974 ("UCP"). A Peruvian company agreed to buy goods, payment to be made by confirmed, irrevocable, transferable letter of credit payable in part on presentation of shipping documents. An employee of the loading broker to the carrier was found to have acted fraudulently in issuing the bills of lading bearing, what was to his knowledge, a false statement as to the date on which the plant was actually on board the ship. It was further found that neither the seller nor its transferee was a party or privy to any fraud by this employee of the loading broker. It can be seen that these proceedings were different from all the ones that have gone before in that the fraud alleged was not on the part of the beneficiary at all but on the part of the employee of a third party. Lord Diplock delivered the only judgment in the House of Lords. His Lordship accepted, as he was bound to do, that pursuant to Article 8 of the UCP the seller and the confirming bank dealt in documents and not in goods. If on their face the documents presented to the confirming bank by the seller conformed with the requirements of the credit the bank was under a contractual obligation to the seller to honour the credit notwithstanding any knowledge of a breach of the underlying contract. His Lordship identified an exception to this principle where the *beneficiary* 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*" (emphasis added) (at 183). His Lordship identified the rationale in *Sztejn's* case as the application of the maxim that "fraud unravels all". He justified the application of the maxim by the proposition that courts will not allow their process to be used by a dishonest person to carry out a fraud. With the most profound respect, this appears to be an inappropriate application of the undoubted maxim. If, in fact, the issuing bank is obligated to pay against documents except in the case of forgeries then enforcing that obligation is not really allowing a dishonest person to use the processes of the court to carry out a fraud. The dishonest person is not seeking the aid of the court to effect the terms of the contract.

I find the whole concept of fraudulent statement in documents presented to an issuing bank to be very difficult to reconcile with the provisions of Article 8(c) of the UCP. That provides that:

> If, upon receipt of the documents, the issuing bank considers that they appear on their face not to be in accordance with the terms and conditions of the credit, that bank must determine, on the basis of the documents alone, whether to claim that payment, acceptance or negotiation was not effected in accordance with the terms and conditions of the credit.

It seems to me that the terms of the Article emphasise what is in any case accepted law that the duty of the issuer is confined to a consideration of the documents alone. The question then is whether the issurer can be compelled to refrain from making payment by circumstances outside the face of the document. Forgery must be an obvious exception to any obligation to pay against documents. Although on its face the document may comply, if it can be shown that it is, in fact, a forgery then one would expect that the issuer could be enjoined from payment.

It is at this point that Lord Diplock's judgment in *United City Merchants* (supra) becomes somewhat difficult to follow. After referring to the undoubted fact that even a forged

document does not detract from the rights of a holder in due course he went on (at 187):

> I see no reason why, and there is nothing in the Uniform Commercial Code to suggest that, a seller/beneficiary who is ignorant of the forgery should be in any worse position because he has not negotiated the draft before presentation. I would prefer to leave open the question of the rights of an innocent seller/beneficiary against the confirming bank when a document presented by him is a nullity because unknown to him it was forged by some third party; for that question does not arise in the instant case. The bill of lading with the wrong date of loading placed on it by the carrier's agent was far from being a nullity. It was a valid transferable receipt for the goods giving the holder a right to claim them at their destination, Callao, and was evidence of the terms of the contract under which they were being carried.
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> But even assuming the correctness of the Court of Appeal's premises as respects forgery by a third party of a kind that makes a document a nullity for which at least a rational case can be made out, to say that this leads to the conclusion that fraud by a third party which does not render the document a nullity has the same consequence appears to me, with respect, to be a non sequitur, and I am not persuaded by the reasoning in any of the judgments of the Court of Appeal that it is not.

The heavy insistence of the House of Lords on knowledge by the beneficiary of the falsity effected by a third party has been strongly criticised by Mr. F.W. Neate in a paper delivered to the Section on Business Law of the IBA in May 1984. Once one accepts that falsity, if established, disqualifies a letter of credit from enforceability, knowledge should not be a requirement.

The law of England and the United States, therefore, is that a false statement in a document, at least if known to the beneficiary, makes the letter unenforceable. In a matter of such importance to the commercial community where uniformity is essential, Australian courts can be expected to fall in line.

However, even though, in principle, established fraud may lead to relief against payment on a letter of credit, in practice proof of the fraud is extremely difficult.

