FRAUD AND MISREPRESENTATION IN RELATION TO LETTERS OF CREDIT - AN AUSTRALIAN PERSPECTIVE

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LETTERS OF CREDIT AND LIKE INSTRUMENTS IN AUSTRALIA

Phillip Wood, in his book on International Finance[1] suggests that the standby credit probably first appeared on the commercial scene during the middle of this century. If this is the case, the standby credit very quickly travelled to Australia. In April, 1953 Westpac's solicitors wrote to the bank (apparently in response to a question on the desirability of such a document as security) advising that:

> "a standby letter of credit is in no material manner different from a guarantee save that a standby letter of credit is drawn upon by means of a draft."

This represents a surprisingly concise answer bearing in mind that, in those days, solicitors were paid by the folio.

With the assistance of 35 years of hindsight, it seems to me that the only other material differences that we should be aware of are that Standby Letters of Credit do not require consideration and are independent of the underlying transaction.

As has been demonstrated today, this second distinction is of some significance. I might add that a properly drawn "first demand" guarantee should also find itself divorced from the underlying transaction.[2]

It is well established in commercial legal circles, that, in the minds of US lawyers and institutions at least, US banking law has universal and worldwide application. The days have long passed since we, as bankers, have questioned the logic, emanating from customers seeking surety, of statement to the effect:

> "Our US bankers are precluded from giving a guarantee so they require us to provide them with a standby L/C instead of a guarantee."

So it has evolved that, in addition to documentary credits, Australian bankers deal with a variety of other credits all of

which can be categorised as "standby". These standby credits often take the place of more traditional products such as Accommodation Guarantees, Performance Bonds and Bid Bonds.

I venture to suggest that the problems raised by Professor McLaughlin apply equally to such bonds and guarantees although the specific fact situations giving rise to the dispute and the preventative measures available may differ.

REQUIREMENTS FOR INJUNCTIVE RELIEF

We have been told that US courts are reluctant to grant injunctions unless the applicant can show that:

- absent the injunction, he will be irreparably injured; and
- there is a substantial likelihood that he will prevail on the merits.

So far as injunctions in this country generally are concerned,[3] an interlocutory injunction, at least, will be granted where the applicant, can show that:

- he has a prima facie case;[4]
- if successful, damages would not provide a sufficient remedy; and
- having regard to the parties' competing interests, an interlocutory injunction is appropriate on the balance of convenience.

Indeed, Gummow J. in April, 1988 held that:

> "The fundamental principle in determining whether to grant an interlocutory injunction, whether prohibitory or mandatory, is that the court should take whichever course appears to carry the lower risk of injustice if it should turn out to be wrong."[5]

These tests, I think, are less restrictive than the US situation and of some assistance to an aggrieved party to a Letter of Credit transaction in that an interlocutory injunction is all that a bona fide applicant would require whilst the substance of the dispute is litigated.

Added to this is the tactical advantage of the ex parte injunction applied for at the last minute effectively putting the other party on the back foot pending argument on the merits of the order at a later date. Whilst I digress, it never ceases to intrigue me the number of people that find it necessary to apply for ex parte injunctions against Westpac on a variety of topics notwithstanding the fact that 90% of the lawyers in Sydney must walk past our registered office to get to the court.

Be that as it may, it seems to me that the tests to be met for an interlocutory injunction in this country are not as rigorous as in the United States.

In injunction applications where a bank is merely confirming or negotiating the credit, it will probably be a passive party and you will typically get no argument from it - except, of course, as to costs. Professor McLaughlin's comments concerning the possible existence of a duty on a bank to take an active role in arguing an injunction when the other party is not present is disturbing although there is some merit in banks arguing for the efficacy of the system (ie. to honour the drawing).

JURISDICTION OF AUSTRALIAN COURTS

In cases where there is no choice of law clause in the credit, the question arises as to whether the Australian court has jurisdiction to entertain an application for an injunction.

This question was considered by Rogers J. in the Supreme Court of NSW in Westpac Banking Corporation v. Commonwealth Steel Company.[6] Whilst not exactly Californian in his views on the court's extraterritorial jurisdiction, his Honour considered it a valid exercise of his discretionary power to order that the dispute be determined in NSW.