Another method of launching an attack on the efficacy of letters of credit in practice may be by means of a Mareva injunction. This type of relief is generally available to a plaintiff who can show that a very clear claim against a defendant may be defeated by the defendant dissipating its assets before judgment. Let it be assumed that a purchaser who effects payment by means of an irrevocable letter of credit knows that the goods being supplied are grossly deficient in compliance with the terms of sale. In the absence of clear proof of fraud, the purchaser cannot restrain the issuer of the letter of credit from effecting payment. Even if it seeks and obtains a Mareva injunction against the vendor that will not prevent payment being made to it under a letter of credit or under a bank guarantee (*Z Ltd v. A-Z and A-A* [1982] 1 QB 558 at 574). Some comments of Lord Denning MR in *Power Curber International Limited v. National Bank of Kuwait* [1981] 3 All ER 607 at 613 could be construed as denying the applicability of the Mareva principle to a seller who wishes to freeze the proceeds of a letter of credit he caused to issue. However, in the subsequent decision in *Z Ltd* (supra) Lord Denning clearly stated that an injunction against dealing with assets will prevent the seller from dealing with the proceeds of the letter of credit. Thus, the independence of the contract between the issuer and beneficiary is preserved but an effective remedy is nonetheless provided in certain circumstances to the innocent buyer against the defaulting seller. On the other hand, it has to be noted that in the same case Kerr LJ held that:

> . . . whereas the proceeds of such documents might be frozen if they came to be paid into an account of the defendant to which the order applied, they should not otherwise be comprised within the terms of the order to which the banks were obliged to give effect. This latter view was based on the inconvenience to the banks in not having any central record system enabling them to locate the receipt of payment under such documents. The great disadvantage of this limitation of the scope of Mareva injunctions is that it enables the wary defendant to preserve from the reach of the order assets received by a bank on his behalf by instructing it beforehand not

> to credit the money to any of his accounts at the bank but simply to pay the money away to himself or a third party. It is respectfully suggested that a better course would be that if the bank is actually aware that payments received by it are within the scope of a Mareva injunction it ought not to dispose of the moneys without first obtaining the direction of the Court. If, due to lack of a central record system, the bank failed to realise that money received by it for the defendant was subject to an injunction and disposed of that money in accordance with the defendant's instructions, it should not be treated as in contempt of Court on that account.

An analogous mode of challenge was narrowly defeated in *Lantz International Corporation v Industria Termotecnica Compana S.P.A.* 358 F Supp 510. The customer in that case began a foreign attachment action in Pennsylvania naming the beneficiary as a defendant and the Pennsylvania bank which was the issuer as the garnishee. The attachment was intended to prevent the bank from remitting the funds to the supplier and preserve the proceeds of the letter of credit as a fund from which the damages claim could be satisfied. The tactic was only defeated because the supplier had already discounted the drafts drawn against the letter of credit. As the author of "Letters of Credit; Expectations and Frustrations" 94 Banking LJ 493 points out:

> This use of foreign attachment has a particularly insidious effect on the dependability of a letter of credit because it effectively interferes with the beneficiaries' expectations without directly challenging the theoretically strict character of the issuer's obligation.

Overall the lesson to be learnt is always to discount the letter of credit at the earliest possible time.

The recommendation of competing interests was adverted to by the Master of the Rolls, Sir John Donaldson, in *Bolivinter Oil SA v Chase Manhattan Bank* [1984] 1 All ER 351 when he said at 352:

> Judges who are asked, often at short notice and ex parte, to issue an injunction restraining payment by a bank under an irrevocable letter of credit or performance bond or guarantee should ask whether there is any challenge to the validity of the letter, bond or guarantee itself. If there is not or if the challenge is not substantial, prima facie no injunction should be granted and the bank should be left free to honour its contractual obligation, *although restrictions may well be imposed on the freedom of the beneficiary to deal with the money after he has received it.* 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 may thereafter be made will clearly be fraudulent. But the evidence must be clear, both as to the fact of fraud and as to the bank's knowledge. It would certainly not normally be sufficient that this rests on the uncorroborated statement of the customer, for irreparable damage can be done to a bank's credit in the relatively brief time which must elapse between the granting of such an injunction and an application by the bank to have it discharged. (emphasis added)

I might say that it seems to be a great pity indeed that, although the International Chamber of Commerce has obviously devoted a great deal of time and effort in producing the new UCP to commence operation 1 October 1984, it has not been found possible to clarify the position I have been discussing.