The facts were refreshingly simple for a matter involving a documentary credit. Commonwealth Steel had agreed to sell certain truck side frames and truck bolsters to a South Carolina company, National Railway Utilization Corporation. Payment was arranged through a letter of credit issued by the South Carolina National Bank which made the purchase price payable against a draft and a full set of clean on board ocean bills of lading. The issuing bank refused to pay on the bill of exchange because it was apparent from the bill of lading that the goods were not "shipped on board" at the time the certificate to that effect was given. The bill of lading was stamped "shipped on board" at Newcastle whereas, in fact, the goods were road freighted to Melbourne and then shipped. The truth is, the buyer decided he did not want the goods and attempted to cancel the order.

The dispute on the substantive issue is not relevant to the discussion at hand but the application by Westpac, the negotiating bank, for leave to file and serve process on the South Carolina National Bank is of interest.

On the application by the South Carolina National Bank to have the ex parte order granting leave to file and serve set aside, Rogers J. held that:

> "The whole point of the issue of a letter of credit is to create a type of currency. It contemplates in its term that a bill drawn under it may be negotiated. It is part of the customary accepted practice of handling letters of credit

> that the bills may be discounted. In other words it must be expected by the issuing bank that the letter of credit may be and is likely to be acted upon by the drawing of a bill and its discounting. When and where it occurs is irrelevant to the issuing bank which has bound itself to extend the credit up to a period of time certain. I adhere to my previous opinion that the contract in this matter was made in New South Wales ..."[7]

His Honour went on to say that NSW was also the more convenient forum having regard to the issues in dispute and that the South Carolina National Bank would not be unduly inconvenienced.[8]

FRAUD AND MISREPRESENTATION AS A BASIS OF RELIEF IN NEW SOUTH WALES

We have heard of the reluctance of the courts to upset the commercial efficacy of letters of credit by interfering with the payment in other than extreme cases. This desire, and the requirement that the credit be treated separately from the underlying transaction is more or less the present situation in Australia.

In Contronic Distributors Pty Ltd (Receiver and Manager Appointed) v. Bank of New South Wales,[9] a 1975 decision of the Equity Division of the Supreme Court of NSW, the question of false documents presented under an irrevocable documentary credit was considered.

The facts of that case were, briefly, that an irrevocable documentary credit was issued in favour of GEC (an electronics company) by the bank at the request of Contronic. The credit was in respect of goods to be supplied by GEC to Contronic ostensibly priced at some $8,000. In fact, the arrangement between Contronic and GEC was that goods to the value of only $2,000 would be delivered with the balance of the monies ($6,000) to be used to satisfy a debt owed by Contronic to GEC.

Balfour Williamson (the second plaintiff) is a confirming house and it confirmed the credit under an arrangement it had with Contronic. The arrangement was that, upon presentation of the credit to the bank, the bank would pay and debit Balfour Williamson's account. Balfour Williamson would then look to Contronic for payment under its credit arrangements. Balfour Williamson became aware of the scheme prior to the drafts being presented and brought proceedings to restrain the bank from paying against the letter of credit and to restrain GEC from presenting the letter of credit for payment.

Helsham J. was unable to satisfy himself that there had been fraud on the part of GEC. He said:

> "However, it could be alleged on the agreed facts that there was no fraudulent intent on the part of GEC preceding the

> issue of the letter of credit. After all, it wanted payment of a debt and was prepared to deliver some more goods to Contronic if that debt was paid along with payment for the goods to be delivered by means of a letter of credit. And that could not be said to be dishonest."[10]

However, his Honour went on to say:

> "But even if there is not fraud sufficient to enable this Court to stop the third defendant from getting the money, I believe that the law enables this Court to restrain the defendant from obtaining payment.
>
> Whatever may have been the state of mind or imputed state of mind of GEC at various stages of the transaction, the fact emerges that the documents were false, whatever part [GEC] played in bringing them into being. Whether or not there was any initial fraud, if I might call it that, there are false documents that have to be used to obtain payment and they are now false to the knowledge of GEC. They were produced with GEC's connivance, and brought into existence to enable the seller of the goods to be paid a sum of money which it no doubt considers it was entitled to be paid. But the goods were never delivered as it was intended to be indicated by the document, and GEC knows this.
>
> Now I add to that situation the facts that the drafts have not been presented for payment, that there is no holder in due course, and no other party except the beneficiary and [the] person to whom the letter of credit was issued that might be affected by any order this Court might take.
>
> It is said that the English law in relation to this topic is not settled, but it seems to me to be sufficiently settled to indicated that this Court can and should make an order restraining the presentation of the payment against this letter of credit."[11]

Then followed a consideration of the texts and cases that Professor McLaughlin has mentioned.

His Honour appears to rely on the approval given to the Sztejn[12] decision in the English case of Discount Records Ltd v. Barclays Bank Ltd[13] and concludes by saying:

> "In my view the law is perhaps now settled, and in any event would establish that a seller can be restrained from presenting a letter of credit for payment or having payment made against it in the event that the documents which are needed to require payment to be made are false to the knowledge of the seller."[14]

With respect to his Honour Mr Justice Helsham, I think his decision takes us a little further than the English line of

authority although such a progression is certainly not a bad thing. I wonder if his Honour was attempting to move away from the concept of fraud, which is notoriously hard to prove, by substituting the word "false".

So far as standby letters of credit are concerned, the 1985 decision of Young J. of the Supreme Court of NSW in Hortico (Australia) Pty Ltd v. Energy Equipment Co (Australia) Pty Ltd[15] which concerned a performance guarantee is probably analogous.

In that decision, a dispute arose under a building contract and the contractor sought an interlocutory injunction preventing the bank from making payment under the first demand guarantee pending resolution of the underlying dispute.

His Honour found that the "guarantee" was more correctly described as a performance bond in that it was an unconditional promise to pay on demand. He found that the general rule is that unless fraud is involved, the court will not intervene and thereby disturb the mercantile practice of treating the rights under such a guarantee as being equivalent to cash in hand. His Honour added that nothing short of actual fraud would warrant the court in intervening though it may be that in some cases (though not in the subject case) the unconscionable conduct may be so gross as to exercise the discretionary power.

His Honour also touched on a very important aspect of standby credits and that is their unconditional nature. The only reason they are so widely accepted is that they are "as good as cash" and to taint them with the underlying dispute renders them ineffective. This argument has been given judicial authority in the High Court of Australia in Wood Hall Ltd v. Pipeline Authority.[16]

Perhaps there is a difference, then (in New South Wales, at least) between a documentary credit and a standby credit. In the former case, the test for an injunction appears to be fraud or circumstances where the documents are known to be false. In the latter, it seems that the test is fraud or "gross unconscionable conduct" (whatever that means). I cannot help but think that the tests are basically the same with the differences merely reflecting the differing uses to which the documents are put.

MEASURES PRESENTLY ADOPTED BY BANKS TO PREVENT FRAUD

I should point out that, whilst disputes on credits and the underlying transactions are fairly commonplace, the incidence of fraud in this country (in Westpac's experience, at least) is not great.

We receive instructions to advise and perhaps confirm a credit in one of three ways:

1. by telex;

2. by mail; and

3. via a SWIFT message.[17]

The telex test key facility and the secure nature of SWIFT make fraud in credits established by these means unlikely and a system of authorised signatures and other procedures in relation to mail instructions render that method equally safe.

In any event, as we have seen (and with the possible exception of documents emanating from Nigeria), the problem lies not with the credit itself but rather with the documents tendered to satisfy the credit or the underlying transaction. In this area, the banks can only be of limited use. Banks can, and do, alert their customers to the requirements of other countries and assist in ensuring that the transaction is bona fide and understood. However, the obligation is really on the customer to prevent fraud or misunderstandings.

In that regard, there are forwarding agents that can assist and bankers' and trade opinions on the other parties are available. The "traps for new players" will always be around but they are usually explained prior to the transaction being entered into. For example, knowledge of the other party sufficient to know that he will look upon the proceeds of a bid bond as his personal fee for selecting you as the successful tenderer can only be obtained through experience. I think it was Lord Denning who commended the tactic of loading your prices by 10% to cover the inevitable call under the "suicide" credit.