Comment: S. Cole

In being asked to comment on the last paper of the day, and having heard the quality of the papers so far and the commentaries thereon, reminds me of the Indian brave in New Mexico, U.S.A., about 39 years ago, sending smoke signals to the neighbouring tribe. It was the 16th of July 1945 and the first U.S. atomic test was in process. An enormous mushroom cloud was appearing on the horizon. The Indian brave turned to his squaw and said 'Ugh, I wish I had said that.'

Mr. Justice Rogers has admirably reviewed for us the development of the fraud exception to the autonomous nature of letters of credit. In my address I would like to briefly summarise the exceptions to the autonomous nature of letters of credit and thereafter suggest strategies by which an account party (or principal) may minimise the possible abuse by an unscrupulous beneficiary who may improperly demand payment under a letter of credit.

Although the courts have repeatedly endorsed the independence and autonomous nature of letters of credit, in order to prevent the due process of law and the courts being used as instruments for unscrupulous businessmen, certain exceptions have been introduced. These exceptions may be summarised thus:

First, '*illegality*' going to the core of the transaction. This matter was touched on by Mr. Nettleton in respect of potential breaches of section 129 of the Companies Code in respect of Redeemable Preference Share issues. Secondly, '*fraud*'. There are two types of fraud.

(a) '*Forged documents*' such that the documents themselves are a nullity. Clearly if the documents are a nullity they haven't satisfied the terms of the letter of credit.

(b) As mentioned by Mr. Justice Rogers, '*fraud in the transaction,*' where although the documents are valid, they include a fraudulent statement or misrepresentation without which the preconditions to payment under the letter of credit are not able to be satisfied. The fraud must be blatant and must be conclusively established at the time of payment under the letter of credit. Mere suspicion will not suffice. The exception to the 'fraud in the transaction exception' is that fraud cannot be established against an innocent third party who has taken by negotiation or on discount, the letter of credit documents in good faith without knowledge of the fraud.

The principles enunciated thus as to the autonomous nature of documentary letters of credit apply equally to standby letters of credit and first demand guarantees by banks. The main reasons why standby letters of credit and first demand guarantees are issued or taken for the protection of the beneficiary are:

(a) the possibility of insolvency of the account party;

(b) where the obligation of the account party may become void or unenforceable; and

(c) by the burden of litigation being transferred from the beneficiary to the account party.

Notwithstanding the growth of the exceptions to the autonomous nature of letters of credit, the account party still bears the risk that a demand under a letter of credit may be unjustified. So what are the strategies for minimising that risk. The extent to which protection may be gained is probably a matter of negotiation between the beneficiary and the account party. The beneficiary will of course be reluctant to concede the necessity for conditions that are outside the reasonable control of the beneficiary to easily satisfy. There must also be certainty as to both the form and the content of the documents to be submitted with the letter of credit.

First strategy. Ensure that the letter of credit or guarantee contains detailed specification of the documents that must accompany a demand.

(a) Clearly *specify the content and nature of the documents.* Require a certificate to be given specifying the actual default complained of, including reference perhaps to appropriate contract clauses rather than a mere general statement that a default has occurred. Require a certified copy of the notice of default that has first been served upon the account party. This will give the account party an opportunity to be aware of the prospective claim and perhaps take injunctive remedy if he considers the claim unjustified.

(b) *Specify who is to sign the documents to be submitted with the letter of credit.* You might require accompanying certificates to be given by an independent third party who will be less likely to misrepresent the position. In the case of a construction contract perhaps an independent engineer. In the case of a contract regarding the payment of monies into a particular account, a statement by the bank manager concerned, of the branch where the payment should have been made. If the beneficiary refuses to involve third parties, then perhaps at least require a certificate to be signed by certain nominated officials of the beneficiary in whom the account party has some confidence of their integrity.

(c) *Desirably, you might request a certified copy of a court judgment or an arbitrator's award,* as a preliminary to the payment under the letter of credit, though I am sure that will be actively resisted by the beneficiary involved.

Second strategy. Endeavour to have the time for payment following a demand delayed. In other words rather than the bank being obliged to pay immediately upon a demand being made, endeavour to have the bank's obligation to pay say ten days or seven days after the demand. This may give the account party some opportunity to seek injunctive relief and establish a claim for fraud, if it is present.

Third strategy. Endeavour to keep the amount of the letter of credit or guarantee commensurate with the outstanding risk under the underlying contract. There are two ways of doing this. Endeavour to have pro rata reductions of the amount secured coinciding with certain crucial completion stages of the underlying contract. Alternatively, require several smaller letters of credit or guarantees with staggered expiry dates (again coinciding with crucial completion stages of the contract). If an abuse does occur, the scope of the abuse is minimised.

Fourth strategy. Ensure that the letter of credit or guarantee has a definite expiry date, with a positive obligation upon the beneficiary to return it at the expiration date or at least in exchange for the demands being made under the letter of credit or guarantee.

Fifth strategy. Try passing off some of the risk or spreading the risk. For example, in construction contracts the prime account party may seek subsidiary guarantees or letters of credit from subcontractors to the transaction, which may be called upon if any demand is made by the main beneficiary in respect of or arising out of work performed by that subcontractor. Alternatively take out insurance cover. I understand that the Australian Export Finance and Insurance Corporation can assist in this respect, perhaps if it is associated however, with an export contract.

By specifying in some detail the documents and their contents, that need to accompany the letter of credit or demand guarantee, where such certifications and documents are falsely given, it may be easier to establish the presence of fraud, so as to come within the exceptions to the autonomous nature of letters of credit.

Finally, it may also be desirable for an account party to endeavour to have the beneficiary accept a first demand guarantee rather than a letter of credit. There are three reasons for this:

(a) If the I.C.C. Uniform Rules for Contract Guarantees can be incorporated, including article 9, then a prerequisite to the payment under the guarantee is the

obtaining of a judgment or an arbitrator's award. That may be resisted however, by the beneficiary.

(b) As first demand bank guarantees are not negotiable instruments, as in the case with letters of credit with the submission of a bill of exchange as the payment vehicle, an innocent third party who has taken the guarantee documents in good faith derives no greater protection than his predecessor in title. Under a standby letter of credit, the exception of fraud in the transaction cannot be established against an innocent third party who has discounted a letter of credit in good faith without knowledge of the fraud.

(c) From the bank's viewpoint, although the obligation upon a bank under a first demand guarantee may be absolute, the courts still look upon the obligation as one of suretyship. Accordingly a bank is entitled by way of subrogation to stand in the shoes of the beneficiary under the underlying contract and thus have recourse against the account party under that underlying contract. I would submit that no such rights of subrogation are available to a bank that pays out under a standby letter of credit although that statement may be subject to some dispute.

Comment: K. Fotheringham

Following those very erudite legal views of his Honour and Mr. Cole in relation to letters of credit it is fairly difficult for me as a practical banker to make many comments of them. The basic point which Mr. Justice Rogers has made about the autonomy of letters of credit, and the separation of documents from the contract of sale, is one which bankers have long emphasised and is enshrined in the Uniform Customs and Practice, and in articles 8 and 16 of the new revised U.C.P. which has just been issued. It is interesting of course that United States courts, and later British courts, have stated that a bank ought not to pay if it knows the request for payment is being made fraudulently. And you will have noted the two qualifications — that there are no innocent third party holders in due course involved, and that the bank has prior advice or knowledge that the documents are forged or there is underlying fraud in the case. As an individual one can easily have sympathy with the approach that a buyer should not be compelled to pay by way of his bankers paying under a letter of credit when there has been fraudulent practice in the underlying transaction. However, as a banker, I am concerned that if the bank pays out against documents which are in accordance with the letter of credit and the application, which is the mandate by the customer for debiting the account, then such debiting is not debarred by a court on account of fraudulent practice or a fraudulent document of which the bank had no prior knowledge. As Mr. Cole said there are really two aspects of this — the case of a forged document and the case of a fraudulent transaction.

I was advised today of a case, and I haven't got documentary record of it, which took place a year or so ago in which a British bank established a letter of credit in favour of a Canadian concern and the Canadian concern presented forged documents. The negotiating bank negotiated and when the documents got to the British bank, the paying bank, they were found to be forgeries or were detected as forgeries and the British bank refused to pay. The courts upheld the British bank's refusal because the documents themselves were forged. There is an increasing number of forged documents circulating in trading circles, in fraudulent trading circles if you like, these days and bankers certainly have to be on their guard to watch that documents are genuine. I suppose the best way in which that can be done is to know your customer, know what is going on and be aware of what your customer is up to and what the market is doing. Banks should not negotiate and pay out funds to people they don't know. There have been numerous cases of this nature in Hong Kong, with Hong Kong shippers purporting to ship goods but there are no goods shipped at all. The invoices are beautiful and the forged bills of lading

are beautiful and sometimes the banks on which they are drawn, and who have established the credit, think the trade is genuine and have paid out but haven't been able to recoup their money as the documents are forgeries.