THE ROLE OF BANKS IN REFORM

One commentator in this area has suggested that the incidence of fraud and misrepresentation can be minimised by the banks, for an increased fee, taking a more active role in the scrutiny of documents produced under the credit. This extends substantially the present obligations under Article 17.[18]

Whilst the suggestion of an increased fee has definite attractions, it must be remembered that banks deal with documentary credits by the thousands, frequently at short notice. For example, it is not unusual, on a day when three or four vessels leave the port of Sydney, for the branches of some banks to be confronted, just before the close of business, with up to sixty sets of documents to be negotiated for same day value. A failure to do so may leave the bank exposed to a claim for interest and, in each case, each of the documents must be examined in the light of the relevant bank's internal guidelines for checking documents. These checks are to ensure that the documents stipulated have been presented and that they are complete in number and consistent with each other.

In these circumstances, if banks were required to do more than examine the documents and treat them at face value (for example,

if they were expected to examine the documents against a contract of sale or for genuineness) then the payment system could well grind to a halt.

This is perhaps one of the reasons why the UCP places no further burden on banks and Australian judicial authority supports this.[19]

Without wishing to wash our hands of the problem, it seems to me that the banks should ensure that the credit is properly and validly issued and that the documents presented are regular on their face. It is the obligation of the buyer and seller to ensure the genuineness and the detail of the deal.

FOOTNOTES

1. Wood, Philip R., Law and Practice of International Finance, (1980), 309.

2. The reference to the separate nature of the guarantee is probably better contained in the application form signed by the customer requesting the accommodation.

3. For a detailed discussion of injunctions, see: Meagher Gummow and Lehane, Equity: Doctrines and Remedies, (1984) 2nd Ed. Chapter 21.

4. Ibid, at para 2168 for a discussion on whether the requirement is merely that the plaintiff has a "seriously arguable case".

5. Businessworld Computers Pty Ltd v. Australian Telecommunications Commission - Federal Court of Australia, Gummow J. - 22nd April, 1988 No. 850/88 [1988] ACLD 493.

6. [1983] 1 NSWLR 69 (see also [1983] 1 NSWLR 735 where the ex parte order was confirmed).

7. Westpac Banking Corporation v. Commonwealth Steel Co Ltd [1983] 1 NSWLR 735 at 741.

8. See also Offshore International SA v. Banco Central SA [1977] 1 WLR 399 (Queen's Bench Division) where it was held that the proper law to be applied to a letter of credit (where there is no express provision) was the law with which the transaction had its closest and most real connection. In that case, the credit was issued by a Spanish bank through a New York bank (without confirmation). Payment was to be made in US dollars against documents to be presented in New York. The proper law was held to be that of New York.

9. [1984] 3 NSWLR 110.

10. Ibid at 114.

11. Ibid.

12. Sztejn v. Henry Schroder Banking Corporation 31 NYS 2d 631 (1941).

13. [1975] 1 WLR 315; [1975] 1 All ER 1071.

14. [1984] 3 NSWLR 110 at 116.

15. [1985] 1 NSWLR 545.

16. (1979) 24 ALR 385. Although argument in this case centred around an injunction on a performance guarantee, the allegation was breach of contract rather than fraud or misrepresentation. It was held that payment under the guarantee was not dependent upon the existence of circumstances giving the beneficiary a right of recourse to the guarantee. The obligation to pay was unconditional.

17. SWIFT (Society for Worldwide Interbank Funds Transfer) is a secure communications system used by banks around the world for advising credits and payments. It should be noted, however, that SWIFT is not, of itself, a payment system and value transactions are still conducted through NOSTRO and VOSTRO accounts.

18. International Chamber of Commerce, Uniform Customs and Practice for Documentary Credits, 1983 Revision (ICC No. 400).

19. See Westpac Banking Corporation v. South Carolina National Bank Co (1986) ALJR 358; 64 ALR 30 (PC) where it was held that a bank which issues a letter of credit is concerned with the form of the documents presented to it and not the underlying facts. It forms no part of the bank's function, when considering whether to pay against the documents presented to it, to speculate about the underlying facts.