I was interested to note one particular case which bears on these matters. It is a fairly lengthy case and I won't give it in a lot of detail but it is interesting in as much as it does quote *Sztejn's* case which Mr. Justice Rogers brought forward. It is the case of *Singer and Friedlander v. Creditanstalt-Bankverein of Austria* in which that bank established letters of credit, a number of letters of credit totalling in all 21 million U.S. dollars, on account of a trading firm in Austria acting on behalf of a Yugoslav trading company and in favour of a Dutch beneficiary. They were obviously established without investigating to any depth the details of the transaction behind it and relied on advices by the parties concerned of the purported transaction going to be consummated in due course. The letters of credit were established in favour of Aronson who was the Dutch trader and Aronson then, in order to raise funds, assigned the letters of credit to Singer and Friedlander and a syndicate of banks in order to finance the shipments. It then transpired after the money had been used that the contractual arrangements to sell these antibiotics to Yugoslavia were fraudulent and indeed the party in Yugoslavia agreed that the whole transaction was fraudulent. There was no question about there being fraud in the case. As a result the Austrian bank refused to pay although they did pay the drawing of the first two credits into the Austrian courts until the matter was determined. I will read a paragraph of their own lawyer's summation of it which says:

> The principles justifying Creditanstalt's line of action are simple. A bank opening a letter of credit does so under a mandate from the buyer its customer. The bank then commits itself contractually to the seller to pay subject to the specified documents being presented and being, on the face of them, in compliance with the terms of the credit. However, there is an overriding requirement that the bank should not be aware of established fraud on the part of the seller before the obligation to pay matures. This rule is not referred to in uniform customs but is universally recognised as a general principle of the law of contracts. .....It is clear from the evidence which Creditanstalt has received from lawyers, not only in Austria but also in England, France, Germany, Holland and the United States that these principles are shared by those countries.

And one of the cases cited was the *Sztejn* case. It is interesting also that it eventually did go to an Austrian court and the matter of litigation continued for quite a lengthy time and ultimately it was settled out of court with Singer and Friedlander being requested to settle by The Bank of England. Exactly what the settlement was I am not certain, I think there was a compromise and both parties shared the loss because there was no way in which any of the parties concerned was going to be able to salvage any of the loss from the deal. There seemed to be in that an acknowledgement, and advisers to Singer and Friedlander also acknowledged, that when there was a clear case of fraud involved and, relying on *Sztejn's* case, that there was no obligation on the establishing bank's part to pay.

In addition Creditanstalt-Bankverein were trying to rely on the fact that there had been an assignment of proceeds of the credit from Aronson to Singer and Friedlander and as they were not privy to any fraud behind it they believed Creditanstalt-Bankverein should make payment to them as assignees irrespective of fraud being involved in the case. As I say, a very interesting case and a very complex one and one on which a banker's magazine commented on these lines:

> Probably no international banking legal dispute has aroused so much interest on both sides of the Atlantic. Opinions have been taken by each side in a number of different countries. Briefly Creditanstalt maintain the assignees can get no greater right that a fraudulent beneficiary and Singer and Friedlander claim that, if there were a fraud upon which they cast doubt, the circumstances of the assignment of the monies and the correspondence enabled them to ignore such defect.

They go on to say:

> For the practical banker there is the thought that fraud might be the subject of a specific reference in a future edition of the Uniform Customs. At present any impact of U.C.P. on the case is indirect. However, of much more importance to international banking as a whole is the attention drawn to jurisdiction. Where litigation may take place is probably the most significant factor in international commercial law.

In relation to Mr. Cole's subject, there is an interesting case on standby letters of credit and which was raised by one of our predecessor banks, The Commercial Banking Company of Sydney Ltd., in relation to Patrick Inter-Marine Acceptances Ltd. in which there were two standby letters of credit, one in favour of one party who was lending funds and the other in favour of another party who was lending that party funds. Unfortunately there was no legal linkage in the security documentation between the two and as a result, although there was a standby letter of credit in favour of Patrick Inter-Marine Acceptances Ltd., it was not assigned to the Commercial Banking Company of Sydney Ltd., and therefore the bank only received the same sharing as any of the other creditors. It is important, therefore, as Mr. Cole suggested, that if you have a standby letter of credit in your favour that you be the principal debtor.

I will read a couple of paragraphs which came from a commentary on the above case by Professor E.P. Ellinger of the Monash University and which I think are interesting, I hope you find them so. He says:

> It seems that four factors have contributed to the increase in the volume of standby credits issued in Australia. In the first place it is a well known principle that an irrevocable letter of credit is independent of, and unqualified by, the underlying transaction. When a banker is tendered a set of documents which complies with the requisites of the letter of credit he need not concern himself with the performance of the contract between the beneficiary and the account party. Moreover the bank is entitled to be reimbursed by the account party even if the documents turn out to be forgeries provided the bank has accepted them in good faith. ..... There remains however a strong inclination in business circles to regard all guarantees as ancillary or secondary undertakings under which the guarantor must satisfy himself of the validity of the beneficiary's claim before meeting his demand.

He says that as a result standby letters of credit are favoured and therefore appear to be a superior document. He goes on and says:

> The lesson to be learned from this particular case is clear. The transfer of the assignment of a standby credit constitutes poor security against the beneficiary's own default.

He further says:

> The second point to which the parties of a commercial transaction should not lose sight when they discuss the furnishing of a standby credit is that in reality such an instrument leaves the account party almost entirely at the beneficiary's mercy,

and those circumstances can be qualified by the aspects which Mr. Cole raised and which I think are all very valid.

I must say that as a bank which handles a great number of standby letters of credit that we find that beneficiaries are so keen to get the credit in order that they may use it to allow settlement of funds to take place, that even when we point out deficiencies and difficulties in relation to any drawing under the letter of credit, and the method by which reimbursement will ultimately be received, they aren't terribly interested. They just want the document so they can get settlement now and they put off the problems which might arise later. So great is the acceptance of a standby letter of credit it is believed the bank is always obligated to accept and pay a bill of exchange accompanied by a certificate in which the beneficiary attests to the account party's default, and that the bank is neither obligated, nor indeed entitled, to investigate the truthfulness of the beneficiary's claim. Case law suggests that this fraud rule is applicable only in extreme occasion in which the

beneficiary's claim is patently without any basis in fact and in which the fraud can be established without difficulty.

Professor Ellinger goes on to emphasise a couple of the points which Mr. Cole made saying:

> There is only one advice which can be given to an account party who is asked to furnish a standby credit or a first demand guarantee. He should insist the certificate of default against which payment is to be made by the issuing banker under a standby credit be provided by an independent third party such as an architect or an engineer in the case of a documentary credit. A similar certificate should be required in respect of a demand made under a financial standby credit. Unfortunately it is more difficult to provide for such certificate to be issued by an independent third party if the standby credit or demand guarantee is issued in order to secure a loan to the account party. But even here it is possible to insist the certificate attesting default be signed by auditors or a firm of accountants. An untruthful statement would usually confer on the account party a right of action for misrepresentation, deceit or negligence against the third party who issued the certificate. The value of such right of course depends on that third party's creditworthiness.

Comment: A. Grandy

There are a fair number of things that have been said so I'll abbreviate some comments also in light of the hour. I think first I might just begin by recounting an incident that happened with me several years ago when I was sitting in the Deputy Governor's office of the Central Bank in a Mediterranean country discussing whether or not a documentary credit opened by a bank under his regulatory purview, should have been injuncted by the court. The case seemed quite clear. The documents conformed, but the goods didn't, although they were generally of the required nature. The local bank was refusing to reimburse Citibank which had paid as a confirming bank in another country. It was refusing because of the injunction brought by the importer. Upon concluding the discussion, the Deputy Governor telephoned the head of the issuing bank, told them to pay us and then to deal separately with the importer and the injunction which had been raised in the local court. I am not sure what happened to due process after that, but we were quite happy that justice had been swift and sure, and I became instantly a believer in the merits of the U.C.P. and also in the merits of knowing the character of those individuals with whom one is dealing.

As traced by Mr. Justice Rogers, the evolution of legal thinking on fraud has led us to some commonly accepted principles regarding these cases, principally those mentioned earlier of forged documents and cases of clear fraud in the underlying transaction. But commercial life has become more complicated in recent times and unfortunately in many cases in which we have had a part, less clear. I would like to raise two cases related to the contract between an opening and a confirming bank.

First let me say that the new U.C.P. includes a new article, article 11, which appears to address precisely the case I had experienced several years ago and just recounted. The article says in part 'the issuing bank authorising the confirming bank to pay against documents does so authorising payment for documents which appear on their face to conform with the terms of the credit and undertakes to reimburse the bank in accordance with the provisions of the articles.' They are clearly following the established principles of dealing with documents on their face and not looking beneath them to the transaction. While the code is clear perhaps in its intent to remove the contract between the banks from that of the underlying transaction, I am not so sure that this principle, which has in fact been around for some time, will become any more clear in the legal

world. I note that the principle has been compromised many times before. In particular with regard to trade transactions there are currently pending cases involving local court interpretations of fraud issues which have often presumed on the part of the bank a greater ability to detect fraud and forgery than banks feel is possible. There are also local regulations which can have articles regarding due diligence and which carry specific sanctions for failure to exercise due diligence without in themselves identifying exactly what is due diligence. We have been involved in a number of these transactions; the breadth of interpretation in local courts ranges from the base of law in the country involved, the independence of the judiciary and a host of other issues that one might call local. These are nevertheless real issues that will be faced in greater frequency as international trade in and out of Australia expands. There are as well the issues related to sovereign acts, and the current negotiations being held in various countries as to foreign debt rescheduling have not been consistent as to the treatment of even normal trade transactions caught in a moratorium.

I will take for a moment the case of standby L.C.s as was previously discussed. Although newly embraced by the U.C.P. as a covered transaction, banks in this case are on even less firm ground than in the case of trade transactions because of the higher potential for disagreement due to the usually higher amount involved in the transaction itself and secondly the structure of these credits. As Steven suggested, there may be ways to address and improve the structure of the transaction, but fundamentally what is required is a claim, usually a simple claim, by a beneficiary, that there has not been performance or compliance with an underlying contract. This structure, when reflected upon in the light of the unchanged article 16, that is the new number in the 1983 code, clearly contemplates that a bank would deal on the basis of the documents alone and again stay out of the underlying transaction. But if the document is only a statement by the beneficiary, and a fraudulent statement is alleged by the opener, where does a confirming bank in the transaction stand. This leads us to the point again which Mr. Justice Rogers covered, that laws of the U.K., Australia, and the U.S. would intervene in the operation of a credit if a fraudulent statement was established, but a confirming bank being demanded for payment in a country other than that in which the credit was opened, while blocked as to reimbursement by an injunction placed on the opening bank by its account party, may not have this protection as to the beneficiary. The dispute may be legitimate or it may be a fraudulent or capricious call. That is difficult, if not impossible, for a bank at some distance to tell.

New article 11 of the U.C.P. seems small comfort as to this contract between banks, without also covering the issue of fraud in the statements included in the documents submitted under the standby L.C., and giving some guidance as to how they should be treated.

Mr. Justice Rogers in his conclusion highlighted this still unaddressed area, even in the new code. And I can only add my agreement and observation that while this doesn't weaken my early found belief in the U.C.P., it does strengthen doubly, the lesson I learned about the need to know the individuals with whom one is dealing. Fundamentally, in spite of all of the improvements in the code, and the case law which has followed over the period of years as international trade has grown, banks are left dealing on the reputation of the various parties in the transaction. That continues to remain the primary protection. Until the U.C.P. and its treatment at law become fully aligned, the commercial banks will be caught in between.

That is in regard to transactions affected by means of letters of credit. And while resolution of this issue and others regarding disputes and documentary credits will perhaps come in due course, there are other developments changing the composition of risk taken by commercial banks involved in the financing of trade transactions.

Principally I refer to the electronic connections being established around the world to allow parties to trade transactions to effect them without all of the usual documentation.

In the initial stages which are now in place, systems of terminals are connected in such a way that documents can be electronically transferred, compared, and processed instantaneously, so that the flow of funds is assured, time is cut, interest costs are cut, and credit risks associated therewith are also reduced because of the confirmation of both the movement of goods and funds. That is where we are today.

In the evolution of this, it is the intent to establish systems where instantaneous confirmation as to the flow of goods and funds will allow trade to take place without L.C.s. This can simply be effected by all of the appropriate parties having the appropriate terminal connections. In this case, without L.C.s in place, the same parties will be involved in the same transactions, and the U.C.P. at that point is going to require further revision in order to deal with the commercial obligations underlying these transactions executed in the electronic world which is now upon us. I will look forward to comments as to how these problems will be solved. I am sure that the fertile minds of our associates in the law profession will have their answers ready. Thank you.